The One-Tier Board
in the Changing and Converging World of
Corporate Governance

A comparative study of boards
in the UK, the US and the Netherlands

Willem J.L. Calkoen

Voorkant en zijkant

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Pictures on cover: Board of Cadbury Plc of 1959
Board and officers of General Motors Corporation of 1973
Combined meeting of Royal De Kuyper BV, i.e.
management board and supervisory board

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De One-Tier Board
(Monistisch Bestuur)
in de veranderende en convergerende wereld van corporate governance

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1. INTRODUCTION

1.1 General introduction

Each country has developed its own corporate governance.

"*The lack of universal solutions for management problems does not mean that countries cannot learn from each other. Looking over de borders is one of the most effective ways of getting ideas for management. But their application calls for prudence and judgment*."[1]

I have chosen for the comparison of the UK, the US and the Netherlands, because UK and US investors directly or indirectly own about 50% of the Netherlands' shares and the UK and US have given corporate governance so much thought.

What are the differences in law and in practice?

Do the three systems converge, in line with growing internationalization?

Can they learn from each other's examples?

This study will concentrate on the structure and functioning of boards in these countries and especially on the pros and cons of one-tier and two-tier boards. My research focuses on companies whose shares are traded on stock exchanges. Corporate Governance Codes in the UK and the Netherlands are applicable to listed companies; US corporate acts also have listed companies as their focus. On the other hand, private companies too are affected by board structures and best practice codes; I will therefore also briefly touch on examples of family companies.

The Netherlands' management culture is used to a two-tier board system with supervisory boards. On 6 June 2011 the Netherlands' Upper Chamber, the Senate, confirmed a new act creating the possibility for an optional one-tier board: the One-Tier Board Act ("the Act"). The Act will probably be effective on 1 January 2012 and is meant to accommodate the foreign – mainly US and UK – shareholders. The introduction of an

[1] Geert Hofstede, Gert Jan Hofstede, Michael Minkov, *Allemaal Andersdenkenden: Omgaan met cultuurverschillen* (2011), p. 338 ("Hofstede, Hofstede and Minkov (2011)"). The quote is my translation.

optional UK and US corporate governance system is a good moment to look into the UK and US practices. The practices of these two countries have interesting differences. These countries have put much thought into better corporate governance and their investment institutions are the most influential.

This study has five main chapters:

1. Introduction
2. UK
3. US
4 the Netherlands and
5. conclusion: changes, convergence, differences, examples worth following, which is at the same time the summary of the whole book.

Each of the country chapters 2 (UK), 3 (US) and 4 (The Netherlands) are composed of sections 1 – history and culture, 2 – who owns the shares, 3 – acts and informal codes, 4 – composition of boards, 5 – role of directors, 6 – duties and 7 – liability of directors. Each time the sections 4, 5, 6 and 7 are concluded by a summary of that section.

With the new alternative in the Netherlands for a one-tier board beside the traditional two-tier board this study aims at those who are interested in the Dutch corporate world. I also hope it will be of interest to UK and US directors and advisors, who may be active in, or for, Dutch boards or want to make a comparison with their own practices.

1.2 Introduction: one-tier board as alternative

The Netherlands has had a two-tier board system – i.e. a management board and a supervisory board – for nearly 400 years.

A draft act presented by the Dutch government, to make a provision for one-tier boards in Dutch company law as an alternative option to a two-tier board structure, was passed by the House of Representatives of Parliament ("*Tweede Kamer*") on 8 December 2009 and the Upper Chamber or Senate on 6 June 2011. This confirmed the optional One-Tier Board Act, which is an amendment to Book 2 of the Dutch Civil Code

(DCC),[2] is hereinafter called the “Act”. Under the new legislation, companies will be able to choose between a two-tier board (a management board and a separate supervisory board) and a one-tier board (executive and non-executive directors on a single board). The main reason for introducing this alternative is to have a flexible law for foreign shareholders,[3] since over 70% of the shareholders in the total of Dutch listed companies are foreigners. There are many foreign board members and institutional investors who favour a one-tier board.

The Act proposes that the different functions of the members of a one-tier board of a one-tier company (executive and non-executive members) should be described in the company’s articles of association. Non-executive members always perform a monitoring role, determine the remuneration of the executive members and one of them holds the position of chairman.[4] If a company chooses to have a one-tier board structure, the positions of CEO and chairman in each company must be fulfilled by two separate persons.

There are special two-tier board rules, which are mandatory in the Netherlands for large companies that meet certain criteria, *structuurvennootschappen*. Those supervisory boards have specific extra powers and are nominated and elected according to specific rules set out in the DCC. These rules will also be applicable to non-executive directors on the new one-tier board of such large companies, which fall under the regime for “*structuurvennootschappen*”.

This is a good moment for the Dutch corporate world to look at the practice of one-tier boards in the UK and the US. It can help the Dutch to decide whether to opt for a one-tier board and, if so, what type of one-tier board and, if not, what Dutch boards can learn from the British and US practice of corporate governance in general. Finding “instances that might be instructive” for Dutch practice in British and US corporate governance practice is one of the main questions to be investigated in this study. Even Dutch companies that retain a two-tier board can learn from the British and US theory and practice of corporate governance. For example, Morris Tabaksblat, retired CEO of Anglo-Dutch Unilever and

[2] This One-Tier Board Act is called “Wet van 6 juni 2011 tot wijziging van Boek 2 van het Burgerlijk Wetboek in verband met de aanpassing van regels over bestuur en toezicht in naamloze en besloten vennootschappen”.

[3] Parliamentary Papers II, 2008/09, 31763 no. 6, p. 3.

[4] Please note that in this book the words he/his/him also cover she/her/her, as appropriate.

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chairman of Anglo-Dutch Reed Elsevier, has said, "a two-tier system with a managing board and a supervisory board is a preferable arrangement, but with a 'turbo on it'; this can happen by having the Dutch supervisory board chairman's tasks move more towards those of the UK chairman."[5]

We can learn as well from the practice of US non-CEO chairmen and "lead" directors. It will be an advantage if Dutch supervisory directors could be inspired by some of the examples of how British non-executive directors and US independent directors to receive timely information, have access to staff, spend time on regular evaluation and have set up succession procedures; in short, how to play a more active role in developing strategy and long-term planning and follow a framework for dealing with company matters and with each other.

Giving Dutch directors a glimpse of the British and US corporate world can be useful for their understanding of expectations of their own UK and US shareholders. In addition, the present book can be of interest to the many foreign, often British or American, directors of Dutch companies, enabling them to compare situations in the three countries: Britain, the US and the Netherlands. It will give them an insight in Dutch practice. A comparison of UK and US practice as observed by a Dutchman might be of value to them. At the same time, I hope this study can foremost be of use to Dutch directors, lawyers and students.

Why have I chosen Britain and the US besides the Netherlands? After all, many other countries have one-tier boards. Indeed, more countries have one-tier boards rather than two-tier boards[6]. The choice of Britain and the US came up for the following reasons.
The British and the Americans have put a lot of thought into corporate governance over the last 40 years:

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[5] Pieter Couwenbergh and Hein Haenen, *De Regels van het Spel: Gesprekken met Morris Tabaksblat* [translated title: *Rules of the Game*], 3rd ed. (2008), p. 138 ("Couwenbergh and Haenen, *Tabaksblat* (2008)").

[6] All former Commonwealth countries, North and South American countries, Spain, Sweden, Switzerland, Belgium and Luxembourg have one-tier boards. France has the alternatives of one-tier and a two-tier system, but mostly uses one-tier boards. Italy traditonally has one general director and statutory auditors and has added one-tier and two-tier alternatives, but usually practices the traditional system. The Netherlands, Germany, Norway, Denmark, Finland and the Middle European countries (some, like Hungary and Romania have introduced the alternative one-tier) and China and Russia have two-tier boards, see Alexander Loos (ed.), *Directors' Liability: A World Wide Review* (2010), ("Loos (2010)").

– Britain has taken the lead in the area of corporate governance since 1992, with the first Code of Best Practice, the Cadbury Code, introducing such concepts as balanced boards, separate board chairmen, hard-working, well-informed outside directors, strategy debate, evaluation and succession;
– the US has actively used the term “corporate governance” since 1977 and was the first to prescribe an audit committee and to develop the practice of executive sessions; furthermore, the US have developed a clear line of case law on the duty of directors; US shareholder activists and institutions have been active since the 1990s, especially in the last 5 years, developing codes of best practices and fighting for shareholder rights.

The second reason is that by far the most investors are organized by way of US and UK investment institutions.

Each of the three countries, the UK, the US and the Netherlands, has had its scandals, such as BCCI, Maxwell, Penn Central, Enron, WorldCom and Ahold; they are lessons how not to go about it.[7] Each country, of course, has many hard-working and trustworthy directors and companies that set good examples for best practices in corporate governance. Other directors can learn from all of this. The recent credit crisis has made everyone – especially people connected with banks – reassess whether boards and board supervision function properly.

The chapters about each country will have sections on history, culture, who holds the shares, corporate law and informal codes, the composition of boards, the role and duties of directors and their liability. These items are briefly described below.

1.3 History and Culture

It is my view that law in general, particularly corporate governance practice, is determined to a large extent by the history and the culture of the country concerned. It is easier to understand the practice of corporate governance of a country if one has an understanding of its history and culture.

[7] Erasmus said: “If no one would be ill, there would not be good doctors or good medicine”.

The three country chapters therefore start with sections on their history and culture. For example, it is important to note that in 1600 the English East India Company had strong shareholder influence and directors that could be dismissed by the shareholders. In the same period, shareholders in the Dutch East India Company (the “VOC”) had very little influence and the directors were well protected.

It tells you something about the US approach to corporate governance if you realize that the first American corporations had powerful boards.

The cultural aspects of corporate enterprises are of special interest. Education, history, practical circumstances and many other factors determine boardroom culture. It is revealing to take note of what directors of a nation really think their culture is and how they like to think of their culture. Of course, generalizations can always be debated, descriptions of culture may apply often but not to all persons, and in each country there will be exceptions to the general rule. Still, the manner of governance of companies in a country is to a large extent determined by its culture and does not normally change very rapidly. American directors, often Masters of Business Administration, are good at swift and effective implementation and execution. In the US business is often approached in an academic way. There is a strong tradition of entrepreneurs and a belief in free enterprise. British directors, who have often enjoyed a broad education, are creative in board meetings: they listen, they like brainstorming and are good at drafting with nuance. They like to think they are pragmatic and they often are. Dutch directors, many of whom are engineering, law or economics graduates are practical and have good knowledge of languages and a liking for transparency, which gives them the capacity to work internationally.

Going through the history of corporate governance we see important changes in the UK since 1992, in the US since 2002 and in the Netherlands since 2004. The three systems are to some extent gradually converging, but differences will remain because of dissimilar legal traditions and cultures.

In sub-sections 2.1.1, 3.1.1 and 4.1.1 I will give the key features of the corporate culture of each of the countries.

1.4 Company legislation and informal codes of best practices

Britain is used to informal rules and developed the idea of a Code of Best Practice, based on a legal duty to "comply or explain". The first of many was the Cadbury Code of 1992. The code concept has been adopted in many other countries, which have often followed the ideas of the British codes. In the UK the stock exchange and investment institutions traditionally play an important role.

The US has a strong legal culture, with many state corporate laws and Federal Securities Laws, stock exchange regulations, an active plaintiffs' bar and courts that set clear criteria. In recent years shareholder activists have introduced many codes of best practice, which have influenced directors, even without a statutory basis. Recently, the Sarbanes-Oxley Act of 2002 has had substantial influence and the Dodd-Frank Act of 2010 will add to the burden of boards as well.

The Netherlands has its DCC and a fair volume of mandatory company law. 1997 saw the publication of the Peters Code, which was followed in 2004 by the Tabaksblat Code. This was updated in December 2008 and is now the Frijns Code. There is a legal duty of "comply or explain" concerning this Code.

1.5 Composition of Boards

Britain has boards consisting of three to five executive directors, a chairman and five or six outside directors. In other words, the boards are well-balanced between executives and non-executive directors and not too large.[8]

US boards very often have only one executive director, the CEO who is Chairman at the same time (in the past often referred to as "the imperial CEO") and nine or ten independent directors, including a "lead" or "senior independent" director.[9] The independent directors hold many executive sessions, which contrary to what the word indicates, are

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[8] These numbers are averages of listed companies as reported by Derek Higgs, *Review of the Role and Effectiveness of Non-Executive Directors* (January 2003), p. 18 ("Higgs Review").

[9] These numbers are averages of listed companies. The Conference Board, *Corporate Governance Handbook, Legal Standards and Board Practices*, 3rd ed. (2009), pp. 22-24 ("Conference Board (2009)").

meetings without any executive directors present.[10] Full board meetings are usually attended by the CEO and all independent directors, who together are the board, and by officers who are not on the board. Board committees consist of independent directors only. There is, of late, a strong movement to split the combined function of CEO/Chairman into an independent chairman and a CEO. At present 30% of listed companies have an independent chairman. The arguments put forward for having a non-CEO as Chairman give a good idea of what a CEO and a Chairman should be doing to fulfil their role properly.

The question has even been asked whether the US is adopting elements of a two-tier board?[11]

Dutch management boards are not the same as UK and US boards of directors. Dutch management boards deal with all aspects of day-to-day management and with the broad strategy, while UK and US boards deal with broad strategy and high level management and leave day-to-day management and representation to executives in the UK and to officers in the US. Dutch companies will typically have about four to five managing directors and about five to six supervisory directors.[12] Under the Dutch law in a two-tier board system the supervisory board only monitors and advises.

Main differences between the Dutch two-tier board and US and UK systems are that Dutch supervisory board members meet less often and receive less information and at a later stage, than US and UK outside directors. As they are not expected to go and see the workplace, they are generally less involved in the development of strategy. By law they are not supposed to participate in the process leading up to proposals, but as supervisors have to wait for management to come with strategy or other essential plans and accept or reject what has been tabled. Therefore, in the majority of the companies, they do not receive more information than is necessary for the fulfilling of their monitoring duties and do not visit the workplace or talk with lower staff.

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[10] Robert Monks and Nell Minow, *Corporate Governance* (2008), pp. 285-286 and Stephen M. Bainbridge, *The New Corporate Governance in Theory and Practice* (2008), pp. 2 and 178 ("Bainbridge (2008)").

[11] Adrian Cadbury, *Corporate Governance and Chairmanship: A Personal View* (2002), p. 71 ("Cadbury (2002)").

[12] These numbers are averages of listed companies. The larger companies sometimes have more, see the "Nationale Commissarissen Onderzoek 2009".

The new Dutch Act introducing one-tier boards as an alternative has opted for a mandatory non-CEO separate chairman and leaves a company free to decide on the number of executive directors and non-executive directors.

In the Netherlands the CEO has in many cases become more powerful over the last 10 years.

Apart from the introduction of a one-tier board, which has clearly been inspired by US and UK examples, the influence of these two countries has also been felt in the growing desire of many supervisory directors on two-tier boards in the Netherlands to be more involved in the development of certain fields, such as strategy, and get more and earlier information.

1.6 Role of directors

Both Britain and the US have thoroughly and for a long time studied and discussed the monitoring and strategic roles of the chairman and the outside directors. It is of interest for all three countries to increase and promote the possibilities of giving an independent chairman and outside directors the ways and means of adding value to the common corporate effort. How do British and US boards tackle this daunting task? We should study the ways these outside directors co-develop strategy without losing their independence from management which they need to maintain in order to be proper monitors.

A US chairman is less prominent than a UK chairman, who is more visible and hands on. There are nuances of difference in these two countries. While UK non-executives are involved in development of strategy by asking many – fundamental and detailed – questions and suggesting creative proposals, US independent directors actively challenge the strategy by asking even more basic and detailed questions and by debating alternatives to the strategy put forward by executives. The practice is, up to now in the Netherlands, that in the majority of the companies the supervisory board limits itself to monitoring strategy. In a minority of the companies – sometimes in very large companies – with strong supervisory directors, who are retired CEOs from other companies, the supervisory board is, to some extent, involved in developing strategy.

1.7 Duties of Directors

There is a difference from country to country as to duties of directors. To whom do they owe duties? To the company? What does this mean? To shareholders or to all parties which have an interest in the company, sometimes called “stakeholders”? What are the standards? In Britain, the Companies Act 2006 defines these duties in detail. Broadly speaking, they are based on the pillars of loyalty to an enlightened shareholder value, of care and of good faith. In the US the pillars are also loyalty and care. Provided American directors fulfil these two duties, they can rely on the safe harbour of the business judgment rule. In both countries case law on these duties give a clear picture. The duties of loyalty and care, in relation to the delegation of risk management and monitoring of what has been delegated, will continue to evolve.

Duties of directors under Dutch law are less clear.

In the US and especially in the UK, companies sign very detailed internal company agreements about duties with their executive and non-executive directors, sometimes running to five or six pages in the case of UK non-executive directors and Chairmen.

In all three countries it is acknowledged, albeit with varying nuances, that the role of non-executive or supervisory directors is different from that of the executive directors.

1.8 Liability

Director’s liability also varies in each of the three countries both from a legal and a practical point of view. In Britain there has not been much liability litigation, but wrongdoing can, indeed, lead to dismissal, disqualification or cold shouldering of a director.

In the US litigation could be said to start at the drop of a hat, but actual out-of-pocket payments by independent directors are rare because of (a) the legal standards, including the business judgment rule, (b) the strong systems of exculpation and indemnification, (c) a very good insurance system and settlement incentives, which typically lead to settlement within Director and Officer (D&O) insurance policy limits.

The volume of litigation in the Netherlands (including the inquiry proceedings before the "*Ondernemingskamer*", the court for company matters, hereafter "Enterprise Chamber") now exceeds that of the UK, but is less extensive than in the US. The legal standards of mismanagement, "*wanbeleid*", in Enterprise Chamber cases are not so clear. This is partly due to the fact that the inquiry proceedings before the Enterprise Chamber are relatively new and have not always been consistent on whether a judge may second guess directors. The Enterprise Chamber judgments only deal with declarations of mismanagement and taking of measures. District courts deal with liability, where the test is serious blame, "*ernstig verwijt*". Again here, the legal standards are not quite clear, because there is not so much case law up to now.

1.9 Purpose of this study

As mentioned above, the first aim of this study is to enable the Dutch to get an insight from UK and US experiences and thereby to make a more informed decision when choosing between a two-tier or a one-tier board and whatever the choice, which of the UK or US best practices can be followed in the Netherlands. It can also help members of international boards to understand each other better, which is one of the reasons why this book is written in English.

I hope that debate about the topics in this book can lead to a better understanding – and hence better practice – of corporate governance.

Such debate could include:

– role of outside directors in developing strategy;
– role of the chairman;
– internal guidelines for these roles;
– best ways of getting outside directors being well informed about the business;
– best composition of boards as to create a counterweight against a strong CEO, getting the best out of all the directors and creating optimal communication within the board;
– best composition of boards to avoid any cover up of disagreement between executives;
– best procedures for succession;
– role, duty and responsibility of outside directors for taking due care into account when delegating part of the monitoring task;

- different roles of executive or managing directors and non-executive, independent or supervisory directors in risk management;
- examples to follow for more active directors and for creating a better culture in the company;
- how to create optimal communication between shareholders and boards;
- whether there are specific aspects that would apply to governance of banks that are or are not applicable to other listed companies;
- which differences will probably remain, notwithstanding the recent substantial changes in corporate governance practices in each of the three countries and the convergence that has taken place.

This study investigates one-tier board practices in the UK, the US and the Netherlands and the comparison with two-tier boards, with the aim of finding good examples for the Netherlands. I have first talked with a number of authorities in all three countries and subsequently studied the available literature and have kept on checking my findings with the experts. This study went to print on 7 July 2011 and covers the law up to that date.

2. UNITED KINGDOM

2.1 History and culture

History and culture have a strong influence on the dynamics of every country. The following sub-section starts with some brief telegram style key words of UK company culture. It is followed by UK company history and then continues with a more detailed description of company culture. Describing the culture of a nation carries the caveat that generalizations do not apply to all cases. I base my views on conversations with experienced observers and on what has been written on the subject.

2.1.1 General characteristics

Some key features of British corporate culture are:

a *Informal regulations work*
Island mentality; change without revolution; centralised society; peer control; "good sports" and fair play; "club membership"; importance of media and publicity; belief that informal self-regulation works better than formal laws.

b *Owners' power*
Respect for ownership; belief that persons act in their own interests (e.g. Adam Smith); company law based on partnership.

c *Strategic thinking*
Respect for history and tradition; broad education; early exposure to and faith in analytical thinking; good eye for strategy; skilled in dialogue, debate and listening; competitive; prepared to accept a small loss; flexible in meetings; articulate; society of classes and sense of class; Industrial Revolution; socially-minded groups (e.g. Quakers).

d *Sometimes long term, sometimes short term*
Tolerant; idea that work can and should be fun; endeavour to be team players because the British realize the importance of results; realisation that, in a team, leadership must come from one person who is captain at that time; no heroes; leaders are replaceable; the tradition of making money by trading.

After a brief outline of the history of company law in the UK, I will explain how these key concepts have influenced British corporate culture. In doing so, I will be writing as a Dutchman who has worked with English lawyers for many years, also in committees and boards of the International Bar Association. I have checked my views with many experienced British commentators.

Dutch and English history have been closely intertwined over the centuries. These nations have been allies and enemies from time to time. They were fierce competitors in trading and in establishing colonies abroad. They fought five sea wars with each other, but they also had close personal ties. Prince William of Orange, the Dutch *Stadhouder* (stadtholder) William III married the daughter of King James II, Mary Stuart, and became King William III of England with the Glorious Revolution.[13] In later days, founders and directors of Shell and Unilever from both nations have often had family connections across the borders of both nations.

2.1.2 <u>History of UK company governance</u>

1600 – the East India Company/power of shareholders

The most obvious difference between UK and Dutch systems of corporate governance is their opposing approach to the power of shareholders vis-à-vis directors. From the early 1600s and all through the 20th century this difference has continued.

In the Netherlands the Dutch East India Company (VOC) of 1602 and its later successors were oligarchic in character, with control concentrated in a small circle of directors. Shareholders had few, if any, powers. In the UK, on the other hand, the English East India Company of 1600 and its successors were less oligarchic. All shareholders had a say and could vote on matters of strategy and the appointment and dismissal of directors.[14]

On 31 December 1600 a royal charter was granted to the English East India Company.

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[13] Lisa Jardine, *Going Dutch*: *How England Plundered Holland's Glory* (2008), p. 70 ("Jardine (2008)").

[14] Ella Gepken-Jager, Gerard van Solinge and Levinus Timmerman, *VOC 1602-2002, 400 Years of Company Law*, *Law of Business and Finance*, Vol. 6 (2005), pp. X-XI ("Gepken-Jager, Van Solinge and Timmerman (2005)").

It began with 218 members called the General Court or Court of Proprietors and was governed by a Court of Directors, also called the Court of Committees.

The Court of Proprietors had voting rights and each share was subscribed at £200. Soon there were several hundred proprietors. The court met infrequently, but it held supreme authority. Its sanction was needed for the raising of funds, and it elected the directors.

The Court of Directors was the executive body and was responsible for the running of the company, although its policy decisions were to be ratified by the Court of Proprietors. The Court of Directors consisted of the Governor, the Deputy Governor and twenty-four directors. It met frequently and had numerous sub-committees for functions such as purchasing, sales and correspondence.

This Court of Directors had the classic functions of a board of today. They selected the chief executive. They were careful to choose someone in whom they had confidence. They were also responsible for the financing of enterprises. They proposed new shipping voyages to the Court of Proprietors. It was they, who developed the strategy of switching the trading focus from the East Indies to India.[15]

The governance continuity is striking. Not only was the governance structure of the English East India Company comparable to that of UK companies today, but so were the issues that faced the board. Even then shareholders differed in their motives. Short-term investors wanted to receive a return after each voyage, whereas others took a longer view and only looked for a possibly larger return after many trips to a certain area. The board also had to monitor its appointees, some of whom took advantage of their remoteness from London to act not only for the company but also for their own account. For this reason the selection of the company's captains and factors was a crucial responsibility.

It is interesting to see that the structure and responsibilities of the board of Britain's most influential company some four hundred years ago are clearly recognisable in those of UK companies today.[16]

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[15] Cadbury (2002), pp. 2-3.

[16] Cadbury (2002), p. 3.

The past 400 years have seen many stock market crashes, vicissitudes of fortune, and endless debate about the balance of power in companies. However, some things remain the same: over time there has been consistent respect for democratic ownership, the power of shareholders, the protection of investors, and the responsibility and accountability of the board for running the company and developing strategy. In many instances, problems have been resolved by quick informal solutions or codes.

1688 – The Glorious Revolution/stock market boom/charters
The Glorious Revolution followed after the only, or at least last, violent British revolution, the one of 1648, which ended with the beheading of King Charles I. In 1688 parliament threw the Catholic James II out in favour of his Protestant son in law, the Dutch William III. Because this revolution took place without much bloodshed so easily and the Bill of Rights limiting Royal power, was so smoothly accepted, it was called the Glorious Revolution. After 1688 the UK has had no more revolutions.

From 1688 a stock market boom started in London. The public (i.e. wealthy aristocratic families and/or those who had made money in business) had a lot of money to invest. The number of charters issued for new companies in a variety of industries rose from 12 in 1691 to 53 in 1694. The main stock exchange trade had moved from Amsterdam to London. In 1694, under William III, Parliament created the Bank of England and raised 1.2 million pounds in government bonds.[17] The fact that the government could raise money on the capital market proved a great advantage in Britain's battles against the French. It made the government economically independent. Even the East India Company lent money to the government in 1698 and 1708 in exchange for a further charter. This was all of supreme importance for the political and military power of Britain at the start of the 18th century.

1720 – Bubble Act/prohibition of stock companies without royal charter
1718 to 1720 were the years of the Bubbles. In France the Scotsman John Law set up a system, which led to five Bubbles and Crashes. The system was designed to raise money and inflate the market price of shares in the Mississippi Company. There were issues in tranches. Only 10% had to be paid on the first tranche and the first shareholders had priority on the

[17] Paul M.L. Frentrop, *Corporate Governance 1602-2002: Ondernemingen en hun aandeelhouders sinds de VOC*, thesis (2002), p. 125 ("Frentrop (2002)").

further tranches, which were announced from the start. A run on shares resulted. The price went up from 500 livres in March 1719 to 1,000 livres in December of that year. The system failed, the Bubbles burst and left France with an economic disaster.

In the UK, at about the same time, the South Sea Company also artificially boosted its share price. Shares were offered to the public in four tranches, with the price rising from £300 per share in April 1720 to £1,000 in the beginning of June of that year. Instalment payment was permitted. Loans were offered against shares. Euphoria gave way to mania. Generally the stock market was still booming.[18] By 1720 there were 196 new companies in the UK that raised money on the capital market, many of them financial institutions and insurance companies. Stock prices went up. The South Sea Company share price increased by a factor of 9.5 (compared with the Mississippi Company increase of 19.6). However, the South Sea Company prices dropped again before the end of July, when the last tranche was to be issued, because so many new companies drew money from the market. The last tranche did not succeed and directors had to inject liquidity.

Upon the proposal of the South Sea Company the Bank of England took measures to block the formation of new joint stock companies. This enabled the South Sea Company to be maintained, as it was protected from suddenly losing its investors to other entrants. Parliament introduced the "Bubble Act", barring all other joint stock companies and this situation continued to exist for more than 100 years. So until 1824 the UK only had partnerships of associates and closed companies and no trading of shares. This meant that for many decades the UK did not have joint stock companies, except those that had received a charter from parliament (and charters were only given for public utility companies for canals or railroads).

19th century/Industrial Revolution

In 1791 there were 81 of these public utility companies.[19] Adam Smith considered that only these companies could be joint stock companies because they had a predictable and steady flow of income. He was one of the chief sceptics about companies that were governed by non-owners. In

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[18] Niall Ferguson, *The Ascent of Money: A Financial History of the World* (2009), pp. 138-158 ("Ferguson (2009)"); and Frentrop (2002), pp. 128-147.

[19] Frentrop (2002), p. 147.

The Wealth of Nations (1776) he famously wrote: "*The directors of such companies, being the managers rather of other people's money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance.*"[20]

After the Napoleonic wars the British economy thrived and in 1824 there were 250 requests for charters. The Bubble Act was abolished, but this was immediately followed by a market crash and the Bubble Act was re-introduced. It was simply too difficult for investors to discipline managers.

Managers often managed companies to their advantage and took too many risks and there was fraudulent activity in the capital market. The English created new systems for the rights of shareholders and regulation of the capital market. In 1844 the Bubble Act was finally abolished and the Joint Stock Companies Act gave legal status to these entities and created a register where the articles of association and the accounts of the company had to be filed. The Act required a "full and fair balance sheet" to be presented. Royal charters were no longer necessary.

The British remained leaders in Europe in the area of company investment law since 1840 and through to the 21st century.[21] The process started with the steel industry and railroad companies, many of which were founded by families and relatively small groups of local investors.

In the first 70 years of the 19th century Britain was the world's strongest economy. In fact its Industrial Revolution had already started in the mid 18th century; earlier than in any other country. Why? The freedom of private enterprise had gained room. Since the Magna Carta of 1225, which laid down elements of the Rule of Law, kings were limited in their power and powers were shared with the aristocracy, cities and the church. There was a feeling of one nation and cooperation. First farms became bigger, then industry developed, inventions led to more efficient production and use of natural resources (coal and iron ore), while on the continent most countries were involved in destructive revolutions. Furthermore, English society managed to give new entrepreneurs and intellectuals a chance.[22]

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[20] Cadbury (2002), p. 4.

[21] Frentrop (2002), p. 165.

[22] David S. Landis, *The Wealth and Poverty of Nations*, Dutch translation (1998), pp. 232-256 ("Landis

During the Industrial Revolution the UK was the workplace of Europe. At the high point, in 1851 the First World Fair known as the "Great Exhibition of the Works of Industry of all Nations" was held in the Crystal Palace in London. The UK led the way in the Industrial Revolution. The Test Act of 1620, which forced anyone wishing to take public office or go to university to adhere to the Church of England, was lifted in 1830, thereby empowering more sections of the upper middle class, such as the Quakers, who were often imbued with a strong sense of entrepreneurship, discipline and social responsibility. This government policy was to create a breed of young men who could be leaders of the expanding UK economy and represent the government and business all over the world.[23] The first investors in a new company often had experience of the business or were family of the founders. It was still the general conviction that limited liability companies invited fraud and speculation and that only unlimited liability held investors back from speculation. The Limited Liability Act of 1855 and the Joint Stock Companies Acts of 1856 and 1860 gave the right to any group of at least seven investors to have the privileges of limited liability, provided the word "limited" was added to its name, which, so it was believed, should avoid misuse. From 1863 to 1866 about 3,500 "limited companies" were founded. Most businesses were family businesses with more or less closed groups of shareholders. The Companies Act of 1879 repeated the need for a "full and fair balance sheet to exhibit a true and correct view" of the company's affairs.[24]

Proposals were also drafted to enable workers to acquire shares in the companies where they worked.

First half of the 20th century – managerial capitalism

Gradually private savings grew and the larger public started to buy shares. Family companies merged with others and started raising outside capital. By 1905 the economic model had slowly shifted from "family capitalism" to "financial capitalism". Representatives of financial institutions had held board positions in the companies in which they invested and could thus monitor whether there would be a regular

(1998)").

[23] Prof. Andrew Chambers, *Corporate Governance Handbook* (2008), p. 357 ("Chambers (2008)").

[24] Cadbury (2002), p. 5 and Mark Goyder, *Tomorrow's Owners: Stewardship of Tomorrow's Company* (October 2008), p. 5 ("Goyder (2008/B)").

dividend.[25] Few industrial companies had their shares listed in 1909: 41 in Britain, 16 in Germany and 2 in France. Public companies were still managed as if they were family businesses.

But family influence waned before the dawn of the "Managerial Revolution" and "Managerial Capitalism". An oligarchy developed in Europe. Bank directors monitored boards. In Germany one banker could be supervisory director of 100 companies. In Britain the maximum was 30 board memberships.[26] While directors became oligarchic, ownership was fragmented and split up among many small shareholders. The fragmentation of ownership limited the power of shareholders. They had no difficulty selling shares and could "vote with their feet".

Berle and Means,[27] the American writers who argued in favour of the primacy of directors as they considered the small shareholders to be incapable of developing a strategy, were cited in the UK. The UK already had an investigation committee in 1926. It was known as the Liberal Industrial Inquiry. It concluded "the truth is that a strong and possibly efficient management rather likes to have an ineffective board, which will know too little to have views or to interfere". In terms of power, it was executive management that was in the driving seat.[28] In the years 1928-1935 protection of shareholders became important due to the Great Depression. The Companies Act was changed in 1929. From then on the board had to publish accounts each year and the Annual General Meeting of Shareholders (AGM) appointed an auditor annually. Britain stayed true to its tradition of not having over-powerful boards nor boards that paid no attention to shareholders.[29] However, as industry became increasingly complicated, it became ever more difficult to monitor managers.[30]

After 1950 – takeover discipline

1958-1959 saw the first unfriendly takeover of British Aluminium by the joint venture of the US Reynolds and the Midlands Tube Investments Ltd. led by Sigmund Warburg, the founder of S.G. Warburg.[31] The

[25] Frentrop (2002), p. 213.

[26] Frentrop (2002), p. 239.

[27] Adolfe A. Berle Jr. and Gardiner Means, *The Modern Corporation and Private Property* (1932) ("Berle and Means (1932)").

[28] Cadbury (2002), pp. 6-7.

[29] *Economist* – August 1931, pp. 211-212 and Frentrop (2002), p. 270.

[30] Frentrop (2002), p. 276.

[31] Ron Chernov, *The Warburgs* (1993), pp. 651-654 ("Chernov (1993)"); and Frentrop (2002), p. 293.

intermediaries in the City felt some order should be introduced and within three months the Notes on Amalgamations of British Business (City Notes) were introduced. These were the first of many informal regulations.

Since 1964 the British developed the concept of groups, conglomerates of interrelated companies, to compete with US and German concerns. An example was ICI, which tried to take over Courtaulds. Mergers and large conglomerates were encouraged by the Labour government of Harold Wilson with the Industrial Reorganization Corporation (IRC) in order to compete with huge US and German competitors. British Leyland was formed in 1968 with government support by the merger of Leyland and British Motor Holdings, but was not successful.[32]

In 1968 the City Code on Takeovers and Mergers and the Panel on Takeovers and Mergers were introduced.
This self-regulation (with no sanctions other than loss of reputation – a very important commodity in the City) was supplemented by the Panel on Takeovers and Mergers. Shareholders were to get equal information and takeover targets could not introduce defence mechanisms without permission of the shareholders. A member of the Panel summarised the City Code as prescribing "How a decent chap behaves".[33]

Subsequently from 1974 onwards, the UK tried to convince Europe to introduce the Takeover Directive, the 13th European Directive, which was introduced after 30 years of negotiation in 2004, but the Directive is full of opt-outs and exceptions for Member States.[34]

The takeover threat continued as a disciplinary measure for lax boards. Freedom of the market is the British motto. Only on 1 June 2010, after the *Cadbury and Kraft* case, has the Takeover Panel issued a consultation paper aimed at raising the standards for tender offers.

In 1977 there was a discussion in the UK about the introduction of a two-tier board especially to facilitate "worker directors" (the Bullock Report), but even the unions did not want this. Managers also started to take

[32] Frentrop (2002), p. 297.

[33] Frentrop (2002), p. 301.

[34] G. van Solinge and M.P. Nieuwe Weme, *Rechtspersonenrecht* (2009), pp. 16 and 748 ("Van Solinge and Nieuwe Weme (2009)").

account of the interests of employees. Such managers were likely to be popular.[35]

From 1979 Margaret Thatcher reintroduced the power of the market. She promoted denationalisation. She wanted a nation of shareholders to counter the power of the unions. In her first years she fought a "social war" (i.e. an ideological clash between nationalised inefficiency and control on the one hand and potential private profit-making services on the other). All of this led to more profit for companies. Corporate governance had not been a subject of debate. Companies had grown steadily.

The UK used "market control" to discipline boards. It was the market which really sounded the alarm for sluggish boards. The takeover threat was seen as alerting the boards of all companies to the need to achieve higher levels of performance.[36]

Death of gentlemanly banking, 1985-2000

From 1695 to 1995 the City was all British and consisted of many different professions: jobbers, brokers, merchant/investment banks and commercial/clearing banks. This complicated organization of separate professions kept foreign – and essentially US – entrants out. As recently as December 1983 Minister Alex Fletcher said, "I think a British-owned securities industry is important".[37] By 2000, the then Chancellor of the Exchequer remarked that the "absence of a single British-owned investment bank is a serious deficiency".[38]

At the same time the governor of the Bank of England light-heartedly noted that "the City is like Wimbledon, it does not matter that foreigners play in the finals, as long as the game is played here". Augur does not agree with the comparison: "the British own Wimbledon, determine that players must play in white and make the money; the same does not apply to the manners of all the foreign investment banks that have taken over the City".[39]

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[35] Frentrop (2002), p. 318.

[36] Cadbury (2002), p. 9.

[37] Philip Augur, *The Death of Gentlemanly Capitalism* (2001), p. 5 ("Augur (2001)").

[38] Augur (2001), p. 6.

[39] Augur (2001), p. 3.

Merchant bankers tended to be upper class, whereas commercial and clearing bankers were middle class. Merchant bankers' contacts were with CEOs and chairmen and concerned Mergers & Acquisitions (M&A) and equity funding. Commercial bankers had contacts with treasurers and CEOs.[40] Values of order and self-confidence, which were taught at the public schools, which are actually private,[41] were good preparation for merchant bankers. Clearing banks were dominated by grammar school boys and were totally different in style and values. They tended to come from the provinces, the North and the Midlands, whereas merchant bankers were from the home counties, Gloucestershire and Edinburgh. Clearing bankers were trained to keep records, but merchant bankers looked down on bureaucracy. There was considerable antipathy between the two groups. This became a serious business issue when clearing banks tried to establish or buy investment banks.[42]

In 1983 Margaret Thatcher announced the "Big Bang" for Monday, 27 October 1987. That put an end to the split between the four professions. The government issued its White Paper in 1985 and the Financial Services Act in 1986.[43] Old values crumbled and old honour codes broke down. The cult of the individual was growing. As part of the ethos of Thatcherism, maximum tax rates went down from 84% to 60% and then to 40%.[44]

Three pillars of the establishment in the UK were the public schools, the gentlemen's clubs and country houses.[45] Eton set the standards for the old city: my word is my bond: "*Dictum meum pactum*".[46] As grammar school-based institutions senior managers of clearing banks lacked the nerve to challenge the overbearing and usually misplaced confidence of the public school boys. Foreign banks were better equipped to cope with changes. They had the size, experience and flexibility to adapt to the new world. They were unencumbered by class-based historical experience. In fact, by imposing so many changes on a City that was manifestly unfit to adapt to new challenges, government, the stock exchange and the Bank of

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[40] Augur (2001), p. 16.

[41] In the UK, the private schools, such as Eton, Harrow and St. Pauls, are called public schools. The really public schools, that are open to all, are called private or grammar schools.

[42] Augur (2001), p. 38.

[43] Augur (2001), pp. 45 and 76.

[44] Augur (2001), p. 21.

[45] Augur (2001), p. 33.

[46] Augur (2001), p. 35. Wellington said: "The battle of Waterloo was won on the playing grounds of Eton".

England ensured that only foreign firms would survive. There was another element: UK merchant bankers were relationship banks, while US investment bankers were product led banks, which aggressively pushed their products to customers. Merchant banking became investment banking.

One after the other the once powerful UK merchant banks disappeared. While in 1995 S.G. Warburg was still world leader with a 15% share of all listings in that year, a couple of poor decisions in 1994 blew the firm away.[47] Barings collapsed in 1995, when the board failed to monitor Mr Leeson.[48] Failure of control at Barings occurred at the highest levels in the firm. At Kleinworth the misjudgment of a handful saw the firm give up its independence.[49]

Barclays and Nat West shared one characteristic: the CEO did not believe in investment banking.[50] At Nat West the CEO Derek Wanless and the chairman, Lord Alexander, a former barrister, did not want to enlarge their investment banking activities. The non-executive directors, however, all wished to continue to grow in investment banking. In board meetings, where the opportunity to buy the large investment bank, S.G. Warburg, was discussed, the chairman, Lord Alexander, listened to his colleague non-executive directors, who were in favour of the acquisition. He went along with the majority, as did the CEO Derek Wanless,[51] but he left soon afterwards, feeling let down. Because Wanless had actually been against the acquisition and had to experience that the board did not agree with his policy, he left. Nat West continued with its plan to buy S.G. Warburg. The problem between Nat West and Warburg, however, was social class (Nat West's new CEO, Owen, had not attended Oxbridge, nor been to a major public school, neither had Derek Wanless for that matter). The gentlemen capitalists of Warburg instead turned to Credit Suisse recommending their offer, although the price was low, Warburg was sold to Credit Suisse, and Owen was left in the cold to look for smaller fry. Class had cold shouldered him.

In the UK investment banks had been working in a barely regulated environment where it was permitted to "warm up" the market in the

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[47] David Freud, *Freud in the City* (2006), p. 165 ("Freud (2006)").

[48] Freud (2006), p. 215.

[49] Augur (2001), p. 252.

[50] Augur (2001), p. 269.

[51] Augur (2001), pp. 180-181 and 269.

press, as occurred in the case of Eurotunnel. During the British Airways Initial Public Offering (IPO) of 1986 a top UK solicitor commented that there was "too much information in this document", implying that he did not see the legal necessity of informing the public properly at that time.[52]

It is interesting to note that the big Dutch commercial banks have not been successful in investment banking for similar reasons. ING bought Barings, but did not know the business. ABN AMRO had continuous internal scrimmages about its costly investment banking. Every year it turned out that ABN AMRO made losses in their investment banking department, which was directed by Wilco Jiskoot, who was in continuous disagreement with his CEO, Rijkman Groenink, while the supervisory directors were not aware of this disagreement.[53]

US investment banks had grown up in a much more toughly regulated and profitable environment. "Conditioning" was forbidden.[54] US bankers received 5%-7% of Initial Public Offering (IPO) value as their fee, whereas in the UK bankers received 0.75%.[55] Freud and Augur imply that the US way of setting the price smells of a cartel.[56] So Swiss, German, Dutch and, in the end, mainly US investment banks took over all their London counterparts. Japan had collapsed, New York had flourished, London had sold out and continental Europe had developed larger banks that also embarked successfully on investment banking.[57] Now the City was in the hands of the "Bulge Bracket", i.e. senior syndicate members bracketed together in deal announcements, specifically by the Super Bulge (MGM) Morgan Stanley, Goldman Sachs and Merrill Lynch.[58] Now, after the crisis, these three, be it that Merill Lynch was taken over by Bank of America after its collapse, are still in the lead. Goldman Sachs is now one of the top two, with its special risk management practice called "The Edge".[59]

Some aspects of the "class society" have remained, but the same cannot always be said of the gentlemanly manners. American bonuses and

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[52] Freud (2006), p. 49.

[53] Jeroen Smit, *The Perfect Prey* (2009) ("Smit (2009)").

[54] Freud (2006), p. 45.

[55] Freud (2006), p. 77.

[56] Freud (2006), p. 163 and Philip Augur, *The Greed of Merchants* (2006), p. 6 ("Augur (2006)").

[57] Augur (2001), p. 325.

[58] Augur (2006), p. 30.

[59] Augur (2006), p. 113.

tougher methods have been introduced. And yet manners and appearance do still count. Whether in Park Avenue or in Canary Wharf, the prevailing decor is Old England, with hunting scenes, gilt-framed mirrors, Regency striped curtains, antique dining tables and traditional chairs.[60]

The extensive description of the "Death of Gentlemanly Capitalism" in the UK shows how class difference until recently spoiled the atmosphere of the City and how the tougher US banking culture took over the industry. Investment banking in London survived and remains one of the most profitable businesses in the UK, even though nearly all the investment banks are owned by foreigners.

Nat West's decision to want to stay and grow in investment banking, was backed by the majority of the non-executive directors despite the opposition of the CEO and the chairman. It shows how important the non-executive directors on a board are. But in this case the board was unable to explain this strategy, of the majority of the board to want to buy an investment bank, to its shareholders, who did not block the following acquisition, but were unhappy, which created problems for Nat West's future.[61]

From 1992 – corporate governance codes

In due course the shareholder scene changed: no longer were most shares in hands of private – small – investors, companies started to feel the presence of institutional investors, such as pension funds with larger stakes, who could not so easily sell their shares and quit if they did not like what they saw. "Exit" was giving way to "voice". These shareholders wanted a greater say and a better insight in what was happening in their companies.

There was growing concern over the reliability of accounts of UK companies. The collapse of the seemingly well performing listed companies Colorell and Polly Peck,[62] whose accounts prior to their failure appeared to give no indication of the true state of their finances, cast doubt on the trust, which could be placed in accounts and audit statements attached to them. This in turn, it was feared, could limit

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[60] Augur (2001), pp. 308 and 321 (comment by author: many New York, Chicago, Washington DC and many other US law firms have the same Old England appearance).

[61] Augur (2001), p. 255.

[62] Cadbury (2002), p. 11.

confidence in UK accounting practices and the reputation of London as financial centre. Therefore, the Financial Reporting Council, the London Stock Exchange and the accountancy profession set up the Cadbury Committee, which drafted a code and created the “comply or explain” concept. The establishment of the Cadbury Committee was soon followed by the failure of BCCI and the collapse of Robert Maxwell’s business empire.

The Committee’s report attracted huge publicity and was yet again an example of English informal self-regulation, which was followed by about 70 codes of best practices all over the world, often copying each other. Here Britain showed real leadership in the corporate investment world.

Britain can thus be said to have taken the lead in new corporate governance and the promotion of independent non-executive directors (NEDs) and an independent chairman. In the last 10 years non-executive directors (NEDs) have become prominent in Britain.

2.1.3 Aspects of British company culture

Although British, US and Dutch culture have much in common, such as the same Christian religions, tolerance, rationality and a tradition of individualism,[63] there are special cultural aspects which account for differences in corporate governance, even in these originally Anglo-Saxon and North European countries. Four aspects of British corporate culture relevant to corporate governance will be described below:

a informal regulations work: pragmatism, case by case approach, reluctance to commit to rigid unchangeable rules
b owners’ power
c strategic thinking
d sometimes long term, sometimes short term.

While describing these aspects of corporate culture, I will make use of broad impressions, realizing that these are generalizations of British character and not a description of the character of each individual. My

[63] Fons Trompenaars and Charles Hampden-Turner, *Over de grenzen van cultuur en management* (2006), pp. 20-25 (“Trompenaars and Hampden (2006)”).

aim is to give a generalized impression by a foreigner and to try to clarify differences in board dynamics by looking at history and culture.

(a) Informal regulations work: pragmatism – case by case approach – reluctance to commit to rigid, unchangeable rules; common law

(a) A ***Island mentality – changes without revolution***

The UK has not been invaded by foreign powers since 1066 and has been fairly content with its forms of government[64] and governance. Its system of government has evolved in its own way, sometimes behind and sometimes ahead of other countries, but always avoiding revolution after the beheading of Charles I in 1648 and the Commonwealth Republic. The so-called Glorious Revolution of 1688 was in fact a restoration of the "constitutional" monarchy without a written constitution, which had been the practice long before continental kings were forced to follow suit.

In 1992 the UK clearly took the lead in the field of corporate governance. The application of codes with the "comply or explain" rule is typical of the imaginative English approach to change, which differs from that of other countries and was in this case quickly followed by many other countries.

(a) B ***Pragmatism***

The British like a case by case approach. there is a reluctance to commit to rigid, unchangeable rules. The long experience of having a parliamentary monarchy without a constitution has convinced the British that not all principles of governance necessarily need to be pinned down in formal laws. The US for example does have a written constitution. As a result the US relies on extensive written acts. Another reason why the UK did not need written legislation, is that it was a close knit society where people could rely on precedent. UK leaders still like to see themselves as pragmatical, which reinforces the will to have informal regulations.

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[64] Jonathan Charkham, *Keeping Better Company: Corporate Governance Ten Years on* (2005), p. 291 ("Charkham (2005)").

(a) C ***Centralised society/peer control***

London is a huge city and a financial hub. A good business reputation is essential in the City.[65] Peer control works strongly: this starts in the public schools and at Oxbridge and then continues in the business world. During the Industrial Revolution, cities such as Birmingham and York became centres of industry, but provincial businesses and listed companies still had their head office in the City. Having a financial centre which is at the same time the place for the head office of all major listed companies makes dialogue with large shareholders easier, especially if one adds the "club membership" atmosphere.

(a) D ***Fair play***

"Fair play", "being a good sport" and of avoiding and not doing things that are "not done" are important aspects of education and English life. In rugby the players listen to the referee and there are few fights. In cricket the players also listen to the umpire. In certain cases a player can be called out by the umpire only after an appeal by the players of the other team crying out "How's that?". Unwritten rules and listening to the referee are clearly very important in these games and in business.[66]

The background of abiding by unwritten rules goes back to the aristocracy and its code of honour, being further developed at schools, like Eton. At those schools rugby and especially cricket were taken very seriously. One speaks of the "spirit of cricket". Such admirable sentiments created the "stiff upper lip" and "my word is my bond". It was also deliberately developed as a government policy in the middle of the 19th century, when the UK was colonizing so many countries around the world and needed a breed of young men that could take charge and would be admired by local princes.[67] They promoted the public schools. Although the aristocracy has lost a great deal of its influence

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[65] Charkham (2005), p. 294 and Arad Reisberg, *Derivative Actions and Corporate Governance* (2007), p. 40 ("Reisberg (2007)") and Chambers (2008), p. 357.

[66] Johan Huizinga wrote *Homo Ludens* in 1938 and emphasized how important it is to observe games to understand culture. He also wrote that fair play in games is what good faith in business is. The last English edition is of 2008.

[67] Chambers (2008), p. 357.

since the Great War, the new leading class aspires to the same set of values and the same sense of class.

(a) E ***Media and publicity***

Media and publicity play an important role in peer control. British citizens enjoy publicity[68] and know how to use it to their advantage.

(a) F ***Self-regulation preferable to formal laws***

The Courts of Equity made law possible without formal laws. Peer control, tradition and belief in informal arrangements have worked well for the Takeover Panel and the Stock Exchange, with the City Code "If you misbehave you're out of business." The same principle forms the basis for corporate governance codes of which the Cadbury Code of 1992 was the first.[69]

(a) G ***Common law and equitable principles***

An aspect of pragmatism is common law. Around 1200 the UK had only limited specific writs for any legal action; they were particular actions, such as "delictus". Around 1250 other free actions were permitted to be brought in equity before the Lord Chancellor. Any request became possible and the law became flexible. An example is trust law. Later the flexible equitable principles flowed into the common law courts, but the common law courts and chancery courts remain to this day. The chancery courts deal with many business matters such as company law, intellectual property law and bankruptcy disputes. Around 1870 the two systems were brought together. At the high court level there are several divisions including a commercial division next to the chancery courts. The Court of Appeals has a separate chancery division. It is interesting that all US states took over the UK common law courts and that only Delaware kept the chancery court for business matters.

[68] Charkham (2005), p. 295, where he says "the UK may be divided in two groups: those who enjoy publicity and admit it and those who enjoy it and pretend otherwise".

[69] Charkham (2005), pp. 297-299.

(b) Owners' power

(b) A ***Respect for ownership***

Land owners – the rural nobility – have always been the backbone of the English nation. The security brought by owning property and the sense of social obligations have been inherited in later times by the founders and owners of family businesses. Their position as owners has always been respected and in the same way owners of shares in a company are respected as having the ultimate power in the company.

(b) B ***Strong institutional shareholders***

Already in the late 1950s large pension funds and institutional investors had large shareholdings in the bigger listed companies. They were a strong force. They supported the first hostile takeovers in 1958. They supported the creation of the Takeover Panel and later they supported the Cadbury Code and the Higgs Review.

(b) C ***Belief that persons follow their interests***

The English view commercial cooperation and joint ventures as engagements of sound self-interest.[70] They believe that each person is free to follow his own interests, and can leave a joint venture at will. They are convinced a CEO will not work as hard for his shareholders as he would for himself (Adam Smith, see page 17, point 2.1.2 under "History"). The British would say that the same applies to the US culture. They are right: it has to do with free enterprise.

(b) D ***Accountability***

Appointing responsible governors or directors to safeguard the interests of partners or shareholders stems from the same critical common sense. It means that governors or directors must do their very best in their fiduciary function. Within their remit they are allotted freedom of judgment, provided they act in good faith. Accountability is a very English word. Directors are appointed by shareholders and must account for their performance at the meeting of shareholders. If they fail to give proper account for

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[70] Charkham (2005), p. 295.

themselves, they can be dismissed or "moved out".[71] In fact, directors are rarely formally dismissed by shareholders. They are, in practice, manoeuvred out of their position, by informal shareholder pressure.[72] They will not be sued at the drop of a hat, as they would be in the US. The British emphasize the two-sided nature of the relationship between governors and those for whom they act. There is focus on the communication aspect, that there are responsibilities on both sides. "Accountability is like a telephone conversation: it requires both sides to listen".[73]

(b) E ***Company law based on partnership: power of shareholders over directors and freedom of articles of association***

UK company law is based on the premise that a company is a type of partnership. In consequence, shareholders are free to arrange their company as they see fit, unhampered by any mandatory law, and are free to elect and dismiss directors as they wish, which is a right even US shareholders do not have, at least not on paper.[74]

(c) Strategic Thinking

(c) A ***Mercantile***

Surrounded by the sea, the British did not need to fear sudden attacks and had time to think strategically about their friends and enemies on the continent. The familiarity with the sea, which needs careful planning in advance, gave them a broader view than many of their land locked fellow Europeans. And what is more, navigating needs creative responses to uncertainties of nature and tenacity to keep the projected course.[75]

[71] Cadbury (2002), p. 40 and Peter Montagnon, 'The Role of the Shareholder', in Ken Rushton (ed.), *The Business Case for Corporate Governance* (2008), p. 83 ("Rushton (2008)"). Ken Rushton wrote and edited this book, which includes chapters by himself, Sir Geoffrey Own, Mivory Steele, David Jackson, Peter Montagnon, Sir Brian Nicolson, Charles Mayo, Keith Johnstone and Will Clark and Stilpon Nestor.

[72] A few examples of shareholder pressure and "rumour in the city" are given hereunder in 2.2.4.

[73] Charkham (2005), p. 368.

[74] P.L. Davies (ed.), *Gower and Davies' Principles of Modern Company Law*, 8th ed. (2008), p. 366 ("Davies (2008)").

[75] Charkham (2005), p. 291.

(c) B **_Respect for history and tradition_**

Studying history is popular in the UK. While CEOs in other countries have usually studied economy, business administration or engineering, the university study that is most popular with CEOs in the UK is history. Even if they have not studied history, their education tends to favour the arts.

Military generals and admirals have often studied history. There is a feeling that a good understanding of history gives a broad view and stimulates strategic thinking. The study of history is kept alive and has influenced the thinking of corporate governance.

Tradition is held in honour in the UK. Foreigners admire the British approach to tradition. In many areas it is often not necessary to have a specific law on a certain subject. It should be enough if everybody realizes that something has always been done in the same way and should therefore continue to be done in that way. Change occurs in the UK too, but is not promoted for change sake only.

(c) C **_Good eye for strategy and debate about strategy_**

People who have studied history get a good understanding of strategy and people who are capable of thinking creatively and broadly are highly respected, even in these times of specialism and analytical detail. It is this concept of strategic thinking that is regarded as important, especially for the role of non-executive independent directors. There is an emphasis on independent, creative and broad thinking, which is regarded as an essential asset. The conviction counts that the talented amateur can add value. The art of debating is cultivated at school and university. Their education should be broad and debating stressed. It gives them the ability to find the right words. Directors go into meetings with an open mind and are prepared to accept that someone else may come up with a better alternative as long as they win in the end. This is different from many foreigners, who are less prepared to consider meetings as grounds for free debate. M. Tabaksblat values the informality of the debate of the English.[76]

[76] Couwenbergh and Haenen, *Tabaksblat* (2008), p. 77.

(c) D *Dialogue and listening*

The Higgs Review[77] and the Combined Code and the UK Corporate Governance Code[78] use the word "dialogue". The *Compact Oxford English Dictionary* defines dialogue as a conversation carried on between two or more persons. According to British understanding, this requires a willingness on the part of both sides to listen as well as speak.

The chairman and the senior independent director should listen to the views of shareholders. And the chairman should listen to all directors.[79] In this way a fresh strategy can be developed by the board. The Dutch often spend much time thinking about what they should or should not say as opposed to thinking of what they could hear or sound out.

(c) E C***ompetitive and combative***

History and custom have it that results are achieved through an attitude open to debate. Discussions in Parliament are contentious, the court system is competitive, relations between the nobility and the Crown have been competitive and throughout history kings have often won the Crown in competitive circumstances. You tend to prefer what you are used to. The British have a pugnacious attitude without resorting to wars or revolutions. Thorough debate is the key to the best strategy, since this is the only way to be sure that all options have been considered.[80]

(c) F ***Social classes/sense of class***

Class has been a constant feature of British society for many centuries: the upper class, the middle class and the working class. Moving from one to the other has not been easy. Normally there is a balance in society. Thinking about balance amongst the social classes leads to strategic thinking and needs room for a long term

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[77] Higgs Review, Annex A provided the basis for Revised Code C1, p. 78.

[78] Combined Code on Corporate Governance, June 2006 ("CC6"), D.1. Combined Code on Corporate Governance, June 2008 ("CC8"), D.1 and UK Corporate Governance Code, June 2010 ("CG10"), E.

[79] Cadbury (2002), p. 90, CG10 A.3 Supporting Principle and the example of Lord Alexander, chair of Nat West, in listening to his non-executive directors, who favoured retaining an investment bank contrary to the views of the CEO and himself. He followed the majority. See Augur (2001), pp. 180-181.

[80] Cadbury (2002), p. 91.

view. Since the First World War ideas and practices have changed, with a widely questioned honours system, a weaker House of Lords and a directionless monarchy. However, Britain has a very different sort of society from that of France, Ireland or the USA, principally because since 1688 it has never experienced a time when those in power have consciously sought to expand the historic symbols of rank and privilege. The members of the aristocracy may have lost their influence, but they have been replaced by the members of the upper middle class, who aspire to much the same set of values.[81] David Cameron, the Prime Minister elected in 2010, is again an Etonian. It is sometimes said that it is striking, how little Britain's social structures have changed since the 18th century.[82]

Members of the upper middle class have a sense of their position in society and many of them are company directors.[83] This may also be a reason why diversity has not yet worked well in Britain. The rather strong separation of the social classes has occasionally even played a destructive role, vide the "Death of Gentlemanly Capitalsm", above under History.

(c) G ***Socially-minded groups of nonconformists such as the Quakers***

In the Industrial Revolution socially aware groups came to the fore, who embraced hard work, better treatment of employees and tranquil solutions to problems, be good for employees and be peaceful. A good example are the Quakers, who were excluded from many activities by the Test Act of 1620, and prohibited from going to university, but were remarkably good at making things, developing industry and looking after their employees.

It was the independent Quaker and nonconformist families that came up with inventions in steel (Darby and Huntsman), railways (Pease, Ellis and Bradshaw), pottery (Cookworthy and Champion), cotton (Bright), banking (Gurney, Barings and Barclay) and chocolate (Cadbury). They created better conditions

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[81] Jon Lawrence, 'The British Sense of Class', *Journal of Contemporary History* (2000), pp. 35 and 307 ("Lawrence (2000)").

[82] *Financial Times*, 13/14 November 2010, p. 7.

[83] Ernest Zahn, *Regenten, Rebellen en Reformatoren: Een visie op Nederland en de Nederlanders*, Dutch translation (2005), p. 130 ("Zahn (2005)").

for employees, combatted slavery and fought for peace. This group has played a major role in American industrial history as well (e.g. William Penn).[84]

(d) Sometimes long term, sometimes short term

(d) A ***Flexibility***

As mentioned above in connection with the English East India Company, it has always been recognised that some shareholders have short-term goals (profit from a single trip) and others a long-term goal (profit after many trips to a region). Modern corporate governance acknowledges that both views can go together.[85] There is a continuing debate about how to match them and the UK Stewardship Code gives some solutions.[86]

Of the three countries, UK, US and the Netherlands, the UK scores the highest on the "uncertainty avoidance index" of Geert Hofstede.[87] This means that British do not get nervous or stressed about new situations. They do not try to avoid suprises.

(d) B ***Tolerant***

Since the 17th century Britain has accepted and assimilated many minorities, which have ideas and entrepreneurial ambitions. The commercial strength of the UK has benefited from these immigrants. Although the UK has had an honest and effective legal system, the British did not develop the US tendency to embark on litigation immediately. There is a willingness to seek out-of-court solutions. In the corporate world too, few liability cases have been brought against directors. Informal ways of resolving issues are: suspending and disqualifying directors and publishing bad results. Such informal solutions often surprise outsiders.[88]

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[84] Paul H. Emden, *Quakers in Commerce: A Record of Business Achievement (*August 1939).

[85] Mark Goyder, *Tomorrow's Owners: Defining Differentiating and Rewarding Stewardship* (2008) ("Goyder (2008/A)").

[86] The UK Stewardship Code of July 2010.

[87] Hofstede, Hofstede and Minkov (2011), pp. 197-199 and Geert Hofstede, *Cultures and Organizations: Software of the Mind. Intercultural Cooperation and Its Importance for Survival* (1991), p. 113 ("Hofstede (1991)").

[88] Charkham (2005), pp. 291-292.

Warburg, Schroders, Rothschild and Kleinwort are all merchant banks set up by continental European families, as was Casenove, an important stockbroker. These families adopted English values to a marked degree.[89]

(d) C **_Work should be fun_**

Books published in Germany, France or the US on how to run meetings and boards and on the composition of boards will seldom, if ever, state that board meetings should be fun. In the UK this is generally emphasized.[90] The English sense of humour and its relish for social gatherings are widely recognized all over the world.

(d) D **_Forming teams_**

Although the British are independent-minded they are good at forming teams. Past and present have shown them that teamwork is necessary for good results. They get an early taste for it by practising sports as youngsters at school and develop it further in the course of their work. Books about boards emphasize the need for teamwork and stress that creating a team is one of the important functions of the chairman.[91]

(d) E **_One-person leadership/No heroes/Captain can be replaced_**

The British realize and are convinced that from time to time leadership should be centred in one person. The team must be led by a leader since this produces optimal results. There should be discussion, but the discussion should not be for discussion's sake, but lead to a decision. A leader is needed to steer this process to conclude the discussion. That person should also communicate with the outside world.[92] CEOs and chairmen have to hold these leading roles. CEOs run and represent the company. Chairmen run boards and lead the dialogue with shareholders.

Unlike France (with its *Président Directeur Général* or "PDG"), Germany and the US, the English do not like to have or worship heroes. There has to be a leader, but that leader is at all times

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[89] Augur (2001), p. 323.

[90] Patrick Dunne, *Running Board Meeings: How to Get the Most from Them*, 3rd ed. (2005), pp. 45 and 48 ("Dunne (2005)") and Chambers (2008), p. 133.

[91] Cadbury (2002), p. 81.

[92] Chambers (2008), p. 357.

replaceable. Winston Churchill was a hero during the Second World War, but was easily replaced in 1945 when the UK electorate had set their minds on Labour. CEOs in Britain can be dismissed by the meeting of shareholders and thus it has been since the first English companies were established in 1600.[93]

Although respect for hierarchy is stronger in the UK than for example in the Netherlands, there is a tendency to get rid of directors readily in the UK. This contrasts markedly with Dutch board culture. The Dutch have no real hierarchy and sometimes keep members on board for too long. They sometimes frown on the easy way the British can dismiss a director.

(d) F ***Making money/trading***

Making money is respected. The British realize that you need money to engage in enterprise. The British, as a seagoing nation, have always been good traders. Gambling also is accepted in every level of society, albeit not among Quakers and some other smaller groups.[94]

2.2 **Who owns shares?**

"He who pays the piper calls the tune" is a well-known English expression.[95] An element of corporate culture is the role of shareholders. In the UK shareholders have a substantial influence. By law they have powers to appoint and dismiss directors and they have to be asked consent for important transactions. In practice, they use these powers, not formally, but by pressure.

2.2.1 Sources of Finance

While many family companies have a large equity percentage, larger companies raise money either from banks in the form of loans or from capital markets.

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[93] Lawrence (2000), p. 36.

[94] Charkham (2005), p. 294.

[95] Charkham (2005), p. 303.

2.2.2 UK banks do not use influence

UK banks do not exert great influence over the companies they finance. They do not take equity stakes to cement the relationship with a borrowing customer. There could be a conflict of interest in their role as lender and shareholder. Companies often borrow from quite a number of banks. It is not typical for the lead banker to want to have influence in a company.[96]

2.2.3 Stock Exchange important for peer control

The London Stock Exchange was formed in 1600 and has decided since 1697, which companies are accepted for listing. Compliance with the Codes of Best Practices forms part of the listing requirements of the London Stock Exchange. Listing on the London Stock Exchange has become more attractive in recent years than a listing on the NYSE or NASDAQ because of the strict and burdensome and hence costly requirements of the US Sarbanes-Oxley Act of 2004.

2.2.4 Who are the shareholders and what is their influence?

The fragmented share ownership of the inter-war period has been replaced by a concentrated form of share ownership as an increasing proportion of shares have come to be owned by institutions. Individuals held over half of UK shares in 1963. Today they hold one eighth. UK pension funds have become particularly dominant by as early as 1970. Around 75-80% of shares of British companies are now held by institutions, with pension funds alone owning about 30%.[97]

This change in the pattern of share ownership in favour of investing institutions, such as pension funds and insurance companies, has encouraged those institutions to use their influence based on the number of their votes. This has increased shareholder influence in general.

Boards cannot disregard the views of important shareholders, especially if there is some degree of consensus between them.
Institutional investors now have powerful incentives to use their influence to improve the performance of their portfolios. Their holdings are

[96] Charkham (2005), p. 304.

[97] Goyder (2008/B), p. 5; Charkham (2005), p. 307; and Montagnon in Rushton (2008), p. 85.

collectively so large, selling has become difficult since this would influence the market. “Get out” is giving way to “influence”. These institutions take a fairly long-term view of their investments. Few UK companies have dominant shareholders with more than, say 25%, ownership, which is also the case in the US, Japan and the Netherlands. There is therefore an incentive for institutional shareholders to “persuade” each other and to create strong voting blocks when particular matters are put to a vote.[98] The key lever that shareholders control is their ability to vote at general meetings, but the practice is that “persuasion” takes place first and then “pressure” to avoid cumbersome general meetings.[99]

The most recent development is that more and more foreign institutions, particularly from the US, hold UK shares. There is a tradition of good “one-on-one” communication with large shareholders.[100] However, this is less easy with foreign shareholders. What the role of hedge funds and of shareholder activists is going to be remains to be seen. Some of them are well informed about companies in which they take stakes and can engage effectively with management. Some of them recognize, too, that corporate governance is connected to value. For example: a better board structure can increase shareholder prices.[101]

British institutional investors, increasingly via voting associations, have influenced corporate governance in various ways, generally by “pressure” and “persuasion”:

(a) ***Separate Chairman***
After the Higgs Review of 2003 on the separation of the roles of CEO and Chairman and the introduction of the Senior Independent Director (SID)[102] institutional investors have taken a strong stance and pressed for the proposed reforms in many companies.[103]

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[98] Cadbury (2002), p. 9.

[99] Montagnon in Rushton (2008), p. 93.

[100] Montagnon in Rushton (2008), pp. 88 and 92 and Sir Bryan Nicholson, ‘The Role of the Regulator’, in Ken Rushton (ed.), *The Business Case for Corporate Governance* (2008), p. 117.

[101] Goyder (2008/A), p. 6 and Montagnon in Rushton (2008), p. 93 and pp. 98-99.

[102] Higgs Review, paras. 5.3, 5.7, 7.4 and 7.5.

[103] Montagnon in Rushton (2008), p. 84, the SID has a role in evaluating the chairman and in the succession of the chairman and replacing the chairman in a crisis. There is some resemblance to the US “lead” director. This is discussed further below.

(b) ***Get the most out of non-executives***

Institutional investors in the same way as outside directors, want to be included actively in strategic decisions and risk management. This is clear from their support of the Codes of Best Practices.[104]

(c) ***Appoint and dismiss directors***

In the UK it is crucial for shareholders to have the power under company law to appoint and dismiss directors.[105] In practice it is quite rare in the UK for shareholders to propose individuals as candidates for a particular board. This normally happens only after a company has run into trouble. Even then there is reluctance to usurp the nomination committee's right to select.

Directors representing institutional investors often use indirect pressure to influence the nomination committee, which also sounds out shareholders. In general, shareholders have pushed for the introduction of a Senior Independent Director to whom they can communicate any comments on the functioning of the Chairman and the CEO.

In 2004 influential shareholders of Sainsbury had made clear before the shareholders meeting that they were going to reject Sir Ian Prosser, the candidate of the nomination committee, as Chairman. Sainsbury had been losing ground to Tesco. Sir Ian had experience in leading a retail company. However, City institutions made it plain they did not feel Sir Ian had the right touch to guide the company out of troubles. Sir Ian gracefully withdrew. The nomination committee consulted shareholders and nominated Sir Philip Hampton, who had financial City experience, complementing the skills of Justin King, Sainsbury's CEO.
Similarly, Michael Green was forced to withdraw in 2003 as Chairman of ITV as a result of shareholder's desire for a properly independent chairman, and Sir Peter Burt, again a figure familiar with the City, was chosen.[106]

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[104] Montagnon in Rushton (2008), pp. 91-92.

[105] Section 168 of the Companies Act 2006 gives the majority of the general meeting the right at any moment to remove a director, but this power to remove is rarely used in a general meeting because it is cumbersome, it is used to exert power to demand accountability. Now in FTSE 350 companies all directors are up for re-election each year.

[106] Montagnon in Rushton (2008), p. 86.

There have been instances where shareholders' representations have influenced the board not to let the chief executive become chairman. The Association of British Insurers (ABI) held ground-breaking discussions with Barclays over its proposal to appoint Matt Barrett, its former CEO, as Chairman in 2004. It may have influenced the bank's decision to change its plan and look outside for its subsequent Chairman, Marcus Agius. Similarly HSBC went out of its way to consult shareholders on its proposal to appoint its CEO, Stephen Green, as Chairman in 2006. Discussions with shareholders led to the appointment of a new CEO at Morrison, the supermarket concern, in 2006. Directors have grumbled about the need for these discussions, but it has created fewer situations of unfettered power in the hands of one person.[107]

Now there is discussion about possibly including one or two shareholder representatives on the nomination committee, which is otherwise composed of non-executive directors.[108]

(d) ***Remuneration policy***

Shareholders also play a role in establishing remuneration structure policy. The ABI, representing shareholders, now receives over 200 requests a year from companies seeking shareholder views on remuneration policy. This has led to less extreme short-term option schemes than in the US.[109]

CEOs and/or chairmen of companies hold many one-on-one meetings with influential shareholders. Hermes, an influential UK pension fund, for example, always divides its one-on-one meetings as a shareholder with CEOs and/or chairmen into three parts: one-third strategy, one-third remuneration and one third succession.[110]

Companies are now[111] obliged to offer shareholders an advisory vote on their remuneration report. As before, a separate binding vote is required on share incentive schemes that are dilutive

[107] Montagnon in Rushton (2008), p. 87.

[108] Mark Goyder and Harlan Zimmerman, *Tomorrow's Company, Tomorrow's Corporate Governance: Bridging the UK Gap through Swedish Style Nominations Committees* (March 2010) ("Goyder and Zimmerman (2010)").

[109] Montagnon in Rushton (2008), pp. 86-89.

[110] Information received orally from Hermes.

[111] Section 438 of the Companies Act 2006 and Davies (2008), p. 385.

and/or involve the issue of shares to directors. The press watches votes on remuneration closely, and companies are concerned about the loss of reputation that may flow from evidence of widespread opposition to their remuneration policy. Moreover, a public dispute over remuneration can seriously demotivate directors. For these reasons companies increasingly seek dialogue with shareholders in order to sort out problems before they arise.[112]

There are three reasons why shareholders have become involved with remuneration. First, a conflict of interest arises when boards have the task of deciding on the remuneration of directors who sit on these same boards. Shareholders have a responsibility to help mitigate this effect. Second, remuneration creates incentives that will determine the approach taken by management in driving the company forward. Shareholders have a strong direct interest in what happens. Finally, there is a general need to preserve the integrity of the system. If lack of discipline and oversight allows companies to bestow lavish rewards on mediocrity and failure, it will no longer be possible to reward success. This will damage entrepreneurialism and inhibit wealth creation.

The efforts of shareholders over the years have met with some success, particularly with regard to the structure of remuneration. It was always possible for the UK to avoid the bonus extremes of the US, where it has become a subject of public interest and anger in the last few years.[113]

(e) ***Remuneration amounts***

Shareholders have had less influence on the overall amounts of remuneration, which is being driven higher and higher. This is partly because they do not wish to get involved in setting the going rate. The ratchet effect is caused by disclosure, which aimed to have a limiting influence through public exposure, but the opposite happened.

More recently, however, shareholders are taking a stance on remuneration matters, such as in Shell Plc’s annual general meeting of shareholders in

[112] Montagnon in Rushton (2008), pp. 88-89.

[113] Montagnon in Rushton (2008), pp. 88-89.

London on 21 May 2009 when a remuneration proposal was voted down by 60%.

(f) ***Risk control***

Shareholders have had an important indirect influence on better internal control.

In 2002 the Association of British Insurers published a brief set of guidelines calling on boards to disclose in their annual report that they had considered the risks and to confirm that the risks were being managed and were manageable.

(g) ***Strategy***

Finally, shareholders have a significant say in important strategic questions. The UK Listing Rules made by the Financial Services Authority[114] give them the right to vote when a company wishes to make a substantial purchase or disposal of assets that will alter the shape of the company. This right is regarded as highly important. In practice shareholders have not used this right to bluntly block actions proposed by the board, but the mere fact that shareholders have such a right forces boards to consider in advance whether they will be able to carry their shareholders with them in any decision. This background explains why strategy and strategic decisions are extensively discussed in boards with non-executive directors at an early stage.[115]

Voting associations[116] often give shareholders advice on how they should vote. This advice if often followed by institutions that do not wish to make costs investigating voting alternatives.

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[114] Davies (2008), pp. 16-17. Listing Rules: LR 10.1.2 and LR 10.5.1, see also advice of Advocate General L. Timmerman to the *ABN AMRO in Sale LaSalle Bank* case, HR 13-07-2007, NJ 2007, 434, nos. 3.31 and 3.32.

[115] Montagnon in Rushton (2008), pp. 90-92.

[116] Montagnon in Rushton (2008), pp. 86-92. Shareholder bodies that play an important role are the Institutional Shareholders Committee (ISC), which codified best practice principles for shareholders in a statement, the Association of British Insurers (ABI), the National Association of Pension Funds (NAPF), the Institutional Voting Information Service (IVIS), Research Recommendations Electronic Voting (RREV), the Investment Management Association (IMA) and the Association of Investment Companies (AIC).

2.3 Formal Acts and Informal Codes

Another element of the corporate culture in the UK is the practice of directing corporate boards by informal codes, beside facilitating company Acts.

The Companies Act of 1985 was quite short and simply provided that managers were accountable to the board and the board was accountable to shareholders. In 1998 the Secretary of State for Trade and Industry, Margaret Beckett, commissioned an independent review of company law which was "fundamental to the national competitiveness". Its aim was to be "primarily enabling and facilitating", leaving a lot of freedom to entrepreneurs to draft their own rules in articles of association. This resulted in the Companies Act 2006, which is more extensive than the Companies Act of 1985.

(i) ***Acts***

An overview of the main sections of the Companies Act 2006 is attached as "Annex UK Acts". The sections that will be discussed in detail in this study are "the duties of directors", in sections 170-174, including the important section 172, which so clearly describes the "success of the company" and the "enlightened shareholder value" (see sub-section 2.6.3 hereof), "duty to avoid conflicts of interest" in sections 175-181 (see sub-section 2.6.6 hereof), "limiting directors' liabilities" in sections 232-239 (see sub-section 2.7.6 hereof) and derivative claims (see sub-section 2.7.3 hereof).

Although directors are dealt with there are no sections dealing with the board of directors as such. Under the Companies Act of 2006 default in performing the duties of a director may be a tort.

The position of directors is also regulated in many other laws, mentioned in the Annex UK Acts. Here I mention the Insolvency Act of 1986, the Financial Services and Marketing Act 2000, including market abuse, the Criminal Justice Act 1993, including insider dealing, the Listing Rules, the Takeover Code, the Company Directors Disqualification Act 1986, under which the court can bar a person from being a director for 2 to 15 years; there is extensive case law on this subject, including an order against all the directors of Barings for the failure to control Mr Leeson.

(ii) ***Informal Codes***

Informal self-regulation is a creative method especially well-suited to the English legal environment. The informal method works: after issuance of the Cadbury Code of 1992, which promoted the separation of the roles of CEO and chairman, there was criticism of the separation of the roles of CEO and Chair, but 94% of the FTSE 350 companies have introduced this separation by 2007; the same thing can be said in relation to required evaluations of the board: these were criticised in 2003, but are now to be deemed correct and quite normal as many companies have found that evaluations lead to improvement in board processes and make an important contribution to succession planning. The market-based approach, as exemplified by the drafting of a Code of Best Practices for Corporate Governance under the "comply or explain" method, has many advantages:

– Codes of Best Practices are flexible;
– the texts are aspirational rather than minimal since they describe the situation of the best, with the aim of encouraging the rest to raise their performance to that level;
– simple words can be used, for example, boards can be described as "effective" and "robust" and directors as being of "high" quality, and texts can talk of the need to avoid "unwieldy" boards and "unfettered" power for one person or group;
– the Codes of Best Practices can be monitored for compliance and updated yearly to improve standards and adapt to new developments;
– the Codes aim to support rather than constrain entrepreneurship;
– the flexibility of the Codes enables them to aim at improving conduct within many different types of companies;
– enforcement by shareholders, i.e. market control;
– the concept of "comply or explain" Codes seems to work internationally; the EU Corporate Governance Forum has stated that "the experience of countries which have

> implemented this approach for several years shows that it does lead to a movement of convergence”.[117]

The development started in 1992 with the Financial Reporting Council (FRC), the London Stock Exchange and the accountancy profession asking a Committee on the Financial Aspects of Corporate Governance under the chairmanship of Sir Adrian Cadbury to consider issues in relation to financial reporting and accountability and to make recommendations on good practice in the following areas:

(i) the responsibilities of executive and non-executive directors for reviewing and reporting on performance to shareholders;
(ii) the case for audit committees of the board, including their composition and role;
(iii) responsibilities of auditors and the value of the audit;
(iv) links between shareholders, boards and auditors;
(v) other matters.[118]

Although its terms of reference concentrated on accountancy matters, the committee extended its remit to include many aspects of the organization of the board of directors and the conduct of directors, despite not having been appointed by and lacking the backing of the Confederation of British Industry (CBI) and the Institute of Directors (I of D). Sir Adrian Cadbury says that although these institutions initially opposed his committee’s far-reaching and wide-ranging ideas, “when I explained the ideas to their open meetings they were very good and came to support our ideas.”[119]

As background it is useful to know that Sir Adrian, a Quaker by the way, had a wealth of management experience.[120] He had been a Cadbury board member from 1958 and became CEO and later Chair of Cadbury PLC, which merged with Schweppes in 1969. He subsequently resumed the position of managing director of

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[117] Nicholson in Rushton (2008), pp. 103-106.

[118] Cadbury (2002), pp. 10-11.

[119] Information obtained during conversations with Sir Adrian Cadbury at his home.

[120] Sir A. Cadbury, *Family Firms and their Governance: Creating Tomorrow’s Company from Today’s* (2000).

Cadbury-Schweppes PLC while Lord Watkinson was Chairman until 1975. Sir Adrian then became Chairman and remained in that role until 1989. At that time Cadbury-Schweppes was one of the UK's most successful manufacturing companies.

Sir Adrian knew all about the separation of the roles of CEO and Chair, the role of outside directors in strategy discussions and the evaluation and succession of boards. He also had experience in the monitoring role of outside directors after 23 years as Director of the Bank of England. Finally, he had been a supervisory director (*commissaris*) of the Dutch car and truck manufacturer, DAF N.V.

The development of the role of the "independent chairman", separate from the CEO, has meant a vital change as well as an important step forward in corporate governance. This step forward is now increasingly being introduced in the US and has also been included in the Dutch Act on One-Tier Boards (the "Act"). The role of the chairman therefore forms an important part of this study.

It is interesting to note how change in the UK can be promoted quite easily by persons of high quality, who are respected and have support in the City. Adrian Cadbury is an example. Higgs and Walker are other examples.

Attached hereto as "Annex Cadbury Code" is a summary of the Cadbury Code of 1992, as drafted by the Committee on the Financial Aspects of Corporate Governance.

The Cadbury Committee later monitored the general compliance and then reported annually.

The Cadbury Committee was followed by:

– the Greenbury Committee, which studied Director's Remuneration in 1995;
– the Hampel Committee, established in November 1995 by the Financial Reporting Council (FRC) to draft a Combined Code, which was published in November 1998 and supported the Cadbury Code;

– the Higgs Review on Non-Executive Directors which was published in January 2003 and again supported and reinforced the Cadbury Code;
– the Smith Report of 2003 on Audit Committees;
– the 2003 Combined Code;
– the 2005 report of the Turnbull Committee on Internal Risk Control;
– the Combined Codes of 2006 and 2008 (“CC6” and “CC8”)
– the Walker Review of Bank Corporate Governance of November 2009[121]
– the UK Corporate Governance Code of July 2010 (“CG10”)
– the UK Stewardship Code of July 2010.

I have referred to the Codes and therefore also to the Combined Code and UK Corporate Governance Code as “soft law”. This is perhaps misleading. At the centre of the CC6, CC8 and CG10 there is a perfectly “hard” obligation.[122] The UK Listing Rules require UK-registered companies with a primary listing in the UK to disclose in their annual report the extent to which they have complied with the CC6, CC8 and CG10 and to give reasons for non-compliance (if any). Again the Walker Review reconfirmed the advantages of best practice codes.

2.4 Composition of UK boards

2.4.1 Introduction on composition of the board

In many countries a board and its members generally fulfil all functions necessary for a successful enterprise. A company should have a purpose, a strategy, policies, a process for risk management, a system for orderly succession, evaluation procedures and rules for communication with shareholders and other stakeholders, such as employees, customers, suppliers and society. In general all these elements must be developed, implemented and monitored. Together, the members of boards fulfil all these roles. The question is what practice has been developed to do so in the most efficient way and how do companies avoid dangers or

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[121] Sir David Walker, *A Review of Corporate Governance in UK Banks and Other Financial Industry Entities*, Final Recommendations, 26 November 2009, Executive Summary, p. 3 and nos. 1-21 (“Walker Review”).

[122] Listing Rules, LR 9.8.6(5).

inefficiencies such as an “imperial CEO”, “group think”, loafing in acceptable sub-optimal work, lack of teamwork, festering disputes and lack of communication?

Each country has developed different best practices for the composition, roles, duties and liabilities of board members. The description of UK boards follows hereunder:
first, for the composition of UK boards – this section 2.4; second, the division of the roles of UK board members – section 2.5; third, the description of duties – section 2.6; and finally, liabilities of board members in the UK – section 2.7.

This section (2.4) describes the best practices in the UK for the composition of the board. First it describes the UK choice of a unitary one-tier board (2.4.2); followed, second, by the composition of average boards, the evolution of boards over the last 30 years (2.4.3); and description of the composition of an average board, consisting of all the executive directors (usually 2 to 4), a separate chairman and a majority of non-executive directors (NEDs), including a senior independent director (SID) (2.4.4); and subsequently by the dilemma for executive directors of having a dual role (being part of the executive team and giving an individual view on strategy) (2.4.5); the important changes in board composition brought about by the codes (2.4.6); balance and independence (2.4.7); the importance of not being too large (2.4.8); and a description of the balance created by having a majority of NEDs on the board and on committees (2.4.9); and by a separate non-CEO chairman (2.4.10); formal lists of responsibilities of NEDs (2.4.11). These aspects are followed by a summary concerning the composition of UK boards (2.4.12).

This section 2.4 on the composition of the board is followed by sections on the role of each type of director (section 2.5), including the three most salient points of UK best practice, (i) the active role of NEDs in developing strategy, (ii) the important roles of the chairman and (iii) the best practices to ensure optimal performance of these roles.

2.4.2 Choice of one-tier board

Before turning to the composition of the board, let us look at its structure.

The UK differs from most countries in that the division of powers between the board and the shareholders is a matter for private arrangement by the members of the company rather than something regulated by law. This may reflect the partnership origins of British company law (under partnership law the partners have the freedom to arrange the internal affairs of the partnership very much as they wish), and it certainly facilitates the use of a single act to regulate all manner and sizes of company and give the members complete freedom to arrange the company as they wish and to choose whatever structure they consider appropriate.

This is also a point of some theoretical (even ideological) importance: the directors' authority is derived from the shareholders through a process of delegation via the company's articles of association and not from being separately granted in an act. Furthermore, this helps to underline the shareholder-centred nature of British company law and the freedom regarding the division of powers as well as regarding appointment and dismissal.[123]

The Companies Act 2006 only provides that a company must have one or more directors, but describes directors' duties in great detail (see section 2.6). It does not mention the board or its composition. In theory, UK companies can therefore choose between a one-tier and a two-tier board.[124] These options are also available in France, Switzerland and Italy. Most companies in those countries opt for the unitary board.[125] Domestic UK law does formally recognize the possibility of a two-tier structure as an option instead of a one-tier board for Sociétés Européens (SEs) (European Companies) that register in Britain.[126]

In the 1970s, 1980s and even the 1990s there was debate in the UK whether a two-tier board system should be adopted, possibly even with employee representation[127] in keeping with the German model. This debate was prompted by the perceived weaknesses of the UK practice of NEDs, usually chosen by the CEO.[128] However, even the UK unions did not want employee representation on boards. Moreover, the UK was not, in general, impressed by the German board system. The German economy was not strong in the 1980s and there were many examples of unduly strong CEOs dodging everything, such as giving very sparse information, to keep the supervisory directors at a distance.

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[123] Davies (2009), pp. 366 and 398.

[124] Cadbury (2002), p. 71.

[125] Cadbury (2002), p. 76.

[126] Davies (2008), p. 399.

[127] The Bullock Report (1975) on Industrial Democracy, including the possibility of employee representation in the UK, Charkham (2005), p. 314, and the Labour Party's Proposal "Winning for Britain" (1994).

[128] Davies (2008), p. 402.

In the 1990s, the debate initiated by the Cadbury Committee about finding ways of curbing the power of an imperial CEO resulted in a decision to create a balance by ensuring that a board had a majority of committed and independent NEDs.[129] This decision made sense only for one-tier boards. In 2009, the Walker Review also assumed that a company has a one-tier board. But interestingly, the Walker Review recommends that there should be separate meetings of only NEDs to consider alternative strategies in a free debate.[130] This comes close to creating a two-tier system ad hoc. It is, indeed, close to the US system of executive sessions, i.e. separate meetings of only non-executives.

It is my view that the US idea of executive sessions before or after each board meeting is a good idea, also in the two-tier system.[131]

2.4.3 NEDs before and after the Codes: from being the "cats paws" of CEOs to holding the balance of power

In the 1980s NEDs were not generally held in high esteem. Chosen by the CEO, they were not expected to do more than attend a few committee meetings and generally do the bidding of the CEO. NEDs were modestly rewarded. The CEO dominated.[132] Most boards only had a few NEDs. Generally the CEO was also the chairman of the board, but if there was a separate chairman, he would often be the former CEO, who would be powerful and could overrule the CEO. The number of non-executive directors varied widely, smaller companies having only a few and large companies having many, sometimes up to even 20. Certainly, in the latter case this was not conducive to a productive debate.

The company secretary has always been important. He reported to the CEO and now supports the Chairman.[133] Annual General Meetings (AGMs) were important events, but as they were attended mostly by small shareholders and rarely by financial institutions with large

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[129] Davies (2008), p. 403.

[130] Walker Review, nos. 2.5 and 2.6.

[131] Lawrence Cunningham (ed.), *The Essays of Warren Buffet*: *Lessons for Investors and Managers* (2009) ("Cunningham (2009)"), p. 45.

[132] Davies (2008), p. 402.

[133] David Jackson, 'The Role of the Company Secretary', in Ken Rushton (ed.), *The Business Case for Corporate Governance* (2008), pp. 67-80; Charkham (2005), p. 321; CC8 A5 and CG10 B5, Supporting Principle and sections 270-280 Companies Act 2006.

shareholdings, they could be worked off quickly, sometimes within an hour.[134]

Since 1992 and the publication of the Cadbury Code, the UK has introduced important changes through the codes and the debates they have sparked. These changes have also been pushed by large institutions such as Hermes and organizations of investors and pension funds. The UK has in fact taken the lead in the corporate governance debate around the world. One factor has been that important business leaders who combine idealism with the capacity to think and write at an academic level have developed the code system with its “comply or explain” principle and high aspirational concepts, which have been followed in most places around the world. Since the introduction of the Cadbury Code, NEDs have been in the majority on boards and their responsibilities have been extended, while the positions of CEO and chairman have been separated. Now there are real differences between the two positions: they have become more of a complementary tandem, equal but different.

2.4.4 Types of directors on UK boards

A typical British board has about 2 to 4 executive directors, a chairman and 5 to 7 outside directors.[135] These numbers, the separate role of the chairman and the fact that the outside directors are in the majority are regarded as important factors in achieving a balanced board. These are essential elements of the Cadbury Code and subsequent codes. The types of directors are described below:

(a) ***Executive directors***

Some members of the board are executive directors: such as the CEO, CFO and COO and the Chief Marketing Director. They carry on the business, work full time and monitor the execution and performance of the company’s activities. The CEO is clearly the boss of the other executive directors. As members of the board they are also, as individuals, involved in the debate about the development of the overall strategy.

[134] Jackson in Rushton (2008), p. 69.

[135] Higgs Review, para. 3.9; Charkham (2005), pp. 315 and 317.

(b) ***Chairman***

99% of UK listed companies have a separate chairman, who is not CEO. The chairman is not an executive director and not an independent director. His role will be discussed separately in detail at 2.4.11 and 2.5.7 below. He is meant to be an independent director, i.e. independent from the business and from the CEO, at the moment of his appointment. However, as he is generally physically present at the company about two days a week and because he will in due course form a team with the CEO, each in their separate roles, he does not remain independent. He has specific roles as leader of the board, leader of the discussion on strategy, leader of the communication with shareholders, and leader in succession planning, evaluation and induction of the Board and all its members.

(c) ***Outside directors/NEDs***

Non-executive directors are also called outside directors. Sir Adrian Cadbury prefers the term outside director as non-executive director for him is too much of a negative description. Many writers abbreviate Non-Executive Director to NED. NED itself has become a household word, which I will use mostly hereafter.

The heart of the matter for outside directors is that they have at least the dual function[136] of:

1. developing strategy, and
2. monitoring the execution of the business.

This aspect of a dual function is described below in sub-section 2.4.6.

If there is a separate chairman, one of the NEDs is called the senior independent director (SID). The role of this director is to take charge of the evaluation of the chairman. See 2.5.7(ix) and 2.5.9 below.

(d) ***Company secretary and internal auditor***

In the UK the company secretary has an important function in company law. In the 1948 Companies Act the company secretary was defined as an officer of the company. The function

[136] Davies (2008), p. 362.

developed into the chief administrative officer of the company. He has a pivotal role in communication among directors. The development of the role is also evidenced by the establishment of the Institute of Chartered Secretaries and Administrators (ICSA).[137]

In the 1980s the role of the company secretary was diluted somewhat, because the functions of general counsel and company secretary were often combined and the work of the company secretary would be delegated to a lower secretary. They would concentrate on monitoring.[138]

With the advent of Corporate Governance Codes and emphasis of non-executives and the Chairman being involved in strategy development, the now again independent function of the company secretary has become important to assist the Chairman in promoting corporate governance and added value of NEDs.[139] He is sometimes called "the conscience of the company".[140]

All public companies must have a company secretary and there are requirements of legal training and/or experience.[141] The company secretary assists the Chairman in the preparation of the annual reports and the annual accounts.[142]
The Guidance on Board Effectiveness of March 2011 also underlines the importance of the company secretary.[143] The internal auditor should carry weight as well be an employee and have direct access to the Chairman.

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[137] David Jackson in Rushton (2008), p. 68.

[138] David Jackson in Rushton (2008), pp. 70 and 76.

[139] Ken Rushton, 'The Role of the Chairman', in Ken Rushton (ed.), *The Business Case for Corporate Governance* (2008), p. 33; Higgs Review, para. II.29, CC8 A.5 and CG10 B.5.

[140] Richard Smerdon, A *Practical Guide to Corporate Governance* (2007), p. 193 ("Smerdon (2007)"), see also complete chapter 9 of his book.

[141] Sections 271 and 273 Companies Act 2006.

[142] Listing Rule 9.8.6.

[143] *Guidance on Board Effectiveness* of the Financial Reporting Council of March 2011, part two.

2.4.5 More executives on the board and their dilemma

In the UK all executive directors are members of the board.[144]

However, in the US it has become common that the CEO is the only executive member of the board. Outside or independent directors should, as is argued in the US, form a large majority in order to counter balance the power of the US “imperial” CEO, who is often Chairman as well.

There are advantages in having all the executive directors as members of the board, as is the practice in the UK. The first obvious advantage is that the NEDs learn more about how and why each executive director takes certain decisions. It leads to a more balanced discussion. Executive directors, who regularly meet with NEDs will have more ease in also pointing out to the NEDs what the dilemmas and weaker points in their propositions are. The UK concept of balance on the board is not one executive versus many non-executives. Second, the NEDs can see for themselves whether the executive directors form a team, when the NEDs are all in personal contact with the team of executives at regular meetings. Finally, such an arrangement gives the non-executive directors greater exposure to potential successors of the current CEO, and the executive directors are obliged to think more broadly about the company as a whole.[145]

Executive directors have the dilemma of playing a dual role within their companies. They are on both sides of the divide between board and management. They have to take off their management hat when entering the board room and replace it with their board hat. Theoretically there is no conflict, because both management and board hats require devotion to the company’s best interests. But in practice this dual role has led to a questioning of the principles on which unitary boards in the UK are based. While at times executive directors are in an invidious position, for example where the matter at issue is the future of their chief executive, a mix of executive and outside directors can be made to work well. The advantage over having the chief executive alone speaking for the management of the business is that the board has the opportunity to hear the views of other key executives and to raise matters with them. While

[144] CC8 A.3, Main Principle and CG10 A.3, Supporting Principle.

[145] Sir Geoffrey Owen, ‘The Role of the Board’, in Ken Rushton (ed.), *The Business Case for Corporate Governance* (2008), p. 17.

chief executives will understandably meet with their executive colleagues before a board meeting to agree on a common line, to have them actually present and even give their views will add to the better information and understanding by the NEDs.[146]

2.4.6 Important changes in composition caused by Codes

What was the corporate governance problem the Cadbury Committee sought to address? Although various problems were identified, the central problem was what was known as the "imperial CEO". The Committee's proposals involved putting in place various balances.[147] These measures were board balance, independent NEDs, no overly large boards, NED majority on the board and committees, a separate chairman, evaluation procedures, a system for re-election/succession, formal lists of the division of responsibilities and timely information for NEDs. All these measures work together to create the right balance for boards.

2.4.7 Board balance and independence

At least one half of the board as a whole, excluding the chairman, should be non-executive directors (NEDs), all of whom should be independent (discussed below at the end of this item).[148]

However, there should be a balance of executive and non-executive directors[149] and "to ensure that power and information are not concentrated in one or two individuals, there should be strong presence on the board of both executive and non-executive directors". The Board should not be too large, but also not too small.[150] The ideal size is about 2 to 4 executives, 1 chairman and 5 to 7 outside directors. The number of executive directors should be sufficient to ensure that the board receives balanced information and the number of outside directors should not be so great as to prevent good debate.

It is all about the balance between executive and non-executive directors and creating the possibility of good communication and creative debate in

[146] Cadbury (2002), pp. 54-55 and 80.

[147] Davies (2008), p. 403.

[148] CC8 A.3.2 and CG10 B1.2 and CG10 B.1.2.

[149] CC A.3, Main Principle.

[150] CC A.3, Supporting Principle and Ken Rushton, 'Introduction', in Ken Rushton (ed.), *The Business Case for Corporate Governance* (2008), p. 7.

a strong unitary board. The general opinion is that NEDs can have more in-depth knowledge and influence if they experience the cut and thrust of debate among the executive directors and are not simply fed the one-sided view of the CEO. This differs from the US idea of counterbalance, which envisages boards with one or two executive directors and about eight non-executive directors. The British idea is based on creating a team that communicates optimally with each other.

Balance also demands a balance of variety of experience.[151] The reason for a wider variety of backgrounds is that they will bring different perspectives to the work of the board. As for specialisation, there is an argument that banks ought to have a number of NEDs who know the banking and finance business: "financial experience and deep experience from elsewhere".[152] The same may apply – possibly to a slightly lesser extent – to other industries.

There are two further balances:[153] international diversity and age and gender diversity.[154] The average age of NEDs is 59 and of chairmen is 62. Very few are women (only 7% of NEDs and only 2 chairpersons), although the percentage of women managers is much higher.[155] The Higgs Review called for the pool of candidates to be widened in order to escape the influence of the old boys' network and Walker repeats the point about women board members.

As with the board as a whole NEDs have a role in "setting the strategy and supervising its implementation, which includes monitoring".[156] Or worded differently "constructively challenge and help develop strategy … scrutiny … management".[157]

The CC8 and CG10 define the term independent.[158] The essence is that a NED is to be independent from management and the company. This

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[151] Cadbury (2002), p. 53.

[152] Walker Review, no. 3.15.

[153] Cadbury (2002), p. 53.

[154] Rushton in Rushton (2008), pp. 38-39.

[155] Higgs Review, p. 17.

[156] CC6, A.1.

[157] CC8, A.1, Supporting Principle and CG10, A.4 Main Principle.

[158] CC8, A.3.1 and CG10, B.1.1 define a person as not independent from the company if he:

– has been employee of the company or group within the last five years;

means that a person who has been an employee of the company within the previous five years or has had a material business relationship with it in the previous three years is not independent. It is interesting to note that a director representing a shareholder is not independent. Such appointments are therefore avoided. This is described in more detail below in sub-section 2.5.7. There is only a minor difference with the Dutch Code. The material business relationship point relates to the past 3 years in the UK and the past one year in the Netherlands. Furthermore, in the UK especially a director becomes not independent if he has served for 9 years on the board and a Chairman becomes not independent upon his appointment.

2.4.8 Not too large

"The board should not be so large as to be 'unwieldy'. The board should be of sufficient size that the balance of skills is appropriate."[159]
The board should consist of about ten members and may be slightly larger in very complicated companies. Cadbury[160] states that the US board may be slightly smaller, but in the US there are usually only one or two executive directors on the board, while the other executives do attend, but not as board members.

Cadbury mentions:
"Sir Walter Puckey, writing on board size, says that in his experience

> 'I have found that its most effective size for first-class participation and decision making is between six and eight excluding the chairman and the secretary, who

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- has, or has had within the last three years, a material business relationship with the company either directly, or as a partner, shareholder, director or senior employee of a body that has such a relationship with the company;
- has received or receives additional remuneration from the company apart from a director's fee, participates in the company's share option or a performance-related pay scheme, or is a member of the company's pension scheme;
- has close family ties with any of the company's advisors, directors or senior employees;
- holds cross-directorships or has significant links with other directors through involvement in other companies or bodies;
- represents a significant shareholder;
- has served on the board for more than nine years from the date of their first election.

[159] CC8, A.3 and CG10 B.1, Supporting Principle.

[160] Cadbury (2002), p. 51.

may or may not be a director. Too many board meetings display verbosity among a few and almost complete silence from the rest.'"[161]

Martin Lipton and Jay W. Lorsch, who have contributed so constructively to the debate on corporate governance in the US as well as internationally, argue persuasively for a reduction in the size of American boards. In their "Modest Proposal for Improved Corporate Governance" their recommendation is as follows: "We believe that the size of a board should be limited to a maximum of ten directors (indeed we would favour boards of eight or nine) with a ratio of at least two independent directors to any director who has a connection with the company …."[162]
They reason that boards of this size enable the directors to get to know each other well enough for their discussions to be frank and searching and to allow every director to contribute to them. With this number it should also be possible for board members to reach a true consensus in coming to their decisions. It is worth adding that the "modesty" of Lipton and Lorsch's proposals lies only in their not being backed by statute, not in their refreshingly radical nature.

Other authorities edge the figure up. Sir Walter Puckey quotes Harold Koontz as saying that it is sensible "to limit a board to thirteen members in order to obtain the free discussion and deliberative interplay which board decisions require. At the upper end, Professor Northcote Parkinson's researches have conclusively demonstrated that what he refers to as the 'coefficient of inefficiency' is reached when the members of a body number between nineteen and twenty-two; at that point an inner cabinet is established, or establishes itself, to take over the functions of the original board or committee."
"Figures quoted in The Professional Board for the top 150 companies showed that on average they had 11.4 directors on their boards. There was, however, a wide variation within that average, with 15 per cent of companies having eight or less and 15 per cent having fifteen or more. Just over half of the board members of those same companies were outside directors. This confirms that the proportion of outside directors to executive directors has risen compared with ten years ago, when boards were more likely to be made up of one-third outsiders to two-thirds insiders."

Warren Buffet stresses the point of not too large boards as well.[163]

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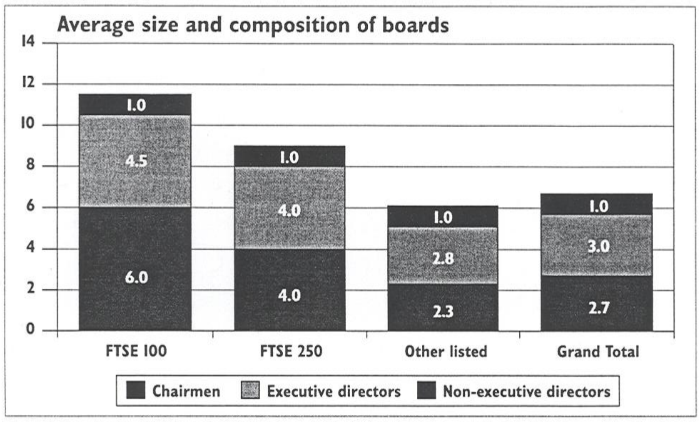
[161] Cadbury (2002), pp. 51-52.

[162] Martin Lipton and Jay W. Lorsch, 'Modest Proposal for Improved Corporate Governance', 48 *The Business Lawyer* 59 (1992), pp. 67-68.

[163] Cunningham (2009), p. 45.

Higgs gives the following overview:[164]

Average size and composition of boards



Patrick Dunne:[165]
Even the Walker Review, which requires an extra NED committee (the risk committee), recommends that the board be kept small.[166]

2.4.9 At least half the board members to be NEDs

At least half of the board, excluding the chairman, should be made up of independent NEDs. The aim should be to strike a balance and not to ensure a large majority. This is better for a well-balanced debate.

The board should have nomination, remuneration and audit committees, of which NEDs should be the only members or majority members. Needless to say, NEDs should decide on the remuneration of executive directors. NEDs may often be the only members of the remuneration committee. The company chairman may be a member but not the chairman of the remuneration committee.[167]

The nominations committee is nearly always chaired by the chairman of the board, who should be independent upon appointment, but will cease to be independent in due course because of his intense contacts with the

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[164] Higgs Review, p. 18.

[165] Dunne (2005), p. 15.

[166] Walker Review, nos. 3.1 and 3.6.

[167] CC8, B.2.1 and CG10, D 2.1.

company.[168] Succession is a vital issue and the chairman should take the lead in that area.

Evaluation of directors and possible criticism of the chairman and his dismissal may be led by the Senior Independent Director (SID) in separate meetings of NEDs.

The audit committee will be chaired by a NED with a financial background, and often attended by the CFO.[169]

The Walker Review recommends that a risk committee be added for banks and other financial institutions (BOFIs).[170]

2.4.10 <u>Separate chairman and CEO</u>

No one individual should have unfettered powers of decision.[171] The CEO and the chairman of the board should not be the same person.[172] The role of the chairman is distinct from that of the CEO. They have different but complementary functions and work as a tandem.[173] The CEO runs the company, formulates and executes the strategy, conducts the business and is in charge of all management. The chairman runs the board and acts as the coach of the CEO and should be happy with the success of the CEO. Not only is there nowhere a description of the chairman's role, but it is hardly recognized in company legislation. Indeed, unlike executive directors and NEDs, the chairman often does not even receive a job description from the company. Nonetheless, the chairman is responsible for leadership of the board, ensuring its effectiveness in carrying out all aspects of its role and setting its agenda. The chairman is also responsible for ensuring that the non-executive directors receive accurate, timely and clear information.[174]

The chairman should ensure effective communication with shareholders.[175] The chairman should also facilitate the effective

[168] CG10, B.2.1.

[169] CG10, C.3.1 and FSA Rule DTR 7.1.1.R (schedule B).

[170] Walker Review, recommendation 23.

[171] CG10 A.2, Main Principle.

[172] CG10, A.2.1.

[173] Owen in Rushton (2008), p. 12 and Rushton in Rushton (2008), p. 23.

[174] CG10 A.3, Supporting Principle.

[175] CG10 E.1.1 and A.2, Supporting Principle.

contribution of non-executive directors in particular and ensure constructive relations between executive and non-executive directors.[176] An illustration of the importance attached to the chairmanship of the board is the provision that in the largest (the FTSE 100) companies a person should hold only one chairmanship (this restriction is currently under review by the Financial Reporting Council (FRC), because of the difficulty of finding good chairmen if the pool of eligible candidates becomes so restricted). The Walker Review recommends that chairmen of major banks should work two-thirds of their time for the bank.[177]

Also "The retiring CEO should not move on to become chair of the board."[178]

Half of UK listed companies had separate chairmen in 1989, three quarters by 1994 and nearly all in 2008.[179]

2.4.11 Formal documentation of roles

There should be a formal statement of matters on which the full board's decision is necessary (i.e. this should not be left to management to decide and report on).[180] In the same way the division of responsibilities between the chairman and the CEO should be clearly established, set out in writing and agreed by the board.[181] These points of corporate governance should be included in the disclosures in the annual report.[182]

2.4.12 Summary of composition of the board in the UK

(i) The UK has a one-tier board system, and is used to this system.

(ii) The aim of the UK Codes is to create a dialogue among a balanced team of executive and non-executive directors. All, or almost all, of the executive directors are on the board. NEDs are in a slight majority. Practically all of UK listed companies have a separate chairman. The chairman has an important role.

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[176] CG10 A.3, Supporting Principle.

[177] Walker Review, recommendation 7.

[178] CG10, A.3.1.

[179] Cadbury (2002), p. 105.

[180] CC8 and CG10, A.1.1.

[181] CC8 and CG10, A.2.1.

[182] Listing Rules 9.8.6(5) and (6).

(iii) Other measures created by the Codes are independent NEDs, no overly large boards, usually, NEDs only on the committees and formal regulations for the division of responsibilities.

(iv) The UK board composition differs from the composition in the US, where only the CEO and about 6 to 9 independent directors are board members. The aim in the US is that the strong majority of independent directors gives independent counterbalance to the CEO. 30% of US listed companies have separate non-CEO chairmen. The other 70% have the one person who is both CEO and chairman and a lead director for counterbalance. In the UK the company secretary has a clear and important role of supporting the chairman in corporate governance and in preparing the annual report and accounts.

2.5 Role of the board members

2.5.1 Introduction on role of board members

As mentioned above in 2.4.1, boards of companies in each country must develop, implement and monitor all the elements: purpose, strategy, policies, risk management, orderly succession, evaluation and communication. The question for each country is how these tasks should be divided. Which board member should have which role? And how can these roles be optimally fulfilled?

The main differences between a one-tier board in the UK and the average two-tier board in the Netherlands concerning the division of responsibilities are that in the UK the non-executive directors (NEDs) have on-site and operational information, receive more and earlier information, are involved in board resolutions and are actively involved in developing strategy. In addition, the UK chairman has a more intensive role and is paid more than the average Dutch chairman of a supervisory board.

These three elements – early, more on-site information, involvement in decision making, involvement in developing strategy – are all worth considering to include in the practice of boards in the Netherlands, whether in a one-tier or a two-tier board system. I will make a proposal for Dutch boards to once a year discuss these aspects and how to deal with them.

In this section (2.5) the role of board members of a UK company will be discussed concerning the following items: first, the legal context of the division of powers between shareholders and board members (2.5.2); the definition of the roles of the unitary board and its members (2.5.3); the dual role of NEDs: monitoring and strategy (2.5.4); followed by the important aspects of the active role of UK NEDs in developing strategy, i.e. what is strategy?; how is strategy discussed?, at what stage and how does the debate take place?, is there debate and is it creative?, what influence on strategy can NEDs have if (a) he/she knows the business or (b) is an outsider (2.5.5)?; and subsequently some specific aspects for banks and the financial industry and what additional input is provided by the Walker Review for the roles of NEDs (2.5.6); which is followed by the important sub-section on the roles of the UK chairman (2.5.7); and finally a discussion about what can be done to enable NEDs to perform their dual roles – strategy and monitoring – optimally: aspects such as involvement, interpersonal behaviour, independence, time commitment, remuneration, early and operational on-site information, committees, the senior independent director (SID), evaluation, induction, training, qualities, diversity, regular selection, documentation on division of roles and NED appointment letters (2.5.8); as well as a description of the best practice for rigorous succession procedures (2.5.9); and the role of shareholders and ways in which boards can single out special shareholders who take a long-term view and are prepared for "stewardship" (2.5.10). This is all closed by a summary of the UK roles of NEDs (2.5.11).

2.5.2 Power of shareholders: freedom of constitution

As described above in 2.4.2, the shareholders in the UK have the power to arrange the company as they wish, subject to some mandatory requirements of the law. In the area of division of roles among directors the shareholders are also free to agree to whatever system they wish, free to delegate powers to board members and free to ask to have a say and to ask for consultation.

The Companies Act 2006 does not mention or describe the board. It does lay down the duties of directors as described in 2.6 below.

2.5.3 Definition of the roles of the board

While the Companies Act 2006 does not mention or describe the board Cadbury[183] summarizes the functions of the board as:

a defining the company's *purpose*;
b agreeing on *strategy*;
c establishing the company's *policies*;
d appointing the executive directors, i.e. *succession*;[184]
e monitoring the executive team;
f assessing their own performance.

Of course, each company has a formal aim described in the Articles of Association mentioning the nature of the enterprise (manufacturing, trading, banking). The corporate aim is determined by the founders and sets the limits of what a company can do. *Purpose* is about developing the goals and the objectives of the company. What does the entrepreneur wish to achieve? The goal is the success of the company, its growth and profitability and usually describes what markets, and what financial targets will be met. Sometimes general aims are added, such as respect for the individual, giving the best customer service and pursuing tasks in a superior fashion.[185] The *strategy*, in the narrow sense, could also be called "tactics" and concerns the company's short-term and long-term goals and the manner of their achievement, what is the core business, what should be disposed of, what should be acquired and how the resources should be allocated. Strategy looks into the future. The *policies* are about the manner of activity, the standards and values and look at present-day activity. *Succession* concerns the manner and practice of proposing new board members.

My collective term for the purpose, strategy, policies and succession and remuneration would be strategy in the wide sense.[186] My definitions for

[183] Cadbury (2002), pp. 36-37.

[184] The author's own preference would be to broaden point d to arranging for proper succession for all board members, and I would also add the policy on executive remuneration.

[185] Thomas Watson Jr., *A Business and Its Beliefs* (1963). Thomas Watson Jr. was the second generation director at IBM.

[186] Cadbury (2002), pp. 37-38. I have discussed this with Adrian Cadbury and he agrees. The Frijns Code mentions that the role of the management board is to determine the purpose or objectives ("*doelstellingen*"), strategy ("s*trategie*") and policy ("*randvoorwaarden*"), which is the strategy in the wide sense. Prof. B. Assink in his inaugural speech of 20 January 2010, 'De Januskop van het Ondernemingsrecht', p. 17 ("Assink

the Dutch words “*strategie*” and “*beleid*” are that there is a "strategy" in the narrow sense, or tactics and that there is a “strategy” in the wide sense, also called “*beleid*”, which is purpose, strategy policy and succession together. I draw this conclusion from the text of article 2.140/250, paragraph 2 (“*beleid*”) and article 2.141/251 (information or “*strategisch beleid*”) DCC in combination with the Frijns Code II.1.2.

Higgs defines the role of the board as follows:

“*The board is collectively responsible for promoting the success of the company by directing and supervising the company’s affairs. The board’s role is to provide entrepreneurial leadership of the company within a framework of prudent and effective controls which enable risk to be assessed and managed. The board should set the company’s strategic aims, ensure that the necessary financial and human resources are in place for the company to meet its objectives, and review management performance. The board should set the company’s values and standards and ensure that its obligations to its shareholders and others are understood and met.*”[187]

In my view the words “entrepreneurial leadership” in the Higgs Review are very important. These words do not appear in any Dutch Code, regulation or opinion as being the task of supervisory directors. It is well known that more money is lost by sluggish leadership than by mistakes. This is an example worth considering for the Netherlands.[188]

In the CC6 and CC8 the following was added:

All directors must take decisions objectively in the interests of the company.

As part of their role as members of a unitary board, non-executive directors should constructively challenge and help develop proposals on strategy. Non-executive directors should scrutinise the performance of management in meeting agreed goals and objectives and monitor the reporting of performance. They should satisfy themselves on the integrity

(2010)”), also describes strategy in the wide sense and the tactics in the narrower sense, which can be for 5 years but adapted each year.

[187] Higgs Review, p. 21. This text is also retained in the Combined Codes of 2006 and 2008 (CC6 and CC8) in A.1, Main Principle and Supporting Principles and in the UK Corporate Governance Code of 2010, which introduced the “long-term success of the company”.

[188] Prof. B. Assink in his oratie of 2010 (Assink (2010)) described entrepreneurship, “*ondernemerschap*”, in substantial detail.

of financial information and that financial controls and systems of risk management are robust and defensible. They are responsible for determining appropriate levels of remuneration of executive directors and have a prime role in appointing, and where necessary removin, executive directors, and in succession planning.[189]

This text was copied from the definition in the Higgs Review of the role of the NED. Interestingly, the words "success of the company" have become a standard expression for defining the duty of directors in section 172 of the Companies Act 2006.

Patrick Dunne says:

> "In running training sessions around the world over the past 15 years, I have found the following shorthand helpful when describing the role of a board and the purpose of board meetings:
>
> - *Right strategy*
>   Ensuring that the right strategy is in place and that it is being executed. Also ensuring that there is a good process in place for developing and monitoring strategy.
> - *Right resources*
>   Making sure that there are the appropriate resources in place to fit with the agreed strategy. The most important of these are people and money.
> - *Keep out of jail*
>   By this I mean that the board needs to ensure that the company complies with the appropriate laws and regulations relating to its industry and location. In other words, 'all the governance stuff'."[190]

In my view the words "constructively challenge and help develop proposals on strategy" in the UK Codes are a good text and a useful guidance for Dutch supervisory directors in a two-tier system or non-executive directors in a one-tier system.

2.5.4 Dual roles of NEDs in developing strategy and monitoring

The role of NEDs has clearly been enhanced and made more important. NEDs have an active role in strategic decision making and they monitor the executives.

[189] CC6 A.1 and in CC8 A.1 of CG10 the Supporting Principle remained the same. Only the Main Principle A.1 of CG10 was changed to: "Every company should be headed by an effective board, which is collectively responsible for the long-term success of the company".

[190] Dunne (2005), p. 9.

"NEDs can suffer from schizophrenia in that they should be encouraging the development of the company, 'the upside', while at the same time monitoring risk to the company, 'the downside'. Working with the executive directors on these areas should lead to greater success for the company and hence enhance shareholders value."[191]

Higgs writes in his review in 6.1 that Cadbury and Hampel identified the tension between these two elements. However, Sir Adrian Cadbury no longer sees the tension as worrisome. He regards the two roles as important and the strategy part as particularly important. Higgs writes in 6.2 of his review that "based on 40 in-depth interviews with directors, the research found that while there might be a tension, there was no essential contradiction between the monitoring and strategic aspects of the role of the non-executive director. An overemphasis on monitoring and control risks non-executive directors seeing themselves and being seen, as an alien policing influence detached from the rest of the board. An overemphasis on strategy risks non-executive directors becoming too close to executive management, undermining shareholder confidence in the effectiveness of good governance."[192] For this reason there is so much discussion about the independent qualities of directors and balance in the board.

Sir Geoffrey Owen:

"A useful distinction has been made between the board as watchdog and the board as pilot. The former implies a strong focus on monitoring and oversight while the latter is much more active, gathering a great deal of information and involving itself directly in decisions."[193]

Now, one can still ask: if the outside director is so deeply involved in the strategic thinking in advance, can he then monitor? The answer in the UK is yes. Exactly, because he is well informed and has been privy to the strategic decisions. He is able to monitor effectively and take a well-reasoned critical view, because he understands the building blocks of the decisions, good or bad, in which he has participated.

[191] Murray Steele, 'The Role of the Non-Executive Director', in Ken Rushton (ed.), *The Business Case for Corporate Governance* (2008), pp. 51-54.

[192] Higgs Review, paras. 6.1-6.2.

[193] Owen in Rushton (2008), p. 27.

2.5.5 The active strategy-developing role of NEDs

As is described above in 2.5.4 two main roles for NEDs are developing strategy with the executive directors and monitoring the executive directors. The long list of UK legislation mentioned in Annex UK Acts clearly shows that the monitoring function is important in the UK as well. It includes the monitoring and assessment of the executive team and of the functioning of the board as a whole. But strategy developing is more than monitoring. Under UK laws and practice NEDs have to play an active role in company strategy development too.

The strategy aspect is the interesting part of the role of British NEDs. Hereunder we discuss the following aspects:

i What is strategy?
ii How is strategy discussed?
iii In what stage is it discussed?
iv Is there real creativity? Is there debate?
v What is the influence of the NED?
vi Can he have influence if he is an outsider to the business?
vii Can he remain a critical monitor once the board has decided on the execution of the strategy?

The reaction to scandals such as BCCI, Maxwell, Enron, WorldCom and the purchase of ABN AMRO by RBS is often: “Where were the directors? Were they independent?” The question is always: did they monitor and did they know the business sufficiently well to carry out their monitoring duties? So, why is the strategy element important? Sir Derek Birkin gives an answer:

> “If a board has the right strategy then you find that operational matters don’t consume too much time at board meetings. This is because major capital expenditure approvals, policy matters and so on will just naturally fit. If they don’t, then you need to revisit the strategy.”[194]

It is often said that less money is lost, because of mistakes than by complacent entrepreneurship. This is easy to say in growth periods, but could seem less relevant in crises of the kind we are currently experiencing. It is said as well that entrepreneurship is the continuous

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[194] Dunne (2005), p. 34.

drive to develop ideas to stay ahead of the competition and the ceaseless striving for new products that can be of use to society and be profitable.

In other words, companies get into trouble for two main reasons: first, a single bad decision that puts the company off course and, second, a slow decline that stems from deteriorating performance on the part of the CEO and his team.[195]

(i) ***What is strategy?***

As described in 2.5.3 above one can speak of strategy in the wide sense, which in my view would be roughly comparable with "*beleid*" in Dutch, i.e. purpose, strategy, policy and succession planning, and strategy in the narrow sense, which would be "*strategie*" or "*tactiek*" in Dutch.[196] Hereunder two quotes about strategy in either sense.

Cadbury quotes Michael Porter: "Corporate strategy is what makes the corporate whole add up to more than the sum of its business unit parts."[197] (This would be strategy in the wide sense.)
and Stiles, Philip and Taylor Bernard in *Boards at Work* (2001): "The first order strategy deciding what areas of business to be in, what is the core business, what should be divested or bought, how resources are to be allocated around the organization, is in the domain of the board."[198] (This would be strategy in the narrow sense.)

While every company has a general aim that is described in the articles of association the word purpose is one step further and can be defined very generally as the success of the company and broadly the products or services the company will offer, the markets it will enter, the financial targets it will meet, sometimes broad terms such as "more customer satisfaction".

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[195] Owen in Rushton (2008), p. 26.

[196] Articles 2:140/250, 2 DCC mention that the supervisory board supervises the management board's "*beleid*". The Frijns Code in II.1.2 gives a list of items that the management board presents to the supervisory board for approval (the list being in my view "*beleid*") and the list includes purpose, strategy and policy.

[197] Cadbury (2002), p. 132.

[198] Cadbury (2002), p. 133.

Elements of strategy in the narrow sense include:

– core business;
– what to divest or buy;
– how to allocate resources;

Policies, internal guidelines, including ethical codes, CSR regulations, whistle blowing rules, risk management directives, are also part of the wider strategy debate.

(ii) ***How is strategy discussed?***

It is clear in the UK that all directors, including outside directors, have a leading and active role in the development of strategy and can add value. In practice, the whole board has an annual strategic meeting (called "away days") in a resort for two or three days. A strategic topic is also discussed at each meeting. Sometimes executive directors prepare strategic options for the board, sometimes outside directors put forward options, sometimes executive directors submit drafts to the board and sometimes they suggest strategic moves (such as a takeover) to the board.

In a two-tier system, such as in the Netherlands, executive directors determine strategy, make drafts for strategic plans and propose takeovers. With exception of a few large listed companies with some experienced supervisory directors, who have been CEO in other companies, supervisory directors generally only supervise, monitor and correct the strategy. In the UK outside directors in most cases actively participate in the debate about strategy, which is meant to be a creative process. Although outside directors may have less detailed knowledge, they can add value by contributing their experience, their independent and critical questions and alternative points of view. This fits in very well with the British idea of team effort and role allocation. In general, the British like to think about strategies. Outside directors in the UK do not merely advise. They are not consultants, but individuals with experience in a wide range of business fields, who can take an intelligent and objective view of the company as a whole.[199] In the UK the chairman should promote debate well in advance, when there is still time to

[199] Owen in Rushton (2008), p. 13.

choose between options.[200] This means NEDs can and should be pro-active. "An exemplary board is one which is a robust, social grouping of individuals which is capable of challenging one another's conclusions through open communications in an atmosphere of respect, trust and candour. This captures the spirit of the board as a collegiate team."[201]

Some examples:

(a) At Cadbury-Schweppes PLC under the chairmanship of Sir Adrian Cadbury, the company had three divisions: the Cadbury chocolate and the Schweppes drinks businesses, which were international and had worldwide trademarks, and, third, a food business with different foods of varied Cadbury and Schweppes origin. These included many old British trademarks. The food business was one of the elements that brought the merger about in the first place – the combination created synergy – and it included some old Cadbury trademarks. An outside director, who was a politician, saw that this division had lower returns and that there was less internationalisation in the food business. He was not an insider at all and had the independence to query why the food business should not be sold, which was not a popular question. The chairman, Adrian Cadbury, let him ask the question and then sought the views of all the directors. New elements came up in a meeting and he therefore postponed the decision until a subsequent meeting. In the end the food business was sold and some of the old trademarks bought back, all for the good of the company.

(b) RBS, as part of a consortium, acquired ABN AMRO in 2008 for a high price when the market was at its top. Little due diligence was carried out. A year later, in 2009, the shareholders were unhappy. The only way in which this might possibly have been avoided is to have had forward-looking strategy on takeovers. A board should regularly discuss whether it wishes to grow by takeovers, and if so, what the procedure should be, what type of due diligence is required, what the criteria should be – such as strategic fit, group finance after the acquisition, can the board control the new group – and what the valuation method should be. This debate in advance avoids situations where an energetic CEO takes the board by surprise and gets his way by saying "This is an opportunity we can't afford to miss". The

[200] Cadbury (2002), p. 34.

[201] Rushton in Rushton (2008), p. 45.

outside directors must be independent and the chairman must allow for time for creative and forward-looking debate.

(c) David Jackson describes two different extremes, first in his capacity as general counsel and executive director at Power-Gen and later in his capacity as company secretary at BP, which make clear that the role of NEDs in a smaller company can be different from the role of NEDs in a larger company.[202]

At PowerGen the executives were entering into new capital projects regularly. The complete board, including non-executives from former government-owned companies, was involved in new projects in new countries all the time. These were seen as strategic moves into new markets. Because bid documents had to be reviewed matters were delegated to committees of executive and non-executive directors. They were operating in an industry which was simultaneously being invented and privatised and developing rapidly. In a more mature organization, they might have stood back and let the executive team deal with these matters within carefully prescribed boundaries. As time went by behaviour changed and they got ahead of things.

At the other end of the scale, in a complex global organization such as BP the contribution of the non-executive directors is different. They will, on behalf of the shareholders, make sure that the executive team is delivering on the agreed purpose and strategy. This seems more like a monitoring role, but when it comes to special lines of strategy and policy, such as the “Green” image of BP, its social, environmental and human rights policies, how to proceed with succession, what the structure of Board Committees should be, and what the boundaries of joint ventures and takeovers should be, the outside directors can play a vital role in the debate on the strategy of the company (David Jackson wrote this in 2008).

It becomes very clear from these examples that there is no “one fits all” system. There are many types of companies in very different sizes. This is important to keep in mind. Professor Sven Dumoulin[203] makes this point clear in Dutch legal literature as

[202] Jackson in Rushton (2008), pp. 74-75.

[203] Prof. Sven Dumoulin, ‘De positie van niet-uitvoerend bestuurders in het monistisch bestuursmodel’, *Ondernemingsrecht* 2005/91, nr. 2 (“Dumoulin (2005)”).

well. In all the examples mentioned it is clear that strategy must be forward looking and that the chairman should make sure that there is sufficient time for debate and he should stimulate the board to reflect creatively on the company's strategy.

Several recommendations by Adrian Cadbury have been discussed above, such as:

– the Chairman should encourage debate well in advance;
– the Chairman should let the other directors give their view first;
– the strategy should be communicated in a consistent way.

It is often said for many countries that so much of strategy development is discussed in the corridors, outside, before and after meetings. That happens and can be fruitful but sometimes confusing. It is especially this aspect that the British try to streamline by creating a good team atmosphere in the meetings.

(iii) ***At what stage is strategy discussed: well in advance and taking time***

Rushton, who gives clear instructions for leadership of meetings by chairmen, says in the chapter of the book he edited:
"It is particularly important that sufficient board time is given to developing and reviewing business strategy … the Chairman must see to it that contributions and challenges are sought from the non-executive directors."[204]

And he gives an example of a chairman who said
"his board spent two days considering strategy at the beginning of each planning cycle so, later in the cycle, they were able to take a more informed view on the individual business strategies" (think of the example above, on p. 66 of the acquisition of a bank).
"Every director needs to take care that his chairman is using the board's time in a way that is consistent with his duty to promote the success of the company. All directors, not just the chairman, could be exposed if agendas and board papers fail to include those matters that are material to the company's success."[205]

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[204] Rushton in Rushton (2008), p. 31.

[205] Rushton in Rushton (2008), p. 31.

So far as running the meeting is concerned, an effective chairman will allow the CEO and his executive colleagues to present proposals or reports that will usually be pre-agreed by management. The chairman will see to it that the presentations are not so long as to leave inadequate time for discussion. It is up to the chairman to set the tone at the board meeting by encouraging non-executive directors to contribute. The quality of the debate is often dependent on the quality of the board papers and presentations.
"Another Chairman said … so long as the weighty issues such as strategy and budget are taken first. He argued … that the chairman's priority is strategy without … limiting time for discussion."[206]

To express the differences in timing of the contribution of NEDs in a one-tier board and of supervisory board members in a two-tier board in merger talks, Cadbury compared the decision making processes in the Daimler German two-tier board and the Chrysler US one-tier board.[207] CEOs Jürgen Schremp and Robert Eaton opened their discussions in January 1998. On 5 February Eaton informed his Chrysler board, including independent directors. His complete board met every fortnight, approving the merger on 6 May and announcing this the next day. On the German side Schremp informed his management board on 7 April and the chairman of the supervisory board on 16 April. The supervisory board was officially informed on 6 May, the day before the merger was announced.

Dunne advises that strategy should be discussed at every board meeting, not only on away days. He also advises that strategy should be a separate agenda item at each board meeting.[208]

Dunne together with Murray Steele of Cranfield also gives some tips for *away days*:

– be clear on the purpose of the away day and your desired outcomes (e.g. selection from a number of well-researched strategic options);

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[206] Rushton in Rushton (2008), p. 32.

[207] Cadbury (2002), p. 233; IMD, Lausanne, Volume 8, no. 4, October 2000.

[208] Dunne (2005), p. 36.

- decide early enough whether to use an external facilitator and, if so, select one with experience of the issues to be discussed who will do the necessary homework;
- the chairman or CEO should brief the facilitator about team dynamics, politics and taboo subjects (the facilitator will then have to interpret skilfully!);
- external facilitators must be good and well prepared;
- decide whether there will be non-board members present and, if so, brief them appropriately;
- hold the away day offsite;
- don't allow interruptions except in case of emergency;
- don't start with an operational board meeting;
- participants should be prepared to challenge each other, in particular to allow differences to surface – a key to success is the quality of debate, both in content and challenge;
- no one has a monopoly on wisdom, so no one should dominate the debate;
- responsibility for implementing actions arising should be clear;
- follow up and review the effectiveness of the day as part of your annual board review;
- finally, "socialising" by the board is an important part of building a strong and cohesive board, so ensure that there is sufficient emphasis and time devoted to this.[209]

(iv) ***Is there real creativity? Is there debate?***

Creative

Patrick Dunne gives further advice: "Is it a creative process or not?"[210]

The NEDs he had spoken with broadly agreed that for the most part a board meeting is a creative process. "Why bother having the meeting if it isn't?" For them, the point of the meetings is to agree on a strategy and regularly assess its effectiveness and within the strategy establish and maintain a clear policy on relevant operational issues and also to consider and enable successful succession planning throughout the organization, gain external input and evaluation for executive decisions and ensure

[209] Dunne (2005), p. 40.

[210] Dunne (2005), p. 9.

the company effects all necessary procedural and compliance items across the range, from health and safety issues to Stock Exchange compliance matters.

British legal literature emphasizes that atmosphere is important. The British boards have a lighter atmosphere and are more fun than US boards.[211]

Talking about strategy can be a lot more fun than merely monitoring whether the business is properly under control.[212]

Debate

The meetings of UK boards often take place in a good atmosphere of debate, where elements of the UK culture of team play, broad thinking, adversarial and nuanced points of view come out well. They understand the differences between "dissent" and "disloyalty" and try to avoid group thinking.[213]

Cadbury gives the following description of a board:[214]
"In a unitary board, strategies, plans and policies are developed over time, through debate and argument, within the board and between the board and senior management. This method of hammering out decisions through a dialogue, between those who form policy and those who put it into effect, is one of the strengths of the unitary approach."

Rushton suggests the following:
"Exemplary board … robust, social grouping … which is capable of challenging one another's conclusions through open communications in an atmosphere of respect, trust and candour."[215]

The board's overriding responsibility is to develop the company, which is more about tough-minded discussion between executives and NEDs in an atmosphere of trust than it is about

[211] Dunne (2005), pp. 43 and 48.

[212] Dunne (2005), p. 34.

[213] Rushton in Rushton (2008), p. 46.

[214] Cadbury (2002), p. 134.

[215] Rushton in Rushton (2008), p. 45.

spinning endless webs of process around the executive directors on the assumption that evil will otherwise triumph.[216]

(v) ***What is the influence of a NED?***
The examples given on p. 66 above in Cadbury-Schweppes, the bank in the ideal situation and David Jackson's examples at PowerGen and BP show that NEDs can have influence.

The example of Nat West (see the history of banks above) shows that, in practice, a majority of NEDs can override the chair and the CEO.

The Walker Review shows that banks and other financial institutions (BOFIs) with challenging NEDs have weathered the crisis better.[217]

(vi) ***Can a NED have influence if he is an outsider?***
The example mentioned above in relation to the Cadbury-Schweppes strategy in 1988, where the politician dared to ask why the group retained a division that was underperforming, makes clear that common sense can win the day.

The board of a BOFI needs to have a majority of NEDs with financial experience, but diverse skills and a wealth of experience from elsewhere are also required, implying that outsiders are essential as well.[218]

(vii) ***Can a NED remain a critical monitor once the board has decided on a strategic route? (This is the main question raised by proponents of a two-tier board)***
Yes, the UK view is that a NED who has helped to decide on a strategic route can continue to adopt a critical stance. Higgs concluded, after 40 in-depth interviews, that there is no contradiction between a NED's monitoring and strategic roles.[219] Walker foresees that a risk committee consisting mainly of NEDs could do due diligence for an acquisition after the board has decided to take steps to acquire a target. The result of the due

[216] Dunne (2005), p. 34.

[217] Walker Review, nos. 2.12 and 2.13.

[218] Walker Review, nos. 3.13 and 3.15.

[219] Higgs Review, paras. 6.1-6.2.

diligence may be that the acquisition is not pursued.[220] The Walker Review in discussing the alternatives of the one- and two-tier systems, concludes that one-tier boards have the advantage of timely information for NEDs and value adding interaction with NEDs.[221]

2.5.6 Banks

As in other countries special attention has since the credit crisis been given in the UK to corporate governance at banks. The themes of the consultation document of the Walker Review of 17 July 2009, were repeated in the executive summary of the Walker Review.[222] It stresses board behaviour, i.e. the need for an environment in which effective challenge of the executive by NEDs takes place in board meetings before decisions are taken on major risk and strategic issues. It also emphasizes time commitment of NEDs, as well as financial industry experience and independence of mind of NEDs.

Some specific items in the Walker Review are:

– banks and other financial institutions (BOFIs) on both sides of the Atlantic with long entrenched imperial CEOs and little NED input have fared materially worse than those with challenging NEDs. The NED contribution was materially helpful in BOFIs that have weathered the crisis better than others;[223] BOFIs where CEOs later became chairmen also fared well;[224]

– the majority of NEDs and the chairman should have financial experience;[225]

– the chairman of a BOFI should be submitted to re-election on an annual basis;[226]

[220] Walker Review, executive summary and nos. 6.30 and 6.31 and recommendation 26.

[221] Walker Review, p. 33.

[222] Walker Review, pp. 9-10.

[223] Walker Review, nos. 2.12 and 2.13; see also two research papers by Nestor Advisors: (i) Governance in Crisis, a comparative case study of 6 US investment banks; those that weathered the crisis best – Goldman Sachs and JP Morgan – had CEOs with shorter terms and more knowledgeable NEDs; (ii) a study of 20 European banks which came to the same conclusions, see www.nestoradvisors.com.

[224] Walker Review, no. 309.

[225] Walker Review, nos. 3.13 and 4.20 and recommendation 8.

– each BOFI should have a chief risk officer (CRO) and a risk committee which has a majority of NEDs; the risk committee should carry out special due diligence investigations in the case of large acquisitions;[227]

– the greater the prospective risk appetite of a BOFI board, the greater will be the need for financial industry expertise among NEDs on the board; however, although the board should have a majority of NEDs with financial experience, these boards will also require some NEDs with other skills;[228]

– there will have to be a greater time commitment on the part of NEDs (up to 35 days a year)[229] and the chairman of a major BOFI (two-thirds of his time).[230]

2.5.7 Roles of chairman

Here , I would like to quote the Walker Review:
"In all this, the role of the chairman is paramount, calling for both exceptional board leadership skills and ability to get confidently and competently to grips with major strategic issues."[231]

In describing the paramount role of the chairman I will discuss the following matters below: why have a separate chairman?; his general role in leadership of the board; agenda setting and promotion of the contribution by NEDs; providing good governance, information for the board, proper evaluation; orderly succession; good relationship with the CEO; guarding reputation of the company and good representation; communication with shareholders; providing for a senior independent director (SID) and a job description of the chairman; appointment and limited period.

[226] Walker Review, recommendation 10, this idea is criticised on the ground that it would promote short termsism; this is already a compromise because the one-year only rule applies to the chairman.

[227] Walker Review, recommendations 23, 24 and 26 and nos. 6.1 to 6.37.

[228] Walker Review, nos. 3.7-3.15.

[229] Walker Review, recommendation 3.

[230] Walker Review, recommendation 7.

[231] Walker Review, p. 6.

(i) ***Why have a separate chairman?***

The basic reason for having a chairman separate from the CEO is to provide balance on the board and offset the "imperial CEO". Sir Adrian Cadbury, who gained experience of both positions over a period of many years, started the discussion and gives five good reasons for having a separate chairman:[232]

I different mixes of ability and experience are required;
II the chairman must build the board team which takes time and commitment;
III putting two functions together concentrates a great deal of power in one person;
IV the combination (of CEO and chairman in one person) makes it more difficult for the board to carry out its supervisory function (see also Rushton);[233]
V sharing out the ever-growing workload (see also Rushton[234]) created by governance and shareholder contact issues.

(ii) ***General role of chairman: leadership of the board***

As mentioned earlier, the role of the chairman is not described in the Companies Act 2006. Before 1990 half of the CEOs combined the position of CEO with that of chairman. The Cadbury Code and subsequent codes as well as institutional investors have pushed for the separation of the roles and for the positions to be held by two different people. Now nearly all larger listed companies in the UK have separated these roles.

The chairman must fulfil the criteria of independence – inter alia not having been employee or CEO of the company – at the moment he is appointed, though he loses his independence as he becomes closer to the company every day. He is, on average, at the company about two days a week and has an office there. He works closely together with the CEO, the CFO, the company secretary and the deputy chairman or SID and with the other independent directors. He is not an executive director and also not an independent non-executive director. His function is to

[232] Cadbury (2002), p. 108.

[233] Rushton in Rushton (2008), p. 29. In the US Ira Millstein says a CEO/chairman is conflicted in the supervisory role.

[234] Rushton in Rushton (2008), pp. 29 and 31.

develop and maintain the board as an optimal team and to ensure that all aspects of corporate governance are performed as well as possible. These include communication within the board, timely information, induction or introduction programme, orderly succession of board members for a well balanced board, good meetings with time for discussion on strategy, and consistent communication with shareholders, analysts, financial institutions and the media. His role is complementary to that of the CEO, who runs the business.

The Higgs Review[235] describes the roles of the chairman summarized as follows:
"The role of the chairman is that he leads the board, sets the agenda, provides timely information to directors and arranges for induction,[236] ensures the provision of effective information to shareholders, arranges evaluation, facilitates effective contribution to board tasks by non-executive directors and ensures constructive relations between executive and non-executive directors and monitors an orderly succession of board members."

(iii) ***Agenda setting and the promotion of contributions by NEDs***
By setting the agenda and sitting at the head of the table the chairman leads and runs the board. In practice, the chairman will often set the agenda with the company secretary. He should delegate legal and compliance issues to the company secretary and the chairman should focus himself as much as possible on strategy.[237]

The main job of the chairman is to ensure that the board operates as an effective team.[238] The meetings should have a good debate

[235] Higgs Review, p. 23, these elements are copied into CC6 A.2, Supporting Principle and with some changes in CG10 A.3.

[236] Rushton in Rushton (2008), p. 41.

[237] Dunne (2005), p. 34, Cadbury (2002), p. 83.

[238] Rushton in Rushton (2008), p. 44.
Cadbury (2002), p. 52, Chairman … to build … an effective team
p. 80, … arriving … at better conclusions … than would have been possible without that debate.
p. 87, Openness and equality between board members are essential to a thorough debate and chairmen have to work on persistently for their achievement…. The challenge for chairmen is to draw on the differences between viewpoints of their executive directors and outside directors, while maintaining their unity as a

and draw out the differences in the opinions of its members, while maintaining their unity as a team. Chairmen should listen first. A telling example (see above in the history of banks) is that of Lord Alexander, chairman of Nat West, who listened to his NEDs, even when the majority disagreed with him.[239] Lord Alexander was not in favour of being in the investment banking business, while the majority of the NEDs were in favour. They prevailed in the meeting. However, it later turned out that they did not succeed in pursuing that course, because their shareholders did not really support the idea and because Warburg's management preferred to join UBS. Later Nat West was taken over by the smaller RBS.

Sometimes it may seem that the chairman has become too powerful which creates a distance between himself and the NEDs. Can the NEDs keep up with the chairman? This risk occurs when the relationship between CEO and chairman becomes too close.[240] The International Underwriting Association of London Limited has commented that if a chairman spends too much time at the company he could become too dominant.[241] If the chairman focuses on creating a good team and follows Sir Adrian Cadbury's advice to reach agreement through debate and argument, these risks will not occur and he will run the board properly. The chairman orchestrates, he does not talk too much, but gives others freedom to speak.[242] The chairman should regularly check informally, possibly over dinner, whether there is any unease or discontent among board members.[243]

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board team.

p. 90, Chairmen must be prepared to accept that in an open debate their conviction may be doubted. Chairmen should at least listen first.

p. 99, Chairmen who can lead their boards, rather than driving them, to arrive at balanced judgments will have earned the respect of their colleagues. A sense of humour is in order.

[239] Augur (2001), pp. 180-181 and 269 and p. 37 of this study.

[240] Walker Review, no. 4.16.

[241] Walker Review, p. 57 (box).

[242] Cadbury (2002), p. 241 and "complete freedom to speak under a reasonably independent chairman is a precious asset", Cadbury (2002), p. 88.

[243] Rushton in Rushton (2008), p. 41.

(iv) ***Provide good governance, timely information to the board and good evaluation***

The chairman should make sure that good standards of corporate governance are met,[244] seeking the support of the company secretary.[245] They must ensure that there are good induction programmes[246] and that good and timely information is provided to the NEDs.[247] The chairman should also ensure that the NEDs evaluate themselves and the executives each year.[248] The SID arranges for separate meetings of NEDs to evaluate the chairman.

(v) ***Orderly succession***

Succession is an important task of the board. The chairman should lead this process and, in most cases, chair the nomination committee.[249]

(vi) ***Relationship with the CEO***

The volume of work for those who head a company is growing all the time. There is more than enough work for two at the top of a public company.[250] The natural split is for the chairman to be in charge of the board and the way it functions and for the CEO to be responsible for in fact running the company. It is vital that they see their jobs as complementary and not as competing.[251] There is a need for a well defined division of labour, trust and avoidance of competition.[252] The chairman should meet the CEO once a week. An important aspect of the role of the chairman is to support the CEO. He should be happy with the CEO's success. He should be the CEO's sounding board.

However, their relationship is part of a network of relationships between board members and senior executives and should not be

[244] Rushton in Rushton (2008), p. 32.

[245] Rushton in Rushton (2008), p. 33.

[246] Rushton in Rushton (2008), p. 41.

[247] CC8 A.2 and CG10 B.5, Supporting Principle and p. 40; Cadbury (2002), p. 85.

[248] Rushton in Rushton (2008), p. 47, see also 2.4.12 above.

[249] CC8 A.4.2 and CG10 B.2.1; Cadbury (2002), p. 96.

[250] Cadbury (2002), p. 121.

[251] Cadbury (2002), p. 117.

[252] Cadbury (2002), p. 117.

to the detriment of those other links. Their thoughts need to be openly shared with the other directors.[253]
In my view it is very important that the CEO and chairman share their thinking, including their dilemmas, with the other directors and not cover up any of their dilemmas or those of the other directors.

(vii) ***Guarding reputation of the company, representation***
While the CEO runs the company and represents the company externally, the chairman is also accountable for everything concerning the company.[254]

Chairmen usually prefer to keep a low public profile and leave their CEO in the spotlight. The focus has tended to shift from chairman to CEO.[255] In times of crisis the chairman is likely to be a key player and the eyes are often on him. In practice the chairman should not be too visible at the start of external problems, such as Union Carbide's Bhopal drama or ICI's explosion at a factory in Peterborough.[256]

In the matter of BP's disaster in the Gulf of Mexico in 2010, the CEO was the face of the company and his US successor is as well. In one instance – the negotiations with President Obama about an escrow account – the chairman of BP played an important role. It proved useful to have a second head.

However, if there is an internal board crisis or a lack of trust in a director, the chairman should play an active role. BP had many separate sessions of NEDs. If there is lack of trust in the chairman or a dispute between the chairman and the CEO, the SID should be active and visible.[257]

(viii) ***Communication with shareholders***
The communication with shareholders is important and the chairman has an important role in this area.[258]

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[253] Cadbury (2002), p. 121; Walker Review, no. 4.16.

[254] Cadbury (2002), p. 117.

[255] Rushton in Rushton (2008), p. 35; Cadbury (2002), p. 136.

[256] Rushton in Rushton (2008), p. 35.

[257] Rushton in Rushton (2008), p. 35.

[258] CC8 A.2, Supporting Principle and CG10 E.1, Supporting Principle and E.1.1.

The annual report always contains a chairman's page, which tends to be the most read page in the UK[259] because it describes the long-term strategy.

At the AGM, UK chairmen endeavour to answer questions of shareholders themselves. They make every effort to be well prepared. Sometimes they have to confer with a specialist board member or arrange for the shareholders to approach the specialist board member after the meeting.

Shareholders often write letters to the chairman marked "for the chairman's personal attention only". A good chairman is interested in all letters from shareholders and either deals with them personally or arranges for them to be answered by the person who knows most about the topic.

Outside financial analysts have started to wield considerable power. Whenever the annual or bi-annual results are published CEOs, CFOs and chairmen in the UK now meet first with the analysts and immediately thereafter with the press.[260]

CEOs, CFOs and chairmen meet and have contacts with larger institutional investors. The Combined Code and UK Corporate Governance Code set out the principle on which relations with institutional investors should be based: "There should be a dialogue with shareholders based on the mutual understanding of objectives. The board as a whole has responsibility for ensuring that a satisfactory dialogue with shareholders takes place."[261] The chairman should maintain sufficient contact with major shareholders to understand their issues and concerns[262] and he should communicate these to the whole board. He should discuss governance and strategy with major shareholders. Other NEDs should be offered the opportunity to attend some of these meetings. The SID should attend as much as possible.[263]

[259] Cadbury (2002), p. 138.

[260] Cadbury (2002), pp. 143-147.

[261] CC8 D.1 and CG10 E.1, Main Principle.

[262] CC8 D.1, Supporting Principle and CG10 E.1.1.

[263] CC8 D.1.1 and CG10 E.1.1.

Therefore, the chairman has the role of listening to and sounding out major shareholders and passing their views on to the board.

In my view the Dutch would do well to follow the British example of listening quietly, without reacting, even by body language. On the other hand it may not go well with the Dutch practice to have a chairman discuss strategy with shareholders. Here the Dutch are closer to the US, where a chairman does not discuss strategy with shareholders.

It should be understood that many of these contacts with major shareholders are "one-on-ones" or "one-on-tens" (with a group of shareholders) and that there is the caveat that they are selective. The warning is that these meetings are usually over lunch. "These meetings came perilously close to passing price-sensitive information to selected investors."[264] There are, however, two safeguards that make it less dangerous in practice. First, high level executives of the investors are more interested in longer term issues of strategy and board competence than price-sensitive short-term points. Second, they are normally willing to be included into the category of "insiders", i.e. confirm that they will not trade or tip as long as the information is not known to all. For example, Hermes, the large UK pension fund often chooses this approach of a lock-up in accordance with the "Code of conduct in support of companies". The FSA has also issued helpful disclosure rules.[265]

This contact with major institutional shareholders is very important in the UK. A few years ago this was relatively easy as these major UK shareholders often jointly had a majority. Now, however, there are more foreign institutional investors and hedge funds. Contact with them is less easy. This is discussed further at 2.5.10 below.

The chairman should ensure that all these communications are consistent.[266]

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[264] Cadbury (2002), p. 147.

[265] Cadbury (2002), p. 148.

[266] Rushton in Rushton (2008), p. 40; Cadbury (2002), p. 134.

(ix) ***SID***

The senior independent director has the following roles to:

– lead the meetings of NEDs, when they meet separately from time to time;
– lead the meetings of NEDs to evaluate the chairman;[267]
– take the lead if there is a crisis involving the chairman, e.g. if there is a dispute or mistrust between shareholders and the chairman, or a dispute between the CEO and the chairman;
– listen to the views of shareholders and to understand their issues and concerns.[268]

(x) ***Job description of the chairman***

Although NEDs always have detailed 3 or 4-page contracts, it sometimes happens that a chairman does not have a job description.[269] Nonetheless, it is very important for the chairman and the CEO to divide their responsibilities clearly.[270]

(xi) ***Appointment***

The board appoints the Chairman upon the nomination by the nominations committee. The SID will play a role in this process, also of sounding out shareholders. It is advisable to appoint one, preferably two potential candidates for the position of chairman in advance on the board as NED, to find out how the candidate can get along with all board members.[271] Upon appointment he should meet the independence criteria.[272] See also sub-section 2.5.9 hereunder on succession.

(xii) ***Limited period***

There is a tendency to keep the period of tenure to a limited period of 6 years.[273] The Walker Review proposes that chairmen should be up for re-election each year.[274]

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[267] CC8 A.6.1 and CG10 B.6.3.

[268] CC8 D.1.1 and CG10 E.1.1.

[269] Rushton in Rushton (2008), p. 34.

[270] Cadbury (2002), p. 117.

[271] Cadbury (2002), p. 118.

[272] CG10 A.3.1.

[273] CG10 B.2.3.

[274] Walker Review, recommendation 10 and nos. 4.23 to 4.26.

2.5.8 Getting the best out of NEDs

After the separation of the functions of the CEO and the chairman, the second next most far-reaching development in the UK during the last 15 years has been the enhancement of the role of the Non-Executive Directors (NEDs), as a result of the various codes and the pressure of institutional investors.

The role of NEDs has been enhanced in many ways:

- they are now involved in developing strategy (see 2.5.5 above) in addition to their monitoring role;
- they have a small majority on the board (balance);
- there is a formalised nomination process to ensure a varied board;
- they are elected for fixed terms;
- they are helpfully induced into the board, receive continued education and timely information;
- they are involved in committee work.

The following sub-paragraph discusses what can be done to make NEDs function optimally.

The role of a NED is complex and demanding

"How complex and demanding the role is today is aptly portrayed by this job advertisement

> Experienced professional required for demanding role in small but influential team. Although the role is part time (up to 18 days, in some cases 30 days, a year) there is scope to make a significant contribution to a multi-million pound operation. Commensurate with this, the successful candidate will need to be fully versed in stakeholder issues and may be required to fall on his or her sword as appropriate.
>
> To be successful, the candidate must have an extensive working knowledge of corporate finance, business planning, financial analysis, auditing, regulation and compliance, human resources, remuneration policy, organizational theory and change management.
>
> On a personal level, he or she will be an experienced diplomat, negotiator, lateral thinker, communicator, trouble shooter, and will have the drive and energy to ensure successful outcomes."[275]

[275] Steele in Rushton (2008), pp. 50-52.

Involved in the business, especially at BOFIs
It is clear that NEDs have to have an understanding of the company's operating environment, e.g. technological change, legal and regulatory developments; the dynamics of the industry; competitors; and customers.

Challenging the executives means getting them to distinguish between prejudice and fact. There is the temptation, especially where executives have worked together over an extended time, for management to lapse into not readily noticeable underperformance. Challenge by NEDs can prevent such slack. For BOFIs, Walker recommends a majority of NEDs with financial experience.[276]

Interpersonal
NEDs need to have strong interpersonal qualities (people's skills). The Higgs Review sums it up as follows: "The key to NED effectiveness lies as much in behaviour and relationships as in structure and process."[277] The Higgs Review adds that consultation responses have identified personal attributes as integrity and high ethical standards, sound judgment, the ability to challenge and probe and strong interpersonal skills.[278] Summarizing, the personal skills of effective NEDs, they should question intelligently, debate constructively, challenge rigorously, and decide dispassionately. NEDs need to make effective contributions which enable them to gain the trust of the executives.[279] Sir Adrian Cadbury has quoted Geoffrey Mills and Angus Murray as follows: "A good non-executive director needs to have intellect, integrity and courage. Of these qualities, courage is the most important, for without it, the other two characteristics are useless."[280]

NEDs must have many qualities and they face at least three dilemmas:[281]

i. they should combine full engagement and involvement in the company on the one hand, and a wise way of mentoring in a remote, non-authoritarian manner on the other;
ii. NEDs should challenge and ask intelligent questions, but should always motivate positively; and

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[276] Walker Review, nos. 3.13 and 3.15.

[277] Higgs Review, para. 6.3, p. 27.

[278] Higgs Review, para. 6.12, p. 27.

[279] Steele in Rushton (2008), p. 55.

[280] Cadbury (2002), p. 57.

[281] Steele in Rushton (2008), pp. 56-57.

iii. NEDs should remain independent and at a distance in order to see things differently, but should at the same time be very involved.

Independence
NEDs must be independent, which is described in sub-section 2.4.7 above.[282]

Time commitment
After the Higgs Review the time involvement for NEDs increased by about 20% between 2003 and 2006. The time commitment for a typical NED can be estimated as two days a month, broken down into one meeting a month plus one day's preparation. Chairmanship or membership of board committees or attending strategy development sessions would be additional.

Research has shown that an executive director in one company becomes ineffective as a NED in another company, in case he has more than two NED appointments in other companies. The general rule of thumb is that if you are a person who makes it a full-time job to be NED, then five appointments are "doable". However, this is based on the assumption that the companies are all performing satisfactorily. If one or more of the companies gets into difficulties, management of the NEDs personal diary becomes an issue. Numerous directors in this situation suddenly find the need to cancel their holidays. There are significant pitfalls if you do not devote sufficient time to the role of a NED. As soon as there are difficulties, even five directorships are too much.

This diagram makes clear the time spent.[283]

[282] CC8 A.3.1 and CG10 B.1.1. See 2.4.7 above.

[283] Steele in Rushton (2008), p. 58.
This diagram is from Independent Remuneration Solutions (IRS), a 2006 survey. Because each NED normally only sits on one committee brackets have been put around the second and third committees. It does mention preparation for Formal meetings, so add 5.

Number of days spent by NEDs:

Formal meetings	Small company	Large company
– Board	9	9
– Strategy	1	3
– Audit Committee	1	4
– Remuneration Committee	(1)	(4)
– Nomination Committee	(1)	(4)
– Other	1	2
Preparation Committees	3	5
Visits on site	1	4
Total	16	27

Since 2006 time spent on all aspects has been increasing. Walker recommends 30 to 36 days for NEDs of BOFIs.[284]

Remuneration

Is it worth being a NED? In the UK the simple answer is that in purely financial terms it is almost certainly not worth it.

A NED would receive between £ 10,000 and £ 40,000 p.a. in a small quoted company and £ 50,000 to £ 100,000 in a large quoted company. These amounts are higher than those received by Dutch supervisory directors and lower than those of their US counterparts. For chairmen the figures are about five times as high.[285] In the UK the NED, unlike US independent directors, do not receive options on shares in the company or performance-related elements.[286] They may buy shares.

Information, early and on site

An important element of an outside director’s work involves contact with lower management. This starts during the period of due diligence before accepting the appointment and, after acceptance, then continues during induction and subsequently while on the job. An outside director should be curious and wish to meet with lower management and see factories. The opportunities are easily available in a one-tier system, less so from the position of a supervisory board member in a two-tier system, where such contacts should be arranged through the chairman.[287] The chairman,

[284] Walker Review, recommendation 3.

[285] Steele in Rushton (2008), p. 59 and Chambers (2008), p. 63.

[286] CG10 D.1.3.

[287] Rushton in Rushton (2008), p. 41.

with help of the company secretary, has responsibility for arranging for proper due diligence, induction, professional advice and information.[288] These aspects, especially induction and visits to factories, are often mentioned in the annual reports of the company.

The senior independent director (SID)

The role of the SID was first proposed in the Hampel Report in 1998 and its value was reiterated in the Higgs Review of 2003 to the extent that it is now enshrined in the Combined Code.[289] Prior to the Hampel Report, there had been a number of situations where a dispute in the board led to one of the NEDs taking the initiative in resolving the conflict.

In simple terms, the role of the SID is to act as an alternative to the chairman, particularly where there is a possibility of the chairman's thinking being unduly influenced by the executive directors, thus potentially compromising the effective working of the board. The SID should be available to shareholders, when these are concerned that they cannot resolve issues with the chairman or chief executive through normal channels of contact. Additionally, the SID should chair meetings of non-executive directors when the chairman does not attend. Shareholders may also wish to voice their unhappiness about the chairman. In such cases the SID should listen and possibly act and when necessary chair the Nominations Committee.[290] It is ideal to have a SID, who does not have the ambition to be chairman.

NEDs and board committees

Membership of the principal board committees – nomination, remuneration and audit – involves a significant time commitment for NEDs. Nearly all quoted companies have these committees. Similarly, private companies, especially those which are backed by private equity or venture capital, are introducing audit and remuneration committees.[291]

Scrutiny by both remuneration and audit committees has increased in recent years: by remuneration committees because of the media's fixation with the "fat cat" syndrome and by audit committees because of their

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[288] CC8 A.5, Main Principle and Supporting Principle and A.5.3 and CG10 B.5, Main Principle and Supporting Principle and B.5.2.

[289] CC8 A.6.1 and D.1.1 and CG10 B.6.3 and E.1.1.

[290] Steele in Rushton (2008), pp. 41 and 60.

[291] Steele in Rushton (2008), p. 60.

responsibility for the accuracy of the company's annual report and accounts.

The Smith Report on Audit Committees, which was released at the same time as the Higgs Review, states that the audit committee should consist of at least three independent NEDs, one of whom should have significant, recent and relevant financial experience. The Smith Report has greatly increased responsibility for checking published accounts. These requirements, together with the greater scrutiny introduced by Sarbanes-Oxley in the US, have affected the willingness of UK NEDs to serve on audit committees. In the Ernst & Young Corporate Governance Survey published in January 2005, two-thirds of NEDs stated that they were less likely to accept the position of chairman of the audit committee than twelve months earlier.

Board evaluation

Another relatively recent issue facing NEDs is that of board evaluation. The Higgs Review recommended that board evaluation should be introduced and it was included in the Combined Code. The principles are listed below:

– The board should undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors.[292]
– Individual evaluation should aim to show whether each director continues to contribute effectively and to demonstrate commitment to his role (including commitment of time for board and committee meetings and any other duties). The chairman should act on the results of the performance evaluation by recognizing the strengths and addressing the weaknesses of the board and, propose that, where appropriate, new members be appointed to the board or that malfunctioning directors resign.[293]
– The chairman should meet with the NEDs without the executive directors being present (it is not stipulated how often) and once a year the NEDs should meet without the chairman to appraise the latter's performance.[294]

[292] CC8 A.6, Main Principle and CG10 B.6, Main Principle.

[293] CC8 A.6, Supporting Principle and CG10 B.6, Supporting Principle.

[294] CG10 A.4.2.

Apart from this, the full board should evaluate the board as a whole.[295]

– The board should state in the annual report how performance evaluation of the board, its committees and its individual directors has been conducted. The NEDs, led by the senior independent director, should be responsible for performance evaluation of the chairman, taking into account the views of executive directors.[296]

Board evaluation is starting to make an impact. An experienced chairman commented that he was now seeing very few "duds" in boardrooms, and he considered that NEDs were much more professional than they were five years earlier.[297]

Training for NEDs
NED training is an interesting but sensitive issue. The Higgs Review made two statements on NED training. First, "There should be a step change in training and development provision for board members." As a result of this observation, there was an initial rush of supply of new training providers. In 2006 very few remained. Despite the encouragement of Higgs, there has not been a step for change in demand by NEDs for training. Research led to the conclusion that "62 percent of NEDs in listed companies have never received any training for their role."[298]

Diversity
Over the past few years the issue of diversity on boards has been debated extensively. The Higgs Review highlighted the lack of diversity and its research concluded that previous board experience is often seen to be the main, and sometimes only, competence demanded of potential NED candidates. Walker has raised the point of diversity again.[299]

Rigorous procedures for appointments and succession
The appointment system is to be formalised. The importance of orderly succession is described below in 2.5.9.

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[295] Rushton in Rushton (2008), p. 47.

[296] CC8 A.6.1 and CG10 B.6.3.

[297] Steele in Rushton (2008), p. 62.

[298] Steele in Rushton (2008), p. 62.

[299] Steele in Rushton (2008), p. 62; Walker Review, no. 3.6.

Regular selection

All directors should be submitted for re-election at regular intervals, subject to continued satisfactory performance. The board should ensure planned and progressive refreshing of the board.[300] This provision emphasizes the power of shareholders and the importance of succession.

Under the CC of 2008 NEDs are to be re-elected after the first 12 months and then again after 3 years. The CG 2010 for FTSE 300, however, demands re-election each year. This is important to avoid acceptance of underperformance and lingering bad relations, is the argument. Now the Walker Review has recommended re-election of the chairman every 12 months.[301] The counter-argument is that this creates short-termism as has been mentioned by the UK's biggest investment funds.

Generally, the thinking is that NEDs, if re-elected several times, should not serve more than nine years. In any case they will cease to be regarded as independent after nine years.[302] Any term beyond six years for a NED should be subject to rigorous review and should take into account the need for progressive refreshing of the board.[303]

All directors are elected by shareholders, who have the power to remove them in an AGM,[304] but in practice a formal dismissal is rare. Because the shareholders do have the built in right to dismiss, shareholders can exert real pressure to get rid of a director. In the US there is no prospect of companies being made effectively accountable to their owners, because shareholders lack the ultimate weapon of being able to dismiss boards. As a result, when crisis strikes, there is no option in the US but to resort to huge pressure by shareholder activists as in the case of General Motors (GM) in 1993 and now happens quite often. Shareholders of Apple, for example, have put tough demands on succession.[305]

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[300] CC8 A.7; the wording of CG10 B.7 of the first sentence is the same. The second sentence is worked out in article B.7.1: annual re-election for FTSE 300 directors and three years for all other directors. The Financial Reporting Council (FRC) has made the annual re-election a comply or explain obligation. On 18 July 2010 three of UK's biggest pension funds – Hermes Equity Ownership Services, Railpen Investments and Universities Superannuation Scheme – wrote to object against annual re-election, because it would promote short termism.

[301] Walker Review, recommendation 10 and nos. 4.23 to 4.26, which give all the arguments for and against.

[302] CC8 A.1.3.

[303] CG10 B.2.3.

[304] Charkham (2005), p. 311.

[305] *Financial Times*, 23 December 2010, p. 14 and 23 February 2011, p. 15

Appointment letters
In the UK NEDs receive and sign 3 or 4-page appointment letters. This shows that serious thought is given to the appointment of NEDs in Britain.[306] This example should be followed in other countries.

2.5.9 Succession; formal; board as a whole

Having good board members is essential. Having the board work as a team is vital. Succession planning, orderly nomination and proper dismissal are important strategic tasks of the board.

Main Principle A.4 of the Combined Code of 2008 and B.2 of the UK Corporate Governance Code 2010 state that there should be a formal, rigorous and transparent procedure for the appointment of new directors. Six code provisions follow. This reflects the findings of the Higgs Review, which considered that the procedure was much too informal and often involved solo actions by the CEO or chairman. The whole board

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[306] The points covered are:

- background to appointment (recent events, strategy point, specific knowledge, replacement of retired NED);
- formality (date of starting + term);
- basis for independent role
  - bring independent and broad view
  - be involved in creation of robust strategy
  - review and monitor detailed plans and budgets needed to make it work

  also
  - long description (of tasks);
- chairman's role (if chair)

  (– leader of board
  - composition of board and committees
  - communication with stakeholders and shareholders);
- induction (how to gain familiarity with the enterprises);
- time commitment (two days a month, including one meeting per month, one away day's meeting per year, customer exhibition, Christmas party);
- information flow (company will provide monthly management accounts, board papers);
- other appointments (company expects you to discuss these regularly with the chair);
- committee (appointment on ….. committee);
- meeting with auditors;
- intended term (3 years subject to annual review; no compensation for loss of office);
- review process (you and chair each year);
- fees, insurance and independent advice.

should be involved after the important preparatory work by the nominations committee. A majority of the members should be non-executives. The chairman should chair the nomination committee,[307] except in case the nomination or dismissal of his own position is under consideration. This is why there should be a senior independent director (SID).[308]

"Succession is a sensitive matter and should not be left to conversations in the corridor. It should be on the agenda of the nominating committee at least each half year. At least then the discussion takes place."[309] Dunne states that a change of board members can create disharmony, because it is a deeply personal thing and touches ambitions.[310] Therefore, the more planning the better. The committee should report regularly to the complete board on the matter."[311]

The complete board should nominate all members of the board. The complete board should also nominate the chairman and the CEO. This recommendation is important in improving board effectiveness. It moved the appointment of NEDs away from the patronage of chairmen and the club-like approach to board membership. If a director feels he owes his position to the chairman, he loses a degree of independence. By involving the board as a whole, all directors share the responsibility of choosing their colleagues. Formal process means searching for those who will add value to the board team or fill gaps in it."[312]

Selecting a chairman requires forward planning. Preferably the chairman should be chosen from the existing NEDs, because if a chairman is selected from outside he will not know the business and may have difficulty in forming a tandem with the CEO, i.e. in being able to counterbalance the CEO. It will also be easier to decide whether the CEO and the potential chair will get along well. Good planning is to identify two NEDs as possible chairman to be prepared for any eventuality.[313]

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[307] Cadbury (2002), p. 96; and Dunne (2005), p. 95.

[308] CC8 A.3.3 and CG10 B.2.1.

[309] Cadbury (2002), p. 96.

[310] Dunne (2005), pp. 95-98.

[311] Cadbury (2002), p. 99.

[312] Citation of a letter from Adrian Cadbury to me of 25 May 2010.

[313] Cadbury (2002), pp. 118 and 176.

The first step to remove a chairman can come either from within (i.e. from board members) or from without (i.e. from shareholders). In both cases the senior independent director should be approached and should then discuss the issue with the other board members.[314] Private pressure is likely to lead to a better outcome than public clamour.[315] An example is the decision of the Standard Chartered Bank Board, chaired by Sir Patrick Gillam, to replace their CEO Rana Talwar. A newspaper reported:

> "While Talwar sipped a cocktail, the Bank's NEDs met at Standard Chartered's head office to decide whether Gillam or Talwar should go. Gillam told them he wanted Talwar out, but then left them (the NEDs) to conduct their own meeting. After 90 heated minutes the decision to axe Talwar was made. On Wednesday Talwar heard the news from Cob Stenharn, a leading NED, and Lord Stewartby, the deputy chairman."[316]

The central responsibility of NEDs is not sitting on audit committees or acting as monitors, it is taking the necessary decisions to ensure that leadership of their company is in the right hands.[317]

The succession of the CEO and other executives is important as well. Companies should have training and succession plans. It is a good thing if the CEO rises from within. If the nomination committee is to have influence there, it should know a good number of senior managers. For this reason it is advisable for senior managers to regularly attend board meetings and make presentations there and for NEDs to visit subsidiaries.

Institutional investors deem succession important. Hermes, a large UK investment fund that buy about 1% of the shares in large listed companies and seeks to have regular dialogue with the companies, says that in one-on-ones with the board they discuss one-third strategy, one-third remuneration and one-third succession.[318]

I believe that formalities and regular formal discussions in the nominations committee about succession are a good way to avoid CEOs

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[314] Cadbury (2002), p. 181.

[315] Cadbury (2002), p. 182.

[316] Cadbury (2002), p. 184.

[317] Cadbury (2002), p. 194.

[318] I was told this by a Hermes representative.

and the chairmen to have too much influence on succession. It is a good example for other countries to be formal about the forward planning on nominations. For the Netherlands I propose that boards discuss annually how they will internally deal with succession.

2.5.10 Role of shareholders: single out long-term shareholders interested in stewardship

As mentioned at the end of sub-section 2.2.4 above there are many influential voting associations in the UK that promote ideas about better shareholdership. They include the Institutional Shareholders' Committee (ISC), the Association of British Insurers (ABI), the National Association of Pension Funds (NAPF), the Institutional Voting Information Service (IVIS), Research Recommendation Electronic Voting (RREV), the Investment Management Association (IMA) and the Association of Investment Companies (AIC).

Then there are not-for-profit institutions that do research in the area of corporate governance, such as Tomorrow's Company under the leadership of Mark Goyder, which has published some very interesting reports and recommendations. One of them is entitled *Tomorrow's Owners*,[319] which reveals that the average shareholding is now shorter than before and that some new categories of shareholder are playing an increasing role, such as hedge funds and sovereign wealth funds as well as private equity. The report also underlines that these new types of shareholders are outweighed by a factor of ten by the world's pension funds, mutual funds and insurance funds.

In 2007 the split of the world wide investments was as follows:
- private equity US $0.8 trillion;
- hedge funds US $2.3 trillion;
- sovereign wealth funds US $3.3 trillion;
- insurance funds US $20 trillion
- mutual funds US $26 trillion;
- pension funds US $28 trillion.

The report continues by providing an overview of all categories of shareholders according to the degree of their "active long-term interest" or "stewardship" in the following order:

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[319] Goyder (2008/B).

<table>
<tr><td>–</td><td>founders</td><td></td><td>high</td></tr>
<tr><td>–</td><td>families/trusts/foundations</td><td>|</td><td></td></tr>
<tr><td>–</td><td>employees</td><td>|</td><td></td></tr>
<tr><td>–</td><td>engaged shareholders</td><td>|</td><td>degree of</td></tr>
<tr><td>–</td><td>unengaged shareholders</td><td>|</td><td>stewardship</td></tr>
<tr><td>–</td><td>traders</td><td>|</td><td></td></tr>
<tr><td>–</td><td>speculator</td><td></td><td>low</td></tr>
</table>

The report emphasizes that it is not useful to demonise the lower categories. They belong to what it terms the “casino economy”, which is useful and necessary for a stock exchange with good trading volume. The higher categories, together with the enterprises, belong to the “real economy”. The report argues that these differences in shareholdership should be accepted and that they are a strong argument for one-on-ones dialogue with shareholders interested in “stewardship”. This is also reflected in the UK Corporate Governance Code of 2010: “Chairmen should discuss strategy with major shareholders.” The FSA has given guidelines in recognition of one-on-ones: Disclosure Rules (DR) 2.2.10.[320]

As mentioned earlier Hermes is another interesting institution. Colin Melvin, director of corporate governance of Hermes and chief executive of Hermes Equity Ownership Services Limited (EOS), explains this relationship in describing the work done by EOS:

> “*The work I do is to some extent aimed at taking the intermediaries out of the system, addressing some of these problems and getting a proper conversation going, a dialogue between the owners of the companies, the pension funds, and the companies themselves. We don’t manage money for these funds. We don’t buy and sell the shares. That’s done by other fund managers. What we do is represent them in engagements and discussions with companies, we vote the stock and we have a long-term conversation with companies about longer term strategy and value creation. And it’s not about giving companies a hard time, it’s not about second guessing or micromanaging them. I wouldn’t pretend to know how to manage some of the largest companies we engage with. It’s about calling to account some of the directors for their performance on behalf of the owners. And that process we very firmly believe adds value for the long-term owner and the pension fund*.”[321]

[320] CG10 E.1.1. For DR 2.2.10 http//fsahandbook.info/DTR.

[321] Goyder (2008/B), p. 26.

On March 24, 2010 Tomorrow's Company[322] issued a new report in which it discusses the Swedish practice of appointing two or three shareholder representatives, elected by shareholders, who do not become members of the board but are voted in as members of the nominations committee. Tomorrow's Company argues that it might be a good idea for the UK as well to allow shareholders to appoint one or two outside members to the nominations committee. Apart from the advantage of involving shareholders in the process of nominating directors, it would also have the advantage of creating more scope for dialogue about strategy between representatives of shareholders and the board, which is a specific UK aim,[323] whereas it is less of a goal in common practice in the US and the Netherlands.[324]

2.5.11 <u>Summary of the role of board members in the UK</u>

(i) The UK system of "comply or explain" codes with their increasing aspirational levels has allowed gradual improvement. The UK continues to lead the way in developing corporate governance.

(ii) The members of a UK one-tier board have joint responsibility for developing, achieving and monitoring all aspects of corporate strategy.

(iii) The NEDs are playing an ever more enhanced role in creative debate about strategy and in challenging the executives on the development of strategy as well as monitoring the achievements of the executives. This role differs from the general position of supervisory directors in the Netherlands.

(iv) All measures for promoting the better functioning of NEDs should be adopted, including the provision of early information and on-site information, time for debate about strategy, induction, training, time for the job, remuneration, evaluation and orderly succession procedures.

[322] Goyder and Zimmerman (2010).

[323] See CG E.1.1.

[324] Chapter IV of the Frijns Code only describes information to shareheolders at general meetings.

(v) The role of the separate chairman involves spending about half of his working time at the company, ensuring that the board works well as a team and providing for all the aspects mentioned at (iv) above. He is complementary to the CEO and acts as his coach or partner. As such, the chairman is responsible for the image of the company and the communication with shareholders. He is actively involved in the communication with major shareholders about governance and strategy.

(vi) The comparison with US boards shows that in points (ii), (iii) and (iv) above, US boards and board members have more or less the same roles as their UK counterparts. There are two differences between the roles of UK and US outside directors. First, while UK outside directors are actively involved in developing strategy and sometimes even come forward with proposals. The US outside directors are also actively involved, but in the US there is more emphasis in asking challenging questions in a Socratic manner about the proposals of management. Second, the UK chairman is more prominent than the US chairman or lead director. He discusses strategy with shareholders, while US and Dutch chairmen do not do that.

(vii) The UK also has special roles for the SID in evaluating the chairman, which is being followed in the US and the Netherlands.

(viii) The UK company secretary has an important role in guiding the corporate governance of the company and clearly assisting the chairman in this task.

2.6 **Duties of directors**

2.6.1 Basis of duties

In the UK directors' duties are based on:

- common law rules and case law;
- statutory law, e.g. sections 170-178 of the Companies Act 2006;
- articles of association of the company;
- listing requirements;
- the UK Corporate Governance Code;
- the City Code on Takeovers;

– the Code of Market Conduct;
– the many items of legislation listed in section 2.3 and Annex UK Acts.

The Companies Act 2006 contains a fairly large number of descriptive rules on duties of directors in sections 170 to 177 in Chapter 2 of D10 of the Act headed: General Duties of Directors. These rules are intended to describe the essentials of common law, which continues to apply.

2.6.2 <u>To whom are duties owed?</u>

Under common law, directors owe their duties to the company and if he is in default of his duties it is therefore the company that must bring an action against a director (this principle was decided in *Foss v. Harbottle*, 1843[325]).

Foss v. Harbottle **(1843)**
Two shareholders brought a claim on behalf of themselves and all other shareholders of the Victoria Park Company alleging that five directors had breached their duties by effecting various fraudulent and illegal transactions, and that there remained an insufficient number of qualified directors to constitute a board. In particular, it was claimed that the directors, in their capacity as directors, had the company buy land from themselves at prices in excess of market value and that in order to fund the purchase, they raised funds for the company by mortgaging Victoria Park's property in an unauthorised manner.
The court noted that it remained possible for a general meeting of Victoria Park's shareholders to be convened, at which the acts of the board could be ratified or otherwise, and that the company was still able to bring a claim by itself. Therefore, the claim by the two shareholders could not proceed.
This case laid down the rule, that where a cause of action is vested in a company, the company is the only proper claimant. Individual shareholders should not generally be allowed to bring claims on behalf of the company.

The principle that duties are owed by the directors to the company is to be found in section 170(1) of the Companies Act 2006.[326] The general duties are described in sections 171 to 177 of the Companies Act 2006. Then sections 178-239 give many detailed provisions for different types of transactions, where there can be a conflict of interest. The centrepiece

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[325] *Foss v. Harbottle*, 67 E.R. 189; [1843] 2 Hare 461, Court of Chancery.
[326] Davies (2008), p. 479.

section is section 172 introducing the “enlightened shareholder value”. The government described this as “most likely to drive long-term company performance and maximise overall competitiveness and wealth and welfare for all”. It also says, “the key company law provision is for the fiduciary duties of directors”. These require them to manage the undertaking for the benefit of the company honestly (“in good faith”). That benefit is defined by case law as the interest of members (shareholders) present and future.

2.6.3 Enlightened shareholder value

Section 172 of the Companies Act 2006, which describes the duty of a director, has as centrepiece the words “to promote the success of the company for the benefit of its members as a whole” and then goes on to say “and in doing so have regard (amongst other matters) to” and lists six elements affecting all so-called stakeholders. It caused great debate and required a lot of explanation by the Attorney General Lord Peter Goldsmith.[327] The question was whether the government had opted for “enlightened shareholder value” or for “pluralism”, i.e. the stakeholder model.[328] The Attorney General’s explanation stressed that the government had chosen for the “enlightened shareholder value” and therefore not for “pluralism”.

This is clear from the first words of section 172, “although in the interests of the company and its long-term members the board should consider all elements”.[329] It also means that there is emphasis on the involvement of the board as a whole, because the duty to consider – “have regard to” – all factors results in a greater mutual reliance by one director on another[330] and at the same time that, if all elements have been considered, the board is free to choose. The judge should not second guess the board in a business decision.[331] In the UK it is clear that the judge will not sit on the chair of the directors who have a good faith business judgment. The Attorney General said as much in Parliament: “Under the duty to promote the success of the company, the weight to be given to any factor is a

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[327] Davies (2008), pp. 506-514.

[328] Davies (2008), p. 509 and Charles Mayo, ‘Directors’ Duties’, in Ken Rushton (ed.), *The Business Case for Corporate Governance* (2008), p. 127.

[329] Davies (2008), p. 509.

[330] Mayo in Rushton (2008), p. 128.

[331] Mayo in Rushton (2008), p. 128.

matter for the good faith judgment of the director. Importantly, his decision is not subject to a reasonableness test and, as now, the courts will not be able to apply a reasonableness test to directors' business decisions".[332] The Company Law Review worded it as follows: "The law recognizes that it is essential for directors to have discretion in the way they manage, and legal actions will not interfere with proper exercise of such business judgment.[333] Lord Wilberforce, giving the judgment of the privy council said in 1974: "Their lordships accept it would be wrong for the court to substitute its opinion for that of management or, indeed, question management decision, if bona fide arrived at."[334]

There is a focus on boards and on the long-term ("inclusive") view of the director's role in the interest of the long-term shareholders. The directors may regard a particular investment as serving the long term interests of the company.[335]

It is clear that in the end, after the board consideration, long-term shareholder interests prevail.[336]

2.6.4 Core duties

The most important duties have always been[337] (a) the duty of loyalty based on fiduciary principles developed by the courts of equity; and (b) the duties of skill and care based on the principles of the law of negligence.

2.6.5 Duty of care and distinction between executives and NEDs

We start with the duty of care, which in the past has always tended to be of a very low standard. A decision of 1925 re *City Equitable Fire Insurance Co*. describes this.[338] In that case, where the chairman was held liable for fraud, a non-executive director was not held liable for having transgressed the duty of care, because he had no serious role. There was no objective standard for expected care and there was a highly subjective duty: "a

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[332] Mayo in Rushton (2008), p. 128.

[333] Company Law Review Steering Group, Modern Company Law, p. 35.

[334] *Howard Smith Ltd. v. Ampol Petroleum Ltd. and others,* [1974] A.C. 821 at p. 832.

[335] Cadbury (2002), p. 42.

[336] Davies (2008), p. 509.

[337] Davies (2008), p. 477.

[338] *City Equitable Fire Insurance Co.,* [1925] Ch. 407; [1925] All E.R. 485, C.A.

director need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from someone of his knowledge and experience". An earlier famous example was the Marquess of Bute, who was appointed president of a bank at the age of six months and attended only one meeting of the board in his whole life. He was not held liable.[339]

The jurisprudence, such as *Dorchester Finance v. Stebbing* and *Norman v. Goddard* and first instance cases in connection the Insolvency Act, section 214, moved the criteria to a more objective test for monitoring. A further boost for an objective test was given by the Corporate Governance Code in 1992, the Cadbury Code, which allocated a major role to the non-executive directors in monitoring the executive directors.[340] The Companies Act 2006 added more objective duties. The jurisprudence was led by:

***Dorchester Finance Co. Ltd v. Stebbing and others* (1989)** [341]

Dorchester Finance was a money lending company with three directors, all of whom had accountancy experience. For the relevant period only Stebbing, the executive director, was actively involved in the company's affairs. There were no board meetings. Harris and Lewis, the two non-executive directors, never looked at Dorchester's books or accounts. They admitted to signing blank cheques, which enabled Stebbing to apply funds, illegally, as he pleased. The non-executive directors relied on the argument that their duties were to a lower standard than applied for executives, and that accordingly they had no duties to perform.

The court held that "A director in carrying out his duties: (i) was required to exhibit in the performance of his duties such a degree of skill as may reasonably be expected from a person with his knowledge and experience, (ii) had, in the performance of his duties, to take such care as an ordinary man might be expected to take on his own behalf, and (iii) must exercise any power vested in him in good faith and in the interests of the company." No distinction could be drawn between executive and non-executive directors.

On this basis, all three directors were found to have been negligent.

Again, a first instance decision by Hoffman J., later Lord Hoffman, member of the Supreme Court, by analogy with section 214 of the Insolvency Act set an objective standard for director's standards.[342] In the

[339] *Cardiff Savings Bank*, [1892] 2 Ch. 100.

[340] Davies (2008), p. 489.

[341] *Dorchester Finance Co. Ltd. v. Stebbing and others*, [1989] B.C.L.C. 498, Ch.D.

[342] *Re D'Jan of London Ltd*, [1993] B.C.C. 646; [1994] 1 B.C.L.C. 561. See also Smerdon (2007), pp. 93 and 104. Section 214(4) of the Insolvency Act 1986 already had the language "reasonably diligent person"

case of *D'Jan* of 1993 Mr D'Jan, the only director and 99% shareholder of the company while his wife had the other 1%, had not read a fire insurance policy before he signed it, because he trusted that his broker had read it. It turned out that there was a misrepresentation in the form. This led to non payment by the insurance when the company's factory burned down. Mr D'Jan had a defence that he and his wife owned 100% of the shares, a subjective argument. Judge Hoffman put forward the objective standard. What can be expected of a reasonably diligent person. The objective standard was confirmed in section 174 of the Companies Act 2006 (a director must exercise "the care, skill and diligence that would be exercised by a reasonably diligent person with (a) general knowledge, skill and experience that may be reasonably expected of a person carrying out the functions carried out by the director in relation to the company (the objective standard for that type of function), and (b) the general knowledge, skill and experience that the director has", (is the subjective element)). There is still a subjective element, but only if it improves upon the objective standard of the reasonable director.[343]

I add that Judge Hoffman held Mr D'Jan liable, but not for the whole damage. This common law right to mitigate damage claims is codified in the UK Companies Act 2006 in section 1197 if the director had acted honestly and reasonably and taking all circumstances into effect. This is also a possibility of exculpation for less involved directors.

The text of section 1157(1) of the UK Companies Act is:
"1157 Power of Court to grant relief in certain cases
(1) if in proceedings for negligence, default, breach of any duty or breach of trust against
(a) an officer of a company; or
(b) a person employed by the company as auditor (whether he is or is not an officer of the company)
it appears to the court hearing the case that the officer or person is or may be liable but that he acted honestly and reasonably and that having regard to all cirumstances of the case (including those connected with his appointment) he might fairly be excused, the court may relieve him, either wholly or in part, from the liability

improved by section 174 of the Companies Act 2006.

343 Davies (2008), pp. 492-493. One of these decisions, *Norman v. Theodore Goddard* (1992), is described below.

> on such terms as it thinks fit.” (Compare Dutch *Staleman v. Van de Ven* definition, see sub-section 4.7.2.1)

What does this mean?
First, although all directors, executives and NEDs are subject to a uniform and objective duty of care, the requirements for the discharge of that duty will not be uniform in each particular case, not only between executives and non-executives but even among individual members of each group and will also depend on the size of the company.[344] Davies gives the example of an Australian case, *Daniels v. Anderson* (1995). The Court of Appeal of NSW, applying an objective test, found that NEDs were not liable for failure to discover foreign exchange frauds being committed by an employee, though the CEO was liable.[345]

Second, there is a minimum standard for NEDs to “take reasonable steps to guide and monitor management”.[346]

Third, directors are permitted to delegate (*Daniels v. Anderson* (1995), see above) and (*Norman v. Theodore Goddard & Ors (Quirk, third party)* in 1992[347]), where objective tests were applied and at least some of the directors escaped liability.[348]

***Norman & Anor v. Theodore Goddard & Ors (Quirk, third party)* (1992)**

Bingham, a partner at Theodore Goddard, a London firm of solicitors, specialising in tax and trust work, was involved in fraudulent dealings with trust funds, including a Jersey settlement of which Mrs Norman was the settlor and tenant for life. The asset of the trust was the share capital of LBI, a company holding property and cash. Bingham arranged for Somerville, an employee of Theodore Goddard, to be made the sole director of LBI and Somerville then appointed a third party, Quirk, as another director. Quirk took on responsibility for the day-to-day business and cheque book. Bingham persuaded Quirk to deposit LBI’s cash with Gibbon in order to obtain offshore tax advantages. Bingham was

[344] Davies (2008), p. 491; and Keith Johnstone and Will Chalk, ‘What Sanctions Are Necessary?’, in Ken Rushton (ed.), *The Business Case for Corporate Governance* (2008), p. 165 (“Johnstone and Chalk in Rushton (2008)”).

[345] *Daniels v. Anderson*, [1995] 16 A.C.S.R. 607. The fact that Davies cites this Australian case to support his description of English law shows Australian cases are relevant for English law as persuasive authority, not a binding precedent.

[346] Davies (2008), p. 491.

[347] *Norman & Anor v. Theodor Goddard & Ors (Quirk, third party)*, [1992] B.C.C. 14; [1991] B.C.L.C.1027.

[348] Davies (2008), pp. 491-492.

"the picture of the respectable member of a very eminent firm of city solicitors". He assured Quirk that depositing the money with Gibbon was more profitable than putting it elsewhere, the money would be available if needed, and that Gibbon was under the control of Theodore Goddard and thus safe. However, Gibbon was in fact owned by Bingham, who stole the funds.

The court held that on the facts "a director… need not exhibit a greater degree of skill than may reasonably be expected from a person undertaking [his particular] duties", but "in considering what a director ought reasonably to have known or inferred, one should also take into account the knowledge, skill and experience which he actually had in addition to that which a person carrying out his functions should be expected to have". Quirk did not breach his duty by relying on the information given to him by Bingham and acted reasonably in not investigating further, given Bingham's position.

It is important to note that directors have the duty to act in the interest of the company above the interest of those who have appointed him. This is clear in jurisprudence in joint venture cases.[349]

Fourth, while delegation is permitted the second requirement of some guiding and monitoring remains applicable, even in case of delegation to sub-board structures, as was mentioned by the Turnbull Committee, which contributed to the Combined Code. One can see this principle at work in the *Barings* case. It was held in *Barings Plc* in 2001[350] that even though delegation is allowed directors should have had internal controls in place in relation to trading activities in an overseas subsidiary whose losses can cause the demise of the bank. The judgment made a distinction between the functions of executives and non-executives, but in this case, all directors were disqualified. In the 1980s thought was given to the misuse of companies and to reform the Corporate Insolvency Law.[351] The objectives were: restoration of business, maximum return to creditors, identifying causes of failure and mismanagement, and, where appropriate depriving directors in the management of companies. For the last element the Company Directors Disqualification Act 1986 was enacted. It makes it possible to seek a court order against directors of insolvency companies on grounds of "unfitness" to be involved in the management of other companies.[352] *Barings* was a large case.

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[349] *R. Neath Rugby Ltd., Hawks v. Cuddy*, [2008] B.C.C. 390; an appeal at [2009] 2 B.C.L.C. 427 (C.A.).

[350] *Barings Plc (No. 5)*, [2001] B.C.C. 273; [2000] B.C.L.C. 523; and see Smerdon (2007), pp. 104-105 and Davies (2008), p. 493.

[351] R. Goode, *Principles of Corporate Insolvency Law* (2005), p. 39.

[352] Davies (2008), pp. 237-238.

Some other disqualification cases are:

***Westmid* (1998)**[353]

Griffiths, Conway and Wassall were directors of Westmid Packaging Services. Griffiths was a "much-respected businessman and a pillar of the community" the controlling force behind the company. Conway and Wassall were "treated more like employees than directors". They did not read Westmid's financial statements or accounts and therefore did not appreciate that Griffiths was using Westmid's assets for the purposes of other companies in his group or that he allowed Westmid to continue trading even past the time that he must have known that the company was insolvent.

The Court of Appeal noted that:

"…the collegiate or collective responsibility of the board of directors of a company is of fundamental importance to corporate governance under English company law. That… must however be based on individual responsibility. Each individual director owes duties to the company to inform himself about its affairs and to join with his co-directors in supervising and controlling them.

A proper degree of delegation and division of responsibility is of course permissible, and often necessary, but not total abrogation of responsibility. A board of directors must not permit one individual to dominate them and use them…".

Disqualification orders against all three directors were upheld.

***Secretary of State v. Swan* (2005)**[354]

Swan was chairman and CEO of Finelist plc. An experienced accountant, North, was a non-executive director and deputy chairman, as well as chairman of the audit and remuneration committees. Finelist practised cheque kiting, taking advantage of the time taken for a cheque to clear to obtain a fictional increase in the balance of the payee's account before the cheque is cleared giving a rosier picture of the annual accounts.

Swan was rarely asked to sign cheques but on one occasion, without asking any questions, he signed four cheques that as a result of their size and matching amounts "called out for comment and question". These cheques crossed between the two subsidiaries thereby creating artificial credit for the group. North was informed of various accounting and financial irregularities by a senior manager. Instead of investigating, he had a short meeting with Swan and the finance director, believed and accepted the finance director's explanation, and did no more. As a result of the cheque kiting, an indebtedness statement in a circular to shareholders showed materially inaccurate figures and the group breached its banking covenants.

[353] *Westmid Packaging Services Ltd (No. 3)*, [1998] 2 All E.R. 124; [1998] B.C.C. 836; [1998] 2 B.C.L.C. 646 (Civ. Dir.).

[354] *Secretary of State for Trade and Industry v. Swan (No. 2)*, [2005] E.W.H.C. 603 (Ch.); [2005] B.C.C. 596.

Swan "was a businessman with obvious flair and drive in relation to operational matters, but he was not a person likely to pay attention to financial or accountancy technicalities or other matters of detail which he did not regard as having an obvious impact on the profit or loss of the group". He was held not to have had actual knowledge of the cheque kiting but he ought to have known as a result of the unusual cheques he had been asked to sign, which should have prompted him to make enquiries. However, on the statement of indebtedness in the circular, he was entitled to have left this to the finance team.
North's response to the allegations by the senior manager was held by the Court to have been "wholly inappropriate, unsatisfactory and inadequate". He had failed to show the "decisive, courageous and independent action" required of a non-executive director.
Neither Swan nor North were found to have acted fraudulently or dishonestly.
Disqualification orders were made against both directors. Swan should have asked further questions as CEO. North should have asked further questions, because he had extra financial expertise. A non-executive director must be prepared to rock the boat.

Fifth, the principles of delegation to managers below board level also apply to the division of responsibilities among directors. Inevitably, executive directors will carry a greater load of management responsibility than non-executives. The CFO will carry particular responsibility in the area of finance. However, all directors have a duty to maintain sufficient knowledge of the company's business and may certainly not be dominated by one of their members.[355]

Sixth, delegation is inevitable in large companies and the directors cannot guarantee that all matters are going well within the company. Subordinate employees may be fraudulent or negligent and the directors may not discover this in time, but this does not necessarily mean that directors have been negligent, that will depend on the facts of the case, including quality of the internal controls.[356]

It is of course interesting to compare all of this with the US duty of care of oversight as defined in the cases *Graham*, *Caremark*, *Stone v. Ritter* and *Citygroup*, described in 3.5.4 under 8 and 3.7.2.1 below. In the US much depends on the facts of the case, whether the directors had in good faith introduced internal controls. Both in the UK and the US the aspect of good faith judgment of the directors comes into play. In the UK the aspect of good faith is mentioned in section 172 of the Companies Act

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[355] Davies (2008), p. 493 and the *Barings* and *Westmid* judgments. The question of delegation among directors is discussed in a comparable way in the Netherlands, see 4.5.9 and 4.5.18 below.
[356] Davies (2008), p. 493.

2006: “a director must act in a way he considers, in good faith, would be most likely to promote the success of the company”. This means that the director must show he has acted in good faith in his considerations about the matter. Section 174 of the Companies Act makes the test an objective one in paragraph 2(a) and adds a subjective element in paragraph 2(b) for directors that have more than normal knowledge. In the US the plaintiff must show lack of subjective good faith.

The usual tests in the UK and the US are: what was the quality of the controls? Were there red flags? What did the director consider? Was his consideration in good faith? The differences in the test of care are that the Delaware Courts have a clear set of procedural steps to arrive at liability, while in the UK it is simply “all facts of the case”.

When asked whether both countries have an objective test for the competence of directors, I would say that is now the case in the UK and the US for listed companies, but in the US is more subjective for smaller companies.

Finally, as in the case of auditors, pointing out that there is a breach of care or loyalty is one step, establishing that the loss for the company is the consequence of that breach is another thing.[357]

Generally developments at common law as well as the Companies Act 2006 have brought the standards of care, skill and diligence into line with those required in other fields by the jurisprudence about negligence. The move from a subjective to an objective test will give the court a greater role in defining the functions of directors, no matter how sensitive the courts are to the need of avoiding the benefit of hindsight. For example, the courts’ decision on the rigour with which the board has to supervise the performance of delegated tasks will help in defining the monitoring role of the board, while decisions about whether the audit committee of the board has sufficiently scrutinised the external auditor will help define the division of responsibilities between the audit committee, auditors and management. Twenty years ago one might have predicted that the courts would either be ineffectual (out of a desire of avoiding reliance on hindsight) or produce undesirable interventions. However, with the emergence of the UK Corporate Governance Codes there is now a body of best practice available on which the courts are free – but not obliged –

[357] Davies (2008), p. 494.

to draw.[358] The case that has made many NEDs nervous of liability is the *Equitable Life Assurance* case of 2003,[359] where NEDs were not able to get excused from the case. In the end the case was not pursued because of costs.

***Equitable Life Assurance* (2003)**

Equitable Life was an unlimited liability society whose members were with-profits policyholders. Until June 1988 policies were provided, in a high number of cases, with guaranteed annuity rates permitting the policyholder to receive an annuity at a guaranteed rate on retirement. Over several years this rate exceeded the normal annuity rate prevailing on other policies at the retirement date, and in the interests of fairness, the board adopted a differential terminal bonus policy, which adjusted the bonuses paid under their policies to equalise annuities payable under policies where the guaranteed rate was chosen and other policies where it was not. Complaints were made and a test case was brought to determine whether Equitable had the right to declare differential bonuses. Equitable lost the case and issued proceedings for negligence against its former directors. Equitable alleged that the directors were negligent in (i) failing to take legal advice as to the validity of the differential terminal bonus policy before awarding the differential bonuses each year, and (ii) after the problem was known and legal advice had been sought and given, failing to reduce bonuses and ensure that existing and prospective policyholders were fully aware of the potential costs to the company should the test case be lost. It also alleged use by the directors of their discretion for improper purpose.
The non-executive directors sought summary judgment, excusing them from liability, arguing that they had relied on the executive directors. The court was not sympathetic, concluding that the duty owed by a non-executive director does not differ from that owed by an executive director saying “It is plainly arguable … that a company may reasonably at least look to non-executive directors for independence of judgment and supervision of the executive management.” The application for summary judgment was refused. The trial began in 2005, but after the case went badly for Equitable – there were difficulties in proving breach of duty and causal links between alleged breach and the damage claim – it agreed to drop the case and pay the legal expenses of the directors.

The case was a much discussed case by directors and lawyers, because of the huge amounts involved and because many directors and lawyers held policies with Equitable Life. In the same case the judge had previously given a summary judgment in favour of the auditors, dismissing a claim against them. A week before the hearing of the directors, his judgment in the auditors’ case was overruled by the Court of Appeal. He was therefore

[358] Davies (2008), p. 494.

[359] *Equitable Life Assurance Co. v. Bowley*, [2003] E.W.H.C. 2263 (Comm.); [2003] B.C.C. 829; [2004] 1 B.C.L.C. 180 Q.B.D. (Comm.), see also in 2.7.2.

more cautious and less robust about dismissing the claim against the directors. In the subsequent trial the plaintiffs abandoned their claim against the directors after presenting it, but before the defence was presented, i.e. the plaintiffs accepted they had no claim. The claim against the auditors was also lost. Nevertheless, the case had made NEDs nervous.

2.6.6 Fiduciary duties

There are six sub-groups of fiduciary duties for directors, executive or non-executive. The first three duties are:

1. to act within the scope of powers conferred on them;
2. to act in good faith to promote the success of the company;
3. to exercise independent judgment;

directors also have the following three duties, which stem from their obligations to avoid conflicts, namely the duty:

4. to avoid entering into transactions with the company ("self-dealing");
5. to avoid conflicts of interest;
6. not to accept benefits from third parties.

Re 1 – Act within powers

This means the duty to act in accordance with the company's articles of association and to exercise powers only for the purposes for which they are conferred (section 171 Companies Act 2006).

This concerns cases of ultra vires, payments of dividends, directors' remuneration or the issue of shares or financial assistance. In such cases the acts can be voided by the company, except where this would harm the interests of bona fide third parties,[360] such as the bona fide purchaser for consideration, where a director could be held liable. The same reasoning applies to unlawful distributions to shareholders and section 847 of the Companies Act 2006. Malafide shareholders have to pay back, bona fide shareholders do not and in that case the company can hold directors liable.[361]

[360] Davies (2008), pp. 497-506.

[361] Davies (2008), p. 505.

Re 2 – Promote the success of the company

Section 172 of the Companies Act 2006 is the modern version of the duty of loyalty.[362] Section 172 reads:

172 Duty to promote the success of the company

(1) A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to

(a) the likely consequences of any decision in the long term,

(b) the interests of the company's employees,

(c) the need to foster the company's business relationships with suppliers, customers and others,

(d) the impact of the company's operations on the community and the environment,

(e) the desirability of the company maintaining a reputation for high standards of business conduct, and

(f) the need to act fairly as between members of the company.

(2) Where or to the extent that the purposes of the company consist of or include purposes other than the benefit of its members, subsection (1) has effect as if the reference to promoting the success of the company for the benefit of its members were to achieve those purposes.

(3) The duty imposed by this section has effect subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company.

This is a much debated section. In the first part of subsection (1) and in subsection (2) it describes the principle of "enlightened shareholder value" and the duty of loyalty. In the second part of subsection (1) and in subsection (3) it gives examples of all the factors (including stakeholder interests) to which the directors should have regard, but is subordinated to the overriding duty to promote the success of the company. This is a requirement of care, in the positive sense of thoughtfulness and cynically a requirement of box ticking and not a method by which the courts are required to second guess the wisdom of the choice (resembles the

[362] Davies (2008), p. 507.

Delaware business judgment rule). It is for this “have regard” that board meetings in the UK are usually carefully minuted. Cynically there is boiler plate language: “we have considered all factors”.

The Attorney General, Lord Peter Goldsmith, explained clearly that this section describes one all-inclusive duty of loyalty to the company and not one of pluralism.[363][364]

Re 3 – Independent judgment

The directors must exercise independent judgment, and not submit to other directors or influences. They may delegate and enter into contracts that bind the company such as long term exclusive delivery contracts with non-competition clauses or an agreement to develop football grounds as wished by a sponsor.[365] This is set out in section 173 of the Companies Act 2006.

Re 4 – Avoid conflicts of interest

Section 175 of the Companies Act 2006 describes the duty to avoid conflicts of interest. Conflicts of interest are to be taken broadly and examples are: corporate opportunities should be left to the company and, dealing with a company of which the director is also a director. The duty is not infringed if the matter has been authorized by the directors, who may give this authorization in the case of a private company. The articles of association usually permit such authorization[366] and in the case of listed companies it is a requirement that there is a provision in the constitution enabling the directors to provide this authorization.[367] Most constitutions of listed companies have a provision about this possibility. Another requirement is that a quorum of independent directors gives this authority.

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[363] Davies (2008), pp. 509-525. (See also 2.6.3 above, p. 107-108).

[364] The Attorney General is a member of the Cabinet of Ministers. He is the legal advisor of the government and defends new Acts in parliament.

[365] Davies (2008), pp. 525-528; and *Fulham Football Club Ltd. v. Cabra Estates Plc*, [1992] B.C.C. 863; [1994] 1 B.C.L.C. 363, where the board, having agreed to sponsor Cabra Estates' plan want to change the plans, notwithstanding its agreement not to do so. The board was bound to the agreement.

[366] Sub-section 175(5)(a) Companies Act 2006.

[367] Sub-section 175(5)(b) Companies Act 2006.

Section 177 of the Companies Act 2006 obliges a director who has a conflict of interest to give notice to the other directors of the conflict before the transaction. This adds a duty of extra vigilance to the duty to avoid conflicts. It follows that the proper practice is for the conflicted director to inform the board and attend the debate and for the others to vote. Usually the articles of association describe that the director, who has informed the board, may participate in the discussions and count for the quorum of presence and vote.

In *Meyer v. Scottish Co-operative* (1959)[368] nominee directors appointed by Scottish Co-operative on the board of the subsidiary Scottish Textiles had the subsidiary enter into contracts which were bad for the subsidiary but good for Scottish Co-operative. They did not inform their co-directors, minority shareholders in the subsidiary. The nominee directors had breached their duty of care.

In *Royal Hastings v. Gulliver* (1967)[369] the directors had profited by the sale of the company without having informed the new shareholders. There was no fraud or negligence, but the case went against the directors anyway, differently from *Bell v. Lever Brothers*, exactly because they had profited without informing shareholders.

Re 5 – Avoid entering into transactions with the company (self-dealing)

Section 188 of the Companies Act 2006 provides that long-term service contracts with directors need the approval not only of the board but also of the members, i.e. shareholders. Such a contract is void if the “members'” approval is absent (section 189). Here the contract is void and not voidable, because no third parties are involved.

Section 190 provides that sales of assets by or to directors and persons connected with them need the approval of the “members”. Sections 198-203 provide for the same requirement of “members'” approval in case of loans, quasi-loans, credit transactions and related transactions. Such transactions are voidable by the company, unless third party rights have intervened.[370]

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[368] *Meyer v. Scottish Co-operative Wholesale Society Ltd.*, [1959] A.C. 324; [1958] 3 All E.R. 66.

[369] *Royal (Hastings) Ltd. v. Gulliver*, [1967] 2 A.C. 134; [1942] All E.R. 378.

[370] Davies (2008), p. 538.

In *Harrisson* (2001)[371] Peter Harrisson bought land from the company and sold it at a huge profit. When he bought it he knew the hidden benefits of planning permits were due to being confirmed. He did not inform his board members of this profit and the Court of Appeal held him accountable.

Re 6 – Not to accept benefits from third parties

Section 176 provides that directors may not receive benefits from third parties, such as bribes. The company may choose to rescind the arrangement or hold the third party and the director jointly and severally liable. Here, differently from section 175, there is only an exception if the shareholders' meeting has given consent.

2.6.7 Voidability, but not against good faith third parties

Acts committed in breach of the articles of association or powers of attorney or infringements of the rules on conflict of interest as described above could be held voidable by – and would therefore not be binding on – the company, unless third party rights have intervened. In addition, the director can be held liable.[372]

For contracts sections 40 and 41 of the Companies Act 2006 apply. These sections clearly provide that notwithstanding any limitation under the articles of association a director binds the company in favour of a person dealing with the company in good faith. Section 40(2)(b) also describes what a good faith third party is and section 41 goes on to make further exceptions to voidability, namely where:
(a) restitution is no longer possible; or
(b) the company is indemnified; or
(c) the rights are acquired bona fide by a third party; or
(d) the transaction is affirmed by the company.

2.6.8 Summary: duties of NEDs

The core duties are of loyalty, skill and care. The Companies Act 2006 has codified these duties in detail.

[371] *J.J. Harrisson (Properties) Ltd v. Harrisson*, [2001] E.W.C.A. Civ. 1467; [2002] B.C.C. 729; [2002] 1 B.C.L.C. 162; [2001] W.T.L.R. 1327 C.A. (Civ. Div.).
[372] Davies (2008), p. 538.

Although in principle the duties of NEDs are equal to those of the executive directors, delegation to sub-board employees and to board members is accepted and directors can delegate and rely on trustworthyness of delegates unless there were warnings. If there have been warning flags the NEDs should take action. Generally, the courts will not second guess directors. Principles of delegation also apply to the division of responsibilities among directors. Executive directors have a greater responsibility than NEDs.

2.7 **Liability of directors**

The duties of directors are a description of what directors should undertake to do. Liability describes the consequences of default in court.

2.7.1 Who can sue?

Directors only have duties to the company. The company can sue the directors in a derivative suit, but only if shareholders are successful in getting permission from the court for the company to do this. A derivative suit is one where the shareholder sues on behalf of the company. This is a special possibility under UK and US law to overcome the problem that shareholders cannot sue directors directly.[373] This is described in more detail in 2.7.3.

Other lawsuits against directors are described hereunder as well. Lawsuits brought by shareholders directly in 2.7.5, by the liquidator in 2.7.7, by regulators in 2.7.8. Other measures are described in 2.7.9.

2.7.2 General atmosphere of liability

UK company law, like US law, does not make a formal legal distinction between the duties of executive and non-executive directors. Instead, all directors generally bear equal legal responsibility for company actions. Case law suggests, however, that the English judiciary has recognized the part-time role that non-executives play in a public company and is prepared to adjust their duties in case of liability claims accordingly. Sections 174(2)(a) and 1157 also give a ground for a distinction between executives and NEDs. See 2.6.5 above.

[373] Reisberg (2007), p. 5; and Davies (2008), p. 609 et seq.

Despite judicial recognition of the distinctive role played by non-executive directors, there has been growing concern in Britain about the risk of liability. A catalyst for this concern was a lawsuit brought by Equitable Life, a major British insurer that nearly went bankrupt in the late 1990s, described in detail above in 2.6.5.[374] The old board was replaced after the debacle, and the new board sued the auditors and fifteen former directors, including nine non-executives, for damages exceeding £3 billion. The non-executive directors sought to have the claim against them dismissed, but this application failed. Equitable had D&O insurance coverage of £5 million, which was insufficient to cover the directors' legal expenses, let alone potential damages. The trial began in 2005, but after the case turned out against Equitable, it agreed to abandon its claim immediately after its presentation and pay the legal expenses of the non-executive directors. Despite this outcome, the litigation was often cited as the sort of nightmare that would make the boardrooms of public companies tougher to fill.[375]

In practice, litigation against directors in the UK is quite rare for various reasons. Primarily because litigation could leave the company worse off than before, because of costs. Often there is an indemnity clause or order in favour of the director. Moreover, the time lost by directors in litigation could be better spent and the company will suffer reputational damage. Directors have more to fear from fines for criminal offences and from naming and shaming. Another possible penalty is disqualification, as in the cases of *Westmid* (1998), *Barings* (2001) and *Swan* (2005) described above under 2.6.5 – duty of care –, where all the NEDs were disqualified. Disqualification is a court order that a person may not act as director of any company for a period of 2 to 15 years.

2.7.3 Derivative suits in the UK

Before the Companies Act 2006 it was very difficult for a shareholder group to start a derivative suit in the UK. As the *Foss v. Harbottle* rule of 1843[376] implied, the grounds for getting relief from the courts were very

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[374] *Equitable Life Assurance Co. v. Bowley*, [2003] E.W.H.C. 2263 (Comm.); [2003] B.C.C. 829; [2004] 1 B.C.L.C. 180 Q.B.D. (Comm.). The facts are described above on p. 102.

[375] Brian R. Cheffins and Bernard S. Black, *Outside Director Liability across Countries*, Stanford Law School, Law and Economics, ECGI – European Corporate Governance Institute – Working Paper no. 71/2006, pp. 1399-1400 ("Cheffins and Black (2006)"). The nuance of the distinction in duties between executives and NEDs is described in detail in 2.6.5

[376] *Foss v. Harbottle*, see 2.6.2 above.

limited. Only members of the board or shareholders have the right, after receiving the permission to do so from the board or the court, to file a derivative suit, which is a suit where a prosecuting shareholder starts litigation against directors for mismanagement and can do so notwithstanding the general rule that shareholders cannot bring action against directors for damages. If the derivative suit is successful damages caused by directors have to be reimbursed to the company.[377] Sections 260-269 of the Companies Act 2006 deal with such a derivative suit.[378] Environmentalists or employees cannot file derivative actions arguing that directors have not sufficiently taken their interests into account. The shareholder group would not get relief if the litigation issue could be better left to the shareholders as a whole. Under section 263(2) of the Companies Act 2006 permission must be refused if the court is satisfied (a) that a person acting in accordance with section 172 (duty to promote the success of the company) would not seek to continue the claim, i.e. it would not be in the interest of the company to continue the claim or (b) that the acts constituting the alleged breach of duty were in fact authorized.

First, the court hears only the applicant to determine whether the application should immediately be dismissed for lack of a prima facie case. If the case is not dismissed immediately, the court will then hear all parties and take evidence.

The court may then, at its discretion, check various factors:[379]

– whether the shareholder seeking to bring the derivative claim is acting in good faith, or whether, for example, the litigation is motivated by personal interests;
– whether the act or omission which constituted the alleged breach of duty is likely to be ratified by the company (i.e. by the shareholders collectively) or – expressed as a separate test – whether in the case of the alleged breach of duty the act or omission is likely to be authorized or ratified by the company; authorization can sometimes be given by the directors who are not involved (this is a very important defence for the directors);
– whether the company (i.e. the uninvolved directors) has decided not to sue;

[377] Reisberg (2007), p. 5.

[378] Reisberg (2007), p. 204.

[379] Davies (2008), pp. 618-620; and Reisberg (2007), p. 143 et seq.

– whether the shareholder could pursue the case in his own right.

It is unlikely that many applications for permission for derivative actions will be successful in Britain, which is what the Law Commission intended. In its consultation paper on derivative suits[380] the Law Commission wrote: “a member should be able to maintain proceedings about wrongs done to the company only in exceptional circumstances” and “a shareholder should not be able to involve the company in litigation without good cause….". Otherwise the company may be “killed by kindness towards shareholders”, or “waste money and management time in dealing with unwarranted proceedings”.[381]

2.7.4 Enforcement by the company

Duties and liability is one thing; enforcement is another. In the US it is quite easy to start litigation, but indemnities from liability in the articles of association protect directors. UK directors have slightly less protection, but procedural factors ensure that public companies rarely sue their directors. Directors owe their duties only to the company. While derivative suits in the US often provide a viable platform, it is much more difficult in the UK for shareholders to get relief through a derivative suit. If the complete board has been changed, as occurred in the *Equitable Life* litigation, the new board can decide to have the company initiate the litigation. This may happen in exceptional cases. The English courts have made the derivative suit possible, but only in limited and very obvious cases, such as for fraud on the minority, ultra vires conduct and acts requiring a special majority of shareholders, and these will rarely apply to outside directors of public companies. Now section 263(2) of the Companies Act 2006, described in 2.7.3 applies. Infringement of duties by outside directors is more likely to involve failure to exercise care or failure to consider all factors necessary for the success of the company, i.e. loyalty.[382]

[380] Davies (2008), pp. 626-627 and Reisberg (2007), p. 5 describe several reasons that should be considered by shareholders not to litigate against the company, see also 2.7.4 below.

[381] Arad Reisberg has informed me on 10 June 2011 that to his knowledge there have been 7 attempts for derivative suits in the UK and that they all failed.

[382] Cheffins and Black (2006), p. 1404.

In the UK the time, hassle and expense involved will discourage the launching of a suit. The question of costs plays a particular role in the UK. For example:

– the "loser pays" rule, i.e. all costs of litigation on both sides, therefore also the costs of the winner, must be paid by the loser; in the *Equitable Life* case, which was abandoned mid-trial, the plaintiffs had to pay their own costs and those of the company and directors – a total of £30 million;[383]
– although lawyers can agree to no win, no fee, the maximum "upside" is 200% of hourly rates; the US practice of contingency fees does not exist in the UK;
– even if plaintiffs win they do not get the proceeds, which go instead to the company; in other words, they have the full downside but not the upside;
– there is one advantage in that if the plaintiff gets leave to go to trial the company can provisionally be ordered to pay the litigation costs;[384]
– the defendant can demand an indemnity order or can benefit from an indemnity clause in the articles.

British literature describes the wisdom for shareholders not to involve the company in litigation. I mention a few points:[385]

– publicity of the case brings long-term reputational damage to the company;
– doubts about success;
– litigation may disrupt the decision making process of the company, because of the time involved for the board;
– deterrence of individuals becoming directors and inducing directors to leave;
– general discouragement of entrepreneurial directors;
– after the fact litigation is difficult.

The first four considerations not to litigate show common sense. They also apply in other countries, including the Netherlands. Shareholders who start litigation should always consider these points. Such UK common sense is a good example.

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[383] Cheffins and Black (2006), p. 1407.

[384] *Wallersteiner v. Moir*, [1975] Q.B. 373 C.A.; and Civil Procedural Rules 19.9 and Davies (2008), p. 622.

[385] Reisberg (2007), pp. 47-50 and Davies (2008), pp. 605-606.

2.7.5 Suits brought directly by a shareholder

A shareholder whose personal rights are infringed may sue in his own name to enforce his rights. Section 994(1) of the Companies Act 2006 permits shareholders who have been “unfairly prejudiced” by conduct in the company to apply for relief. These cases usually involve improper diversion of assets, which result in too low distribution to shareholders or self-serving conduct in favour of directors. They are actions against the company for an order of relief, which may have consequences for the board to be forced to take action. The possible relief can include dismissal of directors, appointment of other directors, forced transfer of shares. The *Neath Rugby Ltd., Hawks v. Cuddy*[386] case is a clear example. This power of the court to give any relief to aggrieved shareholders is comparable with the Dutch Enterprise Chamber powers. The difference is that the Dutch Enterprise Chamber always institutes an enquiry, while the UK courts under this section do not, but the parties do go in depth with their evidence.

Once again, cost factors discourage procedures. The easiest first remedy for shareholders that feel wronged is that they can sell their shares. Especially in the case of public companies it is easy to sell shares on the liquid market. Therefore, petitions by shareholders who feel unfairly prejudiced, would tend to take place more often in the case of private companies. However, in the case of private companies, the courts usually do not uphold them.[387]

In addition to section 994 of the Companies Act 2006 shareholders in a public company can hardly sue in their own name under UK securities law to recover losses caused by false or misleading corporate disclosures. As mentioned in section 463 of the Companies Act 2006, the risks for the directors are negligible. Section 463 on misleading statements of the Companies Act confirms that directors have no liability towards shareholders and only a liability for fraud towards the company and no liability for mere negligence. Section 90A of FSMA opens a possibility for liability for fraud towards shareholders, but this is hardly ever applied.[388] The UK FSA does work with penalties against companies. UK

[386] See note 349.

[387] Cheffins and Black (2006), p. 1409.

[388] Davies (2008), pp. 741-742.

law lacks a provision analogous to SEC Rule 10b-5, the far-reaching US securities law for material misstatements.

UK directors can become liable to shareholders for “listing particulars” (documents in support of a public offering) that fail to include required information or contain certain misleading disclosures. Section 90 of the FSMA provides for the possibility of bringing a claim for compensation against persons responsible for the listing particulars. Directors fall within the definition of responsible persons, including non-executive directors. A claim under section 90 is analogous to a US claim under § 11 of the Securities Act of 1993. Lawsuits of this sort are, however, virtually unknown in Britain.[389] This is due to difficulties associated with organising class actions. The closest British class action has been the “representative action”. However, this is a complicated two-stage procedure. Reforms in 2000 introduced the concept of a “group litigation order” and fuelled speculation that there would be a wave of securities fraud cases. This has not yet occurred. The no win, no fee constraints and the “loser pays” rule discourage these actions. Even if such cases were to become common, the company and the insurer would have the deeper pockets and the directors would be able to rely on the “due diligence” defence.

An important point is that many British public companies (and Dutch as well) have a second listing on an American stock exchange and thus face exposure to US securities class actions. Generally, British and Dutch directors are worried about their US exposure and spend a lot of time and expense meeting the SEC requirements. However, out-of-pocket payments by US outside directors in case of damage claims are also rare for the many reasons described in section 3.7 of this study.

2.7.6 Outside directors insulated: indemnification, insurance

There is little chance that non-executive directors of UK public companies will end up being sued. Directors’ duties are fairly clear and case law shows that judges do not second guess directors with hindsight.[390] This is close to the US business judgment rule – a safe

[389] Cheffins and Black (2006), p. 1411.

[390] Davies (2008), p. 513 and Mayo in Rushton (2008), p. 128.

harbour for directors. Directors are liable if they have infringed the duties mentioned above, which can be summarized as loyalty and care.[391]

The company may indemnify directors in case they are nevertheless sued, but only under certain conditions. The Companies Act 2006 excludes indemnification of a director against claims by the company – section 232. The company may equally not indemnify a director against a fine, administrative penalty or payment of damages resulting from a breach of duty – section 234(3)(a). Also, in contrast to the position in the US, a director who loses in court may not be reimbursed by the company for legal costs – section 234(3)(b). However, the company may give an indemnity in the case of a civil action by a third party e.g. a shareholder class action, covering the liability of the director and the costs of defence, section 234.[392]

But, interestingly, the company is permitted by law – section 233 – to insure its outside directors under D&O coverage. Typically, D&O policies in Britain give cover for "losses" arising from culpable acts or omissions committed in the insured's capacity as a director. "Culpable act" will usually be defined broadly to include breaches of duty, trust, neglect and wrongful trading. "Losses" will include sums paid under a settlement after a trial and legal costs incurred defending claims. D&O policies specifically exclude coverage for dishonest or fraudulent conduct, for obtaining a private benefit or profit, and for intentional misconduct.[393]

Another point is coverage. Partly because of the *Equitable Life* litigation, coverage of £100-200 million and with the largest companies up to £600 million, i.e. comparable to US levels, has become common. This shift to higher policy limits could be a catalyst for more litigation against directors. Still, with regard to out-of-pocket liability for outside directors in case of damage claims, the unfavourable procedural terrain for plaintiffs in the UK should mean that even well-insured UK directors will face much less risk of litigation than their US counterparts.[394]

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[391] Davies (2008), p. 509.

[392] Cheffins and Black (2006), p. 1415 and Davies (2008), p. 596.

[393] Davies (2008), p. 592.

[394] Cheffins and Black (2006), p. 1415.

2.7.7 Company insolvency matters

When a company becomes insolvent, obviously non-executive directors risk damage claims against them to contribute to the assets of the company. This is more a theoretical than a practical worry. Ordinarily the board controls litigation decisions and will rarely sue its own members. The few derivative suits, so far, against directors, are described above and have not been successful to date. However, once a company enters a reorganization process under UK insolvency legislation known as “administration”, the administrator is authorized to sue in the name of the company. The liquidator who is appointed instead upon insolvency of the company has the same power. Also section 212 of the Insolvency Act 1986 authorizes the liquidator to apply to the court for an order requiring the directors to make a contribution to the company’s assets if they have breached a duty owed to the company. There is, however, no reported decision in which an administrator or liquidator has exercised his right to bring an action against a director, whether an executive or an outside director. Liquidators have brought some cases to court, but none involving a public company.[395]

There is another cause of action. A liquidator may petition the court to rule that the directors have engaged in “wrongful trading”. This is the case if the company is insolvent and the director knew or ought to have concluded that there was no reasonable prospect that it could avoid this fate and he failed to take every step a reasonable director could have taken to minimise the creditors’ potential loss. These cases, too, are rare. Essentially because, though the Insolvency Act requires evidence of “failed to take every step that a reasonable director would have taken”, it gives no guidance as to what those steps might be. The amount of the contribution to be paid and “the relationship between cause and effect”, i.e. “causation” can also be difficult. Liquidators, usually accountants, are hesitant to start complicated litigation which they might lose.

Finally, D&O insurance policies typically cover this type of liability in bankruptcy cases. There is doubt about the validity of the insurance, because some view this “wrongful trading liability” as penal, i.e. having a

[395] Cheffins and Black (2006), p. 1417; and Prof. Sir Roy Goode, *Principles of Corporate Insolvency Law*, 4th edition (2011), pp. 682-683.

reference to criminal law, rather than compensatory, i.e. belonging to civil law. If it is penal, it would make the insurance invalid.[396]

2.7.8 Regulator: criminal penalties

The law on accounts has become stricter. Each director must confirm that, insofar as he is aware, there was no “relevant information” of which auditors were not informed. Late filing of accounts is a finable offence with 2,600 convictions in 2004/5 alone. Providing misleading information can also lead to a fine. The former CEO of Sportsworld had to pay £45,000 in fines for failing to notify the market promptly of a change in its business performance. And the former CEO and CFO of the AIT Group were imprisoned and forced to pay substantial sums to investors, because they had recklessly misled the market.[397] There are fines imposed on directors for many offences under many other laws, for example environmental legislation.

2.7.9 Other measures, including disqualification

The Financial Services Authority (FSA) can send best practice letters to listed companies and does so regularly. It can write public letters for disclosure breaches as it did in the cases of Eurodis Electron and Sportsworld.[398] The FSA may suspend or cancel a stock exchange listing or issue penalties. The investigation is not public. The FSA did not punish the directors of RBS for their alleged mistakes in the acquisition of ABN AMRO.[399] The FSA did say they would consider that these mistakes would have influence if these persons should aspire to new board positions in a bank.

There is also the measure of disqualification, which means that a director can be forbidden to act as director of any company for a period of 2 to 5 years. This often happens in the case of insolvency, e.g. all the directors of Barings were disqualified for 15 years.[400] Of some 1,300 director disqualification orders made in 2004/5, over 1,100 followed an insolvency.[401] In most cases this happens in small companies.

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[396] Cheffins and Black (2006), p. 1418.

[397] Johnstone and Chalk in Rushton (2008), pp. 160 and 162.

[398] Johnstone and Chalk in Rushton (2008), p. 159.

[399] *Financial Times*, 3 December 2010, p. 15.

[400] See for the *Barings* case 2.6.5 above under duty of care.

[401] Johnstone and Chalk in Rushton (2008), pp. 162-163; Davies (2008), pp. 237-255; and Cheffins and Black

The Department of Business Investigation Services (BIS), formerly Business Enterprise and Regulatory Reform (BERR), and before that DIT, has the right to investigate companies.

2.7.10 Summary: rare cases

Protecting directors in the UK from liability has not been a priority because the chances of a lawsuit have been so small. However, there has been growing concern in recent years about directors' liability, due in large part to the *Equitable Life* litigation and, in line with similar conerns in the US, attempts to protect directors have increased. The 2006 amendments to the UK Companies Act allow a company to advance the legal expenses to a director, who is being sued, to indemnify directors in third party suits and provide their directors with better D&O protection. Thus far the risk of out-of-pocket payments by outside directors is minimal. The main concerns are naming and shaming, disqualification and regulatory fines.

(2006), p. 548.

3. UNITED STATES

3.1 History and culture

I start with a brief list in telegram style of key features of US culture, followed by US corporate history and US corporate culture painted with a broad brush and therefore including generalizations that do not apply to all persons. I base my views on personal conversations with experienced observers as well as on relevant literature.

3.1.1 General characteristics

Some key features and phrases of US culture are:

(a) *State laws, agencies, courts,*
State laws, SEC, NYSE, NASDAQ, decentralised, Delaware case law, litigation is a right, a way of free expression, not so much soft law.

(b) *American Dream, free enterprise*
Everything's possible for every self-made man, comeback kid, voluntarism, yes you can, come back after bankruptcy, go for it, competitive, large mergers, imperial CEOs, anti-trust laws, abundant size and resources, frontier spirit, country of immigrants, melting pot, business as American Institution, openness, quite direct – like Dutch – unlike British.[402]

(c) *Strategic thinking*
Market discipline by corporate control, support for new entrants, managerial capitalism for corporate value, good training of talent in companies, corporate systems, good implementation, team work and hierarchy, strategy developed at officer level, alternatives debated and challenged at board level, art of questioning, primacy of the board, influence of academics, many changes by pressure groups after long debate.

(d) *Sometimes short term, sometimes long term*
Abundant size and resources, decentralised takeovers, support for new entrants, carrots for directors, bonus culture, all lead to short

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[402] Zahn (2005) described Dutch, German, French, UK and US culture in a similar telegram style.

term strategies; elements for long term strategy thinking are: team work and hierarchy, primacy of the board, managerial capitalism for corporate value, strategic investors.

Below I will elaborate on these key words. I should say at this point that I am a Dutchman who has lived and worked in Chicago for 6 months at the age of 31. As a lawyer I have worked with American lawyers for many years, regularly, on committees and boards of the International Bar Association.

3.1.2 History of US corporate governance

19th century: early separation of ownership and management

A noticeable characteristic of the US corporate world is the separation of ownership and management. Of course, at the start of the 19th century the US too had many family companies that were managed by their owners. As the century progressed, however, share ownership began to spread and often the shareholdings were so small and diverse that management of the corporation had to be left to a professional manager.

There were several reasons for this early widespread share ownership:

– Among the industrialised nations at the time, only America had a continent-wide economy with low internal trade barriers. It alone therefore provided a sufficiently large market for those enterprises capable of achieving large-scale efficiencies.[403]
– Economies of scale made possible by new technologies required US corporations to become so large that their capital requirement could be satisfied only by selling stock widely to outside investors on the market.[404]
– In the huge railroad enterprises ownership and management soon became separated. Much more capital was required to build a railroad than to purchase a plantation, a textile mill or even a fleet of ships. The administrative tasks were numerous, varied and complex. They required the skills and training of full-time

[403] Mark J. Roe, 'The Political Roots of American Corporate Finance', in Donald H. Chew and Stuart L. Gillan (eds.), *Global Corporate Governance* (2009), p. 20 ("Roe (2009)").

[404] Adolf A. Berle Jr., 'Corporate Powers in Trust', 4 *Harvard Law Review* 1049 (1931); Adolfe A. Berle Jr. and Gardiner Means in their classic book Berle and Means (1932), pp. 333-357.

salaried professional managers. The railroad boom started as early as the 1840s.[405]

– The national taste for speculation also played a part in the early growth of trading on secondary stock markets and added, in turn, to the dispersal of stock ownership.[406]
– Retail lending banks were kept small and confined within state borders. This made bank lending on a large scale impossible. Therefore, capital had to be attracted on stock markets. At the time there were stock exchanges in several cities such as Philadelphia, New York and Boston.[407]
– The corporations became so large and exchanges so liquid that the heirs of family owners had an easy way of spreading their risks by trading their shares on stock exchanges.

All of this caused a rapid increase in the number of listed stock exchange companies, in which share ownership was separated from management. The New York stock exchange had 31 listed companies in 1830, mostly railroad companies. By 1859 many more were listed of all kinds of industries. Already by 1857 many Europeans were investing in US shares.[408] Share ownership became really widespread. Even John Rockefeller, the founder of Standard Oil and the richest man in America, ended up by owning only a fraction of the outstanding stock in Standard Oil.[409]

1860s: Civil War: corporate law is the realm of States

The urgent need to raise enormous sums as a result of the American Civil War was instrumental in the development of mass markets in securities.[410] Another development of the Civil War was that President Abraham Lincoln was able to do deals with US entrepreneurs who helped the government finance the war and in turn received facilities to rapidly open up the West. From that time on US corporations used the title "President" for the heads of their corporations. They saw themselves running their own empires. This mindset betrayed a tension between "big business" and the Federal Legislation, which continues until today. The

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405 Alfred Chandler, *The Visible Hand: The Managerial Revolution in American Business* (1977), p. 90 ("Chandler (1977)").

406 Walter Werner, 'Corporation Law in Search of Its Future', 81 *Columbia Law Review* 1611, 1612 (1981).

407 Roe (2009), p. 18.

408 Chandler (1977), p. 91.

409 Roe (2009), p. 21.

410 Frentrop (2002), p. 184.

states deal with corporate law. The Securities Act 1933 and the Securities Exchange Act 1934 and Sarbanes-Oxley Act of 2002 and the Dodd-Frank Act of 2010 are the exceptions.[411]

Takeover fights: market for taking corporate control 1860s-1870s

One of the first mega enterprises was the New York Central Railroad, which ended up in the hands of the famous "Commodore" Vanderbilt. He acquired several railroad corporations, but encountered strong opposition when he tried to buy the shares of the Erie corporation shares from management. Every time a judge gave a favourable judgment for Vanderbilt, Erie's management found another judge to give an opposing judgment. Indeed, the management even went so far as to leave the offices in New York with all the cash and move to New Jersey, together with 125 armed men and even some canons for protection!

Later Jay Gould became owner of the Erie railroad bridge corporation and wanted to buy more railroad corporations. He found a friendly judge ready to dismiss Mr Ramsey, the director of one of his targets, but Ramsey found another judge who dismissed the other directors. This led to a brawl involving about 800 armed men, among whom were the "Bowery Boys", who had left the slums of New York to protect the interests of the Goulds. The takeover fight ended with a merger of the Delaware and Hudson railroads. At this stage, the ways entrepreneurs tried to gain and keep control of corporations had become too rough. A more peaceful disciplinary mechanism was put to work. On behalf of the investors, a merchant banker was added to the board of the companies to look after their interests. This was a sort of "corporate governance" *avant la lettre*, a form of supervision.[412]

Start of 20th century: financial capitalism

In the last quarter of the 19th century a great wave of mergers swept through the manufacturing sector. Nothing like it had ever been seen before. This involved an unparalleled process of horizontal consolidation, i.e. simultaneous mergers of many or all competitors in an industry into a single, great enterprise.[413] These monopolies led to protests and in 1890 the US enacted the Shearman Anti-Trust Act.[414] Whereas before 1897

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411 Chambers (2008), p. 358.

412 Frentrop (2002), pp. 186-187.

413 Frentrop (2002), p. 202.

414 Frentrop (2002), p. 203.

mergers had been initiated only by industrialists, after this date they were increasingly started by financiers in a highly efficient national capital market. This increased the number of mergers.[415] The largest of these merged enterprises was US Steel, a "trust of trusts". After the listing of US Steel, the average number of daily share sales increased from 2 million to 3 million. When first listed in 1901, US Steel had a market value of US $1.4 billion. This boosted the power of the emerging stockbroking houses, which could ensure that the large amounts of securities required were placed with the public, first and foremost by the firm of J. Pierpont Morgan.[416]

It was the practice for partners in investment banks, which had arranged the floating of the bonds and preference shares, to be given a position on the board of the company in order to supervise the board of directors and protect the interests of their clients, the investors. As some of these bankers accumulated numerous directorships they obtained exclusive power, particularly with the growth of trusts. This was referred to as "Morganization" after J. Pierpont Morgan. It also came to be known as "financial capitalism". The Clayton Act of 1914, the second Anti-Trust Act after the Shearman Act of 1890, was meant to curb the size of these huge concerns. American enterprises had become larger than their European counterparts. By 1914 US industrialists had launched a wide variety of new products in the global market such as the telephone, portable camera, phonograph, electric street car, automobile, typewriter, passenger lifts in houses, machine tools. American manufacturers reigned supreme in every one of these fields, just as in the automobile industry, and in several they were monopolists.

In summary, the large railroad companies and the later other industrial enterprises too made use of the possibility of raising capital from the public in bonds and shares.

As the ownership of companies passed from the hands of just a few entrepreneurs to a wider public, corporate governance issues were raised. How could the board attract capital at the right price if the investors did not receive the right information? New capital could be raised by selling the investors preference shares or convertible bonds which gave a fixed

[415] Chandler (1977), pp. 92-93.

[416] Frentrop (2002), p. 206.

interest or dividend. But in order to place ordinary shares the public needed sufficient information if they were going to invest their money.

The second problem was the classic agency question. How could investors get sufficient assurance that the board would act in their interests? This problem was solved by appointing financial intermediaries as supervisors. J. Pierpont Morgan was the first of such financial supervisors.[417]

A market for ordinary shares of fluctuating value needed more disciplinary mechanisms than an investment banker on the board. As long as stock exchange prices were going up there was not a problem. In the 1920s no one worried and there were hardly any laws governing securities. The situation changed only after the Great Crash in 1929 and the introduction of the economic programmes and securities laws by the administration of President Franklin D. Roosevelt under his "New Deal".

1933: New Deal, SEC, managerial capitalism

The shareholder base had spread to include many small shareholders. Between 1920 and 1929 the number of shareholders investing through the NYSE doubled from 14.4 million to 30 million.[418] This pushed up share prices. However, in the Great Crash of 1929 share prices plummeted by 83%. The Great Depression of the 1930s spurred a public debate about corporate reform and formed the backdrop for the first federal securities laws. Franklin D. Roosevelt created the Securities and Exchange Commission (SEC) and introduced the Securities Act of 1933 and the Securities Exchange Act of 1934. Neither of these Acts addressed the need for independent directors or changes of corporate boards. Instead, Congress crafted a robust disclosure regime to empower investors through provision of information. It required independent auditors for listed companies to ensure reliability of information, and introduced a series of changes in proxy and takeover procedures.[419]

The crisis also led to the passing of the Glass-Steagall Act of 1933. This Act separated investment banking from commercial banking. It was a

[417] Frentrop (2002), p. 228.

[418] Frentrop (2002), p. 246.

[419] Roberta Karmel, 'Independent Directors: The Independent Corporate Board: A Means to What End?', 52 *George Washington Law Review* 534 (1984), p. 537 ("Karmel (1984)").

wise decision and, in hindsight, it might have been better if this legislation had not been repealed in the 1990s.

From the 1920s and 1930s onwards a managerial hierarchy developed. Berle and Means famously identified the separation between ownership and control and the potential for divergence of interests between owners and managers.[420] They argued that managers should administer corporate assets not in their own interest, or in some form of ambiguous public interest, but as trustees in the best interests of shareholders as the owners of the corporate enterprise. Although lip service was paid to their proposal, scholars, practitioners and regulators gradually came to agree that the imposition of a monitoring function of the board of directors, including outside directors, could serve as an effective antidote to what economists dubbed "agency costs" arising out of the separation between ownership and control. Such was expected in theory. In reality, outside directors were no more than decorative figures beholden to the imperial CEO. These outside directors were usually the banker, the lawyer and the accountant friends of the CEO or a representative of a customer or supplier. The CEOs were a close-knit group. They generally had much the same type of training, often attending the same group of schools. They joined the same professional societies and read the same journals. As their role came to require more narrowly specialised expertise, they became increasingly independent of the owners. The managers soon controlled the destiny of the enterprises by which they were employed. A sociologist called this the "managerial revolution". Lawyers saw the "corporation" becoming an institution. Economists saw the "Economic Theory of Managerial Capitalism" at work.[421]

The number of small shareholders grew once again in the 1950s.[422] In the 1960s yet another wave of mergers produced conglomerates such as GE. The merger mania reached its pinnacle in 1968 with for example the tender offer by Gulf & Western for Sinclair Oil.[423]

[420] Berle and Means (1932).

[421] Frentrop (2002), p. 277.

[422] Frentrop (2002), p. 289.

[423] Frentrop (2002), p. 299.

1970s: independent directors and corporate governance; political correctness

Throughout the 1940s, 50s and 60s the SEC was unsuccessful in its efforts to have amendments to the federal securities laws passed and in getting existing laws to be interpreted in the sense that independent directors for listed corporations would be required by law.[424] However, though legislative reform had not yet materialised, the notion of directors' independence began to gain attention during this time. William O. Douglas, who served as chairman of the SEC and later as Justice on the Supreme Court, was an early and influential advocate of the need for independent directors.[425] In 1956, the New York Stock Exchange recommended that listed companies include at least two outside directors on their boards to help ensure prompt and full disclosure of corporate information.[426] In 1966, the Standard Oil Company of New Jersey nominated outside directors for the first time. In the mid-1960s and throughout the 1970s, public debate on corporate governance resumed in the context of the Vietnam War and the Watergate scandal. Director independence increasingly came to be seen as the crucial element that would help the board to monitor management, promote honesty and prevent the recurrence of corporate malfeasance. Public confidence in business had been thoroughly shaken by the perception of a corrupt alliance between corporate managers and political officials, and accusations of corruption pervaded all levels of society – not just the White House or the government, but inside corporations and within boardrooms. The growing stagflation and the long bear market gave stockholders a further reason to seek changes in the prevailing corporate governance regime.

From the early 1970s onwards, the SEC and the stock exchanges began to embrace the concept of the board as a monitor of management and demanded ever greater director independence.

In 1972, the SEC issued a release that concluded with the statement that "the Commission endorses … the establishment by all publicly-held companies of audit committees composed of outside directors." In 1973, the New York Stock Exchange strongly recommended that each listed

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[424] Karmel (1984), p. 537.

[425] See William O. Douglas, *Go East Young Man* (1994), p. 272.

[426] See Historical Timeline of the New York Stock Exchange, available at: http://www.nyse.com/about/history/timeline_regulation.html.

company form an audit committee, preferably composed exclusively of independent directors. In 1974, the SEC restated its support for independent audit committees by amending its rules to require disclosure of the existence or absence of an audit committee in proxy statements, i.e. information packets put together by officers of corporations and sent to all shareholders of corporations for the board to obtain proxies from shareholders for general meetings of shareholders. In 1976, in response to the SEC's investigation into questionable corporate payments and practices, prompted in particular by the uncovering of falsified corporate records and the use of slush funds, the chairman of the SEC suggested that the New York Stock Exchange (NYSE) "take the lead in this area by appropriately revising its listing requirements, thus providing a practical means effecting important objectives without increasing direct government regulation."[427] On 9 March 1977, the SEC approved the new Stock Exchange rule requiring all listed domestic companies to establish and maintain audit committees comprised solely of directors independent of management and free from any relationship that would interfere with their exercise of independent judgment as a committee member.

In April 1977, the SEC announced that it would hold public hearings into shareholder communications, shareholder participation in the corporate electoral process, and corporate governance in general.[428] In the opinion of the then SEC chairman Harold Williams, it was important for boards to be able to operate independently of management. Accordingly, he proposed a series of rules aimed to facilitate the restructuring of boards and make them fully independent. At the very least, Williams believed, the nominating, compensation and audit committees should be composed entirely of independent directors.[429] However, the SEC had no statutory authority to regulate the composition or membership of boards, or even committees, because corporate law is left to the individual states. As a result, Williams proposed that all corporations subject to the SEC's proxy rules should label directors as either "independent" or "affiliated". However, the proposal was considered too sweeping – there had not been any expectation that directors needed to be independent, and labelling

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[427] Cynthia A. Glassman, 'Board of Independence and the Evolving Role of Directors', at 26th Annual Conference on Securities Regulation and Business Problems (2004).

[428] Re-examination of Rules Relating to Shareholder Communications, Shareholder Participation in the Corporate Electoral Process, and Corporate Governance Generally, 42 Fed. Reg. 23, 901 (1977).

[429] Harold M. Williams, SEC Chairman, 'Address on Corporate Accountability – One Year Later', at Sixth Annual Securities Regulation Institute (San Diego, CA; 18 January 1979).

them as such or as affiliated was deemed an unnecessary intrusion. The proposed disclosure requirements elicited a wave of protests from the business community. It should be noted that although the SEC chairman fully supported a shift towards greater independence of directors, he did not favour federal legislation mandating such a change.

The failure of Penn Central in 1977 was one of the major scandals of the time. The outside directors had been very lax.[430] As mentioned above, in March 1977 the SEC approved the general obligation introduced by the New York Stock Exchange for domestic listed companies to have audit committees composed of independent directors. Even then, however, the SEC would not propose that this be included in federal legislation.

All the same, this marked the beginning of a shift in the main role of the board from supporting and advising the CEO to overseeing and guiding the CEO, senior management and corporate operations. The board's function changed from advising to monitoring. The wave of reform in the 1970s marked the birth of the concepts "independent director" and "corporate governance". The term "corporate governance" was already used in the US in 1977.[431] As a corollary of the shifting role of the board, arguments for having a chairman separate from the CEO began to surface.

1980s: hostile takeovers and defence mechanisms

During the 1960s public offers for shares were not regulated. Bidders used "creeping mergers" and "surprise offers". Offers were often announced after stock markets closed on a Friday, with the period open for acceptance set to close early the following week, sometimes even on the Monday, with the announcement that the bidder had already "secretly accumulated" a holding of 25 or 30%. These so-called "Saturday night specials" were felt by Congress to thwart efforts to give shareholders adequate information and time to come to a well-considered decision. In 1968 Congress responded by amending Sections 13 and 14 of the 1934 Securities Exchange Act. Much of the legislation focuses on disclosure and contains obligations to register when acquiring more than 5% of a listed corporation and procedural and substantive rules on timing and the

[430] Cadbury (2002), pp. 7-8.

[431] Luigi Zingales, *Corporate Governance in the New Palgrave Dictionary of Economics and the Law* (1977).

content of bidding documentation. This legislation is called the Williams Act.[432]

Public share offers continued in the 1970s. Hyperinflation in the 1970s meant that "hard assets" of many companies were more valuable than the goods they produced. It became profitable to buy corporations for their assets, i.e. asset picking. Inflation also led to lower stock prices. Many mature businesses were no longer growing, but were still generating cash. Furthermore, institutions owned a larger percentage of shares and many institutions were keen to maximise the value of their investments. Attitudes toward debt changed as the US became more debtor-oriented. The availability of credit and the growth of the high yield "junk" bond market made money more easily available. Bidders could borrow to finance tender offers, making even large corporations vulnerable. Attitudes towards public share offers changed. Investment banks, law firms and even corporate executives, who had once viewed the business of unfriendly public offers as unseemly could no longer resist the high fees or success of many early takeovers.[433]

A policy debate developed on whether hostile offers were beneficial to corporations and the economy as a whole and whether the boards of target corporations should be active in the process and should have defence mechanisms at their disposal to be able to stall or block hostile tender offers. The arguments pro and con and the case law accepting defence mechanisms as in the *Unocal* and *Paramount v. Time* are discussed below in 3.7.3.2. The jurisprudence that is the basis for American corporate law is largely influenced by the Delaware Chancery Court of 5 chancellors and the Delaware Supreme Court; see for a detailed exposition in 3.1.3(a)E.

1990s: number of institutional investors increases

From 1980 to 1996 large institutional investors nearly doubled their portion of ownership of US listed corporations from 30% to over 50%. From 1990 onwards the pattern of corporate governance activity started to change again. Hostile takeovers declined substantially. New corporate governance mechanisms began to play a larger role, particularly executive stock option plans, by which directors acquired more shares,

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[432] Arthur R. Pinto and Douglas M. Branson, *Understanding Corporate Law*, 3rd ed. (2009), pp. 393-394 ("Pinto and Branson (2009)").

[433] Pinto and Branson (2009), pp. 362-363.

and a greater involvement of boards where many directors now held larger parcels of shares.[434]

Institutional investors promoted stronger supervision and monitoring by the board and its independent members, especially through its composition. They realized that the cost of simply changing the board in order to make the company listen to them would be less than mounting a big takeover battle. “Fix the board” became the theme. However, it was not easy for institutional investors to clean up boards because the 1992 proxy rules made it very difficult to organise a proxy contest. It was and still is nearly impossible for shareholders to get a candidate for the board nominated or put on the ballot without bearing the costs of a proxy fight.

Shareholders increased pressure by criticising CEOs year in, year out, on items such as underperformance and overcompensation. In 1993 the board of directors of General Motors ousted its chairman/CEO and made a landmark decision to split the functions of chairman and CEO by appointing a non-executive chairman and a separate CEO. Within three months three other listed companies followed suit. The SEC helped by permitting shareholders to include their criticism on the CEO’s compensation on the proxy ballot as a non-binding opinion.

In April 1994, the GM board published its “Corporate Governance Guidelines”, which were dubbed by the media as “Magna Carta for Directors”.[435] It would become a watershed document in US corporate governance opening up more possibilities for shareholders to have influence on the boards of companies. The GM guidelines focused on strengthening the role of an independent board of directors through the adoption of improvements ranging from executive sessions to annual board evaluations. CalPERS, the largest pension fund of California government employees, which had and has an important shareholders activist role, took the initiative to give corporations grades “A+” to “F” based on compliance with the GM guidelines.[436] The SEC supported the

[434] Frentrop (2002), p. 389.

[435] See Carolyn Brancato, *Getting Listed on Wall Street* (1996), pp. 190-191 (“Brancato (1996)”) and Appendices B and C, the GM Guidelines. She mentions that many of the provisions of the Guidelines resemble the text of the Cadbury Code of a year earlier. I would add that Ira Millstein was the legal advisor to the board of GM and a good friend of Adrian Cadbury.

[436] Gregory V. Varallo and Daniel A. Dreisback, *Fundamentals of Corporate Governance* (1996), p. X, Management: other concerns are likely to follow GM in splitting the posts of chairman and CEO, *Wall Street Journal*, 4 November 1992, at B1.

idea that an ideal board would consist, except for the CEO, of members completely independent of management.[437]

The institutional investors introduced the concept of "relationship investing", a new form of "financial capitalism" directed at long-term investing. They were optimistic about the increase of monitoring by independent directors.[438] Several newly energised corporate boards, led by independent directors seeking to become more involved in overseeing the direction of their corporations, saw their CEOs depart. Behind these more active boards were often major institutional investors. Such a development was sometimes called "political governance". However, there was no institutional basis yet for this shareholder influence. It ran into strong opposition from traditional boards based on legal arguments and from executive management groups, such as that of the Business Roundtable, a meeting of CEOs of the largest corporations which was well advised by capable lawyers such as Martin Lipton.

In the 1990s the US administration did not create "soft laws" for better governance. Soft laws, unwritten rules, do not fit in well with US legal culture. Institutional investors therefore resorted to two methods: presenting shareholder proposals at the company's meeting of shareholders and jawboning boards of directors to push for a change in management or strategy.[439]

However, "political governance" by shareholders, often activated by institutional investors, did not really work yet. In the 1990s it did not matter so much, because stock prices continued to rise whether management was under- or outperforming. Another idea took hold: rather than trying to discipline directors by wielding a "stick" it might be better to offer them a "carrot" in the form of stock option plans. In the UK the Greenbury Report discouraged this, at least for independent directors. The British were convinced that independent directors should not have options because this would endanger their independence. In the US, however, option plans for directors seemed to solve the "problem of controlling directors". This would have directors promote "shareholder

[437] Remarks of Richard Y. Roberts, Commissioner, U.S. Securities and Exchange Commission, 'Suggestions to Improve Corporate Governance', Annual Corporate Governance Review (Washington D.C., 1 November 1993).

[438] Carolyn Brancato, *Institutional Investors and Corporate Governance* (1997), p. 15 ("Brancato (1997)").

[439] Frentrop (2002), p. 397.

value”. The Business Roundtable – the association of CEOs – moved from promoting the interests of the stakeholders to those of the shareholders.[440]

21st century: crashes, lessons, many developments

The Enron, Tyco and WorldCom scandals of 2001 and 2002 showed once again that higher compensation packages for directors – the “carrot” – is no guarantee of better management.

The WorldCom directors permitted the CEO to cook the books by not disclosing a loan of $250 million granted to him by the company without collateral and let him make multi-billion dollar acquisitions without due diligence. In Enron the directors permitted the executives to cook the books by not disclosing a scheme of internal transactions, thereby hiding liabilities. In both cases the esteemed firm of Arthur Andersen had supported the executives. In Tyco a director received a finder’s fee of $20 million without disclosing it. All three companies went bankrupt. These corporate scandals of 2001 and 2002 were, at the time, the largest and most catastrophic business failures in US history. These very public corporate disasters received a tremendous amount of public attention and served as the catalyst for regulatory changes.

On 20 July 2002 President Bush signed the Sarbanes-Oxley Act into law, and shortly afterwards the NYSE and NASDAQ followed suit with new detailed corporate governance regulations that built upon the Sarbanes-Oxley independent director requirements. These have to a great extent changed US boardroom discipline and boardroom dynamics. These changes were instigated by the Sarbanes-Oxley Act. Some are positive, but there are many negative consequences. The Act goes into such detail that it promotes “check the box” practices. It forces boards to “recognize all the trees, but lose sight of the forest”. The Act has also created substantial extra administrative costs, which is a burden for US and foreign corporations listed on the US stock exchanges and has prompted a number of foreign listed companies to leave NYSE and NASDAQ and

[440] Prof. Jay W. Lorsch and Rakesh Khurana, ‘The Pay Problem’, *Harvard Magazine* (May-June 2010), pp. 30-35, “Prominent business organizations switched from advocating a ‘stakeholder view’ in corporate decision making to embracing the ‘shareholder’ maximization imperative. In 1990, for instance, the Business Roundtable, a group of CEOs of the largest U.S. companies, still emphasised in its mission statement that the directors’ responsibility is to carefully weigh the interests of all stakeholders as part of their responsibility to the corporation or to the long-term interests of its shareholders.” By 1997, the same organisation argued that “the paramount duty of management and of boards of directors is to the corporation’s stockholders; the interest of other stakeholders are relevant as a derivative of the duty to the stockholders.”

move to the London Stock Exchange. Hereunder I focus on the US emphasis on independence of directors and the recent change in the requirements of process in board meetings.

The Sarbanes-Oxley Act dramatically changed the nature of federal securities laws with regard to corporate governance by directors. Significantly, Sarbanes-Oxley requires that all listed companies maintain wholly independent audit committees comprised solely of outside directors. This was an important breakthrough since it contrasts with the principle that federal law should not deal with the internal organisation of corporations. Reflecting a more tangible and robust definition than in the past, the term "independence" was defined as meaning that no members of the committee may accept any consulting, advising or other compensatory fee from the company or its affiliates, or be an affiliated person of the corporation or any subsidiary.[441] In fact, this definition of independence was stricter than prior stock exchange listing requirements for audit committee members, which only required that members be free of relationships that might "interfere with their exercise of independent judgment as committee members".[442] Beyond just requiring that the audit committee consist of independent directors, Sarbanes-Oxley introduced several reform measures designed to structurally empower board members to remain independent. Section 204 of the Act requires auditors to report directly to the audit committee instead of to the management. Additionally, the audit committee was granted full authority to engage independent counsel and other advisors and be adequately funded, as well as to establish procedures for receiving, retaining and treating complaints and anonymous tips. Whistleblowing regulations were also introduced.

Furthermore, the NYSE Corporate Accountability and Listing Standards Committee issued a report of recommended changes to listing standards on 6 June 2002, nearly two months before Sarbanes-Oxley was signed into law, thus affording legislators the benefit of taking note of the exchange's broader requirements for board independence. The changes recommended in the report were soon approved by the SEC and adopted on 16 August 2002. Under the NYSE standards, an "independent director" is one who has no material relationship with the listed company. The NYSE also required listed companies to have a majority of

[441] Sarbanes-Oxley, § 301, 15 U.S.C. § 78j-1 (2002).

[442] See Exchange Act Release No. 13,3436, 11 SEC DOCKET 1945, 1956 (9 March 1977).

independent directors.[443] Additionally, listed companies were required to have nominating and compensation committees composed entirely of independent directors, and to hold regularly scheduled executive sessions, without any executive, of the board chaired by a lead director or independent chairman.

The recent financial crisis has once again prompted a re-evaluation of corporate governance. Outside directors have failed to provide the oversight that optimistic forecasters expected. Unaffiliated directors may not have the expertise or access to information that would permit effective supervision of corporate management.

A significant indicator of the growing role of the board as an independent player in corporate governance was the change in composition of the board. Whereas in the 20th century directors were typically members of management or otherwise closely linked to management (e.g. lawyers, investment bankers or other advisors of the company), board membership in the 21st century reflects a significant majority of independent directors. In 1950 only 20% of directors of large public US company boards could be deemed independent, but by 2005 average independent director representation had reached 75%. A typical board is now composed of the CEO and about 8 or 9 independent directors.

In board meetings due process is very important. The board must be well informed, take time to receive good outside advice and debate all alternatives before coming to a well-reasoned decision.

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[443] NYSE Section 303A.02 Independence Test

- General: board must affirm – given all relative facts and circumstances – that each director is independent;
- also for the last 3 years that he/she (or family member) has not been:
  - an executive director of issuer;
  - a recipient of more than $120,000 in any year from the issuer;
  - an officer of a contracting company for more than $1 million or more than 2% of the company's consolidated gross revenue in a year;
  - executive director of another company where one of the executives of the issuer is independent director and on the compensation committee;
  - employee of auditor of issuer.

NASDAQ 5605(a)(2) Independence Tests

- for the last 3 years he/she (or family member) has not been (same list as in the NYSE rules, except that the threshold for a contracting company's officer is not $1 million but $200,000 per year).

An important case involving an “imperial” CEO/chairman was the *Disney* case. In 1994 Disney had lost its COO/president Frank Wells in a helicopter crash. Eisner was chairman and CEO. Eisner assumed the presidency temporarily, but only 3 months later was found to be suffering from a heart disease and had to undergo bypass surgery. These events persuaded Eisner and the board to find a successor for him. Eisner and Irwin Russell, chair of the Compensation Committee, together approached Ovitz for the COO position. Ovitz, who would receive $150-$200 million over the next 5 years at the job he was then holding, initially refused. However, negotiations were subsequently resumed. Everything was discussed by telephone with 3 other Disney directors, who said that they had received sufficient information. Expert advice had been obtained. It was agreed that, as in his existing job and like Eisner, he would get a 5-year contract. He was terminated without cause after 14 months of service and Disney after the board had again taken expert legal advice paid about $130 million in compensation.

The first complaint, filed by a shareholder called Brehm, asking the court to permit a derivative suit, i.e. a law suit by the company against the directors, was dismissed straight forward by the Chancellor for failure to sufficiently allege particularised facts supporting the cause of action.[444] This part of the decision was affirmed by the Delaware Supreme Court, but the Supreme Court went further to advise the plaintiffs to use their inspection rights to gather more information.[445] The Supreme Court seemed troubled by the case, but pointed out that standards of liability are not the same as ideal corporate governance best practices.[446] The Supreme Court gave plaintiffs the right to inspect books and records and re-plead the case in part. The plaintiffs used this right and, when more facts were adduced, their case was not dismissed and the plaintiffs could take the case to trial.[447]

It turned out that Ovitz and Eisner were unable to manage Disney together and the hiring was problematic from the start. The plaintiffs argued breach of duty of care, good faith and waste. They pleaded inter alia that the dismissal should have been for cause but could not prove that point. The case was tried before the Chancellor over 37 days. The Chancellor found the board process failed to meet best practice standards, which meant that the Compensation Committee should have received spreadsheets showing what Ovitz would have received if dismissed in respectively years 1, 2, 3, 4 and 5. Moreover, more extensive meetings should have taken place before the dismissal. Finally, the Chancellor found that the board acted in a sufficiently informed manner and had not therefore

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[444] *Brehm v. Eisner*, Ch. 731 A.2d 342 (Del. Ch. 1998).

[445] *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000).

[446] Norman Veasey, ‘What happened in Delaware Corporate Law and Governance from 1992-2004’, *University of Pennsylvania Law Review*, Vol. 153:1399 (2005), p. 1419 (“Veasey (2005)”) and 3.6.2 below.

[447] *Walt Disney*, motion 1, 825 A.2d 275 (Del. Ch. 2003) and *Walt Disney*, motion 2, 2004 WL 2050132 (Del. Ch. 2004).

breached the duty of care in making its decision. The Chancellor handed down an opinion of 174 pages in favour of defendants.[448] The Supreme Court confirmed this ruling.[449]

In 2004 at Disney's AGM, 43% of the shareholders withheld their votes for the re-election of Eisner. Although re-elected as director, the board decided to replace him as board chairman/CEO. This *Disney* case is cited often in corporate governance literature and is a warning that due process must be observed in boards and that boards must have a large majority of independent directors to counterbalance the CEO.[450]

Shareholder activism has effect on voting items from 2004

Financial institutions were mostly passive at the turn of the century. They are profit driven and do not want to spend money on corporate governance. Legally they had hardly any rights and a number of impediments. Many listed companies had defence mechanisms, including staggered boards, where only 1/3 of all directors were up for re-election each year. Shareholders rarely went to shareholders meetings. They gave proxies to brokers. It was prohibitively expensive to start a proxy fight against the board's proposals. A proposal of shareholders could only be initiated in "precatory" language, that would not bind the board.[451] Nearly all nominations of the board for director positions were pushed through, because of the pluralist voting system, where any nominated director would be voted in, if he had more positive votes than any other candidate. In absence of votes for another candidate one vote was enough. Because of the broker proxy system most voters would not vote. In the Disney saga, in 2004, there were 11 nominated directors for 11 places, who all got in as directors. This caused shareholder activists to push for a change from the traditional plurality standard to majority voting, where a director who receives less than 50% of the shareholders' positive votes, resigns voluntarily. In some companies this voluntarily resignation is binding, but in others the board may refuse to accept the resignation.[452] From 2004 mainly government employee pension funds, such as CalPERS and

[448] *Walt Disney Company Derivative Litigation*, 907 A.2d 693 (Del. Ch. 2005) and Cons. C.A. No. 15452, 2005 Del. Ch. Lexis 113.

[449] *Walt Disney Company Derivative Litigation*, 906 A.2d 27 (Del. Sup. 2006).

[450] The *Disney* case: a virtual roundtable discussion with Chancellor William B. Chandler III, Prof. Lawrence Hammermesh, Prof. John Coffee and William T. Allen, former Chancellor, and Corporate Governance (2009), p. 15.

[451] Bainbridge (2008), p. 216.

[452] Bainbridge (2008), p. 212 and Lisa M. Fairfax, 'Making the Corporation Safe for Shareholder Democracy', *Ohio State Law Journal*, Vol. 69-53 (2008), pp. 65-66 ("Fairfax (2008)").

TIAA-CREF, both active since 1992, became the torch bearers for change on voting issues. Voting advisory companies like Risk Metrics, now renamed Institutional Investor Services, were able to coordinate the votes of the traditionally silent majority, which gave shareholder activists substantial influence. There are three methods to push through: urging other shareholders to vote in line with the activist with the help of voting advisors, one-on-one meetings with the board and shaming the directors via the media.[453]

The Dodd-Frank Act, 21 July 2010

The credit crisis has taught us more lessons and there will be additional changes to come. The Dodd-Frank Act, signed by President Obama on 21 July 2010, not only makes dramatic reforms to the financial regulatory system in the US but also contains a number of significant provisions relating to corporate governance and executive compensation of all listed companies.

The Dodd-Frank Act (the Act) settles many highly debated aspects of corporate governance by setting out more additional requirements to be met by directors. On most items the Act directs the SEC to make further regulations for detailed requirements.

Proxy access

The SEC issued a proposal in 2009, which provoked considerable debate and criticism from corporate circles. Now the Act, in an amendment to Section 14(1) of the Securities Exchange Act 1934, authorises, but does not require, the SEC to adopt rules on free proxy access, but makes an exception "if it disproportionately burdens small issuers". "Issuers" herein means "listed corporations". Shareholders have for a long time had the right to elect directors but in practice they could only vote for or against the board's nominations mentioned on the company's proxy statement. If shareholders wished to nominate a director, they had to go through the huge expense of filing their own proxy statement, which made their right to elect directors rather limited. This new proxy access will give large shareholders a strong instrument. The proposed rule would establish the right to nominate a director on the corporation's proxy card (i.e. at no cost). The proxy card is issued by the corporation to shareholders at their documented request months before the AGM together with the board's proxy material. The shareholders will have the

[453] Bainbridge (2008), p. 219 and Fairfax (2008), pp. 54-107.

right to nominate a director, if those shareholders (or groups of shareholders) hold at least 1% of the company's shares for a period of at least one year (this applies to the largest companies, while higher ownership thresholds apply to smaller companies). Access to the proxy card would be of no use to a shareholder seeking to change control of the company (i.e. on the continuing assumption that boards can defend themselves against hostile takeovers) and there are various disclosure and qualification requirements. Up to 25% of a board could be installed through this proxy access in any one year. Following debate, the thresholds have been raised. Indeed, on 25 August 2010 the SEC issued a regulation that proxy access is only open to shareholders (or groups of shareholders) holding at least 3% of the company's shares for a minimum period of 3 years.[454] The 3% requirement is comparable to the Dutch proposals for the right of shareholders to add items to the agenda. There is still strong opposition against this proxy access rule. The Business Roundtable has started litigation in the federal court of first instance of Washington DC, asking the court to declare the whole rule unconstitutional. The second agreement against the measre is that no cost benefit appraisal was made. As of 1 July 2011 this litigation is still pending. US corporate governance specialists have informed me that the corporate world is afraid that large pension funds may be able to push through the nomination of union members as candidates for membership of the board or that hedge funds may be able to push through the nomination of one of its representatives. The worry is that the board will no longer serve the interests of the shareholders as a whole, but each director will only take care of special interests. They add that this debate about nominating rights is a separate issue from the debates about plurality vs majority voting and staggered boards. These two issues are not dealt with in the Dodd-Frank Act, but are a hot topic of debate in many shareholders meetings in 2011. These issues are described below after some items of the Dodd-Frank Act.

CEO/chairman structure disclosure

The Act adds a new Section 14B to the Securities Exchange Act 1934 under the heading "Corporate Governance" and directs the SEC to issue rules requiring US listed companies to disclose in their annual proxy statements the reasons why the company decided to have the positions of CEO and chairman filled by the same person or by separate individuals. This provision of the Act is a repetition and serves to rub in the point,

[454] Wachtell Lipton Memo of 25 August 2010, see Wachtell website.

because the SEC had already adopted such rules as part of its December 2009 "proxy disclosure enhancement rules" contained in Item 407 of Regulation S-K. It is clear that the issue of one person being both CEO and chairman is a major point of debate at present. The reporting requirement which the SEC now will have to make mandatory comes close to the UK "comply or explain" rule, see 2.1.2(viii) and 2.2.3(ii).

Limitations on broker discretionary voting regarding directors
NYSE rule 452 allows brokers to cast discretionary votes, i.e. they do not need to have specific authorisation from the shareholders they represent, on "routine" matters. "Broker discretionary votes" constitute between 10% and 20% of the votes cast at most companies. This meant that in the past brokers – who are usually influenced by the CEO – had a say in director elections. Rule 452 was amended in 2009 to stipulate that the election of a director is never "routine", and the Act now codifies this requirement through amendment of Section 6(b) of the Securities Exchange Act 1934. The Act goes on to require all stock exchanges to amend their rules to prohibit broker discretionary voting on non-routine matters, including voting on executive compensation matters.

It is because of this provision prohibiting brokers from voting on directors appointments that the SEC has issued a release on other possible ways for issuers to communicate with beneficial owners, so that on the one hand the beneficial owners are well informed and on the other hand they can have more real influence on elections.[455]

Say-on-Pay (shareholder votes on executive compensation matters) and golden parachutes
The Act adds a new Section 14A of the Securities Exchange Act 1934, under which public companies must give shareholders a non-binding advisory vote at least every three years on the compensation of certain executive officers specifically named by function.

In recent years there have been a limited number of say-on-pay votes voluntarily proposed by management. Shareholders will be able to vote on compensation and on whether they wish to vote every one, two or three years. Several companies have already in advance of the law voluntarily adopted say-on-pay votes biennially (e.g. Prudential) and triennially (e.g. Microsoft). According to the Cravath Public Company

[455] Wachtell Lipton Memo of 15 July 2010.

Alert[456] in 2010, three companies – Motorola, Occidental Petroleum and Key Corp. – did not receive majority shareholder approval on say-on-pay votes. The consequence of failed votes on compensation is expected to be that certain directors, particularly compensation committee members, may be the target of "withhold the vote" campaigns and may not be re-elected.

The Act also requires disclosure to shareholders and a non-binding advisory shareholder vote regarding "golden parachutes" for executives in any merger or acquisition transaction requiring a proxy or consent solicitation.

Disclosure of institutional investor's voting records on compensation matters

As a complement to the new federally mandated say-on-pay and say-on-golden parachutes votes every institutional investment manager subject to Section 13(f) of the Securities Exchange Act 1934 will now be required to disclose, annually, how it voted. This type of disclosure is already best practice on the websites of investment institutions.

Independence of compensation committee members

Similar to the public company audit committee requirements added by the Sarbanes-Oxley Act of 2002 to Section 10A of the Securities Exchange Act 1934, the Act has added a Section 10C that addresses the issue of the independence of compensation committees. Although NYSE and NASDAQ require all committees to have solely independent members, there has not previously been a Federal Exchange Act provision to back up the SEC rule regarding independence of compensation committee members. This is the second departure – the first being the section of the Sarbanes-Oxley Act providing for the independence of the audit committee members – from the principle that federal laws should not regulate the internal organisation of corporations. It should be noted that directors affiliated to large shareholders may not be eligible to serve on compensation committees. However, this is not yet included in the definition of NYSE or NASDAQ. Their sole concern is whether the director is affiliated to the listed corporation in question.[457]

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[456] Cravath, Swaine & Moore LLP Public Company Alert, 21 July 2010, see Cravath website.

[457] See 3.4.9 below.

Independence of compensation committee advisors
The Act does not require compensation committees to use only independent advisors, but only that independence be considered and that the corporation must pay the advisors.

New disclosures about compensation
New requirements of disclosure on compensation are:
Pay versus performance
Companies will be required to disclose the relationship between "executive compensation actually paid" and "the financial performance of the issuer", taking into account any change in the value of the shares and dividends of the issuer and any distributions.
Internal pay ratio
Companies will be required to disclose the manner of compensation of all employees of the company (other than the CEO), plus the total compensation of the CEO, and also provide the ratio between the CEO's income and others.
Hedging
Companies will be required to disclose whether directors and employees are permitted to purchase instruments "to hedge or offset any decrease in the market value of shares" if they have received put options.

Claw backs
The Act creates a new Section 10D of the Securities Exchange Act 1934, which requires listed public companies to implement policies to recapture – or "claw back" – compensation "erroneously awarded" to executives prior to a restatement of the company's financial statements. It applies to all present and former executives and to restatements of accounts for any reason, not only in cases of misconduct. It is therefore very wide-ranging.

It should be noted as background that under Sarbanes-Oxley the SEC has hitherto been empowered to require the recovery of certain compensation from CEOs and CFOs (but no others) in the case of restatements resulting from misconduct.

The change to all executives, i.e. not only the CEO an CFO, and restatement for any reason, not only fraud, broaden its scope greatly. In recent years over 650 companies have made restatements annually. This will make boards rethink their bonus criteria.[458]

[458] Cravath, Swaine & Moore LLP, Public Company Alert, 21 July 2010.

Compensation restrictions at "covered financial institutions"

The Act imposes extra compensation-related requirements on "covered financial institutions". Covered financial institutions are those financial institutions on a specific list, which are specially supervised by the Federal Government. They are obliged to report to the appropriate federal regulator the structure of all incentive-based compensation arrangements. This is to enable the federal regulators to determine if the compensation structure "provides an executive officer, employee, director or principal shareholder of the covered financial institution with excessive compensation" or "could lead to material financial loss to the covered financial institution". The Act also directs the regulators to adopt rules to prohibit any types of incentive-based payment arrangements that encourage inappropriate risks.

Whistleblower provisions and "bounty" payments

The Sarbanes-Oxley Act has provisions to protect whistleblowers from "discharge, demotion, suspension, threats, harassment or discrimination". As a result, many companies introduced their own internal guidelines for whistleblowing and ethical treatment. Now the Act establishes a "bounty" programme at the SEC, under which whistleblowers may be awarded 10% to 30% of the amount the government receives in fines if the fines are above $1 million. This applies only to "original information". It could give the incentive to the whistleblower not to go to the company first with the information, but to bypass the company and immediately go to the SEC out of fear that the company may report itself, as a consequence of which the whistleblower's information would not be "original". It is expected that corporate circles will strongly object to this system, which does not promote internal ethical behaviour.[459]

Summary

Congress passed, and the President signed, the Dodd-Frank Act on 21 July 2010. Its application is in many cases subject to regulatory measures, and it is likely that there will be pressure from corporate circles for the SEC and other regulators to relax implementation to some extent.

Debate about staggered boards

Although not an item in the Dodd-Frank Act many shareholder activists raise the issue that they want the company to delete the staggered board

[459] Wachtell Lipton Memo, 21 July 2010.

system. By this arrangement directors are not all re-elected each year but one third of directors is re-elected every three years. This is regarded as a semi-protection device. At present, about one third of listed corporations have a staggered board; see sub-section 3.4.10 and note 540 below.

Debate to change from plurality to majority voting in 2011

Many corporations still have a plurality voting system by which a director can be re-elected in case at least one shareholder votes him in, while the other shareholders withhold their votes. Shareholder activists are pushing for a change to majority voting, either irrevocably or subject to board decision. This resignation subject to board decision is called "plurality plus". "Majority voting is the number one issue for the 2011 proxy season at shareholders meetings. This is the year that the focus shifts back from regulatory changes to the annual meetings."[460] As an example, in 2010 at a smaller listed company that had majority voting with resignation subject to board decision, activists withheld their votes to re-elect the one third of the directors that were up for re-election in a staggered board. The reason for the withholding of votes was that the board refused to abandon the staggered board system. The directors, who did not gain the majority, resigned. The board decided to give shareholders their way and deleted the staggered board and reappointed all directors, because there had been no material criticism against the directors.

Lawyers say that many of the Dodd-Frank measures will be contested in court or politicly, with the arguments that they are unconstitutional or that there is lack of a cost benefit appraisal.

3.1.3 Aspects of US corporate culture

Although the British, the Americans and the Dutch have much in common, such as Christian religions and tradition, tolerance, rationality and independence,[461] there are certain aspects of their business culture that give rise to divergency in corporate governance. Four aspects of US culture are relevant to corporate governance:

(a) legal practice;
(b) free enterprise;
(c) strategic implementation;
(d) sometimes short term, sometimes long term.

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[460] *Financial Times*, Wednesday, 23 February 2011, p. 16 about the change at Apple Corp.

[461] Trompenaars and Hampden (2006), pp. 20-25.

Each aspect is described below. Again, my remarks are based on general impressions. I realize that I may be sometimes repeating old generalisations and that they are not applicable to each individual. The reader might nevertheless be interested or amused by these impressions of a foreigner with a long experience with Americans and their legal and business views and practice.

(a) Legal practice

(a) A *State laws*

The US has a federal system of government and in principle leaves regulations of corporations to the individual states. Most states have flexible laws that facilitate business. In the field of corporate law Delaware plays an important role in providing a clear and predictable legal framework.

(a) B *SEC and Stock Exchanges*

The SEC has played an important role since 1933, as did the strong disclosure provisions of President Roosevelt's New Deal laws after the 1929 Crisis. Most director liability cases are based on insufficient transparency in issuing securities (Securities Act 1933, Section 11) and in selling securities (Security Exchange Act 1934, Section 10(b)). The Enron crisis led to the passing of the Sarbanes-Oxley Act in 2002, which has had a marked disciplinary effect and caused the SEC, NYSE and NASDAQ to promulgate strong federal corporate governance regulations. The Dodd-Frank Act of 21 July 2010 may have an even greater impact.

(a) C *Law first: little room for informal codes*

State laws and court judgments determine corporate law; there has traditionally been little room for informal directives and codes coming from the government, although several big private institutions such as the National Association of Corporate Directors (NACD), the Conference Board, which advises its corporate members on corporate governance, large pension funds such as CalPERS and Risk Metrics, the largest voting advisor, have set up best practice guidelines, widely disseminated and available to any director and even taught in special educational courses for board members. NYSE and NASDAQ too have introduced several best practice regulations. In the US the law in liability cases reflects the minimum standard of the business judgment rule, which only applies when fiduciary duties are breached. Everything is allowed unless it oversteps the line of liability. This is the opposite of the British approach, where “comply or explain” codes set aspirational best practices but have not been tested in court.

(a) D *Decentralised*

People move from one end of the country to the other, making friends and new starts with equal chance. They worry little about burned bridges behind them. States have varying rules and laws and there are many different business cultures. Diversity is celebrated. America is a country made by immigrants.

(a) E *Courts: Delaware*

Americans have a good feel for due process and fair hearing, the value of liberty and justice for all. The courts play an important role: in the field of corporate law. These are the state courts. In the 19th century, different courts in different states often gave mutually contradictory judgments.

About that time states started to develop corporate law statutes to protect investors. And towards the end of the 19th century a number of states lowered taxes and enacted corporate statutes, which were liberal and enabling. New Jersey was the first to liberalise. Delaware eventually took the lead and became the most attractive state for publicly held corporations. Some argue that Delaware law is purposely management-friendly in order to induce managers to opt for Delaware. Others argue that the logical course is to choose a shareholder-friendly state, because this enhances the value of the company. In fact the Delaware Courts usually find a nuanced middle ground between board and shareholder interests.

The Delaware Courts give clear direction on what boards of directors may and may not do and have managed to make the law clearer and more certain for the whole of corporate America. They have thereby attracted the vast majority of the Fortune 500 companies and more than half of all listed corporations to incorporate in Delaware. Because of the extensive experience of the Delaware courts, Delaware has a more well-developed body of case law than any other state,[462] which gives corporations and their counsel greater guidance on matters of corporate governance and transaction liability issues.

[462] Pinto and Branson (2009), pp. 16-17.

Disputes on the internal affairs of Delaware corporations are usually filed in the Delaware Court of Chancery, which is a separate court of equity, as opposed to a court of law. Because it is a court of equity, there are no juries, and its cases are heard by the judges, called Chancellors. Currently the Chancery Court has one Chancellor and four Vice-Chancellors. The Court of Chancery is a trial court, with one Chancellor hearing each case. Litigants may appeal from decisions of the Court of Chancery to the Delaware Supreme Court, which has five members. Chief Justice Myron Steele and Justice Jack Jacobs have rendered many important opinions and communicate openly with the corporate legal world, leading to a clear understanding of corporate law.

The Delaware courts have clearly supported the business judgment rule, leaving business decisions to the directors, provided they are loyal to the company and take their decisions with due care. The most recent case law makes clear that the complete board should be involved in each decision and that the board must be well-informed before taking a decision.

(a) F *Many lawsuits*

Apart from the Delaware corporate injunction and liability cases directors are generally confronted with securities class action cases in the federal courts. All of these cases deal with the issue of insufficient information in filed registrations. Although many cases are lodged, it is rare for directors personally to have to pay out of pocket, because in nearly all cases the company indemnifies them and they are protected by good D&O policies. *Enron*, *WorldCom*, *Tyco* and about 11 other cases are the exception, where independent directors did have to stump up individually, because the plaintiffs found the behaviour so seriously breaching all duties of directors that an example had to be set. These “send a message” lawsuits are making directors increasingly nervous.

(b) Free enterprise

(b) A *American Dream; free enterprise*

Americans believe that a person can make a success of a new business even though he has failed before. A failure is seen as a lesson for the future and as an opportunity rather than as a bad mark that makes it impossible to do business later. Starting from nothing is possible. From newspaper boy to CEO is the American Dream, and everything is possible for “comeback kids”. Americans love comebacks. “Yes we can” is an appealing term, although at the time of publication of this study, not so much heard as two years ago. Success and money are not dirty words in the USA, whereas they are downplayed in the UK and the Netherlands. Working hard in the US does not make a person look suspicious and ambition is not a negative word.

Government does not get in the way of enterprise. Anti-trust laws help new entrants. The Sarbanes-Oxley Act and Dodd-Frank Act might be called exceptions to the concept of free enterprise. They are certainly more restrictive on corporate freedom than any laws before.

(b) B *Voluntarism*

The first key element of voluntarism is believing and behaving as if each person is a sovereign individual: unique, independent, self-reliant, self-governing and ultimately self-responsible. Free men of early America stressed "competency" and virtue. The second key element of voluntarism is believing and behaving as if each individual succeeds through fellowship in a group of his free choice. Because success means doing well in voluntary groups, a voluntary culture encourages individuals to strive for status. The typical American has a "can-do" confidence, conformism in his team and a status-driven culture.[463]

(b) C *Go for it; assertivenes; recognition*

Americans are winners, they want to win and as soon as they start an enterprise they really "go for it" in all respects. A job application letter and CV of an American person looks very different from the letter and CV of the same type of person from the Netherlands. The American letter is full of superlatives and landitory expressions, while the Dutch letter is – or used to be – rather modest. The US scores very high on the assertiveness list of Geert Hofstede as do the British.[464] Americans value hard work, whereas the English set great store by success that seems effortless and "natural". In the US risk-taking is encouraged: people are encouraged to "shoot for the stars". Business leaders (the CEOs) value talent and gather talented people around them. They are also prepared to encourage to share in successes. Successful businessmen show magnanimity for charitable foundations; examples are Gates, Buffet, American Aid and the Peace Corps.

[463] Claude S. Fischer, *Made in America: A Social History of American Culture and Character* (2010), pp. 10-11, 97-101 ("Fischer (2010)").

[464] Hofstede, Hofstede and Minkov (2011), pp. 148-150; Hofstede (1991), p. 84. Hofstede calls the assertiveness list the masculinity index.

(b) D *Abundant size and resources*

The country's immense size and ample natural resources mean that companies can grow strong within the US market, as there are no practical borders and no import duties between states. This strength provides them with an excellent springboard for doing business and mounting takeovers throughout the world.

(b) E *Imperial CEO*

US business has a reputation for success engineered by all-powerful CEOs. Examples are Rockefeller, J. Pierpont Morgan and, more recently, Eisner at Disney, Greenburg at AIG, Robert Woodruff at Coca Cola, Jack Welch at GE, Bill Gates at Microsoft and Steve Jobs at Apple. How did this strong one man leadership develop in an otherwise predominantly democratic country? Some say it goes back to the first British settlers at the start of the 17th century, when Britain was not democratic yet. Some say it developed in the Lincoln era, when many strong heads of enterprises were successful in developing pan American companies. Some say it is connected with respect for individualism and meritocracy: if someone is successful, give him freedom to develop. Some say it is custom and has always been that way and has led to spectacular successes. Custom and following the example of successful "imperial CEOs" must be an important cultural aspect. However, the situation has changed since the Enron, WorldCom and the Disney disasters. Now a strong counterbalance is provided by independent directors and non-CEO chairmen. The strong charismatic CEO/chair is no longer the model. More modest CEOs are often successful in this day and age.[465]

(b) F *Country of immigrants, direct*

All Americans feel they are immigrants. This explains their diversity, their "can do" mentality and their direct way in communication, which is like the Dutch directness, but unlike the British.

(c) Strategic implementation

(c) A *Discipline instilled by takeovers/support for new entrants*

If a company is underperforming the company should be taken over. It was this notion that led to the formation of huge conglomerates, starting with Gould and Vanderbilt (railroads) in the 19th century and US Steel

[465] Jim Collins, *Good to Great* (2001) describes the success of modest CEOs at Kimberly Clark and Gillette.

and Standard Oil at the turn of the 20th century. At the same time Americans wish to prevent monopolies, hence the American anti-trust, anti-monopoly and anti-cartel laws. Corporations are allowed to develop defence mechanisms to remain independent. Just as in the sporting world, the weakest team gets first choice of the draft of the best new players each year. Ever since 1830 there has been a culture, backed by state laws, of keeping banks small and inhibiting the growth of interstate banks. Only since 1990 have banks grown through mergers to much larger banks. Although established business power is admired, there is always support for a new entrant.

(c) B *Academics*

Academia play an important role in the US. The courses in business administration at Harvard, Yale, Columbia, Stanford and Michigan are world famous and many top directors from the US and elsewhere have studied there. These universities have developed important economic theories which have influenced legal developments. They also have famous law schools. Law professors in the US might give less direction to the Law than in the UK and the Netherlands, because of the strong role in the US of judges, lawyers and the SEC, but still professors, such as Bebchuck and Bainbridge have produced research and theories that have a large following among law makers and judges. Contrary to the other two countries, studied in this book, judges in the US write in legal professional publications and give regular talks at seminars. Chancellor Leo Strine and Chief Justice Myron Steele of the Delaware courts are good examples. They wield great influence, as do leading lawyers such as Martin Lipton, Ira Millstein and Holly Gregory.

(c) C *Good implementation*

It is common knowledge that Americans are good at devising and implementing plans, at least in business. This is something they have learned when studying for their masters degree in Business Administration. An MBA is highly regarded and a feature of US business culture.[466] The British and Dutch have followed this example of their US competitors by establishing business schools at their own institutions of higher learning.

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[466] Philip Delves Broughton, *What they teach you at Harvard Business School* (2007).

(c) D *Adversarial system of justice; changes through long debate*

The law advances as a result of an adversarial process in which advocates challenge each other in debate and the best argued case wins the day. The law develops organically and steadily. Examples are the development of poison pills, the rights of shareholders, the long fight for independent directors and, most recently, the move towards independent non-CEO chairmen. Change often comes after protracted debate over many years and lobbying by pressure groups. The CEOs are organised in the Business Roundtable. Besides, there is the NACD; recently the Chairman's Forum is gaining momentum. Shareholder activists and their organisations such as Risk Metrics, now called ISS, add to this influence.

(c) E *Teamwork and hierarchy*

The US believes in teamwork and is convinced that people working together are more likely to come up with good ideas than a person working alone provided teams have strong leaders. A US company is built up of groups in many levels who report to each other. At each level the group leaders know what mandate and room for action they have. Europeans are often struck by the many written internal regulations at US corporations, also called "systems", as well as by the combination of teamwork and a strong hierarchy. That particular combination provides a good breeding ground for future leaders. The Dutch can learn from them how to lead. It also provides management with a talent scouting opportunity throughout the grades and promotes efficient planning of careers and succession.

(c) F *Business as a science*

A strong point of US business leaders is finding new ways of improving communication within the corporation and with shareholders and the outside world. In the area of negotiating, for example, a method has been developed at Harvard University to ascertain both parties' real interests, as opposed to taking strong positions at the start of the negotiations.[467] New forms of mediation as a form of alternative dispute resolution also evolved at Harvard.[468] Moreover, many ideas about talent development and coaching, about "recognition of joint success moments" as corporate

[467] Roger Fisher, William Uri and Bruce Patton, *How to Get to Yes: Negotiating Agreement without Giving In*, Harvard Negotiating Project (1991).

[468] Mediation Services developed in de US in the 1930s to settle labour disputes; R. Singer, *Settling Disputes* (1991), p. 6 ("Singer (1991)").

culture development and systems have been formulated in the US and brought into practice in the past ten years.

(c) G *Strategic debate*

Students practise the Socratic method. They learn how to debate in a civilised manner. They learn to ask questions. There is a real understanding that strategic decisions are best taken after extensive debate, where the alternatives have been thoroughly investigated. In this respect there is a difference between the US and the UK. In the US the independent directors only challenge the strategy plans of the officers. In the UK, by contrast, non-executive directors are actively involved in development of ideas of strategy. American directors are good at asking questions. British directors like to think creatively about strategy.

(c) H *Primacy of the board*

Although US law has evolved from English law, public corporations in the US are not looked upon as partnerships as they are in the UK. As early as the late 19^{th} century, it was realized that it is impossible for a large number of shareholders to manage a corporation. The need for separation of ownership and control was seen early on. A corporation is seen as a “nexus of contracts” and the board represents and executes this nexus. The primacy of the board is accepted. Shareholders have traditionally had little influence over the appointment and dismissal of directors. This only started to change in the 1990s as a result of very vocal shareholder activism.

(d) Short term? Long term?

(d) A *Quick success; leave ashes behind you*

Success in business can come very quickly in the US, failure too. Both are accepted. “Leave the burned ashes behind you” is advice that gains ready acceptance and so is the recommendation of what to do next: “go West, young man”. Quick success is possible because of the vast space of the US and its ample resources. This often implies a short-term perspective.

(d) B *Bonus culture*

Money is seen as a measure of success. The realisation in the 1990s that the best way of motivating executives was to give them a carrot led to the development of the bonus culture and meant that executives could make millions of dollars a year. This culture has spread to other countries, but is still strongest in the US. However, it has promoted the short-termism and over-optimistic risk taking leading to the financial crisis of 2008-2009.

(d) C *Openness*

Disclosure is always paramount. Privacy is not important. Everything about people's private life and finances is in the public domain. The English, on the other hand, are very fond of their privacy and try to keep their financial situation out of the public eye.

(d) D *Strategic investors*

Notwithstanding strong tendancies to short-termism, strategic investors, such as Warren Buffet, are highly regarded in their support for long-term strategies.

3.2 **Who own shares?**

3.2.1 Sources of finance

Retail banks have been traditionally barred from growing beyond a local presence. Since the early 1800s the US banking system has been highly fragmented. States chartered their own banks, and Congress, influenced by local interests, refused to charter national banks that could operate more extensively than the politically powerful local banks.[469] All of this meant that companies seeking to grow at a national level in the US did not go to banks to borrow capital, but instead raised capital on the equity markets.[470]

3.2.2 Stock exchanges important for regulations

The various US stock exchanges have for many years made extensive regulations for listed corporations. Often these regulations have been supported by the SEC. The existence in America of large and creative stock exchanges for the past 150 years has supported the development of US corporations.

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[469] Roe (2009), p. 18; René Stultz, 'The Limits of Financial Globalization', in D.H. Chew and S.L. Gillan (eds.), *Global Corporate Governance* (2009), p. 23 ("Stultz (2009)"). The National Banks Acts of 1863 and 1864 gave national banks only limited powers. In 1892 the Supreme Court ruled that national banks could not own stock.

[470] Pinto and Branson (2009), p. 92.

The US has the largest number of publicly traded corporations in the world: about 6,900 in 2003. Listed companies were good for 60% of US gross domestic product and represented 51.9% of all stock in 2001 owned by private shareholders.[471]

3.2.3 Who are the shareholders?

Although on paper in corporate law shareholders do not have much power in the US, shareholders have and are obtaining more and more leverage through activists and combining their power and by enlisting the media.[472]

1990s: more institutional shareholders
Whereas share ownership was very fragmented until the 1980s, it has now become slightly more concentrated. In 2001 more than 50% of the shares of US public companies have been owned by investment institutions. This is a smaller percentage than in the UK, and each of the institutions owns a smaller percentage than is normal in the UK. A dialogue between boards and shareholders has always been less frequent and open in the US than in the UK.

Although all shareholders of the same class are equal according to the strictly legal definition of their rights,[473] in the 1980s financial markets showed a complex web of relationships between corporations and varying types of institutional investors. In some cases real economic and political power is exerted by such institutions. When they act in groups, the pressure can be overbearing.

Different shareholders: investors ↔ traders
In practice, it can no longer be assumed that all shareholders are equal. Shareholders should be classified according to their investment objectives along a spectrum, with investors at one end and traders at the other. In this way, managers of corporations will come to realize the concept of "shareholder value" is not sufficient if the different types of

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[471] Pinto and Branson (2009), p. 92.

[472] Leo E. Strine Jr., *Toward Common Sense and Common Ground*, Paper for Harvard John Olin Center and University of Pennsylvania Law School (October 2007) ("Strine (2007)").

[473] Brancato (1997), pp. 3-4.

shareholders are left out of the equation. Not all shareholders have the same motives.[474]

There are various levels of shareholder participation:

1. active large investors and active voters – striking examples are Warren Buffet, the ukulele playing "sage of Omaha" with his publicly quoted Berkshire, and LENS Inc.[475] as well as major pension funds. They hold a relatively large block of shares in a few companies and use their voting power to influence vital corporate decisions; also called "relationship investing";[476]
2. passive small investors and active voters – such investors hold relatively small percentage blocks in diversified fields of business, they do not want to be actively influencing corporate decisions, but they do display active voting behaviour. Examples are CalPERS and other state pension funds and some activist hedge funds;
3. active large investors and passive voters – investors such as trust accounts at banks and corporate pension funds, who do not vote actively;
4. trader and passive voters – they typically look at small profit margins for a quick turnover and do not care to vote their shares. Examples are money managers, programme traders and hedge funds.[477] Activist hedge funds should be classified in group 2 above.

This is comparable to the findings for the UK of Tomorrow's Company, described in sub-section 2.5.10 above.

Different shareholders have different aims and goals. For example, level 3 and 4 shareholders may want higher dividends, whereas level 1 and 2 shareholders may want profits to be ploughed back into R&D.[478] Two myths exist about investment behaviour in the US: first, that institutional investors buy and sell stock for the short term, and second, that business corporations carry out their business only to please short-term investors.

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[474] Brancato (1997), p. 4

[475] LENS Inc. is owned by the famous Bob Monks and Nell Minow, see Jay W. Eisenhofer and Michael J. Barry, *Shareholder Activism Handbook* (2010), pp. 3-64, at 46-47 ("Eisenhofer and Barry (2010)"), about Bob Monks, who is a good friend of Adrian Cadbury.

[476] Eisenhofer and Barry (2010), pp. 3-63.

[477] Brancato (1997), p. 13.

[478] Brancato (1997), p. 19.

Generally speaking, these myths are unfounded: first, level 1 and 2 investors, as described above, invest for the long term;[479] second, many business corporations develop strategies for the long term.[480] Many active investor-oriented shareholders are mindful of stakeholder interests.[481] Cultural and legal resistance against banks, insurers and mutual funds holding and voting large blocks of shares has not yet been overcome. Most corporate pension funds are not active in corporate governance issues of the companies in which they hold shares. By contrast, public pension funds have been more active. For example, CalPERS and others[482] have prodded boards to set up governance and review procedures.[483]

Shareholder activism, redefined ↔ communication with shareholders
Shareholder activism by large US public pension funds has traditionally been pursued only by means of shareholder proposals and direct engagement and negotiations with senior managers rather than by outright proxy contests. This is because trustees and asset managers of such pension funds are subject to stringent fiduciary duties.[484] Their stake in a company remains limited and there is no economic justification for the costs of an activism campaign. Usually large public pension funds first adopt and update corporate governance guidelines and promote adherence to them. In this process, pension funds tend to rely on support from influential proxy advisors (such as Risk Metrics, now Institutional Shareholder Services (ISS)) and shareowner associations (including the Council of Institutional Investors (CII)) and International Corporate Governance Network (ICGN)). Mutual funds and other institutional investors are often solicited to give support by voting in line.

However, some hedge funds regard shareholder activism as a real investment strategy. They tend to acquire larger interests in fewer corporations and demand changes regarding a wide variety of issues (from governance improvements to financial corrections and even fundamental strategic changes). They can discretely engage with

[479] Brancato (1997), pp. 29-31.

[480] Collins (2001), which describes the success of corporations that climbed from good to great, such as Kimberly-Clark and Gillette. Their typically modest CEOs collected excellent staff around them and developed a sound business and succession strategy.

[481] Fairfax (2008), pp. 83 and 107.

[482] Eisenhofer and Barry (2010), pp. 3-27.

[483] Stultz (2009), pp. 28-29.

[484] Section 404(a) of the Employment Retirement Income Security Act of 1974 (ERISA).

management and corporate boards, but are sometimes prepared to become hostile (e.g. going public with the debate, launching a proxy contest or making a takeover bid). Having incurred the costs and removed the obstacles to their governance wishes, they then ask others to tag along, vote in line with the hedge fund and benefit from the change without the expenditure. To this end, hedge funds can rely on new SEC rules permitting solicitation of the votes of up to 10 additional shareholders without filing proxy materials.[485]

In the US good communication between boards and major shareholders is considered important. The most recent developments show that activist shareholders often rely on their ability to obtain support from fellow – more passive – investors. For the board, establishing a continuous dialogue with these large investors usually serves the purpose of making the views of management and board filter through to those more passive investors.[486]

The main point from the board's point of view of having good communication with institutional shareholders is to obtain backing for the board's strategy. This clearly happened in 1995 when the board of Chrysler and its CEO Robert Eaton successfully defended itself against a hostile takeover by Kirk Kerkorian, who was backed by former Chrysler CEO Lee A. Iacocca. The Council of Institutional Investors, representing nearly 100 public and private corporate pension funds, supported the Chrysler board.[487]

To quote Robert Eaton:
"On a number of occasions, I would leave and let the board member and the fund manager talk one on one. We had a simple story that combined solid performance over the past few years with a compelling strategy for the future. None of our institutional owners asked us to change direction. Not one of them told us to compromise the future for the sake of today."

[485] Rule 14a-2(2) under the Securities Exchange Act of 1934 and Regulation FD, The SEC adopted Regulation FD to address the problem of selective disclosure of material non-public information by public companies., SEC Release Nos. 33-7881, 34-43154, IC-24599, No. 87-31-99 ("the Adopting Release"). The SEC simultaneously adopted Rule 10b-5(1) (clarifying that liability for insider trading turns on "awareness" of material information) and Rule 10b-5(2) (addressing family and non-business relationships which may give rise to liability in insider trading).

[486] Conference Board (2009), pp. 71-72.

[487] Brancato (1997), pp. 6-11.

In 1992 the SEC changed its proxy rules to make it easier for shareholders to communicate with each other.[488] The rise of shareholder activism in recent decades, since 1992 and especially since 2002, has increased the importance of communication between board members and shareholders. Today more than ever, the business community recognises the need to restore investor confidence and the credibility of capital markets. In this environment, activist shareholders can act as catalysts for change by creating a triggering event (e.g. a revision of capital structure, a strategic decision such as the sale of non-core business lines, a new incentive-based compensation scheme, or a cash distribution) that will unlock shareholder value and yield investment return. The SEC contributed to this trend by relaxing the rules in 2003 and 2010.

Many aspects of communication in the US by management and boards with major shareholders and shareholder activists hold useful lessons for Dutch practice.

However, communication is still less easy for US shareholders than for their British counterparts because the Regulation Fair Disclosure under the Securities Exchange Act of 1934 prohibits the selective disclosure of material non-public information – Regulation FD[489] – which, however, is recently being interpreted in a more friendly way, as described hereunder.

Shareholder communication in one-on-one fashion
In the US one-on-one meetings of directors with individual shareholders are regarded as useful for directors' long term strategy but the legal pitfalls are substantial.

The general legal concerns are (1) prohibition of misleading statements or omissions[490] Any misleading has to be material which means any fact, projection or estimate that would alter the full information for a reasonable investor and omission means failure to correct or update statements in mandatory filings such as annual and quarterly reports. Insiders must disclose or abstain from trading and all material information must be made public, once given to anyone, which means

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[488] Eisenhofer and Barry (2010), pp. 3-48; exemption if the votes of only 10 or fewer shareholders are solicited and announcement of intended vote is permitted.

[489] Regulation FD, adopted by the SEC, Release No. 33-7881, 34-43154, File no. 57-31-99.

[490] Rule 10b-5 of the Securities Exchange Act of 1934.

that if certain information is given to an analyst or investor during a meeting it is very dangerous to give different information in another smaller group.[491] (2) Selective, i.e. material non-public disclosure is not permitted, especially when it is given to broker dealers, investment advisors, investment companies and any holder of shares, with the exemption of "temporary advisors", who owe trust and confidence to the issuer, or those who expressly agree to confidentiality, of credit rating agencies, for the purpose of public rating and/or "road shows" and (3) special care is required concerning earnings and earning estimates, Mergers and Acquisitions and Joint Ventures, changes in assets, new discoveries, acquisition or loss of contracts, changes in control in management, change in management stock splits, dividends, defaults, bankruptcies. If such information is given selectively it must simultaneously be made public by Form 8-K.[492] In the US it is normal not to announce anything about pending negotiations until a deal is final.

The general advice of US lawyers to whoever enters this minefield is to (1) be consistent, (2) centralize the response in one person, (3) keep a log, (4) prepare questions and answers, (5) do not give selective disclosure of material information, (6) be ready to make public disclosures, (7) respond to rumours, (8) have periodic, quarterly calls with analysts, (9) plan them by requesting questions in advance, avoid forward-looking financial information, avoid commenting on analysts' estimates, avoid giving any information in "black-out" periods and realize that speaking at industry conferences is non-public.

From the above summary, one might get the impression that there are so many "doubts" that it were better not to see or communicate with any shareholders, except at AGM's or through the public media. To counter this impression the SEC has recently issued a Question and Answer: Does Regulation FD prohibit directors from speaking privately with a shareholder or a group of shareholders? The answer is: No. Regulation FD prohibits selective disclosure of material non-public information to a shareholder in circumstances where it is foreseeable that the shareholder will purchase or sell securities based on that information. The company

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[491] Section 27A of the Securities Act of 1933 and Section 21[E] of the Securities Exchange Act of 1934 give certain safe harbour provisions for "forward-looking statement".

[492] Regulation FD, the penalties of Sections 13(a) and 15(d) of the Securities Exchange Act of 1934 and Regulation FD are administrative actions by the SEC cease and desist orders and civil actions for monetary damages and administrative actions against employees.

should implement procedures to avoid Regulation FD violations, such as pre-clearing discussion topics with the shareholder or having company counsel participate in the meeting. Of course if the shareholder enters into a confidentiality agreement there is no problem.[493] In the Netherlands the *Autoriteit Financiële Markten* (AFM) has also issued a comparable Question and Answer notice.

Generally, the non-CEO chairmen rarely talk with shareholders alone. If they meet shareholders, they usually do so with an executive or at least the general council. One of the reasons is that executives know more of the facts and know better what is insider knowledge and what is not.

Summary

In recent years private US groups have won many rights for shareholders, not only in practice but also in law.[494]These have included proxy access, say-on-pay, voting by brokers and a separate non-CEO chairman. The Dodd-Frank Act of 2010 has represented a breakthrough on all these points.

As mentioned above, the best protection for companies against shareholder activists is steering good and detailed communication with major shareholders, which is possible and important and should be done with care. Selective distribution of material non-public information is prohibited if it is foreseeable that the shareholder will trade in shares abased on that information.

3.3 <u>Many formal Acts, informal codes in US by private initiative</u>

The sources of corporate law are the corporate law statutes of each state. Each state also has jurisprudence or common law applicable to corporations. The courts not only interpret the statutes but also create important legal practices and principles such as derivative suits and the business judgment rule. The corporate law of the State of Delaware is paramount.

Federal securities law is another important source of law for corporations. The most important federal statutes are the SEC Securities Act 1933 for “going public” and the SEC Securities Trading Act 1934 for “being

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[493] SEC letter of 4 June 2010. Regulation FD Question and Answer 101.11.

[494] Bainbridge (2008), pp. 209-225.

public", with many other SEC regulations, which give rights for both criminal and civil actions.[495] Traditionally, the Federal Congress and the SEC have left corporate law to the states. The most recent statutes of importance to our subject are the Sarbanes-Oxley Act of 2002 and the Dodd-Frank Act of 2010, with which Congress introduced some new federal corporate law by creating obligations for boards. In these cases, Congress has expanded the historical boundaries of securities law and moved closer to a federal regime for corporate governance.[496]

Whereas many countries, including the UK and the Netherlands, have national corporate governance codes such as the Cadbury and the Tabaksblat Codes, which have a basis in the law in that companies are obliged to explain in their accounts if they do not comply with the Code, the US has a vast number of corporate governance codes published by private groups, all of which put pressure on corporations to improve corporate governance, but have no basis in the law.[497]

The main semi-private organisations that have drafted codes are:

– institutions: the American Law Institute (ALI), the American Bar Association (ABA) with the Model Business Corporation Act, the Conference Board, the Business Roundtable (for CEOs), NACD (for directors), the Blue Ribbon Chairman's Forum, Kennesaw University, the Millstein Institute at Yale and the Korn/Ferry surveys;[498]

[495] These federal securities laws were preceded by State Blue Sky laws, which were introduced in many states at the start of the 20th century. They still exist. There are also state securities administrators. The New York Blue Sky Act is called the Martin Act. After Enron, Eliot Spitzer, the attorney general of New York, made use of the Martin Act. The term 'Blue Sky' comes either from selling 'building lots in the blue sky' or 'speculative schemes which have no more basis than so many feet of blue sky'; see Eisenhofer and Barry (2010), pp. 2-24.

[496] Conference Board (2009), p. 15 and see Eisenhofer and Barry (2010), pp. 2-38. As long ago as the 1990s former SEC commissioner and corporate law professor Roberta S. Karmel wished to issue federal corporate governance rules, but could not do so due to the *Business Roundtable v. SEC* decision of 1990 of the D.C. Circuit Court of Appeal (declaring an SEC rule against "dual-class companies" void). She had already argued in favour of independent directors in 1984.

[497] In the UK by Listing Rule 9.8.6(5) and (6) and in the Netherlands by article 2:391,5 DCC.

[498] Pinto and Branson (2009), pp. 3-4.

– shareholder groups: Breeden for MCI, the Council for Institutional Investors, CalPERS,[499] TIAA-CREF,[500] Risk Metrics (now ISS);[501]

– companies such as GM in 1992 and by 2004 companies like Pfizer, Intel, Frederic W. Cook & Co, Inc., some 96% of all listed companies had written guidelines on corporate governance. Establishing such internal guidelines has been mandatory for all US companies listed on the NYSE since 23 November 2005.[502]

3.4 Composition of US boards

3.4.1 Introduction on composition of boards

As described in sub-section 2.4.1, the boards of all companies in the three countries under study must develop, implement and monitor all the following elements: purpose, strategy, policies, risk management, succession, evaluation and communication. In each country it is questioned how boards should be composed in order to best deal with these functions and to limit risks such as an "imperial CEO", group think, loafing and accepting sub-optimal work, lack of teamwork, festering disputes and lack of communication.

Some US corporate governance practices will now be described in the following chapters. First, the composition of US boards (section 3.4), second, the division of the roles of US board members (section 3.5) and finally, the duties and liabilities of US board members (sections 3.6 and 3.7).

I start with topics concerning the composition of the board, first the tradition of the one-tier board, the primacy of the board gradually assuming elements of a two-tier board

[499] CalPERS is a huge pension fund for California government officials, which was very active in the US in 1993 in changes at GM and is well known in the UK and the Netherlands.

[500] Teachers Insurance Annuity Association-College Retirement Equities Fund (TIAA-CREF), a huge pension fund and an activist shareholder and has been successful since 1992 with private communication with listed companies that brought change in corporate governance, see Willard T. Carleton, James M. Nelson and Michael S. Weisbach, 'The Influence of Institutions of Corporate Governance through Private Negotiations, Evidence from TIAA_CREFF', *The Journal of Finance*, Vol. L111, No. 4, August 1998, pp. 1335-1361.

[501] Risk Metrics, now called Institutional Shareholders Services, is very influential. For example, in the chapter on employee compensation in his 2009 general report to clients, well-known corporate lawyer Martin Lipton (pp. 201-206) repeatedly advises them not to ignore the recommendations of Risk Metrics.

[502] Section 303A, subsection 9, of the NYSE Listed Company Manual.

(3.4.2); second, the evolution of boards over the last 30 years (3.4.3); third, the composition of an average board (3.4.4); and the practice that most officers who are not on the board do attend board meetings (3.4.5); as well as the emphasis on counterbalance provided by independent directors on the board and committees (3.4.6); and executive sessions special to the US, which are meetings of independent directors, without executives (3.4.7); the size of the board that should not be too large (3.4.8); the desire that independent directors should be in a strong majority on the board and be the sole members of board committees, plus qualitative requirements for independent directors (3.4.9); a description of the views on term of office of directors (3.4.10) the formal documentation of responsibilities (3.4.11) and finally a summary (3.4.12).

This section 3.4 on the composition of US boards is followed by sections on the roles of various types of director (section 3.5), including the four most salient points of US best practice, (i) an active role of independent directors in challenging the strategy plans of management and debating alternatives and in establishing an orderly succession of directors and especially of the succession of the CEO, (ii) the important roles of the separate non-CEO chairman or lead director, (iii) further remarks about the executive sessions and (iv) the best practices to ensure optimal performance of these roles.

3.4.2 US one-tier board: "primacy of the board" and one-tier turning into two-tier or multiple-tier board

A saying in the US is "let the officers manage". This means that the rest of the board – the independent directors – should not micromanage the company's business and order its management team about.[503]

The unitary or single board of directors is the rule laid down in the Acts for US corporations.[504] Since the early part of the 19th century and certainly from the turn of the 20th century the US has had corporations with widely spread shareholdings. These corporations have run more and more complicated enterprises. Everyone realized that widely spread shareholders should not try to direct the business and that control of management had to be left to the board.[505]

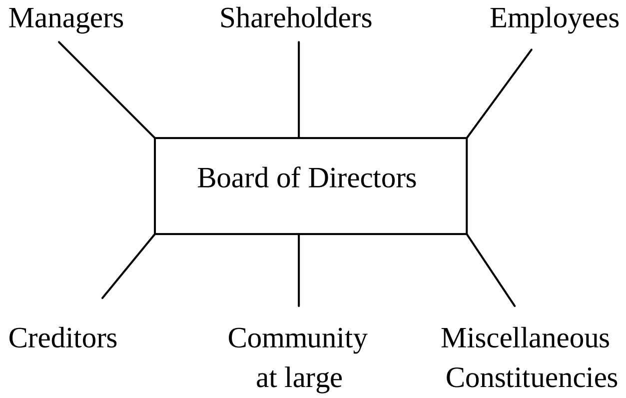
Corporation law statutes in every state make it clear that the board of directors is the focal point. The Delaware General Corporation Law states:

[503] Conference Board (2009), p. 20.

[504] Pinto and Branson (2009), p. 131.

[505] Bainbridge (2008), pp. 6-8 and 14; and Berle and Means (1932), see note 404.

"*the business and affairs of every corporation … shall be managed by and under the direction of the Board of Directors*".[506]
Put simply, the board is the corporate nexus of contracts between the company and the stakeholders. Bainbridge calls this nexus of contacts (note 505).



The primacy of the board is a specifically US concept and differs from practice in the UK, where the company was originally seen as a partnership and where shareholders have absolute power and can discuss with the directors whenever they wish and can hire and fire them. The US understands that where companies have a vast number of shareholders, it is more efficient to discuss strategy in a small group, such as a board, than in a meeting of shareholders. This is called "bounds to rationalism". Moreover, because of agency costs, i.e. the costs for shareholders of having professional managers run the business, the efficient course is to leave control of the company to the board. While in the US the rights of shareholders on paper seem to be less strong than in the UK it is clear that shareholder pressure groups have fought and are continuing to fight, currently together with the federal administration, for just as many rights in practice as shareholders have in the UK.

US boards are one-tier boards. Because of the current practice of (a) executive sessions, which are separate meetings of independent directors without executive directors, and (b) the importance of board committees, such as the audit committee, the nominations committee and the compensation committee, and now also a risk management committee,

[506] Delaware General Corporation Law (Delaware GCL), § 141(a).

the latest addition, consisting exclusively of independent board members and often meeting separately with their own independent advisors, it is often said that US boards are gradually turning into two-tier boards. I might even say they are turning into multiple-tier boards, i.e. the officers, the independent directors and 3 or 4 independent committees, which often have separate powers delegated by the full board.[507] Martin Lipton has described this to me orally as the "Balkanization of the board".[508] Indeed, although boards in the US consist of a one-tier only according to both theory and statute, there are elements of a two-tier system in the division between independent directors, who monitor, on the one hand and officers, who run the business, on the other.

3.4.3 Evolution of US boards over the last 30 years

The typical US board of the 1950s, 1960s and 1970s was composed of all the chief officers and about five non-executive directors. The CEO was the chairman. Non-executive directors were often the company's trusted advisors, such as its lawyer, investment banker, accountant and most important customer. They were chosen by the CEO/chairman and their role was to give advice.[509]

From the 1990s shareholder activists fought for more balance. They caused change through (1) the requirement that non-executive directors be *independent*; (2) enhancement of the role of independent directors by way of committee work and *executive* sessions; (3) more balance by splitting the role of the CEO who is at the same time chairman of the board, into a separate CEO and independent chairman, i.e. the *non-CEO chair*, in some companies. However, most US corporations still have a combined CEO and chairman, but of late such corporations have tended to appoint a *lead independent director* as counterbalance against the combined CEO/chairman.

Thirty years ago, "managerism" dominated. In both theory and practice, a team of senior managers – the officers – ran the corporation with little

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[507] Balotti Corp 123, Delaware GCL § 141(c).

[508] Martin Lipton and NACD Report, *Risk Governance: Balancing Risk and Reward* (2009), p. 13 ("NACD on Risk (2009)") too use the words a "fragmented" or "balkanized" investment.

[509] Martin Lipton has orally confirmed to me that these 'advising directors' were in practice quite independent, because of their professional standards. However, see also the quote of Justice Jack Jacobs in his speech of 2006, in which he describes a typical advisory board of 1985 in the pre-*Van Gorkom* period as CEO entrenched.

interference from shareholders, who were essentially powerless, or from the directors, who were little more than rubber stamps. Today, American corporate governance looks very different. The imperial CEO is a dying breed. Most importantly, for our purposes, boards are increasingly active in monitoring top management and challenging their strategy rather than serving as mere pawns of the CEO.

Several trends have helped these developments:

– director compensation now comes more as stock and less as cash, thus aligning director and shareholder interests;
– courts have made clear that effective board processes and oversight are essential;[510]
– shareholder activism;
– the Enron and WorldCom scandals of 2001 and 2002;
– the Sarbanes-Oxley Act of 2002.[511]

3.4.4 Types of directors on US boards

A typical US board of directors now has about 8 to10 members, of whom the CEO is the only executive director and the others are independent directors. In an increasing number of listed companies (about 30%), one of the independent directors is chairman, separate from the CEO. In the other 70% there is a lead director.

(a) *CEO and executives; officers represent the corporation*
The reason why the CEO is now the only officer on the board and the other officers are no longer members, is the general wish to have a purely independent board and independent board committees.[512] In practice, the independent directors regularly see the other executives called “officers". These usually do attend board meetings to make it possible for the independent directors to ask questions. The CEO is the leader of the executive team of

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[510] For example *Smith v. Van Gorkom* (board members must decide on an informed basis), *Caremark* (oversight necessary with detailed systems), *Disney* (due process in meetings and advisors necessary) and *Lyondell* (due process in meetings necessary). These cases are described hereunder.

[511] Bainbridge (2008), p. 1.

[512] Section 303A.01 of the NYSE Rules ‘Requiring a majority of independent directors will increase the quality of board oversight and lessen the possibility of damaging conflicts of interest’. For committees to be composed exclusively of independent directors see Sections 303A.04, 05 and 07 of the NYSE Rules. The Sarbanes-Oxley Act § 301(3) provides that only independent directors can be members of the audit committee.

officers and manages and runs the enterprise with that team. The officers legally represent the company. Officers are corporate agents.[513] The officers have specific powers, the CF for financial or the COO for operational matters and the HRO for human resource matters. Each of them gives information to the independent directors.

(b) *Chairman or lead director*
In 2009 over 70% of US listed corporations were led by CEOs that were also chairman. Companies with a combined CEO/chairman are therefore in the majority, unlike in the UK. However, this percentage is decreasing, and the number of companies with a separate chairman and CEO is now over 30%. The US chairman has many roles, such as leading the board and seeing to orderly succession of CEO and board members similar to a chairman in the UK. However, in the US the chairman is usually less dominant than his UK counterpart. Lead directors do not lead the board, but do lead the executive sessions of the independent directors and the nomination process.

(c) *Independent Directors*
Independent directors are occupied with corporate matters usually at least two days a month or more. If they are member of a committee, this can rise to about four or five days a month. They have a double function in that they are supposed to (1) actively challenge the strategy proposed and executed by the officers (promoting the "upside") and (2) monitor the execution of the business (avoiding the "downside"). All committees are made up of independent directors only.

(d) *Executive sessions*
A typically US concept is the "executive session", which is contrary to what the term suggests a meeting of independent directors without any executives present – see 3.4.7 below.

(e) *Corporate counsel*
Most US listed companies have a corporate counsel, an in-house lawyer who, besides heading the in-house legal department, is in

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[513] Balotti (2010) Corp 142B and *Joseph Greenspon's Iron & Steel Co. v. Pecos Valley Gas, Co*., 156 A. 350 (Ch. 1931).

charge of corporate governance and takes care of all legal formalities. Like his Dutch counterpart, his role is less clear than that of a UK company secretary. The US corporate counsel generally reports to the CEO and is important. Sometimes he is also the corporate secretary. In the UK the company secretary is vested in the law and assists the chairman directly.

(f) *The board acts and decides as a unitary board*
When acting for the corporation directors must act as the board. Decisions are decisions of the full board.[514] This is comparable to the UK unitary board. In the Netherlands the management board decides and the supervisory board merely gives or withholds consent, i.e. says yes or no. Here we find an important difference between one and two-tier boards.

3.4.5 Most officers who are not on the board do attend board meetings

The word "officer" comes from US corporate law. Day-to-day business of the company is handled by the corporate officers, who are appointed by the board of directors. Thus the relationship between the board and the officers is defined.[515] The legal model of US corporate governance is that shareholders own shares and the board of directors oversees the management of the company.[516] In a public company the board of directors determines the policy and selects the officers who manage the business.[517] The board of directors monitors the officers. In so doing the board makes all decisions. Officers, selected by the board, represent the corporation. Their authority of representation depends upon their position as officer, not on their directorship. Individual directors are not agents, unless they are officers.[518] This is comparable to the Dutch management board, in which a director has power to represent the company only if he is authorized as such and entered into a public registry as representing the corporation. Officers who are not board members may attend board meetings on invitation to provide the board with as much information as

[514] Balotti (2010) Corp 129 and *Bruch v. National Credit Co*, NGA 739 (Ch. Cr. 1923).

[515] Balotti (2010) Corp 142B and Delaware GCL § 142.

[516] The business and affairs of the corporation are managed by or under the direction of a board of directors, § 8.01 of the Model Business Corporation Act (MBCA) and Delaware GCL § 141(a).

[517] Pinto and Branson (2009), p. 111.

[518] Pinto and Branson (2009), p. 133 and Balotti (2010) Corp 142B. This signing authority and responsibility is also apparent from SOX Rule 302 that the CEO and CFO, both officers, must sign for the correctness of accounts.

possible. How this is arranged differs from company to company. In some companies they sit in the second row and may only respond to questions and give presentations on their own area of responsibility, whereas in others they can sit in the front row and be involved in the discussion on general strategy. Whatever the case, they nearly always attend informal gatherings and dinners. By their presence they give support to the CEO. Engaging them, and giving them more time to speak and sitting on the front row is better, because then (i) the board is better informed, (ii) other board members get a feeling for the dynamics within the executive team, (iii) it is good for the independent directors to get to know all executive officers, because the board has to ensure that there is an orderly plan of succession for officers.

3.4.6 Counterbalance provided by independent directors

As stated above, US corporations traditionally have a strong CEO who is also the chairman. Nevertheless the American corporate world wants a system of checks and balances to guard against an unduly powerful CEO/chairman by having a number of independent directors on the board and ensuring that committees consist exclusively of independent directors.

This is different from the UK where a small majority of NEDs on the board is deemed sufficient to provide for proper balance.

Another reason why US corporate governance emphasises the role of independent directors is that traditionally outside directors simply provided advice. The board was protected by defence mechanisms such as poison pills, staggered boards and the proxy system and had relatively few genuine outsiders. Under the current regulatory environment and with shareholder activism encouraging short termism, it is felt to be good for the corporation to have truly independent directors who can bring an independent view from outside and will give effective consideration to all interests concerned.[519]

It has been argued that this overemphasis on independence is only a disguise for the wish to be politically correct. Martin Lipton has said to me that he worries about how an “independent” director can know

[519] Jeffrey N. Gordon, ‘The Rise of Independent Directors in the United States, 1950-2005: Of shareholder value and stock market prices’, *Stanford Law Review*, Vol. 59 (April 2007), pp. 1465-1568.

enough about the business. Professor Maarten Kroeze makes the same point in an article in the Dutch review "*Ondernemingsrecht*" with reference to the US.[520] The Walker Review of 2009 in the UK also raises concern about this point. There is an awareness of the danger of selecting directors mainly for their independence without regard to their knowledge of the business.

3.4.7 Executive sessions

The second method of securing proper distance between independent directors and the CEO is having executive sessions, a phenomenon confined to the US. Contrary to what the words say these executive sessions are meetings without any executives. The NY Stock Exchange recommends regular scheduling of such meetings, not only to foster better communication among independent directors, but also to prevent officers from becoming alarmed when such sessions are suddenly convened.[521]

An independent chairman of a US listed company has informed me that he first holds an executive session before every board meeting to develop alternatives and promote questioning, and then again after each board meeting, to hear the views of all the NEDs. The next morning he communicates those views to the CEO. Executive sessions merely constitute a discussion forum and may not be used for actions which have to be taken by the whole board. Detailed minutes are not customary and are discouraged.[522] Another independent chairman has informed me that in his company executive sessions normally take 2 minutes, but if there is a problem with the CEO they take 2 hours.

While in the Netherlands the supervisory board nearly always meets together with the managing directors, except for the annual evaluation meeting, some large Dutch companies already hold separate meetings of supervisory directors more often. In the UK, NEDs do not generally meet separately more than once or twice a year to evaluate themselves and the executives. However, some companies in the UK are now starting to adopt the US practice of having regular meetings of NEDs only.

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[520] Prof. Maarten Kroeze, 'Onafhankelijkheid van commissarissen', *Ondernemingsrecht* 2005/92 ("Kroeze, Article (2005/A)").

[521] NYSE Rules Section 303A.03.

[522] Conference Board (2009), p. 42.

3.4.8 Not too large

Most listed companies have between eight to twelve board members.[523]

Martin Lipton and Jay W. Lorsch wrote: "We believe that the size of a board should be limited to a maximum of ten directors (indeed we would favour boards of eight or nine) with a ratio of at least two independent directors to any director who has connections with the company ……".[524] Boards need to be large enough to accommodate the necessary skill sets and competences, but still be small enough to promote cohesion, flexibility and effective participation.[525] On this point the US and UK have the same view, see also 2.4.9 for UK views.

Martin Lipton said in a speech of 2010: "the trend for the future is for smaller boards to become larger so as to have sufficient independent members to fill the audit, nominating and compensation committees – and last but not least the risk committee! – as well as members for other special expertise, such as IT or derivatives, who may not necessarily be independent".[526]

3.4.9 Independent directors in a strong majority on the board and as sole members of committees, plus requirements for qualifications

Independent directors in the US play an important role in bolstering investors confidence.[527] After Enron and WorldCom the SEC prompted Congress to accept the Sarbanes-Oxley Act, which established that the audit committee should be exclusively composed of independent directors. The NYSE Rules subsequently stipulated that the majority of the board should consist of independent directors and that each committee should consist exclusively of independent directors.[528]

There are some qualitative requirements for the audit committee. The NYSE Rules require that each audit committee member must be or

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[523] Conference Board (2009), p. 22 and Jaya A. Conger and Edward E. Lawler III, *Sharing Leadership on Corporate Boards: A Critical Requirement for Teamwork at the Top*, Marshall School of Business Working Paper No. MOR 19-09 (April 2009), p. 189 ("Conger and Lawler (2009)").

[524] Lipton and Lorsch (1992), p. 67-68.

[525] Conference Board (2009), p. 22.

[526] Martin Lipton, 'Future of the Board of Directors', Speech of 23 June 2010 for Chairmen & CEO Peer Forum Board Leadership in a New Regulatory Environment, NYSE (2010) ("Lipton NYSE Speech (2010)").

[527] NASDAQ Rules: IM 4350-4, Rule 4350(c).

[528] See sub-section 3.4.4(a).

become financially literate. In addition, one member of the audit committee must be a financial expert.[529]

The concept of *independence* has been defined *de jure*. However, the independence of directors must be *de facto* as well. Outside directors need to be more than independent, they need to be independent-*minded*. They must also be *courageou*s.[530]

In various court cases the concept of independence has been given a stricter interpretation. The ***Oracle*** *Corp.* case of 2003 is an example where a special litigation committee was "fraught with conflicts".[531]

Vice-Chancellor Strine wrote in the opinion that members of a special litigation committee, a committee of outside directors which had to decide whether the company should litigate against the executives, must really prove their independence. It is more difficult for directors to decide to have a company sue a fellow director than to say no to a proposal to sue a friend. In the case of *Oracle* the special litigation committee had to decide whether the company should introduce a derivative case against four directors and officers, who were close to the business, and who were accused of insider trading. The CEO/chair, the CFO, the chairmen of the audit committee and compensation committee had given positive messages about Oracle in the autumn of 2000, sold many shares in January 2001 for $30 per share and came with bad news in March 2001, which made the share price fall to $16. They were sued for insider trading. These four directors had all donated large sums to Stanford University and one of them was a Stanford professor. Two members of the special litigation committee were also Stanford professors. One of them had been a student of the Stanford professor who was being sued. The Vice-Chancellor argued that such a special board committee has to prove its independence and that this special litigation committee would not pass the test because of all the Stanford connections. (Strine is Chancellor from June 2011.)

The expectation required of such an extra, higher level of independence can also play a role in takeover cases, where directors may have a self-interest. The same Delaware Vice-Chancellor, Leo Strine, wrote in 2002 after Enron: "The question of whether a director can act independently is inherently situational".[532]

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[529] NYSE Rule Section 303A.07.

[530] NACD Report, *Board Evaluation: Improving Director Effectiveness* (2005) ("NACD (2005)").

[531] *Oracle Corp.*, 824 A.2d 917 (Del. Ch. 2003).

[532] Leo E. Strine, Jr., 'Derivative Impact? Some Early Reflections on the Corporation Law Implications of the Enron Debacle', 57 *The Business Lawyer* 1341 (2002) ("Strine (2002)").

The qualitative requirements for independent directors are multiple and serious: sufficient time for the job,[533] diversity and mix of knowledge and experience and in some cases specialist knowledge of the business. As regards time, directors should not have too many other board directorships. Most corporations limit the number of other board positions. Executives should usually have not more than one or two other directorships. A good many independent board members are limited to two other board membership, or three or four at most.[534]

Diversity is a well-developed requirement in the US. A recent study found that greater diversity of board membership is associated with higher returns to investors.[535] There should be at least one woman, one academic and one person of colour. Nearly all corporations comply to the requirement of at least one woman and one person of colour. [536]

A board should also be able to draw on a mix of knowledge and experience from its members in the fields of accounting and finance, risk management, strategic and business planning, legal matters and compliance, human resources, marketing, e-commerce and *internet*[537], international trade, and industry-specific research and development and, on the boards of banks, specific knowledge of the banking industry.

In the post-Enron business environment, it has become more difficult for companies to attract qualified directors. This is partly due to the stricter independence rules, partly due to the requirement of a financial expert on the auditing committee and lastly because of increased scrutiny by enforcement agencies and institutional investors. Other factors include the greater risk of liability and the time commitment. The first to feel the consequence are CEOs who now rarely join boards of other companies. Prestige and the opportunity to gain additional knowledge and experience and add value will continue to serve as important incentives for qualified persons to wish to join the boards of corporations.[538] Now we have to

[533] Conger and Lawler (2009), p. 188.

[534] Conference Board (2009), p. 26.

[535] Conger and Lawler (2009), p. 188.

[536] Conference Board (2009), p. 22.

[537] NACD Report, *The Role of the Board in Corporate Strategy* (2006), p. 21 (“NACD on Strategy (2006)”) and Conger and Lawler (2009), p. 187.

[538] Conference Board (2009), pp. 21-22.

start questioning whether the pool of eligible independents is large enough to fulfil the demand.

3.4.10 Term of office

Directors are elected and re-elected by the shareholders at their annual meeting.[539] The majority of listed corporations now hold annual re-elections. However, a large number still have staggered boards. Of the Fortune 500 companies 25.2% have staggered boards and of all 1411 NYSE companies 41.8% have staggered boards.[540] In staggered boards, the directors are re-elected every three years, and one third are up for re-election every year, which system can be used as a defence against unfriendly takeovers. The protective system of "plurality voting", which means that directors can easily be reappointed with only a minority of shareholders voting in favour and the large majority abstaining, is now giving way to the more democratic system of majority voting.[541] Other aspects of the procedure for voting on the reappointment of board nominees or for putting forward and voting on shareholder nominees are (1) separate notice and record dates for shareholder meetings to eliminate the "empty voting phenomenon", (2) proxy access reform to help shareholders gain free access to the proxy solicitation ballot as described above in connection with the Dodd-Frank Act and (3) electronic delivery of proxy materials.[542]

Proxy access on the company proxy ballot will, in practice, give shareholders many further rights. This system may become applicable for the 2011 proxy season, if it is not blocked by the pending litigation against it.[543]

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[539] Pinto and Branson (2009), p. 131. Shareholders can opt to stagger the election of the board so that directors have longer terms, e.g. three years, in which case only a third of the directors are elected at the annual meeting. This is a defence mechanism.

[540] Commercial database of Shark Repellant and an e-mail of Adam Emmerich of Wachtell Lipton as per 10 August 2010, examples *Air Product v. Airgas, Sysco*.(for more see note 1182)

[541] Conference Board (2009), pp. 50-52.

[542] Conference Board (2009), pp. 52-54.

[543] Cravath, Swaine & Moore LLP, "Public company alert", 21 July 2010.

3.4.11 Formal documentation of roles

Decisions are taken by the full board.[544] The authority of the officers consists of the power to represent and run the company in the ordinary course of its operations. They enjoy an explicit or implicit agency. US principle is that there should be flexibility. Every company can have a different structure and division of roles. Companies are sometimes inventive in creating new types of functions and systems, such as the lead director and the apprentice system. The apprentice system involves a retired CEO assisting and coaching his successor for about 6 months. This flexibility means that it is a responsibility of the board to describe precisely how the roles are divided.[545]

Explicit authority may be found in bylaws, corporate resolutions made by the board or properly approved and detailed employment contracts.[546] US practice is to be clear about who may do what. Decisions of the board are taken by the full board and powers of attorney are given to one or more officers to execute the action. If there is a non-CEO chairman or lead director, their respective functions should be clearly defined.[547]

3.4.12 Summary of the composition of US boards

(i) The US has a one-tier board system to which it is traditionally accustomed. Over the last 50 years there has been a fight to introduce independent directors to boards and have committees consisting solely of independents. 30% of listed companies now have separated the function of CEO from that of Chairman. In the past 15 years there has been a trend towards holding more distinct meetings in committees and towards independent directors meeting separately in "executive sessions".

(ii) US boards are composed in such a way as to create a counterbalance to the formerly all-powerful CEO (this has been due to the efforts of shareholder activists and rule makers such as the SEC and stock exchanges).

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[544] Balotti (2009) Corp 129 on § 141.

[545] Conference Board (2009), p. 20.

[546] Pinto and Branson (2009), p. 135; Conference Board (2009), p. 20; and the NACD on Strategy (2006), p. 4.

[547] Policy briefing no. 4 for the Chairman's Forum (2009 text), Millstein Center for Corporate Governance and Performance, *Chairing the Board: The Case for Independent Leadership in Corporate North America*, Policy Briefing No. 4, Yale School of Management (2009) ("Millstein Chairing the Board (2009)").

Counterbalance is provided in the following way:

– the board is composed by a large majority of independent directors (about 8 to 12), there is only one executive: the CEO. However, the other officers (CFO, COO, HRO and CRO) are always invited to attend the board meetings. The aim of board meetings is to create the best long-term strategy for the corporation. The independent directors challenge the officer's proposals and ensure that all alternatives are discussed;
– independent directors meet in executive sessions, without the officers, before and/or after each board meeting;
– 30% of US listed companies have a non-CEO chairman. The other 70% have a lead director, who leads the executive sessions.

(iii) The composition of boards in the US differs from that of the UK. In the UK all executives are members of the board together with NEDs who have a small majority. The aim in the UK is to achieve balance, rather than counterbalance as in the US. Whereas the non-CEO chairman has only recently gained ground in the US (still only 30% of all the listed corporations), 99% of UK listed companies have separate chairmen. Executive sessions are a special feature of the US system.

3.5 **Role of US board members**

3.5.1 Introduction on role of board members

As described above at 2.4.1, 2.5.1 and 3.4.1, boards of companies in each of the three countries, which are subject of this study, must develop, implement and monitor all the elements: purpose, strategy, policies, risk management, succession, evaluation and communication. The question is how should these roles be divided. Which board member should have which role? And how can these roles best be promoted?

Main differences in the division of roles between a one-tier board in the US and the average two-tier board in the Netherlands are that in the US independent directors have on-site and operational information, receive more and earlier information and are more involved with the company than Dutch supervisory directors. This is because US directors are or can be directly involved in making the decisions and are actively involved in challenging the strategy developed by management and discussing alternatives, whereas Dutch supervisory directors merely say “yes” or “no” to the management’s proposals. This is a slightly different nuance from the position in the UK, where NEDs are involved in developing strategy but not in hands on management. By contrast, the role of Dutch supervisory directors in most companies and according to the law is confined to monitoring strategy development.[548]

There are also similarities between US independent directors and Dutch supervisory directors. Neither represent the company. Only the officers (in the US) and managing directors (in the Netherlands) can represent the company.

In this section 3.5 the role of US board members, the officers and the independent directors will be discussed under the following headings: first, the definition of the roles of the board and its members (3.5.2); the active role of challenging and debating strategy by independent directors (3.5.3); a description of US Enterprise Risk Management (3.5.4); a description of the discussion in the US about non-CEO chairmen and what roles the non-CEO chairman has and, in the alternative, the lead director (3.5.5); a description of elements of best practice, early and on-site information, time commitment, evaluation and continuing education, teamwork, payment and committees (3.5.6); CEO succession (3.5.7); and a comment on US corporate governance at banks (3.5.8). The section will be closed by a summary on the role of US board members (3.5.9).

3.5.2 Definition of roles of the board and its members

All business and affairs are managed by and under the direction of the board of directors while the officers represent the corporation.[549] This means that the board has the freedom to arrange a division of roles among its members, to regulate internally the tasks of, and define the scope of the work of independent directors and officers, of executive sessions and committees. A strong and effective board of directors should have a clear view of its role in relationship to management. How the board organises itself and structures its procedures will vary with the nature of the business, with business strategy, size and maturity of the company, and with the talents and personalities of the CEO and the directors.

[548] A Dutch director of a US company has told me that US corporate directors consider supervisory directors to lack commitment.

[549] Delaware GCL § 141(a).

Circumstances particular to the corporate culture of a specific corporation may also influence the board's role. The board focuses principally on guidance and strategic issues, the selection of the CEO and other senior executives, risk oversight, performance assessment, and adherence to legal requirements. The officers implement the business strategy and run the company's day-to day operations with the goal of increasing shareholder value for the long term.[550]

Based on federal securities laws, state corporation laws and formulations developed by the Conference Board, the American Law Institute, the Business Roundtable and the NACD, general board responsibilities should include (i) approving a corporate philosophy and mission, (ii) nominating directors, (iii) selecting, monitoring, advising, evaluating and compensating the CEO and officers, i.e. the CEO, CFO, COO, CRO and others, if so agreed (iv) orderly succession, (v) reviewing and approving strategic business plans, risk management programmes, financial objectives and material transactions, (vi) helping ensure ethical behaviour and compliance with laws, (vii) assessing itself, and (viii) performing other functions required by law or regulation.[551]

3.5.3 Active role of independent directors in challenging and debating strategy

Since the Enron, Tyco and WorldCom scandals much emphasis has been laid on monitoring. However, the main item on the agenda of the board of a US company is still discussing company strategy.[552]

As the board has the power to initiate and adopt corporate plans and actions,[553] its members clearly have an active strategic role. In the US view risk management should be an enterprise-wide, top-down strategic effort of the board rather than merely a compliance practice.[554]

The board and hence the independent directors should be involved in the active challenging of the strategy proposed by the officers. It therefore

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[550] Conference Board (2009), p. 18.

[551] Conference Board (2009), p. 18.

[552] The Conference Board, *Corporate Governance Handbook: Legal Standards and Board Practices* (2007) ("Conference Board (2007)"), pp. 14 and 100; Conference Board (2009), pp. 18 and 144; also Veasey (2005), p. 1415.

[553] Pinto and Branson (2009), p. 132.

[554] Carolyn Brancato, Matteo Tonello and Ellen Hexter, *The Role of US Corporate Boards in Enterprise Risk Management* (2006), p. 17 ("Brancato, Tonello and Hexter (2006)").

goes without saying that not only the CEO and his fellow officers, but the independent directors too should be involved in determining strategy. The full board acts and decides together.[555] In every opinion of the Delaware courts about board decisions, the names of all board members are mentioned. In the *Disney* case it was regarded as an important factor that all directors had been involved in the decision making process. The following quote shows that the strategy role is the starting point: "An increasing number of directors acknowledge they must oversee business risk as part of their strategy-setting role."[556]

The role of NEDs in strategy development in the UK was described in 2.5.5 above. A description of the role of US independent directors in strategy follows below and the differences between the UK and the US will be discussed:

i what is strategy?
ii how is strategy discussed?
iii at what stage is it discussed?
iv is there real creativity? is there debate?
v what is the influence of the independent director?
vi can he have influence if he is an outsider to the business?
vii can he remain a critical monitor once the board has decided on the adoption of a certain strategy?

(i) ***What is strategy?***

The answer to this question is the same in the US as in the UK (for the UK see paragraph 2.5.5(i) above). In the US too strategy also exists in the wider sense, which includes purpose, vision, philosophy (this can include questions such as what role or added value does the company wish to provide to society), succession, enterprise risk management, financial objectives and material transactions. Strategy in the narrower sense is making business plans, defining core businesses, what to divest or buy and how to allocate resources.

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[555] Balloti (2009) Corp 129.

[556] The Conference Board, *The Role of US Corporate Boards in Enterprise Risk Management* (2007), p. 15 ("Conference Board, *Risk* (2007)").

(ii) ***How is strategy discussed?***

It is clear that in the US all directors, including the independent directors, have a leading and active role in strategy debate and can add value. In practice, the whole board has an annual strategic meeting (called "away days") in a resort for two or three days. A strategic element is also discussed at each board meeting or at least every third board meeting. In the US the emphasis is on flexibility. Corporate law allows directors great latitude in how they divide their activities in relation to corporate strategy – without undue interference from shareholders or the courts.[557] There is not a "one size fits all" division of roles or procedures. The board itself decides on the procedure for discussions.

Officers draft, board actively challenges

In most companies officers design a strategic plan (and changes to existing plans), whereas the board regularly reviews and endorses such plans and changes. To fulfil their responsibilities in strategy development, directors should understand the company's business, the factors driving its growth and the major risks and vulnerability to which it is exposed.[558] This requirement of in-depth knowledge is very important and is an integral part of being a decision-maker, even as an outside director. Directors stimulate, broaden and criticize the quality of the officers' strategic thinking.[559] Boards should rarely have to take the initiative to draft a company's strategy or create its vision, mission statement or detailed plan. The officers do that. The board's role should be to provide strategic thinking, to oversee and to encourage, rather than to suggest specific strategic tactics. Its members must understand the assumptions and analysis of the officers. To obtain this understanding often requires that directors become engaged in the formulation of the strategy at an early stage. If directors have approved the management's proposal for a strategy, based on a thorough understanding, they will be better able to monitor its execution.[560]

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[557] NACD on Strategy (2006), p. 4.

[558] Conference Board (2009), p. 144 and NACD on Strategy (2006), p. 4.

[559] NACD on Strategy (2006), p. 4.

[560] NACD on Strategy (2006), p. 5.

Step-by-step cooperation

In the process there should be step-by-step cooperation between the board and the officers. Below is a diagram showing an example of such cooperation.[561] It illustrates the methodical, almost scientific, approach to management and business in the US. Although this approach is followed more and more in other countries where American style business schools have opened, it still differs – this is, of course, a generalization – from the style in the UK and the Netherlands where business organization is less a matter of academics and more of tradition and gut-feeling.

[561] NACD on Strategy (2006), p. 10.

Strategic Teamwork: An Example of Roles and Actions			
B	Spells out broad guidelines for future strategy, noting expectations and constraints.	**B**	Reviews proposed budget. Ensures that the budget's major provisions and thrust are consistent with the strategy and plan previously approved. Modifies as needed, and approves final draft.
M	Drafts statements of vision, mission, and strategic objectives and targets, within given guidelines and with board input.	**T**	Reviews all corporate activities that have an impact on strategy, for example ensuring that incentive plans are aligned with strategy.
T	Reviews drafts and discusses and amends drafts as needed.	**M**	Makes periodic reports to the board (after launching strategy) on validity of crucial assumptions, milestones, changes in environment and competitive considerations.
B	Approves revised statements.	**B**	Monitors execution of strategy by monitoring financial performance and other measurable milestones that have strategic implications.
M	Schedules meetings and evaluations, and conducts data collection and analyses necessary to prepare a preliminary strategy.	**T**	Agree to changes in strategy as circumstances warrant.
T	Holds special board meeting or retreat in which draft strategy is presented, discussed, reviewed and amended, including any final instructions and directions from the board.		
M	Revises and verifies approved draft. Draws up strategic plan. Notes and highlights crucial assumptions made and proposes meaningful milestones for execution.		*Key: M = Management; B = Board; T = Together
B	Reviews points based on crucial assumptions and selected milestones. Approves final strategy and plan. Notes any guidelines for preparation of next budget.		*Adapted from a model provided by Professor Boris Yavitz Dean Emeritus, Columbia University School of Business.*
M	Prepares budget and key checkpoints for board approval.		

Examples of step-by-step strategy development

Below is a famous example of cooperation between the board and the officers in the "bet-the-company decision" on the design of the *Boeing 787*.

Such a decision could not be made in one sitting, based on one fat binder plunked in front of each director. In order to ensure board scrutiny, the officers broke up the overall design decision into smaller pieces and had the board weigh all three critical go or no-go points in the development of the plane. <u>This is the first example.</u>

First, the multibillion dollar budget and timeline for the aircraft's development. The future of air travel had to be appraised. Airbus had cast its lot by opting for the double-decker A380, the huge superjumbo that would appeal to carriers serving crowded hub-and-spoke airports. The A380 could carry double the normal load with the same number of gates, pilots and takeoffs. Boeing's officer proposal was banking on a different view of the future. The company believed that the traditional hub-and-spoke system was breaking down as passengers increasingly demanded direct service between two points. In the proposal it was promised that the 787 could operate a long-haul, point-to-point service for 20% less cost because of net weight-saving technologies. The directors challenged the officers' numbers and assumptions. The team returned to the board's questions in several subsequent board meetings with verified forecasts, convincing the board in 2002.

Second, management asked the board to rule on whether the time was right to allow sales managers to discuss the aircraft's specifics with the airlines. Was Boeing sure to succeed in the lower costs? The directors required evidence and authorised the sales team in 2003 to communicate the lower cost.

Third, the board was asked to give the final go ahead for production of the aircraft, which would require Boeing to commit additional billions of dollars to the project. Then after that the sales team would secure written orders with stiff penalties if Boeing failed to deliver as promised. So directors pressed the officers for a detailed production plan and proof that engine suppliers General Electric and Rolls Royce could create the required thrust at an acceptable price. After many board meetings, Boeing's directors voted in 2004 to commence the formal product launch. Even after the formal launch, however, the directors insisted on monitoring both manufacturing progress and order flow. [562]

The board's first two decisions were a necessary precursor to the third, and all three were required for the full go-ahead. On each occasion the directors had sought tangible evidence to support management's major assumptions. Two principles emerge:

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[562] Michael Useem, 'How Well-Run Boards Make Decisions', *Harvard Business Review* (November 2006), pp. 5-7 ("Useem (2006)"). In August 2010 there was a press announcement that some suppliers for the Boeing 787 were late and that delivery had been postponed to the beginning of 2011 (*NRC Handelsblad*, 19 August 2010). The Boeing 787 was successful in obtaining 825 orders before any delivery, which is a record. Recently, the delivery of the Boeing 787 has been announced to be postponed even further. However, the board process of decision making in stages is still seen as a good example.

strategic decisions should be divided into smaller steps and directors should remain vigilant and keep on requiring evidence.

A second example is *Tyco International's come-back after 2002*, which was achieved by shedding assets. After Kozlowski was indicted for the $600 million fraud and the board had resigned, Tyco's new management board concluded that the group's revival would depend on its swift conversion from a buying engine to an operating machine. The new CEO, Breen, and the new lead director agreed that there should be a mass disposal of underperforming companies and that the board should have a hand in this activity.

First, the CEO, CFO and the board agreed on the disposal criteria.

Second, the directors pressed the CEO's team to explain the financial and strategic pros and cons of disposing of each unit. They questioned the timing. If all went on the block at the same time, wouldn't that depress prices? And they inquired whether another management team couldn't resurrect the unit. Some of the questions prompted the officers to amend the list.

This example shows that the decision on disposals can be split into steps: first, a decision on the criteria in general and, second, a decision on each individual disposal. The same applies to the criteria for acquisitions and the decisions on each acquisition.[563]

A third example is the step-by-step cooperation by the board and management of the *North Western Company* on a 5-year strategy process to transform the company through strategic thinking. The process began with a detailed situation analysis. Afterwards, management formulated several alternatives to a five-year plan, which were challenged and changed. Finally, the board chose from the alternatives. They concluded that North Western's greatest opportunity was to transform itself into "America's best service and solution experience".

These examples can teach us that strategic thinking evolves over time and in a series of many consecutive meetings and that US boards can serve best by providing strategic thinking, oversight and enhancement rather than suggesting specific strategic tactics. Progress on initiatives is not linear and management and directors continually reinvent initiatives. Finally, an interactive,

[563] Useem (2006), pp. 7-8.

participative process nourishes open and full communication between management and board.[564]

Directors should work with management to get a better grasp of the current strategic position. In turn, management should draw up and propose a number of different long-term strategies. Boards should test and challenge them before deciding, with management, on the most appropriate strategy.[565]

Strategy development nearly always involves the following steps:

1. Management and board should develop a well-defined vision and a clearly articulated strategy to achieve this vision.
2. Management and board should establish procedural guidelines for developing the company's strategy. If possible, the assumptions should be presented by the board as a set of alternatives.
3. The development of strategy should be a topic at every board meeting.
4. Management should express the approved strategy in a written document.[566]

To summarize, US independent directors do not develop strategy themselves. However, they are actively involved in all the steps of the development of strategy. They sometimes require management to build up a process of a step by step development plan and they challenge management and require further evidence of assumptions. Boards also ask management to present alternatives.

The board of directors, while deciding on a long-term strategic plan, should be mindful that shareholder value depends on a nexus of relations with other business stakeholders, including

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[564] NACD on Strategy (2006), pp. 29-30.

[565] Robert F. Felton and Pamela Keenan Fritz, 'The View from the Boardroom', *The McKinsey Quarterly,* Special Edition (2005), p. 55 ("Felton and Fritz (2005)").

[566] NACD on Strategy (2006), pp. 8-9.

employees, suppliers and customers, as well as the local communities where the company operates.[567]

(iii) ***At what stage is strategy discussed? well in advance and leaving ample time***

The examples under (ii) above, especially the step-by-step procedures, show that in the US the board generally gets involved well in advance of taking a decision.

Again, it is seen in practice that the manner of communication varies. In many corporations the board takes ample time for each board meeting. The *Disney* case[568] is an example of one extreme sparse communication, where board members did a lot by phone, particularly after the chairman/CEO, Eisner, had issued a press release about Ovitz's appointment.

In the *Lyondell* case[569] the question was whether the board had taken sufficient time to consider the options. The Delaware Chancellor found that the board had not taken sufficient time for discussion. Although the Supreme Court reversed this decision, this case serves once again as a warning for many boards to take their time for strategy discussions.

The *Time (Warner)*, *Dollar Thrifty* and *Air Products v. Airgas*[570] cases were examples where the court considered the time taken and the seriousness of the discussions on strategy and the fact that there was a long term strategy. In both cases the board prevailed. The cases are described below in the list of takeover cases in 3.7.3.2.

(iv) ***Is there real creativity? Is there debate?***

Bainbridge describes US research showing that groups of 5 to 8 come up with better ideas than individuals alone because they contemplate more alternatives. This debating of alternatives is the

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[567] Conference Board (2009), p. 20.

[568] The *Disney* case (see note 448) is often used in literature such as Conference Board (2009) as a warning of the need for better procedures.

[569] *Lyondell Chemical Co. v. Ryan*, Delaware Supreme Court (25 March 2009), C.A. No. 3176.

[570] *Paramount Communications Inc. v. Time*, Fm 571 A.2d 1140 (Del. 1989), *Dollar Thrifty* (Del. Ch. August 27, 2010), Cons. C.A. No. 5458 – *VCS* and *Air Products v. Airgas*, 15 February 2011, C.A. No. 5249/5256 CC.

US style of discussion.[571] Some boards have open discussions. There are even cases where an outside facilitator leads a group discussion to stimulate creativity.[572] In other boards, the discussion is much less open and more an exercise in brisk formal decision making based on detailed preparatory work by committees.

Creativity is seriously jeopardised if too many outside lawyers are in the room. I have seen a power point slide of Cravath Swaine & Moore (a highly ranked New York law firm), saying: "stay out of the boardroom", by which they mean[573] outside lawyers should steer clear of boardrooms if at all possible. Clearly, the problem is recognised.

Open dialogue also requires the right people to participate, by invitation, in boardroom discussions on strategy and risk, including all officers, general counsel, controllers and business unit leaders.[574]

(v) ***What is the influence of the independent director?***

A 2004 survey by Chris Bart entitled "The governance role of the board in corporate strategy" and a 2008 survey conducted by the McKinsey Quarterly both revealed that:

– Most boards claim to be already quite involved in their organisation's strategy formulation process (both reports). In over 60% of cases, boards reported that they were involved to a "considerable" or even greater extent in discussions on strategy (both reports). Specifically, strategic discussions tend to focus on the strategic planning process, the company's mission, vision and core values as well as objectives senior executives should be held accountable for, as budget approval, monitoring the

[571] On p. 15 of the Conference Board (2007) there is an interesting list of all the elements that can be considered in strategy-related matters. The source is PriceWaterhouseCoopers, *Corporate Governance and the Board* (2000), p. 5. It gives a list of 17 questions. The first is about what alternate strategies exist and further on it contains risk factors and best, worst and most likely scenarios.

[572] NACD on Strategy (2006), p. 51.

[573] Richard Hall, a partner in Cravath Swaine & Moore, has explained this to me in conversation.

[574] NACD on Risk (2009), p. 17.

execution of strategy and its achievement, and approving changes to strategy as warranted (both reports).

– Boards performed their strategic governance role for a couple of hours at every third board meeting, which was often supplemented by a two-day strategic retreat. By their own admission, however, respondents recognised that the time currently spent on those discussions was insufficient (Bart). Board members freely acknowledged the need to continue increasing their strategic advisory role, especially with respect to issues of talent development that are directly related to strategy (e.g. executive compensation issues and CEO succession planning) (McKinsey).

– The frequent lack of an adequate set of extra financial indicators of performance in the communication between management and corporate directors pointed to a major shortcoming in strategy planning (both reports).[575]

(vi) ***Can he have influence if he is an outsider to the business?***
The US concept of board activity is that directors should have their own specialism and they should know the business well or at least get to know the business quickly. They should quickly become well educated about the business so they can contribute added value. It is essential that they have received full information.[576] In the US knowledge of the business is highly cherished.

(vii) ***Can he remain a critical monitor once the board has decided on the execution of strategy?***
The US view on corporate governance is that a director can be a better critical monitor of the execution of strategy if he has been involved in its development.[577] Because he has been involved in

[575] Conference Board (2007), p. 146; Conference Board (2009), p. 146. The *McKinsey Quarterly*, March 2008, which surveyed 378 private and 161 public companies, and Chris Bart, ‘The Governance Role of the Board in Corporate Strategy: An Initial Progress Report’, *International Journal of Business Governance and Ethics*, Vol. 1, No. 2/3 (2004), pp. 111-125.

[576] Conference Board (2009), p. 19.

[577] NACD on Strategy (2006), p. 5.

the decision making, he has more understanding of the issues and can add value in being a critical monitor.

3.5.4 Special aspects of enterprise risk management, standards of supervision and care

Overseeing risk management (also called enterprise risk management or ERM) is an increasingly important task for US boards. A Conference Board survey of 2006 showed that progress had been made in the development of ERM practices under pressure of external stakeholders.[578] Agood many large and excellent corporations in the US have now developed exemplary enterprise risk management systems and important new ideas.

1. ***Understanding the critical link between strategy and risk and the necessity of continual dialogue***
Every business model, business strategy and business decision involves risk. In business there is no reward without risk. Risk is not merely something that can be avoided, mitigated and minimalized; risk is integral to strategy, it should be weighed against the probability and the size of the reward; decisions should be made about the risk appetite. Boards should encourage management to pursue prudent risks in order to generate sustainable corporate performance and value.[579] An increasing number of directors acknowledge they must oversee business risk as part of their strategy formulation.[580] As Ralph Larson, director of GE and Xerox, has said: "… risk is embedded in every product or management decision".[581] Although in the period immediately after the introduction of the Sarbanes-Oxley Act, audit committees felt obliged to look at micro risks, directors now understand they must look at the big picture, the whole format.[582]

The board's overseeing of risk should be based on the assumption that the company's strategy and risk are appropriate. Essential for such balancing is the understanding and acceptance of the

[578] Conference Board, *Risk* (2007).

[579] NACD on Risk (2009).

[580] Conference Board, *Risk* (2007), p. 15.

[581] Conference Board, *Risk* (2007), p. 21.

[582] NACD on Risk (200), p. 4.

amount of risk the organisation is willing to run or absorb. Its "risk appetite" should be based on foreseeable risks, shareholders' expectations, available capital, management skills, possible rewards and acceptable volatility.[583] The concepts of *risk appetite* and *risk tolerance* are often confused. *Appetite* refers to the amount of risk that the enterprise is willing to accept, whereas *tolerance* refers to the degree of variance from the level of appetite that the enterprise is willing to accept.

Too often boards limit themselves in strategy matters to "review and concur". Real board engagement and assessment of risk require choices and alternatives. If the board is provided with several strategic alternatives, together with management's assessment of different scenarios of risk and return, it can provide more meaningful input. The board can also ask for further evidence of the assumptions. The strategy and risk dynamic is not an annual or semi-annual activity. It requires a dialogue at all board meetings and an ongoing effort by the board to evaluate shifting internal and external factors.[584]

2. ***The role of the board and the standing committees in risk management***

The NYSE rules[585] impose some risk oversight responsibilities on the supervisor of risk on the audit committee. This may create confusion. It adds "not the sole body". Increasingly, it is understood that risk monitoring cannot be delegated to the audit committee. The unitary board has overall responsibility and should look at the broad picture. The other committees too have their specific roles in the supervision of risk; the Risk Committee should oversee the connection between all the risks in its coordinating role, the Nomination Committee should monitor the risk of making wrong appointments and the Compensation Committee should assess the risk of short-term bonuses, which could result in the wrong corporate culture.

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[583] NACD on Risk (2009), p. 6.

[584] NACD on Risk (2009), p. 7, and see the *Boeing 747* case described above.

[585] Section 303A of the NYSE Listed Company Manual.

It is important for the board to make clear and transparent divisions of responsibilities, of those who deal with risk management. An example of a structure at a bank could be:

– an annually updated list of staff involved in risk management;
– a chief risk officer who designs plans and systems that deal with risk interplay and who invites the board to comment if the bank develops new products that are not mentioned in its strategy and in risk paragraphs in the annual accounts;
– a clear assignment to the various board committees of specific kinds of risks;
– procedures to keep the board well informed about different kinds of risks and their treatment.

3. ***Interplay of risks***

Risks are not isolated, but interrelated. Problems often occur in groups, thereby making the sum of the risks much greater. In other words, the proverbial "perfect storm". Many little "yellow flags" can add up to a "red flag". The board, acting in its oversight role, is well positioned to consider the interplay of various risks.[586]

4. ***Underlying assumptions of strategic direction should be challenged***

To be effective, independent directors should challenge CEOs and ask for evidence of assumptions of risk factors in company strategy.[587]

5. ***Realize that corporate culture may be the largest risk***

More and more directors are realising the importance of corporate culture and that it is necessary to cure the causes and not just the symptoms.[588] The NACD suggests that directors ask themselves the following questions:

– What is the style of management? How do they get things done?

[586] NACD on Risk (2009), p. 10.

[587] NACD on Risk (2009), p. 11.

[588] NACD on Risk (2009), pp. 4 and 17 and Association of Chartered Certified Accountants (ACCA), *Risk and Reward: Tempering the Pursuit of Profit* (June 2010), p. 11 ("ACCA (2010)").

- Are open and candid communications encouraged?
- Does management use directors as sounding boards to test assumptions or as rubber stamps?
- Is there an effective process to facilitate information flow?
- Are incentive compensation targets realistic and focused on the long term? What risks do the incentive structures pose to the enterprise?
- Is there a commitment to competence throughout the organisation?
- How does senior management demonstrate its commitment to an appropriate corporate culture?
- Are reputational issues for the corporation considered in strategic planning?

Formulating a proper corporate culture also requires transparency, not only between the board and management but also between the company and shareholders. Disclosure should include which committees oversee which aspects of risk and how. The board should also disclose how it has assessed its risk appetite and tolerance level.[589]

6. ***It is vital that directors are well informed***
Directors must have a sound understanding of the company's business. Continuing education for management is important. Directors must "kick the tyres" and visit business locations, including foreign offices. Directors must also find time to read extensively about the business, the competition, regulatory aspects and environmental issues.[590]

7. ***Questions, questions, questions***
US literature on business contains plenty of pertinent questions that should be asked by directors. For a good example, see the list under 5 above of this sub-section on page 180.

8. ***Legal aspects of risk management***
The Delaware Court of Chancery is developing its interpretation of the duties of care, loyalty and good faith that define director

[589] NACD on Risk (2009), p. 18.

[590] NACD on Risk (2009), p. 14.

responsibility. In the area of risk management relevant cases are those that deal with supervision and oversight.

In general, the main points of these cases are that (1) the board has the authority to manage the business of the corporation, (2) the board has the duty of loyalty to put in place "due corporate information and reporting systems", (3) the board must react to obvious warnings or red flags, and (4) although all directors are basically equally liable there are examples of individual exculpation on the one hand and on the other hand the demand of a higher standard of care for insiders (i.e. managers and officers) than for outside independent directors.

According to Section 141(a) of the Delaware GCL, the business and affairs of the corporation are "managed by and under the direction of the board of directors". The law does not say "by the board of directors". This implies that the board has authority and leeway for arranging management and having the necessary systems set up for the gathering of information and reporting. It may delegate certain tasks, which implies that insiders have a higher standard of care than outsiders and that it may trust employees, provided the board keeps an eye on its agents and reacts to red flags.

Standards of supervision

Important cases relevant to this item are *Bater v. Dresser*,[591] *Graham, Caremark, Stone v. Ritter, Citigroup* and *AIG*.[592] These cases are described below, as well as under liability in paragraph 3.7.3.1.

Bater v. Dresser (1920)

Coleman, the bookkeeper of a small bank in Cambridge, defrauded the bank. Semi-annual examinations had not revealed any wrong doing. A claim for damages was filed against the directors. The US Supreme Court made a distinction between Dresser, the president, and the other directors. As Dresser was at the bank for many hours every day and had received several hints and

[591] *Bater v. Dresser*, 251 U.S. 524 (1920).

[592] *Graham* (Delaware Supreme Court 24/1/1963, 188 A.2d 125), *Caremark* (A.2d 959, 967 (Del. Ch. 1996)), *Stone v. Ritter* (Delaware Supreme Court, 911 A.2d 362 (Del. 2006)) and *AIG* (Vice-Chancellor Strine, 965 A.2d 10/2/2009) and *Citigroup* (964 A.2d 106, Del. Ch. 24/9/2009).

warnings, he was held liable. The other directors, who were outsiders and had been persuaded by the president and the semi-annual examinations that nothing was wrong, were held not to have been negligent. This case is important because it makes clear that the US courts distinguish between insider directors and outsider directors in liability cases.[593]

Graham (1963)

Graham, the plaintiff, alleged that the directors of Allis-Chalmers had knowledge of anti-trust price-fixing arrangements, although the corporation had agreed to a consent order 20 years earlier not to violate antitrust laws. Allis-Chalmers manufactured a variety of electrical equipment and had 31,000 employees, 24 plants and annual sales of $ 500 million. Its policy was to decentralise management and to have prices set by particular department managers. The 14-strong board, which consisted of 4 executive and 10 non-executive directors, met once a month and was supplied with financial and operating data. They made all decisions on general business policy. In this case some of the company's employees were suspended, interrogated and indicted. The board members were not. Graham wished to sue the board members for damages on the grounds that they knew of the anti-trust activities. The Chancellor and the Delaware Supreme Court ruled that the individual directors were not liable because they had not known of the activities. Some employees of Allis-Chalmers had violated the anti-trust laws and thus subjected the corporation to a loss. There was no duty upon the directors to install a corporate system of espionage if they had no reason to suspect wrongdoing. They were entitled to rely on the honesty and integrity of the employees. This was especially true given the large size of the organisation. In short, there were no red flags. Directors are liable for mistakes of employees only if they have recklessly reposed confidence in an obviously untrustworthy employee.

The modern view is that directors should implement procedures and programmes to assist them in their monitoring role.[594] Federal sentencing guidelines have provided for lesser sentences to corporations that have implemented compliance programmes.

Caremark (1994)

This case recognised the trend and interpreted the Graham standard more narrowly. The directors of Caremark Int. Inc. were successful in their motion to dismiss the case against them. The plaintiffs had claimed that Caremark

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[593] Pinto and Branson (2009), pp. 220-221.

[594] A.L.I. Corp. Gov. Proj. § 4.01.

directors should have known that officers and employees of Caremark were involved in violations of the federal Anti-Referral Payments Law. That law prohibits health care providers from paying any sum of money to induce referral of Medicare or Medicaid patients. The court held that “It is important to be reasonably informed that the board exercises good faith (under loyal) judgment that the corporation’s information and reporting system is adequate to assure the board has appropriate information in a timely manner as a matter of ordinary operations. However, directors cannot be required to possess detailed information about all aspects of the enterprise. Only a sustained or systematic failure of the board to exercise oversight, such as an utter failure to attempt to assure a reasonable information and reporting system, will establish the lack of good faith (under the duty of loyalty) as a necessary condition for liability”. Boards have the duty (a) to institute a system of supervision and (b) to record and monitor that the system functions, but do not have the duty to possess detailed information about the activities of all employees. Some form of monitoring system must therefore be in place.

Stone v. Ritter (2006)
Stone was shareholder in AmSouth. In 2004 AmSouth Bank paid $ 40 million in fines and $ 10 million in civil penalties arising from violations of anti-money laundering regulations, alleged to be the largest ever of its kind. KPMG confirmed that AmSouth had a longstanding compliance programme. There were many AmSouth employees involved: BSA officer, BSA/AML Compliance Department, Corporate Security Department and Suspicions Activity Oversight Committee. The BSA officer trained the board of directors annually. The board at various times enacted written policies, e.g. a board-wide policy directing all AmSouth employees to immediately report suspicious transactions. The claim that directors are liable for employees’ failures is “possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment” [...] “Only a sustained or systematic failure of the board to exercise oversight [...] will establish the lack of good faith (under the duty of loyalty) that is a necessary condition to liability. “In the absence of red flags, good faith in the context of oversight must be measured by the directors’ actions to assure a reasonable information and reporting system exists,” as noted in the *Caremark* decision. The Chancery Court and the Supreme Court dismissed the case. The directors are therefore only liable for failure to implement a reporting system or, if there is a system, for consciously failing to monitor the system.

AIG (February 2009)
A motion by AIG directors Maurice R. (Hank) Greenberg and Smith to dismiss the complaint filed by the plaintiffs was not accepted by Vice-Chancellor Strine

in a 108-page opinion. In this case a litigation committee of independent directors had been appointed. This committee had decided to institute the litigation initiated by plaintiffs against Greenberg and Smith and the "inner circle".

AIG had invested hundreds of millions in offshore subsidiaries and then entered into worthless reinsurance contracts with them. Also, AIG invested in buying up for itself elderly people's existing insurance policies while telling the public it was issuing new insurance policies. Greenberg and his inner circle inspired and oversaw a business strategy premised in substantial part on the use of improper accounting and other techniques designed to make AIG appear more prosperous than it in fact was. Each of the inner circle had been awarded an enormous amount of stock by Greenberg; they had supervisory authority over AIG's investments and served on AIG's finance and executive committees. In some of the wrongdoings Matthews, one of Greenberg's top managers, was kept in the dark by Greenberg and his inner circle. Here Greenberg and Smith and the "inner circle" were likely to be liable because they had acted in this way without informing the other directors. The motion to dismiss was not accepted and the case will go on to trial.

Citigroup (September 2009)
Citigroup suffered huge losses because of direct and indirect investments in subprime markets. These investments turned out very poorly. However, risk management systems were in place and there was an audit and risk management committee that had the duty to assist the board in monitoring the risk analysis. This committee met about 11 times a year. The Chancery Court considered that the board knew of the deterioration of the subprime market and of the possibility of further deterioration. The plaintiffs in this shareholder derivative suit did not even specify how the monitoring system was inadequate. The Court held that the "red flags" mentioned by the plaintiffs were only general market circumstances and therefore more a sign of poor decision making than of acting in breach of fiduciary duties. The plaintiffs were denied the right to start litigation and the motion to dismiss was accepted. Again, if there are risk management systems in place and there were no specific red flags, the directors are not liable.

While courts continue to adhere to the *Caremark* case, the possibility of demanding higher standards of care for directors of financial institutions could be extended to all corporations. Specialized committees, use of expert consultants, tutorials and expanded director education will go a long way to enable boards to meet even a strengthened duty of oversight obligations.[595]

There are many developments in this area. The NYSE requires risk assessment and management policies.[596] The SEC endorses self-regulatory frameworks, that is the Committee of Sponsoring Organizations of the Treadway Commission (COSO) Enterprise Risk Management – Integrated Framework of September 2004.[597] The framework is a regulation of systems that is followed by the corporation. The COSO Framework is also used in the Netherlands. Amendments to the Securities Exchange Act 1934 require risk factor disclosure in annual and quarterly reports.[598] As mentioned above, a federal sentencing guideline provides for more lenient treatment of corporate crimes if the organisation had established a well-functioning and qualifying compliance programme.[599] Certain industries – especially banks and insurance companies – are adopting leading “best practices”. Rating agencies are becoming more attuned to companies’ systems of enterprise risk management systems.

3.5.5 <u>What is the status of the discussion about non-CEO chairmen? What roles does a lead director have?</u>

As mentioned earlier, the US was used to having companies with a sole leader who combined the function of CEO and chairman. Since 1994, following the changes promoted by GM and CalPERS, and especially since 2002, subsequent to Enron and WorldCom, there has been a strong lobby, led by Ira Millstein and the Blue Ribbon Chairman’s Group, to have separate non-CEO chairmen. However, the Business Roundtable, the association of CEOs, has raised doubts and objections against this trend. As mentioned before, 30% of the larger listed companies have non-CEO chairmen and the other 70% have a combined CEO/chairman, but do have a lead director who presides over the executive sessions. Pressure groups, such as Risk Metrics, are attending shareholders’

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[595] Lipton NYSE Speech (2010).

[596] Section 303A of the NYSE Listed Company Manual.

[597] Conference Board (2009), p. 154.

[598] Item 1A of Securities Exchange Act Forms 10-K and 10-Q and item 503(c) of Regulation S-K.

[599] Chapter 8 (Sentencing of Organisations), Amendment 673 (Supplement to Appendix C, 2004 Federal Sentencing Guidelines Manual).

meetings to get boards to agree to split the functions of CEO and chairman. This is the third important structural change in US boards after the switch to a strong majority of independent directors and the adoption of executive sessions. Activists argue that oversight of the CEO by an independent chair might have helped mitigate the risk-taking that contributed to the recent financial meltdown.[600]

Risk Metrics, now called Institutional Shareholder Service, in its February 2010 report entitled “U.S. Season Preview on Governance”, implies that an even greater use of outside directors is the appropriate response, specifically the use of an outside chairman. The report calls 2009 a breakthrough year for advocates of an independent chairman, inspiring it with the hope that it would continue to earn more support for these proposals. Risk Metrics cites investor advocates who had noted that no large financial firms had an independent chairman before the crisis and had argued that such companies were too large and complex to be run by a combined CEO and chair. Risk Metrics are putting pressure on large companies to move to the non-CEO chairman model within 3 years. Many companies such as Microsoft, Intel, Citigroup, Sara Lee and NYSE/Euronext have already introduced it.

Discussion on a separate chairman to balance the CEO

Traditionally, in US public companies, the CEO heads the management team overseen by the board and is also a member of the board. Those who favour preserving this traditional structure of duality argue that a single leadership fosters more operational efficiency, facilitates internal communication with the board, and ultimately allows better business performance. The Business Roundtable, for instance, believes that most American corporations have been “well served” by a structure where the CEO also operates as chairman of the board, since it bridges management and directorship levels while ensuring that both act with a commonality of purpose. On the other hand, detractors of this practice observe that separating the roles gives boards an organizational basis for acting independently of management and avoiding dangerous instances of CEO

[600] Conference Board (2009), pp. 33-35. Only 29.3% of large companies with revenues of 9 billion or more report separating the CEO and board chairman positions; however, 68.1% of the same sample report having appointed a lead director. Variations can also be observed from industry to industry, with only 31.6% of companies in the energy industry with a non-CEO chair compared to over 50% in other sectors (including insurance and financial services).

imperialism and avoids a conflict of interest for the CEO who otherwise monitors himself. These arguments are discussed hereafter.

The arguments for having a separate chairman used by the Chairman's Forum[601] can be summarized as follows:

(1) Experience in countries, such as e.g. the UK and Canada, has shown that the model of a separate chairman works well. The CEO is accountable for running the company in the interests of the shareholders. This is a separate and time- intensive responsibility. The independent chairman curbs conflicts of interest, promotes oversight of risk, manages the relationship between the board and the CEO, and serves to know the views of shareholders. The idea of the separate chairman is a logical next step in the development of an independent board.

(2) In the context of the economic crisis peer independent chairmen believe that lead directors are not considered the equivalent of board chairmen by the board or shareholders. "He who sits at the head of the table runs the meeting."

(3) The responsibilities of managing a complex enterprise are not necessarily the same as those required to lead the board in overseeing management. Moreover, given the time and effort required to manage in today's context, managing and promoting the business is a very different function from leading the board.

What's next?

In view of the present crisis and the many bank failures, the need for a next step is apparent. US corporate governance has come a long way from managerial capitalism to independent board monitoring and executive sessions. Notwithstanding the improvements, many boards are still led by a person with a potential conflict of interest, being required to monitor himself, as CEO and to monitor senior management. The next step is to have a separate independent chairman.

The main arguments in favour of a separate chairman are that the CEO as chairman is the leader of the monitoring body, and has a conflict of interest, when monitoring himself; and that the growing demands on management, i.e. strategy, process and shareholder contact, require two persons.

[601] Millstein Chairing the Board (2009).

Objections to a separate chair refuted[602]

"US boards are well served, so why fix what is not broken" say the objectors. The response is that in the many scandals over the last 30 years the main cause has been insufficient monitoring by the board. The majority of financial institutions that failed in the recent crisis had a combined CEO/chair. Moreover, foreign institutional investors want the roles to be separated.

The objectors point to a dearth of evidence that separation of the roles positively impacts share price. The proponents respond that there is no evidence to the contrary. The evidence is, as with all corporate governance changes, neutral. It cannot hurt, but might help.

The objection is that it creates potential confusion and duplication. In the opinion of the proponents of a separate chair it creates a well-delineated division of functions.

The objectors fear potential animosity between the CEO and the chairman. The proponents respond that better monitoring means that difficult questions will not be avoided. Rubber-stamping the activities of executives is not what is required. Improvement of oversight functions is what is needed.

One leader is sufficient for decision making, say the objectors. The response is that a group usually takes wiser decisions than one individual on his own.

The objectors argue that a separate chairman creates extra cost. The proponents respond that having a separate chairman can ensure that executives are not overpaid or "paid for failure".

The objectors say potential disruption could occur if the CEO becomes demoralised. The timing of the change is difficult. The advice of the Chairman's Forum is to change when the CEO changes. Its view is "better late than never".

The objectors say CEOs prefer the combined role. The proponents say independent monitoring may not be popular with CEOs, but it is efficiency enhancing. Just because one constituency does not like it, is no reason not to do it.

The objectors say that in practice the separate chair is unworkable. The response is that 72.8% of interviewed directors with experience with an independent chairman are positive.[603]

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[602] Millstein Chairing the Board (2009), pp. 18-20.

[603] This has risen to 86.7%, according to the NACD, *Public Company Governance Survey* (2009), p. 16.

The objectors say that having a lead director is just as good. The response is that the experience is different. A lead director does chair the executive sessions, but not the full board meetings. "He, who sits at the head of the table leads". This also gives the chairman the possibility of asking the views of officers other than the CEO and to take time out if the chair senses disagreement.

Objectors say that one size does not fit all. True, say the proponents, but it fits most. 72.8% of interviewed directors say that if a company board explains to shareholders and they agree, there can be an exception to having a separate chair. It does not have to be mandatory. When companies deliberate about which structure to adopt, they should take into consideration factors such as their culture, stage of development, performance, concerns by investors, etc. No one model provides an absolute guarantee of business success.[604] In a family business where the CEO holds most of the shares there does not have to be a separate chairman, is the general view, even of the defenders of the separation of the functions of the CEO and Chairman.

Another issue about the non-CEO chairman model is whether a CEO who sits on the board with about 8 to 12 independent directors would not be overpowered by them. The answer given to me by Professor Ira Millstein of Yale University is that board dynamics do not weaken the CEO. The CEO knows the business better than any other board member. His proposals are being discussed. That gives the CEO the power to convince and gives him prestige. Usually things go somewhat as follows. The CEO's proposals are being discussed; he has all the information to defend his plans. The CEO is supported by his officers, who attend the board meeting and show support by their presence and body language. If the CEO is not sure of their support, he should inform the board in advance about any dilemmas he and/or his officers have or first try to convince the officers with his arguments. The CEO prepares the board meetings with the chairman and will know before the meeting whether any independent directors have doubts about his proposals, in which case he can try to convince each of them before the meeting. He can also ask the chairman to adjourn such an agenda point.

The most recent legislative proposal from the SEC would require disclosure of a company's leadership structure as well as the rationale for believing that such a structure is the best for the company.[605] This

[604] Conference Board (2009), p. 35.

[605] Conference Board (2009), pp. 33-35.

approach is, of course, a “comply or explain” concept, which is now confirmed and repeated in the Dodd-Frank Act of 21 July 2010.[606]

With these developments and with pressure through shareholder proxy resolutions it is reasonable to assume that in a few years separation of the functions of CEO and chairman will be more widespread.[607]

Functions and qualifications of the separate chair

The functions of a non-CEO chairman are to (i) convene and preside over board meetings and executive sessions; (ii) lead the board and uphold high corporate governance and ethical standards; (iii) establish the operating procedure for the board and committees; (iv) organise the board agenda with assistance of the CEO, board committee chairs and corporate secretary, and provide sufficient time for discussion of agenda items and focus the board’s attention on relevant matters, limit distraction and discord, and work towards consensus; (v) supervise circulation of proper, timely and relevant information to the directors; (vi) ensure that all directors contribute at the meeting; (vii) communicate effectively with management on a regular basis and act as sounding board for the CEO; (viii) take the lead in board evaluation and succession planning of the CEO and other directors; and last but not least (ix) ensure good communication with shareholders.

The qualities required of the non-CEO chairman are independence and the courage to ask questions, to have experience in a similar industry and the ability to commit enough time, e.g. 2 to 3 days a week, not necessarily at the office, but full time in times of crisis, to be a good communicator, and have a sense of modesty and humility.

Clear documentation of functions and qualities

It is important to clearly document the duties of the chair and the CEO to avoid duplication and/or conflict and put this information on the website.

Timing of change to separate non-CEO chairman

Timing the change from imperial CEO – combined CEO/chairman – to CEO and independent chair is not easy. The CEO will see change as an insult. Probably the best moment is when a new CEO is appointed, although this too may be seen as criticism and offering a new person a

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[606] See section 3.1.2 towards the end.

[607] Lipton NYSE Speech (2010).

downgraded job. Risk Metrics, now called Institutional Shareholder Services, is advising some large corporations to make the change before the end of three years.

Appointing a lead, presiding or senior independent director

When boards do not choose to separate the chairman and CEO positions, a lead, presiding or senior director can be appointed. He should meet the independence requirements under the applicable listing standards. The responsibilities of the lead director (or other equivalent designation) would include chairing executive sessions, but not the full board, i.e. the independent directors plus the CEO/Chairman, serving as the principal liaison between management and independent directors, and working closely with the CEO/chairman to finalise board meeting agendas. In practice he has a veto on setting the agenda. The lead director would also be in charge of approving the information flow to the board and of other operational aspects of board functioning, of the evaluation of the CEO and he would take over the CEO office temporarily when it is unexpectedly vacant.[608]

The separate non-CEO chairman does have a stronger position than a lead director: (i) the chairman shapes board dialogue and sets the tone and the agenda; he determines which of the officers other than the CEO should be involved in the dialogue; he also ascertains whether there is disagreement among the executives and it is easier for him to stimulate other independent directors to be active in the discussions; (ii) the chairman has visibility and can, if necessary, communicate independently with other parties; and (iii) the chairman has board leadership of the board. Moreover, if there is a non-CEO chairman the other directors will feel less inhibited in challenging the CEO in a full board meeting.[609]

The trend to have at least a lead director, even if the CEO is also Chairman, may also be explained by the fact that NYSE rules[610] now require that an outside director should preside over executive sessions of the boards of listed companies. Thus, companies whose CEOs function as board chairmen – almost 70% of listed companies – do need lead or independent directors to comply with this requirement.

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[608] *Wall Street Journal*, 13 September 2010.

[609] Conger and Lawler (2009), p. 185.

[610] Section 303A of the NYSE Listed Company Manual.

3.5.6 Elements of best practices

Early and on-site information

The performance of the corporate board ultimately depends on the ability of directors to access in good time all useful business information needed to make informed decisions in the interest of the company. Senior and lower managers are the major providers of such information. They owe a duty of candour to members of the board. To maintain objectivity, the board must receive data from external sources too, such as market trends, analyst reports and competitive analysis. The board should also examine the books and inspect the facilities.[611] In most cases they give the CEO advance notice of such visits.

It is US practice to provide directors with timely and detailed information by means of extensive "information packs" before every meeting. Since the Enron debacle, independent directors do their homework well. There is more emphasis on receiving information from lower management and separate divisions.

Directors need to be more actively involved and have information in three main areas, i.e. the company's long-term strategy and health (its ability to survive and develop over the longer term), its short-term financial performance, its strategy and assessment of risk and its leadership and succession.[612]

For the board's role in its monitoring risk oversight role the directors need to be informed about all essential aspects of the business. They must also pay on site visits, meet officers of subsidiaries and understand the business. They should not be burdened with an information overload, but should instead be supplied with succinct information especially put together for them.[613]

Boards should have regular tutorials by both company employees and outside advisers. Board retreats of two or three days will have longer agendas for the education of directors about special issues.[614]

[611] Conference Board (2009), pp. 19-20 and NACD (2005).

[612] Felton and Fritz (2005).

[613] NACD on Risk (2009).

[614] Lipton NYSE Speech (2010).

Time commitment

Board members need to give sufficient time to the company. This is important in order to develop teamwork on the board and between the board and management. Generally CEOs take on few other board positions. Jack Welch, when CEO of General Electric, refused to be on any other outside board. This is rather extreme given that CEOs can gain experience when sitting on other boards. The general US opinion is that CEOs should be on no more than one or at most two other boards. Retired executives might sit on a few more boards.[615]

The number of times the whole board meets in the US is not much more than that of Dutch supervisory boards, i.e. six to nine per annum (six in industry, food and utilities and nine in commercial banks). In the US the number of board meetings is not influenced by the size of the company, but there is far more material to be studied in boards of larger companies.[616] However, US board committees meet more frequently than Dutch Committees. In 2008, its audit committees met on average 9.1 times per year,[617] compensation committees 6.6 times[618] and nomination committees 4.5 times.[619] These figures were not much higher than the 2007 averages. Other differences between US and Dutch companies which indicate that US independent directors put more time into their task than Dutch supervisory directors do are the frequency of on-site inspections and informal get-togethers and the volume of information packs in the US. Each meeting usually involves a dinner plus a whole day (either afternoon meeting, dinner and morning meeting or dinner and meeting next day). The directors often fly in. Furthermore, the fact that directors really make the decisions (the board decides as a whole) gives them a greater sense of involvement. In the US independent chairmen and lead directors devote even more time to the company business than the other independent directors.

[615] Conger and Lawler (2009), p. 188.

[616] Conference Board (2009), p. 41.

[617] Conference Board (2009), p. 95, for Netherlands: De Bos and Lückerath (2009/0), p. 16.

[618] Conference Board (2009), p. 79.

[619] Conference Board (2009), p. 48, for UK see pp. 82-83 of this study.

Overview of meetings of boards in listed companies

	UK NEDs (2006)	US Independent directors (2008)	Dutch Supervisory directors (2009)
Board	9	9	7
Audit	4	9	4
Remun.	(4)	(6,6)	(4)
None	(4)	(4,5)	(4)
Other	5	5	
Prepare	5	10	5
On site	4	4	
Total	27	37	17

Increasing time demands on board members will result in a greater use of modern conferencing and communication technology so that travel time can be reduced, committees can meet apart from meetings of the whole board and special meetings with consultants can be arranged. Dealing with crises and important issues will demand more frequent special meetings with outside consultants.[620]

Evaluation and continuing education

Evaluation of the board as a whole and individually of its members and of the CEO takes place under the leadership of the nominating committee. There is a three-level assessment of the complete board, the committees and of individual directors. Most companies assess the first two annually. The assessment of individual directors often takes place only before reappointment or retirement. Normally, the non-CEO chairman or lead director chairs the nominating committee.[621] The fact that there will be a formal evaluation and the manner in which it will be conducted has to be made public by being placed on the website. The result of evaluations themselves are confidential and aim to promote teambuilding.[622] Risk Metrics, now called Institutional Shareholder Services, has been factoring director training into its governance ratings or assessments, which has

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[620] Lipton NYSE Speech (2010).

[621] Conference Board (2009), p. 62.

[622] Conference Board (2009), pp. 61-62.

acted as another key driver for companies to arrange continuing education for their directors.[623]

Teamwork

US companies devote much time and care to promote teamwork, but are aware of the constraints. Board members are often unable to spend enough time together and then resort to phone calls and email communication among themselves. Limitations include other demanding jobs and the fact that there is only one full-timer on the board, i.e. the CEO, who can control most information. There is a tendency for board members, often former or present CEOs or executives in other companies, not to challenge the CEO too seriously and too often.[624] Some board members have connections with or are nominated by different shareholder groups. There are other interests which some board members feel close to, and there are – as in every organisation – ego clashes. Some directors are extrovert or dominant and some are more reserved. The present day over-emphasis on committee work, caused by the Sarbanes-Oxley Act divides up the board in many separate meetings, all factors which make teamwork difficult.[625]

Various suggestions have been made for improving teamwork.[626] Having a separate non-CEO chairman or lead director could promote a shared leadership approach. In these cases the CEO and the chairman or lead director would always prepare for board meetings together and, again communicate with each other after each executive session. Effective chairmen have techniques such as "calling on directors" for comment on each item, "going around the room/asking all directors", polling the board and having pre-meeting conversations with individual directors, encouraging them to speak to one another, making sure directors are selected with ample time and an appropriate mix of team members of varied areas of expertise and backgrounds, as well as creating an appropriate mix of team members with varied areas of expertise and diverse backgrounds.

[623] Conference Board (2009), p. 62.

[624] Conger and Lawler (2009), pp. 184-185.

[625] Jay Lorsch and Robert C. Clark, 'Leading from the Boardroom', *Harvard Business Review* (April 2009), p. 1 ("Lorsch and Clark (2009)").

[626] Conger and Lawler (2009), pp. 185-188.

It is worthwhile for the board to evaluate the extent of the board's teamwork with rigour and candour. In this evaluation the board should at given times be assisted by outsiders. The evaluation confirmation should be laid down in writing and discussed in meetings. Boards should not be too large (8 to 12 members), on the assumption that leadership involving specific problems is often provided not only by the CEO, the chair and the lead director, but sometimes also by committee chairs or sometimes a specialist or simply each director.[627]

Committees

– *Audit committee*
  The audit committee may only have independent members.[628] There must be at least three members who are financially literate. One member must have accounting and related financial management expertise.[629] The company must disclose whether there is a financial expert. The committee is responsible for hiring and firing the outside auditor. The liability of outside auditors should not be limited. Meetings should be held with an outside auditor and also with the chief legal counsel at least quarterly. The audit committee should be free to hire independent advisors. In 2005 the Fortune 1000 audit committees met on average nine times a year, which was up from five a year in 2002.[630] This number of meetings a year was still nine in 2008.

– *Compensation committee*
  The corporate articles of association should describe the scope of authority, the power to delegate, the role of any executive in determining the compensation of any other executive and the role of the compensation consultant.

  The Dodd-Frank Act confirms that all compensation committee members must be independent. The role of the compensation committee is to oversee the corporation's overall compensation structure, review the corporate goals and objectives relating to executive compensation and performance measurement, evaluate executive performance in light of those goals and objectives and

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[627] Jay Lorsch and David A. Nadle, *NACD Board Leadership Report* (2004), p. 2.

[628] SEC rule 10A-3.

[629] Item 401 of Regulation S-K.

[630] Conference Board (2007), p. 230.

determine and approve executive compensation. The committee should oversee the company's disclosure practice with respect to executive compensation and play an integral role in preparation of the compensation discussion and the analysis to be included in the proxy statement and annual report. The compensation committee should regularly report to the independent directors, who should review and ratify committee decisions. The committee should maintain appropriate communication with shareholders and provide full disclosure on compensation matters. Other functions are to ensure that a strong executive team is in place, to work closely with the nominating committee to ensure leadership and effective succession planning and to ensure consistency of pay practices at all levels.

Compensation committees met 5 times on average in 2005.[631] This rose to 6.5 times in 2008.[632]

– *Nominating/Corporate Governance committee*
The functions of this committee are to select candidates and make nominations for appointments to the board of directors, including the position of CEO in case of succession, and to take initiatives relating to corporate governance principles of overseeing the board and overseeing offers to evaluate and hire search firms. These committees meet 4.5 times a year on average.[633]

3.5.7 CEO succession

CEO succession has always been an important issue for the board in the US. Generally US companies are very good at career development, training those persons with the highest potential and grooming them for top positions. In the US it is often quite clear who is promising among their staff. The ladder practice, also called "auditioning", is being increasingly used.[634] Who has the potential to be CEO is often quite clear in advance. In many cases "laddering" goes more or less as follows: a potential CEO is first appointed as COO, then as President and only

[631] Conference Board (2007), p. 230.

[632] Conference Board (2009), p. 79.

[633] Conference Board (2009), p. 48.

[634] Conference Board (2009), p. 66 and Per O. Karlson and Gary L. Nielsson, *CEO Succession 2008: 'Stability in the Storm'* (May 2009), p. 4.

afterwards, if he has fulfilled expectations, as CEO. The successor is never publicly announced, but often there is an awareness of who is being groomed.[635] Often there are several persons to choose from, who have demonstrated their abilities as heads of divisions. The effectiveness of this long-term process has been mentioned to me by Dutch captains of industry as an example of good US practice. Indeed, Dutch directors who work in large US corporations have told me that even at lower levels two or three candidates are named and groomed for key positions.

In the past the CEO/chairman took the lead in the process of selecting his own successor and asked the board for agreement at the last moment. Ovitz's appointment as COO by the Disney board in 1995, which was planned by CEO/chair Eisner, was an example that worked out badly, but has served as a warning for many companies and boards.[636] At GE the appointment of Immelt to replace Welch, which was prepared 5 years in advance, was an example of how things should be done.

The framework within which US boards work on succession matters has changed radically in the past few years. Regulations and guidelines, especially concerning the nominations committee and disclosures, required by the Sarbanes-Oxley Act, NASDAQ and NYSE, have increased the pressure to ensure effective CEO succession. Shareholders, investors and employees are holding boards accountable for CEO performance. As a result, directors are getting more involved in succession planning.

It is crucial to assign the oversight of the CEO succession planning to the independent nominating committee and to have the lead director or independent non-CEO chairman chair that committee. It follows that control over this critical strategic factor has shifted from the CEO to the independent directors.[637]

Best practice advice to independent directors concerning CEO succession is to plan three to five years in advance and ensure that there is full board

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[635] NACD, *The Role of the Board in CEO Succession*, Board Leadership Series (2006) ("NACD, CEO Succession (2006)").

[636] John W. Anderson and Karen L. Pascale, 'THE *DISNEY* CASE: A Virtual Roundtable Discussion with William T. Allen, John C. Coffee, Jr., Lawrence A. Hammermesh, and James B. Stewart', *Delaware Lawyer* (Winter 2005/2006), pp. 26-36 ("Anderson and Pascale (2005)").

[637] Conference Board (2009), p. 78.

involvement. Succession planning should also integrate business strategy and risk management.[638]

Other measures generally promoted are to establish an open and ongoing dialogue and annual review and make the process transparent, to develop and agree on selection criteria, to use a formal assessment process of all internal (and, if any, external) candidates for their work in prior years, to interact with internal candidates by having managers make presentations at board meetings, attend offsite meetings, retreats and social events and have managers meet individually with board members. The best way to test potential candidates is to have them discuss strategy in a board consisting of strong, opinionated people. An often heard warning stresses the need of not leaving career development to the Human Resource department, but having directors themselves meet the top 50 staff members of the company. This is one of the reasons for on-site visits. It is also advisable to stage the succession, but avoid horse races. The consensus among directors is that “having a clear front-runner is the right way to go”. However, if a board is developing multiple prospects, it should never publicly announce who is being considered for the role and should develop internal candidates rather than recruiting externally. Internal candidates are familiar with the company’s unique business and culture. [639] Companies like General Electric, Lowe’s, Microsoft and McDonalds have processes that strongly favour internal candidates. These companies all have effective executive development programmes. Companies that have the best development programmes will have the best internal candidates.[640]

The next best practice, at a change over, is to either have the outgoing CEO leave, or stay on as a chairman for a limited period of up to 6 months. Most directors are in favour of the CEO leaving immediately. “Welch (at GE) isn’t trying to tell Immelt what to do”. If the outgoing CEO stays on briefly, this works best, when there is absolute clarity about the division of roles and the symbols of leadership. For example, the office of the outgoing CEO should be moved to another floor. It can be useful if the lead director is prepared to act as mediator and if the outgoing CEO gets coaching during the interim transition and the other directors help as well. This short period of 6-12 months, during which the

[638] Conference Board (2009), p. 78.

[639] NACD, CEO Succession (2006), p. 1.

[640] Conference Board (2009), p. 64.

outgoing CEO stays on as chairman, is called the "apprenticeship model". This "apprenticeship" system has become increasingly popular over the years in the US.[641]

It is certainly advisable to prepare a comprehensive emergency succession plan. McDonalds is often mentioned as the perfect example. When the company's 60-year old CEO suddenly died from a heart attack, the board had "a good plan" in place and acted immediately by naming a respected insider, thus reassuring franchises and investors that the same strategy would continue to be followed. Steps to be taken by directors in connection with the emergency plan are to ask the current CEO who the internal candidates are, make a requirement of having an emergency plan and be prepared to replace the entire executive team when necessary, have a communication strategy and prepare for a search.

3.5.8 Corporate governance at banks

A report of Nestor Advisors of April 2009 entitled "A comparative case study of six US investment banks"[642] shows that two failed banks – Bear Sterns and Lehman Brothers – had "stale", entrenched boards with high stakes in shares, whereas Goldman Sachs and JP Morgan Chase had younger boards with a higher percentage of independent directors with experience of financial institutions. All these banks had a combined CEO-chairman. Citigroup, after it had to be rescued too, now has a separate non-CEO chairman.

3.5.9 A summary of the role of board members in the US

(i) US corporate tradition gives primacy to the board, the nexus of the corporation; shareholders traditionally have fewer rights on paper than in the UK. From 1972 onwards the SEC supported audit committees by advocating that they should consist solely of independent directors and from 1977 onwards endorsed them. In 1977 the term "corporate governance" was used first in the US. Since 1992 shareholder activists have won rights and promoted private codes. After the Enron and WorldCom collapses and the Sarbanes-Oxley Act of 2002, the SEC encouraged stock exchanges to develop codes that give best practice rules for the

[641] Conference Board (2009), p. 66.

[642] Nestor Advisers of April 2009.

nominations of independent directors and more shareholder rights; in response a number of aspirational private codes have been launched. The move towards more shareholder rights is continuing and the Dodd-Frank Act provides direction in many areas. Shareholder activists are urging for changes in majority voting for directors, elimination of staggered boards and separate non-CEO chairmen for all listed companies.

The main new features of change for US boards are independent directors, executive sessions and the growing number of non-CEO chairmen.

The emphasis on shareholders' rights and sharp focus on stock prices, cause growing pressure from outside on the company. This has put independent directors in the limelight and has forced them to concentrate on monitoring and challenging, optimizing the results of the company and the interest of long-term investors and a score of other stakeholders.

The major role in creating an orderly succession has passed from the CEO to the independent directors, and US career development programmes have become an example for other economies.

(ii) The members of a US one-tier board have joint responsibility for developing, achieving and monitoring all aspects of corporate strategy. They take all decisions jointly. The division of board roles between executives and non-executives is flexible, but must be clearly documented in writing.

(iii) Independent directors are playing a more enhanced role in debating strategy options and in challenging officers on their development of strategy as well as in monitoring the achievements of these officers. Particularly noteworthy is the cooperation between US executives and non-executives in dividing up strategy development into steps, so that the non-executives effectively have an active role even if the drafts are made by the executives. This active role of independent directors in the US in challenging strategy differs from the general position of supervisory directors in the Netherlands, whose sole function is to supervise. It also differs from NEDs of the UK, who are supposed to do more than challenging strategy proposals, in that NEDs are actively involved in the development of the strategy.

(iv) Adopted measures for promoting the better functioning of independent directors include the provision of early information and on-site information, time for debate about strategy and systems for enterprise risk management, introduction, training, time for the job, income, evaluation and, last but not least, proper succession procedures.

(v) The majority – 70% – of US listed companies still have a CEO who is also the Chairman. In these corporations the leadership role of the independent directors is fulfilled by a lead director, who chairs the executive sessions. He is the one who also takes all measures to promote the proper functioning of the independent directors as mentioned at (iv) above. 30% of listed corporations have a separate non-CEO chairman. The separate chairman does what the lead director does, but as he also chairs the full board meeting and therefore influences the debate, he has more knowledge of the performance of the officers. He is complementary to the CEO and acts as his partner. He is less involved in day-to-day business and goes to fewer meetings with shareholders than a UK chairman. Dutch chairmen can learn from both these systems.

(vi) As far as a US-UK comparison is concerned, points (ii), (iii) and (iv) show that US boards and independent directors have more or less the same roles as UK boards and NEDs. On the whole, US independent directors have slightly less influence in the shaping stage of strategy than UK board members. The main formal differences are that in the US independent directors hold executive sessions and only 30% of listed companies have separate non-CEO chairmen. Most of the other 70% have lead directors.

3.6 **Duties of independent directors**

3.6.1 Introduction on duties of independent directors

The two previous sections (3.4 on the composition of the board and 3.5 on the role of independent directors) complement each other. Similarly, there is a connection between sections 3.6 on the duties of independent directors and 3.7 on their liabilities.

In the comparable parts of the chapter on the UK, section 2.6 on the duties of NEDs receives much more emphasis than 2.7 on the liability of NEDs because in the UK the duties are extensively described in corporate governance codes under the "comply or explain" concept and in the Companies Code of 2006. Moreover, the UK has produced little in the way of only sparse liability litigation, but more disqualification cases.

In short, there is more emphasis in the UK on aspirational and best practice duties, whereas in the US the emphasis tends to be on liability litigation. Therefore this section on duties in the US situation is shorter than the next section (3.7) on liabilities.

The Netherlands has a large volume of Civil Code law on companies, a best practice code, case law in a special court for the inquiry of the mismanagement of companies, called the "Enterprise Chamber" and separately from that there is liability litigation in the civil courts. The balance between duties and liability in the Netherlands could be said to be somewhere in the middle, between the UK and the US.

The following topics are dealt with in respect of duties and liabilities of directors in the US: the distinction between duties and liabilities, best practice codes (3.6.2), the developments since Enron of 2002 (3.6.3), the basis for duties (3.6.4), to whom do directors owe duties? (3.6.5), the pressures on boards (3.6.6). The section will be closed by a summary on duties (3.6.7).

The topics covered in section 3.7 on the liability of independent directors are: who can sue? (3.7.1), the procedural complications (3.7.2.), the liability standards in various proceedings, including corporate liability cases, the business judgment rule and the duties of loyalty, including good faith and duty of care as well as securities cases and creditor cases (3.7.3), the protection of directors by means of indemnification and insurance (3.7.4). The section will be closed by a summary on director liability in the US (3.7.5).

3.6.2 Distinction between duties and liabilities, best practice codes

In the US a clear distinction is made between best practice duties and duties based on law. The Model Business Corporation Act (MBCA) of 2002 makes the distinction between "standards of conduct" in § 8.30 and "standards of review" in § 8.31.[643] Standards of conduct include conduct that is required of directors and aspirations for what is expected of directors. Standards of review, on the other hand, govern whether directors will be held liable. The Dutch terms for standards of conduct and standards of review are respectively "*gedragsnormen*" and "*toetsingsnormen*".[644] Although this distinction is implied in Delaware case law and has been mentioned in speeches and articles, it has not been developed in liability cases.[645]

A review of standards of conduct in general can best start with the duties and responsibilities of directors. Directors must direct the management of the corporation. They also have a duty of oversight – the American word for supervision – while confusingly the British meaning of the word oversight is the opposite: "an unintentional failure to notice something". They have the duty to monitor management, albeit without going into micromanaging. They must carry out their responsibilities in accordance with principles of fiduciary duty. Although the business judgment rule applied by the courts is the standard of review, these fiduciary duties are embodied in the rule itself. That is, directors are expected to act – and are presumed to act, unless the presumption is rebutted – "on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company".[646]

As mentioned before basic responsibilities of the board of directors stem from the Delaware General Corporate Law, which requires that "the business and affairs of …. [the] corporation …. be managed by or under

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[643] See ABA Corporate Laws Committee, *The Corporate Director's Guidebook*, American Bar Association (ABA), Business Law Section. See also Melvin A. Eisenberg, 'The Divergence of Standards of Conduct and Standards of Review in Corporate Law', 62 *Fordham Law Review* 437 (1993).

[644] See B.F. Assink, 'Pre-advices to the Association of Commercial Law', in B.F. Assink and D. Strik, *Ondernemingsbestuur en risicobeheersing op de drempel van een nieuw decennium: een ondernemingsrecheljke analyse* (2009), pp. 75-77 ("Assink in Assink and Strik (2009)"); Levinus Timmerman, 'Toetsing van ondernemingsbeleid door de rechter, mede in rechtsvergelijkend perspectief', *Ondernemingsrecht* 2003/15 ("Timmerman (2003)") and Levinus Timmerman, 'De grondslagen van geldend ondernemingsrecht', *Ondernemingsrecht* 2009/1 (inaugural speech as professor in Rotterdam) ("Timmerman, Speech (2009)"); and Willem J.L. Calkoen, 'Actualiteiten, Discussie over Commissarissen en belang van Chairman', *Ondernemingsrecht* 2010/88 ("Calkoen (2010)").

[645] Norman Veasey, former Chief Justice of Delaware Supreme Court, Veasey (2005).

[646] Veasey (2005), p. 1417 and *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

the direction of the board of directors”.[647] One of the meanings of the noun “direction”, and the verb “direct”, is defined in Webster's dictionary, besides “control of operations”, “tell or show someone the way”. Both meanings when applied to corporations “strategic control and goal orientation”. Webster’s dictionary expresses the meaning of the noun “direction” even more forcefully: “guidance or supervision of action, conduct, or operations”, and “something that is imposed as authoritative instruction”.[648] The meaning of the verb “direct” follows from these definitions. The root “direct” in this statutory mandate for directors has two components: (1) to determine policy in their decision making role of “telling the way” and “imposing authoritative instruction”, what the law calls” managed by” and (2) to guide and supervise in their oversight function what the law expressed with “under the direction. Thus, directors “manage and are not merely the supervising group that hire and fire the CEO and advise management.[649] This is an essential point for a one-tier board. The board members, including the independent directors, are involved in decision making.

In a two-tier board system the supervisory directors are not involved in the development of decision making. They only veto or give consent.

The marketplace is developing the expectation that directors will engage in best practices, i.e. an extra-legal standard of conduct or “soft law”. This expectation is, for now, primarily an aspirational standard of conduct. Failure to adhere to the standard of conduct reflected in aspirational best practices may not necessarily result in liability, as the Delaware Supreme Court made clear in the *Disney* case.[650]

This is a case about whether there is personal liability of the directors of a Delaware corporation to the corporation for lack of due care in the decision making process and for waste of corporate assets. This case is not about the failure of the directors to establish and carry out ideal corporate governance practices. All good corporate governance practices include compliance with statutory law and case law establishing fiduciary duties. But the law of corporate fiduciary duties and remedies for violation of those duties are distinct from the aspirational goals of ideal corporate governance practices.

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[647] Del. Code Ann. tit. 8, § 141(a) (2001).

[648] *Webster’s Third New International Dictionary* (3rd ed., 2002), p. 650.

[649] Veasey (2005), p. 1419. Here I see the dual function of active involvement in (i) strategy determination and (ii) monitoring.

[650] *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000) (the appeal in the first *Disney* case).

Aspirational ideals of good corporate governance practices for boards of directors that go beyond the minimal legal requirements of corporation law are highly desirable, often tend to benefit shareholders, sometimes reduce litigation and can usually help directors avoid liability. But they are not required by corporation law and do not define standards of liability.[651]

This is a good example of Delaware judges expressing their views about better corporate governance, but at the same time making clear what the law on liability is.

The *Disney* cases[652] have had a huge impact on corporate governance counselling , especially on proper board procedures and on the use of external advisors by nomination and compensation committees. It is often repeated by Delaware judges and retired judges that, as a matter of prudent counselling, the directors' conduct may be measured not only by evolving expectations of directors in the context of Delaware common law fiduciary duty but also by other standards, such as standards from the Sarbanes-Oxley Act, rules of the SEC, Listing Requirements of the NYSE and NASDAQ and even the best practice codes of all private institutions. These corporate governance codes set a high standard of board behaviour that most boards aim to comply with, but this standard is not identical to the standard of review required by the courts, which is lower.

The difference between preaching by Delaware judges and immediate judgments about transactions is described clearly by Professor Ed Rock:[653]

"These opinions illustrate a striking feature of the Delaware fiduciary duty cases, specifically, the multivalent character of the outcomes. In these cases, and in the ones that follow, the courts avail themselves of one of three options: denying the request for an injunction and blessing the behaviour; denying the motion for an injunction and criticizing defendants' behaviour; or granting the injunction. The intermediate position plays three roles. First, it provides guidance applicable to future cases, that is, what kind of behaviour the courts are likely to find to be a

[651] See Anderson and Pascale (2005) interviewing a professor and former vice chancellor and Wendi J. Powell, 'Corporate Governance and Fiduciary Duty, The Mickey Mouse Rule' (2007), File: Powell Doc.

[652] See sub-section 3.1.2 above.

[653] Prof. Edward B. Rock, 'Saint and Sinners: How Does Delaware Corporate Law Work', 44 *University of California at Los Angeles Law Review* 1009 (1997) ("Rock (1997)").

breach of fiduciary duty. Second, in these intermediate cases, although the court denies plaintiffs' motion for a preliminary injunction, it also typically denies defandants' motion to dismiss, leaving defendants with some substantial damages exposure. Finally, and perhaps most importantly – and certainly least notices – it tells directors, who we may suppose are generally trying to do a good job, what they should do."

3.6.3 Developments since Enron (2002)

In the last seven years the ways of independent directors of large corporations have fulfilled their duty to develop the strategy and monitor the corporation's affairs, has attracted wide spread and critical political attention. Given the WorldCom and Enron debacles, the recent meltdown in the US financial sector, the dependence of workers on equity investments to secure their retirements, the globalisation of American law principles and the complexity of managing corporations with international operations, legal standards used to evaluate whether directors have complied with their duties are the subject of growing national US and world interest. US policymakers know and realize this. The reaction to WorldCom and Enron was the enactment of the Sarbanes-Oxley Act of 2002, which also led to reform of SEC regulations and NYSE and NASDAQ Rules. The Dodd-Frank Act will also have substantial influence.[654] The effect on US independent directors has been to prompt them to perform their duties more diligently. Directors of foreign companies listed on US stock exchanges have felt obliged to devote more time and energy into monitoring their risk management and their accounting systems, and following SEC requirements or recommendations.

3.6.4 Basis of duties

Although boards usually feel obliged to abide by codes and best practice rules, their duties are essentially based on state statutes, common law, court decisions and US federal laws and regulations as well as the rules of any stock exchange.

The board owes fiduciary duties to the company and thereby indirectly to the shareholders as a class as well as to all other stakeholders. When a person buys shares in a company, his relationship with the company, its

[654] Signed by President Obama on 21 July 2010.

board and most other interested parties is regulated by contractual relationships. Under the contract theory, shareholders of a corporation buy into a “hierarchy” of laws and other provisions that define the respective rights and responsibilities of the corporation, its shareholders, and its directors. This “hierarchy” rests on the following sources: (1) federal and state constitutions, (2) federal and state statutes, (3) common law, i.e. case law of the courts, (4) the corporation’s certificate of incorporation (also known as the articles of incorporation) and (5) the corporation’s bye-laws.[655]

Many provisions of state statutes facilitate the position of the boards by giving corporations the possibility of making their own particular arrangements for organizing the board and their liability exposure. Section 3.7.4 below describes the scope for insulating the directors from liability by means of indemnification and insurance by the company. Virtually all state corporate statutes recognise the rule that corporate powers are exercised by the board and that the business and affairs of the corporation are controlled by the board.[656] In contrast, the rights and powers of shareholders are generally restricted. While shareholders have the right to elect directors, which is an important right, other rights are restricted. For example, shareholders have the right to “propose certain action to be undertaken” (only propose, not instruct) and to “approve or disapprove” of certain extraordinary transactions which “fundamentally affect the character or nature” of the corporation (e.g. mergers, dissolutions and amendments to the articles of incorporation or bye-laws).[657]

Some specific stipulations in the Delaware GCL are of interest to directors. These are the right of corporate directors to rely in good faith on the corporation’s records and information presented to them,[658] the

[655] Eisenhofer and Barry (2010), pp. 2-53.

[656] Delaware GCL § 141(a); MBCA § 8.01(b).

[657] Eisenhofer and Barry (2010), pp. 2-57. The list of consent powers for shareholdersin the US is more limited than the comparable article 2:107(c) DCC in the Netherlands and than the UK listing rules. In Delaware a board would not need shareholder consent to sell off a subsidiary worth 50% of the group’s equity, whereas in the Netherlands consent would be needed to sell off a subsidiary worth one third of the balance sheet total. The criterion in Delaware CGL § 271 is divestment by a company of ‘substantially all its assets’.

[658] Delaware GCL § 141(e) and § 172. This is interesting in connection with the case law on supervision, see 3.7.3 below.

right of the company to void transactions due to a conflict of interest[659] and the right of shareholders to demand inspection of corporate books and records in certain circumstances.[660]

The articles of incorporation can be changed only by resolution of the board supported by the majority of shareholders.[661] The articles of incorporation are usually short and may contain some limitations on the board's powers and provisions concerning the qualifications of directors and exclusion of the liability of directors.

Bye-laws form the operational document of the corporation. They are normally longer than the articles of incorporation and are typically described as a "contract" between the corporation and its shareholders. The majority of shareholders can change the bye-laws at their own initiative.[662] It is of interest that the board may object to changes in the bye-laws, if the stipulation would impose restrictions on the ability of the company's board of directors to manage the corporation. Below are two examples of litigation on this subject.

– Professor Bebchuk, as a shareholder of CA Inc., wanted a change in the bye-laws to limit the ability of the board to implement a "poison pill" which in this case was a shareholder rights plan. CA Inc. refused, arguing that such a limitation would be illegal because it restricts the board's exercise of its power to manage the affairs of the company. The court held that Professor Bebchuk's claim was not yet "ripe for decision", but also mentioned that there was tension between the provisions in Delaware GCL Section 109 giving the right of stockholders to change the bye-laws and Section 141(a) of the Delaware GCL, which requires the board to direct the business of the corporation.[663]

– AFSCME Employees Pension Plan wanted a change in the bye-laws, once again of CA Inc., by including a clause requiring the corporation to reimburse reasonable proxy expenses incurred by a director candidate, if nominated. CA Inc. refused. The court ruled that, in principle, such a clause would be legal, but this clause was not legal, because it was completely without any nuance, i.e. it

[659] Delaware GCL § 4.

[660] Delaware GCL. This procedure is often used to start litigation, see also Veasey (2005), p. 1498.

[661] Delaware GCL § 242(b); MBCA § 10.03.

[662] Delaware GCL § 109(a); MBCA § 10.20(a).

[663] *Bebchuk v. CA Inc*., 902 A.2d 737, 742 (Del. Ch 2006).

did not contain an exception for the costs made for purely personal interests or for cases of petty concerns.[664]

These cases are of interest because they show that the principle that the board should be free to manage the company is upheld to a large extent by common law. They also illustrate the determination of shareholder activists, including academics such as Professor Bebchuk.

As mentioned above, in principle management should be free to manage the business of the corporation as it wishes. However, there is one area where the board should give shareholders room and that is the right of shareholders to vote directors in and out in the general meetings of shareholders. This is made clear in the following cases:

– In *Schnell v. Chris-Craft*[665] the board of Chris-Craft faced a proxy fight over issues of managerial underperformance. The board took action, within its legal powers, by holding the general meeting in December, at short notice, in some little town in upstate New York instead of in January in Manhattan, as usual. The aim was to dampen the turnout and leave the dissidents little time to solicit proxies. The Chancery Court of Delaware ruled on the basis of legal technicalities that the board's action was permissible. The Supreme Court went the other way and ruled, in equity, that because the aim was to frustrate the right of shareholders to vote the action was not permitted.

– In the *Blasius* case[666] Chancellor Allen ruled against the Atlas board, which had wanted to quickly appoint two directors to prevent Blasius, which was regarded as a dangerous oppressor, from being in a position to appoint a majority of directors. The Chancellor made clear that boards should be very careful when acting in an election context.

– In hostile takeover cases the courts often permit defence mechanisms, if proportional, since they reason that the oppressor can always start a proxy fight.[667]

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[664] *CA Inc. v. AFSCME Employees Pension Plan*, 953 A.2d 227 (Del. 2008).

[665] *Schnell v. Chris-Craft*, 285 A.2d 437 (Del. 1971) and Leo E. Strine Jr., 'If Corporate Action Is Lawful, Presumably There Are Circumstances in Which It Is Equitable to Take That Action. The Important Corollary to the Rule of Schnell v Chris-Craft', 60 *The Business Lawyer* 877 (2005), p. 29 ("Strine (2005)") in an article in which Leo Strine compared elements of law and equity.

[666] *Blasius Industries Inc. v. Atlas Corp.*, 564 A.2d 651 (Del. Ch. 1988) and Strine (2005), p. 38.

[667] *Moran v. Household International*, 500 A.2d 1346 (Del. 1985) and *Yucaipa Am. Alliance Fund 11, L.P. v.*

Common law is, of course, the main basis for the duties of directors in the US. Delaware's common law process, which places case law at the forefront of corporate law, and has become the functional equivalent of judicial legislation. Delaware law on fiduciary duty is judge made. It offers corporations a variety of benefits, including flexibility, responsiveness, insulation from undue political influence and transparency.[668] The US concept of common law is that of a "clear" law, because the background principles, which are applicable to all cases, provide predictability. No viable corporate governance regime can be founded on a "one size fits all" notion. Fiduciary law is based on equitable principles.[669]

Below is a quote of former Chief Justice Norman Veasey of the Delaware Supreme Court on the duties of independent directors.[670]
"*As I see it, there are seven normal expectations that a stockholder should have of a board of directors. Although others may apply in some situations, the stockholders expect at least that (i) the stockholders will have a right to cast a meaningful vote for the members of the board of directors and have a right to vote on fundamental structural changes, such as mergers; (ii) the board of directors will actually direct and monitor the management of the company, including strategic business plans and fundamental structural changes; (iii) the board will see to the hiring of competent and honest business managers; (iv) the board will understand the business of the firm and develop and monitor a business plan and the operations of the company; (v) when making a business decision, the board will develop a reasonable understanding of the transaction and act in good faith, on an informed basis, and with a rational business purpose; (vi) the board will carry out its basic fiduciary duties with honesty, care, good faith, and loyalty; and (vii) the board will take good faith steps to make sure the company complies with the law.*"

Riggio, C.A. No. 5465 – VCS (Del. Ch. 11 August 2010).

668 Prof. Jill Fisch, 'The Peculiar Role of Delaware Courts in Competition for Corporate Charters', 68 *University of Cincinnati Law Review* 1061, 1074-5 (2000). Although the Delaware statute provides general guidelines about corporate formalities such as the scheduling of annual meetings and the required components of a corporate charter, the statute does not deal with the fiduciary principles that provide the foundation of corporate law and allow, under appropriate circumstances, judicial scrutiny of corporation decision making …

669 Veasey (2005).

670 Veasey (2005), pp. 1414-1415.

Stockholders also have expectations of the courts that are overseeing the stockholders' expectations of the board. Stockholders look to courts to enforce fiduciary duties in highly textured fact situations by applying the general principles that underlie the relationship between the investors and the board of directors. As I see it, the courts have at least seven key obligations. They are (i) be clear, (ii) be prompt; (iii) be balanced; (iv) have a coherent rationale; (v) render decisions that are stable in the overall continuum; (vi) be intellectually honest; and (vii) properly limit the function of the court.

As we have seen, independent directors are obliged to fulfil their duties to (i) let shareholders vote on board appointments and mergers, (ii) direct and monitor, including active directing and monitoring of strategy, (iii) arrange for succession, (iv) understand the business and develop and monitor strategy (dual function), (v) when deciding, understand the details and act in good faith, on an informed basis, with a rational business purpose, (vi) carry out **fiduciary duties** with honesty, **care**, good faith and **loyalty** and (vii) make sure the company complies with the law (which, of course, includes all federal laws such as the Securities Law and the Anti-Trust and the Foreign Corrupt Practices Act).

3.6.5 To whom do directors owe duties?

Directors are the nexus of the company. Their first duties are to the corporation, i.e. the corporate enterprise. In their capacity as directors of the corporation they have duties in their contractual relationships with employees, customers, society, creditors and shareholders. Their main fiduciary duties are to serve the long-term interest of shareholders, because shareholders have the least chance of having a good contract with the board.[671] In the event of insolvency or looming (called "near") insolvency their main duty shifts to the creditors. And in the event of a takeover of the corporation, they generally have even stronger enhanced duties to the corporate enterprise. In special cases, when the company is clearly put up for sale and there will be a change of control, they have short-term duties to the shareholders.

[671] Bainbridge (2008), p. 37, Assink in Assink and Strik (2009), p. 81; Veasey (2005), p. 1422. *North American Catholic Educational Programming Foundation Inc v. Gherwalla* (Del. 2007).

3.6.6 Pressures on boards

It is typical for Americans to be active, free entrepreneurs. The US believes in the primacy of the board and lets board members get on with management, hence the business judgment rule. At the same time these boards work under pressure caused (a) by competition from peers, (b) by litigation in the form of corporate litigation in state courts and federal securities litigation (Sections 11 of the Securities Act and 10(b) of the Securities Exchange Act) and often by class actions led by an active plaintiffs' bar, (c) by the SEC and state securities litigation, civil and criminal and (d) by shareholder activists who fight hard and are rapidly getting more rights, especially in the areas of proxy access for elections and say-on-pay and (e) the media.

3.6.7 Summary of Duties

There are many initiatives in the US to introduce best practice codes. These are mostly of a private nature, rather than government initiated. They set standards of conduct. Court cases, such as *Disney*, make clear that these aspirational standards exist, but they also make clear that falling short of standards of conduct is not automatically deemed to be a breach of the standards of review held by the courts and leading to director's liability.

3.7 **Liability of independent directors**

3.7.1 Who can sue?

3.7.1.1 *The company in a shareholder derivative lawsuit*

Directors have fiduciary duties of loyalty and care to the corporation. If they fail to perform these duties, they are potentially causing direct harm to the corporate entity and indirect harm to others, including shareholders, creditors and employees. Only the corporation itself has the power to enforce and seek remedy for violations by directors. In recognition of this issue, corporate law allows shareholders to bring a suit on the corporation's behalf in a derivative lawsuit. This is described in more detail in sub-section 3.7.2.1 below.

3.7.1.2 *Creditor's rights*

The rationale of the fiduciary duty owed by directors to shareholders is that corporate law and its case law provide the only protection for shareholders of a company whereas other parties have contractual protection. However, when a firm is near insolvency, it is generally established that directors should extend the circle of beneficiaries of their duties to include creditors.

3.7.1.3 *Shareholders directly against directors*

Sometimes shareholders have a direct claim against directors, such as in the *Smith v. Van Gorkom* case,[672] where the CEO/chairman ("imperial CEO") had sold off the shares of the company at what shareholders later argued was an unduly low price. This decision had been rubber-stamped by the board in a two-hour meeting based on a 20-minute oral presentation by the CEO without producing copies of any agreements or documents. The board gave its approval without any investigation, thereby causing damage to shareholders, as the court decided.

Most lawsuits brought by shareholders against the company (issuer) and directors and advisors are securities cases under Section 11 of the Securities Act 1933 and also under Section 10(b) of the Securities Exchange Act of 1934 for misleading statements. This is described in more detail in 3.7.3.5.

3.7.1.4 *Regulatory action*

Through federal or state prosecutors the government can bring criminal or civil actions against directors under federal and state "blue sky" securities laws.[673] The SEC can bring civil actions for securities laws violations. The US Department of Justice is the regulatory entity that enforces federal criminal law by prosecuting criminal conduct. For example, the Department of Justice successfully brought charges against Bernie Ebbers, former chairman and CEO of WorldCom, resulting in a 25-year prison sentence. Directors can also be held liable under many other laws, e.g. environmental or foreign corrupt practice regulations.

3.7.1.5 *ERISA*

ERISA claims are new claims instituted since the introduction of the Employee Risk Investment in Securities Act (ERISA) of 2000. They are

[672] *Smith v. Van Gorkom*, Delaware Supreme Court 14 March 1985, 488 A.2d 888 (1985).

[673] All the states have their own Securities Laws, which are called "blue sky" laws. The name "blue sky" comes from the proverbial positive promising "only good weather" information provided by the issuers of securities. Young associates in law firms do "blue sky serveys" for issuing clients and check all the state laws.

claims brought on behalf of employees concerning their stock ownership plans (ESOPs).

3.7.2 Procedural complications

3.7.2.1 *Derivative lawsuits*

If shareholders wish to hold directors liable for violations of duties to the corporation, they can take the following action to have the corporation sue the director or obtain leave to sue the directors themselves. Plaintiffs must either address a demand to the company's board for the company to pursue the suit against its own directors or persuade the court that making such a demand would be futile. To succeed in showing futility, the plaintiff must allege specific facts that "create a reason to doubt that (1) the directors are disinterested or independent or (2) the challenged transaction was otherwise the product of a valid exercise of business judgment".[674] These defaults refer to the board as a whole, which means that a majority of the board or the relevant committee must have been compromised in one of these respects or must have been dominated by a powerful director who has raised doubt about his loyal independence or his good faith care.

Even if the plaintiff succeeds at the demand stage, the company may, at any point in the course of the case, establish a special litigation committee comprised of independent directors to consider whether the company should move to dismiss the case. Grounds for moving to dismiss include a determination by the committee that the case is not meritorious or, even if it is meritorious, that "ethical, commercial, promotional, public relations, employee relations, fiscal as well as legal"[675] factors support dismissal. There is no guarantee that a special litigation committee will conclude that the case should be dismissed, especially if there has been a change in the board composition as often occurs in the wake of serious fraud. If, however, a special litigation committee does recommend dismissal, a court will subject the committee's determination to a moderate level of scrutiny provided it finds that the committee was independent and that it followed a careful deliberative process in reaching its resolution.[676] If the court finds that

[674] *Walt Disney Co. Derivative Litigation*, 825 A.2d 275, 285 (Del. Ch. 2003) (quoting *Aronson*, 473 A.2d at 814).

[675] *Zapata Corp. v. Maldonado*, 430 A.2d 779, 788 (Del. 1981).

[676] Bernard S. Black, Brian R. Cheffins and Michael Klausner, 'Outside Director Liability', 58 *Stanford Law*

this was not the case, scrutiny will be more severe again, no second guessing.

3.7.2.2 *Creditors suits in bankruptcy*

The potential for a suit to be brought by bankruptcy trustees or creditors' committees if the company is insolvent makes litigation based on an allegation of a breach of duty by directors technically more difficult for the defendants. These are suits based on a breach of fiduciary duty to the corporation and are brought in the name of the corporation. The recovery, if any, goes to the corporate estate for the ultimate benefit of creditors. The Delaware Courts have ruled that, in these cases, outside directors have the protection of exculpatory charter provisions, authorised by Section 102(b)(7) of the Delaware GCL, and of the business judgment rule, just as they do in shareholder derivative suits. Consequently fiduciary duty suits initiated by creditors on behalf of the bankrupt estate do not differ greatly from derivative suits brought by shareholders. Outside directors sued on the basis of a breach of loyalty face the risk of having to pay out of their own pockets, but those being sued for a failure to exercise sufficient oversight face hardly any danger.

In the procedure, outside directors have less protection in creditors' cases than they do in suits brought by shareholders. There is no demand requirement of and no possibility to ask for the institution of a special litigation committee in creditor suits. If the merits of a case against outside directors are strong, creditor-initiated fiduciary duty cases pose a greater threat of at least nominal liability than do shareholder derivative suits where the company is solvent. Nevertheless, only in one case, *Credit Lyonnais v. Pathé* of 1991, did an outside director have to make an out-of-pocket payment in such a litigation.[677] Bankruptcy cases are usually dealt with in Federal Courts. In *Gheewalla* the creditor did not

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Review 1055 (2006), p. 1092 ("Black, Cheffins and Klausner (2006/A)"). In the *Oracle* case described above, the court held that the committee was not independent because of all the Stanford connections where the CEO donated $100 million to Stanford and four of the directors were Stanford professors.

[677] Black, Cheffins and Klausner (2006/A), p. 1092. See also *Credit Lyonnais Bank Nederland N.V. v. Pathé Communications, Corp.*, 1991 WL 277613 (Del. Ch. 1991) No. (1991) 12150, Del. Ch. Lexis 215, in which Paretti voted in bad faith with respect to a corporate government agreement with Credit Lyonnais by forcing Credit Lyonnais' representative out of the board and Paretti was held liable. The Chancellor said in his opinion: "I do not lightly conclude that the covenant of good faith and fair dealing was violated here, but the entire course of conduct forces me to this conclusion". See also Veasey (2005), pp. 1429-1430.

win against the directors.[678] Both the Court of Chancery and the Supreme Court of Delaware ruled that if a company was in the zone of insolvency the directors owe fiduciary duties to the company and shareholders. Creditors do not have a derivative action in the period before insolvency. The facts must be very special.

Most cases against directors in insolvency cases are started by receivers in the federal bankruptcy courts, but these cases are rare.

3.7.2.3 *Direct shareholder damage and securities class action lawsuits*

Sometimes shareholders do not have to go the route of the derivative suit and can bring a direct claim for damages against directors, as in *Smith v. Van Gorkom*, where the board gave a rubber stamp agreement without any investigation leading to a loss for the shareholders.

The largest volume of shareholder claims involve securities cases. A typical securities class action seeks damages on the grounds that the company has misled investors. The defendants typically include the company itself, the CEO and the CFO. Outside directors are named in 50% of the cases based on Section 11 Securities Act 1933 and in 15% of the Section 10(b) Securities Trading Act 1934 cases. Other defendants may include the company's auditor and investment banker. In all these cases the court appoints a lead plaintiff, as in all class actions, and directors can file a motion to dismiss the case, for lack of prima facie facts presented by the plaintiff to suggest liability. Of all actions it is the Section 11 action that is most feared by outside directors, because the standard of conduct there is negligence, and the outside directors have the burden of proving an absence of negligence.

3.7.2.4 *SEC enforcement*

The SEC can take action to involve the US Justice Department, which can initiate criminal proceedings against directors and seek prison sentences. The SEC can also start civil proceedings against a director to relieve him of any gains or to levy a civil fine.

State prosecutors can also take action based on state securities laws. The New York Attorney General, Eliot Spitzer, did so successfully in the post-Enron era.[679]

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[678] *North American Catholic Educational Programming Foundation v. Gheewalla*, 930 A.2d 92 (Del. 2007).

[679] Monks and Minow (2008), pp. 32, 577 and 607.

3.7.2.5 *ERISA*

A fairly new source of liability risk for outside directors (since 2000) is the Employment Retirement Income Security Act (ERISA). ERISA class action suits resemble securities class actions, but are brought on behalf of employees whose retirement plans include company shares. These plans can be either employee stock ownership plans (ESOPs), whose principal purpose is to invest in company shares, or self-directed defined contribution 401(k) plans, for which an investment in company shares is an option. If the shares were purchased while the company's market price was inflated by improper disclosures, the employees can attempt to show that the outside directors were ERISA fiduciaries, that they failed to adequately supervise the plan, and that they should therefore be liable for employee losses when shares later decline in value. Outside directors have a realistic opportunity to succeed in a motion to dismiss if plaintiffs cannot show that the outside directors were ERISA fiduciaries and/or cannot make a prima facie showing negligence by the outside directors.[680]

3.7.3 Liability standards of directors in various proceedings

3.7.3.1 *Fiduciary duty violations under corporate law, business judgment rule, duty of loyalty, duty of care*

The source of the law on corporate fiduciary duty is the case law of the courts. Clear law on this subject has been developed by the Delaware Chancery Courts and the Delaware Supreme Court as most listed corporations are registered in Delaware and the Delaware judges, chosen on merit from experienced corporate lawyers. They write lucid opinions which are instructive for corporate lawyers and hence also for the whole US corporate world. Moreover, they take their decisions quickly. Director liability cases, usually derivative cases, start with a motion to dismiss. These motion cases are dealt with quickly in days, weeks or a few months. These decisions are important for the negotiations between parties. When the case does go to trial, i.e. the motion to dismiss failed, the procedure will take longer. The injunction cases, such as all the takeover cases, are dealt with in days or weeks, therefore very quickly.

[680] Black, Cheffins and Klausner (2006/A), pp. 1355-1357.

<u>Business judgment rule</u>

The basis of Delaware and US corporate law is the business judgment rule, which protects directors in that the courts may not second-guess board decisions provided they are taken with (a) loyalty and (b) care. These two elements are therefore the only areas which the judge may review. Judges should not (even marginally) question the wisdom of the decision itself. This means that a plaintiff can win a case only if he proves (a) disloyalty or (b) insufficient care or (c) good faith in exercising loyalty and care.

> The Court of Chancery of Delaware in *Benihana of Tokyo, Inc. v. Benihana, Inc.* of 2007 gives a clear reference: "*In Re RJR Nabisco, Inc. Shareholders Litigation, the Court stated: The business judgment form of judicial review encompasses three elements: [1] a threshold review of the objective financial interests of the board whose decision is under attack (i.e. independence), [2] a review of the board's subjective motivation (i.e. good faith), and [3] an objective review of the process by which it reached the decisions under review (i.e. due care). In this case, I have followed those steps and I have concluded that a majority of the disinterested and independent directors approved the (...) transaction. Then, I found that the directors acted with a good faith belief that equity financing represented the best method to finance Benihana's (...) Plan and that the directors believed equity financing best served the interests of the Company. Finally after reviewing the process through which the directors approved the Transaction I have found that the directors reached their decision with due care. Consequently, the Board validly exercised their business judgment in approving the (...) transaction. This court will not disturb that decision.*" [681]

The old cases that are often cited as business judgment cases are:

Dodge v. Ford Motor Co. (1919) [682]

Ford Motor Company listed in 1903 thrived so extraordinarily well that the retained earnings or surplus above stock in 1916 was $111,960,907.53. Henry Ford announced

[681] *Benihana of Tokyo, Inc. v. Benihana Inc*. (Del. Ch. 2000). See also B.F. Assink, *Rechterlijke toetsing van bestuurlijk gedrag – Binnen het vennootschapsrecht van Nederland en Delaware* (2007), p. 245 ("Assink (2007)").

[682] *Dodge v. Ford Motor Co.* (Michigan Supreme Court 7/2/1919, 284 Mich. 458 (1919)).

plans for raising salaries, lowering the price of cars by $80, building new assembly plants, iron mines and smelteries as well as ships to transport the iron. He also announced – rather haughtily – that no further special dividends would be paid. Shareholders had already collected much more than their investment. The Dodge brothers, who were minority shareholders, asked the Court of Michigan for a restraining order in respect of all the investment plans and an order for the company to pay out all surplus above stock as dividend, i.e. about $50,000,000. The Court issued a restraining order for the iron producing and transport investments and ordered a payment of $19,275,385.96 in dividends, which was 50% of the surplus cash. Henry Ford and the company appealed. The plaintiffs, the Dodge brothers, contended that Ford was motivated by considerations of improper altruism towards workers and customers. The Supreme Court of Michigan agreed and strongly rebuked Ford, holding that "A business corporation is organised and carried on primarily for the profit of stockholders". The discretion of directors is to be exercised to that end, and does not extend to a change in that end itself, to the reduction of profits or to the non-distribution of profits among shareholders in order to devote them to other purposes. This is the fiduciary duty to shareholders rule.

On the other hand, the Michigan Supreme Court went on famously to invoke the business judgment rule in refusing to enjoin Henri Ford's plans to expand production. As justification for its decision, it modestly observed that "The judges are not business experts". The Supreme Court of Michigan confirmed the order to pay dividends, but assuming that the expansion plans were in the interests of the company, reversed the restraining order for the expansion into iron production and transport.

And *Shlensky v. Wrigley* (1968)[683]

Shlensky was minority shareholder in the Chicago National League Ball Club (Inc.), which owned Chicago Cubs and Wrigley Field. Wrigley was majority shareholder and president. In 1961-1965 the Cubs consistently lost money. Shlensky brought a derivative suit and contended losses were due to low home attendance and that this was attributable to the refusal of Wrigley and other directors to permit the installation of lights and night baseball, because Wrigley believed (1) baseball was a daytime sport and (2) night baseball might have a negative impact on the neighbourhood. The court dismissed the case, because the board could have business reasons for its decision, for example that "the effect on the surrounding neighbourhood might well be considered by a director" and "the long-term interest […] might demand […] consideration […] of the neighbourhood […]. We do not mean that we have decided the decision was the right one. We are merely saying that the decision showed no fraud, illegality or conflict of interest […] Directors are elected for their business capabilities and judgment […] Courts cannot decide these questions in the absence of a clear showing of dereliction of any duty." The Illinois Court

[683] *Shlensky v. Wrigley*, Illinois Appellate Court 25/4/1968, 95 Ill.App.2d 173 (1968).

dismissed the case and did not even allow Shlensky to get up to bat! The *Shlensky v. Wrigley* case gives directors broad discretion in making business decisions and in considering interests other than those of shareholders.[684]

The board must develop and execute the strategy of the corporation in the following manner:

1. it must not favour any interest which is alien to the corporation, but must only act in the interests of the corporation (duty of loyalty);
2. it must be diligent and well-informed and act prudently and precisely (duty of care);
3. and it must act subjectively in good faith (duty of good faith, which is part of the duty of loyalty).

Below I discuss the duties of (a) loyalty and (b) care and also good faith, which can be classified under the category of loyalty. To have a chance of winning a case a plaintiff must prove (a) disloyalty or (b) insufficient care.

(a) The duty of loyalty

The duty of loyalty is necessary because of the separation of management from ownership. The duty of loyalty has two elements, the negative element (no violation of trust of shareholders) and the positive element (subjective bona fides).

The fact that bona fides – good faith – falls under the duty of loyalty follows from cases such as *Stone v. Ritter*.[685]

Good faith

While loyalty and care are taught as the two duties that judges always check in fiduciary cases, the terms "good faith" and "bad faith" appear very often, most recently in 2009, in the *Citigroup* case.[686]

[684] For those interested in sports and society, the following may be of interest. Later, after the team was sold to the Tribune Company, efforts to install lights were opposed by fans. Finally, Major League Baseball forced the club to install lights 20 years later.

[685] *Stone v. Ritter*, 911 A.2d 362 (Del. 2006).

[686] *Citigroup Inc. Shareholder Derivative Litigation*, 964 A.2d 106 (Del. Ch. 2009).

> "Delaware law does not permit that kind of "judicial second-guessing of director" business decisions – even decisions that turn out to have catastrophic results – as long as those decisions were not made in bad faith."

The criterion of good faith also appears in the Delaware General Corporation Law,

– § 141(e): "directors are protected … in relying in good faith upon records … and information …"
– § 145(a) and (b): directors can be indemnified "if such person acted in good faith and in a manner such person reasonably believed to be in or not opposed to the best interests of the corporation"
– § 102(b)(7): to protect directors from personal liability for gross negligence,[687] but not "(i) for any breach of the director's duty of loyalty …. (ii) for acts or omissions not in good faith ….. (iii) under § 174 (wilful incorrect dividends, explanation author), (iv) ….. improper personal benefit".
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In *Cede & Co. v. Technicolor, Inc.* (1993),[688] the Delaware Supreme Court announced for the first time that directors owe a "triad" of fiduciary duties, including not only the traditional duties of loyalty and care, but a third duty of good faith.

The term good faith appears in many Delaware decisions, before and after Technicolor. There have been many articles in law reviews about the question of the applicability of Section 102(b)(7) of the Delaware GCL, i.e. non-liability of directors for gross negligence if they have acted in good faith, as mentioned above.

Former Chief Justice Veasey does not really mind whether it is a separate fiduciary duty. In discussing whether a director with extra knowledge has a heightened liability, he takes the view that this is not always necessarily so, though if the director has any particular knowledge he should inform his fellow directors. Accordingly, Veasey does consider that "good faith" can be one

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687 This section was included in 1986 after the alarming *Smith v. Van Gorkom* case.

688 *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993).

of the elements when judging a director's loyalty.[689] In *Stone v. Ritter* (in 2006 after the retirement of Chief Justice Veasey), the Delaware Supreme Court made absolutely clear that "good faith" is important, but falls under the duty of loyalty.[690]

As for the definition of good faith it is clear that it draws much of its content from the directors' subjective state of mind. A sincere belief that one is acting in the best interests of the company is not enough. In addition, there must be some objective basis. Veasey says: "Directors must not act irrationally, irresponsibly, disingenuously, or so unreasonably that no reasonable director would accept the decision or conduct".[691]

This brings us back to the ***duty of loyalty***. Each director has the duty to be disinterested (no interest other than the corporation and shareholders) and independent. Disinterestedness means a director may not stand on both sides of a transaction, may not engage in self-dealing, may not be entrenched, may not have material advantage and, if he notices a corporate opportunity or a problem, must inform the whole board (positive requirement).

In cases of self-dealing or whenever the directors have an interest, the business judgment rule is not applicable to them. Instead, unless the transaction is approved by a disinterested majority of directors or shareholders, the burden of proof is on the directors to show that the transaction was intrinsically fair to the corporation.

In *Aronson v. Lewis* of 1984[692] a 4.7% stockholder, who was also CEO, secured for himself a lucrative employment contract by obtaining the approval of the other directors who, the plaintiff alleged, were under the control of the CEO stockholder. A special form of self-dealing occurs where a director exploits a corporate opportunity for himself and does not inform the full board. Independence means a director makes decisions

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[689] Veasey (2005), pp. 1444-1445.

[690] Leo E. Strine, Jr., Lawrence A. Hammermesh, R. Franklin Balotti, Jeffrey M. Gorris, 'Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law', 98 *Georgetown Law Journal* (2009), pp 1-90.

[691] Veasey (2005), p. 1453.

[692] *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984).

independently under no pressure from third parties, e.g. the CEO or a major shareholder. “Directors must be able to debate and confer and not simply follow a dominant director”. The directors were liable, because they had been entrenched by the CEO.

Oversight and supervision cases since *Stone v. Ritter* of 2006[693] fall under the category of loyalty. It is a duty of loyalty to have “due corporate information and reporting systems”. Indeed the judicial standard for liability is loyalty, while the behavioural duty is care. But some experts classify oversight under care.[694]

Supervision and oversight

According to Section 141(a) of the Delaware GCL, the business and affairs of the corporation will be managed by and under the direction of the board of directors.

Cahall v. Lofland of 1921 and *Bater v. Dresser* of 1920[695] made a distinction between administration, supervision, direction and control which the courts assigned to directors and details of business being delegated to officers, which the courts classified under “management”. The concept of different roles was codified in the Delaware General Corporation Law in the phrase “and under the direction of” in Section 141(a). This also means that a director may have another onus of duty, than an officer, depending on the role he played. So exculpation is possible in certain circumstances.

The legal standard for liability applicable to a director’s supervisory authority, was explained in *Graham* in 1963.[696] “Directors are entitled to rely on the honesty and integrity of their subordinates until something occurs to put them on suspicion that something is wrong” … “or unless he has recklessly reposed confidence in an obviously untrustworthy employee”. These issues were addressed again in 1996 in *Caremark*[697] a case also involving violations of federal law by employees. The Delaware Court of chancery ruled: “It is important that the board exercise a good faith judgment that the corporation’s information and

[693] *Stone v. Ritter*, 911 A.2d 362 (Del. 2006).

[694] Assink (2007), p. 186.

[695] *Cahall v. Lofland*, 114 A. 224, 229 (Del. Ch. 1921) and *Bater v. Dresser*, 251 U.S. 524 (1920).

[696] *Graham v. Allis-Chalmers*, 188 A.2d 125 (Del. 1963).

[697] *Caremark International Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996).

reporting system is, in concept and design, adequate to assure the board that appropriate information will come to its attention in a timely manner as a matter of ordinary operations." "Duty to attempt in good faith to assume that a corporate information and reporting system … exists." In the *Caremark* case there was also the test of subjective good faith as again in *Gagliardi v. Trifoods International* (Del. Ch. 1996).[698]

The Supreme Court of Delaware approved the court's decision in *Caremark* in 2006, in the case of *Stone v. Ritter*,[699] holding director oversight liability in circumstances where "(a) the directors utterly failed to implement any reporting system or controls or (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations, thus disabling themselves from being informed of risks or problems requiring their attention. If the board fails to act in the face of obvious warnings, then the board's behaviour could suggest a reckless or intentional disregard of the duty of care. Such allegations could be sufficient to rebut the presumption of the business judgment rule."

So, in short, directors are not disloyal if there is an adequate system of controls and no red flags have been raised.

Legal standards

A basic principle is that directors owe fiduciary duties to their corporation and its shareholders to act in the best interests of the corporation and to show the loyalty and care in the management of the corporation's business that ordinarily careful and prudent men would use in handling their own affairs.[700] The new cases of 2009 are *Citigroup*[701] (motion to dismiss the case accepted because the directors, who had ensured that control systems were in place, should not be liable for failing to recognise the extent of a company's business risk) and *AIG*[702] (motion to dismiss refused

[698] Assink (2007), pp. 200-201.

[699] *Stone v. Ritter*, 911 A.2d 362 (Del. 2006).

[700] *Graham v. Allis-Chalmers*, 188 A.2d 125, 130 (Del. 1963), and *Smith v. Gorkom*, 488 A.2d 858, 872 (Del. 1985).

[701] *Citigroup* (964 A.2d 106 Del. Ch.) 24/9/2009. See for this case also 3.5.4 above.

[702] *AIG* (965 A.2d (Del. Ch. Vice-Chancellor Strine 10/2/2009)). See for this case also 3.5.4 above.

because a core group of directors had kept to themselves decisions about information systems that would put them on notice of fraudulent and criminal conduct and had not involved the other directors). These oversight cases are of great interest in these times of worry and concern about monitoring and risk management. Delaware makes a distinction between failing to recognise business risks while having reasonable information systems which do not lead to directors' liability and constructively failing to have systems to check fraudulent and criminal conduct, for which directors are liable.

(b) The duty of care

The duty of care makes its appearance when it comes to decision making by the board. In *Aronson v. Lewis* of 1984[703] the directors rubber-stamped the decision of the CEO/shareholder, who awarded himself a lucrative contract. The directors were liable because they had been "entrenched" by the CEO and had not taken proper care when they made the decision.

Under the business judgment rule the courts accord directors a broad discretion in business decisions. Thus, in general, the courts will not second guess business decisions made in good faith by an independent and fully informed board. The test for whether a board is fully informed – and therefore has met its duty of care – is one of gross negligence (see *Smith v. Gorkom*,[704] where the directors did nothing to inform themselves). The test of care is not whether the content of the board decision leads to a loss, but more the consideration of good faith or rationality of the process of decision making (*Caremark*[705]). However, when directors fail to exercise any business judgment this may possibly be a failure to act in good faith (*Disney*,[706] where directors did exercise some business judgment).

Section 141(e) of the Delaware GCL repeats that directors are protected if they rely in good faith on the records of the

[703] *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

[704] *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

[705] *Caremark International Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996).

[706] *Walt Disney Co. Motion 1*, 825 A.2d 275 (Del. Ch. 2003).

corporation.[707] Decisions with respect to how much information to obtain and from what sources are themselves business decisions: *Cede & Co. v. Technicolor* of 1993, in which case the Delaware Supreme Court found that the directors had not taken enough time to obtain sufficient information.[708]

The business judgment rule was given a different perspective in *Cinerama v. Technicolor*.[709] The court found that the directors had not fully informed themselves in approving the merger transaction but despite the board's lack of full information, the merger was entirely fair. The Supreme Court upheld the Chancery Court's finding. The "entirely fair" solution is a different manner of not holding directors liable even if there was insufficient care.Besides, a corporation can in its articles of incorporation eliminate the liability of directors for the duty of care pursuant to Section 102(b)(7) of the Delaware GCL. This would not have protected directors from monetary liability in cases like *Smith v. Van Gorkom* of 1985,[710] where they had been very sloppy. In fact, they did nothing at all to collect information, and were therefore liable. The elimination of liability only applies if there was no duty-of-disloyalty.

In *Aronson* of 1984[711] the board did collect information before taking a decision. The court applied the business judgment rule and declined to say that the decision taken was wrong. Self-imposed time limits could be an infringement on the duty of care if that means that the board could not collect sufficient information.

[707] § 141(e) Delaware GCL says: "A member of the board of directors, or a member of any committee designated by the board of directors, shall, in performance of such member's duties, be fully protected in relying in good Faith upon the records of the corporation and upon such information, opinions, reports or statements present6ed to the corporation by any of the corporation's officers or employees, or committees of the board of directors, or by any other person as to matters the member reasonably believes are within such other person's professional or expert competence and who has been slected with reasonable care by or on behalf of the corporation."

[708] *Cede & Co. v. Technicolor*, 634 A.2d 345 (Del. 1993).

[709] *Cinerama Inc. v. Technicolor Inc*., 663 A.2d 1156 (Del. 1995).

[710] See note 672.

[711] *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

Disney was a case about the collection of information necessary to take a decision. The conclusion is that the board should not be sloppy in collecting information.

3.7.3.2 *Enhanced business judgment rule, hostile tender offers, merger cases and deal protection measures*

While the business judgment rule applies to most decisions, acts and omissions, i.e. the court will not second-guess management if it is not in breach of its duties of loyalty or care, there is a slight difference in the event of hostile takeover and merger cases.

Whereas in the UK the board remains passive in hostile takeovers and may not make use of legal defence mechanisms,[712] in the US the board may or indeed should be active in hostile takeovers and may make use of defence mechanisms. In this respect, Dutch law is closer to US law than to UK law.[713]

Actions of directors in reacting to offers or other threats to control are subject to the "enhanced business judgment rule", "modified business judgment rule" or "proportionality test" developed by the Delaware Supreme Court, also known as the "*Unocal* standard".[714]

Some defended hostile tender offers as beneficial to the "market of corporate control". This view is based on the hypothesis that the market is efficient and values all listed corporations correctly. If a company is undervalued, this means that its management is not good enough and should be replaced. Minority shareholders do not take the time and trouble to replace directors. Bidders who assume control by a public offer and/or a proxy fight usually force a change of management. Therefore management that is not protected by defence mechanisms will be more intent on not being lax in their management and on producing shareholder value. Easterbrook and Fischel were proponents of this theory.[715] One of

[712] In the UK the debate is now just started due to the *Cadbury and Craft* merger with a consultation paper of 1 June 2010 of the Takeover Panel raising thresholds for public officers.

[713] M.J. van Ginneken, *Vijandige Overnames: De Rol van de Vennootschapsleiding in Nederland en de Verenigde Staten*, thesis (2010) ("Van Ginneken (2010)").

[714] *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985). This and the following cases are discussed in detail in this sub-section.

[715] F.H. Easterbrook and D.R. Fischel, 'Proper Role of Target's Management in Responding to a Tender Offer',

their arguments was that public offers are good for shareholders because on top of the true value of their shares they often receive a premium.[716]

Opponents of hostile public offers argued that they were harmful to shareholders because the future value of the target would be higher than the bidder's offer and thus potential future shareholder gains accrue to the bidder. Some of the tender offer tactics such as "front-loaded two-tier tender offers", where a bidder willing to pay, say $25 a share, offers $30 in cash for the first 51% and $20 in shares for the rest, exerted undue force on shareholders. Moreover, public offers might be harmful to others with an interest in the corporation, such as employees, creditors and the community at large. Opponents maintain that hostile takeovers hurt the economy as a whole by merely reshuffling assets at substantial expense. There was concern that, in reality, takeovers were aimed not at inefficient companies but at well-run corporations. Hostile offers tended to put the emphasis on short-term profit-making. Furthermore, the use of debt to finance offers created problems. Some also attacked the "efficient market hypothesis". Martin Lipton was and is a strong proponent of the anti-hostile takeover view.[717]

In the end, it was generally conceded that target shareholders did benefit by receiving premiums. In many cases the bidders' shares did not appreciate as many of the acquisitions did not create better enterprises. Unsurprisingly, one plus one often turned out to be just two and not more, but often less.

In the 1980s those who were the targets of takeover battles developed ever more ingenious tactics to facilitate or frustrate bidders. Battles were fought in boardrooms, shareholders meetings and, increasingly, in the courts.

A bidder has two main ways of obtaining control: a hostile tender to acquire the majority of shares and thereby of the votes to replace the board, and a proxy fight, to obtain not the majority of shares, but only the votes to replace the board. Sometimes a combination of these two methods is used. When a tender offer is opposed by defence mechanisms, a proxy fight could result in the majority voting down the defence

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94 *Harvard Law Review* 1161, 1173-74 (1981).

[716] Van Ginneken (2010), describes all the US arguments pro and con on p. 361.

[717] Martin Lipton, 'Takeover Bids in the Boardroom', *The Business Lawyer* 101 (1979) ("Lipton (1979)").

mechanism. Proxy fights are expensive and there are many regulations, complicating the matter. The outcome is fairly uncertain because of shareholder laxity. Offers to acquire a majority of the voting shares are a surer way of obtaining control. There are many sharp tactics such as the front-end, two-tier tender offer. Some regard this as a form of coercion. Bidders' use of debt to finance a purchase has given rise to problems when they, upon success, repay the debt by selling assets of the target company. A "bust-up" takeover of this kind can adversely affect both the target by destroying know-how and goodwill, and its employees.

Defence tactics available to target companies include amending the articles of association and bye-laws, either to frustrate the vote to have the board replaced or to frustrate or block the tender offer. Examples of how to frustrate the vote include staggering the three-year terms of office of directors so that only one third of the directors are elected each year, having a super majority requirement for any changes to the articles, or, more extremely, having two classes of shares, one of which holds the significant voting power and is in the hands of the board.

To frustrate a public offer, the target board can also make use of restructuring tactics such as the "crown jewel defence" (selling off significant assets or granting an option to sell them), splitting the corporation, or purchasing its own shares. Alternatively, it may try to attract a "white knight", ready to come to the target's rescue, or a "white squire", i.e. a shareholder willing to sign a "standstill" agreement, i.e. an agreement not to buy or sell shares in that company for a specific period. Sometimes employees have options to buy shares and act as white squires.

The most potent defensive tactic is the "shareholder rights plan" or "poison pill", because of its ability to thwart an unfriendly takeover and give control to the target directors. The plan is generally triggered by a predetermined event, usually the announcement or threat of a tender offer. Thereupon, the target issues certain "rights" to its shareholders, i.e. options to obtain securities at a substantial discount. The relevant securities that can be obtained by existing shareholders of the target can be the shares in the bidder corporation ("flip-over" plan) or shares in the target ("flip-in" plan). The poison pill in *Moran v. Household International Inc.* of 1985, discussed below, was a flip-over. The poison pill in Unocal of 1985 was a flip-in. Both are discussed below and were upheld by the courts as they were judged proportionate to the threat posed (the *Unocal* standard).

When a target's board institutes actions to defend the corporation from a hostile takeover, they are usually faced with a charge of breach of fiduciary duty to the corporation and its shareholders under state law. Fiduciary duty is generally divided between on the one hand the duty of care and loyalty for the business judgment rule and, on the other hand in case of takeovers, the modified business judgment rule. The most important court cases are discussed here in chronological order. The business judgment rule has been described above in 3.7.3.1 and, in short, means that directors are free in their business judgment, unless they are in breach of loyalty or care. The modified business judgment rule has been developed in takeover jurisprudence and requires an extra proportionality test.

Many states introduced laws intended to make defence mechanisms possible. The rationale was often to protect local business, while some of these laws ostensibly gave power to officials to block offers if they were unfair or gave lax information. At first, some of the laws were held to be unconstitutional, but upon further testing in court, most of them were upheld. In 1982 the prevailing mood was not against hostile takeovers, but attitudes had started to change by 1987.[718]

The takeover cases

The main standards for the board's fiduciary duties in the event of hostile takeovers were set by the Delaware courts, i.e. the Chancery and Supreme Courts, in very important cases in 1985.

The first case in 1985 was a "sale of company" case, but did not refer to a hostile tender offer, defence mechanism or deal protection. It was the famous case of ***Smith v. Van Gorkom***.[719] Just before his retirement, Van Gorkom, the "imperial" CEO/chairman of the publicly listed Trans Union Corporation, had sold off all the shares to a Mr Pritzker. The sale was at a 50% premium, but the board failed to consider that the share value was well below the intrinsic value because of substantial hidden value in investment tax credits. The board gave its consent after a 20 minute oral presentation by Van Gorkom and a 2-hour meeting, without even looking at the documents. A damage claim was filed by Smith on behalf of the existing shareholders. The Supreme Court – by a split vote – held the

[718] Pinto and Branson (2009), pp. 392-402.

[719] *Smith v. Van Gorkom*, 14 March 1985, 488 A.2d 858 (Del. 1985).

directors liable for gross negligence and referred the case to the Chancellor to determine the damages suffered by the other shareholders because their shares were sold off in a friendly tender offer at too low a price, i.e. the difference between the price paid, including premium, and the higher intrinsic value, which had been neglected. The case was settled by Pritzker, the buyer, paying $23 million more to shareholders.[720]

It has been said by Justice Jacobs: "At the time of *Van Gorkom* corporate boards were regarded as essentially passive advisors, with the CEO being completely dominant and the board having no prescribed role other than to give advice when asked for and to approve executive proposals when presented". *Van Gorkom* changed the corporate culture of American public company boards, by sending a strong message that corporate boards had an affirmative duty to be sceptical, to act with due care and to make a carefully informed decision, independent of management."[721]

This case emphasises that the board should decide in its entirety, be well informed and take time to discuss all alternatives. The board should not be passive and let shareholders decide. This case was widely discussed and received a lot of attention. It led, in 1986, to the addition of Section 102(b)7 to the Delaware GCL, permitting a company to include in its articles of association an exclusion of liability for directors, even in cases of gross negligence.

The first and most important public offer case is ***Unocal*** of 1985. In *Unocal Corp. v. Mesa Petroleum Co.*[722] the bidder Mesa Petroleum, controlled by the famous T. Boone Pickens,[723] owned 13% of Unocal and commenced a front-loaded, two-tier takeover bid for the target. The first step was to buy up to 51% at $54 cash and the second to acquire the remaining 49% with shares for $54, but in fact at a lower value because these exchange shares were heavily subordinated to junk bonds. The target board, the majority of whose members were outside directors (this was regarded as important by the Delaware Supreme Court), decided in a 9-hour meeting, which included an executive session, that the tender offer was inadequate in price and coercive. It responded by making a self-tender of $72 cash per share to purchase 49% of the Unocal shares not included in Mesa's first offer. The target's self-tender excluded the 13% owned by Mesa and was funded with new Unocal debt. This debt made Unocal highly leveraged, which hampered Mesa's ability to finance its tender offer. Mesa challenged the self-tender. It

[720] Pinto and Branson (2009), p. 229.

[721] Delaware Supreme Court, Justice Jack Jacobs in a speech at an OECD Explanatory Meeting in Stockholm on 20 March 2006.

[722] *Unocal Corp. v. Mesa Petroleum Co*., 493 A.2d 946 (Del. 1985).

[723] Strine (2005), p. 30.

argued for a standard of "entire fairness", because it was excluded. Unocal, on the other hand, argued that it was acting in good faith (loyalty) and with due care to protect the company and its shareholders.

The Delaware Supreme Court rejected the Vice-Chancellor's opinion that the defensive mechanism was selective and hence unlawful as it was not entirely fair to Mesa. The court held that the board must prove (i) that it had reasonable grounds for believing that a danger to the corporate policy existed (the *threat*) and (ii) that the defensive tactic was reasonable to the threat posed (the *response*). In addition, the presence of a majority of independent directors unaffiliated with the target materially enhances the credibility of directors when they conclude that a threat exists and the response taken was proportional. This test differs from the normal application of the business judgment rule by placing the initial burden of proof on directors and allowing some scrutiny of not just the process but also of the substance of the decision (i.e. whether the response was proportional to the threat). This has been named the modified business judgment or the proportionality test.

> The Delaware Supreme Court cleverly found innovative middle ground which did not leave corporations and their boards unprotected, but also did not defer completely to directors. Its solution was to require boards to demonstrate that their defensive measures passed the test of reasonableness and that their defensive actions addressed a legitimate threat to corporate interests. This is the proportionality test.[724]

In ***Moran*** *v. Household International, Inc.*,[725] also of 1985, the Delaware Supreme Court confirmed the Vice-Chancellor's decision to uphold the poison pill drafted by Martin Lipton as lawyer for Household, which was a two-step "flip-over", i.e. the right of shareholders of the target to acquire shares in the bidder corporation at a discount, making the offer economically disastrous for the bidder and its shareholders.

The two top corporate lawyers of the US post-war era, Joseph Flomm (for Moran) and Martin Lipton (for Household, the target)[726] squared off. Flomm argued that the Delaware corporate law statute was not intended to allow boards to create illusory "rights" to preclude, and effectively veto, a hostile offer. The Delaware Supreme Court rejected Flomm's arguments. In this case the bidder could have bought 19.9% of the outstanding shares in Household available in the market and initiated a proxy fight to oust the board

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[724] Pinto and Branson (2009), p. 379; and Strine (2005), pp. 32-33.

[725] *Moran v. Household International*, 500 A.2d 1346 (Del. 1985). The *Moran* case was argued on May 21, 1985. *Unocal* was decided less than a month later, which meant that good lawyers could predict the result of *Moran*, which was published in November 1985 and cited *Unocal* heavily.

[726] Strine (2005), p. 33.

and then redeem the pill. The court cited *Unocal* and repeated: "Our corporate law is not static. It must grow and develop in response to, indeed, in anticipation of, evolving concepts and needs. Merely because general corporation law is silent as to a specific matter, does not mean it is prohibited."

As it turned out, it is not statutory law – takeovers are not dealt with in the statutes – but jurisprudence – in the form of the new "reasonableness review" introduced by *Unocal* – that regulates the power of boards.[727] The court confirmed that the use of poison pills is acceptable. The court considered that the poison pill did not preclude the bidder from starting a proxy contest. The court also ruled that in this case the poison pill could be used, applying *Unocal*, since the threat was considered reasonable and the response was proportionate.

In ***Revlon** Inc. v. MacAndrews & Forbes Holding Inc.*[728] also of 1985, the Delaware Supreme Court was faced with the application of the Unocal test. Initially, the bidder tried to negotiate a friendly acquisition, but was rebuffed by Revlon claiming an inadequately priced offer. Revlon used several defensive tactics, including a poison pill and a self-tender. The tactics had the positive effect of inducing the bidder to raise the tender offer bid. However, Revlon found a white knight, Forstman Little, which was willing to make a competing bid in return for (1) a "no-shop" provision (Revlon would not look for another bidder), (2) a $25 million cancellation fee if the bid failed, and (3) a crown jewel lock-up (the white knight could buy a valuable division of the target at a discount if its offer failed). Of course, the defence mechanisms of poison pill and self-tender were withdrawn to ensure that they could not be activated against the white knight upon its tender offer.

The first bidder challenged the actions of Revlon's board as a breach of fiduciary duty and asked the court to prohibit the lock-up. The court indicated that lock-ups that encourage other bids are permissible, whereas those that end bids are not. In finding a competing bid, Revlon had effectively been put up for sale by the directors and the break-up of the company had become a reality. The deal with the white knight had in fact closed the way for other bidders. The court therefore prohibited the lock-up and, applying the Unocal rule, required further enhanced scrutiny and held that when a target is up for sale the board cannot "play favourites".

As a result of *Revlon*, the target directors' duty is not only to preserve the corporation, but under circumstances to maximise its value for shareholders. If the corporation is up for sale, as a result of board actions,

[727] Strine (2005), p. 34.

[728] *Revlon Inc. v. MacAndrews & Forbes Holding Inc.*, 506 A.2d 173 (1985), decided just after *Moran*.

the directors have to behave as auctioneers and get the best price for shareholders.

As became apparent, three years later, in ***Blasius***[729] of 1988, boards cannot, by deliberate action, thwart the right of the shareholders to vote and elect the directors they wanted in a takeover case. The Delaware Vice-Chancellor held that the board has less leeway in the context of the basic right of shareholders to elect directors.

In the *Blasius* case the board of Atlas, a gold mining company, had seven directors. Under the articles of association there was a staggered board (a protection against the board being ousted in a single round of voting). However, for this protection to be effective, it would have been necessary for the board to be composed of 15 directors, which was the maximum number under the bye-laws. With only 7 directors the board was vulnerable to the majority of shareholders voting in 8 other directors. The board could avoid this by proposing to the AGM to appoint two more directors, thus bringing the number up to 9. Before the board fixed the problem, a raider, Blasius Industries, emerged, suggesting a plan to pay Atlas stockholders immediate cash up front, with the promise of an additional reward later.

Vice-Chancellor Allen considered the Blasius plan to be dangerous and found that the board had appointed two really independent directors. However, even if the board had acted with subjective good faith, it was not a question here of the board's business judgment in managing the corporation's property; instead, it involved usurpation of the power of the shareholders to vote on the election of directors. Vice-Chancellor Allen applied a stringent test for judging if it is acceptable for a board to purposefully impinge on the stockholders' ability to elect a controlling vote in a new board, but only if the board could show a "compelling justification" for that decision. In this case, the board did not succeed in meeting this onerous standard.

Blasius obviously taught boards and their advisors to be very careful in matters relating to board elections.[730]

Fifteen years later, in 2003, in ***MM Companies Inc. v. Liquid Audio, Inc.***,[731] the Delaware Supreme Court clarified the Unocal proportionality test and the Blasius "compelling justification" test. The bidder, MM Companies, sought to buy the target Liquid Audio, but was opposed by the target's directors. There was a complicated proxy

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729 *Blasius Industries Inc. v. Atlas Corp.*, 564 A.2d 651 (Del. Ch. 1988).

730 Strine (2005), p. 38.

731 *MM Companies Inc. v. Liquid Audio, Inc.*, 813 A.2d 1118 (2003).

fight involving proposed changes to the bye-laws regarding the number of directors and elections to the board. The board elected 2 directors and, although this made the procedure more difficult for the bidder, it did not absolutely preclude the bidder from taking control of the board. This was unlike *Blasius*, where the board really did try to preclude the insurgents from taking control of the board. Here, in MM Companies, the board only diminished the bidder's chances, but did not preclude the possibility of the bidder obtaining control. It was therefore decided that *Blasius* did not apply and the court could apply *Unocal* and *Unitrin*, described two pages hereafter, and conclude that the measure was not draconian and therefore permissible.

Together, *Unocal* and particularly *Revlon* suggest that the Delaware courts were taking a more active role in scrutinising defensive tactics and putting greater emphasis on shareholder concerns. At that time it was still unclear if and when the Revlon obligations to auction the company would apply. In the ***Time Warner*** case of 1989,[732] the Delaware Supreme Court put to rest the idea that the courts would actively substitute their judgment for that of outside directors on takeover issues.

The Time directors spent more than a year negotiating a deal with Warner Brothers which would enable Time to keep its culture of journalistic independence and retain important board positions. The aim of the Time board was an effective merger, not a takeover of Time by Warner. Paramount, as third party, announced a substantial cash offer for Time. The Time directors were able to defend the company from a Paramount takeover. Time changed the original deal with Warner to a cash offer by Time for 51% of the shares in Warner, for which Time did not need shareholder consent. The remaining 49% in Warner would be acquired later for cash and securities. The court rejected the use of the Revlon ruling. The court did not find that the negotiations with Warner amounted to a dissolution or break-up of Time. Time was allowed to pursue its long-term strategy of combining with Warner.

Applying the *Unocal* test, the threat was that Paramount's non-coercive bid, and the high premium, would confuse the Time shareholders and disrupt the planned merger with Warner. The response of Time's board of protecting a long-term pre-existing plan of the board was reasonable. The big difference with *Revlon* was that there was no planned break-up of Time. The court indicated that in this case it was up to the directors to decide which was a better deal for shareholders.

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[732] *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140 (Del. 1989).

The Delaware Supreme Court's opinion in ***QVC*** in 1994,[733] however, suggested that the scope for directors to decide was not so broad. Paramount, not courting this time but being a willing bride, agreed to be acquired by Viacom in a friendly acquisition for cash and Viacom shares worth $69.14 a share. The agreement included (1) a "no shop" provision, which limited Paramount's ability to accept another bid, (2) a $100 million termination/break-up fee and (3) an option for Viacom to buy 19.9 % of Paramount shares at $69.14. After the merger Viacom's controlling shareholder, Summer Redstone, would directly and indirectly own 70% of Paramount. QVC, as third party, offered a higher price than Paramount. Paramount's directors viewed the Viacom offer as fitting into its long-term business strategy and relied on the Time Warner decision, which, ironically, Paramount had lost. They paid no attention to the QVC bid, which was $1.3 billion higher than Viacom's bid. QVC successfully sued to block Viacom's offer and all Paramount's defensive tactics, i.e. the termination fee and the option.

The Delaware Supreme Court applied *Revlon* and not *Time Warner*; boards should leave the decision to shareholders when there is a chance of competition between bidders, because in the *QVC* case there had been a change of control as Viacom had a single controlling shareholder which would have a majority of the shares in the combined company. The court found that, although directors do have the room to make a choice between bidders, as a matter of process they must at least investigate the competing bid if the target is potentially being sold to a controlling shareholder, i.e. directly or indirectly controlling shareholder.

Practitioners are often faced with *Revlon* issues when advising boards in connection with the sale of a company. In particular, bidders often insist on "lock-up options", "break-up fees" and "no shop" provisions. *QVC* is the leading case in this area. Whereas the Delaware Supreme Court invalidated the provisions in *QVC*, the Court of Chancery and Supreme Court permitted them in "Rand".[734] Arguably the option in favour of the acquirer was "draconian", but by the time the board agreed to the clause the market of potential acquirers had been fully canvassed and it turned out there was only one potential acquirer and there were no others interested to make a public offer, and therefore the option did in practice not restrict the circle of bidders and did not have to be invalidated.

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[733] *Paramount Communications Inc. v. QVC Network Inc.*, 637 A.2d 34 (Del. 1994).

[734] *Rand v. Western Air Lines Inc.*, C.A. No. 8632 1994 WL 89006, affirmed 659 A.2d 288 (Del. 1995).

In ***Unitrin*** of 1995[735] the Delaware Supreme Court reversed the Chancellor's injunction barring Unitrin to repurchase its own shares in order to thwart American General's hostile takeover. The Unitrin directors, who owned 23% of the shares, did not sell their shares to Unitrin in the self-tender, which brought their shareholding up to 28%. The Delaware Supreme Court agreed with the lower court that, by the *Unocal* standard, the threat had been reasonably investigated (and deemed real, namely an inadequate price). The Supreme Court differed with the lower court by accepting that the self-tender, bringing the directors' shareholding up to 28%, was proportionate because, although difficult, the bidder could still organise a proxy fight in order to replace the directors, redeem the extra poison pill and try in that way to achieve a friendly merger. The court did not consider the self-tender to be "draconian".

Gradually thereafter, the important cases became "deal protection" cases. In fact, the *Revlon*, *QVC* and *Unitrin* cases had already been about "deal protection" and application of the "Is the measure draconian?" criterion. An important more recent deal protection case was ***Omnicare*** in 2003.[736] Here NCS was subject to competing bids by Omnicare and Genesis Health Ventures, Inc. (Genesis). NCS was in financial distress, having defaulted on debts of $350 million. Omnicare was invited by NCS to make a public offer for the NCS shares. It declined and only offered an asset purchase in bankruptcy, which would have left the shareholders completely unpaid. Genesis came up with a better offer for the shares and NCS's only option seemed to have to accept to be acquired by Genesis. NCS, represented by a special independent negotiating committee of directors, and Genesis agreed to a deal involving protective devices, which were exclusivity agreements without a "fiduciary out". The deal, as contested in this case, was approved in advance of the shareholders' meeting by two controlling shareholders of NCS, its chairman John Outcalt and its CEO Kevin Shaw, who had a clear majority of the voting power. Moreover, the deal included a "force the vote" provision, i.e. a provision that a merger may be put to a shareholder vote even if the complete board no longer recommends the merger, which in this case made the exclusivity complete. The special negotiating committee had excluded Outcalt and Shaw from the negotiations. Omnicare then made a slightly higher bid than Genesis for the NCS shares, which therefore included an amount for all the shareholders, but the NCS committee did not respond. Genesis then raised its bid, but demanded an immediate acceptance or it would walk away. The NCS committee accepted. Omnicare sought to bar the merger. Vice-Chancellor Lam applied Unocal and found that the threat of loss of any deal was large and that the response, although it gave one bidder exclusivity without a fiduciary out, was reasonable.

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[735] *Unitrin, Inc. v. American General Corp*., 651 A.2d 1361 (1995).

[736] *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914 (Del. 2003).

The Delaware Supreme Court – there are five justices – in a rare split decision of 3 to 2, did not agree with the vice-chancellor's conclusion and decided there was a threat under *Unocal*, but that the response – an absolute exclusivity with no "fiduciary out" – was not proportionate. The majority of 3 seemingly set a bright-line rule that absolute exclusivity with no "fiduciary out" is not permitted. Chief Justice Norman Veasey and his successor, the present Chief Justice, Myron Steele, however, wrote strong dissenting opinions, in which they reasoned that there can always be circumstances where absolute exclusivity may be given, especially since NCS was nearly bankrupt and this was the end of a negotiating process.[737]

NCS was in financial distress and had been thoroughly shopped around, i.e. the board had done everything it could to find interested parties and seemingly had no option but to merge with Genesis. NCS and Genesis agreed to a deal including protective devices. The majority of three justices against two found that, in concert, the protective devices were coercive, because they did not include a "fiduciary out". But still, the Vice-Chancellor and the largest minority of the Supreme Court, i.e. two of five members found that the context of the near insolvency of NCS was of such a nature that the board had acted correctly in agreeing to the protection devices.

Another case was "*Orman*"[738] of 2004 in which the Court of Chancery went the other way, and upheld the protective devices by finding that the facts of that case indicated that there was a "fiduciary out".

Deal protection measures and their validity are quite context dependent. Veasey is of the view that the courts should not be too quick in striking them down, but that advisors should be cautious in proposing such measures.[739]

It is of interest to note that the *Unocal* standard still applies today. In ***Yucaipa*** in 2010[740] Vice-Chancellor Strine, citing "decades of settled law", upheld the validity of a standard shareholder rights plan, i.e. an

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[737] Veasey (2005), pp. 1459-1461 and Strine (2005), p. 47, who seems to agree with Vice-Chancellor Lam and the minority of the Supreme Court.

[738] *Orman v. Cullman*, C.A. No. 189039 2004 WL 2348395 (Del. Ch. 2004).

[739] Veasey (2005), p. 1461.

[740] *Yucaipa Am. Alliance Fund 11, L.P. v. Riggio*, C.A. No. 5465 – VCS (Del. Ch. 11 August 2010).

issue of favourable securities to existing shareholders, to address not only threatened takeovers, but also acquisitions of substantial, but not controlling positions, especially if the shareholder/bidder could in fact start a proxy contest.

In the Yucaipa case activist investor Ronald Burkle acquired 8% of Barnes & Noble and met its founder and largest shareholder in March 2009 to promote his ideas of strategy for the company. When Barnes & Noble declined to accept those ideas, Burkle increased his stake in the company to 17% in November 2009 and filed notice of his possible intention to acquire more or even bring about a change of control. Barnes & Noble adopted a rights plan that would be triggered when any shareholder acquired more than 20%. The plan "grandfathered" the founder, who held 29%, but would be triggered if he acquired more. The Vice-Chancellor rejected Burkle's challenge of the board's rights plan, holding that the defensive action was a reasonable and proportionate response to Burkle's threat and that Burkle could still run a proxy contest. He made especial mention of the "influence over the vote" of proxy advisory firms such as Risk Metrics. He added that the rights plan was permitted, even in combination with the staggered board defence, stating that "the reality ….. that even the combination of a classified board and a rights plan are hardly show-stoppers in a vibrant American M&A market".

The August 2010 ***Dollar Thrifty***[741] decision of Vice-Chancellor Strine represents another marker in a long line of cases endorsing the primacy of corporate directors' strategic decisions. The court held that the board reasonably focussed on the "company's fundamental value" and remained ready to respect a sales process, even a limited one, that is structured in good faith by an independent and well-informed board.

Again, in February 2011 in ***Air Products & Chemicals, Inc. v. Airgas**, **Inc.**,*[742] Chancellor Chandler confirmed that the directors of Airgas Inc. could refuse to redeem the company's poison pill in the face of an inadequate hostile offer, even if the majority of the stockholders, many of whom were merger arbitrageurs, would likely tender. This is a reconfirmation of the "just say no" doctrine. Again, it was important that Airgas had a long term strategy plan, that it discussed regularly.

Although the judicial decisions on hostile bids, starting with *Unocal*, were initially deemed "management friendly", they made a significant contribution to consolidating board centrality in corporate governance.

[741] *Dollar Thrifty* (Del. Ch. 27 August 2010, Cons. C.A. No. 5458-VCS).

[742] *Air Products v. Airgas*, 15 February 2011, Chancellor Chandler C.A. No. 5249/5256 CC.

The Delaware cases permitting poison pills were a clear management and board victory in takeover battles and a victory for Martin Lipton's "stakeholder theory".[743] The judgments stressed that boards were at the centre of the corporate decision making process and contributed to a power shift from management to boards.[744] The board was helped in Court in these cases if the decisions were taken by independent directors and if a thoughtful strategy had been adopted by the whole board after consideration of all the options.

3.7.3.3 *The duty of disclosure*

The word "candour" has crept into case law. In *Stroud v. Grace*[745] of 1992, the Delaware Supreme Court reaffirmed its preference for the materiality standard over the concept of "candour", which it found "confusing and imprecise". Next to federal law Delaware State law and state courts can certainly be applicable to cases of misinformation or incomplete information by the board to stockholders in proxy material.[746]

3.7.3.4 *Conflict-of-interest transactions*

Section 144 of the Delaware GCL makes clear that transactions between the company and a director or a third party will not be voidable solely because they are entered into by a director, who has a conflict of interest, if any of three provisions applies: (1) the director's interest was disclosed and was authorised by disinterested board members in good faith, or (2) the director's interest was disclosed and approved by the shareholders, or (3) the contract is fair when authorised by the board or approved by shareholders. There is no reason why the conflicted director should not attend the debate in the board. Indeed, it is actually deemed better if he does.

3.7.3.5 *Securities Law duty violation*

There are two types of securities claims, which are both usually class action claims by shareholders:

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[743] Martin Lipton, in a widely cited article Lipton (1979); Martin Lipton, 'Corporate Governance in the Age of Finance Corporatism', 136 *University of Pennsylvania Law Review* 1 (1987).

[744] Bainbridge (2008), pp. 137-139 and Rock (1997).

[745] *Stroud v. Grace*, 606 A.2d 75, 84 (Del. 1992).

[746] Veasey (2005), pp. 1476-1477.

(i) Section 11 of the Securities Act 1933:
These are claims for misstatements or omissions in any registration statement filed with the SEC for public offerings, in other words prospectus liability. The company usually called "issuer" has a strict liability. It has no defence. The directors, inside and outside, and advisors have a due diligence defence. The standard is negligence. Section 11(b)(3) of the Securities Act 1933 determines that outside directors are under a lesser duty to investigate than inside directors.[747] The inside directors, the advisors and the company are jointly and severally liable. The Section 11 obligations are the disclosure obligations of going public. The outside directors are only proportionally liable and usually do not have to pay out of pocket.[748]

(ii) Section 10(b) of the Securities Trading Act 1934:
These are claims for material misstatements or omissions in any documents concerning the purchase and sale of securities. The relevant documents can be any of annual or quarterly accounts or any other statements. The misstatements or omissions must be "scienter", i.e. in making the material misstatement there must have been "knowledge" or "a high degree of recklessness" on the part of the defendants. It is logical that outside directors run a lower chance of liability. The explicit difference between inside and outside director applies as well in the obligation under the Sarbanes-Oxley Act for the CEO and the CFO to sign a "control statement". This obligation is also a Section 10(b) obligation. The Section 10(b) obligations are all the disclosure obligations of being public. Furthermore, the liability is not joint and several, but percentage-based. This is yet another reason why outside directors have minimal liability.

The main securities statutes are federal. However, there are also many state securities acts. Shareholders may file cases in federal or state courts and combine them with actions for common law fraud, arising out of securities transactions. The Securities Litigation Uniform Standards Act 1998 (SLUSA) coordinates all of this. Between 1991 and 2004 3,239

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[747] Paul Vizcarrondo Jr. and Andrew C. Houston, *Liabilities under Federal Securities Laws*, of Wachtell Lipton, July 2010, p. 18 ("Vizcarrondo and Houston (2010)").

[748] Black, Cheffins and Klausner (2006/A), p. 1081.

cases were filed in US federal courts, an average of just 230 a year. About 140 fiduciary duty cases are filed in Delaware each year. Most cases are settled within the maximum of the insured value. Only in about 11 cases did outside directors have to pay.

3.7.3.6 *Insolvency, creditors rights*

In cases of insolvency the fiduciary duty standards do not change. However, the primary duty is no longer owed to the company and the shareholders, but to the creditors.

3.7.3.7 *Criminal law cases*

The SEC, the Department of Justice and state prosecutors such as Eliot Spitzer can start many cases under the Securities Acts and also under legislation such as the Anti-Trust Act, the Shearman, Clayton and Hart-Scott-Rodino Acts and the Foreign Corrupt Practices Acts.

3.7.4 <u>Insulation of directors from out-of-pocket payments</u>

Various measures can be taken to protect directors from the threat of litigation.

(a) *Indemnification*
Most listed companies have a clause in their articles by which the directors are indemnified against all claims of the company and of third parties, including criminal fines. Legal costs too can be reimbursed if the director wins. Indemnification is conditional upon the director having acted "in good faith and in a manner such person reasonably believed to be in or not opposed to the best interests of the corporation".[749] Indemnification against the consequences of securities laws is sometimes refused by the courts, in any case if the infringement is committed "with knowledge". Sections 102(b)(7) and 145 of the Delarware GCL make I possible for the articles of companies to eliminate or limit the personal liability of a director for all cases except for (i) authorizing unlawful corporate distributions, (ii) failing to act in good faith, (iii) international misconduct or (iv) knowing

[749] Delaware GCL § 145 and § 102(b)(7), which is an exculpation clause, which is an extra cause for judges to look at the circumstances of each director to see if he has different duties.

violations of the law. This means, provided there is good faith, there is even indemnification in cases of gross negligence. There is therefore indemnification in "care" case, but not in "disloyalty" cases.[750]

Indemnification does not have a positive effect for the directors in case the company is insolvent or insufficiently solvent to cover the directors' damages. The SEC precludes indemnification in Section 11 cases, i.e. prospectus liability.[751] Indemnification works in Section 10(b) cases, i.e. in connection of regular disclosure and it works as exculpation in derivative cases and especially in derivative oversight cases.[752] The scope for indemnification is greater than in the UK, where indemnity against claims of the company and criminal fines is excluded.

(b) *D&O insurance*

Section 145(a) of the Delaware GCL also permits the corporation to buy D&O (directors and officers liability) insurance. The policies exclude "criminal or deliberately fraudulent misconduct" or "any personal profit or advantage to which he is not legally entitled". These definitions are narrower than the "good faith" standards of indemnifications. Sometimes policies have full "severability of conduct" clauses, which cause outside directors to suffer from acts of inside directors. Insurance can furthermore be rescinded in case of incorrect information of the inside directors to the insurance company. New policies have clauses to provide separate coverage for innocent outside directors. Problems can also arise in the event of the corporation's bankruptcy. The court may decide that the corporation is entitled to the insurance proceeds. However, the policy may cover this eventuality as well.

3.7.5 Summary of director liability

A great many cases come before the Delaware Courts, some of which are of great importance. The rulings are clear and swift. The *Citygroup* and

[750] Vizcarrondo and Houston (2010), partners of Wachtell, Lipton, Rosen & Katz, p. 124.

[751] Black, Cheffins and Klausner (2006/A), p. 1084.

[752] Black, Cheffins and Klausner (2006/A), pp. 1093-1095.

AIG cases are good examples of the law on oversight of risk management.

The Delaware courts make a clear distinction between the standards of (best) conduct and standards of liability. The *Disney* case is an example of guidance on better procedures in board meetings. The courts do give an opinion about standard of (best) conduct, but without any legal consequence. These “views” of the court, one could call it “preaching”, do have effect on corporate governance standards. They mainly give opinions as to liability and these are not based on standard of (best) practices, but on the Business Judgment Rule.

The merit of US law is that by sticking to basic principles such as the business judgment rule and the fiduciary duties of loyalty, including good faith, and due care, as reflected in case law, it can be flexible and yet fitted to the facts of any specific case in a predictable manner.

In hostile takeover cases and in deal protection cases, case law serves as a solid beacon for practising lawyers as well, *Unocal*, *Moran*, *Revlon*, *Time Warner* and *QVC* are good examples.

The federal securities laws of 1933 and 1934, amplified by the Sarbanes-Oxley Act of 2002 and the Dodd-Frank Act of 2010, are highly relevant to the day-to-day activities of directors. Especially the Section 11 Securities Act 1933 on prospectus liability cases are a worry for directors and to a lesser extent the Section 10 Securities Trading Act 1934 on regular filings are worrisome as well.

There is a vast legal activity in the US, because first the parties pay their own costs without the loser having to repay the winner for its costs, second the class action system and third the no cure no pay practice, where the winners lawyer gets a substantial profit.

US policymakers (lawmakers, rule making institutions, e.g. SEC and judges) realize that it is important to attract good candidates to be directors of corporations and therefore not to make them personally liable to pay out-of-pocket expenses if they act in subjective good faith and do not commit deliberate fraud, collect illegal profits, profit from self-dealing or deliberately neglect their duties. Judges, academics and, above all, external and in-house legal and other counsellors play a very important role in advising boards about best practices and standards of conduct in board processes.

Although outside directors in the US are frequently sued, which is not only very expensive and time consuming but also a source of much anxiety and worry about media exposure for them, they are rarely ordered to pay damages. There are various reasons for this.

(a) Owing to the standards applied by the courts in corporate liability cases, in particular the "business judgment rule" and the duties of "loyalty" and "care", liability exists only in exceptional cases.

(b) As shareholders can attack directors in corporate liability cases only via derivative procedures the procedural hurdles are not easy on the plaintiffs.

(c) Even under Section 11 of the Securities Act, which requires that the company's registration statements when getting listed are without material misstatements or omissions, where the evidence requirements of plaintiffs are the easiest, all directors have a due diligence defence (i.e. "reasonable investigations" and "reasonable grounds"). This is a negligence standard and it is easier to defend outside directors than inside directors.

(d) Under Section 10(b) of the Securities Exchange Act, those responsible for material misstatements or omissions can be held liable while getting listed, the standard for a successful claim by shareholders is not as easy to satisfy as under Section 11 of the Exchange Act. The standard of Section 10(b) is "scienter" and only comes into play when there is a high degree of recklessness with regard to truth, for example where directors fail to investigate reports of problems ("red flags") in their corporation.

(e) Practically all listed corporations include full indemnity clauses in their articles of incorporation, by which the company pays directly or reimburses all expenses, including damage claim amounts and costs of the directors, provided the directors have acted "in good faith and reasonably in the interest of the corporation".

(f) Practically all listed corporations have good D&O insurance policies and there are economical reasons to settle cases at or below the maximum insured value.

The end result of all this is that although there are over 230 federal securities class action cases filed in the US federal courts each year and approximately 140 public companies annually facing lawsuits alleging breaches of corporate fiduciary duty by their directors in the state courts such as Delaware, most of these cases are settled and few come to a final trial verdict. In all settlements and judgments involving large companies, only in the *Smith v. Van Gorkom*,[753] *WorldCom* and *Enron* cases and about 10 other cases since 1980 have outside directors had to pay amounts out of pocket.[754]

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[753] In the end the case was settled by the buyer paying $23 million to the shareholders.

[754] Bernard S. Black, Brian R. Cheffins and Michael Klausner, 'Outside Director Liability: A Policy Analysis', *Journal of Institutional and Theoretical Economics (JITE)* 162 (2006), pp. 10-11 ("Black, Cheffins and Klausner (2007/B)"). Also Bernard S. Black, Brian R. Cheffins and Michael Klausner, 'Outside Director Liability', University of Texas School of Law, *Working Paper No. 26* (2004); and Black, Cheffins and Klausner (2006/A), p. 1086.

4. **THE NETHERLANDS**

4.1 **History and Culture**

I would once again stress at the outset that boardroom dynamics in the Netherlands too have been deeply influenced by history and culture. This section starts by listing in telegram style some of the characteristics of Dutch culture.[755] It is followed by a historical overview and a more detailed description of some aspects of Dutch boardroom culture. By their very nature generalisations do not apply to all circumstances. I have had many conversations with experienced observers and read much of what has been written on the subject to help form my observations.

4.1.1 General characteristics

Some keywords of Dutch corporate boardroom culture are:

a) *Consultation and consensus*
Dutch directors like to reach and maintain consensus. They consult readily, rarely debate principles and conduct their discussions at a pragmatic level. All participants are free and have an equal voice; relations are open and direct and there is little hierarchy.

b) *Plurality of interests*
Water, dikes and a densely populated country of semi-sovereign cities have contributed to a tradition of taking into account a variety of sometimes mutually opposing interests; concerns about the environment and the well-being of employees are important.

c) *Two-tier board system*
There is a long tradition of supervisory directors, who monitor at a distance from management directors; they were and are supposed to take all interests of the enterprise into account, not only those of the shareholders.

d) *Oligarchic tendencies*
Board members have always been well protected and have often been able to co-opt their successors either directly or indirectly

[755] See Zahn (2005), p. 130 for a description of Dutch, German, French, UK and UK culture in telegram style.

also with help of supervisory directors. In the early years of the 21st century shareholders have acquired more influence, which has been a shock to many directors.

4.1.2 Historical influences on Dutch boardroom culture

Water, trade and a long history of corporate governance are three factors that have influenced boardroom culture.

Water

The ever present awareness of water as friend and foe has been at the root of the Dutch talent for cooperation in small groups, with a free voice for each member and with minimal hierarchy. The topic of discussion was usually a practical problem and the solution had to reflect the interests of all concerned. In the beginning, large parts of the territories that would become the United Provinces of the Netherlands were marshes, lakes and river deltas along the coast of the North Sea. The Dutch had to fight the tides and floods. They built dikes, dug channels and constructed windmills to pump the marshes dry and change them into "*polders*" where they could farm and build their cities. Although they succeeded in taming the water, it was still everywhere. Ships plied the inland waterways, making the exchange of people and ideas easier. Soon Dutch ships were exploring the world, taking cargo to and from the Baltic, the Americas and the Indies. From the end of the 19th century, shipping once again triggered growth.

Trade and cities

The successful organisation of cargo trade and the operation of merchant ships depended on the responsibility of many a captain, boatswain, mariner, stevedore, shipowner and middleman. People learned to cooperate and to respect one another's responsibility and initiative. The exchange of goods led to a spirit of give and take. As the land was split up by rivers and lakes, the population was obliged to concentrate in small communities, which grew into towns and cities as early as the 13th century. The minor land owners, local counts and bishops had to cooperate with these townspeople to keep the land dry and the public treasuries filled. These circumstances naturally led to forms of commercial cooperation for a specific *polder* and its management, the equipment of a merchant ship or fleet, initially perhaps for one specific voyage and later for general shipping and trading and for the colonisation of overseas territories. The Netherlands was and is a collection of cities and small cooperatives. In all the cities successful merchants assumed the reins of government. In the absence of hereditary aristocracy or a central King's Court, local elites became a ruling oligarchy rooted in trade and shipping.

The development of corporate governance

Efforts for which many hands, heads and purses are needed in a spirit of give and take and mutual respect for one another's interests usually focus on finding practical solutions to problems. The lack of hierarchy and the absence of a central, monarchical power was compensated for by the respect for an oligarchy consisting of the most able and successful entrepreneurs, shipowners and merchants, who at the same time governed the cities. In effect, the concept of a single king commanding the allegiance of the nation was replaced by that of a hundred small kings cooperating with each other and with the people who made these efforts possible.

Throughout the corporate history of the Netherlands companies have tended to be led by a small group of directors who consult together in order to achieve consensus. Usually this has been arranged in a two-tier system, where some are responsible for day-to-day management and others play a supervisory role. Supervisory boards as we know them today have existed since 1623, when the Dutch East India Company (the VOC) created such a body. This two-tier system continued down the centuries. In 1898 Royal Dutch Petroleum[756] used defensive clauses in its articles of association, effectively allowing the board to co-opt members in order to ward off Standard Oil. A tradition of supervisory boards with oligarchic provisions in the articles of association allowed boards of public limited liability companies (NVs) to continue to manage companies by means of consultation aimed at consensus throughout the 20th century and was considered to be the Dutch tradition of governance. The evolution of Dutch corporate governance is described in detail in 4.1.5 and the cultural development of Dutch supervisory boards is related in 4.1.6(c) after discussing the influences of water in 4.1.3 and trade in 4.1.4.

[756] The full name of Royal Dutch Petroleum was Koninklijke Nederlandsche Maatschappij tot Exploitatie van Petroleumbronnen in Nederlandsch-Indië, later N.V. Koninklijke Nederlandsche Petroleum Maatschappij (referred to below as Royal Dutch Petroleum).

4.1.3 Water: friend and foe

The term used by the Dutch to describe their consultation mentality, their search for compromise and their willingness to abide by the resulting consensus is "*polder model*", with its accompanying verb *polderen*. These words are actually quite new and were introduced by Prime Minister Wim Kok in 1994.[757] A "*polder*" is an area of reclaimed land enclosed by dikes.

Free peat farmers AD 1000-1200

Until about AD 1000 roughly half of what is now the Netherlands was uninhabited. The northern and western territories, called the maritime provinces, consisted mainly of marshes, lakes and rivers. Sand dunes along the coast of the North Sea and some sandy ridges in the provinces of Holland, Zeeland and Friesland and part of Utrecht provided a meagre and fearful existence for a small and unruly population as well as a poor Count and some hard-working monks under a colonising bishop in the city of Utrecht, which was founded by the Romans. Around AD 1000, the Count of Holland, Dirk III, found that the marshy peat land behind the dunes on the west coast could be exploited if it were drained and the water controlled. Some Frisians from the northern provinces came and made an enterprising deal with Dirk III. He gave marsh land to groups of Frisian farmers under the leadership of a developer. Each farmer received a plot of 100 by 1,250 meters, 12½ hectares, a viable area for one farming family. The farm houses were to be built facing a drainage canal dug along the short side of the plot. The farmers paid a nominal amount of 5 cents a year to confirm the sovereignty of their overlord.[758] In exchange, the Count granted the plot in perpetuity and confirmed that the farmer was a *free* person. Elsewhere under the feudal system farmers were treated by their overlords as serfs. The free farmers under Dirk III and his successors worked to drain the marshes, dig the drainage ditches between their plots and build their villages, activities that required cooperation, consultation, consensus and compromise.

Polders, dikes and windmills from AD 1200

The early settlers found the peat on their plots useful. When cut into bricks and dried, it provided excellent fuel. They had to remove the upper

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[757] D. Bos, M. Ebben and H. te Velde, *Harmonie in Nederland, het Poldermodel van 1500 tot nu* ("Bos, Ebben and Te Velde (2007)").

[758] Jona Lendering, *Polderdenken: De Wortels van de Nederlandse Overlegcultuur* (2005), p. 25 ("Lendering (2005)").

layer of peat in any case, in order to reach the fertile soil underneath. This could then be turned into pasture land for cattle.[759] The sea, however, remained the biggest threat to all efforts of the settlers to create their own land. A lake in the middle of the country was substantially enlarged to a sea, called the "South Sea", or "Zuiderzee". Around 1170 the Low Countries were hit by terrible storms and floods. Storms drove the sea right up to the city walls of Utrecht. The settlers responded by starting to build dikes. Each farmer who had frontage on the main drainage waterway would build and maintain a dike along the 100-meter side of his land. A farmer behind him could take advantage of the safety of the dike. Neighbours would consult as free men to split the costs. On a larger scale there were meetings and deliberations of local inhabitants (*vergadering van ingelanden* and *waterschappen*). These meetings would be attended by a *dijkgraaf* (chairman of the water board) who represented the Count of Holland. Around 1200 the *ingelanden* (local land owners and farmers) decided in such a meeting to build dikes in the area where Amsterdam[760] would rise soon afterwards, as "the Venice of the North".

In 1230 the Count of Holland took up his residence in what is now The Hague, the official capital of the Netherlands. The first windmill capable of lifting water from low-lying land to a higher river or lake was built in Alkmaar in 1408.[761] A great many farms, sometimes more than a hundred, surrounded by dikes and windmills constituted a "*polder*", which was governed by a *waterschap* (water board). *Polders* were organised in the same way as the settlements of peat farmers. The overlord gave an *octrooi* (charter) to a developer who, together with the farmers of the area concerned, would create a *polder* and arrange for public governance and infrastructure such as a churches and roads. The members of these "*waterschappen*" deliberated with one another on an equal footing, all "*ingelanden*" having freedom of speech. The farmers had been free men for 300 years. This system of free farmers deliberating about the common good of their communities was a unique feature of the Low Countries.

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[759] Prof. Jan Luiten van Zanden and Arthur van Riel, *Nederland 1780-1914: Staat, Instituties en Economische Ontwikkeling* (2000), p. 76 ("Van Zanden and Van Riel (2000)").

[760] These dikes included a dike along the IJ, protecting the North side of Amsterdam, up to above Haarlem and a dike of 125 kilometers around West Friesland, i.e. Hoorn, Enkhuizen, Medemblik, Schagen, see Lendering (2005), pp. 33 and 36.

[761] Lendering (2005), p. 43.

From 1581, when the seven provinces declared their independence from Spain and its Habsburg dynasty, the States of Holland and West Friesland, as the sovereign power of the most important province, continued to grant licences or charters – known as an "*octrooi*" – to private entrepreneurs.[762] Normally, an *octrooi* for land to be reclaimed would be issued to one or two entrepreneurs, who collected a group of investors and influential persons around them. These acted as a sounding board for the entrepreneurs with respect to external interests such as neighbours, and they might also have a role in supporting the entrepreneur in the event of a dispute with a neighbour. The outside investors were obliged only to pay up their promised share in the proposed capital of the venture, an early form of limited liability.[763] They usually got a handsome return on their investment. Before the start of the project, compromises were made with surrounding municipalities and land owners who might lose access to water and transport as a result of the project. This process of finding compromises and taking all interests into account usually took place by deliberation aimed at achieving consensus. However, sometimes a committee of supervisors had to be appointed.[764]

The "*octrooi*" issued to the entrepreneur would name the first board members, who would run the business. The board would have a small group of managers, meeting once a week, and a larger group of influential and well-connected members who would meet once every two months. These were comparable to 20th century supervisory directors.[765] The board had the freedom to deal with the project of reclaiming the land and managing the village and the church to be built there. The board included a "*dijkgraaf*" who represented the government. Under the terms

[762] Han van Zwet, *Lofwaerdighe dijckages en miserabele polders. Een financiële analyse van landaanwinningsprojecten in Nollands Noorderkwartier*, *1597-1643* (2009), p. 40 ("Van Zwet (2009)").

[763] Van Zwet (2009), pp. 28-29 and 54; see also note 768 on the next page; Oscar Gelderblom, Abe de Jong and Joost Jonker, 'An Admiralty for Asia: Isaac le Maire and Conflicting Conceptions about Corporate Governance of the VOC', *Origins of Shareholder Advocacy*, Papers presented at Yale, Millstein Center for Corporate Governance, 6 November 2009 (January 2011), pp. 35-36 ("Gelderblom, De Jong and Jonker (2011)") and note 835 on page 256; H.M. Punt, *Het Vennootschapsrecht van Holland*, thesis (2010), p. 75; W.C.L. van der Grinten, *Handbook for the NV and the BV* (1989), p. 3 ("Van der Grinten (1989)"); and Van Solinge and Nieuwe Weme (2009), p. 1.

[764] Van Zwet (2009), p. 52.

[765] See Van Zwet (2009), p. 55, the influential board members sometimes included members of the States General and the Supreme Court to ensure support in the event of disputes.

of the *octrooi* the board was obliged to forward its accounts to the *Rekenkamer* (accounts office) of the States of Holland and Friesland. The board had full autonomy and was free to operate as it saw fit. Board members appointed their own successors.[766]

These *polders* were interesting examples of public-private cooperation: i.e. private finance and the execution of public functions by private boards with the backing and subject to the light supervision of the provincial or city government. In fact, they were an example of a stakeholder model.

From 1400: active shipping

After 1400 the landscape of the maritime provinces of the Netherlands started to change. A network of harbours sprang up and navigable rivers and waterways were crowded with vessels of all kinds. Seagoing ships too used the canals and rivers to reach the warehouses in the many inland ports to discharge their valuable cargos. These cities became the hub of the import and export trade in almost all commodities used in Europe at that time. In 1560 the province of Holland alone had 1,800 sea-going vessels, six times larger than the Venetian fleet of 100 years earlier.[767] In the 17th century, 40% of the Dutch were dependent on activities directly or indirectly in shipping.

In the period between 1400 and 1600 shipping was organised by partnerships for single voyages only. All partners were fully liable, jointly and severally. By contrast, partners in *polders*, as described above, were not liable for amounts in excess of their share of capital.[768] This was a form of limited liability.

Shortly before 1600 the States of Holland and of Zeeland issued *octrooien* (charters) exclusively for voyages to distant destinations to some private companies formed by citizens of various cities in these provinces. One of them, the famous expedition under the command of Willem Barentsz to discover the Northeast Passage to the East Indies, ended in a long winter of suffering by Barentsz and his crew in 1596-1597 on "*Nova Zembla*". However, most other trips to Africa and the Far

[766] Van Zwet (2009), pp. 40, 55 and 57.

[767] Landis (1998), p. 154.

[768] Gelderblom, De Jong and Jonker (2011), pp. 35-36.

East were successful and profitable. Indeed, some expeditions made an average annual profit of 27%[769]

VOC

As early as 1598 the States General, led by Johan van Oldenbarnevelt, expressed its concern that so many mutually competing private expeditions and companies would undermine "the common wealth" and become an easy prey for the Dutch public enemy, i.e. the Spanish and Portuguese governments that treated the Indies trade as a state monopoly and defended their claims against rivals. Thanks to the foresight and diplomatic efforts of Van Oldenbarnevelt, the city companies of Amsterdam, Rotterdam, Middelburg, Delft, Hoorn and Enkhuizen finally merged into one big *Vereenigde Oost-Indische Compagnie* (VOC/Dutch East India Company). To encourage the board members of the separate, profitable city companies to cooperate, they were given far-reaching powers. These cities appointed seventeen directors (*de Heeren Zeventien*). For the first time, they were appointed for life and were not liable for the VOC's debts.[770]

Johan van Oldenbarnevelt, one of the strongest statesmen the Dutch have ever had, used the existing system of *polders* and the *voor compagnieën* (pre-companies). He convinced the States General to grant the VOC an *octrooi* giving the company the exclusive right to trade and deal with the East Indies and the whole area of the Indian Ocean, including the power to represent the Republic there in dealings with foreign heads of state, and the right to take military action and set up and administer new colonies. Unlike the *polder* boards, there was no government representation on the board of the VOC.[771] However, under the "*octrooi*" the States General did reserve the right to instruct the board on specific matters of public policy in the colonies. As a result, the *Heeren Zeventien* were also responsible for running Dutch foreign policy in the East Indies and performing all the tasks of a government, including matters of war and peace.[772]

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[769] Gelderblom, De Jong and Jonker (2011), p. 36

[770] See Article 42 of the 1602 Octrooi, Gepken-Jager, Van Solinge and Timmerman (2005), p. 65, Dr. J.G. van Dillen, *Het oudste aandeelhoudersregister van de Kamer van Amsterdam der Oost-Indische Compagnie* (1958), p. 27 ("Van Dillen (1958)"); and Gelderblom, De Jong and Jonker (2011), p. 25.

[771] Gelderblom, De Jong and Jonker (2011), p. 40

[772] Gelderblom, De Jong and Jonker (2011), p. 47

VOC in the 18th century

The VOC stagnated in the 18th century. The investors were paid dividends, but no new capital was raised. At the end of the 18th century the political and economic life of the once so vigorous Dutch Republic was beset by internal troubles and neighbouring predators. Whereas the Netherlands had accounted for 40% of world shipping in the 17th century, this fell to 12% in the 18th century.[773] The VOC sank into bankruptcy and was taken over by the State in 1798 and then dissolved.

19th century: shipping from zero back to leader again

During the Napoleonic period from 1795 to 1813 the British navy blockaded the whole European continent and no overseas voyages were possible.[774] Shipbuilding started up again in Rotterdam and Amsterdam in the 1820s. At this time shipyards that would later become household names, for example Roentgen, Ruys, Van Ommeren, Van Vlissingen and Smit, were still building only sailing ships.[775] In the aftermath of the Napoleonic upheavals the Republic of the Seven United Provinces had become the Kingdom of the Netherlands. Its first king, Willem I, descendant of the "*stadhouders*" from the House of Orange, known as the merchant king, took the initiative in establishing a general trading and manufacturing company known as the Nederlandsche Handel-Maatschappij. One of its tasks was to promote shipbuilding.[776] When the Suez Canal opened in 1869 it became more attractive to operate steamships on the East Indies route as the distance had been cut.[777] True to the saying "*navigare necesse est*",[778] the Dutch quickly recovered their predominant position in shipping. By 1910 the tonnage of steam-powered vessels sailing under the Dutch flag exceeded even that of the UK, and was well ahead of each of the US, France and Germany. Coal mines in the area of South-Limburg from 1900 onwards became a source of wealth and a driver of industrial development.[779] The old entrepreneurial spirit

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773 Van Zanden and Van Riel (2000), p. 37 and Dr. I.J. Brugmans, *Paardenkracht en Mensenmacht, Sociaal-Economische Geschiedenis van Nederland 1795-1940* (1969), p. 23 ("Brugmans (1969)").

774 Brugmans (1969), p. 41.

775 Brugmans (1969), pp. 73 and 95 and Michael Wintle, *An Economic and Social History of the Netherlands: Demographic, Economic and Social Transition 1800-1920* (2000), pp. 132-133 ("Wintle (2000)").

776 Wim Wennekes, *De Aartsvaders, Grondleggers van het Nederlandse Bedrijfsleven* (2000), pp. 33-34 ("Wennekes (2000)").

777 Brugmans (1969), p. 355.

778 Brugmans (1969), p. 369 and Wintle (2000), p. 345.

779 Production at the coal mines of South-Limburg only started in 1901, Brugmans (1969), p. 353.

flowered again. In shipping, for example, companies joined forces to avoid being taken over.[780] Shipping and the cargo business preceded the development of Dutch industry in the 20th century. In the wake of shipping followed new companies such as Royal Dutch Petroleum, Dutch breweries and tobacco manufacturers, Unilever, Philips and KLM, all of which became major international companies and were often dependent on the links with the Dutch colonies. [781]

Canals and further land reclamation

In the 19th century wider and deeper canals and waterways were dug to develop the Netherlands as a distribution hub of northern Europe. Other projects included the creation of new *polders* such as the Wilhelminapolder,[782] where a group of investors established a model farm for some farmers, and the Haarlemmermeerpolder,[783] where Schiphol Airport is now located. The construction of the *Afsluitdijk* (barrier dam) and the creation of huge *polders* in the resulting inland lake were planned by Lely in 1880 and the project was completed in 1950.[784]

Water, an important foe and friend

Water has always been an important factor in the Dutch way of life. The seas gave them freedom. Water had to be "domesticated". It helped the Dutch to defend themselves when their freedom was threatened. Their fight for independence from the Spanish who tried to suppress the rise of reformative religious movements in the Eighty Years' War from 1568 to 1648 started with an invasion mounted by irregular Dutch seamen who had fled to friendly English ports and returned suddenly to capture the little town of Den Briel on 1 April 1572. This was the first victory in the Eighty Years' War, and the *Watergeuzen* (Sea Beggars) as they were dubbed passed into legend. 1 April is still celebrated as April Fools' Day, i.e. the day on which the *Watergeuzen* fooled their oppressors, the Spanish. In 1574 the city of Leiden breached its dikes in order to inundate the surrounding area and create a barrier against the Spanish army. In the 17th century the Dutch fought many battles, nearly all of them at sea. When the French armies invaded the Republic in 1672, the provinces of Holland and Zeeland opened the dikes along their eastern borders and

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[780] Brugmans (1969), pp. 358 and 361.

[781] Zahn (2005), pp. 301-302.

[782] Brugmans (1969), p. 163.

[783] Brugmans (1969), p. 499 and Wintle (2000), p. 131.

[784] Brugmans (1969), p. 499.

withdrew their forces behind a barrier of water. The French never occupied these provinces. However, water could just as easily be a foe as a friend and continued to pose a threat to the *polders* and riverside towns. After the disastrous floods of 1953 the Dutch had to raise the height of their dikes yet again.

4.1.4 History of trade and business

Traders, free from feudal shackles

As the Netherlands borders the North Sea, is criss-crossed by rivers and inland waterways and is centrally located in Europe, it is perhaps hardly surprising that its inhabitants became cargo shippers, merchants and international traders. By the 13th century feudalism was on the wane, central government was weak and city merchants were assuming the role of leaders. Free trade with surrounding countries was the basis of their wealth and power.

In the 15th and 16th centuries the grain trade with the Baltic countries (particularly the Hansa cities) and the Mediterranean flourished. Amsterdam was the staple market for grain, herring, salt, hides, timber, wool, silk and French wine. The Dutch even managed to buy grain from France and sell it back to other French merchants. Around 1500 the cities of the province of Holland were leaders in European shipping.[785] Trade was able to grow disproportionately fast because the Netherlands did not have a feudal nobility dependent on agriculture. In the rest of Europe the problems of feudalism and mercantilism combined to impede economic development.[786]

Traders are pragmatic and take quick decisions. They deal with foreigners and learn to be adaptable, but are less interested in long-term broad strategies. They swallow their pride if this enables them to conclude an advantageous deal.

17th century: Dutch Golden Age

The Dutch are proud of their "finest hour", the Golden Age in the 17th century. The foundations for their political and military success, for their wealthy cities, their excellent shipping, innovative banking and insurance,

[785] Herman Pley, *'Moet Kunnen': Een kleine mentaliteitsgeschiedenis van de Nederlander* (2010), p. 20 ("Pley (2010)").

[786] Johan Huizinga, *Nederlandse beschaving in de zeventiende eeuw* (1941), pp. 32-35.

their universities and their culture, including the exceptional prominence of Dutch painters, were laid in the 15th and 16th centuries

Religious peace was achieved in the early 17th century without civil war, after the country had won independence from Spain in the Eighty Years' War. Their feudal neighbours – the German states, the Spanish and the French – protected their trade and industry with mercantile measures. The Dutch flourished by free trade, like their English neighbours across the North Sea, their only real competitors. Trade wars, restricted to encounters at sea with the English, did not seriously interrupt Dutch progress and prosperity. An enlightened oligarchy of *homines novi,* city merchants versed in matters of state as well as in trade and shipping, made this progress possible. They encouraged a degree of free speech and tolerated foreigners settling in the maritime provinces, mainly foreigners with drive, know-how and money. Although the family names of these ruling merchant clans, called "*regenten*" (regents) are now only rarely found among today's elite, their spirit lives on and many *homines novi* of the last 50 years – successful bankers, government ministers, mayors, university leaders and directors of large enterprises – have adopted the traditions of their "regent" predecessors. [787]

The Netherlands, a small country surrounded by great powers
In the 17th and 18th centuries Dutch foreign policy steered a course designed to ensure that the Republic had at least two good friends among England, France and the eastern neighbours at any time. The German states did not pose a real threat, but both England and France were watching the rise of the Dutch Republic with envy. Initially, they had both helped the Dutch in their struggle for independence from Spain. In the wake of the rise of the Dutch Republic came commercial rivalry with England, culminating in three sea wars between their navies in the 17th century. Then in 1672, *het Rampjaar* (Year of Disaster), the Dutch Republic was invaded by the armies of Louis XIV, in connivance with his cousin, King Charles II of England. The sea saved the Low Countries. The Dutch fleet, led by Admiral De Ruyter, was victorious.[788] The city fathers of the western provinces decided to inundate the border area of Holland, and a few feet of water formed an impregnable barrier for the French armies.

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[787] Zahn (2005), p. 54 and Meindert Fennema and Eelke Heemskerk, *Nieuwe Netwerken: De elite en de ondergang van de N.V. Nederland* (2008), p. 124 ("Fennema and Heemskerk (2008)").

[788] Lendering (2005), p. 97.

The necessity to manoeuvre between such powerful kingdoms confined the Dutch the virtue of flexibility, which the Dutch had already acquired from their experiences in trade. The presence of so many foreigners and refugees on Dutch territory also made the Dutch tolerant and open-minded. "*Polderen*" was the state of mind. [789]

Economic stagnation between 1670 and 1780

Between 1672 and 1720 government debt increased from 130 to over 300 million florins.[790] The Netherlands could not afford any wars and had no urge to fight. Until 1672 the rich merchant families had invested in ships and commerce. Now, these investments slowed down. Trade stagnated as England made every effort to replace the Dutch as cargo shippers and colonisers and gradually overtook Amsterdam as the main staple market for foreign goods. The French protected themselves through their mercantilism. The volume of trade passing through Dutch ports from 1670 to 1780 remained nominally the same, but the Dutch market share declined from 40% to 12%.[791] Wages of city workers increased and caused a drastic decrease in manufacturing.[792] The Netherlands no longer developed new technologies[793] and played little if any role in the first wave of the Industrial Revolution in the 1770s. Nonetheless, up to the 1780s Amsterdam was still the world's largest financial centre.[794] Henri Hope, who came from England to the Netherlands in 1762 with his three brothers, founded Hope & Co. They and other Amsterdam bankers financed Sweden, Poland and Spain. The first loans to the newly independent United States of America came from Amsterdam bankers. [795] The English considered the aid the Dutch gave to the rebels in America a *casus belli* and declared war on the Dutch Republic. This time the English managed to cut the sea lanes to the Dutch East and West Indies, thereby dealing a disastrous blow to the Dutch economy. The resulting decline in trade and shipbuilding was aggravated by the events of 1780-1787: the era of "revolutionary" movements within the Dutch Republic.

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[789] Lendering (2005), p. 129.

[790] Van Zanden and Van Riel (2000), p. 34.

[791] Van Zanden and Van Riel (2000), p. 37 and Brugmans (1969), p. 23.

[792] Van Zanden and Van Riel (2000), p. 38.

[793] Van Zanden and Van Riel (2000), pp. 43-44.

[794] Wintle (2000), pp. 96 and 207.

[795] Hendrik G.A. Hooft, *Patriot and Patrician to Holland and Ceylon in the Steps of Henrik Hooft and Pieter Ondaatje, Champions of Dutch Democracy* (1999), p. 50.

The adherents of the House of Orange, from which the hereditary stadtholders (equivalent to presidents of the Republic) were drawn, championed sharp and sometimes armed conflict with the “Patriots”, who believed in the French ideal of a stronger political say for the middle classes.[796] These French ideals at first seemed to match the tolerant and conciliatory traditions of the Dutch, but this time they did not lead to typical Dutch compromises and conciliation, but to polarisation and an invasion by the army of the King of Prussia, at the invitation of his brother-in-law, the last Dutch stadtholder Willem V, to restore order in the Dutch Republic.

The Netherlands was ripe for an even more disastrous invasion and occupation. Ten years later, the revolutionary armies of the French Republic occupied the whole of the Netherlands. This time the Dutch relied in vain on their natural bulwark, water. The rivers and waterways, guarding the access to the western provinces were frozen solid. The French army was able to walk over the ice. The invasion swept away the old order. In 1800 the VOC went bankrupt and was dissolved.[797]

King Willem I: Dutch East Indies and the Netherlands Trading Company
After the Napoleonic Wars ended in 1813, the conference held by the victorious powers in Vienna agreed that the Austrian Netherlands (present-day Belgium) should be apportioned to the Netherlands in order to create a strong country to the north of France. These united Netherlands were to be a buffer state.[798] The Dutch East Indies, which had been occupied by the English in 1811, were restored to the Netherlands in 1816.[799] That colony was to play a vital role in the recovery of the Dutch economy.[800] It was in Vienna too that the English achieved their wish to see a strong government established in the country of their neighbours across the North Sea. As they reasoned, a king vested with “un-Dutch” powers was what those headstrong, independently-

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[796] Jaap van Rijn, *De eeuw van het debat: De ontwikkeling van het publieke debat in Nederland en Engeland 1800-1926* (2010), p. 57 (“Van Rijn (2010)”).

[797] Gepken-Jager, Van Solinge and Timmerman (2005), pp. 85-105.

[798] Van Zanden and Van Riel (2000), p. 110 explains the reason for the later separation in 1839. The Union lasted only until 1839, when Belgium became an independent kingdom. See also Wennekes (2000), p. 32.

[799] Van Zanden and Van Riel (2000), p. 138 and Brugmans (1969), p. 105.

[800] Van Zanden and Van Riel (2000), pp. 143-144. The “*cultuurstelsel*” in the East Indies led to dependable agricultural production of tea, coffee and tobacco, a substantial flow of goods to the Netherlands and considerable revenues for the Dutch exchequer.

minded Dutch needed. The ideal candidate was at hand, right there in London and an Anglophile to boot, namely the son of the last stadtholder, Willem V, who had fled to London when the French occupied the Netherlands.

This Prince of Orange, confirmed as King Willem I, had witnessed at first hand the English success in manufacturing, trade and banking during the First Industrial Revolution since the 1770s. When he returned home he found a country that was run down[801] and burdened with huge debts[802] and countrymen who had lost their traditional spirit of enterprise and adopted the habits of rentiers, retired to their country estates and became gentlemen of leisure.[803] Willem I wanted to be a "merchant king" and dreamt of a new VOC. He promoted the creation of a new company, in 1824, called the Nederlandsche Handel-Maatschappij (Netherlands Trading Company).[804] The shares were to be underwritten by public subscription. The public subscribed for 70 million guilders, while only 20 million had been expected. The king decided that a subscription of 37 million guilders would be sufficient and took four million for his own account. He appointed the president, the secretary and three executive board members. Five supervisory directors, who were to represent the shareholders, were appointed to supervise the executives. In their future role they would also nominate the five executive board members. It is worthwhile noting that the practice of a supervisory board was continued. The five executives and the supervisory directors usually met together, rather in the manner of today's combined meetings of management and supervisory directors.[805] This company was, at the time, the only publicly owned Dutch corporation. The Netherlands continued to be orientated towards agriculture, brewing, domestic manufacturing, small-scale trade and home crafts.[806]

19th century: small-scale enterprise followed by industrial revolution
Since the early 1600s there had been a "*Beurs*" or Exchange in Amsterdam, opposite the Town Hall, around which the lives of

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801 Strikingly expressed in the story of E.J. Potgieter, *Jan Jannetje en hun jongste kind* (1841).

802 Van Zanden and Van Riel (2000), p. 130. The government debt was 575 million florins in 1814, 900 million in 1830 and 1,200 million in 1840. See also Brugmans (1969), pp. 111-115.

803 Van Zanden and Van Riel (2000), p. 152 and Wennekes (2000), p. 32.

804 Van Zanden and Van Riel (2000), p. 139; Brugmans (1969), p. 69; and Wennekes (2000), p. 33.

805 Frentrop (2002), p. 155 and Brugmans (1969), p. 109.

806 Van Zanden and Van Riel (2000), p. 152.

Amsterdam “regents” revolved. Commodities, shares and bonds and every form of negotiable paper had been traded there. Now, in 1876, an official Securities Exchange was founded in Amsterdam, trading mainly in foreign paper.[807] At that time the Netherlands was a capital-exporting country. Marten Mees was an exception.[808]

King Willem I abdicated in 1840. His son Willem II reigned only until 1849 and was succeeded by Willem III. By then the position of prime minister had gained in importance. Johan Rudolf Thorbecke, a liberal and prime minister in various instances from 1849 to 1872,[809] was one of the most important statesman the Netherlands produced. He came from a business family, had been to universities in other countries and was a follower of Adam Smith. As such he believed in promoting free enterprise, i.e. enterprise free from government interference.[810]

The Technical University of Delft was founded in 1843.[811] In 1858 Charles Stork was producing steam engines. He was financially assisted by Marten Mees. Capital was available. There was a lot of old money in the Netherlands. In the first half of the 19th century rich Dutchmen tended to invest in landed estates or foreign government bonds. There were others, however, who believed in promoting local industry. Samuel Sarphati founded the Association for Pharmaceutical Development, the Amsterdam Garbage Collection Service, the Amstel Hotel and an industrial bank in Amsterdam. The textile manufacturers of Twente, in the north-east of the country, established the Twentsche Bank. Marten Mees was involved in founding the Rotterdam Bank and the Amsterdam Bank, forerunners of AMRO, and later the National Postbank, a savings bank. He was a member of the supervisory board of each of those new institutions, which grew quickly and formed the basis for the large Dutch banks of the 20th century.[812]

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[807] Frentrop (2002), pp. 191 and 193 and Brugmans (1969), p. 134.

[808] Wennekes (2000), p. 40. Another exception was the Van Eeghen family who invested in the Dutch East Indies. Van der Zanden (2000), p. 397 and Brugmans (1969), p. 268.

[809] Thorbecke was minister of internal affairs in a few intermittent years.

[810] Zahn (2005), p. 136.

[811] Wennekes (2000), p. 34. According to Brugmans (1969), pp. 197 and 287, and Wintle (2000), p. 130 the date was 1863. Delft’s engineers tell me it was 1843!

[812] Wennekes (2000), p. 35. As regards Sarphati, Twentsche Bank and Marten Mees, see Wennekes (2000), pp. 109-139. For the purposes of this study it is of interest to note that large companies had influential supervisory directors and that Marten Mees held many of these positions. Mees & Zonen later merged with

Although most people both here and abroad think of the Golden Age of the 17th century as the start of Holland's prosperity and industry,[813] it should be noted that the present-day economy is in fact based on the spirit of enterprise that started in the 1870s, although the elements of trade and water have always remained influential.[814] By 1880 Dutch industry had made huge leaps forward.[815]

Growth of Dutch Society from its 1870 basis

The period from 1870 to 1900 produced strong industrial growth based on innovations in chemistry, power generation and machine building. Generally, this period has been called the Second Industrial Revolution, although in fact it was the first for the Netherlands. It set the stage for what the Netherlands would become in the 20th century.[816] There was substantial investment in larger companies that combined production, distribution and transport management.[817] For instance, the families of Van den Bergh and Jurgens initially manufactured margarine[818] and later merged with the British company Lever Brothers to form Unilever. As noted above, Royal Dutch Petroleum was founded in 1890. It grew

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Hope & Co. (in 1966). See also Wintle (2000), p. 208.

813 Landis (1998), pp. 154-184.

814 Van Zanden and Van Riel (2000), p. 387. Wennekes (2000), p. 40, mentions, besides socially-minded Marten Mees, Jacques van Marken (founder of Gist Brocades, the present DSM) and Charles Stork. Other prominent men who founded major companies were Van Vollenhoven, Dutilh, Roentgen, Ruys and Van Vlissingen (shipping and shipbuilding), Van den Bergh and Jurgens (margarine), Misset (printing), Palthe (chemical washing), Begeman (machines), Lips (locks) and Heineken (brewing), as well as De Pesters and Van Marwijk Kooij, who started the Amstel brewery, which was at that time larger than Heineken. Most of these businesses were founded around 1870. Only the shipbuilders started earlier, Wennekes (2000), pp. 81-105 and Brugmans (1969), pp. 95-98.

815 Van Zanden and Van Riel (2000), p. 397 and Zahn (2005), pp. 127-128.

816 Van Zanden and Van Riel (2000), pp. 416-417 and Wintle (2000), p. 343.

817 Van Zanden and Van Riel (2000), p. 380.

818 Van Zanden and Van Riel (2000), p. 381; Brugmans (1969), pp. 332-333; and Wennekes (2000), pp. 221-283. Margarine was a French invention that was copied by Dutch butter producers Van den Bergh and Jurgens. Because of mercantile trade barriers put up by certain countries they chose to build factories there. They also copied Lever's soap patent. The Van den Bergh conglomerate remained a partnership until 1906, when it became a public company (NV). Van den Bergh and Jurgens made a secret pooling agreement with the British company Lever in 1908 and merged with it in 1927 and 1929, thus creating Unilever. Jurgens introduced the idea that top managers should be recruited only from within the company's own ranks. Paul Rijkens was the first strong leader who was not a member of the founding families and was an example of a new professional.

because of high demand for its products in the European market and became an integrated company, with oil fields, refineries and tankers as well as its own distribution network. Although small in comparison with Standard Oil, it protected itself by means of defence mechanisms and by its own mergers and acquisitions.[819] Like Van den Bergh and Jurgens, Philips[820] too benefited from the abolition of the Patent Act in 1869. By the time a new patent law was introduced in 1912, these companies had taken full advantage of the free-for-all.[821]

Farmers established cooperatives for milk and butter factories and cooperative banks for farming loans, the forerunners of Rabo Bank.[822] Networks of cross-supervisory directorships developed.[823] Debating societies flourished. However, these societies started later and finished earlier than their British counterparts. Membership of Dutch debating societies was limited to the elite, whereas British societies had much broader membership.[824]

In the 1920s the chemical industry evolved still further, helped by the opening of new coal[825] and salt mines. Salt and chemical products were largely developed by Koninklijke Zout and AKU (Algemene Kunstzijde Unie), which later merged to form AKZO. Unilever, Gist Brocades and DSM expanded. Long-distance communication with ships and aircraft had become important. Fokker built some of the world's first aircraft, which helped the Dutch to create one of the first international airlines, KLM.[826]

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819 Van Zanden and Van Riel (2000), p. 382; Brugmans (1969), pp. 339-243; and Wennekes (2000), pp. 341-391. Oil had previously been used in the East Indies as balm. Heilco Zijlker, a young tobacco planter, realized that oil offered more possibilities. While travelling by boat to the Netherlands he met some financiers whom he managed to interest in oil. Together they founded a company for the production and sale of petroleum in the Dutch East Indies. In due course this became Royal Dutch Petroleum and, later, Royal Dutch Shell, after merging with the British Shell Transport and Trading Company. This is described in more detail below in the section entitled "1898 defence mechanism of Royal Dutch Petroleum".

820 Brugmans (1969), p. 336; Van Zanden and Van Riel (2000), p. 383; and Wennekes (2000), pp. 285-338.

821 Van Zanden and Van Riel (2000), p. 383; Wintle (2000), p. 129; and Wennekes (2000), p. 38.

822 Brugmans (1969), pp. 229-303.

823 Van Zanden and Van Riel (2000), pp. 297 and 385 and Brugmans (1969), p. 503.

824 Van Rijn (2010), p. 272.

825 Brugmans (1969), pp. 353 and 479.

826 Brugmans (1969), pp. 486-487 and Zahn (2005), p. 262.

The division of Dutch society along ideological and denominational lines and the sudden process of modernisation in the period 1965-1985
A typical feature of Dutch society has always been *soevereiniteit in eigen kring* (sovereignty of one's own group or milieu), which is itself closely related to the division of society along ideological and denominational lines. Over the centuries many different national groups (e.g. French Hugenots, Germans and Portuguese Jews) and Christian denominations lived almost parallel lives, with their own schools, churches, clubs, political parties and customs. Traditionally these milieux are described as *zuilen* (pillars). Hence the concept of *verzuiling* (literally, pillarisation). All were left by the authorities to run their own affairs. This tendency grew stronger in the 19th century and continued until after the Second World War. Over time society divided into different pillars along denominational and ideological lines, for example Protestant, Catholic, socialist and liberal.[827] Together they engaged in consultation with the aim of reaching consensus.[828] In typical Dutch fashion, pillarisation did not lead to factionalism. As a matter of necessity in such a tightly knit society, the different pillars continued to cooperate with each other in order to achieve consensus on practical matters at regular intervals. Dutch governments since 1848 have usually been coalitions between parties representing the various pillars.

The 1960s brought sweeping social change internationally, but especially in the Netherlands. Dutch society secularised rapidly as Dutch Catholics distanced themselves from Rome[829] and many Protestants simply forgot about the church altogether.[830] The Netherlands led the way in such fields as overseas aid, euthanasia, abortion, drugs, peace, equal income, architecture and art.[831] With the decline of the denominational parties ideology lost its dominant influence.[832]

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[827] Van Zanden and Van Riel (2000), pp. 408 and 415; Wintle (2000), pp. 258-263 and 346; Zahn (2005), p. 173; and Gert van Klinken, *Actieve Burgers, Nederlanders en hun politieke partijen 1870-1918* (2003), p. 449 ("Van Klinken (2003)").

[828] Pley (2010), p. 92; Zahn (2005), p. 173; and Van Klinken (2003), p. 449.

[829] James C. Kennedy, *Bezielende Verbonden, Gedachten over Religie, Politiek en Maatschappij in het Moderne Nederland* (2009), p. 111 ("Kennedy (2009)").

[830] Kennedy (2009), pp. 42-98 and Zahn (2005), p. 252.

[831] Kennedy (2009), pp. 16-18 and 124-151.

[832] Van Rijn (2010), p. 273.

Pillarisation and the existence of a large number of political parties are typical of the Netherlands. They are the product of the country's history and of the attitudes of the inhabitants of its *polders* and small semi-independent cities[833] who managed to work together on practical issues. Pillarisation itself is not noticeable in the composition of Dutch boardrooms whose members tend to be drawn from a commercial elite. For foreigners the existence of all these different divisions in society is sometimes confusing, but in the comparatively small world of the Netherlands everyone seems to know everyone else, where they come from and to what pillar or milieu they belong. This is usually not discussed openly, but simply taken as read. The tendency to focus on practical issues has remained a typical feature of Dutch corporate culture.

Mergers in the 1960s and 1990s

Until the 1960s most companies and their managers and board members tended to have strong local roots in cities such as Amsterdam, Rotterdam, Eindhoven and Maastricht. Another example is the textile industry of Twente and its technical university. In 1964, the Rotterdam Bank and the Amsterdam Bank merged to form AMRO Bank. In the same year the Nederlandsche Handel-Maatschappij and the Twentsche Bank merged to form Algemene Bank Nederland (ABN). Gradually, the city elites lost their local base. Although corporate boards had always included *homines novi*, a new national elite now started to evolve and the distinctions between the corporate world and the civil service began to blur.[834] Many mergers were a consequence of the formation of the European Union and led to the creation of large national champions. Around 1990, there was a new wave of large mergers. ABN and AMRO amalgamated to form ABN AMRO, and the Postbank, Nederlandse Middenstands Bank and Nationale Nederlanden merged to form ING. Although these large banks achieved improved bank ratings, they had already run into problems before the 2008 credit crisis.

Modern polder model

In the same period the Netherlands benefited from the institutionalised "*polder model*" applied in the Social and Economic Council (*Sociaal Economische Raad*/SER), which is the forum in which representatives of the employers and employees and government and independent members meet to discuss and usually resolve sensitive issues such as salary levels.

[833] Pley (2010), p. 106.

[834] Fennema and Heemskerk (2008), p. 33.

The SER is an important institution that represents the spirit of compromise and consensus in economic matters that constitutes the modern-day *polder model*.

Trade continues

Even today the Dutch are primarily a trading nation. The Netherlands is still a major distributor and is the world's fourth largest exporter after China, the US and Japan. It is also the largest European importer of Chinese products. The transit trade accounts for a substantial part of its imports and exports.

4.1.5 Evolution of corporate governance

Early management boards, the VOC and similar companies

The small groups of peat farmers who worked the land beside the streams and rivers around AD 1000 started a tradition of cooperation and free consultation between equals that was designed to achieve consensus. The licences, "*octrooien*", they received from the Count of Holland were unique arrangements. The tradition of consultation was continued by the dike builders of around AD 1300 who formed *waterschappen* (water boards) to manage the *polders* and control the water. The water boards had members, who were fully liable, and supporters, gentlemen of influence who contributed as limited partners.

The partnerships formed for a single sea voyage, the *voor compagnieën* (pre-companies), of the last decade of the 16th century had managers with full liability as well as limited partners, who have been compared to the *commendators* (sleeping partners) known from *societas* of Northern Italy in Renaissance times. It is a matter of debate whether these limited partners (i.e. partners whose liability was limited to their contribution) were based on the earlier Italian examples of traders or on the Dutch water boards.[835]

These companies for a single voyage were already popular before the sea route to the East Indies was discovered. In the years immediately

[835] Van Solinge and Nieuwe Weme (2009), p. 1, where the authors state that in his thesis Van der Heijden defended the notion that the Dutch concept of limited partnership and limited liability for shareholders was of Dutch origin and originated from the water boards; see also Punt (2010), p. 75 et seq.; see also Mr E.J.J. van der Heyden, rewritten by Mr W.C.L. van der Grinten, *Handboek van de Naamloze Vennootschap* (1955), p. 3 ("Van der Grinten (1955)"), and Van der Grinten (1989), p. 3; see also Gelderblom, De Jong and Jonker (2011), pp. 35-36.

preceding the formation of the Dutch East India Company (VOC) the provincial states of Holland and Zeeland had issued ordinances prohibiting unlicensed voyages.

Dutch East India Company (VOC)

When the States General, inspired by Van Oldenbarnevelt, persuaded all these *voor compagnieën* (pre-companies) to merge, the VOC received an *octrooi* for 21 years. It was provided that the contributed capital would be returned to shareholders with accrued profits in the tenth and twentieth years.[836] When the VOC was founded it managed to raise just under 6.5 million guilders from a wide range of investors on the strength of the success and profits of the earlier companies.[837] The VOC was less profitable initially because of the costs of the military tasks it was required to perform. Indeed, no dividends were paid in the first few years. Just before the end of its first decade, however, the board paid all investors a dividend of 162.5%, i.e. 6.25% interest per year compounded.[838] This was paid partly in cash and partly in kind, which led to arguments about the valuation of the distributed assets. Dividends were paid in 1612, 1613, 1618 and 1620. Then dividend payments stopped, decreasing the value of the shares from 250% to 165%.[839] In 1622 and 1623 shareholders and shareholder activists (*doleanten*) had asked for more rights. By publishing pamphlets they tried to influence public opinion and put pressure on the negotiations between the States General and the *Heeren Zeventien* for a renewal of the *octrooi*.[840] Nevertheless, the States General did not consent to giving the shareholders more rights when they issued a new *octrooi*.[841]

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[836] Johan Matthijs de Jongh, 'Shareholder Activists *Avant la Lettre*: The "Compaining Participants" in the Dutch East India Company, 1622-1625', *Origins of Shareholder Advocacy*, Papers presented at Yale, Millstein Center for Corporate Governance, 6 November 2009 (January 2011), p. 11 ("De Jongh (2011/A)"). For the text of the licence and its translation into English, see Gepken-Jager, Van Solinge and Timmerman (2005), pp. 33 and 44, and Van Dillen (1958), p. 26.

[837] Gepken-Jager, Van Solinge and Timmerman (2005), pp. 44 and 58 and Frentrop (2002), p. 57.

[838] Gelderblom, De Jong and Jonker (2011), p. 48.

[839] De Jongh (2009/B), p. 6.

[840] Gepken-Jager, Van Solinge and Timmerman (2005), p. 44 and Johan Matthijs de Jongh, 'Oligarchie en thema en variaties. Zeggenschap van aandeelhouders vóór 1900', in R. Abma, P.J. van der Korst and G.T.M.J. Raaijmakers (eds.), *Handboek Onderneming en Aandeelhouder*, OO&R-uitgave (2011), p. 7 ("De Jongh (2011/B)"), where he also refers to his 2009 publication in which he describes the pamphlets of 1622 and 1623 and the actions of Isaac Lemaire and Willem Usselinks of 1609.

[841] Gelderblom, De Jong and Jonker (2011), pp.50-51.

Dutch corporate historians tend to cite the VOC of 1602 as the first public limited liability company with fixed paid-up capital. The VOC was a large public company, which indeed had limited liability in the modern sense, a separation of ownership and management and tradable shares.[842] The VOC was a merger of some of the East India companies established in various cities in the provinces of Holland and Zeeland and consolidated into Chambers (those of Amsterdam, Rotterdam, Middelburg, Delft, Hoorn and Enkhuizen). The VOC's executive board (the *Heeren Zeventien*) had authority over the six Chambers.[843]

Shortly afterwards the *Wisselbank* of Amsterdam was founded. This bank arranged an efficient system for the exchange of currencies and established a system of current accounts and cheques. In 1611, the Amsterdam Exchange (the *Beurs*) moved to splendid new buildings opposite the City Hall. As a result, the two symbols of Amsterdam's power stood facing each other.[844]

Differences between the VOC and the English East India Company
For this study it is interesting to note that the most obvious difference between the VOC and the English East India Company (EIC) was the different approach to the power of shareholders. The corporate structure of the VOC reflected the oligarchic nature of the semi-independent city states of the Dutch Republic, with control concentrated in the hands of a small group of directors (the Board of Seventeen or *Heeren Zeventien*).[845] Even after protests of shareholders and the creation of the Committee of Nine, a sort of supervisory board, in 1623, the shareholders still had no

[842] Gepken-Jager, Van Solinge and Timmerman (2005), p. 58; Ferguson (2009), p. 134; and Cadbury (2002), p. 5. Although the *Heeren Zeventien* had limited liability pursuant to article 42 of the 1602 *Octrooi* (see Gepken-Jager, Van Solinge and Timmerman (2005), p. 65; Van Dillen (1985), p. 27; Gelderblom, De Jong and Jonker (2011), p. 39; and Punt (2010), pp. 104 and 109), plaintiffs did occasionally sue the *Heeren Zeventien*, Punt (2010), pp. 106-107. For example, in a case about dividends for the heirs of stadtholder William III plaintiffs filed their claim against the *Heeren Zeventien*; see also Punt (2010), pp. 201-202. Hugo Grotius (Hugo de Groot), the world famous international jurist, also argued that shareholders were not liable, Punt (2010), p. 81, Hugo de Groot in *De Iure Belli ac Pacis* (1625).

[843] Gepken-Jager, Van Solinge and Timmerman (2005), pp. 43 and 47 and Van der Grinten (1989), pp. 2-3.

[844] Frentrop (2002), p. 85; Ferguson (2008), p. 49; and Van Dillen (1958), p. 32.

[845] Gepken-Jager, Van Solinge and Timmerman (2005), p. 15 and De Jongh (2011/A), p. 36. The *Heeren Zeventien* were appointed for life and new replacements were chosen by their friends, the city governors, Gepken-Jager, Van Solinge and Timmerman (2005), pp. 54-55.

influence. The Committee of Nine consisted of major shareholders, but they did not have voting rights at meetings with the *Heeren Zeventien*. The English EIC was much less oligarchic. In the EIC shareholders, called members, could dismiss directors, and had extensive information and approval rights,[846] where each shareholder had a vote in the General Court or Court of Proprietors, comparable to the present-day meeting of shareholders.[847] In the VOC, the *Heeren Zeventien* were appointed by the governing six city "Chambers" out of the members of these city oligarchies, therefore de facto by co-optation.[848] In the first phase the VOC directors were even appointed for life.[849] EIC directors were appointed for one year and could be dismissed. In the EIC shareholders had considerable power.[850] It is interesting to note that the same difference of attitude to the power of shareholders vis-à-vis the board between the Netherlands and the UK can still be observed in the beginning of the 21st century.

The VOC licence was dated 20 March 1602. The EIC's charter was two years older.[851] However, the VOC was larger, having an initial paid-up capital of 6,449,688 guilders and 20 cents as compared with the EIC's start-up capital of £68,000.[852] At the conversion rates at that time (9 pounds to 100 guilders) [853] this meant the initial capital of the VOC was 10 times higher than that of the EIC. Throughout the 17th century the VOC remained larger than the EIC. The Dutch VOC served as an example not only for the Dutch West India Company of 1621, but also for other European shipping and trading companies in the 17th century.[854]

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[846] De Jongh (2011/A), p. 74.

[847] Gepken-Jager, Van Solinge and Timmerman (2005), p. XI; Cadbury (2002), pp. 2-3; and De Jongh (2011/A), p. 74.

[848] Van Dillen (1958), p. 28 and Gepken-Jager, Van Solinge and Timmerman (2005), p. XI.

[849] Gepken-Jager, Van Solinge and Timmerman (2005), p. 54.

[850] Gepken-Jager, Van Solinge and Timmerman (2005), p. XI and Cadbury (2002), p. 3.

[851] Gepken-Jager, Van Solinge and Timmerman (2005), pp. X and 1 and Cadbury (2002), p. 3.

[852] Gepken-Jager, Van Solinge and Timmerman (2005), pp. 58 and 225; Lendering (2005), p. 85; and Van der Grinten (1989), p. 4.

[853] Jardine (2008), p. xxiii.

[854] Gepken-Jager, Van Solinge and Timmerman (2005), p. 109 for Denmark, p. 133 for France, p. 196 for Italy, and p. 234 for the UK, "EIC throughout the 17th century the largest in the UK and second in Europe after the VOC".

The VOC's octrooien of 1602 and 1623: a two-tier board

The *Heeren Zeventien* formed the executive board of the VOC but were entitled to trade for their private account in the VOC's products. This led to widely criticised conflicts of interest. It should be noted, by the way, that a similar situation developed at the EIC. In 1623 these malpractices were corrected in the VOC by the new *octrooi*.[855]

In the first years of its charter from 1602 to 1623, the *Heeren Zeventien* had features of both a one-tier and a two-tier board. The change in 1623 resulted in a distinction between a management body and a body of supervisors (the Committee of Nine), which was the first instance of a two-tier board.

The right to appoint the *Heeren Zeventien* was reserved to the constituent founders, i.e. the six Chambers. Amsterdam chose eight directors, Middelburg four and Rotterdam, Delft, Hoorn and Enkhuizen one each. The seventeenth, who was the chairman, was chosen by the last five cities together.[856] In the first years the board members were appointed for life. From 1623 directors were appointed for 3-year periods, but could be reappointed, which usually happened because they were appointed by the Chambers from which they came.[857] Directors were major shareholders themselves. Each had to invest at least 6,000 guilders. Later this requirement was dropped. The *Heeren Zeventien* made all the decisions about voyages, ships, budgets, fitting out, crews, cash, provisions, the division of goods brought back from abroad, dates for auctions, the building of new ships and the declaration of dividends. Although some decisions were delegated to *bewindhebbers* (administrators) of the city Chambers, the *Heeren Zeventien* clearly exercised all the executive powers of the VOC.

As noted before, shareholders had no say at all in the management of the VOC during the first 21 years. In 1623 the *octrooi* was up for renewal and the States General had taken into account the complaints of shareholders about malpractices at the top of the VOC. The main innovation was the Committee of Nine. This consisted of nine major shareholders from the various Chambers. The Committee had the task of auditing the VOC's accounts each year. It also had advisory powers in the

[855] De Jongh (2011/A), p. 80 and Gepken-Jager, Van Solinge and Timmerman (2005), p. 66.

[856] According to article 2 of the *Octrooi*, Gepken-Jager, Van Solinge and Timmerman (2005), p. 30.

[857] Gepken-Jager, Van Solinge and Timmerman (2005), pp. 55 and 58.

event that the *Heeren Zeventien* wished to sell goods and "other important items". The Committee of Nine was given the right to attend meetings and make recommendations and also to inspect warehouses. This Committee may be regarded as the precursor of the present-day supervisory board.[858] By 1720 the name of the Committee of Nine had changed to *Raad van Commissarissen*, the same name as carried by the present-day supervisory board under Dutch corporate law.[859]

Some shareholders wanted the Committee of Nine to have not only advisory rights, but also real voting rights on the board. If this had happened they would have made decisions together with the *Heeren Zeventien*. In such a case, there would have been a one-tier board of 17 executive directors and 9 non-executive directors. However, this demand by the shareholders was not accepted by the States General. The lobbying of the merchant-regents (i.e. the *regenten* of the big cities) prevailed,[860] and the Committee of Nine remained supervisory directors only.[861] There was now a two-tier board. This development came to a business world that was accustomed to the role of outside influentials as sounding board and supporter in the "*polder*" tradition. Nowadays, many Dutch commentators argue that the country has been used to a board of supervisory directors for about 400 years and that two-tier boards should therefore remain. They have become a feature of Dutch corporate culture.

The so-called Accounting Committee, also established in 1623, was appointed to receive the accounts for the past 21 years from the *Heeren Zeventien*. The latter more or less boycotted this committee, but could not stonewall the Committee of Nine as it consisted entirely of major shareholders. However, the *Heeren Zeventien* knew how to deal with

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[858] Gepken-Jager, Van Solinge and Timmerman (2005), p. 57; P. van Schilfgaarde and J.W. Winter, *Van de BV en de NV* (2009), pp. 31 and 235 ("Van Schilfgaarde and Winter (2009)"); M.J.G.C. Raaijmakers and W.J. de Ridder, *Corporate Governance in Nederland* ("Raaijmakers and De Ridder (2008)"); Prof. P.J. Dortmond, 'De one-tier board in een Nederlandse Vennootschap', *Nederlands ondernemingsrecht in grensoverschrijdend perspectief*, Serie Instituut voor Ondernemingsrecht, deel 40 (2003), p. 111 et seq. ("Dortmond (2003)"); Van der Grinten (1989), pp. 2 and 512; and G.J. Boelens, *Oligarchische Clausules in Statuten van N.V.'s [Oligarchic Clauses in Articles of Association of NVs]*, thesis (1949), p. 90 ("Boelens (1949)").

[859] Van der Grinten (1989), pp. 5 and 512, where it is stated that from then on supervisory directors became an important power, and Dortmond (2003), p. 111 et seq. who confirms this.

[860] Frentrop (2002), p. 104.

[861] De Jongh (2011/A), p. 79 and Mr J.M. de Jongh in an article, 'Aandeelhoudersactiviteiten avant la lettre' in a book, *Welberaden* (2009), p. 270 ("De Jongh (2009)").

these supervisory bodies. They saw to it that their friends were appointed, and they pacified shareholders by paying out substantial dividends. When profits declined in the 18th century, the VOC still managed to regularly pay out smaller, equalised dividends, thereby satisfying the shareholders who were by this time no longer entrepreneurs but rentiers.[862] In the 17th century one or two other companies resembling the VOC were established in the Netherlands, such as the West India Company (WIC) in 1621. All of them had a multi-purpose function, i.e. a mixture of trading and the governance of overseas territories.[863]

As mentioned previously, the total number of participations entered in the share registers in 1602 was worth nearly six and a half million guilders, to be precise 6,449,688 guilders and 20 cents. This total did not change. Although there were no shares with a fixed nominal amount, registered shareholders were free to sell and transfer their total shareholding or part of it by new registration at the offices of Chambers in the presence of one or two members of the *Heeren Zeventien*. In practice, it became common to trade participations of 500 guilders, which was a fairly large amount in those days. The entries in 1602 even showed shares of 50 guilders in the name of clerks and chambermaids, subscribed by their benevolent bosses.

Changes to NV law in 1720

In 1720 the Dutch followed the British example, the new charter stated the total outstanding capital, with each share having an equal value. The charter now envisaged regular shareholder meetings. However, the Dutch did not follow the British example of creating a large number of shareholder companies and as a result did not suffer a share bubble and bust, as happened in both France and England. They did create several insurance companies with limited liability, of which the oldest still in existence is the Assurantiesociëteit Stad Rotterdam Anno 1720. In the articles of association of these companies the name *commissarissen* (supervisory directors) appeared for the first time.[864] The responsibility of the supervisory directors varied from simply checking the accounts to a right to veto certain decisions, and even to management tasks. Other insurance companies were founded in 1776, 1807 and 1809. All of them

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[862] Frentrop (2002), p. 111 and De Jongh (2011/A), p. 82.

[863] Van der Grinten (1955), p. 5.

[864] Van der Grinten (1989), pp. 5-6 and 512 and Dortmond (2003), p. 111 et seq.

had supervisory boards that verified the accounts on behalf of the main shareholders.[865]

Dutch corporate law before and after the Code Napoleon

Old company law remained applicable to existing companies. This had already been determined in draft codes prepared by Dutch jurists, including M.S. Asser in 1809. These drafts never became effective. After the Netherlands was incorporated into the French Empire in 1810 the French *Code de Commerce* became applicable. The old corporate practice and the clauses in articles of association remained applicable for existing companies, because the *Code de Commerce* saw a corporation as an agreement between shareholders. It followed that shareholders had freedom of organisation once they decided the regime of the company, even when that had been established many years previously. The part of the *Code de Commerce* pertaining to corporate law was short. After the liberation of the Netherlands in 1813, a committee of Dutch jurists was formed to draft a new Commercial Code. This took a long time because of the main discussion point: whether the government would have the power to permit or veto the formation of limited liability companies and dissolve them at its discretion or, at the other extreme, could only check compliance with specific legal requirements. The Commercial Code that was finally enacted in 1838, contained only very brief provisions on company law. It had 21 articles applicable to companies with limited liability, called "NVs" (*Naamloze Vennootschappen*).[866] The language it employed was sweeping and vigorous, as was that of the French *Code de Commerce*. As the company was seen as an agreement between shareholders, existing companies continued to function under their existing regime, but, according to French "revolutionary" ideas for new companies, the meeting of shareholders would be the highest organ for new companies. The implications of this last point were less than might have been expected because most companies were old family enterprises in which shareholders and directors were the same persons and the old system of supervisory directors who represented the main shareholders for the purpose of checking the accounts remained in force.[867] In practice,

[865] Van der Grinten (1989), pp. 5-6 and 512; De Jongh (2011/B), p. 17; and Punt (2010), p. 112. Punt describes several 18th century cases of litigation including the case of VOC dividends for the heirs of stadtholder William III and several other cases involving smaller companies, also with supervisory directors.

[866] Van Solinge and Nieuwe Weme (2009), p. 5. NV is the abbreviation of "*Naamloze Vennootschap*", which comes from "*Société Anonyme*".

[867] Van der Grinten (1989), p. 512.

supervisory directors did often check the accounts for the shareholders, as there were no external auditors.[868] The 1838 Code allowed substantial flexibility and, besides permitting the old system (where the duties of the supervisory directors could be limited to "bare" supervision), provided that the supervisory board could even engage in management.[869] The Code of 1838 had the following characteristics:

(i) a notarial deed and government consent were necessary for the articles of association;
(ii) registration of companies and directors in trade registers;
(iii) personal liability of directors in the case of non-registration and also in the case of non-compliance with the articles of association;
(iv) choice between bearer and registered shares;
(v) if a director infringed the articles of association all the directors were jointly and severally liable to third parties (a consequence of fraternal boards);
(vi) flexibility of the role of the supervisory board as described above;
(vii) managing directors appointed by the meeting of shareholders;
(viii) possibility of limiting the voting rights of each shareholder to six votes by a clause in the articles of association;[870] the aim of this clause was to make it possible to limit the power of large shareholders and give other shareholders more influence, but the result could be to strengthen the position of the board vis-à-vis the shareholders.

Apart from the Nederlandsche Handel-Maatschappij, which had a supervisory board that nominated the executive directors,[871] only a few other NVs were incorporated between 1838 and 1850. 137 NVs registered by 1850.[872] In the following decades several attempts were made to introduce a more detailed code. In the 1880s, the era of many cooperatives and cross-networking, several informal companies ("*maatschappijen*") actually mentioned in their articles of association that

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[868] J.R. Glasz, *Enige beschouwingen over zinvol commissariaat*, thesis, Serie Recht en Praktijk, no. 84 (1995), p.160 ("Glasz (1995)"), referring to an advice given by Crookewit of 1880.

[869] Van Solinge and Nieuwe Weme (2009), p. 4 and De Jongh (2011/B), p. 20.

[870] Articles 36-56 of the Commercial Code of 1838. The points mentioned here can be found: (i) and (ii) in article 38, (iii) in article 39, (iv) in article 40, (v) in article 45, (vi) in article 52, (vii) in article 44 and (viii) in article 54.

[871] Frentrop (2002), p. 155 and Brugmans (1969), p. 109.

[872] Brugmans (1969), p. 88.

the supervisory board appointed the executive directors.[873] This was an oligarchic clause that marked the start of a tradition of defence mechanisms enshrined in the articles of association.

1898 defence mechanism of Royal Dutch Petroleum

Royal Dutch Petroleum, later called Royal Dutch Shell, was formed in 1890.[874] Heilco Zijlker had discovered oil in the East Indies and found financiers to back him. The company grew quickly and was listed. The founders and several knowledgeable politicians formed the supervisory board and employed August Kessler and Hugo Loudon as managers. Their sons were later directors of the group. When Henri Deterding joined 6 years later, he proved to be a strong CEO, a rather un-Dutch "imperial" CEO. At first oil was used for lamps and sold thoughout eastern Asia. Deterding cut out the distributors and transport shippers and included these services in the activities of Royal Dutch Petroleum. This was a period of big mergers in the US. John D. Rockefeller was shaping American Standard Oil into a huge conglomerate. From 1898 Dutch corporate culture allowed boards to co-opt their successors. In 1898 Rockefeller approached Royal Dutch Petroleum with a proposal for a merger by public offer. He said that he could provide the company with the capital needed for expansion. The proposal was refused, because Kessler, the CEO, was able to convince his supervisory directors that Royal Dutch had "concessions for everlasting oil fields" and could raise all the necessary capital on the stock exchange. Rockefeller did not give up. He started a "baisse operation" and the share price of Royal Dutch Petroleum shares fell drastically. Deterding realized that Rockefeller's strategy was to buy enough shares to dominate the general meeting of shareholders and then arrange for that meeting to appoint new supervisory and management directors consisting of Rockefeller's men. This strategy would work because the articles of association of Royal Dutch Petroleum, in keeping with the Commercial Code of that era, gave the general meeting of shareholders the right to appoint members of the boards. Deterding, with the approval of the supervisory directors, asked the Minister of Justice to approve a change to the articles of association in order to create a special class of shares (then known as preference shares and later as priority shares[875]) to be held by the supervisory directors. Henceforth the supervisory and management directors would be appointed by the meeting of holders of these new shares. This meeting could also block

[873] De Jongh (2011/B), p. 23.

[874] Van Zanden and Van Riel (2000), p. 382, Brugmans (1969), pp. 239-243 and Wennekes (2000), pp. 341-391, also mentioned above.

[875] R.P. Voogd, *Statutaire beschermingsmiddelen bij beursvennootschappen*, thesis, Serie Vennootschaps- en Rechtspersonen, deel 32 (1989), pp. 4, 40, 55 and 60 ("Voogd (1989)"), and Van Zanden and Van Riel (2000), p. 386 and R. Polak, *Wering van Vreemden Invloed uit Nationale Ondernemingen [Protection against foreign influence over national enterprises]*, thesis (1918), p. 59 ("Polak (1918)"); *Staatscourant* of 23 June 1989; and Boelens (1949), p. 10.

any change in the articles of association. Initially, the Minister of Justice objected because the requested changes were contrary to the general principles of law, but the Colonial Ministry convinced the Dutch government that it was in the national interest to help Royal Dutch Petroleum defend itself against a takeover by Standard Oil. The articles of association were changed accordingly. Thus in 1898, the Dutch corporate community received official sanction for the appointment of boards by co-optation. The times of the VOC with its oligarchic arrangements and government help had returned. This had been the trend from 1600 onwards right down to the 19th century.[876] Standard Oil gave up trying to take over Royal Dutch when it realized it could never get control even if it acquired a majority of the shares.

Standard Oil then made a tender offer for Moeara Enim ("Enim"), another Dutch oil company extracting oil in Sumatra. This offer was supported by the Enim board. The listed price of Enim doubled and Royal Dutch Petroleum shares fell by 20%. The Enim board called a meeting of shareholders and recommended the offer, arguing that Standard Oil would provide capital for tanker ships. Deterding replied that Royal Dutch Petroleum would be a better partner as it could provide capital on more favourable terms and would respect Enim's independence. Deterding again visited the Minister of Colonies, who said that he might refuse a licence for a merger of Enim and Standard Oil. Standard Oil withdrew. Kessler and Deterding had won the takeover war only to discover the promised "everlasting oilfields" were being rapidly depleted. The board and the supervisory directors were late in informing shareholders and the listed price of Royal Dutch Petroleum dropped by 90%. Enraged shareholders threw stones through the windows of Deterding's house in The Hague.[877]

Royal Dutch later acquired all the shares of Enim and of Billiton NV, a mining company. In 1901 it entered into a cooperative arrangement with the British Shell Trading and Transport Company. Together they became one of the world's largest oil companies. When they merged in 1906 the company included the oil operations of the Rothschilds and Gulbenkian. By this time the main product had become petrol, for which Royal Dutch Shell built a large refinery in Rotterdam. It competed intensely with Standard Oil, but concluded a standstill agreement with the Americans in 1928.

Change in company law in 1928

From the 1880s onwards Dutch businesses flourished. The Netherlands played a role in international peace treaties. The Peace Palace in the Hague, sponsored by Andrew Carnegie, was built. Statesmen from all over the world gathered there in 1907 and 1913 to promote world peace.

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[876] De Jongh (2011/B), p. 25.

[877] Fentrop (2002), pp. 216-220.

Notwithstanding their efforts, the First World War broke out in 1914. However, the Netherlands stayed neutral, to the benefit of its commerce and industry.

Abraham Kuyper, the founder of the Dutch Reformed Anti-Revolutionary Party, defended the interests of the "*kleine luyden*" ("little people"). These petty bourgeoisie found a voice in this party, which dominated the centre of Dutch politics at a time when revolutions were spreading over Europe. Efforts were made to reform company law and make it more "democratic". The public started to develop an interest in the shares of listed companies and thought had to be given to company law. On this occasion consensus was once again the basis for a new draft of company law. The new provisions would have created more transparency for shareholders and greater protection of corporate capital and minority rights and introduced director liability. The Minister of Justice introduced the bill in 1910.[878] However, the time was not yet ripe and the law was not enacted until 1928[879] under Justice Minister Donner and only then after lengthy debate. During the First World War the Germans started to buy Dutch shares. There was a fear of *Ueberfremdung* (dominance by foreigners), but this was not confined to the Netherlands. Dutch companies introduced oligarchic clauses in their articles of association. Other countries created different classes of shares with multiple voting rights.[880] Dutch company law allowed other oligarchic clauses in the articles of association, e.g. transfer of shares exclusively to Dutch shareholders, board membership restricted to Dutch nationals, and transfer of shares only to Dutch holding companies.[881] In 1920 Philips established such a holding company, which was called NV Gemeenschappelijk Bezit. This company was controlled by the Philips family and owned the majority of the listed shares. Heineken has employed the same system right down to the present day.[882] The family owns 51% of the shares in a listed holding company, which owns 51% of the operating company, which is also listed. Hence the family is able to control the business by holding 51% of 51%, i.e. 26.01%.

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[878] Fentrop (2002), p. 223.

[879] Fentrop (2002), p. 263.

[880] Frentrop (2002), p. 240 and Boelens (1949), pp. 26-80.

[881] W.L.P. Molengraaff, *Handelsrecht* (1923), p. 244 ("Molengraaff (1923)").

[882] Frentrop (2002), p. 243.

Between 1910 and 1928 protection measures were extensively discussed in legal and corporate circles. In 1910 the draft of a new Companies Bill would have banned oligarchic clauses. However, the threat of *Ueberfremdung* during the First World War and the subsequent volatility of currencies led most continental European countries to permit defence techniques. France, Belgium, Switzerland and Germany once again abolished these possibilities in the 1930s.[883] The Netherlands kept its oligarchic clauses. By 1928 Justice Minister Donner wished to abolish all oligarchic clauses, but Dutch business strongly objected. As a result, companies could still include a clause in their articles of association allowing for binding nominations of managing and supervisory directors.[884]

The Commericial Code of 1928 had 122 articles dealing with NVs, as compared with the 21 articles of the 1838 Code. The main elements of the new code were as follows:

(i) the meeting of shareholders could appoint managing and supervisory directors, but provisions allowing for binding nominations by the holders of a special class of shares – a defence mechanism – remained a legal possibility;

(ii) the role of supervisory directors remained flexible;[885]

(iii) publication of financial statements;

(iv) the paid up and maximum capital had to be stated in the articles of association;

(v) liability of founders and managing and supervisory directors was increased;

(vi) each board member had an obligation to perform his duties properly; all directors were jointly and severally liable for matters that came within their remit unless they could prove that they were not to blame and had not failed to take measures;[886]

[883] Boelens (1949), pp. 26-80.

[884] Boelens (1949), pp. 93 and 107; and G.H.A. Grosheide, *Machtsverhoudingen in NVs [Power division in NVs]*, advisory report presented to the Royal Netherlands Notarial Organisation (1959), p. 45 ("Grosheide (1959)").

[885] Van der Grinten (1989), p. 512.

[886] Joint and several liability is a consequence of fraternal board membership. See W.L.P.A. Molengraaff, *Leidraad van het Nederlandse Handelsrecht* (1940), p. 255 ("Molengraaff (1940)"). Joint and several liability, with the possibility of exculpation, was introduced into the regulations governing NVs in 1928 as a copy of a similar provision in the Code on Cooperative Associations, articles 29, 31-32, Molengraaff (1940), p. 307 and H.F.A. Völlmar, *Het Nederlands Handelsrecht* (1931), p. 151 ("Völlmar (1931)").

(vii) shareholders could ask for an investigation by court-appointed investigators.[887]

Mergers of Royal Dutch Shell and Unilever

Royal Dutch Petroleum merged with the English Shell Transport and Trading Company (Shell Transport) in 1907 and formed a group with two holding companies, one listed in London and the other in Amsterdam. Each of them owned shares in intermediate holding companies in a ratio of Royal Dutch 60% and English Shell 40% and each was entitled to the dividends from these intermediate holding companies and paid dividend taxes in a ratio of 60:40, as arranged under the terms of an equalisation agreement. In 1929 the UK Lever Brothers merged with Van den Bergh & Jurgens to form Unilever N.V. and Unilever Plc. They too operated as dual-headed companies and were listed in both cities. Each owned 50% of the shares in intermediate holding companies, and under an equalisation agreement each of the top holdings would pay out equal dividends. Both Royal Dutch Shell and Unilever were and still are very successful. The British and the Dutch have played complementary roles in their cooperation. For example, Morris Tabaksblat, retired CEO of Unilever, has stated that Unilever's corporate culture is a good mix of the informal discussion of the British and the informal decision making of the Dutch.[888]

Further legal defence mechanisms

The UK never allowed legal defence mechanisms. The UK maintains the "passivity rule", implying that boards should not take any action in shareholder matters. In the US the Ford Company Foundation issued new shares to the public in 1955. The family Ford retained B shares, a small percentage of the newly issued shares, but these shares carried 40% of the votes. At the time this was exceptional for the US.

In the Netherlands, however, it was quite usual to include some sort of defence in the company's articles of association. Polak, already in 1918, had given as the main reason for defence mechanisms the fear of takeovers by foreigners.[889] In 1949 Boelens added some more reasons, including (i) dangers resulting from fragmented ownership,

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[887] These items can be found in the Commercial Code of 1928 as follows: (i) in article 48a, (ii) in article 51b, (iii) in articles 49b and 52, (iv) in article 36d, (v) in articles 36g, 47b, 47c, 591, 59b and 52, (vi) in article 47c and (vii) in articles 53 and 53a-d (the court-appointed investigators were possibly the predecessor of the Enterprise Chamber, which was introduced in 1970).

[888] Couwenbergh and Haenen, *Tabaksblat* (2008), p. 77.

[889] Voogd (1989), p. 8 and Polak (1918), pp. 25-57, where Polak describes the danger of infiltration by foreigners taking over Dutch companies. Polak himself was not in favour of defence mechanisms.

(ii) speculators and (iii) the advantage of having a supervisory board, (iv) continuity of the board, (v) freedom of the board to focus on company business without having to worry about shareholders' wishes and actions and (vi) independent shareholders. He concluded "it is awkward to let shareholders decide on important matters".[890] This was a clear expression of the idea, then prevalent in Dutch corporate culture, that weak shareholders needed a guardian. Shareholders cannot instruct.

The Supreme Court decision in *Forumbank* of 1955[891] made clear that the general meeting of shareholders cannot give instructions to the board. A 60% shareholder had borrowed money from Forumbank and had pledged his shares as security. He then called a shareholders meeting at which the purchase by the company of his and the 40% minority shareholder's share was on the agenda. The managing and supervisory boards objected as did the minority shareholders. The general meeting voted, of course, with the 60% majority shareholder prevailing, in favour of the resolution. The minority shareholder asked the court to declare the resolution null and void. The District Court, Appellate Court and Supreme Court did indeed declare the resolution null and void, confirming that the shareholders meeting could not instruct the managing board.

As stated before, the articles of association of many Dutch companies contain a variety of defences, such as giving the holders of a special class of shares ("*prioriteitsaandelen*") the right to appoint directors and to take other important decisions in the manner Royal Dutch Petroleum had done in 1898. The Companies Act of 1928 established clearly that companies could enshrine in their articles of association the right of the board of supervisory directors to appoint its members. Co-optation of the members of that board became common practice. By and after the Second World War other oligarchic clauses and clauses limiting the voting rights of shareholders found their way into the articles of association.[892]

After the Second World War NVs added a new weapon to their arsenal of defence against predators, the right to issue shares to a foundation especially established for that purpose and controlled by management.

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[890] Voogd (1989), pp. 8-10 and Fentrop (2002), p. 281 and Boelens (1949), pp. 9-25, which arguments were still valid in 1971, see the brochure of that year of the Foundation Maatschappij en Onderneming, Profs. Kuin, Bosman, Van Doorn and Uniken Venema, pp. 16-20.

[891] *Forumbank*, HR 21/1/1955, NJ 1959, 43.

[892] Voogd (1989), pp. 20 and p. 29-191 and Boelens (1949), pp. 107-140.

Usually such shares were preferred shares and the number which the board could issue at low cost was large enough to outvote any predator.[893]

A defence, already used in 1918, was to issue share certificates to bearer, "*certificaten*". The idea came from the US voting trusts. A company would transfer shares with voting rights to a trust, controlled by the board of the company, in exchange for "Depository Receipts". In the Netherlands the original shares were transferred to an administration vehicle, "*administratiekantoor*", sometimes an association or company, but usually a foundation, the board of which had the voting rights of the shares. For each share this administration vehicle issued a bearer certificate, listed on the Amsterdam Stock Exchange. The dividends and other economic rights attached to the shares were passed back to the certificate holders. The board of such a vehicle would be friendly to management, so that management could control the voting rights.[894]

The system of *certificaten* was used again in the Second World War. The Amsterdam municipality had to pay a penalty of 30 million guilders to the occupying Germans, because the city had gone on strike. The municipality paid in certificates of Hoogovens, the only Dutch steel company. These certificates had been issued for this purpose by the company and represented an economic or beneficial ownership. The voting rights remained with the administration vehicle, administered by the municipality.[895] The Germans accepted this.

In 1954 the committee Hellema found that of the 70 largest companies, listed in Amsterdam, only 4 did not have any form of defence mechanism.[896]

It is important to note that defence mechanisms can only work, if the law, i.c. the company law codes and jurisprudence, allow them, but it is also essential that the body responsible for permitting of a listing accepts the practice. At the time the responsible body was the "*Vereniging voor de Effectenhandel*". It could refuse to list the shares of a company, whose articles of association were not to its liking. The board of the "*Vereniging voor de Effectenhandel*" consisted of brokers and bankers who usually

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893 Voogd (1989), pp. 195-260.

894 Voogd (1989), pp. 21-27 and F.J.M.A.H. Houben, *Het Certificaat*, thesis (1942), pp. 33-34 ("Houben (1942)") and Polak (1918), pp. 66-67.

895 Frentrop (2002), pp. 281-282.

896 Voogd (1989), p. 25 and Houben (1942), p. 34.

were sympathetic to the wishes of a company's board and were less supportive of activist shareholders.

New Company Laws of 1971

In continental Europe the discussion in the 1950s and 1960s was whether the company's aim should be the maximisation of shareholders value or whether there are other decisive stakeholders' interests.

There was a strong employee interest lobby. There were suggestions to appoint employee representatives on the supervisory board as in Germany.

In 1964 the Committee Verdam on enterprise law laid the basis for later developments. [897] The following laws were enacted in the 1970s:

1 the Works Council Act of 1971 obliging larger enterprises to establish a Works Council, which has rights of advice, consultation on certain board decisions, such as mass dismissals and acquisition or disposal of companies, and consent on employee regulations;
2 the Law laying down the requirements of a company's annual statements, of profits and loss statements and balance sheet with explanations and the statement of the auditor;
3 the changes in the Law on Investigation of Enterprises, "*Enquêterecht*", that could be initiated by shareholders, the public prosecutor and/or trade unions and the establishment of the specialized Enterprise Chamber to deal with these cases, which form the 1990s led to a body of corporate case law; and
4 the Law on Structure Regime Companies, which provided the Dutch solution for employee influence on the boards of large companies.

All these laws, as well as some additions to the company law in the new Book 2 of the DCC of 1976, described on the next page, referring to the "interest of the company and its enterprises", breathe an atmosphere of pluralism and equal rights for all stakeholder interests, especially including the interest of employees. Another regulation in the atmosphere of that period were the Rules on Mergers of the Social Economic

[897] Van Schilfgaarde and Winter (2009), p. 414, nr. 137 (structuur); Van der Grinten (1989), pp. 19-20 and P.J. Verdam, *Herziening van het Ondernemingsrecht* (1971) ("Verdam (1971)").

Council, the “*SER Fusie Gedragsregels*”, the first chapter giving consultative rights to trade unions in cases of acquiring or disposing of companies. The SER has been mentioned before as the institution embodying the modern “*polder model*”, as a meeting place for consultation between employers and employees.

The Enterprise Chamber for Enquiry of companies created a body of jurisprudence, from the 1990s concerning the rights and obligations of boards.

The law on structure regime companies is of interest, because the Netherlands chose its own unusual two-tier model called the “Structure Regime”, which is relevant to board practices. Although this model was set up to create employee participation in the governance of the company, the consequence was that it elevated the supervisory and management boards to a legal position that made them immune to shareholder criticism, because the supervisory board of large companies were given extra powers of co-opting themselves, appointing the management board and vetoing important decisions.[898] This came in addition to the defence mechanisms described above. In 1970 the general view in the Netherlands was that with the widespread shareholder-ownership these fragmented shareholders were only interested in their own profits and therefore companies had to be protected by giving their boards and works councils more power. Most of the power was concentrated in management and supervisory boards. It led to managerial capitalism. The strengthening of the voice of employees was a confirmation of the already existing stakeholder or pluralistic model.

Introduction of Book 2 Dutch Civil Code (DCC), 1976

The new civil code was a project developed some decennia earlier. Professor Meijers wrote many parts of it in the 1930s. Company law was to be dealt with in Book 2 of the new Civil Code, hereinafter to be called Book 2 DCC), the book on legal entities. The text of Book 2 DCC was finalized in 1960 and enacted on 8 April 1976. With respect to the NV (limited liability company, with many shareholders, comparable with the UK Plc, German AG and French SA) and the BV (limited liability company, with a closed number of shareholders, comparable with the UK Ltd., German GmbH and French SarL) Book 2 DCC replaced all the articles 36-58g of the Commercial Code. There were no important

[898] Zahn (2005), pp. 264-265.

changes. The BV had been introduced in 1971. The first articles 1 through 25 of Book 2 DCC are applicable to both the NV and the BV. Articles 64 through 174 deal with the NV and articles 175 through 284 deal with the BV. They are very much alike and most of the articles for the BV are 110 numbers higher than those for the NV. For example, the main article describing the duty of supervisory directors is 2.140 DCC for the NV and 2.250 DCC for the BV. Hereinafter, this study will often refer to 2.140/250 DCC to make clear that a certain point is applicable to both NVs and BVs. Other legal entities, such as the state, provinces, municipalities, church associations, associations, co-operatives and foundations are also dealt with in Book 2 DCC. Then there are chapters on mergers and splitting of legal entities, disputes and enterprise investigation and finally the annual report and accounts, which were changed several times. Annex Book 2 DCC to this book gives a summary of Book 2 DCC. The summary includes the articles of the pending draft articles on one-tier boards, such as 2.129a/239a DCC (Act). One-tier boards are the centrepiece of this book. The alternative option to have a one-tier board instead of the usual two-tier board system was first proposed as a possibility in the Tabaksblat Code. This concept was introduced by the government in a bill, which was accepted by the Second Chamber of Parliament on 9 December 2009 and by the First Chamber of Parliament on 6 June 2011 and is expected to be enacted on 1 January 2012.

Three "Anti-Misuse" of Bankruptcy Acts 1987

In the beginning of the 1980s there were many bankruptcies, many of them the consequence of fraud or fraudulent bookkeeping. First, an Act which made constructors liable for debts of their bankrupt subcontractors, second, an Act holding directors liable for failing to inform the tax and social security premium collector in case of near bankruptcy and third and most important for this study the articles 2:139/248 DCC creating joint and several director liability for sloppy bookkeeping, failing to file accounts and other causes of bankruptcy.

Defence mechanisms maintained, 1987

In 1987 the Committee Van der Grinten[899] came to the conclusion that defence mechanisms could be left as they were, but that the courts should intervene in extreme cases. In the same period Professor Maeijer spoke in

[899] Van der Grinten was the most influential corporate law professor of that period; the *Handbook for the NV and the BV*, Van der Grinten (1989) became the corporate law bible.

favour of defence mechanisms, in his Silver Jubilee speech in 1987, as a way for the board to act in the "interest of the company.[900] This attracted attention at the time, because of the takeover battle between the publishing companies Kluwer and Elsevier. Elsevier wished to take over Kluwer, but Kluwer had defence mechanisms and successfully protected itself.

Discussions about defence mechanisms from 1989

From 1989 the "*Vereniging voor de Effectenhandel*", the body running the "*Beurs*", the Association of Stocktraders, supported by the Minister of Finance, Mr Onno Ruding, argued and negotiated for less defence mechanisms or at least less far reaching defence mechanisms. The old boys network of brokers and investment bankers at the top of the Amsterdam Stock Exchange had become less tight. The former, by now, thought that there would be higher volume of trade in a free market without boards that can impede takeovers of "their" companies. In these discussions the Association of Large Listed Companies (VEUO) opposed the Minister of Finance Ruding and his successors Kok and Zalm and the "*Vereniging voor de Effectenhandel*". The discussion was settled by a compromise: the establishment of the Netherlands first corporate governance committee, the Committee Peters in 1997, which would give more rights to shareholders and lay down a number of obligations for supervisory directors.

Enterprise Chamber injunctions from 1994

In the same period shareholders and other stakeholders got the right to start Enterprise Chamber cases with immediate impact, because they could ask for preliminary injunctions. Asking for an investigation had been theoretically possible since the Companies Act of 1928. At the time Professor Mr E.J.J. van der Heyden was strongly opposed to this idea. He argued that it was against the interests of companies.[901] In 1971, as mentioned above, the new Investigation Court, the Enterprise Chamber, was founded, giving shareholders, the prosecutor and unions the right to ask for an investigation. The first big case was *OGEM*, a huge bankruptcy, where directors were found to have been guilty of serious mismanagement. The receiver in the bankruptcy was the plaintiff and the

[900] *Naamloze Vennootschap* 76/1, January 1989.

[901] E.J.J. van der Heyden, *Het Wetsontwerp op de Naamloze Vennootschappen 1925* (1926), p. 69 ("Van der Heyden (1926)"), where he writes "Risum tenamus, don't let us laugh".

case made the public aware, to much surprise, that respected directors of such a large public company could mismanage so badly.[902]

In 1994 an important change was made in the Law of Investigation of Enterprises, "*het Enquêterecht*", introduced already in 1928 and amended in 1971. The new point was that plaintiffs could ask for immediate injunctions such as blocking decisions or agreements, appointment and dismissal of directors, etc. This led to a large volume of cases concerning smaller unlisted companies and some well published cases involving large listed ones. These large cases are explained in further detail in the section on duties of directors (in sub-section 4.6.4), but are described in summary here to show how effective this 1994 extension of the law was.

The first large case involving injunctive relief requests was the *Gucci* case of 1999, the handbag war where LVMH, Louis Vuitton Moët Hennessy, threatened Gucci NV by silently buying a large percentage of shares and Gucci defended itself by issuing shares to an employee benefit fund, giving it extra votes, in order to outvote LVMH. LVMH asked the court to order that Gucci could not use these extra votes and Gucci asked the court to order that LVMH would not be allowed to vote its recently acquired shares. First, the Enterprise Chamber ordered that none of the parties could vote with the extra shares. However, Gucci's issue of shares to employees had been paid thanks to a huge loan from Gucci, which transaction was in the end, upon appeal, in 2000, declared as against the rules of financial assistance by the Supreme Court.[903]
RNA, Rodamco North America N.V., case was the target in the next takeover defence case of 2003, where the target took temporary defence measures. The Enterprise Chamber ordered that these mechanisms could not be used, but in the end they were validated by the Supreme Court.[904]
HBG, Hollandsche Beton Groep N.V., was the object of the first large shareholder rights case in 2001, where shareholders demanded the right of consultation with the management board on major strategic moves.[905]
The shareholders got the Enterprise Chamber to order HBG not to enter into a large transaction, but the Supreme Court overturned this decision in 2003.

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[902] *OGEM*, HR 10/1/1990, NJ 1990.

[903] *Gucci*, HR 27/9/2000, NJ 2000, 653.

[904] *RNA*, HR 18/4/2003, JOR 2003, 1001.

[905] *HBG*, HR 21/2/2003, NJ 2003, 182.

The subsequent shareholder rights case involved Stork N.V. in 2007, where shareholders wanted a say in strategy (in order to split the group). Shareholders asked for an order that an issue of shares by Stork to a friendly foundation could not be used and Stork asked for an order, that shareholders could not vote out the supervisory board. The Enterprise Chamber found a middle way by deciding that parties had to negotiate and chose the solution of forcing parties to negotiate under the guidance of 3 super-supervisory board members.[906]
In the *ABN AMRO in Sale LaSalle Bank* case of 2007 shareholders asked for the right of veto for the sale of LaSalle Bank by ABN AMRO – and the Enterprise Chamber, indeed, ordered a stay of the transaction, which decision was overturned by the Supreme Court.[907]
In the *ASMI* – a large semi conductor producer – case of 2009 in the Enterprise Chamber and the decision of the Supreme Court in 2010 shareholders wanted a say in strategy (wishing to split the group) and got half a victory in the Enterprise Chamber, which stayed all voting and again ordered parties to negotiate to find a solution. This decision, however, was overturned by the Supreme Court.[908]
In the *DSM N.V.* case of 2007 US shareholders asked the Enterprise Chamber to block a special clause in the articles of association of DSM in

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[906] *Stork*, Enterprise Chamber, OK 17/1/2007, JOR 2007/42, the US investors Centaurus and Paulson, who acquired 31.4% in Stork, demanded that Stork split itself into 3 divisions: aerospace, food systems and technical services and sell off the last two. The Stork board reacted stiffly. The communication was not good. Centaurus asked for a meeting with the chairman, who reacted that he did not deal with strategy and referred Centaurus to the CEO. Both Centaurus and Stork approached the Enterprise Chamber, which concluded that the communication between the boards and these two large shareholders was not good and that they were both at fault. The Enterprise Chamber ruled that the board could not use its defence mechanism outside a hostile takeover, merely to protect itself, and certainly not indefinitely, and that the supervisory board could not be dismissed by shareholders and it appointed three super-supervisory directors to be in charge of the negotiations of strategy.

[907] *ABN AMRO in Sale LaSalle Bank*, HR 13/7/2007, NJ 2007, 434, see note 928 below.

[908] *ASMI*, HR 9/7/2010, NJ 2010, 544. The *ASMI* case is a long winded case that went in and out of the Enterprise Chamber three times. The shareholder activists were unhappy with the founder, CEO, 21% shareholder Del Prado, who as they said ran the company as a family company, appointing his son as his successor and having the supervisory board appoint himself as advisor to that board. The Supreme Court confirmed again that the management board determines the strategy and that the supervisory board supervises strategy. They should be free to do so and decided importantly that the supervisory board does not have the obligation to mediate between shareholders and the managing board but can act as deems fit, which was a point that the Enterprise Chamber had left rather vague in its *Stork* and *ASMI* decisions. The Supreme Court referred the case back to the Enterprise Chamber, which decided that the investigation would be stopped.

2007 the purpose of which was to give higher dividends to shareholders who owned the shares for more than three years. The Enterprise Chamber blocked the arrangement that would have favoured long-term shareholders, but the Supreme Court overturned the decision.[909]

Since 1994 the volume of Enterprise Chamber cases has grown to about 45 per annum. Most are joint venture cases and cases concerning unlisted closed companies, the Dutch "BVs", comparable to British Ltd's. In those smaller cases the Enterprise Chamber functions well in providing an orderly, third party forum for what would otherwise remain shareholder quarrels. There are about two large cases per annum concerning listed companies. There is some discussion about the way these cases are being handled, mainly because of the danger that the Enterprise Chamber might fall for the temptation to second-guess directors. Both the SER and a group of professors of the Groningen and Rotterdam Universities have published studies on this subject.[910] The SER has offered several points of advice. It discussed the suggestion that the Enterprise Chamber follow the concept of the US Business Judgment Rule. It did not go so far, but generally agreed that the US practice of judges giving better motivated judgments with clear tests is a worthwhile example to follow. Mention is made by the SER of Assink's (2007) (thesis), who argues for a Dutch Business Judgment Rule.[911]

The Peters Code of 1997

The idea of a code of best practices of corporate governance came from the UK, i.e. the Cadbury Code of 1992. The first Dutch code was the Peters Code of 1997. The committee, chaired by Jaap Peters, retired CEO of the large insurance company Aegon, made 40 recommendations. A summary is attached as Annex "Peters". Many of the relevant points – 21 on the supervisory board, 4 on the management board, 8 on shareholders and 7 on compliance – were addressed as recommendations.[912] Compliance was not swift but the report did result in lively discussions which formed the base for the Tabaksblat Code of 2004.

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[909] *DSM*, HR 14/12/2007, NJ 2008, 105.

[910] SER advices *Evenwichtig Ondernemingsbestuur* of 14 February 2008 ("SER (2008)") and Prof. Dr. K. Cools, Mr P.F.A. Geerts, Prof. Mr M.J. Kroeze and Mr Drs A.C.M. Pijls, *Het recht van Enquete* (2009) ("Cools, Geerts, Kroeze and Pijls (2009)").

[911] SER (2008), pp. 53-54.

[912] See Annex Peters Code.

Changes in favour of shareholders, 2004

When the Euro was introduced in 1999 shareholder-ownership of Dutch companies rapidly became more international at the same time. Dutch shareholders started to spread their investments to other European companies. Pension funds have since 1996 been free to invest elsewhere. Dutch investors went through the Ahold and the World Online dramas, where boards were alleged to have grossly misinformed the public. In the aftermath Dutch shares were relatively cheap. US and UK investors raised their holdings of Dutch listed shares. While in 1995 37% of Dutch listed shares were owned by foreigners, this jumped to 75% in 2005 and also to 72% in 2009. About half were held by North American and UK investors.[913] Suddenly Dutch directors had a different shareholder base to deal with. The foreigners, often with strategic stakes, made it clear that they wanted more influence. In the same period the number of foreign board members of the largest Dutch companies grew to more than a third of all board members.

In 2004 important rules for corporate governance were introduced, the so-called Tabaksblat Code, which apart from describing duties of management and supervisory boards, gave shareholders more rights and supported the elimination or reduction of defence mechanisms.

Furthermore, in that year the Act on the change of the Structure Regime gave shareholders more rights as follows.

Shareholders could now appoint and dismiss the board of supervisory directors. A 1% shareholder or a shareholder holding EUR 50 million could submit an item for the agenda of a shareholders' meeting. Shareholders received the right to veto major transactions that would change the enterprise; they were given say on pay and received the voting right on the share even if they only had a depository receipt ("*certificaat*"), and the right to start an inquiry procedure and ask for preliminary injunctions in the Enterprise Chamber were to be used more easily.

[913] Riens Abma, 'De veranderde positie van de aandeelhouder in goed bestuur', *Tijdschrift over Governance*, no. 2, pp. 11-12 ("Abma (2006/B)"), see also Assink in Assink and Strik (2009), p. 34, Monitoring Committee Corporate Governance Code of 3 August 2006, p 10 and SER (2008), p. 33. See also Rapport Nijenrode, *Aandeelhoudersbetrokkenheid in Nederland* (2010), p. 50 ("Aandeelhouders Rapport Nijenrode (2010)") and Xander van Uffelen, 'Angelsaksische investeerder rukt op', *Volkskrant,* 3 April 2010.

Since 1999 shareholder activists have been approaching boards of important companies, in some cases causing minor culture shocks. Boards were not used to communicate with critical shareholders, shielded as boards had been by defence mechanisms and by their protected position in structure regime companies, where supervisory boards co-opted themselves and appointed management and could afford to disregard the opinions of shareholders.[914]

Recent repercussions, 2008

Aggressive actions by shareholder activists and hedge funds, and takeovers of Dutch icons by private equity houses quite rapidly created a backlash and led to second thoughts about such unfettered power for shareholders. Since 2008, the government has proposed bills to increase the transparency concerning the identity of activist shareholders. These proposals include a reduction of the threshold for mandatory notification of ownership from 5% to 3% and a requirement for shareholders to notify the board if they want to object to the strategy set out by the board. The threshold for adding an item to the agenda of a general meeting is to be raised from 1% to 3%.[915] The waiting period for a demand for an agenda point is extended from 60 to 180 days.[916] Defence mechanisms will still be allowed. Draft laws limiting the maximum period during which a defence mechanism can be operative to 6 months were shelved and a law restricting the use of certificates was mitigated.[917] In the implementation of the EU takeover directive (the 13th European Directive) the Netherlands opted out of many stipulations that would have limited protection devices.[918]

Monitoring of Code, New Frijns Code 2008

The Tabaksblat Code was followed by monitoring reports, at least each year and the Frijns Code of 2008, which did not deviate from the

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914 Couwenbergh and Haenen, *Tabaksblat* (2008), pp. 91-93.

915 Parliamentary Papers II 2008/09, 31763, Memorandum of Reply, 2 May 2011, p. 4.

916 Assink in Assink and Strik (2009), pp. 41-43.

917 Couwenbergh and Haenen, *Tabaksblat* (2008), p. 104.

918 Van Solinge and Nieuwe Weme (2009), pp. 746-774. See also SER (2008), p. 40, which mentions that 75% of European countries did not opt out of the limits on defence mechanisms. One of the arguments used in the Netherlands to maintain defence mechanisms is to keep a level playing-field with the US, where defence mechanisms are allowed in reciprocity vis-à-vis the US (see Van Ginneken (2010), p.86). Another argument is the exceptionally vulnerable position of Dutch boards, see SER (2008), p. 37, because of the low threshold for agenda additions and the easy access to preliminary injunctions in the Enterprise Chamber.

Tabaksblat Code but did add a few points.[919] Generally there is a high degree of compliance with these codes. Annex Frijns gives a summary of the Frijns Code.

Complexity of powers in companies at present: outside influences
The most recent development can be described as follows: the CEO has become stronger. He stands above his executive colleagues and is not inclined to accept the increasing influence of the supervisory board; the chairman of the supervisory board on the other hand has not become much stronger so there is insufficient balance vis-à-vis this strengthened CEO. This tends to weaken the power of the supervisory board as a whole. This weaker position instead of contributing to the development of strategy might result in supervisory directors limiting their task to monitoring and to work less on strategy development. On the other hand the outside world in the shape of shareholder activists, share-vote advisers, politicians, civil servants and the media are interfering more and more in company matters, which should be a reason for more board discussion about strategy and more proactive participation of supervisory boards in strategy development. Corporate governance has become more complicated.[920]

4.1.6 Features of Dutch Corporate Culture: consultation, plurality of interests, two-tier system, defence mechanisms

Although British, US and Dutch culture have much in common, such as a crave for the same Christian religions, rationality and independence, I would like to mention four special aspects of Dutch corporate governance.

First the habit to hold discussions in an atmosphere of consultation always with the aim of reaching consensus, second, that all stakeholder interests are considered, third, the role of separate supervisory boards, and fourth, oligarchic features, which even into the 21st century give directors a feeling of being protected.

[919] See annex Frijns Code available at
http://www.commissiecorporategovernance.nl/page/downloads/DEC_2008_UK_Code_DEF_UK_pdf.
[920] Prof. S. Schuit, *The Chairman Makes or Breaks the Board* (2010), p. 33 (“Schuit (2010)”).

A Consultation and consensus

Consultation with the aim of reaching consensus
Dutch boards consult with the aim of reaching consensus. All those present are free to speak on an equal basis. This is the *polder model*.[921] An important consequence is a “collegial” or “fraternal” board model as is described in 4.1.3 above.[922] Boards find practical solutions and try to avoid having to discuss underlying principles. Hard basic questions are seldom asked. Criticism of a consensus through compromises is not appreciated. Board members deal with each other with less hierarchy[923] and more informality in decision making than their colleagues in the UK and the US. In the Netherlands it is unusual to vote in board meetings. That fact that Dutch consultation can take a long time and that there is no hierarchy to speed up decision making, can be confusing for foreigners.

Education is technical and practical
Dutch engineers, economists and lawyers have a thorough rather technical, education.[924] Graduates of liberal arts, such as history or sociology, which give broader general views of society, are seldom found among members of Dutch boards. [925] This leads to practical thinking and a tendency for practical discussions.

Direct and frank
Members of Dutch boards, not only of companies but also of churches and societies, are used to speaking their mind. They expect their colleagues do the same and respect them for it. Often they come up with unexpected things to test the waters. This direct, open, frank and cost conscious Dutch attitude makes it natural for a Dutchman to ask challenging questions about practical matters. But once a compromise is reached everybody

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921 Bos, Ebben and Te Velde (2007), p. 45; Zahn (2005), p. 262; and Kennedy (2009), p. 145.

922 Molengraaff (1940), p. 255; and Van der Grinten (1955), p. 420, nr. 242, Van der Grinten (1989), p. 385, no. 385, Van Schilfgaarde and Winter (2009), no. 42, Van Solinge and Nieuwe Weme (2009), no. 417, H. Beckman, ‘Bestuurder, taak en aansprakelijkheid’, in J.R. Glasz, H. Beckman and J.A.M. Bos, *Bestuur en toezicht*, Serie Recht en Praktijk, no. 71 (1994), p. 55 (“Beckman (1994)”), and Timmerman (2009), last point.

923 Zahn (2005), p. 262.

924 G.G. Bekenkamp, *President-directeuren, posities en patronen* (2002), p. 89 (“Bekenkamp (2002)”).

925 Trompenaars and Hampden (2006), pp. 20-25.

agrees to act accordingly, confident that even if they have been straight forward, the others will not be upset. Dutch directness and uprightness is often experienced in other countries as aggressive, blunt and pushy.[926]

Many factors contribute to the mentality of consultation leading to consensus mentality
The threat of water and of surrounding superpowers, a ruling merchant oligarchy, a small country, social control within such an oligarchy backed by a critical Calvinist church, different religions, many political parties and more recently the interests of employees and environmental concerns have contributed to this spirit of and respect for compromise and consultation.

B Plurality of interests

Interests of others than shareholders
There is a tradition of taking more than just shareholder interests into consideration. Since the 1960s employee and environmental concerns play a larger role. In the 1960s employee rights even became a centrepiece of Dutch enterprise law with the Works Council Act and the Structure Regime Act. The Supreme Court has recently reconfirmed[927] this concept of plurality of interests in the *ABN AMRO*[928] case. That the interests of employees count is

[926] Reinildis van Ditzhuizen, updating Amy Groskamp ten Have's, *Hoe hoort het eigenlijk?* (1939), p. 350 (book on manners); Pley (2010), p. 67; Kennedy (2009), p. 18.

[927] The concept of plurality of interests had already been decided in *Doetinchemse IJzergieterij*, HR 1/4/1949, NJ 1949, 405, when the supervisory board used the term “interest of the company” in their defence against a threat of a takeover.

[928] *ABN AMRO in Sale LaSalle Bank*, HR 13/7/2007, NJ 2007, 434. ABN AMRO was negotiating with Barclays Bank to merge. A consortium of Royal Bank of Scotland, Bank Santander and Fortis Bank announced that they would propose a higher tender offer. ABN AMRO went public with the decision to sell LaSalle Bank and to merge as equals with Barclays. The Dutch Association of Investors (VEB) objected to the sale of LaSalle arguing that this was a major transaction and needed shareholder consent. The VEB asked the Enterprise Chamber to block the sale. The Enterprise Chamber did so with arguments such as reasonability. The Supreme Court reversed that decision confirming that article 2:107a DCC defines major transactions as at least one third of the balance sheet total, which LaSalle was not. The Supreme Court stated clearly that this article should be interpreted restrictively, because of the need for legal clarity for the practice of boards and companies. In his conclusion, Advocate General Timmerman, discussed the *Revlon* argument, but counters with *Unocal* and *QVC* arguments as well as Delaware GCL § 271. He also referred to English law, which requires shareholders’

confirmed by article 2:347 DCC that gives trade unions the right to initiate a case in the Enterprise Chamber as was in the recent case of 2010, where the Enterprise Chamber gave a judgment against management of the publishing house PCM and a private equity buyer at the request of unions. [929]

Dutch law mentions in many places that all interests should be considered. A centrepiece of company law is article 2.8 DCC, which determines that the managing and supervisory directors and the shareholders are obliged to act in a reasonable manner towards each other. The requirement of reasonability is again a cornerstone of contract law. Although this is not directly relevant to corporate governance, Dutch literature[930] on corporate law stresses the importance of the general principle of Dutch law for all parties are to take the interests of other parties into account.

A key decision of the Supreme Court in contract law is *Baris-Riezenkamp* of 1957.[931] Baris sold a business, producing auxiliary engines for bicycles, to Riezenkamp, the buyer, who said it was essential that the production cost price would be Guilders 135 at maximum per engine. Baris, the seller, said that he had really investigated and according to him a cost price of Guilders 135 was possible. Then Riezenkamp raised his offer by 10%. The sale took place. Later, after the acquisition, Riezenkamp had a calculation made by experts, who concluded the cost price was Guilders 250. The Supreme Court concluded: buyer and seller have the obligation to seriously consider the interests of the other side when giving information.

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consent for important disposals. The UK had wished to put shareholders' consent for large disposals in the 13th European directive, but found the Netherlands explicitly against such requirement. The Supreme Court stated clearly that the management board determines strategy and the supervisory board supervises strategy and that boards must act in the interest of all stakeholders.

[929] *PCM*, OK 27/05/2010, LJN:BM 5928. The unions started the case. The Enterprise Chamber found that a major shareholder forced a sale of the shares in PCM, a publishing house of important newspapers, to a private equity group APAX, which highly leveraged this acquisition and caused a too heavy financial burden on PCM. The Enterprise Chamber found that management and supervisory boards of PCM and APAX had mismanaged, because they had not considered the totality of the enterprise, including the interests of the employees. There was no appeal in this case.

[930] Maeijer (1989) and L. Timmerman, 'Over de toekomst van het vennootschapsrecht', *RM Themis* 1999/2, pp. 43-51 ("Timmerman (1999)").

[931] *Baris-Riezenkamp*, HR 15/11/1957, NJ 1958, 67.

Boards of companies must act in the interest of the company and its enterprise. This important rule, laid down in article 2:140 DCC, describing the obligations of board members, is to be interpreted that board members should take into account the interests of all concerned.[932] This is further discussed in detail in 4.2.5 below.

C Supervisory boards, two-tier system

All through the centuries an important role has been reserved for outsiders, independent from day-to-day management. In the "*polder*" boards the "*dijkgraaf*" was an outside advisor as were the "influential" outside investors, who were attracted as sounding board and potential supporters. The "*polders*" had a commercial object as well as a communal aim. The same applies for the VOC, which had a commercial object and a communal aim of colonisation and defence at sea.[933] The *Heeren Zeventien* did not have any central government representative as "outsider" looking into governance, but they did consult with city representatives as outside sounding boards and supporters for their co-optation. The first formal committee, that was meant to advise and monitor management, was introduced in 1623 in the VOC. It represented the shareholders, but did not report back to shareholders and, in fact, kept shareholders at a distance. With the focus of enterprises purely on commercial aims, "*commissarissen*" were deemed to look after the interest of shareholders. In the 18th century, this sort of outside committees became known as "*Raden van Commissarissen*", supervisory boards. Supervisory boards were part of Dutch culture and were continued after the French *Code de Commerce* of 1813 and also contained this system, were reconfirmed in the acts of 1838, 1928 and 1971. These directors always had a certain supervisory role, which implied a role in the nomination of the directors, "seeing to it that there is good management". In 1971 the legislator added that supervisory boards should "monitor in the interest of the company and its enterprise" and "assist", "*staat ter zijde*", management with advice.[934] In the same year the Structure

[932] Articles New (in the Act) 2.129/239, 4, 2.150/250, 2 DCC.

[933] Van der Grinten (1955), pp. 4-5.

[934] Article 2.150/250 DCC.

Regime was introduced, which emphasized the role of the supervisory board as taking an independent stance and considering the interests of all involved and not only of shareholders. Most experienced Dutch directors, management and supervisory directors as well, give great value to this "independent stance" of supervisory directors. In the consideration of whether or not to change from a two-tier system with supervisory directors and to change to a one-tier board with non-executive directors and no supervisory directors, it is important to be cautious and develop a sensitive view. Supervisory boards are part of the Dutch software of the corporate governance mind.

D Oligarchic clauses, defence mechanisms

Oligarchic clauses and defence mechanisms in general
As we have seen, the Dutch developed the combination of private investors' capital with professional management of commercial enterprises, often mixed with public tasks, in a way which reflects a non-hierarchical spirit of governance characterized by frequent consultation, discussions and compromises. Part of this arrangement was that the participants, the boards and supervisors supported each other in their co-optation and in maintaining their positions, as "collegial" or "fraternal" board. For some centuries this had worked well, leading the country into its Golden Age. Peer pressure among the oligarchs within cities and public criticism of excesses from pulpits and in pamphlets prevented this set-up for a long time from degenerating into a corrupt and self-seeking regime.[935] The disastrous years around 1800 destroyed much of the fabric of this system, but the spirit revived in the 19th century together with the revival of commerce and industry. Only recently have challenges been mounted against this spirit of oligarchy bred into most supervisory board members and managers. At the same time the walls of protection against outside influences on the leaders of Dutch public companies are being undermined.

[935] Zahn (2005), p. 262.

Boards not used to outside pressure
This cosy atmosphere was disturbed by the increase of foreign shareholders, many Enterprise Chamber cases, by new laws and the Code of 2004.[936]

Changes 2004 a culture shock
One could call these changes of 2004 a culture shock for many Dutch board members.[937] Those who were internationally trained had less problems.[938] It can be expected that Dutch boards have now become more attentive to foreign corporate governance practices, behaviour of directors and expectations of foreign shareholders. Discussions among directors and top managers of corporations now have to deal with the question of how to adapt to the new rules and the new circumstances that bring demands from foreign shareholders, the media and government supervisors. This study aims to contribute to this discussion.

4.2 Who are the shareholders of public companies?

Traditionally shareholders in the Netherlands have less power than in the UK. It is often said that shareholders in the Netherlands also have less say than in the US. This is not true from a legal point of view. On paper US shareholders have fewer specific rights, such as calling meetings or taking resolutions that the company must issue shares or suspend or dismiss directors. However, through shareholder activism and class actions in securities cases the rights of shareholders in the US have become stronger in the last 20 years. US shareholders, indeed, regard the boards as their representatives.[939] The importance of shareholder influence in the Netherlands is increasing, now there are many active US and UK shareholders of Dutch companies.

4.2.1 Sources of finance

There are many smaller family companies which make up a large equity percentage of the national economy. Family companies have their own

[936] SER (2008), pp. 35-40.

[937] Couwenbergh and Haenen, *Tabaksblat* (2008), p. 105.

[938] Bekenkamp (2002), p. 101.

[939] *Financial Times*, Wednesday, 23 February 2011, in article about Apple and the fight of shareholders for majority voting, the proxy issue of the season of 2011.

equity and have credit arrangements with banks. Larger companies raise money from banks in loans and from the capital markets.

4.2.2 Dutch banks do not use influence

In the Netherlands, as in the UK, banks do not have a large influence in the companies they finance. In the 1990s the Dutch government, including the then Minister of Finance, Mr W. Kok, promoted more correcting influence by financial institutions, but this never became a fact.[940] Although Dutch banks and pension funds held considerable shareholdings, they did not use their voting power to wield influence. With the recent credit crisis and the resulting reduction of bank lending, there is no reason to expect a growing influence of banks on Dutch companies.

4.2.3 Stock exchange not so important for peer control

As we are focussing on publicly listed companies, a word about the Amsterdam Stock Exchange is necessary. Its roots go back to the informal but regular meetings of merchants and traders in or around buildings and bridges in the 16th century. In 1602 a splendid building was inaugurated, specially designed for market activities. Besides commodities, insurance policies and letters of exchange, participations (shares) in the VOC and the WIC were traded. They were registered, but many creative manners were developed to transfer the shares or merely the economic rights. In the 17th and 18th century Amsterdam was the most important securities and money market in the world. In the 19th century a formal stock exchange was established with listings of Dutch and foreign shares, the Amsterdam Stock Exchange. It has rarely tried to play an important role in corporate governance, although it is, of course, in the position to accept or veto listings. It is now part of Euronext (Paris, Brussels, Amsterdam), which is in turn part of NYSE Euronext and is now merging with the Franfurter Börse.

For a short active period in the late 1980s the Amsterdam Stock Exchange insisted that companies, wanting to list their shares, adopt rules of good governance with the aim of reducing defence mechanisms. The "*Vereniging voor de Effectenhandel*" wanted freer trade in listed shares and initiated discussions with the association of listed companies. This

[940] Frentrop (2002), p. 385.

led to the setting up of the Peters Committee and resulted in the Peters Code.[941]

4.2.4 Who are shareholders?

Share-ownership typically remained fragmented from the 1900s up to the 1980s, longer than in Britain. Then Dutch pension funds and financial institutions started to buy shares of Dutch listed companies on a greater scale. Some of the big banks had 5% shareholdings in each other, but did not try to influence the corporate governance or strategy of their investments.

In 1995, listed shares in the 25 largest Netherlands' companies were held as follows:

– 19% by Netherlands private individual shareholders
– 19% by Netherlands companies (cross participations)
– 24% by Netherlands institutional investors
– 37% by foreign investors
– 1% by the Dutch government.

In 2005, the picture had changed. The percentage of shares held in the top 25 listed companies by foreigners had doubled from 37% to 75%. The percentage of Dutch private investors had been reduced to a mere 5%, cross participations by Dutch companies to 9%, institutional investors (10%) and the government (1%), bringing the total shares in Dutch hands to 25% only.[942]

In 2006, the percentages held in different countries of the total of listed AEX companies were:

– 21% in the Netherlands (total individual, companies and pension funds)
– 25% in the US/Canada
– 21% in the UK and Ireland
– 26% in the continent of Europe
– 7% in other places.[943]

[941] Willem J.L. Calkoen, 'De Commissie Corprorate Governance "Peters" zwengelt discussie aan', TVVS (1996), no. 96/12, pp. 333-338 ("Calkoen (1996)").

[942] Abma (2006/B), pp. 11-12.

[943] Monitoring Committee Corporate Governance Code of 3 August 2006, p. 10.

Foreigners held 79% of all listed Dutch companies. Only two years later, in 2008, the percentage of foreign held shares in all companies listed on the Amsterdam Stock Exchange had risen to 85%.[944]

Such big shifts had several causes. In 1999 the Euro giro system was introduced, which meant that Dutch investors were advised and facilitated to invest all over Europe. Dutch pension funds were only allowed to invest in foreign shares after 1996. In 2001 the Netherlands suffered from the Ahold and World Online scandals with a depressing effect on the Dutch stock market. Foreigners started buying when they perceived that Dutch shares were undervalued. No other European stock market has such a high percentage of foreign held shares as the Amsterdam Stock Exchange.

Among these foreigners US and UK activists in particular elicited discussions with Dutch boards, initiatives to which Dutch directors had not been accustomed. The Dutch Association of Investors ("VEB") plays an important role in these discussions. The VEB has started litigation on corporate governance matters, such as in the *ABN AMRO* case.[945] Foreigners did not restrict themselves to initiatory discussions with boards of Dutch companies. Dutch pension funds, organized in an association, called Eumedion, usually combine their comments at shareholders meetings. [946] US shareholder activists started action against both ABN AMRO in 2007 and Stork in 2006,[947] which ended up in litigation in the Enterprise Chamber. Hedge funds and the UK pension fund Hermes have started Enterprise Chamber proceedings against ASMI in 2010.[948]

In the same period many boards of Dutch listed companies attracted foreign board members. As mentioned before, by 2006 more than a third of the total of management and supervisory board members of Dutch

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[944] Abma Report for 1995 and 2005 and SER (2008), p. 33 for 2002 and 2007.

[945] See for description of the *ABN AMRO* case, note 928.

[946] When Eumedion – the Dutch Association of Pension Fund Investors – writes to give its views it sometimes also writes in the name of CalPERS, which in June 2008 had EUR 1.2 billion invested in the Netherlands, e.g. the letter of 28-09-2009 of Eumedion.

[947] See for description of the *ABN AMRO* case, note 928, the whole merger development and necessity for ABN AMRO to make strategic moves had been triggered by a "dear chairman letter" of the US investor TCI. The *Stork* case is described in 4.4.2.2 where structure regime companies are described.

[948] *ASMI*, HR 9/7/2010, NJ 2010, 544, see note 908 in 4.1.5.

listed companies were foreigners.[949] This has changed the atmosphere of the Dutch board dynamics substantially.[950]

4.2.5 Convergence: adaptation of Dutch legal concepts to foreign ones

In this section – "who are the shareholders?" – this sub-section 4.2.5 on adaptation of Dutch legal concepts to foreign concepts is a side step. As will be seen it is an important point of the Dutch legal culture. The reason for the adaptation is amongst others to favour the wishes of the foreign investors, who represent more than 70% of the shareholders in Dutch listed companies. Dutch company law in many ways meets special wishes of foreign investors. First, exemptions were introduced in company law in the 1970s and 1980s, for certain holding companies from a variety of legal requirements for Structure Regime companies as well as exceptions from obligations regarding the consolidation and publication of accounts. Many of the changes introduced by the Tabaksblat Code and the subsequent changes in company law of 2004 can be seen as an adaptation to UK practices. Second, in December 2009 the Act on the alternative of a one-tier board system and the draft act on a more flexible BV law was accepted by the second house of representatives, "*de Tweede Kamer*", and the Act has been approved by the Senate, the "*Eerste Kamer*" on 6 June 2011. Third, several legal concepts, such as the interpretation of agreements, good faith in negotiations and the interest of the company, connected with the stakeholder model, are in some cases being interpreted by the Dutch courts in the light of English-American jurisprudence and international trade practices.

First, exceptions for foreign holding companies
The Act on Structure Regime Companies, introduced in 1971, required large companies with more than 100 employees and an equity of € 16 million or more, to have a supervisory board. Such a board was given the

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[949] Fennema and Heemskerk (2008), p. 186. This is still the case in 2010. On all AEX companies there are 101 Dutch supervisory directors and 64 foreign supervisory directors, see the Monitoring Committee Report of 2010, p. 44.

[950] Prof. J.A. van Manen, in his thesis of 1999, *Monitor in het belang van de vennootschap. Een analyse van de functie van commissarissen* ("Van Manen (1999)"), has quoted various opinions of Dutch supervisory directors among which we find the view that foreign board members help to change the tendency amongst Dutch directors to protect each other, p. 292. I have also been informed by a supervisory board member of a major Dutch listed company that the foreign members of that supervisory board asked the board to consider a change to a one-tier board system.

right to co-opt itself, to veto important transactions and to appoint the managing directors.[951] Such a structure regime is unattractive to foreign investors; it reduces shareholder influence to the extent that even a majority shareholder does not have control over the company. At the request of the Dutch Association of Entrepreneurs exemptions were added in the 1971 Act on Structure Regime Companies to mitigate this regime for Dutch companies with more employees outside the Netherlands than in the country. In such cases shareholders appoint and dismiss the managing directors.[952] Furthermore holding companies that only have the function of financing a group of companies and again have more employees outside the Netherlands than in the country, are exempt from all the legal requirements of the structure regime.[953] The reasoning is that the Netherlands has employee participation rules, but that these rules only apply to the territory of the Netherlands. One of the reasons for these exemptions was to facilitate foreign investors. This still applies, as was reconfirmed by an advice of 2008 of the Social Economic Council, *Sociaal Economische Raad* (SER), the forum for consensus discussions between government, employees and entrepreneurs.[954]

Other facilities for foreign and Dutch international concerns that have intermediate holding companies in the Netherlands are: first, that the intermediate holding company does not have to consolidate its accounts with its subsidiaries,[955] second, that it does not have to have its accounts publicly registered[956] if its European top parent company has consolidated this intermediate holding into its accounts and has filed a statement that it guarantees all obligations of the intermediate holding company. These are special Dutch facilities for intermediate holding

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[951] See for a further explanation 4.4.2 below.

[952] Article 2:155/265 DCC; Van der Grinten (1989), pp. 68-71. Van Solinge and Nieuwe Weme (2009), p. 673; Winter (2006), p. 403; P. Sanders and W. Westbroek, *The BV and NV*, adapted by Paul Storm and F.W. Buyn, 9[e] druk, Serie Recht en Praktijk, no. 23 (2005), p. 244 ("Sanders, Westbroek, Storm and Buyn (2005)").

[953] Article 2:153/263, 3 DCC; Van der Grinten (1989), pp. 71-74; Van Solinge and Nieuwe Weme (2009), pp. 674-676; Winter (2006), p. 407; Sanders, Westbroek, Storm and Buyn (2005), p. 242.

[954] SER (2008), pp. 24, 28 and 41.

[955] Article 2:408 DCC; Van der Grinten (1989), p. 599; Winter (2009), p. 3278; Sanders, Westbroek, Storm and Buyn (2005), p. 448.

[956] Article 2:403 DCC; Van der Grinten (1989), p 615; Winter (2009), pp. 328-329; Sanders, Westbroek, Storm and Buyn (2005), pp. 441-442; Maeijer (1994), pp. 606-611; Prof. H. Beckman, *De jaarrekeningvrijstelling voor afhankelijke groepsmaatschappijen*, thesis (1995), pp. 367-434 and especially the English summary on pp. 797-805.

companies that the Netherlands wishes to attract. There are many intermediate holding companies in the Netherlands, because of the many double tax treaties and the tax exemption for income and capital gains from a subsidiary, called the participation exemption and a dependable ruling system to go with it. This participation exemption differs from the tax credit system known in most other countries and can be considered as further evidence of the Dutch international trading tradition.

Many aspects of the Tabaksblat Code of 2004, such as the mentioning of the possibility of a one-tier board system are to be seen in the light of adapting to foreign business practices. The same applies to the Act on changes to the Structure Regime of 2004, including changes such as appointment of the supervisory board by shareholders and a say for shareholders on important transactions.[957]

Second, draft laws on the One-Tier Board and on the Flexible BV
Since the introduction of the BV (limited company) in 1971, comparable with the UK Ltd., the German GmbH and the French Sarl, the Dutch BV law was nearly the same as the NV law and rather rigid. In December 2009, the second House of Parliament, "*de Tweede Kamer*", accepted a draft for a law on the BV very different from the NV law. The draft contains many provisions facilitating foreign investors. The law is called the Act on the Flexible BV with pliable rules for calling general meetings, the possibility to hold general meetings outside the Netherlands, and to adopt shareholders' resolutions in writing outside a meeting, the creation of shares of various classes with different votes and profit rights, with flexibility for the appointment of directors, feasible qualitative requirements for directors, the possibility for shareholders to give binding instructions to directors, the exclusion of transferability of shares and the deletion of capital protection requirements, such as the elimination of financial assistance rules for BVs. In the same month of December 2009, the draft law on the possibility of a one-tier board as an alternative to the existing two-tier board system for NVs and BVs was accepted by the "*Tweede Kamer*" and has been confirmed by the *"Eerste Kamer"* on 6 June 2011. These initiatives indicate the willingness of the Dutch government and even the trade unions, who supported these bills, to further adapt Dutch corporate laws to Anglo-American practices.[958]
The fact that there has been an increase of foreign shareholding in Dutch

[957] See sub-section 4.1.5.

[958] Parliamentary Papers II 2008/09, 31763, no. 5, p. 1.

listed companies from 37% in 1995 to 85% in 2008 shows that the Netherlands has been an attractive centre for foreign investors and for internationally operating foreign conglomerates.

Third, adaptation of legal concepts

The judiciary too has contributed to this internationalisation of Dutch company law, in two areas: interpretation of agreements and negotiating parties not bound..

Interpretation of agreements: intent or text.

In the 1980s and 1990s the Supreme Court seemed to let the supposed intent of the parties and the principle of reasonability prevail over the literal text of written agreements. The cases *Haviltex*[959] of 1981 and *Hoog Catherijne*[960] of 1995 are examples of this type of interpretations.

This created confusion among English and American parties who are used to extensive and exhaustive documents. Recent decisions of the Supreme Court indicate that an unambiguous and clear contractual clause has to be interpreted according to its obvious literal meaning, especially if both parties are experienced and have been advised by legal and financial

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[959] *Haviltex*, HR 13/03/1981, NJ 1981, 635.

Haviltex of 1981was an important case of interpretation of contracts. Haviltex had bought a foam cutting machine. There was a short clause in the agreement, giving Haviltex the right to return the machine before the end of that year. Further details of this clause were worked out in later letters, which could be said to deviate slightly from the literal text of the clause. Haviltex, arguing that the further details in the letters should be used for the interpretation of the intent of the parties, won in all courts and the Supreme Court said that the text of an agreement should not only be interpreted according to the literal text, but also in accordance with the intent of the parties.

[960] *Hoog Catherijne*, HR 22/12/1995, NJ 1996, 300.

Hoog Catherijne of 1995. ABP (*Algemeen Burgerlijk Pensioenfonds*), the largest Dutch pension fund for public officials bought a real estate project in Utrecht from HC BV, a joint venture of two large Dutch real estate investors. In the acquisition agreement HC BV had warranted that its balance sheet was correct. ABP did a thorough due diligence with expert advisers. ABP, referring to the warranty of HC BV of its balance sheet, which did not show two debts of a total of Hfl 7.5 million, claimed damages, i.e. these higher debts from HC BV. ABP won in the district court, but lost in the Appellate Court and the Supreme Court. The highest courts argued that ABP, notwithstanding the clear warranty, should have asked more questions and should have had a closer look at documents it received at the last moment. The higher courts use the argument of "reasonability". The judgment made parties in M&A transactions insecure about obligations of the seller and the buyer, when a due diligence exercise takes place.

experts and certainly if the agreement contained an "entire agreement clause". *Meijer/Pontmeijer* of 2007[961] is an example.

Negotiating parties bound by their intent, unless they explicitly confirmed an opt out

In the 1980s there were several judgments, e.g. *Plas/Valburg* of 1982,[962] which made clear that if parties negotiated and showed an intent to continue the negotiation, one party could not suddenly terminate the negotiations without incurring liability. There was a so called pre-contractual good faith obligation to continue the negotiations or conclude them in an orderly fashion. This caused problems for UK and US parties, in mergers and acquisitions negotiations. They were used to having an easy way out, by stipulating in their letter of intent that all offers are "subject to contract". Judgments of the 1990s made it clear that if a letter of intent contained a "subject to contract" clause, parties could make use of this literal text: *Van Engen/Mirror* of 1995 and *De Ruyter/MBO* of 1997. [963] This is another example of Dutch jurisprudence adapting to international business practices.

The interest of the company, stakeholder or pluralist model; is there a tendency to pay more heed to the long term shareholders' interest?

One of the principles of Dutch company law is that directors act in "the interest of the company and its enterprise", in Dutch "*belang van de vennootschap en de met haar verbonden onderneming*". This is the "pluralist" or "stakeholder" approach. The question is: is the tendency of convergence and adaptation to international trends as described above in this sub-paragraph a reason for demanding more attention to long term shareholder interests?

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961 *Meijer/Pontmeijer*, HR 19/1/2007, NJ 2007, 575.

In a typical M&A negotiation about a Share Purchase Agreement, SPA, there was a tax indemnity in which the seller indemnified the purchaser and the target for all tax consequences. The clause mentions an exception for the period "as of the date of the running financial year". The buyer argued that the literal final text should apply, especially because there was an "entire agreement clause", unless the seller can prove that parties "meant something else". The Appellate Court and the Supreme Court followed the buyer's argumentation: the literal text should apply but a party may prove that "parties meant differently".

962 *Plas/Valburg*, HR 18/6/1982, NJ 1983, 723.

963 *Van Engen/Mirror*, HR 24/11/1995, NJ 1995, 162 and *De Ruyter/MBO*, HR 14/6/1996, NJ 1997, 481.

The term the “interest of the company” was already used as an argument by the supervisory board in their defence against a threat of a takeover in the case of the *Doetinchemse IJzergieterij*, as early 1949.[964]

In 1971 the DCC introduced the obligation for supervisory directors that they should execute their duties in the interest of the company and its enterprise (article 2:140/250 DCC). The addition of the words “and its enterprise” was meant to stress the point that all factors should be taken into account, including the interest of subsidiary companies.[965]

In the Netherlands some authors, including Maeijer, argue that the “interest of the company” is one single concept of the continuity of the enterprise while others, including Van Solinge and Nieuwe Weme, Van der Grinten and Van Schilfgaarde and Winter see it as a mix of various interests. Those who see it as a mix of various interests go on to say that the directors should weigh the interests and decide according to the “upshot”, in Dutch “*resultante*”.

In my view directors must consider all the interests and may then decide as they deem fit. I do not think the words “weigh”, “upshot” or “resultant” are realistic. Entrepreneurial directors’ decisions are not based on arithmetical weighing of interests with one answer. In many situations more than one decision can be a reasonable decision. Then there is not one and only one correct decision. I would like to add that in the last decade communication has become more important in recent years. Directors must inform all interested parties in time. I would summarize my view as: consider all interests, freedom of entrepreneurial decision, proper and timely information to interested parties; in other words a business judgment rule with proper information to all parties as an additional element.

Strangely enough, the concept of “the interest of the company” was not mentioned in the articles of the 1971 DCC, dealing with the specific task of the management directors. Most authors, however, agreed that managing directors too have to be guided by “the interest of the company”. These words have been included in the task description for all

[964] *Doetinchemse IJzergieterij*, HR 1/4/1949, NJ 1949, 405.

[965] Van Solinge and Nieuwe Weme (2009), pp. 479-480 and Assink (2010), p. 38, describe the discussion between Maeijer, and others about the “interest of the company”.

directors, both management and supervisory, in article 2:129/239, paragraph 5 DCC of the Act.

It is important to discuss this principle, because first, it is seen by many as the beacon or the compass for all directors (supervisory, managing, non-executive and executive directors), second, it is broad enough to apply in different situations, third, it is sufficiently vague to allow for the development of an interpretation based on case law, and fourth, it is comparable with the UK Common Law principle of the "interest of the company", updated in section 172 of the Companies Act 2006 to the "success of the company" or "enlightened shareholder value". It also tallies with the US concept that the directors have fiduciary duties of loyalty to the company in combination with the business judgment rule to act in the interest of the company.

What does the duty to act in "the interest of the company and its enterprise" mean? Under Dutch law, as in UK and US law, the trend seems to be that directors, when making a decision, should consider all factors and interests, i.e. the interest of shareholders (long-term, short-term, large, small, minority, etc.), managers, employees, creditors, the community, e.g. the environment, associated companies and other constituencies. As long as all those interests are running in tandem, there is no problem, but what if there is a conflict?

Professor L. Timmerman wonders whether all these interests should carry equal weight or whether there should be a hierarchy, and if so, should the long-term shareholders carry the heaviest weight?[966]

Timmerman refers to the Tabaksblat (2004) and Frijns (2008) odes, especially to preamble no. 7 to the Frijns Code: "The code is based on the principle accepted in the Netherlands that a company is a long-term alliance between the various parties involved in a company. The stakeholders are the groups and individuals who, directly or indirectly, influence – or are influenced by – the attainment of the company's objects, i.e. employees, shareholders and other lenders, suppliers, customers, the public sector and civil society. The management board and supervisory board have overall responsibility for weighing up all these interests, generally with a view to ensuring the continuity of the enterprise, while the company endeavours to create long term shareholder value". Furthermore he refers to section 172 of the UK

[966] Timmerman, Speech (2009), which journal contains the text of his "oratie", his formal speech accepting the appointment of professor of the principles of company law at the Erasmus University on 19 December 2008.

Companies Act 2006 with its concept of the "success of the company" and "the enlightened shareholder value".

The "interest of the company" has been a subject for many corporate law authors in the last few years.[967]

Professor Alexander Rinnoy Kan, Chairman of the SER, has said "the supervisory board should be accountable to stakeholders once per year, at least to the prime shareholders and employees". [968]

What can the Dutch learn from the English and American concept of "interest of the company"?
The "interest of the company" is an old, well-known term in UK Common Law. Section 172 of the Companies Act 2006 – and especially the relevant debate about it – builds on the vague text "interest of the company"the modern term "the success of the company", which appears in the text of this section 172. The accepted interpretation rejects a "pluralist" approach (in the UK the term "pluralism" means equal treatment of all factors making up the "interest" or the "success" of the

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[967] H.J. de Kluiver, 'Vennootschappelijke repliek op Timmerman's grondslagen', *Ondernemingsrecht* 2009/4, pp. 17-20; J.M.M. Maeijer, *Het belangenconflict in de naamloze vennootschap*, oratie (1964) ("Maeijer (1964)") and 25 years later, '25 jaren belangenconflict in de Naamloze Vennootschap', NV 67/1, January 1989 ("Maeijer (1989)"); Van der Grinten (1989), p. 445; H.J.M.N. Honee, 'Commissarissen, gezanten uit Niemandsland?', NV 1996, no. 11, p. 276; P.C. van den Hoek, 'Vrijheid alleen is niet genoeg, een reactie', *Ondernemingsrecht* 2006/9, pp. 24-27; Timmerman (1999), pp. 43-51, specifically p. 44, in which article Timmerman already foresees a One-Tier Board Act, see p. 49; M.W. den Boogert, 'De vergeten band tussen raad an commissarissen en algemene vergadering: De Januskop van de commissaris', *Ondernemingsrecht* 2005/87 ("Den Boogert (2005)"); Van Schilfgaarde and Winter (2009), pp. 11 and 212 and Jaap Winter, 'Level Playing Fields Forever', in H. Beckman, H.L. Kaemingk and C. Honée (eds.), *De nieuwe macht van de kapitaalverschaffer* (2007), pp. 7-8 ("Winter (2007)"); Assink in Assink and Strik (2009), pp. 67-71. In short, Van den Hoek, Den Boogert and Winter give the view that the supervisory board should pay more attention to the interests of the shareholders, at least more than before 2004. In this view Den Boogert goes furthest in favour of shareholders generally, while Van den Hoek makes the nuance of long-term shareholders interest. There is criticism on this extreme favouring of shareholder interest of Den Boogert by Assink, who asks what shareholder interest is, because there are so many varied shareholder views. There is also criticism of favouring long-term shareholders by De Kluiver, who asks what long-term shareholder interest is, because there may be many views on the subject. I believe the UK and US experiences can help here.

[968] Chairman of the Social Economic Council, "SER", the forum of discussions between government, employers and employees in his speech to company lawyers on 14 November 2008; *Bestuur en Toezicht*, uitgave vanwege het Instituut voor Ondernemingsrecht, RUG, no. 67.

company) and imposes on a director the obligation "to have regard" to all factors, many of which are defined, including the meaning of "long-term". His basic duty is to promote the purposes of the company "for the benefit of its members as a whole". This may go contrary to the aims of short-term shareholders.[969] It is up to the directors, in good faith to determine what policies the success of the company demands.[970] Directors are, in the UK, expected to make business judgments and decisions in good faith, and courts are generally reluctant to second guess those judgments and decisions.[971]

The Attorney General, Lord Peter Goldsmith, said in Parliament in 2006[972]: "under the duty to promote the 'success of the company' the weight to be given to any factor is a matter for good faith judgment of the directors. Importantly, his decision is not subject to a reasonableness test, and, as now, the courts will not apply a reasonableness test to directors' business decisions." I call this: "the director is free to decide" and I add: "as entrepreneur". With respect to "entrepreneurship" I refer to the words "entrepreneurial leadership" in A1 supporting principal of the UK Corporate Governance Code, discussed in 2.5.3 above.

Communication is also important. In the Netherlands information to shareholders should be developed further than up to now.

A recent UK study[973] discusses categories of shareholders: founders, families, foundations, employees, engaged shareholders, unengaged shareholders, such as some investment institutions and sovereign wealth funds, traders and speculators, such as hedge funds, and says that without saying that any particular category is good or bad the first are logically interested in long-term strategy or "stewardship", while others play in a "casino economy" and are useful for liquidity of the market. The study finds indicators that shareholders who are not interested in stewardship may be on the increase and globalization of capital markets could make communication between boards and shareholders more difficult. It concludes with the opinion that directors should focus their dialogue on

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[969] Davies (2008), pp. 507-519.

[970] Smerdon (2007), p. 89.

[971] Smerdon (2007), p. 94.

[972] Mayo in Rushton (2008), pp. 127-128.

[973] Goyder (2008/A) and (2008/B).

the stewardship shareholders which would require them to obtain a clearer picture of whom and where such shareholders are.

In the US boards do not have to follow shareholder instructions. Shareholders have the right to elect directors, but not to give them binding instructions. The directors must take their own decisions, but with requirements of due process. US judges apply the business judgment rule. There is no reasonableness test, but alternatives and the interests of the company and all concerned must have been considered. A decision may in no way be disloyal to the company, i.e. no self-interest: loyalty to the long-term shareholder interests, not plurality, is the US bright-line.

US practice makes a distinction between shareholders, from “traders” to “strategic investors (like Buffet and Monk)”. It is also held advisable to communicate directly with these long-term shareholders.[974]

On the other hand, Netherlands’ jurisprudence, for example *ABN AMRO* of 2007 and *ASMI*[975] of 2010, supports pluralism in the Dutch sense. Boards should consider all interests involved. This could lead to several alternatives, resulting in several acceptable business judgments.

Now we come back to the question of hierarchy when considering the interests and the influence of shareholders. Dutch, like their US and UK colleagues, do not have to follow instructions from shareholders.[976] Traditionally, Dutch boards could even behave remotely towards shareholders. As we have seen (vide preamble 7 of the Frijns Code above and the laws of 2004 in favour of shareholders), a growing influence of shareholders has been acknowledged in Dutch corporate culture. There is a strong current in UK and US literature that recommends boards to communicate with those shareholders who are interested in long-term stewardship.[977]

For the Netherlands I would like to refer to the *Verenigde Bootlieden* case of 1994, where the Supreme Court said that there can be reasons to deal with different shareholders in different ways and to the *DSM* case of 2007

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[974] Brancato (1997), pp. 11-33.

[975] See notes 928and 908 above.

[976] *Forumbank*, HR 21/1/1955, NJ 1959, 43.

[977] Goyder (2008/A) and (2008/B) and Brancato (1997).

and especially in the conclusion to that case of the advocate general.[978] In the Netherlands the literature on one-on-one meetings of directors with shareholders started with Eisma,[979] who realized in 1998 that the Dutch should adapt to the UK and US practice, but concluded that he was basically against one-on-ones, because he found two dangers: such contacts could be in contravention of the principle of the equality of shareholders expressed article 2:92, paragraphs 1 and 2 DCC and could lead to insider trading prohibited by the then *Fondsenreglement* 28h. Professor Vletter-Van Dort[980] in her thesis deals with these aspects in detail and basically agrees with Eisma, but does find examples of exceptions for the equality of shareholders and concludes, along the lines of the *Verenigde Bootlieden* judgment, that if it is in the interest of the company to make an exception to this principle, the court should allow it. I would argue that it can be in the interest of the company to have one-to-ones with shareholders, who have a long-term interest and with any shareholder who expresses the wish to have a one-on-one with the board. I do realize the danger of spreading insider knowledge which article 28h of the former *Fondsenreglement* intended to avoid and which prohibition is now laid down in articles 5.25i and 5.27 of the Act on Financial Supervision (*Wet Financieel Toezicht*).

Generally institutional investors in the UK have larger percentages of shares than Dutch investors have. This would seem to decrease the Dutch interest in one-on-ones. However, 56% of the Dutch listed companies report to have more than 12 one-on-ones per year and 34% report to have more than 50 one-on-ones per year.[981]

Boards should sound out long-term shareholders and listen. A good base of long-term shareholders is important and worth cultivating. Because shareholders fall in different categories, boards should be free to choose with which sort of shareholders they communicate. They must make their

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[978] *Verenigde Bootlieden*, HR 31/12/1993, NJ 1994, 436 and *DSM*, HR 14/12/2007, NJ 2008, 105 with conclusion Advocate General L. Timmerman.

[979] Prof. Mr S.E. Eisma, 'Investor Relations', inaugural speech (The Hague 1998) ("Eisma (1998)")

[980] Prof. Mr H.M. Vletter-Van Dort, *Gelijke Behandeling van Beleggers bij Informatieverstrekking*, thesis (2001) and Prof. Mr H.M. Vletter-Van Dort, 'Nogmaals gelijke behandeling van aandeelhouders', in J.B. Huizink, J.B. Wezeman and J. Winter (eds.), *A-T-D Opstellen Aangeboden aan Prof. mr P. van Schilfgaarde* (2000), p. 429, who was not in favour of any exceptions.

[981] Aandeelhouders Rapport Nijenrode (2010), p. 80. One-on-ones also called one-to-ones.

communication policy public on their website.[982] Thoughtful communication should be established with all "stakeholders" as this is usually directly or indirectly in the interest of long-term shareholders. Boards should communicate with relevant stakeholders in specific cases, but in all cases with shareholders. The UK practice is in favour of one-on-ones, also called one-to-ones. The UK FSA has issued a guideline for this. In the US the Securities and Exchange Commission (SEC), and in the Netherlands the *Autoriteit Financiële Markten* (AFM), have set up websites with question and answer programmes on the subject of one-on-one meetings between representatives of a board and individual shareholders. Both authorities confirm that one-on-ones are permitted. They emphasize that boards in such one-on-ones must not give sensitive information, that is not available to others.[983] In the Netherlands, the AFM has, after one of its directors said he was against one-to-ones, issued a Q&A – comparable with the SEC's Q&A – confirming that one-to-ones are permissible with caveats for sensitive information. Sometimes lock-up and secrecy agreements will be necessary.[984] The UK Stewardship Code of 2010 also emphasizes that representatives of institutional investors should meet with board members. This Code advises at the same time that institutional investors should avoid becoming insiders.[985] One-on-ones with selected shareholders are usually held by the CEO and CFO, sometimes in the presence of the chairman of the supervisory board or of the one-tier board. In some cases of one-on-ones it may be necessary to agree to lock-ups restricting trade in shares of the company for a specific period.[986] The Frijns Code, too, deals with this

[982] Frijns Code requires to do this, IV.3.13, but hardly any listed company in the Netherlands has followed up on this, yet. Philips N.V., which in my view does communicate excellently, does mention its policy in its annual accounts and refers to its website, but the website does not yet contain such policy. The Monitoring Report of the Committee Streppel of 2010 complains about the lack of this follow-up.

[983] SEC letter of 4 June 2010, Regulation FD Question and Answer 101.11, see chapter on US section 3.2.3; Dutch AFM website http:/www.afm.nl/nl/professionals/diensten/veelgestelde-vragen/marktmisbruik/one-on-ones-aspx?perpage=10. The UK FSA has issued a guideline for this purpose, DR 2.2.10 http/fsahandbook.info/FSA/html/handbook/DTR.

[984] Q&A to be found on website:
http:/www.afm.nl/nl/professionals/diensten/veelgestelde-vragen/marktmisbruik/one-on-ones.aspx?perpage=10.

[985] The UK Stewardship Code of July 2010 made by the Financial Reporting Council describes visits with board members in principles 1, 2 and 3.

[986] See also Prof. Dr. A.W.A. Boot and Prof. Dr. K. Cools R.A. in their advice to the Royal Association for Country Policy, 'Private Equity and aandeelhouders activisme' (2007). They promote (a) more transparency with and among shareholders, market manipulation, (b) lock-ups for shareholders that have one-on-ones, (c)

subject, vide preambles 9 and 10: "the greater the interest, which the shareholder has in a company, the greater is his responsibility to the company …" (see 9) and "good relations between the various stakeholders are of great importance in this connection, particularly through a continuous and constructive dialogue" (see 10). Dutch boards could and should have one-on-ones with stewardship shareholders, follow the UK example of listening, and publish their policy in this matter on their website.

The UK and US examples teach us that classifying shareholders in different categories and ranging these groups into an order of priority is a worthwhile effort.

"Hierarchy", according to UK and US ideas, does mean that in all decisions the boards must think of the long-term shareholders. If there are no shareholders that express a view it would be the imaginary long-term shareholder and if there is a shareholder who expresses a long-term view, boards must consider these views. They must take time and energy to explain their thought process to shareholders. It is important for the board to manage its relationship with shareholders. The board must make clear what its strategy is, what growth it is aiming for and what acquisition strategy it has. If an opportunity comes about to buy a company, it should go ahead without asking shareholders and explain immeditely after the acquisition how it fitted in the strategy. If it does not give this information, it will have a problem.[987]

The same applies to closing a factory. Communication in advance with the works council and later with shareholders as well is vital. Boards should be free in their good faith business decisions and free from a reasonableness test, but they should take time to explain to shareholders. This implies that I am in favour of giving long-term shareholders a higher position on the ladder of information obligations, because they are always concerned.[988]

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use of transparency defence mechanisms and (d) quorums for dismissal of directors.

[987] Couwenbergh and Haenen, *Tabaksblat* (2008), pp. 110-113.

[988] In connection with "hierarchy" it is interesting to mention Van Manen (1999), pp. 256-261. He asked 45 supervisory directors whether they would consent to a mass dismissal of employees, if this would (a) cause substantially more profitability, (b) cause the enterprise to at least make a minimal profitability instead of losses and (c) protect its continuity, i.e. avoid bankruptcy. In all cases, the majority and in the last case 100% of the supervisory directors responded that they would favour a decision for mass dismissal. Of course, the supervisory board would require proper communication with shareholders, the Works council and unions.

4.3 Formal acts and informal codes

Dutch corporate governance law is based on Book 2 DCC and the Frijns Code of 2008 on best practice, which succeeded the Tabaksblat Code of 2004. The DCC is discussed at the end of sub-section 4.1.5 and in sub-section 4.6.2. The Tabaksblat and Frijns Codes are discussed at the end of sub-section 4.1.5 and in sub-sections 4.5.2 and 4.5.3. The Netherlands is a civil law country and has detailed legislation on NVs and BVs in Book 2 DCC, which contains a large number of stipulations, many of which are mandatory law and some of which are optional. In addition, corporate governance is influenced to a large extent by the Frijns Code, which is regarded as soft law in the “comply or explain” tradition, taken over from the UK system of codes of best practices. In the same way in the UK listing rules, there is an obligation in the Netherlands to report about deviations from the Frijns Code in the annual report of the company.[989]

4.4 Composition of Dutch boards, division of tasks

4.4.1 Introduction

The UK and the US have only a one governance system, i.e. the one-tier board system. The compositions of UK and US average boards were alike up to the 1980s. They had a CEO, who was also chairman, about 3 other executive directors and 4 or 5 outside directors. Since 1993 the UK made changes to separate the functions of CEO and chairman, maintaining the 3 other executive directors and the 4 or 5 outside or non-executive directors in order to have a balanced board. In the US changes were different. There was a focus in the 1990s, and certainly from 2002, on a strong majority of independent directors. The typical board is composed of a CEO, who in most cases is also chairman and about 7 to 8 independent directors, who are typically led by a lead director to create counterbalance. The other executives, officers apart from the CEO, are not on the board, but do attend meetings. Since 2002 many US companies have instituted executive sessions of independent directors meeting alone and are gradually going over to appointing a separate non-CEO chairman.

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[989] Article 2.391,5 DCC.

We see that the UK and the US have one and the same basic system with large flexibility and that the composition has changed in the last 20 years in different directions.

The law in the Netherlands specifies two possible systems: a simple management board or a two-tier board. The institution of a supervisory board is optional in the Netherlands, but for larger companies it is the norm. Most larger companies have a management board of about 3 or 4 and a supervisory board of about 6 members. Furthermore there are special large companies, the Structure Regime companies, that must have a supervisory board with specific powers. Then the Act of 6 June 2011, which is expected to be effective on 1 January 2012, makes the one-tier board a possible alternative for all companies, next to the two-tier system, whether in a Structure Regime company or not. This means that from the date that the Act has become effective, there will be five alternative compositions of boards: first, the simple monistic management board system, used for many small companies and a few larger ones, second, the two-tier board system used in most large companies, third, the two-tier board Structure Regime companies for even larger companies, fourth, the one-tier board companies and, fifth, the one-tier board Structure Regime companies. These compositions will be discussed hereafter in section 4.4.

As in the UK and the US, Dutch companies too should have (i) a purpose, (ii) a strategy, (iii) policies, (iv) risk management, (v) succession, (vi) evaluation systems, and (vii) a policy for communication with shareholders and other interested parties, such as employees, customers, suppliers and society. All these elements must be developed, implemented and monitored. The members of two-tier boards or of one-tier boards have to work together to fulfil these tasks. The question is what best practice for the composition of the board can be developed in the Netherlands to fulfil all these elements and roles in the most efficient way and to avoid inefficiencies brought about by risks such as the “imperial CEO”, “group think”, loafing in acceptable sub-optimal work, lack of teamwork, continuing disputes and/or lack of communication.

This section (4.4) describes the various practices in the Netherlands for the composition of the board. First it describes the legal basis of the normal Dutch two-tier board system, the structure regime, examples of the use of the one-tier board system under present law and the description of the new Act on the alternative of a one-tier board (4.4.2); followed, second, by a description of the composition of what average boards look like in the usual two-tier boards, the present one-tier boards and expected future one-tier boards under the Act (4.4.3); and the changes in board composition brought about by the codes, and creation of committees (4.4.4); as well as the element of non-executives being in the majority on the future one-tier board (4.4.5) and size (4.4.6). These aspects are followed by a summary concerning composition of boards in the Netherlands (4.4.7). This section 4.4 on the composition of the board(s) will be followed by a section describing the role of each type of director in the different compositions (section 4.5), followed by sections on duties (section 4.6) and liabilities of directors (section 4.7).

4.4.2 Dutch board composition, present and future

4.4.2.1 *Dutch board composition, usually two-tier board*

Dutch company law is described in Book 2 DCC. Every Dutch NV must have a management board. A supervisory board is optional. Most companies, that are listed or have more than one shareholder, have two boards. Having a two-tier board system, is part of Dutch corporate culture. As described before, throughout the centuries Dutch companies have had separate supervisory boards with functionaries, who were not part of the management board and had an independent role in looking after the interests of the shareholders and others involved with the enterprise and sometimes in providing support for management. The background of this culture is described in 4.1.6C and D above. The early "*polder*" enterprises were commercial project development enterprises, that also had as aim to create and run the villages and churches in the "*polders*". The VOC had the aim of trading for profit and at the same time had a colonial and a naval defensive role. Most 17th century enterprises had dual commercial and communal objects.[990] This meant that it was logical to ask for outsiders in a supervisory role to check and support management in connection with these other interests. In this atmosphere the committees that had a monitoring role in the name of shareholders, such as in the VOC from 1623 did so independently without reporting to the shareholders. These committees, from 1720 called supervisory boards, always functioned in a limited advisory and non-directive role. At the same time these independent functionaries were to advise management independently about other interests connected with the enterprise and these distant functionaries also often had a direct or indirect role in the nomination and appointment process of board members, from the city chambers in the VOC to the binding nominations in Royal Dutch Petroleum, to the structure regime. It is with this background that Dutch company law describes the role of the supervisory

[990] Van der Grinten (1955) and (1989), pp. 4-5.

board as supervising and standing by the management board with advice, taking all interests into account.[991]

4.4.2.2 *Structure regime supervisory boards*

In the 1970s worker participation became important. The Netherlands chose for a different two-tier board system from Germany. In Germany supervisory boards of large companies had to make nearly 50% of the seats available for representatives of trade unions. In the Netherlands this option was not chosen, because neither the unions nor the enterprises wanted union members or employees on the supervisory board. Most UK and US literature dealing with two-tier boards looks at the German system.[992]

The two-tier system of Germany has a history and culture of its own since the *Allgemeine Deutsches Handelsgesetzbuch* of 1861, of the period following the unification of Germany. Since the *Aktienrechtsnovelle* of 1870 larger companies had a mandatory supervisory board, "*Aufsichtsrat*", of shareholder representatives. The *Aktienrechtsnovelle* of 1884 made it possible for non-shareholders to be supervisory board members. They could supervise especially, because of their qualities. The law gave a further description of the supervision function. Further reforms were introduced with the employee participation rules of 1920, 1931 and 1937. There were further changes in 1951, 1952 and 1976, which reform describes that AGs with more than 2,000 employees just below half of its supervisory board members had to be employee representatives.[993]

In the international arena the Dutch were able to develop a two-tier system that on the one hand gives some influence to works councils, at least for consultation and good communication and maybe even in some cases for sounding out the employee base for strategic decisions, and on the other hand does maintain the possibility for the management board to continue its management function with limited outside interference and in harmonious consultation with a supervisory board. This system was laid down in the 1971 Act on Structure Regime Companies, which perpetuated the time-honoured tradition of a supervisory board with

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[991] Article 2:140/250, 2 DCC.

[992] Charkham (2005), pp. 29-107; Cadbury (2002), p. 229.

[993] Marcus Lutter, 'Der Aufsichtsrat im Wandel der Zeit', *Aktienrecht im Wandel*, Band II (2007), pp. 389-429, Chapter 'Der Aufsichtsrat im Wandel der Zeit' ("Lutter (2007)").

substantial powers and independent, not special interest, director.[994] Employees got their say in another way than through their own directors.

The Dutch did introduce works councils with the Works Council Act of 1971. Every company with more than 50 employees must have a works council. The works council is a body of representatives of the employees of the company. It must be consulted by management to give advice on important decisions, such as acquisitions or disposal of shares or enterprises, large loans, mass dismissals or a change in management structure. For example, if a company would contemplate a change from a two-tier system to a one-tier system, the works council would have to be consulted.[995] Its advice must, by law, be taken into account by management before it takes its decisions on these major matters. If the works council gives a negative advice on the proposed decision of management, management must wait for a month to give the works council the possibility to lodge an appeal with the Enterprise Chamber.[996]

The essential novel part of the Dutch worker participation system is the so-called “Structure Regime” arrangement for large companies laid down in the Structure Regime Act of 1971. Large companies, for the Structure Regime, are companies with more than € 16 million[997] equity (paid-up capital plus reserves), with at least 100 employees and a works council that has been active in its group of companies for more than three years.[998] These large companies must have a supervisory board, which is independent from shareholders and management and considers the interests of the company and its enterprise, i.e. all stakeholders. A supervisory board in a structure regime company is powerful, because it appoints, suspends and dismisses[999] the management board and can veto all important decisions of management, such as the acquisition of disposal of shares, large loans and mass dismissals. To provide for this independence of the supervisory board the act initially stipulated that it co-opted itself, with some rights of shareholders and the works council to

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994 Prof. Huub Willems, former chairman of the Enterprise Chamber, ‘It Needs Three Tiers to Tango’, *Ars Aequi* (September 2010), p. 651, in which he also refers to an interview of Fritz Frölich, former CFO of AKZO, who is on many German and French boards and who is very complimentary of the Dutch system.

995 Article 25(e) Works Council Act.

996 Articles 24 and 25 Works Council Act.

997 This number is adapted regularly with inflation by Royal Decree.

998 Article 2.153/263, 2 DCC.

999 Article 2.162/272 DCC, there are exceptions for subsidiaries of foreign groups.

propose candidates and to object against nominations. As mentioned in 4.2.5 above this appointment procedure was changed in 2004.[1000]

Since the changes in the Law on Structure Regime Companies in 2004, the shareholders' meeting appoints and dismisses the supervisory directors. There must be at least 3 supervisory directors. The rule is still valid that supervisory directors nominate their successors with some influence from the works council in these nominations, but the shareholders have the right to refuse to follow the nomination. The influence of the works council rests on its right to pre-nominate one-third of the nominations of the supervisory board. The fact that shareholders may dismiss the complete supervisory board was shown to be an important power of shareholders in the *Stork* case.

The *Stork* case[1001] of 2007 involved a shareholder activist dispute between US hedge funds, Centaurus and Paulson, who together owned 31.4% of the shares, and management. The activists typically demanded a split up of Stork, Netherlands' oldest industrial conglomerate of 1883. Management was opposed to a split. The hedge funds wished to discuss this with management, but the shareholders were not very open with their arguments. The activists asked to discuss strategy with the chairman of the supervisory board. He referred the shareholders to management, saying that the supervisory board does not deal with strategy. The shareholders put the dismissal of the whole supervisory board on the agenda for the shareholders' meeting. Management, supported by the supervisory board, issued shares to a friendly foundation to outvote the shareholders. The communication was so bad that the matter ended up in the Enterprise Chamber.

The Enterprise Chamber decided before the shareholders meeting with a compromise by blocking the dismissal of the supervisory board and blocking the vote with the issued shares, and at the same time appointing 3 "super" supervisory directors, who would have 6 months to guide parties to a solution of the dispute on strategy. The court said that the supervisory directors should in such cases have a mediation role between shareholders and management or at least should not escalate the discussion. This point was later

[1000] Change of Structure Regime Act, which gave more rights to shareholders, 1 October 2004. For a detailed description of the original Structure Regime, see Prof. S. Schuit, *Corporate Law and Practice of the Netherlands: Legal, Works Councils and Taxation* (2002), pp. 113-116 ("Schuit (2002)"), which will be updated in 2011. For the English text of the DCC see Hans Warendorff and Richard Thomas, *Company and Business of the Netherlands, Complete DCC Translated* (a loose leaf book).

[1001] *Stork*, Enterprise Chamber, OK 17/1/2007, 2007, NJ 15.

corrected by the Supreme Court in the *ASMI* decision of 2010. Since this decision the law is that supervisory directors do not necessarily have to mediate.

An example of the decision power and independence from shareholders of a supervisory board under the structure regime was the *Corus* case of 2003, which was rather a surprise to the international business community.[1002]
In 1999 British Steel and Koninklijke Hoogovens merged and created Corus Group Plc, which owned 100% of the shares in Corus Netherlands, which in turn owned an aluminium producer. Corus Group Plc was in need of cash and wished to sell off the aluminium producer. Because this involved the sale of an important enterprise of Corus Netherlands, the works council and the supervisory board had their right of say concerning the sale. They said they resisted the sale, or would at least want some guarantees that the proceeds of the sale would be ring fenced for Corus Netherlands and not only be used for the financing problems of Corus UK. The works council gave a negative advice. The supervisory board gave consent under the condition of a ring fencing agreement, which Corus Group Plc did not want to accept. Corus Group Plc took the matter to the Enterprise Chamber, which said that the supervisory board had acted in the interest of the company and had acted reasonably. In the end the aluminium plant was sold, but only after a ring fencing agreement was signed.

A comparable case is the recent *Organon* case of 2010, where the US pharmaceutical group Merck Corporation, had some years before acquired 100% of the shares of Organon NV. Merck had decided on mass dismissals at Organon. The works council of Organon had not been asked to give advice and the supervisory board announced it would veto any proposal for mass dismissals.[1003] The works council put the case to the Enterprise Chamber. The hearing was planned for 2 September 2010. On 1 September 2010 parties settled the matter by Merck Corporation promising to postpone its plans for dismissals by 5 months. After 12 months parties settled. The result was that not 50% of the employees but only 25% were dismissed.

These cases show how independent supervisory boards in Structure Regime companies are and how little power shareholders have. The lesson for these and other shareholders would be to communicate well in advance in an open and informative way about their plans with the supervisory board and the works council in which case their chances of success would be better. This is a consequence of the consultation culture

[1002] *Corus*, Enterprise Chamber, OK, 13/3/2003, NJ 2003, 248.

[1003] *Financieele Dagblad*, 3 September 2010, pp. 1 and 11.

of the Netherlands. The shareholder or director, who omits one of the consultation obligations usually runs into problems.

The fact that the supervisory board in a Structure Regime company appoints and dismisses management directors is very important for its power. In the majority of regular classical Dutch companies the supervisory board does not have this power. There the shareholders' meeting appoints and dismisses management and supervisory board members, which means that those supervisors have less power vis-à-vis the management board. In practice, however, they usually do nominate management directors or at least influence these nominations.

4.4.2.3 *One-tier boards under present law*

As mentioned above, a Dutch company that is not a structure regime company does not have to have a supervisory board. These companies can have a single or "monistic" board. The basic idea is that there are only managing board members. This legal possibility has given creative enterprises and lawyers the possibility to have one-tier boards with day-to-day, "inside", directors and "outside" directors, who only have an advisory and monitoring role. Generally, the Dutch one-tier boards under present law have "inside" directors who have the right to represent and sign for the company – and are registered as such in the trade register – and "outside" directors who cannot represent the company and have more of a monitoring role. The articles of association (in Dutch "*statuten*") describe this and can also give further colour to the roles of the different directors. A board regulation can give further detail. There are quite a number of private – not public – companies that operate in this creative one-tier board fashion.

The main concern of "outside" directors in one-tier boards under present and future law is that their liability is increased when they become non-executive directors in a one-tier board instead of supervisory directors in a two-tier system.[1004] The possibility of exoneration or disculpation,

[1004] D. Strik, *Grondslagen bestuurdersaansprakelijkheid*, thesis (2010), p. 105 et seq. ("Strik (2010)") and D. Strik, 'Aansprakelijkheid van niet-uitvoerende bestuursleden: you cannot have your cake and eat it!', *Ondernemingsrecht* 2003/10, pp. 367-374 ("Strik (2003)"), and Prof. W.B. Wezeman, 'De toezichthoudende rol van commissarissen en "audit-commissies"', *Tijdschrift voor Jaarrekeningenrecht*, No. 4, augustus 2009, p. 94 ("Wezeman (2009/A)"), and W.B. Wezeman, 'Persoonlijke aansprakelijkheid van uitvoerende en niet uitvoerende bestuurders', *Bestuur en toezicht*, p. 100 ("Wezeman (2009/G)"). Both Strik and Wezeman argue for more disculpation possibilities for non-executives from the traditional joint and several liability to be added because of their “outside role”, is deemed not to be sufficiently certain.[1005] The answer of the Minister of Safety and Justice to the Senate repeats that while there is joint and several liability for all directors,[1006] a director is only liable in case of serious blame depending on all facts as confirmed in the decision *Staleman v. Van de Ven*, HR 10/1/1997, NJ 1997, 360.[1007] Because there are not many one-tier boards, this aspect whether a non-executive director would be excused to a lesser extent than a supervisory director has not been tested in court and creates insecurity.[1008]

Examples of well known big companies with a one-tier board under present law are:
(1) Unilever NV, which was not a Structure Regime company, because it benefitted from the holding company exception, had a board of “inside” directors, who could appoint “advisory” members to the board, who did meet with the “inside” directors in one board, but had no vote or veto and were not registered in the trade register as directors. In 2004 Unilever NV, referring to the Code Tabaksblat, which mentioned the possibility of having a one-tier board, and to a European Directive on the European Company, which gives the alternatives of a one- and two-tier board, changed its board structure. Now the board has 2 executive directors (CEO and CFO) and 12 non-executive directors. One of the non-executives is chairman. This is very close to the UK model. In fact, the directors of Unilever NV are the same persons as the directors of Unilever Plc.[1009]
(2) Reed Elsevier NV uses the “combined board” model. It is a structure regime company with a management and a supervisory board. This looks like a two-tier board system. However, it has been creative and has made use of the Dutch stipulation that the joint meeting of the management board and supervisory board is the “combined board” and is a legal organ, just like the legal organs the management board, the supervisory board and the shareholders meeting are.[1010] The combined board meets often. All managing board members and supervisory board members are present. Actually this is not very different

to article 2:9 DCC.

[1005] Strik (2010), p. 81 et seq.; Wezeman (2009/A), p. 93.

[1006] Parliamentary Papers 2011, 31763, Memorandum of Reply to the First Chamber, 2 May 2011, p. 6.

[1007] Parliamentary Papers 2011, 31763, Memorandum of Reply to the First Chamber, 2 May 2011, p. 16.

[1008] Prof. Mr L. Timmerman, ‘De Two-Tier Commissaris/One-Tier Niet-Uitvoerend Bestuurder’, *Bestuur en Toezicht* (Conference in Groningen, 2009), p. 26 (“Timmerman, Two-Tier (2009)”) and Wezeman (2009/G), p. 96 and Strik (2010), p. 105 et seq.

[1009] Strik (2010), pp. 108-109 and Couwenbergh and Haenen, *Tabaksblat* (2008), p. 143 et seq. in which Morris Tabaksblat, as interviewed, very interestingly explains to his interviewers Couwenbergh and Haenen that peaceful changes in structures can take 10 years.

[1010] Article 2.78a DCC and formerly the *Departementale Richtlijnen* (rules for “*statuten*”). See Dortmond (2003), pp. 115-116 and Strik (2010), pp. 110-111.

from the usual practice in a Netherlands supervisory board where members usually meet in the presence of the management board members. But in most companies the supervisory directors discuss decisions that have been planned by the management board members. In most companies the supervisory board members have a monitoring role. In Reed Elsevier NV the arrangements are different. For a long list of important decisions a positive decision of the combined board is necessary. So in practice the combined board, as a whole, makes all the important decisions and is involved in the development of the decisions as well. This special aspect of Reed Elsevier NV is laid down in a “governing agreement” and special stipulations in the “*statuten*” that describe the powers of the “combined board”.[1011] The members of these boards of Reed Elsevier NV are the same persons – plus one extra – as the ones on the one-tier board of Reed Elsevier Plc. It is probable that the one extra person of the Reed Elsevier NV supervisory board member is the member nominated by the works council.

One could conclude that the Netherlands needs no new Act for One-tier Boards, because practice creates enough possibilities to be flexible. Although there are examples as mentioned above, there are only a few listed companies with a one-tier board: in 2003 only 7 one-tier board companies were listed on Euronext, of which some are foreign and in 2008 only 10 on Euronext, but the increase is due to 3 new listings of foreign companies.[1012]

One could also argue that the Act is unnecessary, because supervisory directors are becoming so active that the Dutch already have a one-and-a-half-tier board in which the tasks of supervisory directors have increased, without any structural change.

Professor Sven Dumoulin, then inhouse counsel of Unilver NV and now of Akzo Nobel NV, made clear that there are some reasons why a simple short act would be useful. He does so by identifying 18 differences between supervisory directors and non-executive directors in companies, such as Unilever NV.[1013] His article has been inspirational for our minister of justice, when preparing a Draft Act or Bill on One-tier Boards.

[1011] Strik (2010), p. 110 and Couwenbergh and Haenen, *Tabaksblat* (2008) on many pages and Schuit (2010), p. 13.

[1012] Strik (2010), p. 105.

[1013] Dumoulin (2005), pp. 1-11. The 18 differences and the reasons for the Act are described below in 4.5.7.

4.4.2.4 *Act on One-tier Boards*

On 8 December 2009 the second house of parliament, "*Tweede Kamer*", and subsequently the first house of parliament, "*Eerste Kamer*" on 6 June 2011 accepted the One-tier Board Act, which is called "*Wijziging van Boek 2 van het Burgerlijk Wetboek in verband met de aanpassing van regels over bestuur en toezicht in naamloze en besloten vennootschappen*", freely translated as "changes of Book 2 of DCC in connection with directing and supervising NVs and BVs", hereafter referred to as the "Act" or "the One-tier Board Act".

The reasons for the Dutch government to introduce this Act were the desire for more flexibility of Dutch company law, adaptability to foreign business practices and the European Law on the European Company.[1014] An important ground was the admission of the fact that the majority of shareholders of Dutch listed companies are from the US and the UK. An important reason of the Act is the improvement of the investment climate.[1015] Here we see a continuation of the Dutch trader's tradition adapting to foreign commercial opportunities.

The English summarized translation of the Act and the text of the Act in Dutch are attached hereto as Annexes 6.4 and 6.5.

The Act proposes that as an alternative to the two-tier system a one-tier system can be laid down in the articles of association by describing the different functions of the members of the board of a one-tier company (executive and non-executive members). The tasks of monitoring and nominating board members, the remuneration of the executive members and the position of the chairman can be fulfilled only by the non-executive directors. Under the Act, in companies with a one-tier structure the positions of CEO and chairman must be separate.[1016] The special two-

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[1014] Parliamentary Papers II 2008/09, 31763, no. 3, p. 1.

[1015] Parliamentary Papers II 2008/09, 31763, no. 5, p. 1.

[1016] The centre piece article is article 2.129/239(a) DCC. One-tier Board:

1. *The articles of association may provide that the duties of the board are to be divided between one or more non-executive directors and one or more executive directors. The task of supervising the performance of the duties of the directors cannot be withdrawn from the non-executive directors. Nor may responsibility for chairing the board, nominating persons for appointment to the board and determining the remuneration of executive directors be allocated to executive directors. Non-executive directors must always be natural persons.*
2. *The executive directors may not take part in decisions on their own remuneration.*

tier board rules which are mandatory in the Netherlands for large companies falling under the structure regime with substantial powers for supervisory board members and the way they are nominated and appointed are applicable *mutatis mutandis* to the non-executive directors of a one-tier board of a Structure Regime company. This last point has the support of the unions.[1017]

When the *Tweede Kamer* accepted the Bill on 8 December 2009 a few last minute amendments were added upon the proposal of members of parliament who wanted to "score" popular points. They are the non-cumulation article (not more than 5 supervisory or non-executive directorships per person, where being chairman counts double) and the diversity article (at least 30% ladies in the board as a comply or explain basis). These two points are discussed below at the end of 4.4.3. Also an amendment was added to the effect that a managing director may not have an employment contract, thereby limiting their right to demand large amounts in indemnities if they are dismissed. At first this seemed to cause administrative problems because of extra social security formalities for non-employees who work fulltime. This problem is being solved by the Ministry of Social Affairs, which has determined that non-employee fulltime workers fall under the social premium and pension regulations as if they were employees.[1018]

The Act was pending in the Senate for one and a half year. The main point of discussion was the non-cumulative article. The Act was accepted on 6 June 2011 and will probably become effective on 1 January 2012.

No One-Tier Board for Banks

A point that is rarely discussed is that the Act on Financial Supervision (Wft) determines explicitly in article 3.19 that the banks and insurance companies must have a supervisory board of at least three members and that the Netherlands Bank may only give dispensation for cases of a missing supervisory director or so. Theoretically one could argue that the Netherlands Bank could give dispensation for a one-tier board with three monitoring non-executive directors, but because the Ministry of Finance

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3. *The articles of association that one or more directors can validly decide on matters that come within their remit. Any such provision indirectly by way of the articles must be in writing.*

[1017] Commentaar FNV on the Act, Amsterdam 2008, http://home.fnv.nl/02werkgeld/arbo/wetgeving/medezeggenschap/bestuur_en_toezicht.htm

[1018] Parliamentary Papers 2011, 31763, replies to First Chamber, p. 13.

knowingly maintained article 3.19 Wft[1019] I am of the view that the Netherlands Bank cannot do this in practice. The maintaining of article 3.19 Wft is remarkable, because on 5 December 2008 the then Minister of Finance publicly declared that he would prefer the financial institutions to have One-tier Boards.[1020] There are a number of other relevant people who think that banks should have a One-tier Board, because of the requirement for banks to have knowledgeable and well involved outside directors.

Proposal: it should be possible for banks to have a one-tier board
For this reason I propose that this article 3.19 Wft should be changed to the effect that banks and insurance companies should at least have a supervisory board with 3 members or a One-tier Board with at least 3 non-executive board members.

4.4.3 Composition of the average boards

In general, the number of directors in Netherlands' boardrooms is not different from that of the US and the UK boards: on average in all these countries there are about 4 to 5 "inside" directors and 5 to 6 "outside" directors. The difference is that they have different "name tags" and by consequence have different tasks.

In the UK there are about 4 to 5 executive directors, a chairman and an average of 5 to 6 non-executive directors (NEDs). In the US the CEO is usually also the chairman. He is the only executive board member. The other officers, about 3 or 4 are not board members but do usually attend board meetings. These US boards are further filled with 6 to 7 independent directors, including a lead director – who often meet

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[1019] The translation of article 3.19 Wft is:

1. A clearing institution or credit institution vested in the Netherlands, which is an NV or BV, or an insurer vested in the Netherlands, which is an NV or BV, has at least a suprvisory board with three members, as meant in articles 140 and 250 of Book 2 DCC.
2. A clearing institution or credit institution vested in the Netherlands which is not an NV or BV has a body comparable with a supervisory board of at least three members.
3. The Netherlands Bank can upon request give dispensation in whole or in part and for limited or indefinite period of the above paragraphs 1 or 2 if the requiron shows that it cannot reasonably fulfil the stipulation and that the aims of this article can be fulfilled otherwise.

[1020] *Financieele Dagblad*, 'Bos prefereert Angelsaksische bestuur banken', 5 December 2008, p. 11.

separately in executive sessions. In 30% of the listed companies there is a separate non-CEO chairman instead of a lead director.
In the Netherlands there is a management board of about 4 to 5 and a supervisory board of about 5 to 6[1021] and they usually meet together. Upon introduction in the Netherlands of a one-tier board in the Act there would most likely be 4 to 5 executives, including the CEO and 5 to 6 non-executives, including the chairman.

Management board
Traditionally a Dutch management board was composed of a general managing director ("*algemeen directeur*"), a finance director and one or two other directors. They managed by consultation of equals leading to consensus and there were checks and balances within the management board, the co-pilot model.[1022]

CEO
From about 2000 the "*algemeen directeur*" changed into a CEO. Not only did the name change, but the function became more important. The stock exchange, foreign investors, foreign financial markets and media wanted a visible personal leader. It is also a consequence of centralisation of global conglomerates.[1023]

Supervisory directors
Dutch listed companies, whether in a structure regime or not, have by average 5 to 6 supervisory directors. Their tasks are increasing. They work harder and they are nominated independently. One of them is the *chairman*. The growth of the role of the chairman has not kept pace with the rising star of the CEO.[1024] The company also has a *vice-chairman* who can replace the chairman and lead the evaluation of the chairman.[1025]

[1021] *Nationaal Commissarissen Onderzoek 2009*, assembled by Prof. Dr. Auke de Bos and Dr. Mijntje Lückerath-Rovers ("De Bos and Lückerath (2009/O)"), p. 17.

[1022] For a further description of the co-pilot model, see 4.5.2 below.

[1023] Couwenbergh and Haenen, *Tabaksblat* (2008), pp. 130, 152-153. Schuit (2010), pp. 43 and 45. Jeroen van der Veer, retired CEO of Shell and supervisory director of Philips, Unilever and ING and Anthony Burgmans, retired CEO – later chairman – of Unilever, supervisory director of BP and ABN AMRO and now chairman of the monitoring committee of banks have orally mentioned this at conferences on respectively 29 January and 25 May 2010.

[1024] Couwenbergh and Haenen, *Tabaksblat* (2008), p. 133. Schuit (2010), p. 44 and Jeroen van der Veer and Anthony Burgmans at the above mentioned conferences.

[1025] Frijns Code III.4.3.

One-tier board under present law
In examples mentioned above[1026] there are “insiders” and “outsiders”.

One-tier board under the Act
The Act leaves completely open how many executive directors and how many non-executive directors there should be. In the UK NEDs must have a majority, in the US the independent directors must form a vast majority. The Dutch are used to 4 to 5 executives and 5 to 6 supervisory directors/non-executives, it is likely that this will continue. The Tabaksblat and Frijns Codes stipulate that there should be more independent non-executives than executives.[1027] This is important for the balance and stimulates to follow the UK model.

Theoretically a Netherlands’ company in deciding for a one-tier board could opt for the US model of only a CEO and 5 or more non-executives on the board and the other officers in the room by invitation. An argument for such US type boards could be: they only discuss broad lines and strategy anyway and it is more efficient. The counter argument would be: if other officers are also on the board, there is more insight for the non-executives in the background arguments of the officers, more insight in the dilemmas, more insight as to whether the management team functions well and more insight in who would be suitable candidates for the top.

Company secretary
The supervisory directors or non-executives are, according to the Frijns Code, to be assisted by an independent company secretary who is appointed by the management board upon the proposal of the supervisory board and with its consent. On paper the arrangement seems good.[1028] In practice, however, he works for and is instructed by the management board and the supervisory board at the same time.[1029] The example of the UK company secretary is good, because in the UK it is absolutely clear that the company secretary works for the chairman and the NEDs. The

[1026] See 4.4.2.3 above.

[1027] Frijns Code III 8.4.

[1028] Frijns Code III 4.3.

[1029] Schuit (2010), p. 62, quotes R. van Oordt and R. Zwartendijk. M.W. den Boogert, ‘De Raad van Commissarissen onder de nieuwe Corporate Governance Code’, *Ondernemingsrecht* 2004/4, p. 118 (“Den Boogert (2004)”).

UK experience has been that if the functions of general counsel and company secretary are combined in one person, the secretary work is usually delegated to a more junior person and is then diluted. If there is a real separate company secretary, who is the conscience of the company and who supports the Chairman in corporate governance and strategy development, the company secretary can add substantial value. The UK example shows that it is advisable to have a senior and independent person as company secretary. See for the UK sub-section 2.4.4.

Committees

Dutch supervisory boards – since the Tabaksblat Code of 2004 – have audit, remuneration and nomination committees if there are more than 4 supervisory board members. In the Netherlands the nomination committee is called “selection and approval committee”, “*selectie- en benoemingscommissie*”. The members of these committees are supervisory board members. The chairman of the supervisory board may not be chairman of the audit or remuneration committee,[1030] although he is usually chairman of the nomination committee. In Dutch one-tier boards under the Act the committees will be the same and the members will be non-executives. Article 2:129/239(a) of the Act on one-tier boards restricts the monitoring and nomination roles to non-executives.[1031]

As in the UK and US one of the members of the audit committee must be a financial expert. This idea of the financial expert was developed by the Sarbanes-Oxley Act.[1032] In the UK the names of the committees are the same as in the Netherlands although in the Netherlands the Nomination Committee is often called the selection and appointment committee. In the US there are audit, compensation (US word for remuneration) and nomination committees.

In the composition of the committees we see a substantial convergence in the US, UK and Dutch practice, except that in the US there is a strict rule banning executives from the meetings and US committees tend to deliver more finished and final work to the board than Dutch and UK committees do. Having more independent advisers in board committees and in board

[1030] Frijns Code III.5.6 and III.5.11.

[1031] Also Frijns Code III.8.3 stipulates that the committees will only have non-executives as members. This is the same as the US. The UK is more flexible.

[1032] Wezeman (2009/A), p. 92 and H. Langman, ‘De audit-commissie’, *Ondernemingsrecht* 2005/8, p. 259 (“Langman (2005)”).

meetings is a general trend in the US. This trend is followed to a lesser extent in the UK and the Netherlands, but may grow further. “Over use” of advisers has draw backs. Caused indirectly by the Sarbanes-Oxley Act Dutch audit committees may now sometimes be more “directive” than Dutch supervisory directors were in the past.[1033]

Limitation of holding other positions (non-cumulation)
The Tabaksblat Code and Frijns Code already had a stipulation limiting supervisory directors to not more than 5 board memberships, where the chairman counts for two memberships.[1034] The House of Representatives on 8 December 2009 amended the Act to have this stipulation added into the Act, to determine that executives can only serve on two boards as supervisory director and non-executives can only serve on five supervisory boards at one time.[1035] It is interesting to note that such best practises are already quite normal and accepted in the UK and the US, not only because of any cumulation, but simply because of the time involved in these functions. The main point of the amendment is that it is mandatory instead of a "comply or explain" rule and can have draconian, i.e. voidness, effects as a consequence.

Diversity
The House of Representatives added a further amendment to the Act aiming for a diversity, on a comply or explain basis, that both management and supervisory boards should have at least 30% women and at least 30% men.[1036]

4.4.4 Changes in board composition brought about by codes, committees

The Tabaksblat and Frijns Codes have not caused basic changes in the composition of supervisory boards and management boards. This is different from the US and the UK where new regulations and codes did introduce substantial changes in the functioning of boards. The changes in the UK and the US often go to the heart of the matter. In the Netherlands there is a tendency to make practical and less principally based corrections. The US went the way of a strong majority of

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[1033] M.J. van Ginneken, ‘Sarbanes-Oxley Act of 2002: Het Amerikaanse antwoord op Enron (II)’, *Ondernemingsrecht* 2004/5, no. 54, p. 152 et seq. (“Van Ginneken (2004)”).

[1034] Frijns Code III.3.4.

[1035] Articles 2:132a/242a and 2:142z/252a DCC.

[1036] Articles 2:166/276 DCC.

independent directors and of executive sessions. The UK emerged with the separate non-CEO chairman and a majority of NEDs on the board. The Dutch Codes have caused discussion about more serious work of supervisory board members, formalized the criteria for independence of supervisory directors and emphasized already existing thoughts that supervisory directors should work harder. One could say that the most principally based changes of the Tabaksblat Code were the promotion of committees and the introduction of the proxy for Depository Receipt holders, "*certificaathouders*", to vote the underlying shares.

Most supervisory boards now have audit, remuneration and nomination committees.[1037] The Codes have had an impact on the degree of involvement of supervisory directors and on the debate about a more active chairman. The Codes have also given an impetus to the debate about one-tier boards in the Netherlands.[1038]

4.4.5 Non-executives in the majority on the future one-tier board

Generally supervisory boards are larger than management boards. At present, the point is not very important, because supervisory boards have their veto right even if they are small. The Frijns Code does stipulate for one-tier boards that non-executives must have a majority.[1039] The Act is silent on this item and this is regarded as remarkable by some. The fact that the Act has not made an explicit requirement of such majority can be seen against the background of Dutch culture, not to make a point about power and about majorities. In the VOC, the city of Amsterdam did not insist on having a majority, although Amsterdam had contributed most of the capital. The Dutch traditionally attempt to seek consensus; power is veiled. The fact that the Act does not explicitly stipulate that for a one-tier board the non-executives must be in the majority, does not mean that boards can ignore this requirement, because as mentioned before, the Frijns Code does stipulate such a majority and the Frijns Code is applicable for listed companies. There could be a problem for Structure Regime subsidiaries of large groups, such as Corus BV and Organon BV. If they would for example have had a one-tier board with five executives and three non-executives and the executives would vote for the parent's

[1037] The Monitoring Committee Corporate Governance Code of December 2009, p. 69, has confirmed the importance of the committees for the functioning of the supervisory board.

[1038] Frijns Code III.8.

[1039] Frijns Code III.8.4.

strategy, they would outvote the non-executives. Most likely the Works Council, when asked to advise[1040] on a change from a two-tier to a one-tier system, will advise positively under the condition that there will always be more non-executive directors than executive directors. For important resolutions in Structure Regime companies the consent of the majority of the non-executive directors is required by article 2:164a/274a(4) DCC. In his answer to the senate, "*Eerste Kamer*", the Minister of Safety and Justice, says that in practice it is unlikely that the non-executives will be smaller in number than the executives.[1041]

4.4.6 Size

Sometimes Dutch boards have been very large. ABN AMRO, in 2007, had 5 management board members and 12 supervisory directors. That was – in hindsight – regarded as too large.[1042] Basically the Dutch are well advised to pay attention to the recommendations given in the US and the UK that boards should not be too large. The Dutch generally are mindful of this point. They do consider size.[1043] The report of the Committee Maas, giving advice for better banks, has suggested that supervisory boards should be larger with access to more knowledge: at least 10 for big banks and at least 6 for small banks.[1044] The then Minister of Finance, Bos, advised against outsized supervisory boards. I would say that for larger companies 9 would be a maximum, i.e. 3 members for each of the 3 committees. In smaller companies the supervisory board can have a lower number to avoid unwieldy discussions or supervisory directors that stay silent.

4.4.7 Summary of composition of boards

1. The Netherlands traditionally have a two-tier board system, even though having a supervisory board is not required by law, except in Structure Regime companies. Listed companies have about 3

[1040] If a company would change from a one-tier board system to a two-tier board system, it would require the positive advice of the Works Council, according to article 25e of the Works Council Act.

[1041] Report of discussion in Senate of 24 May 2011, p. 22.

[1042] See Smit (2009), which describes the board dynamics at ABN AMRO.

[1043] De Bos and Lückerath (2009/O), p. 17, says that the average for a supervisory board of listed companies is 6.2 in 2008. The number of supervisory directors of all companies decreased from 5.88 in 2006 to 5.33 in 2008 according to the Monitoring Report of 2009, p. 41.

[1044] Cees Maas, *Naar herstel van vertrouwen* (2009), p. 13, advice 1.3 ("Maas (2009)").

to 5 managing board members and an average of about 6 supervisory board members.

2. Structure Regime companies have a mandatory supervisory board with substantial powers.
3. Although most other companies have a supervisory board, there are some examples of one-tier boards with executive and non-executive directors.
4. The Act on the one-tier board as alternative option is made up of a short set of practical articles. Structure Regime companies can fall under the Act and can have a one-tier board as well, in which cases the rules for supervisory directors are mutatis mutandis applied to the non-executive directors.
5. I propose to change article 3.19 Wft so that banks and insurance companies are also permitted to have one-tier boards with at least three non-executive directors.
6. When considering a one-tier board one should realize that this system has developed in different directions in the UK and the US. UK boards typically have about 4 executive officers, a separate chairman and 5 or 6 NEDs, while US boards on average have a CEO/chairman and about 7 independent directors, who interestingly often meet separately before or after each board meeting.

4.5 **Role of board members**

4.5.1 Introduction

As described above, boards of companies in each country must develop, implement and monitor such varied elements as purpose, strategy, policy, risk management, succession, evaluation and communication. Since the composition of boards and the division of tasks have been dealt with in section 4.4, I shall now consider what roles are appropriate to each type of director and how these roles can best be promoted.

In this section (4.5) the role of the members of Dutch supervisory and management boards in the two-tier system and of executive and non-executive directors in a one-tier system will be discussed in relation to the following aspects: the evolution of the role of supervisory board members in a two-tier system over the last 30 years, culminating more or less in a one-and-a-half-tier board (4.5.2); the legal context of the division of powers between shareholders and board members (4.5.3); the roles of the different board members in two-tier and one-tier systems (4.5.4); the role of the management board members and supervisory board members in strategy development (4.5.5); the difference between a two-tier and a one-tier board in relation to early and on-site information and access to junior management (4.5.6); the differences between supervisory board members and non-executive directors (4.5.7); the role of representing the company (4.5.8); the dual function of management board members: action and monitoring (4.5.9); independence in today's two-tier boards 4.5.10); the role of the chairman in the present and future (4.5.11); the role of the separate chairman and CEO in a two-tier and one-tier board in companies of varying size (4.5.12); evaluation (4.5.13); term of office, re-election, selection and dismissal (4.5.14); formal documentation of functions in two-tier and one-tier boards (4.5.15); getting the best out of directors (4.5.16); succession (4.5.17); enterprise risk management (4.5.18); corporate governance at banks (4.5.19); and, finally, a summary of the roles of directors (4.5.20). While discussing these matters, I shall also describe some of the differences between one-tier boards in the UK, US and the Netherlands and what elements of UK and US corporate governance could usefully be adopted Dutch two-tier and one-tier boards.

4.5.2 How supervisory boards have evolved in the last 30 years into a one-and-a-half-tier system

We have seen in the chapters on the UK and the US that the positions of NEDs and chairmen in the UK changed substantially from 1993 onwards and that the position of independent directors and chairmen or lead directors in the US has changed especially since 2002. In the Netherlands the changes to the positions of supervisory board members and chairmen have occurred mainly since 2004.

Before 2000 a typical Dutch management board under the two-tier system consisted of a managing director known as the *algemeen directeur*, a finance director and, possibly, another member. They operated by consensus. There was hardly any hierarchy and the managing director was a *primus inter pares*. This was characteristic of the Dutch style of consultation leading to consensus.[1045] The managing director was creative and developed and "sold" new ideas. The typical finance director was careful and cautious and in practice personified the checks and balances that existed within the management board. This was a real strength of Dutch corporate governance. Very interestingly, this idea of the CFO providing balance within the board and monitoring the CEO has recently been identified as a new phenomenon in the UK and the evolution of the CFO's role has been aptly summarized as "Number

[1045] Couwenbergh and Haenen, *Tabaksblat* (2008), p. 130; Kennedy (2009), p. 150; Lendering (2005), p. 25; Langman (2005), p. 262.

cruncher to co-pilot".[1046] Examples are Mark Loughridge of IBM and Simon Henry of Royal Dutch Shell, who are hailed as generalists capable of keeping their CEO under control. CEOs are described by Simon Henry as "marketeers" who have great ideas, but, as he adds, "somebody has to bring reality to the table."

Many companies had anti-takeover defence mechanisms. The "structure regime" that conferred powers on the supervisory board and left few powers on shareholders was seen as an extra protection device. This encouraged managers to believe that they did not have to communicate with shareholders. Another factor was the high rate of absenteeism at shareholders' meetings, which were generally attended, in person by proxy, by no more than a third of shareholders.[1047] Although, technically, shareholders had the right to appoint and dismiss directors,[1048] alter the articles of association, vote on mergers and splitting,[1049] discharge directors from liability,[1050] declare dividends,[1051] issue shares, determine pre-emptive rights, redeem shares[1052] and call a general meeting of shareholders, they rarely made use of these rights. However, it is important to keep in mind that these rights are not part of management (*bestuur*).[1053]

Supervisory boards were often management friendly. Usually the management board would propose candidates for appointment to the supervisory board. This was even the case in "structure regime" companies, where the law said that supervisory directors were appointed by the supervisory board. The role of supervisory board members was to "assist" the management board by providing advice and meeting with it for the purposes of consultation.[1054] They were often representatives of

[1046] *Financial Times*, 9 September 2010, p. 10.

[1047] Abma (2006/B), p. 14, whereas the US is 85% and the UK 60%.

[1048] Articles 2:132, 1/242, 1 and 2:134, 1/234, 1 DCC for management board members and 2:142, 2/252, 2 and 2:144, 1/2:144, 1 DCC for supervisory board members.

[1049] Articles 2:121, 1/231, 1 DCC and 2:117, 1/755 and 2:334m, 1 DCC.

[1050] Article 1:101, 3/211, 3 DCC.

[1051] Article 2:105/215 DCC.

[1052] Article 2:110/220 DCC.

[1053] Van der Grinten (1989), p. 443, no. 231.

[1054] Article 2:140/250(2) DCC. The words '*staat met raad ter zijde*' were introduced in 1971.

shareholders, for example advisors such as bankers, accountants and lawyers, and sometimes related customers and politicians.[1055]

Management could operate without paying much attention to shareholders. This was the atmosphere in most companies, whether or not they were "structure regime" companies.

In 1982 and 1983 three serious cases of mismanagement hit the headlines in the Netherlands.

Rijn-Schelde-Verolme was a conglomerate of shipbuilders centred around a company run by maverick entrepreneur Verolme. The bankruptcy of the group led to a parliamentary inquiry whose proceedings were broadcast on TV. The inquiry revealed that:

(a) the management board was not fit for its task: although the CEO did have industrial experience, it was not in shipbuilding;

(b) the supervisory board had taken no action even in the face of disaster; in addition, the chairman had arranged for the company to pay for many of his private expenses. A moratorium on payment of the group's debts was agreed on 9 February 1983 and the government provided large amounts of state aid to the business before bankruptcy.

OGEM was a conglomerate of construction companies that went bankrupt in 1982. There was a lengthy investigation by the Enterprise Chamber. It was the first major mismanagement case and was decided by the Supreme Court in 1990.[1056] The main cause of the problems at OGEM was that the executives had strong egos, tended to act independently of one another and were united only in their disrespect for the supervisory board. The chairman of the supervisory board saw it as his function to blindly support the CEO. Two memoranda from supervisory board members who objected to the course of events were swept under the carpet.

The Association of Shareholders (*Vereniging Effectenbeheer*) instituted proceedings before the Enterprise Chamber, which in due course held that there had been mismanagement. Subsequently, the liquidator held the members of the management and supervisory boards liable. As they were not insured, the matter was settled for low amounts. However, all were kept busy with investigations, court cases and newspaper reports, and it was bad for their personal reputation.

[1055] Couwenbergh and Haenen, *Tabaksblat* (2008), p. 132.

[1056] *OGEM*, HR 10/1/1990, NJ 1990, 466.

Tilburgsche Hypotheek Bank was declared bankrupt in August 1983. At that time interest rates had soared to 14% and property values had plummeted. As a result, properties often provided insufficient security for mortgages. In response, the mortgage bank's managers transferred real estate back and forth with new "fixed" valuations. Members of the supervisory board noticed the problem and had it investigated, but did nothing. The members of both the management board and the supervisory board were held by Breda District Court to be liable to the liquidator.[1057] The supervisory board members were not covered by D&O insurance and paid liquidated damages.

The many bankruptcies of the 1980s and especially the abuse of empty BVs to leave national insurance contributions unpaid resulted in the inclusion of new provisions in the DCC and other legislation regulating the liability of directors in bankruptcy cases.[1058] Another result was that most directors took out D&O insurance. As long ago as 1986 Jaap Glasz, a well-known lawyer, dean of the Dutch Bar and an effective supervisory board member of many companies, wrote a book entitled "Recommended Rules of Conduct", which had been praised earlier at a meeting of the Dutch Centre of Directors (NCD) in 1985.[1059] His suggested rules contained many ideas that would later be incorporated in codes of best practices.

1995 saw the publication of the first Dutch corporate governance report: the Peters Report. Jaap Peters, retired CEO of Aegon, was a director of considerable authority. His committee produced 40 recommendations.[1060] The aim was to stimulate discussion in boardrooms and shareholders' meetings. Although there was initially plenty of discussion, there was not much follow-up.[1061]

In 2001 the *Ahold* case caused huge turmoil. It suddenly came out that the board had overstated the group's turnover in the accounts by including the turnover of joint ventures they did not really control and using side letters, possibly to confuse their accountants. This was even referred to as

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[1057] *Tilburgsche Hypotheek Bank*, Breda District Court 1/5/1990, NJ 1990, 740.

[1058] The three Insolvency Abuse Acts (of which article 2.138/248 DCC was the third) introduced the concept of joint and several liability for directors, subject to certain defences. Under the third Act liability could arise as a result of sloppy accounting, failure to file accounts and other causes of bankruptcy. The second Act provided for liability for failure to inform the tax and social security contribution authorities in the case of near bankruptcy. Under the first Act contractors could be held liable for debts of their subcontractors.

[1059] Prof. Jaap Glasz, *De Commissaris. Aanbevolen Gedragsregels*, Serie Recht en Praktijk, no. 44, tweede druk (1992) ("Glasz (1992)") (also published in 1986). See also Glasz (1995).

[1060] Calkoen (1996), pp. 333-337, see also Annex Peters.

[1061] Couwenbergh and Haenen, *Tabaksblat* (2008), p. 88.

the "Ahold scandal". Although Royal Dutch Shell came in for criticism in 2001 for the way in which it had accounted for "future oil reserves", the directors were regarded as having acted in good faith. Nonetheless, this case too raised issues about better governance. The *Enron* and *WorldCom* cases in the US fuelled the debate still further. In my view, the spectacular growth in international ownership of Dutch listed shares and the rise in the number of foreign members of boards of Dutch companies have also been major factors prompting change.[1062]

Eventually, the debate culminated in the appointment of the Tabaksblat Committee. Morris Tabaksblat, retired CEO of Unilever and Chairman of Reed Elsevier, has vast international experience in Brazil, New York and London. Despite his cosmopolitan background, Tabaksblat is also very much a Dutch *polderaar* at heart, in other words, someone who believes that it is best to keep on talking, compromising and soliciting support. He has been quoted as saying, "I can bring things together reasonably well, I believe."[1063]

The Tabaksblat Committee produced a draft code in 2003 and, after wide consultation, the final Tabaksblat Code in 2004. Like the Cadbury Code, Higgs Review and Combined Code in the UK, the Tabaksblat Code introduced principles and best practice provisions on a "comply or explain" basis. In the Netherlands it is also called a "apply or explain" basis. The Tabaksblat Code also proposed legal reform, which was introduced on 1 October 2004, for more shareholder rights and, interestingly, the possible alternative of a one-tier board.[1064]

The Tabaksblat Code was given a statutory basis in the DCC, which introduced the requirements that every listed company must mention in its annual report (*jaarverslag*) whether it complies with the Code and if not, explain why not.[1065] The government also appointed a monitoring committee under Jean Frijns – the Frijns Committee – which reported each half year and updated the Tabaksblat Code on 10 December 2008.

[1062] Den Boogert (2004), p. 113 and Winter (2007), p. 6.

[1063] Couwenbergh and Haenen, *Tabaksblat* (2008), p. 173.

[1064] Tabaksblat Code, p. 6.

[1065] Article 2:391, 5 DCC and a general decree.

All of this had an important impact, and even marked “the beginning of a revolution for supervisory board members.”[1066] Many extra duties and roles were assigned to supervisory board members. The time needed to carry out their duties increased by 100%. Until the Tabaksblat Code supervisory board members functioned for and with management. Now they were to be independent and nominated by a nominations committee in keeping with a profile for every position. Supervisory board members were to be involved more intensely in monitoring the strategy of the management board. Greater emphasis was put on the roles of the chairman, assisted by a company secretary, and the audit, nominations and remuneration committees. There was even talk of co-management (*medebestuur*) by supervisory boards.[1067]

In the area of strategy many supervisory board members take the view that they only monitor. Others – often retired CEOs of large, successful companies – wish to be more active like their US counterparts and even propose alternatives like their UK counterparts.[1068]

The Tabaksblat Code was introduced on 1 October 2004. On that same day an important reform of Dutch company law introduced extra rights for shareholders, such as the right to appoint and dismiss supervisory board members. It also gave 1% of shareholders the right to put items on the agenda of general meetings, veto very important transactions and have a say on pay, as described above. Here the Dutch legislator may have overdone things in its zeal to adapt to foreign investors.

The Tabaksblat Code of 2004, the Act of 1 October2004, various Enterprise Chamber cases such as *OGEM* and *HBG*,[1069] the rather sudden internationalisation of the shareholders and of the boards of Dutch listed companies and the influence of foreign financial markets, including the indirect effect of the US Sarbanes-Oxley Act[1070] all combined to bring about substantial changes in the position of board members in Dutch companies. And there have, indeed, been substantial changes in

[1066] Den Boogert (2004), p. 114.

[1067] Den Boogert (2004), p. 115.

[1068] Schuit (2010), p. 26 in interviews of well-known Dutch CEOs.

[1069] *OGEM*, HR 10/1/1990, NJ 1990, 466 and *HBG*, HR 21/2/2003, NJ 2003, 182.

[1070] Van Ginneken (2004), p. 152 et seq.

practice.[1071] As a result of all these changes, many now speak of a one-and-a-half tier system.[1072]

There is a noticeable convergence with UK practice: harder working supervisory board members, independent nominations, more involvement in strategy, etc. US and Dutch boards are also converging, with harder working supervisory board members in the Netherlands and more non-CEO chairmen and the executive sessions in the US. And both US and Dutch boards now have more independent nominations and important committee work. To a large extent this is also influenced by large international investment institutions and their advisory voting institutions.

A monitoring committee – the Frijns Committee – was appointed to report on compliance at least once a year. The rate of compliance is generally good. After this committee had added a few new provisions to the existing Tabaksblat Code in 2008, the code was renamed the Frijns Code.

4.5.3 The legal context of the division of powers between shareholders and board members

The general meeting of shareholders is not the highest organ of a company since it cannot instruct the management board.[1073] Until 2004, shareholders in the Netherlands, notwithstanding their technical rights under the DCC,[1074] were disinclined to get involved in discussions about strategy or about any other company matters for that matter. They were not required to make allowance for the interests of the company and generally voted in their own interests.[1075] The Tabaksblat Code of 2004 and the Frijns Code of 2008 made clear that the management board develops strategy, the supervisory board supervises and shareholders may exercise their right to vote, add items to the agenda and call a meeting.[1076] Furthermore, shareholders can engage in dialogue with the company.[1077]

[1071] Couwenbergh and Haenen, *Tabaksblat* (2008), pp. 128 and 175.

[1072] Schuit (2010), p. 115; also Floris Croon, founder of the strategy advisors Boer & Croon, defended the one-and-a-half-tier board at a conference at Nijenrode, chaired by Steven Schuit on 25 May 2010.

[1073] *Forum-Bank* case, HR 21/1/1955, NJ 1959, 91. Here there is convergence with the UK and the US. Their shareholders too cannot instruct the board.

[1074] See above at 4.5.2, notes 969-974.

[1075] Frijns Code: point 9 of the preamble.

[1076] Frijns Code: point 9 of the preamble and very clearly confirmed by the Supreme Court in the *ABN AMRO*

The management board and the supervisory board are accountable to shareholders in the shareholders' meeting. There are many stipulations in the Frijns Code concerning transparency and the timely provision of information by the management board to the shareholders.[1078]

As regards dialogue between boards and shareholders, the Frijns Code does mention in paragraph IV.4, second principle, that shareholders should be open to dialogue, but the Code makes no reference to any obligation on the part of management to initiate dialogue with shareholders. The only obligation mentioned is that the chairman should act as the main contact for shareholders regarding the functioning of management and supervisory board members.[1079] This is different from the UK Corporate Governance Code, which obliges the board in many different ways to engage in dialogue with shareholders about strategy.[1080]

The *Stork*, *ABN AMRO* and *ASMI* cases of 2006, 2007 and 2010 respectively show that shareholders have become more active and have a wish for dialogue. This has created a discussion as to whether management and supervisory boards have obligations to enter into dialogue with shareholders. The general view is that the management and supervisory boards should ensure that communication between shareholders and the two boards is as good as possible,[1081] although it is clear that boards have no real obligation to discuss strategy with shareholders or to mediate between management and shareholders.[1082]

and *ASMI* cases.

[1077] Frijns Code IV.4, second principle.

[1078] Frijns Code IV.3.

[1079] Frijns Code III.4.

[1080] UK Corporate Governance Code 2010 D.1 Main Principle: 'There should be a dialogue with shareholders based on mutual understanding of objectives,' and D.1.1 'The chairman should discuss governance and strategy with major shareholders.'

[1081] Frijns Code, point 10 of the preamble.

[1082] *ABN AMRO in Sale LaSalle Bank*, HR 13/7/2007, NJ 2007, 434 and *ASMI*, HR 2/6/2010, NJ 2010, 544 and see the opinion of Advocate General Timmerman in the *ASMI* case.

4.5.4 Roles of boards in a two-tier and one-tier system

Role of management board: develop and achieve

The function of the management board is to manage the company.[1083] The Dutch term *besturen* (managing or directing) means more than just running the company; it also encompasses buying and selling important assets and determining policy and strategy. Managing the company does not include exercising rights that by law belong to the shareholders, such as the right to issue shares, unless this right has been delegated to the he management board in the articles of association.[1084] Apart from running the company, the management board has the task of developing (formulating) and achieving objectives and strategy and defining and implementing risk profiles and CSR policy and is also responsible for financial reporting.[1085] The management board and each of its members represents the company in all its contacts and contractual relations with third parties.[1086] The management board must also provide the supervisory board with timely information on a regular basis and on the topic of strategy at least once a year.[1087]

The management board develops the company's objectives and strategy[1088] and must also achieve and implement them.[1089] In the *ABN AMRO* and *ASMI* cases the Enterprise Chamber and the Supreme Court confirmed that the management board is responsible for determining strategy and the supervisory board for supervising strategy.

Role of supervisory board: supervise and advise

Article 2:140/250 DCC states that it is the function of the supervisory board "to supervise the strategy of the management board and the overall management of the company and its enterprise". It assists the management board "by providing advice". The word "assists" (*staat ter zijde*) should be viewed against the Dutch background of harmonious consultation. The word "advice" reflects the advisory role of the

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[1083] Article 2:129/239 DCC and Van Schilfgaarde and Winter (2009), p. 150.

[1084] Van der Grinten (1989), p. 443, no. 231.

[1085] Frijns Code II.1.

[1086] Article 2:130/240 DCC.

[1087] Article 2:141/251 DCC and Frijns Code II.1.2.

[1088] Van Solinge and Nieuwe Weme (2009), p. 474.

[1089] Frijns Code II.1.

supervisory board.[1090] However, supervision is the main task. The supervisory role is described at length in the legal literature, which confirms that the provision of advice is part of this role and involves merely acting as a sounding board and not developing ideas independently.[1091]

The supervisory board supervises the management board in its work of developing and achieving objectives and strategy, defining and implementing risk profiles and CSR policy and its financial reporting[1092] and supervises the performance of the management board as well. The supervisory board is basically dependent on the management board for its information.[1093] However, supervisory board members can now gather their own information.[1094] This means that the supervisory board has a duty to gather information (*haalplicht*) and that the chairman has a duty to coordinate this.[1095] Ten years ago supervisory board members did not have to check the text of an acquisition agreement or ask whether there are sufficient vendor guarantees and a financial analysis.[1096] Would this low standard of conduct still be acceptable today, ten years later? I doubt it. I think it is now standard practice for the supervisory board to check whether due diligence has taken place before an acquisition and whether there are sufficient vendor guarantees and a financial analysis. The standards for directors have become higher.

[1090] Frijns Code III. Role of the supervisory board. See also Van Schilfgaarde and Winter (2009), p. 235.

[1091] Van Solinge and Nieuwe Weme (2009), pp. 603-605 devote more than two pages to supervision and only eight lines to advice, Assink in Assink and Strik (2009), pp. 93-94. Prof. M.J. Kroeze gives the same impression and says that the advisory role of the supervisory board may be growing, Kroeze Article (2005/A), p. 7.

[1092] Article 2:140/250 DCC and Frijns Code II.1.2, III.1 and point 9 of the preamble.

[1093] Article 2:141/251 DCC.

[1094] Frijns Code III.1.9.

[1095] Frijns Code III.4.1(b).

[1096] Van Solinge and Nieuwe Weme (2009), p. 604 with reference to the case of *Verto/Drenth*, The Hague Court of Appeal 6/4/1999, JOR 1999/142. Verto acquired a company after doing only very limited due diligence and very limited financial analysis. The management board members negotiated the agreements. The supervisory board members failed to study the texts of the agreements or ask whether guarantees had been provided. The acquisition created huge losses for Verto. Verto (and the Association of Shareholders/VEB) claimed liability on the part of both the management board and the supervisory board, albeit for different standards of conduct. After the Enterprise Chamber had ruled that there had been ‘no mismanagement’, the members of the management and supervisory boards were not held liable by the courts.

One of the main supervisory duties of supervisory board members is to ensure that there is a good management board and that it functions well.[1097] Supervisory board members must check whether there are tensions within the management board. The supervisory board must be diligent in monitoring the composition of the management board and its entrepreneurship and succession. In "structure regime" companies and under the articles of association of many companies, the supervisory board appoints the management board members. Even if the articles of association provide that the shareholders' meeting appoints the management board members, the supervisory board usually nominates them or at least has influence on these nominations. This influence on nominations by outside supervisory board members has always been part of Dutch board culture. The Frijns Code emphasizes the role of evaluating the management board.[1098]

Furthermore, the supervisory board is charged with setting the remuneration of the management board members under the policy adopted by the general meeting[1099] and with representing the company if the management board members have a conflict of interest[1100].

Roles of board members in a one-tier board under the Act

Under the Act the new article 2:129a/239a to be added to the DCC provides that all duties or roles in a one-tier board are to be divided among the executive and non-executive directors. However, a mandatory provision is that the supervising and nominating duty will be performed by the non-executives. Developing and achieving the aims and strategy of the company, in other words running (*besturen*) the company, is the duty of the executives. The non-executives are responsible for supervising the performance of the executives. Developing strategy and risk management is the duty of the whole board (executives and non-executives together). Strategy development decisions are made in the whole board. It is the whole board that will choose the direction to be taken, i.e. whether to adopt the US model in which non-executives actively challenge executives or the UK model in which executives and non-executives cooperate in developing company strategy.

[1097] Glasz (1992), pp. 17-18; Van der Grinten (1989), p. 515 and Van Solinge and Nieuwe Weme (2009), p. 603.

[1098] Frijns Code III.1.7.

[1099] Article 2:135 DCC.

[1100] Article 2:146/256 DCC.

4.5.5 Boards' roles on strategy

Management board determines strategy and supervisory board only supervises (different in the case of one-tier boards)
A diagram for strategy development, achievement and supervision is given below. Dutch literature makes a distinction between developing or planning strategy (*ontwikkelen*) on the one hand and implementing it (*realiseren*) on the other hand. There is more emphasis on implementation[1101] than on development, whereas in the UK there is substantial emphasis on the development of strategy.

	Develop	Implement	Supervise
1-tier board	Complete board	Executives	Non-executives
2-tier board	Management	Management	Supervisory

Under Dutch law supervisory board members do not actively participate in planning strategy. Jean Frijns, the chairman of the committee that produced the Frijns Code, states that in the vast majority of Dutch listed companies supervisory board members are indeed not involved in formulating business strategy. Most executive board members want their supervisory board members to limit themselves to monitoring in a reactive rather than a proactive manner. Most supervisory board members say that their main task is to supervise the strategy plans of the management board. Some say that if the management board does not develop strategy plans, they may ask questions and even make suggestions.[1102] In most cases the management board develops – one might even say adopts – the strategy plan and gives a draft to the supervisory board. In fact, they discuss it only once a year[1103] at a meeting that generally lasts half a day or, at most, one or two days. This tends to result in no more than a few minor changes to the company's strategy plans.

In a minority of companies, many of which are large companies such as Philips, Shell, Unilever, Heineken, DSM and Akzo, supervisory board members tend to be more active and wish to discuss strategy. Often this is because the supervisory boards of such companies include some very experienced CEOs (or retired CEOs) of other companies as well as

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[1101] Frijns Code II.1, *realisatie* principle, and Van Manen (1999), p. 92.

[1102] Van Manen (1999), pp. 150-155.

[1103] Article 2:141/251, 2 DCC.

foreign members. These supervisory boards are actively involved in developing the strategic plan. Such practice has developed in "turbo" supervisory boards (also called the one-and-a-half-tier system), but is not based on the law or the Frijns Code. A basis for these more active supervisory board members can be found in the words "assist the management board by providing advice" in article 2:140/250 DCC and "advice" in the Frijns Code III.1. In giving their advice, supervisory board members should limit themselves to broad strategy. The general view in the Netherlands is that they should not involve themselves in matters of detail.[1104]

There has sometimes been confusion in the Netherlands about the role of supervisory board members in strategy. When Centaurus and Paulson wrote to the chairman of the supervisory board of Stork[1105] that they wished to discuss strategy with him, he wrote back: "I have forwarded your letter to the management board since it, as you know, deals with strategy." This was explicitly mentioned in the judgment of the Enterprise Chamber, which was mainly critical of the manner of communication rather than the fact that the supervisory board did not concern itself with strategy.

The *ABN AMRO* and *ASMI* cases have made it absolutely clear that the management board determines strategy and the supervisory board supervises strategy, and also that the supervisory board should make every effort to promote optimal communication between shareholders and the management and supervisory boards. At the same time, it is clear that the boards have no obligation to follow any instructions of shareholders or even an obligation to discuss strategy with shareholders.[1106]

We must realize that there are many different types of companies. In small companies, the management board members develop the strategy themselves and present the strategy plan to the supervisory board for approval once a year. At the other end of the spectrum there are the large conglomerates where strategy is often developed from the bottom up in strategy groups or in "scenario development" groups. These groups

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[1104] Van Solinge and Nieuwe Weme (2009), p. 605.

[1105] *Stork*, Enterprise Chamber, OK 17/1/2007, JOR 2007, 42.

[1106] *ABN AMRO in Sale LaSalle Bank*, HR 13/7/2007, NJ 2007, 434 and *ASMI*, HR 2/6/2010, NJ 2010, 544. See also the opinion of Advocate General Timmerman in that case, and the Frijns Code, point 9 of the preamble.

discuss strategy development with the management board members, who then decide on the strategy plan and present it to the supervisory board members for approval. In some small companies supervisory board members are more actively involved in the discussions about the development of strategy. And in some of the large conglomerates supervisory board members are involved in the discussions with the bottom-up strategy groups and scenario groups, and do not wish to be asked to approve a predetermined strategy plan. In many companies the management board spends a lot of time preparing presentations for supervisory board meetings and suggesting alternatives and pointing out problems. These are, in my view, encouraging developments.

Having stressed the value of development of strategy, I add that there should also be focus on the implementation of the strategy. It is my view that supervisory directors in a two-tier board or non-executive directors in a one-tier board will be better supervisors of the implementation of the strategy, if they have actively been involved in the development of the strategy and understand all the building blocks of the strategy.

Strategy in the broader sense

Jeroen van der Veer, retired CEO of Royal Dutch Shell and present Chairman of Philips and ING and Vice-Chairman of Unilever, said in an interview concerning his vice-chairmanship of a special strategy committee of NATO that "*strategy is: what do you want and do you have the means*".[1107]

The supervisory board's role in respect of the "*what do you want?*" aspect is merely to supervise, but it has important influence as regards the "*means*" and, especially, board succession.

In summary, strategy in the broader sense includes:

(a) defining the company's purpose or objects;
(b) agreeing on strategy;
(c) establishing the company's policies;
(d) appointing the executives and regulating the succession of members of the management and supervisory boards.

[1107] *NRC Handelsblad*, 18 December 2009, p. 12.

For points (a) to (c), general Dutch law would use the word "policy" (*beleid*).[1108] The management board takes the initiative in formulating policy and the supervisory board supervises these aspects. As regards succession under (d), the supervisory board clearly plays an active role in the process of nominating and appointing directors and that the shareholders' meeting is responsible for making the appointment.[1109] By both tradition and law, nominations are always made by the supervisory board members. Recently, such nominations are always on a profile, as required by the Frijns Code and the DCC.[1110]

Strategy role of supervisory board in "structure regime" companies
When the Structure Regime System Act was introduced in 1971, the supervisory board of many Dutch companies attained greater powers. These supervisory boards now had the power to approve or veto many important decisions on matters such as takeovers and large-scale redundancies. Having more powers should imply more responsibility and active involvement. This has, however, not happened. The practice in most of these "structure regime" companies stayed as it was: the management board remained responsible for taking the initiative and the supervisory board limited itself to supervision and approval. This was also the case at Stork, which was a "structure regime" company; not only did the supervisory board consider that it was it was not responsible for strategy but it also communicated insufficiently with shareholders. This resulted in litigation: the *Stork* case of 2006.

Development of strategy not high on the list of priorities in the Netherlands
Unlike the UK Cadbury Code, the Higgs Review, the Combined Code, the UK Corporate Governance Code and the Walker Review, the Frijns Code makes little mention of strategy development. The UK Codes give examples.

– Combined Code 2006, Supporting Principle A.1
"The non-executive directors, as equal members of a unitary board, should be involved in strategy as the executive directors."

[1108] Article 2.140/250, 2 DCC.

[1109] Article 2:132/242 DCC.

[1110] Frijns Code III.3.1 and for 'structure regime' companies article 2:158/268, 3 DCC.

– Combined Code 2008, Supporting Principle A.1 and UK Corporate Governance Code A.4
"As part of their role as members of a unitary board, non-executive directors should constructively challenge and help develop proposals on strategy."

– Higgs Review puts the strategic role first.

– Walker emphasizes in recommendation 6 that NEDs should be encouraged to challenge and test executive proposals on strategy, and recommendation 9 makes clear that the chairman must, in setting the agenda of the board and in chairing the meetings, ensure that sufficient time is given to strategic issues. An informed and critical contribution of directors is encouraged and expected on matters of risk and strategy.

It is interesting to note that in the US the Delaware courts honour the concept of long-term strategy in that where the board can show that it has developed a long-term strategy this will be treated as a valid defence. In the *Time Warner* case it was acknowledged that the board of Time had a long-term strategy when it chose its preferred merger partner and wished to preserve Time's identity and the independence of its journalists. In the recent case of the Dollar Thrifty merger with Herz, the court respected the long-term strategy of Dollar Thrifty.[1111] Similarly, in the case of *Air Products v. Airgas* it respected Airgas's 5-year plan.[1112]

The Frijns Code merely states as follows:

II.1 The management board is responsible for achieving the company's aims, strategy and risk profile and for corporate social responsibility (no mention of the development of strategy).

II.1.2 The management board shall submit the strategy and parameters for strategy to the supervisory board for approval.

III.1 The role of the supervisory board members is to supervise and give advice.

[1111] *Dollar Thrifty*, C.A. No. 5458-VCS (Del. Ch. 8 September 2010, Leo Strine).

[1112] *Air Products v. Airgas*, 15 February 2011, Chancellor Chandler C.A. No. 5249/5256C.

III.1.6 In more detail, this role is to supervise (a) the objectives, (b) the strategy, (c) risk management, (d) the financial reporting process, (e) compliance with the law, (f) the relationship with shareholders and (g) corporate social responsibility.

An argument for supervisory board members to become involved in developing strategy rather than merely supervising its achievement is that there are many more views on strategy than those expressed by management. Stewardship shareholders, activist shareholders, NGOs and the media all have views that also count. For this reason alone, it is vital for supervisory board members to play a more active role in the development of strategy.

Summary: the supervisory board only supervises strategy plans, but takes the lead in succession matters
It may therefore be concluded that apart from their active role in succession planning Dutch supervisory boards do not play a very active role in developing strategy, although the supervisory board members of some companies are becoming increasingly active in this field. Holding lengthy and repeated discussions of strategy is fairly alien to Dutch corporate culture. However, external factors may pressurise supervisory boards into becoming more proactive.

Proposal
I would like the next code of best practices (or the advice of one of the committees monitoring best practices) to include a step in the direction of supervisory board members being increasingly involved in the process of developing the company's strategy. This would mean that supervisory board members would have to inform themselves better about the business of their companies, listen to lower management and visit the shop floor. Moreover some supervisory board members are already playing a more proactive role in the development of strategy. In this connection, there is also a general wish for better information and access to lower management and on-site visits as is mentioned in sub-section 4.5.6 below. I propose that the boards discuss the way and means for this process at least once every year.

For example, the Corporate Governance Code could be amended as follows:

II.1 “The management board has the entrepreneurial leadership in developing and achieving the aims, the strategy, the risk profile and CSR”;

III.1.1 Add a second sentence: “The supervisory and management boards will deliberate with each other at least once a year to adopt a procedure:

- for the provision of timely and relevant information to be given to the supervisory board; and
- for the possibility for supervisory directors to talk with lower management and visit the premises of the enterprise; and

they will establish a timetable for regular meetings between the two boards in which entrepreneurial strategy, risk management and CSR are discussed; and

they will settle what the role of the supervisory directors will be in those discussions and the ways and means of their functioning with each other. If there is a one-tier board the board should hold these annual deliberations.”

Alternatively this text could be added to III.1.8 or III.1.9.

If supervisory board members wish to play a more active role in developing strategy, be involved at an earlier stage, receive more timely information and have more time to deliberate strategy in their meetings, they might consider becoming non-executive directors of a one-tier board. Even then it would be advisable for the boards to discuss the details of the process each year.

Whether a company chooses a two-tier or one-tier system, it is advisable for the boards to discuss the procedure for developing strategy, for more information and regular discussions about strategy and to confirm the outcome of the annual discussion.

4.5.6 Early and on-site information, access to lower management: difference between two-tier and one-tier boards

One of the worries of Dutch supervisory board members at present is the quality and timeliness of the information they receive.[1113] In a two-tier board supervisory board members only approve and do not take part in the decision making process. After all, in the case of a two-tier board

[1113] De Bos and Lückerath (2009/O), p. 33, nearly half of supervisory board members think they receive inadequate information and receive it too late.

supervisory board members do not have access to lower level managers or visit their operations.

In the case of a one-tier board, by contrast, non-executive directors have earlier and easier access to lower management and on-site information. Here there are elements of US and UK corporate governance that could be followed by Dutch companies.[1114] There is no legal obstacle, even under the present two-tier system, that would prevent supervisory board members from insisting on receiving relevant information in good time and being able to make on-site visits. There is a connection between receiving early and on-site information and participating in strategy development.

4.5.7 <u>Differences between supervisory board members and non-executive directors</u>

If a company with a two-tier system were to change to a one-tier system, this would involve the supervisory board members becoming non-executive directors. It is therefore useful to discuss the differences between the two. This will give an insight into the functioning of supervisory board members and non-executive directors under present law and under the regime introduced by the Act and in some cases make clear why it would be an improvement if the Act were to be enacted:

(a) *Involvement in decisions*
Supervisory board members are not involved in decision making: they merely approve or veto decisions. Non-executive directors are involved in all decisions of the board. They vote together with the executive directors. As they are involved in decision making, they need to know more, receive more in-depth information and have a greater understanding of the reasons for the decision. They are involved in the development of strategy. Accordingly, they are more involved and have greater responsibility than supervisory board members, which is an important difference (see 4.5.5 above).

(b) *Veto on major decisions?*
A supervisory board as a whole, and therefore its majority, has a right to veto major decisions.

[1114] US section 3.5.6 and UK section 2.5.8.

In a one-tier board the non-executives only have a veto if they outnumber the executive directors. It is a best practice rule of the Frijns Code that there should be more non-executive than executive directors.[1115] To ensure that the non-executive directors can outvote the executive directors, the law allows a provision in the articles of association of the company giving non-executive directors a double or even treble vote.[1116]

(c) *Instructions to the executive directors*
The supervisory board may give instructions to the executive directors on general guidelines only if this is possible under the articles of association.[1117] In a one-tier board non-executive directors can take initiatives, which are binding on the board. Their influence is, of course, larger if they are in the majority by number of weighted votes.

(d) *Extra powers*
Supervisory board members may have extra powers if provision for this is made in the articles of association (*statuten*).[1118]

(e) *Co-management*
Supervisory board members may not co-manage *(kunnen niet meebesturen)*. This creates problems if supervisory board members wish to do so anyway, as sometimes happens in a crisis. Such situations bring forth the "one-and-a-half-tier boards" referred to above. These complicated questions involving supervisory board members acting in excess of their powers may arise in cases where a company elects to have a combined board (e.g. Reed Elsevier). The same problem arises in a different way

[1115] Frijns Code III 8.4.

[1116] Article 2:129/239, 2 DCC makes it possible for companies to give double or treble votes, provided that this is not done in such a way that one person would have all the power. Instead, the power can be given to the supervisory board as a group.

[1117] Under article 2:129/239, 4 DCC, the articles of association may provide that the supervisory board members are empowered to give instructions about general policy. In the absence of such a provision in the articles, the supervisory board cannot instruct management. *Euro Motorcycle v. Bosman*, The Hague Court of Appeal 25/8/1998, 98/127 Injunction.

[1118] Article 2:140/230, 3 and 4 DCC.

for non-executive directors. They can manage and give instructions, but may not represent the company.

(f) *Chairman*

The position of a chairman of a one-tier board differs from that of a chairman of a supervisory board. The chairman of a one-tier board runs the board as a whole, presides over the meetings and arranges for the provision of information. In such a case, the CEO can focus on the day-to-day management.

(g) *More information and at an earlier stage*

The supervisory board has the right to receive information only from the executive directors and only if it is necessary for the giving or withholding of approval.[1119] If a supervisory board member wants extra information he must go through the chairman and afterwards the complete board. Only then is he free to approach management. Non-executive directors receive more information, in particular more in-depth information about the business and the market, and receive it at an earlier stage.[1120] Also non-executives can collect information at their own initiative, in most cases informing the chairman and CEO that they are doing so. Therefore it is easier for non-executives than for supervisory board members to sense whether there is good teamwork in the executive team. These are important differences (see 4.5.6 above).

(h) *Represent the company*

Supervisory board members cannot represent the company.[1121] Non-executives can, in theory, represent the company, unless this they are not given signing powers in the articles of association (this is likely to be the case in most companies once the Act is enacted).

[1119] Article 2:141/251 DCC.

[1120] Jeroen van der Veer, retired CEO of Shell and present Chairman of Philips and ING and Vice-Chairman of Unilever, has confirmed this information difference to me. In his words, "In a one-tier board non-executives can get 'operational' information".

[1121] Article 2:130/240 DCC.

(i) *Knowledge attribution*
The knowledge of a supervisory board member is not attributed to the company. However, the knowledge of a non-executive can be attributed to the company unless he is excluded from representing the company, which will usually not be the case.

(j) *Representation in case of conflicting interest*
Supervisory board members may represent the company in cases where the executive directors have a conflict of interest.[1122] Non-executive directors do not have this power. The Act solves this problem by inserting a provision in article 2:129/239, paragraph 6 DCC that precludes any director with a conflict of interest from attending the board meeting and states that, if this does not solve the problem, the shareholders' meeting may decide.[1123]

(k) *Legal person as director*
Only natural persons may be supervisory board members.[1124] By contrast, legal persons t may be managing or executive directors. The Act determines that only natural persons may be executives. This difference is of a technical nature.

(l) *Calling meetings*
The supervisory board as such may call a meeting. Non-executive directors do not have this power without the majority vote of the complete board. This could have been arranged in the Act, but has not been. Naturally, however, provision for this could be made in the articles of association.

(m) *Appointment*
Under the present DCC it is possible to stipulate in the articles of association that one-third of the supervisory board members are appointed by persons or bodies others than the shareholders' meeting.[1125] This should also apply to non-executive directors, but is not stipulated in the Act.

[1122] Article 2:146/256 DCC provides that the general meeting of shareholders may appoint persons to represent the company.

[1123] Article 2:129/239. 6 DCC.

[1124] Article 2:140/250, 1 DCC.

[1125] Article 2:143/253 DCC.

(n) *Who determines remuneration?*
The remuneration of supervisory board members is determined by the shareholders' meeting. Under article 2:135, paragraph 3 DCC the remuneration policy in respect of the management board (and hence of non-executive directors too under the old law) is determined by the shareholders' meeting. Remuneration policy includes share and option plans, but not the amount of remuneration as such. In order to make the same arrangement for non-executive directors, i.e. that their remuneration is determined by the shareholders' meeting, this would have to be arranged in the articles of association.

(o) *Structure regime*
Supervisory board members are important in "structure regime" companies. The DCC regulates their powers and their nomination and appointment. Under old law a "structure regime" company cannot have a one-tier board. However, the Act makes this possible. Article 2:164/274(a) of the Act provides that the articles of the DCC on supervisory board members in a "structure regime" company apply *mutatis mutandis* to non-executive directors in a one-tier board of such a company.

(p) *Committee membership*
Committees are deemed to be part of a supervisory board. Usually they consist solely of supervisory board members. However, there is no legal obstacle to having other persons, for example executive directors, as members of board committees.

In company with a one-tier board it would seem logical to have only non-executives as members of committees because of their monitoring role. Here too, however, there is no legal obstacle to having others as members.

4.5.8 Role of management board members in representing the company

An important element of the role of directors is whether they can represent the company and, if so, to what extent.

The First Council Directive of 9 March 1968 (68/151/EEC; OJ EC L65/8) emphasizes the importance of the registration of directors in the trade register of the country where the company is registered. In the

Netherlands the Chamber of Commerce administers a trade register known as the *Handelsregister*. It is meant to facilitate the freedom of trade between member states by means of clear and transparent rules, thereby enabling third parties dealing with a company to easily ascertain who has the power to represent the company. If a director is entered in the Trade Register as managing director, he may represent the company in all contracts and legal actions, without limitation,[1126] unless the register shows that more than one signature is required. A provision may be entered in the register that the company can be represented only by two management board members, or by two executive directors.

Third parties may rely on registration in the trade register as exclusive evidence of who may represent the company. Apart from managing directors, who have full power of representation, it is also possible to register a proxy holder with limited power of representation. The Netherlands does not have a system comparable to that of the US, where each officer may represent the company. Under the Dutch system those with the power of representation are either a managing director with full power of representation or a proxy holder with limited power. Others have no registered power of representation (see article 2:130/240 DCC). Under the Trade Register Act, especially section 18, managing directors are obliged to file and update the registrations. This obligation of directors is also mentioned in most articles of association and, although it is an administrative task, it is regarded as important.

Sometimes a company or board may wish to give a limited proxy to one management board member to act alone in certain limited matters, notwithstanding the fact that a two-signature system has been registered. In practice, if two signatures are required, two directors representing the company give a limited proxy in writing to the person who may act alone.[1127] This could also be done under article 2:129(a)3/239(a)3 DCC as introduced by the Act (hereinafter "DCC (Act)").

[1126] *Bibolini*, HR 17/12/1982, NJ 1983, 480, where the Supreme Court held that a director registered as such in the trade register can represent the company even if the third party knew about the requirement of shareholder approval. If a director has signed without the approval of the supervisory board or shareholders, despite such a requirement in the articles of association, the signature is valid vis-à-vis third parties, but the director personally can be held liable. This was decided in *Schwandt/Berghuizer Papierfabriek*, HR 29/11/2002, NJ 2003, 455.

[1127] Van Solinge and Nieuwe Weme (2009), p. 484 and Sanders, Westbroek, Storm and Buyn (2005), p. 172.

As we have seen, a power of representation in the Netherlands is based on registration and article 2:130/240 DCC, which confirms that the company can be represented by the management board and every management board member, provided that the articles of association may determine otherwise. In the UK section 40 of the Companies Act 2006 also determines that the power of directors to bind the company is deemed to be without limit. There is a difference. In the Netherlands, if the articles impose a limit on the management board members, that will not be held against the third party. In the UK, however, if a director has a limit imposed by the articles of association of £1 million, that limitation is deemed to be public knowledge and can be held against the third party because the articles are public.[1128] In the US, representation power is usually based on position (CEO or president are deemed to have the authority to bind the company), bye-laws, board resolutions or apparent or ostensible authority.[1129] In the US the authority of an officer is not overtly clear, hence the practice of legal opinions.

In the Netherlands there can be internal limitations, such as the requirement of the prior approval of supervisory board members or the shareholders' meeting. If a management board member enters into a contract with a third party without such consent, the contract is still valid vis-à-vis that third party, but the management board member will then be held liable internally.[1130] In other words, the power of representation of management board members is unlimited and unconditional.[1131] This is different from the UK and the US as described above.

Generally, supervisory board members cannot represent the company. Only in exceptional cases, such as if all the management board members have a conflict of interest, may the company be bound by supervisory board members.

For a one-tier board it will be logical to register only the executive directors – and not the non-executives – as persons who can represent the company. This last point also applies to the chairman, who will not have

[1128] Davies (2001), p. 161, nos. 7-9.

[1129] Pinto and Branson (2009), p. 134, revised Model Business Corporation Act § 8.41.

[1130] *ABN AMRO* case and article 2:107a DCC and *Schwandt/Berghuizer Papierfabriek*, HR 29/11/2002, NJ 2003, 455.

[1131] Article 2:130/240, 3 DCC, and Van Solinge and Nieuwe Weme (2009), p. 485 and Prof. J.M.M. Maeijer, *Vertegenwoordiging in Rechtspersoon: De Naamloze en de Besloten Vennootschap* (1994), p. 370.

the power to represent the company. If the company so wishes, the chairman and or other non-executives could have the power of representation.

4.5.9 Dual task of managing directors: action and monitoring

Under existing Dutch law each member of the management board has a dual task: day-to-day management and monitoring. In the first place he has his specific daily duties. For example, the COO of an oil and chemical storage company is responsible for the storage tanks, their maintenance and the buying and selling of tanks. Let us suppose that he has been given the authority to bind the company in matters within his remit, without the consent of anyone else, up to a limit of €5 million per transaction. This same COO, as management board member, is required to monitor his fellow finance director in so far as general policy and the main aspects of the latter's tasks are concerned. For example, the COO will also study the financial accounts. The finance director in turn will monitor the work of the COO when he enters into contracts for the building of an LNG tank for €20 million.

The Dutch term for the specific (non-monitoring) duties of an individual director is *taak,* as set out in the present article 2:9 DCC and in articles 2:9 and 2:129/239a, paragraph 3 DCC as amended by the Act. There is also a reference in the old article 2:9 DCC to *werkkring*, which may be translated as "area of work" or "sphere of duties". The subject of the monitoring task is the general course of affairs (*algemene gang van zaken*). Article 2:9 DCC of the Act mentions that the whole management board has responsibility (*draagt de verantwoordelijkheid*) for the general course of affairs, which implies that this board has to act as a team and is jointly and severally liable for the general course of affairs. The present article 2:9 DCC says that each of them is liable for the whole (*ieder van hen voor het geheel aansprakelijk*), whereas the proposed article 2:9 DCC uses the expressions "bears the responsibility" (*draagt de verantwoordelijkheid*) and must "monitor the general course of affairs".

This distinction between the specific duties of an individual director and the general task of overseeing is an important topic in Dutch legal literature in general and in particular in connection with thoughts about one-tier boards in particular.[1132]

[1132] Dumoulin (2005), pp. 268-269; Dortmond (2003), pp. 118-119; Van den Ing (2000), pp. 140-141; Van den

The general view is that the management board manages the company (the Dutch word is *besturen*).[1133] This means that the powers are vested in the whole management board, which is responsible for all aspects of the governance of the company. This is comparable to the US concept in section 141(a) of the Delaware GCL: “the … shall be managed under the direction of the board” and to the UK concept of the unitary board. In the US and the UK the board as a whole takes all the decisions.

The general view in the Netherlands is that the board as a whole can delegate certain aspects of its work to a specific director. But such delegation does not relieve the board of the responsibility to give clear instructions, to delegate only to a person who is capable of performing the task, to consult and to monitor. This is important not only for the general functioning of a board but also when discussing the possibility of dividing up tasks within a one-tier board. The general view is that delegation is possible under old law and is expressly described in the Act. The Act requires a statutory basis for the division of tasks in article 2:129/239a, paragraph 3 DCC.[1134]

There is a specific difference between Dutch law and practice on the one hand and UK and US law and practice on the other. In the UK and the US it is possible to delegate general powers to a non-director. For example, in US and UK joint venture agreements there is often a clause permitting an “alternate director” (i.e. a replacement director) to attend a board meeting instead of a board member.[1135] This idea of an alternate director is not possible under Dutch law, because the responsibility of a director for the general policy is purely personal.[1136]

Ing (2005), p. 115 et seq.; P.J. Dortmond, ‘Delegatie binnen het toezichthoudend en het bestuurlijk orgaan’, *Ondernemingsrecht* 2005/90, p. 263 (“Dortmond (2005)”); Mr J.M. Blanco Fernández, ‘Rechtspositie in aansprakelijkheid van bestuurders en commissarissen’, *Ondernemingsrecht* 2000/17; Strik (2010), p. 105 et seq.; Wezeman (2009/G), p. 93; Van Solinge and Nieuwe Weme (2009), p. 171.

[1133] Article 2:129, 1 DCC.

[1134] Article 2:129/239a(e) DCC: “The articles of association may directly or indirectly provide that one or more management board members can validly decide on matters that come within their remit. Any such provision pursuant to the articles of association must be in writing.” (*Bij of krachtens de statuten kan worden bepaald dat één of meer bestuurders rechtsgeldig kunnen besluiten omtrent zaken die tot zijn respectievelijk hun taak behoren. Bepaling krachtens de statuten geschiedt schriftelijk*.)

[1135] Davies (2008), p. 381.

[1136] Sanders, Westbroek, Storm and Buyn (2005), 6.2, p. 202. There is also no scope for “alternate supervisory

Dutch authors make a distinction in 4 (some say 3) tasks of directors: first, the specific task allocated to him; second, all tasks not specifically allocated; third: the general course of business (the second and third can be one group); fourth: monitoring each other. The first is individual, the second, third and fourth are collective.[1137] See also 4.6.2 below.

The general view is that managing the general course of affairs of a company is the task of the complete management board and, in the case of a one-tier board, of all the executives and possibly the non-executives as well, and that this entails joint and several responsibility and liability for all actions of each and every director, even if the actions were undertaken by a director to whom powers had been delegated. This is in line with the Dutch tradition of governance by consensus.

4.5.10 Independence of supervisory board members

Interestingly, the Frijns Code not only defines independence in technical terms but also sets a standard of behaviour (the duty to "act critically"). This is one of the few cases in which the Frijns Code broaches the subject of behaviour (*gedrag*).[1138]

The Frijns Code stipulates that all but one of the supervisory board members must be independent of the company and defines independence as not having been connected with the company as an employee or contracting party during the preceding year, not having cross-board memberships (see (d) in the note) and not holding or directing a company that owns more than 10% of the shares in the company.[1139]

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board members".

[1137] Strik (2010), p. 137; other jurists say there are 3 tasks, because they put the seond and third together.

[1138] Frijns Code Principle III.2.

[1139] Frijns Code III.2.2.

In summary the supervisory board member or any member of his family:

(a) may not be an employee or management board member;

(b) may not receive fees from the company;

(c) has not had important business relationship with the company during the preceding year;

(d) is not a management board member of another company where a management board member of the company is supervisory board member;

(e/f) does not hold or manage a company that holds 10% of the shares in the company;

(g) has not managed the company in the preceding 12 months as a replacement management board member.

The main difference of principle between the Dutch and US positions is that in the US independent directors can be and are encouraged to own shares in the company on the grounds that having a stake in the company is a motivational factor. In the Netherlands, however, they are discouraged from owning shares as it is thought that this would make them less receptive to other stakeholder interests and the long-term view. The Frijns Code puts the threshold at a 10% shareholding.[1140] In the US cross-directorships are deemed to compromise independence only if the cross-director is a member of the compensation committee. In the Netherlands all cross-directorships should be avoided.[1141] The Frijns Code says that all cross-directorships create a lack of independence. The difference with the UK is that in the Netherlands a maximum term of 12 years applies to supervisory board membership,[1142] whereas in the UK a director is deemed to have lost his independence after 9 years of service. The UK Corporate Governance Code even suggests that a company should actively consider whether a director should be reappointed after 6 years.

The question is whether the drive for independence is not overdone. Will the pendulum swing back? If one over-emphasizes independence, the pool of available business knowledge and expertise becomes very small. The Frijns Code only permits one non-independent supervisory board member/non-executive director. Professor Maarten Kroeze argues that this should be more flexible, and there is international support for his view.[1143] The UK system of balanced membership is more flexible.

UK chairmen are not regarded as independent after their appointment. This point has not been raised in the US and the Netherlands, probably because they do not yet have a track record of “hands-on” chairmen. This point may crop up in the future.

[1140] Frijns Code III.2.2(e).

[1141] Frijns Code III.2.2(d).

[1142] Frijns Code III.3.5.

[1143] Kroeze, Article (2005/A), with reference to US economics studies. Martin Lipton informs me he is of the same opinion. The UK Walker Review warns that too many independents might be detrimental to the knowledge represented in the board. Warren Buffet in Cunningham (2009), p. 55 makes the same point.

The last independence criterion in the Frijns Code is not having acted as de facto manager of the company in the preceding year.[1144] This is analogous with the UK reasoning that a chairman is ipso facto no longer independent. It is my impression that in the US independence is generally a matter of fact, not of formal rules, because the US courts hold that there is a duty of loyalty to the company. Under the Dutch Code, by contrast, independence is more of a box-ticking exercise.

4.5.11 Chairmen in the present and future

Introduction

Under present Dutch law the chairman of the company is the chairman of the supervisory board.

The general view is that whereas the role of the CEO has become stronger the chairman's position has not grown at an equal pace. This means that a certain balance has been lost.[1145]

There are many instances where a strong CEO has managed to dominate the chairman. After all, the CEO has all the information, can choose what he wants to tell and has the opportunity to influence the chairman in one-on-one meetings and calls. In this way the CEO can also create a distance between the chairman and the other members of the supervisory board.[1146] This can only be prevented if the chairman has the initiative and can gather information about the company and its business from other internal sources. So far, however, the Dutch consensus culture has expected the chairman to behave not as an active leader, but as a *primus inter pares*.[1147] The DCC makes no mention of the chairman of the supervisory board.

Tabaksblat

The Tabaksblat Code and the Frijns Code have given the chairman of the supervisory board a substantial role in ensuring the functioning of the supervisory board and its committees. Under the Codes the chairman has

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[1144] Frijns Code III.2.2(g).

[1145] Schuit (2010), p. 33.

[1146] Smit (2009), which describes the board dynamics at ABN AMRO, where supervisory board members for years seemed ignorant of a continuing disagreement between the CEO, Groenink, and the director for investment banking, Jiskoot.

[1147] Sanders, Westbroek, Storm and Buyn (2005), 6.6.3.

to act as the main contact between the supervisory board and the management board members and shareholders and to ensure the orderly and efficient conduct of proceedings at general meetings.[1148]

General meeting

Conducting the general meeting of shareholders is an external function. As mentioned above, the DCC does not state who should chair the meetings, but most articles of association provide that the chairman of the supervisory board should preside over the general meetings.[1149] General meetings in the Netherlands are less well prepared than in the US and UK, where the lead time is much longer and all the procedures are observed for proxy voting and the provision of extensive information. General meetings in the Netherlands are often full of surprises. An example is the *HBG* case of 2003, where shareholders had asked the chairman to consult the shareholders' meeting about a substantial transaction (the conclusion of a joint venture), although there was no legal obligation to seek the approval of the general meeting. At a later meeting the boards gave some information about the transaction, but the shareholders questioned whether it was sufficient. The Enterprise Chamber held that there had been mismanagement, but the Supreme Court overturned the decision. This was an example of a supervisory board having to deal with a novel and unexpected situation.[1150] Foreign chairmen are not used to surprises at formal meetings. Chairing may become increasingly difficult[1151] if general meetings of shareholders are shown live on the company website and electronic voting becomes possible.[1152] Given the large percentage of foreign shareholders and the difficulties for foreigners in speaking and voting at general meetings, the pressure to move the debate with shareholders to an earlier date before the meeting, as is the practice in the US with proxy soliciting, is likely to increase.[1153]

[1148] Frijns Code Principle III.4.

[1149] Sanders, Westbroek, Storm and Buyn (2005), 6.6.3.

[1150] *HBG*, HR 21/2/2003, NJ 2003, 182.

[1151] Cees J.A. van Lede, Chairman of Heineken, retired CEO of AKZO, 'De rol van de voorzitter' ['The Role of the Chairman'], *Ondernemingsrecht* 2005/8, p. 258 ("Van Lede (2005)").

[1152] Van Lede (2005), p. 257.

[1153] Riens Abma, director of Eumedion, 'Changed Position of the Shareholder', *Goed Bestuur* 2 (2006), p. 16 ("Abma (2006/A)").

External
The responsibility for chairing general meetings of shareholders results in other external duties, such as giving the company a human face (a duty shared with the CEO), promoting the company's image in the long term, and deputising for the CEO in cases of illness or sudden absence (as happened at ING, where chairman Homme replaced the CEO when he suddenly fell ill). The chairman may possibly also be called upon to explain matters in the case of a crisis and to explain the company's remuneration policy to the outside world. All these functions suggest that while the CEO is chosen for what he can do the chairman is often chosen for the impression he makes. Nonetheless, he should be modest![1154]

Internal team leader
The most important internal function of the chairman is to advise, encourage and act as a sounding board for the management board, especially the CEO.[1155] He should know the company well. He should also understand the dynamics of the management team and take action as soon as he suspects any disagreement between management board members. He should talk to them and inform his fellow supervisory board members. As soon as he senses disagreement between two executive directors during a meeting, he should adjourn informally and talk to each of them. In that sense he acts as the coach of the management board.

Some commentators say that Dutch companies have a triangular organisation: management board, supervisory board and shareholders. All three should communicate well internally and with each other.[1156] If there is a problem of communication the chairman should try to mend the lines of communication.[1157]

He is clearly the team leader of the supervisory board and as such responsible for ensuring the best possible results in the following fields: induction, training, information, agenda setting, allowing for sufficient time for consultation and decision making, committee functioning, appraisals at least once a year, election of the vice-chairman, meetings of

[1154] Van Lede (2005), p. 257.

[1155] Van Lede (2005), p. 258.

[1156] Frijns Code III.4.1.

[1157] This principle is to be found in article 2.8 DCC: "All concerned with the company should act reasonably towards each other". This is a basic principle of Dutch company law. It starts with good communication and also involves taking due account of one another's interests.

the supervisory board without management board members present, proper contact with the management board and works council,[1158] and the planning of an orderly succession for management and supervisory board members. The harder the chairman works, the more important it is that he ensures that no information gap exists between him and the other supervisory board members, because he will only get the best out of his fellow board members if they are fully involved and informed.

Clearly, the Tabaksblat Code was inspired in part by the UK Combined Code. The UK literature on chairmen is often used as example in the Netherlands.[1159]

The UK codes and literature have also inspired the most recent Dutch book by Professor Steven Schuit entitled "*The chairman makes or breaks the board*". Professor Schuit interviewed captains of Dutch industry and, based on the information they provided, made recommendations. These recommendations deal with the points mentioned in the Frijns Code, which are in many cases influenced by the UK codes. The chairman should ensure (1) proper succession of board members, (2) proper consultation and debate in the supervisory board, (3) proper coaching and "employment" of the management board members,[1160] (4) proper committee composition, (5) proper distribution of information, (6) proper follow-up to board decisions, (7) independent monitoring, (8) proper coordination of advice, (9) proper training and education, (10) proper evaluation, (11) meetings of the supervisory board without management board members present, (12) proper discussion of the development and achievement of strategy, (13) proper communication with important shareholders, (14) transparent reporting, (15) choosing a vice-chairman to evaluate the chairman, and (16) proper documenting of the division of

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[1158] Frijns Code III.4.1.

[1159] E.g. Cadbury (2002) and Rushton (2008).

[1160] Schuit (2010), pp. 57-58. Ensuring proper coaching and 'employment' of the management board members is an important function of the chairman. Schuit explains on pp. 57-58 that the chairman should act as sounding board, coach and confidential counsellor for the management board members. He should also take a lead in promoting their well-being and functioning and hence in their remuneration. In addition, the chairman should be a member (not the chair) of the remuneration committee. He should take the lead in appointing and dismissing management board members and be chairman of the nomination committee. The word 'employment' was introduced in this context by P. Elverding, CEO of DSM and retired chairman of ING and Océ.

duties between the CEO and the chairman.[1161] The book includes an English summary and is well worth reading. Schuit is of the view that chairmen should be more active than they are at present in order to get the best out of their fellow supervisory board members. He pleads for "heavyweight" chairmen. The same points would also be applicable to the chairman of a one-tier board, who would then also act as team leader of the executives and non-executives. The sheer number of quotes from people who are or were in positions of authority in large companies, such as Morris Tabaksblat, Hans Weyers, Jeroen van der Veer, Rob Zwartendijk, Jan Michiel Hessels and Kees van Lede, lends extra weight to these recommendations. It is interesting that the emphasis placed by Professor Schuit on the chairman's role as an inspiring team leader fits in well with the Dutch tradition of teamwork and consensus.

Questions

Schuit raises the question of whether the Dutch should follow the UK example exactly. Whatever the answer to this question might be, it is thought-provoking to read about "chairmen/team leaders" in the UK literature. It raises the question of whether UK chairmen are not becoming too powerful. Is it right that they should have a room next to the CEO? Would it not be better if the CFO were to sit in the room next to the CEO and that the chairman were to have a room on another floor, for example a floor above or below the CEO? Or should he perhaps have no room in the company's offices at all, as suggested by Kees van Lede.[1162] Should there be greater emphasis on the CFO? Is it right for the chairman to speak to shareholders about strategy without the CEO being present? Hans Weyers believes this should not happen.[1163] As UK chairmen are experts in just listening and not saying anything, not even by body language, it may be acceptable for them to have meetings with shareholders, but this may not be advisable in Dutch corporate culture. The advice of the Frijns Monitoring Committee is that the chairman should be able to speak to shareholders to sound out their views in the presence of another supervisory board member and an executive.[1164] It is also Martin Lipton's advice that a chairman or lead director should not

[1161] Schuit (2010), pp. 49-96, where he provides quotes from captains of industry in support of all 16 of these items and sets out his own proposals for the text of a code on internal regulation. He calls his proposals 'observations'.

[1162] C. van Lede quoted in Schuit (2010), p. 94.

[1163] H. Wijers quoted in Schuit (2010), p. 78.

[1164] Monitoring Committee June 2008, p. 66.

speak to shareholders other than in the presence of the CEO. Again, what is possible in the UK where the chairman only listens may not be appropriate in the US or the Netherlands. For a low key approach and not too much hands-on leadership we might look to the US examples of non-CEO chairmen and lead directors.

Finally, what should a chairman do if there is a dispute between management and shareholders? In the *Stork* and *ASMI* cases[1165] the Enterprise Chamber gave the impression that the supervisory board should act as a go-between. The term used by the Enterprise Chamber – *bemiddelen* – is generally translated as mediate, but the meaning of the Dutch term is wider. The word mediate has a neutral connotation. In my view, a supervisory board can hardly be called neutral because it must have its own view. If it does not agree with the strategy of the management board it should say so immediately, but only to the management board. If it agrees with the management board it should support it. If the supervisory board then talks to shareholders it has to express support for the position of the management board, but remain open to the views of the shareholders. It may suggest a compromise in the presence of a management board member, after having consulted with management, but has no obligation to do so.

A completely different question is what the chairman of the supervisory board should do if he senses that communication between the management and the shareholders is not good. He should make every effort to ensure that communication improves and should in any case do nothing that could exacerbate the situation. In some cases the supervisory board might then be free but is not obliged to play a conciliatory or mediating role,[1166] as proposed by the Frijns Monitoring Committee and Advocate General Timmerman in the *ASMI* case.[1167] This requires politeness, respect and sensitivity to the feelings of the parties or, as Mrs M. Bax has said, emotional intelligence.[1168] This does not mean the

[1165] *Stork*, OK 17/1/2007, NJ 2007, 15; *ASMI*, OK 5/8/2009, JOR 2009/254.

[1166] In my view, the word "*bemiddelen*" has too much of a mediation connotation.

[1167] The view expressed by the Frijns Monitoring Committee, June 2008, p. 66, and in the opinion of Advocate General Timmerman in the *ASMI* case is that there is no obligation but only a freedom to mediate. In the *ASMI* case the Supreme Court held that the supervisory board did not have a duty to mediate. HR 2/6/2010, NJ 2010, 544.

[1168] At a seminar held by DLA Piper on 24 March 2010 Mrs Marieke Bax, a trained lawyer and MBA and member of the supervisory board of several companies, mentioned the importance of chairmen being supervisory board has to make concessions. It can listen and say it will give the matter thought.

In a one-tier board the role of the non-executive chairman is much clearer. He monitors, coaches and, if he agrees, supports management. I do not think that UK or US judges or lawyers would suggest that a chairman has a mediating role; naturally, he has a role in improving communication, but no more.

As regards committees, the chairman should not chair the audit committee or the remuneration committee, but should chair the nomination committee. There is convergence on this point in the UK, US and the Netherlands.[1169]

4.5.12 Separate chairman and CEO: exceptions in family companies?

Under Dutch law the chairman of the supervisory board and the CEO cannot be the same person. No one can be on the management board and supervisory board at the same time. The Act too states that all one-tier board companies must have a separate chairman who is a non-executive director and therefore cannot be the CEO at the same time.[1170]

In the UK and the US even the most convinced proponents of separate non-CEO chairmen make exceptions for family companies. For example, Cargill Corporation, a US company, is 100% owned by the family. Cargill is a huge conglomerate with operations in the food, energy, chartering and finance sectors. It has a board of five executive directors, five outside directors who are also family members and five independent directors. No family members are employed by the company. Cargill has a non-family professional CEO/chairman, who has the complete trust of the family; as CEO he has a high profile within the company and ensures that he meets a lot of staff in many different locations. He is also in close touch with the family and gives them direct information. Cargill is successful and has come through the crisis well. The close cooperation between the CEO/chairman and the family is regarded as a plus. Would a separate chairman in any way improve the communication with family shareholders? In the event of a dispute a lead independent director can

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emotionally intelligent.

[1169] Frijns Code III.5.6, III.5.11.

[1170] Article 2.129/239(a) DCC of the Act.

always step in. The family considers it an advantage that they need deal with only one person, namely the CEO/chairman who manages the company and represents it – in his capacity as chairman – in dealings with the outside world. Keep it simple!

The point I wish to make is that there are good examples of a combined role working. So the question could be asked why the Act mandatorily prescribes that these positions should in all cases be held by two separate persons. Even UK and US proponents of separate non-CEO chairs say that it would not be appropriate to have a "one size fits all" rule.

If Cargill were a Dutch company and still wanted to have a combined CEO/chairman after the Act becomes law, it would be advised that by law it is required to have a CEO/president and a separate chairman. It could also be advised to include a provision in the board bye-laws to the effect that only the CEO/president should communicate with shareholders. The bye-laws would state that the chairman presides over the board meetings, but could also stipulate that the chairman should always follow the advice and suggestions of the CEO/president. The chairman would also chair the shareholders' meetings, but let the CEO/president deal with all items on the agenda of the meeting.

As we are not dealing with a public company in this hypothetical case, a more straightforward alternative would be for the company to have only a classic management board without non-executive directors. The CEO could then be called chairman of the board and the five family members and independent directors would constitute an advisory board in the same way as Unilever used to work, see 4.4.2.3 above.

Possible ways of achieving greater flexibility would be to amend article 2:239(a) DCC as proposed in the Act or to insert a clause in the Act on liberalisation of the rules on share capital and governance in private limited liability companies (known as the Flex BV Bill) providing that the general meeting of shareholders could resolve by a large majority to opt out of the requirement that the position of chairman be held by a non-executive director. However, I shall refrain from making such a proposal, also because there are practical solutions to solve this problem as described above.

There are many views and possibilities of using the one-tier board system in family companies, where family members may want to be more involved in the business as non-executive directors. The One-Tier Board Act gives substantial flexibility.[1171]

4.5.13 Evaluation

One of the most important functions of the supervisory board is to carry out formal evaluations of both the management board members and its own members.[1172] At least once a year the supervisory board meets, without any management board members present, to discuss the functioning of its own members and its own profile as well as the management board's strengths and weaknesses[1173] In the US it is common practice to hold separate meetings for non-executives only (confusingly known as "executive sessions") before or after each board meeting. At these meetings one of the topics is nearly always the evaluation of the executives. In the Netherlands some companies are starting to follow this example.

Another question is whether advisors should be involved in the evaluation. Professor Steven Schuit suggests an evaluation by external advisors every two years.[1174] I support this as a best practice suggestion for large companies. The increased use of external advisors is discussed also in sub-section 4.4.3.

The nomination committee (also called the selection and appointment committee), consisting of supervisory board members only, is involved in the evaluation of the management and supervisory boards as a whole and of the individual members and reporting this to the supervisory board.[1175] In practice this is an open discussion where, normally, all members are present, including those who are being evaluated. If there is likely to be friction or a possible dispute, the members may consult together beforehand either by telephone or in a smaller group. If the aim is to dismiss a director or obtain his resignation, he will often be asked to briefly leave the room. Subsequently he will have the opportunity to defend himself. The vice-chairman presides over the evaluation of the

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[1171] *Financieele Dagblad*, 23 April 2011, p. 11, "*Familiebedrijven kunnen baat hebben bij een 'one-tier board'*".

[1172] Glasz (1992), pp. 17-18; Van der Grinten (1989), p. 515; and Van Solinge and Nieuwe Weme (2009), p. 603.

[1173] Frijns Code III.1.7.

[1174] Schuit (2010), p. 73.

[1175] Frijns Code III.5.14(b) and (c).

chairman.[1176] The task of the remuneration committee is, of course, to express an opinion on the value of each management board member when it advises on that person's remuneration.

In the case of a one-tier board the Act explicitly states that the remuneration of the executive directors is determined not by the whole board but only by the non-executive directors.[1177]

The Monitoring Committee, the committee that monitors and reports on compliance with the Corporate Governance Code, reported in December 2010 that there is room for improvement in the transparency provided by supervisory boards to shareholders and other stakeholders about their evaluation procedures.[1178]

4.5.14 Term of office, re-election, dismissal of supervisory board members and non-executive directors

The term of office for supervisory board members is four years and can be repeated three times.[1179] It is considered unusual in the Netherlands if a supervisory board member does not complete the full twelve years. This tendency to remain firmly ensconced in one's seat is seen by many as a drawback of the Dutch tradition of consensus-seeking consultation among people who are for the most part members of the old boy's network and are, above all, keen not to upset the apple cart.[1180]

One way of avoiding painful dismissals of supervisory board members or routine renewal of their term of office after the standard four years would be to have them re-elected at shorter intervals. One-year intervals have been mentioned. The UK Corporate Governance Code of 1 July 2010 gives annual re-election as a best practice rule. However, in an open letter

[1176] Frijns Code III.4.4.

[1177] Article 2.129/239(a), 2 DCC, as proposed in the Act.

[1178] Monitoring Report (2010), p. 6.

[1179] Frijns Code III.3.5. Management board members too are appointed for four years at a time, without a maximum, Frijns Code II.1.1. Article 2:161/271(2) DCC also gives a statutory 4-year maximum for supervisory board members in 'structure regime' companies.

[1180] Prof. Auke de Bos and Dr. Mijntje Lückerath-Rovers, *Gedragscode voor Commissarissen en Toezichthouders: Discussiedocument* (2009) ("De Bos and Lückerath (2009/D)"), mention that this tradition is not conducive to good standards of conduct; see also Schuit (2010), p. 73 and Van Manen (1999), p. 292.

in the *Financial Times* three important pension funds have objected to this annual re-election rule, arguing that it promotes short-termism.[1181]

Interestingly, the opinion of the UK pension funds has been used as an argument in the US too against appointing directors for short terms. In the US a majority of listed companies have annual elections, but a large minority[1182] have boards with staggered three-year terms. I agree with the argument of the UK pension funds about the dangers of short-termism under a regime of annual re-elections and would favour three- or four-year terms, but it seems that Dutch directors themselves have decided to move on more quickly. The Monitoring Report of December 2010 informs us that 43% of the supervisory board members withdraw after their first term of four years.[1183] What is said above about terms of office also applies to non-executive directors of a one-tier board.

As regards the maximum total term, the Frijns Code mentions twelve years whereas the UK codes suggest nine years for chairmen and six years for executive directors. Generally, it could be argued that a six- or nine-year maximum would be preferable in these busy and fast-moving times.

4.5.15 Formal documentation of functions in two-tier and one-tier boards

Because the roles and functions of the management board and the supervisory board in a two-tier system are described in the DCC and also in various articles of association, there has been little demand in practice for documentation on the functioning, powers and standards of management and supervisory board members in the Netherlands.[1184]

[1181] Open letter in the *Financial Times* of 16 July 2010 from Hermes Equity Ownership Services, Railpen Investments and Universities Superannuation Scheme, in which they argue that annual re-election promotes short-termism and refer to the Stewardship Code for Institutional Investors of 2 July 2010 and to the opinion of the chairman of the Association of FTSE Companies.

[1182] 4% of the largest 100 companies, 25.2% of Fortune 500 companies and 41.9% of the NYSE companies have staggered boards. See the commercial database of Shark Repellant. This was also confirmed to me by Adam Emmrick, partner in Wachtell Lipton, by e-mail of 10 August 2010. Examples of corporations with staggered boards are Airgas, Air Products, Bank of America, Barnes & Noble, Baxter, Blackrock, Dole, Eastman, Fidelity National Financial, Hertz, Huntsman, Kellogg’s, McDonalds, Metlife, Mousanto, NRG, Sysco, Estée Lauder, Western Union, US Airways, Visa and Western Refining.

[1183] Monitoring Report (2010), p. 49.

[1184] De Bos and Lückerath (2009/O), p. 35. Only 33% of supervisory board members have specific descriptions

At present, articles of association often list the decisions of the management board that need the prior approval of the supervisory board. Sometimes the articles of association state that the supervisory board can give instructions to the management board about general policy matters. The articles of association can also describe which director is authorized to sign on behalf of the company and whether two signatures are necessary and, if so, whose signatures. All of this should be public and is indeed public because the articles of association are filed in the trade register at the Chamber of Commerce. Article 2.129/239(a) DCC (Act) provides that the duties of board members should be described in the articles of association. This is a good addition because it will increase transparency.

It is, of course, important to record all the further details in board bye-laws and letters of appointment, as is the practice in the US and the UK.[1185] The detailed letters of appointment for NEDs in the UK are particularly good examples to follow. This is also of importance in connection with possible exculpation as described below in sub-section 4.7.1.

4.5.16 How board committees can help to get the best out of directors

In the Netherlands a nomination committee is concerned solely with nominating supervisory and management board members. Most Dutch remuneration committees have until now restricted themselves to the remuneration of directors. Since 2008 the remuneration committees of banks only have become involved in the remuneration of certain levels of middle management following the introduction of new rules on the financial rewards for large groups of bank employees.[1186]

The differences between a two-tier system and the proposed one-tier system will become noticeable in the scope of work of the various board committees once a one-tier board is introduced. An interesting point can be made about the difference between the committees of a two-tier board and a one-tier board. In a two-tier board it is logical for the nomination committee to discuss only the succession of the management and

of their duties.

[1185] UK sub-section 2.5.8, US su-bsection 3.5.6.

[1186] Controlled Remuneration Policy Decree and DNB Regulation on Controlled Remuneration Policy.

supervisory board members. In a one-tier board it is to be expected that the nomination committee will also be involved in discussing the succession to all key positions in the company and its subsidiaries. The same is broadly true of the remuneration committee. In a two-tier board this committee discusses the remuneration of the management board members only, whereas in a one-tier board they have to discuss the income policy at middle management levels as well.[1187]

This aspect of a one-tier board, where its remit includes management development in a broader sense, should be studied in the light of US practice and experience. In the US, succession is given much consideration at board level.[1188] US business leaders understand that choosing the right people throughout the company and ensuring they receive appropriate remuneration is part of risk management and should be regarded as setting the tone from the top.

Over the last ten years Dutch practice has to some extent converged with that of the UK and the US. Here too, board committees are increasingly preparing decisions in great detail before proposing them to the full board for final decision. This is in keeping with the example of the US,[1189] where committees sort out the details so that matters are ready for brief discussion and a quick vote by the board.

4.5.17 Succession

The system of succession in Dutch public companies has always tended to vary from company to company and has not followed uniform and transparent rules. A variety of pressure groups could make binding or semi-binding nominations or even appoint management and supervisory board members. These groups included priority shareholders and board-friendly foundations, in cases where defence mechanisms had been installed. And in the case of "structure regime" companies supervisory board members and works councils had rights of nomination and appointment. Even in the absence of such privileged groups, it was customary for the CEO to propose his own successor and the successors

[1187] Van Lede (2005), pp. 258-259.

[1188] US Chapter, sub-section 3.5.7 above.

[1189] Frijns Code Principle III.2: "… to prepare decision making". In the UK, the FRC Guidance on Audit Committees: "Nothing in the guidance should be interpreted as a departure from the principle of the unitary board." The SEC and NYSE apply the same principle. Langman (2005), p. 261.

of other management board members. Often such a successor was accepted by the supervisory board. Similarly, the chairman of the supervisory board and other heavyweight fellow members appointed their successors. Now, with the recent evolution of nominations committees presided over by the chairman, there is a more formal process.

The Dutch can learn both from the UK example of rigorously following the procedures for nominations and of regularly discussing succession[1190] and from the example of US boards, which actively plan recruitment, development and succession for all key positions.[1191] Although the introduction of nomination committees has seemingly improved the Dutch succession planning system, the CEO is still felt by some to exercise too much influence.[1192]

Nomination committees are now required to draw up a profile for the board as a whole whenever they make a nomination.[1193] The idea of a profile was put forward by the Peters Committee in 1997 and even earlier, in 1984, by the Social and Economic Council (*Sociaal Economische Raad/*SER), in its advisory report on the members of supervisory boards of "structure regime" companies. This idea was developed further in the Tabaksblat and Frijns Codes.

In my view, a certain amount of formalisation of the nomination procedures is a good idea and a profile can be helpful in this respect. There are many companies where this works well, but there are others where profiles and formal procedures are just window-dressing, or box-ticking exercises, designed to conceal the fact that a dominant director is still pushing his or her favourite. Another criticism, often heard about profiling, is that it focuses on formal aspects such as residence, nationality, knowledge and experience and less on the personal qualities

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[1190] Cadbury (2002), p. 96, Main Principle A.4 CC8 and B.2 GC10, and sub-section 2.5.9 above.

[1191] US Chapter, sub-section 3.5.7 above.

[1192] *Financieele Dagblad*, 12 October 2010, p. 11 in which Peter Elverding, Chairman of ING, Océ and Q-Park utters some critical remarks addressed to business leaders, who have too little knowledge of human relation issues.

[1193] Frijns Code III.3.1 applies as a profile for all listed companies; since 1 October 2004 article 2:158/268, 3 DCC requires a profile for structure regime companies. A special committee, under chairman Cees Maas, which was asked to advise about the future of banks, published an advisory report on 7 April 2009 (Maas (2009)). That committee recommended that a profile be made for the supervisory board as a whole and for each supervisory board member individually, see p. 12.

needed for good human resource and teamwork aspects. The introduction of nomination committees does provide for a proper procedure. It is important to follow the UK example of discussing succession and nominations regularly in meetings to avoid decisions being prepared and taken informally. Dutch corporate practice would also do well to follow the US example of discussing mid-level succession and formulating emergency plans for sudden vacancies.

Proposal
I suggest that the following text be added as III.2.4 to Principle III.2 of the Frijns Code: "The supervisory and management boards will deliberate with each other at least once a year about the procedure and the ways and means of discussion, the frequency and timing of the evaluation and succession of supervisory and management board members and about the desirability and, if so, the frequency, to ask outside advisors to assist in this process, as well as the terms of office of all the directors, and which middle management persons should fall under the evaluation and succession process. If there is a one-tier board, the complete board should hold these annual deliberations."

4.5.18 Risk management

Risk management is treated as important in the Netherlands. Article 2.141/251 DCC puts it on the same level as strategy. That article mentions that the management board must report at least once a year to the supervisory board on strategy and risk management. The Frijns Code includes provisions for risk analysis based on operational and financial objectives, guides for the layout of a financial report and a system of monitoring and reporting,[1194] including the highlighting of the main risks and a description of major failings detected in risk management.

The Frijns Code puts the responsibility for strategy and risk on the management board.[1195] Risk management was also discussed extensively by the Association for Commercial Law on 8 December 2009. The association was advised by Professor Bastiaan Assink and Dr Daniëlla Strik, who is litigation partner at Linklaters and defended a thesis on

[1194] Frijns Code II.1.3 and 4.

[1195] Frijns Code (2008): Best Practice II.1.3. There is convergence with the UK and US on the point that risk management is part of strategy. The Maas Committee's Report for Banks, described below in subsection 4.5.19, takes the same view on p. 12.

director liability in 2010.[1196] Generally, the view is taken that in banks the CEO should be responsible: he sets “the tone from the top”.[1197] There should also be a Chief Risk Officer (CRO), who should be a member of either the management board or the management team.[1198] There should be a risk committee of supervisory board members.[1199] The Maas Committee, mentioned below at 4.5.19, also recommends that banks should have a risk committee.[1200] The supervisory board members are to supervise the management board in the performance of its risk management activities. Here there is a parallel with the supervisory board’s monitoring of strategy.[1201] All these measures are to be combined for better risk management.

Examples of important risk management or supervision cases:

– *Laurus* (2005)[1202] was the product of a merger of food shop chains. It developed an aggressive plan – the “Konmar Plan” – to integrate the chains. The Enterprise Chamber did not condemn this ambitious strategy. The point at issue was whether there had been sufficient follow-up by the management and supervisory boards in their monitoring of the plan once it started to fail. The Enterprise Chamber ruled that there had been mismanagement by the management and supervisory boards on the follow-up aspect. It also confirmed that mismanagement does not automatically imply liability. The issue of liability is dealt with by the District Courts (*arrondissementsrechtbanken*). The Supreme Court upheld this decision, but declared that the plaintiff’s allegation of mismanagement by the supervisory board members should be dismissed because the arguments put forward by the plaintiff were insufficient to enable the supervisory board to defend itself. This was a case of insufficient follow-up and is difficult to prove in court.

– *Ceteco* (2007)[1203] was a trading company that had a very ambitious plan for expansion. The management and supervisory boards continued to approve further acquisitions,

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[1196] B.F. Assink and D. Strik, *Ondernemingsbestuur en risicobeheersing op de drempel van een nieuw decennium: een ondernemingsrechtelijke analyse* (2009) (“Assink and Strik (2009)”).

[1197] Principle 4.1, Code for Banks, no. 4.1 and Maas (2009), 1.18.

[1198] Code for Banks, nos. 3.1.7 and 4.1.

[1199] Assink and Strik (2009), pp. 237-238.

[1200] Code for Banks, no. 4.5.

[1201] Article 2.141/251 DCC and D. Strik, ‘Pre-advices to the Association of Commercial Law’, in B.F. Assink and D. Strik, *Ondernemingsbestuur en risicobeheersing op de drempel van een nieuw decennium: een ondernemingsrechtelijke analyse* (2009), pp. 241-242.

[1202] *Laurus*, HR 8/4/2005, JOR 2005.

[1203] *Ceteco*, Utrecht District Court 12/12/2007, JOR 2008/10.

although they should have realized that the administrative systems would be unable to cope with the expansion. This was a typical example of "overstretching". There were red flags. Both boards should have investigated whether the plans for expansion should be continued. In due course Ceteco went bankrupt and the liquidator started liability proceedings against the management board, the supervisory board and one large shareholder. They were all held to be liable by the District Court. The case was settled by payments by the defendants. This case has caused concern among supervisory board members of other companies.

– *Henkel* (1997) had JMG Promotion organise a promotional campaign with toy panda bears as presents for its customers. JMG went bankrupt with only 200,000 panda bears, available for 280,000 enthusiastic customers. Henkel asked the court to hold the sole director of JMG liable for miscalculating the volume and not taking out insurance for the risk. The Court of Appeal and the Supreme Court confirmed that the director of JMG had made an incorrect commercial decision, but deemed it a normal risk and did not hold the director liable. (HR 14/11/1997, NJ 1998, 270)

– *Beklamel* (1990) bought feed products from Stimulan and resold them to a buyer who did not pay, stating it had a counterclaim. Beklamel went bankrupt and could not pay Stimulan the purchase price. Stimulan claimed this amount from Beklamel's managing director because he should have realized, when entering into the purchase contract, that Beklamel could not pay if things went wrong and should therefore have taken out insurance for this matter. The courts held that the director was not liable. (The insurance issue would be decided differently if there is an explicit undertaking to insure.[1204])

– *Tax Collector v. Roelofsen* (2006).[1205] The tax collector claimed that Roelofsen, CEO and 100% shareholder of two companies, both of which had gone bankrupt and could not pay their tax debts, was liable because he had systematically filed incorrect tax returns and ran up a large debt. The Court of Appeal and later the Supreme Court did not hold him liable.

– *OGEM* (1990).[1206] OGEM was a conglomerate of construction companies that went bankrupt. The Enterprise Chamber concluded there had been mismanagement on many counts, and the management and supervisory board members had to pay relatively small sums out of their own pocket, because they were not insured. The Enterprise Chamber discussed the risk management of this fast growing conglomerate. It was the duty of the management and supervisory boards to obtain sufficient information from the various

[1204] *Beklamel*, HR 6/10/1989, NJ 1990, 286.

[1205] *Tax Collector v. Roel*ofsen, HR 2/12/2006, NJ 2006, 659.

[1206] *OGEM*, HR 10/1/1990, NJ 1990, 446.

departments to fulfil their management and supervisory tasks. When this turned out to be impossible the management board should have taken action. The supervisory board too had failed to take action or show any initiative, despite all the red flags. Members of both boards did not even read essential documents. The Enterprise Chamber held that this constituted mismanagement, and its decision was upheld by the Supreme Court. The Supreme Court ruled that even one act or omission can be mismanagement if it causes substantial damage. The case revealed that many of the company's executive directors had strong egos and had acted on their own and in utter disregard of one another. They had been united only in their joint disrespect for the supervisory board. The chairman of the supervisory board saw it as his task to blindly support the CEO. Two memoranda from supervisory board members who objected to the course of events were "swept under the carpet".

Comparison of these Dutch supervision cases with the Delaware supervision cases (*Caremark*, *AIG* and *Citigroup*) reveals similarities, but differences as well.

As to the standard of care in the Delaware cases, there is a distinction between care in transactional decisions such as *Van Gorkom*, *Disney* and *Lyondell* on the one hand,[1207] where the test is whether the board tried to consider all aspects in making its decisions, and general supervision over a longer period on the other, in cases such as *Caremark*, *AIG* and *Citigroup*.[1208] As to the question of the individual liability of each director, the Delaware Courts look at the different facts for each director and his specific involvement. This implies that outside directors are less likely to be held liable than inside directors.

Let use now consider how the Delaware Court might have dealt with each of the Dutch cases described above.

– In the *Laurus* case, the Delaware Court would also not have condemned an ambitious plan (see its ruling in the *Citigroup* case). As regards the "insufficient follow-up response to the failure of the

[1207] *Van Gorkom*, 14 March 1985, 488 A.2d 2858 (Del. 1985) described above in subsection 3.7.3.1 under Takeover cases, *Disney* (Del. Sup. 2000), (Del. Ch. 2005) and (Del. Sup. 2006) described in subsection 3.1.2 above and *Lyondell* 25/3/2009, C.A. No. 3172 described in subsection 3.5.3 at (iii).

[1208] *Graham* (Delaware Supreme Court 24/1/1963, 188 A.2d 125), *Caremark* (Delaware Chancery, 1996 A.2d 959, 967), *Stone v. Ritter* (Delaware Supreme Court, 911 A.2d 362 (Del. 2006)) and *AIG* (Vice-Chancellor Strine 10/2/2009 965 A.2d) and *Citigroup* (Del. Ch. 24/9/2009, 964 A.2d 106) are described above in subsection 3.5.4 in item 8 and again in subsection 3.7.2.3.

strategy plan", it would have considered the specific facts relevant to each individual director, but would not have held the director liable provided he had "tried" to monitor, was not in bad faith and had no other conflicting loyalties (see the *Caremark* judgment), even without an exculpatory clause in the articles of association.

– In *Ceteco*, the Delaware Court would have looked at the part played by each individual director in the "overstretching". Had they tried, were they in good faith, did they not have any other conflicting interest? If there had been no clear red flags, the director would probably not have been held liable (see the *Caremark* judgment), even without an exculpatory clause.

– In *OGEM*, the Delaware Court would probably have held the insider directors liable for not even trying to read essential documents, for disloyalty, for misinforming other directors and shareholders and for blatantly ignoring warnings (red flags). The supervisory board members, who had heeded the warnings, would not have been held liable.

Comparison with UK judgments shows that the courts there attach less importance to the duty of supervision and judge a director more on how he performs his duty of care, which is a more objective criterion (as in the *Barings* case).[1209] They are called "care" cases and not "oversight" cases, and there has been a move away from a mere subjective test to an objective test as in *Barings*. In the UK there is a tendency, both in liability and disqualification cases, to allow for the fact that NEDs spend less time at the company and have less information than executive directors. UK law therefore distinguishes between NEDs and executive directors.[1210] In the US there is a tendency to focus liability on the officers and possibly the chair of the audit committee. As the board is basically unitary, this is an individual test for each director. Where management board members are held liable in the Netherlands, the supervisory board members too are usually liable, but this is always measured against their own standard of conduct (entrenched attitude and no care in the *OGEM* case, not doing their own home work in the *Tilburgsche Hypotheek Bank* case and failure to take action in the *Bodam*

[1209] *Barings* (no. 5), [2001] B.C.C. 273; [2000] B.C.L.C. 523, described above in sub-section 2.6.5.

[1210] CC8 Schedule B and Strik (2010), p. 118.

case[1211]). Whether this distinction would be possible in the Netherlands between the individual directors is discussed in 4.7 below.

Convergence

The Dutch apply a risk management system similar to the “Enterprise Risk Management Integrated Framework” of the US Committee of Sponsoring Organisations of the Tradeway Commission (COSO), and UK companies use the Turnbull Guidance.[1212]

One-tier board – non-executive directors in the Netherlands

The Advisory Committee for the Future of Banks in the Netherlands (the Maas Committee)[1213] makes no mention of the role of non-executive directors on a one-tier board. As the non-executive directors of a one-tier board would be involved in decision making and therefore also responsible for decisions about risk management and as they would also be quite well informed in advance about risks and could ask questions in advance, it seems reasonable to assume that they would have an influential role and would therefore have much the same chance of being held liable as the executive directors.[1214] What does this mean? Are executives and non-executives supposed to understand all control systems and new products that are developed in the bank? The Frijns Code has introduced, for public companies, the concept of the “in control statement” of the management board.[1215] Article 4.5 of the Code for Banks of the Maas Committee (see below at 4.5.19) confirms that there must be a product consent procedure. The Chief Risk Officer (CRO) and the Risk Committee, a committee of board members introduced by the Maas Committee, should be involved in these matters. They should receive reports about the bank’s products from an internal auditor. They should also understand the risks mentioned in the annual report. The same applies to large industrial companies. It follows that not each non-executive director is supposed to understand all the bank’s systems and products, but they must know of the existence of the systems and reports about products.

[1211] *Bodam Jachtservice*, HR 28/6/1996, NJ 1997/58, in which the managing director kept no proper accounts and did not file any accounts. He was held liable for his failure to perform these duties. The supervisory board members were also liable for not making the managing director cure his default.

[1212] Strik (2010), p. 224.

[1213] Maas (2009).

[1214] Strik (2010), p. 127.

[1215] Frijns Code II.1.5.

Many corporations in the US have come to realize that the largest risks are caused internally and that risks in all aspects of the business, such as nomination, compensation and finance, can be evaded to some extent by the tone from the top. This can be a good example for Dutch companies. The UK Walker Review correctly identified that the wrong type of behaviour was at the root of governance failure in many banks, which is much the same thing.[1216] The Walker Review also emphasized that the Risk Committee should perform due diligence before acquisitions. Such a practice would also, of course, be beneficial for Dutch and US companies.

4.5.19 Corporate Governance at Banks

On 7 April 2009, the Advisory Committee on the Future of Banks in the Netherlands (*Advies Commissie Toekomst Banken*), also referred to as the Maas Committee after its chairman Cees Maas, former CFO of ING, presented its report "*Restoring Trust*" (the Maas Report or Maas (2009)).[1217] The Maas Committee was set up in November 2008 as an independent advisory committee on the initiative of the Netherlands Bankers' Association (*Nederlandse Vereniging van Banken*), with the mandate of making recommendations to improve the functioning of Dutch banks. The immediate reason for setting up the Maas Committee was the acute lack of trust in the financial sector that arose in the autumn of 2008 as a result of the financial crisis (the credit crunch). On 9 September 2009 the Netherlands Bankers' Association issued the "Code for Banks", which dealt with more or less the same points, but differed in some aspects. The Minister of Finance and the Netherlands Bankers' Association established a committee to monitor compliance with this Code. The Monitoring Committee published its first report in December 2010.

One of the key recommendations for banks is, once again, to make the customer their primary concern when weighing up the interests of the various relevant parties. The Maas Report also contains far-reaching recommendations on strengthening the governance structure and risk management of banks, with a key role being assigned to the chief risk officer (CRO) and a separate risk management committee, alongside the

[1216] Walker Review and ACCA (2010), p. 12.

[1217] Maas (2009).

other three committees (i.e. the Audit, Nomination, and Remuneration Committees). In implementing the recommendations of the Maas Report and the Code for Banks, banks should apply the “comply or explain” principle.

The response to the Maas Report from both the financial sector and politicians has, in general, been positive. The Maas Committee’s recommendations are particularly relevant to Dutch financial institutions, but it is possible that certain recommendations may also have an impact on businesses outside the financial sector. The committee’s most important recommendations concern the areas of governance, risk management, the relationship with shareholders and remuneration.

Governance

Banks should once again focus primarily on the interests of customers and savers. In making this recommendation, the committee redefines the stakeholder model – under which directors should ensure that due consideration is given to the various interests of all of an enterprise’s stakeholders – for financial institutions and possibly goes too far by singling out one category, i.e. the customer. The Code for Banks redresses the balance [1218] by saying that the supervisory board and the management board should consider all interests, i.e. those of customers, shareholders and employees, but does emphasize the duty of care (*zorgplicht*) towards customers. The renewed focus on the public role of banks is also emphasized by the recommendation in the Maas Report that a bank’s management board members should sign an “ethics and morality statement”, through which they acknowledge and affirm their corporate social responsibility. The Code for Banks has adopted this recommendation.[1219] By now board members of nearly all Dutch banks have signed such a statement.[1220]

A much more intrusive requirement proposed by the Maas Committee is that all of the bank’s managing directors should pass a banking examination prior to taking up their appointment, and should also follow compulsory further training while in office. This proposal too has been adopted by the Code for Banks.[1221] Banks have started to comply, but it

[1218] Code for Banks, nos. 2.1.2, 2.1.8, 3.2.1 and 3.2.2.

[1219] Maas (2009), 1.16.

[1220] Code for Banks, no. 3.2.4.

[1221] Code for Banks, no. 3.1.4.

remains to be seen how this unusual requirement will be enforced. Nothing similar exists in the UK or US.

Finally, the Maas Report recommends that banks aim for greater diversity on their supervisory and management boards. This recommendation too is taken up by the Code for Banks.[1222] The Maas Committee has gone a step further than the Frijns Code, which recommends that the composition of the supervisory board be more diverse. The Act advocates diversity in the composition of one-tier boards and also for management and supervisory boards: at least 30% women and 30% men.

The Maas Committee recommends that the duties of supervisory boards of financial institutions be expanded considerably in terms of content and responsibilities. This is echoed in the Code for Banks.[1223] It argues, for example, in favour of a statutory requirement for expertise assessments of supervisory board members, in combination with compulsory further training. In his response of 10 April 2009 to the report, the Minister of Finance has indicated that the expertise assessment will be provided for in the Financial Supervision Act, which is currently in the process of being amended. Supervisory board members – particularly the chairman of the supervisory board and the chairmen of the audit committee and the risk management committee – must have sufficient experience of the financial sector, and their time availability must be sufficiently guaranteed in order to ensure the proper fulfilment of their responsibilities.[1224] Here there is convergence with UK (Walker Committee) and US regulations.

Finally, both the Maas Committee and the Code for Banks emphasize the role of the external auditor. When auditing a bank's annual report, the auditor should make an in-depth assessment of the actual functioning of the bank's governance system. Besides carrying out an annual internal assessment, the supervisory board should have an external party assess its performance once every three years.[1225]

[1222] Code for Banks, no. 3.1.1.

[1223] Code for Banks, no. 2.1.

[1224] Code for Banks, no. 2.1.6.

[1225] Code for Banks, no. 2.1.10.

Risk management

The Code for Banks, following the example of the Maas Committee, has drawn up a number of specific recommendations for the purpose of improving internal checks and balances relating to risk management. The committee envisages a key role for the supervisory board in particular.[1226]

First, when drawing up the bank's risk strategy, the management board should pay explicit attention to the formulation of a "risk appetite statement", i.e. a statement indicating the bank's readiness to accept risks, which must fit in with the bank's general strategy.[1227] This is the responsibility of the CEO. The Chief Risk Officer (CRO) must also be involved in the process.[1228] The Code for Banks puts more emphasis on the CEO and less on the CRO.[1229] The Code has followed the Maas Committee by requiring that a risk appetite statement be submitted to the supervisory board for approval at least twice a year. The decision making process in this regard is to be initiated by the supervisory board's risk committee; an internal and an external auditor should also be involved in the process.[1230]

The management board is charged with implementing risk policy based on the risk appetite statement; an important role for implementation is assigned to the CRO. The supervisory board should supervise the implementation of the risk policy and regularly examine whether the products offered by the bank and the client base to which the products are offered fall within the bank's overall risk profile. As part of an ongoing management of risks, the management board should set up the risk management system in such a way that it is at all times aware of the current risks affecting the bank's capital. Any interim decisions influencing the bank's risk profile must be submitted to the supervisory board for approval. Risk management approval is required prior to the introduction of new financial products ("product approval process").

Relationship with shareholders

In the view of the Maas Committee, a financial institution should strive for a shareholder structure that is in line with the institution's nature. The committee believes that the one-sided approach to shareholder value by

[1226] Code for Banks, no. 4.2.

[1227] Code for Banks, no. 3.1.7.

[1228] Code for Banks, nos. 3.1.7 and 3.1.8.

[1229] Code for Banks, no. 4.1.

[1230] Code for Banks, nos. 2.2.1, 2.2.2, 5.2 and 5.4.

groups of shareholders whose main focus is on short-term profits has led to undesirable developments in the past few years. To counteract this, it recommends that the shareholder structure of financial institutions should ensure the presence of a proper balance between the interests of the shareholders, on the one hand, and those of the other stakeholders (the customers, employees and society as a whole), on the other.

The Maas Committee recommends that listed banks strive in particular for a stable group of shareholders who are willing to commit themselves to the company for a longer period. According to the Committee, these long-term stewardship shareholders could be rewarded by, for example, a loyalty dividend. However, in light of the 2007 Supreme Court decision in the *DSM* case,[1231] the practical implementation of this recommendation is still to be worked out. The Maas Committee also points to the importance of registration and identification of shareholders in order to facilitate a dialogue with the management board. In his response to the report, the Minister of Finance has said that the soon-to-be-published corporate governance bill will contain proposed statutory rules for the identification of shareholders in listed companies.

Finally, the Maas Committee mentions depositary receipts – a defence mechanism that has made something of a comeback – as a useful way of preventing a situation in which a limited number of shareholders can exert a disproportionately large influence on the outcome of a vote at the general meeting of shareholders as a result of the absence of many of the other shareholders. The Maas Committee recommends that receipt holders who are present or represented at a general meeting should be able to exercise their voting rights at all times. This is a reference to the fact that, under the DCC,[1232] receipt holders may be prevented from exercising their voting rights in certain circumstances, for instance in a hostile takeover situation. In the Committee's view, such prevention should not be possible. The reactions to this proposal have so far been mixed: the Minister of Finance has largely endorsed it, but the

[1231] *DSM*, HR 14/12/2007, NJ 2008, 105. DSM had tried to alter its articles of association in such a way that shareholders who held their shares for more than 3 years would get a 30% higher dividend and an extra 10% for each further year. It also wanted to introduce the right for DSM to obtain information from shareholders to check the period they had owned their shares. Franklin Mutual objected, claiming equality of shareholders and privacy, and succeeded in having the Enterprise Chamber block the alterations to the articles of association proposed by DSM. However, the Supreme Court, as requested and argued by Advocate General Timmerman, reversed the judgment.

[1232] See article 118(a) DCC.

Association of Shareholders (*Vereniging van Effectenbezitters*/VEB) has been extremely critical. The Code for Banks has not adopted this recommendation.

Remuneration policy
The credit crisis has fuelled criticism of the remuneration paid to directors of financial institutions. The Maas Committee makes a number of specific recommendations regarding banks' management board members, which partly supplement and partly deviate from the Frijns Code. The Code for Banks has adopted most of these recommendations.

The total remuneration paid to a bank's management board members should, according to the Maas Committee, remain just under the average of the remuneration for comparable positions outside the financial sector, taking into account international comparisons.[1233] In addition, the Code for Banks puts forward supplementary rules with respect to the variable income components of the remuneration and proposes that the total amount of variable remuneration for directors be limited to a maximum of 100% of the fixed remuneration,[1234] although an exception is granted for certain medium-sized banks. In any event, the remuneration structure must be compatible with the remuneration granted within the company as a whole.[1235] Moreover, the variable remuneration should consist only of cash and shares and not, for instance, of options.

The performance criteria by which the level of the variable remuneration component is judged must, according to the Maas Committee (and the Code for Banks) include non-financial indicators, such as client satisfaction and the quality of risk management.[1236] In addition, the supervisory board should have the discretion, in certain situations, to reduce retroactively the variable income component awarded or paid earlier.[1237] In any event, no variable remuneration should be granted to management board members if the bank is not generating a profit. The Code for Banks also confirms that the exit provisions of the Frijns Code – i.e. a maximum of one year's salary – should also be applied by banks. Finally, the Code for Banks recommends that the supervisory board be required to approve the total remuneration of the individuals in the first

[1233] Code for Banks, no. 6.3.1.

[1234] Code for Banks, no. 6.4.2.

[1235] Code for Banks, no. 6.3.1.

[1236] Code for Banks, no. 6.4.3.

[1237] Code for Banks, nos. 6.4.5 and 6.4.6.

layer below the management board (senior management). A detailed regulation for income of bankers is applicable since 1 January 2011. [1238]

4.5.20 Summary of roles of supervisory board members/non-executive directors

1. In a two-tier system the management board formulates and implements strategy. The supervisory board supervises both aspects. Under the Act, the non-executive directors in a one-tier board join the executive directors in formulating and developing strategy. The Act leaves open exactly what role the non-executives will have in developing strategy: actively challenging as in the US or jointly developing as in the UK. US and UK examples of boardroom practices with regard to strategy development and regular discussion about strategy are worthwhile, as is the early, on-site information UK and US board members receive. Also useful are the possibility of free access by board members to middle management and the US and UK practice of holding more executive sessions before or after each meeting, frequent discussions about evaluation and succession of board members and middle management. I have proposed in sub-sections 4.5.5 and 4.5.17 that the committee monitoring the Frijns Code should put these points on the agenda in its next report and recommend that the one-tier board or, in the case of a two-tier system, the management and supervisory boards should discusses annually how they will deal in their meetings with strategy, early and on-site information, access to middle management, executive sessions, evaluation and succession.

2. There are three important differences between two-tier and one-tier systems for supervisory board members and non-executive directors; first, whether or not they are involved in decision making; second, the time when they receive information; and third, whether or not they receive on-site business information and have access to middle management. The other side of the coin is that supervisory board members are said to be more independent than non-executive directors.

[1238] Controlled Remuneration Policy Decree and DNB Regulation on Controlled Remuneration Policy.

3. Representing the company is a power formally reserved to executive directors in the Netherlands. Registration of powers of representation in the trade register is essential.

4. The role of the chairman is rapidly increasing in both one-tier and two-tier boards. Generally, the UK practice whereby the chairman acts as team leader of the whole board deserves to be followed, although a Dutch chairman should be slightly less hands on and may not have to have an office in the company building or talk to shareholders about strategy on his own. He should stay closer to the typical US chairman. These are among questions that can be discussed as suggested in sub-section 4.5.11. It is advisable to confirm the division of roles between the chairmen and the CEO in writing and to work out extensive contacts with all outside directors.

5. There is convergence with the UK and the US in that Dutch outside directors are now working harder and are more independent. In addition, in all three countries there are separate non-CEO chairmen of the boards, committee work plays an important role and the chairmen usually chair the nomination committee. In the area of risk management there is convergence with the US and UK in ideas of “tone from the top” and the responsibilities of CEOs, CROs and risk committees.

4.6 **Duties of Dutch board members**

4.6.1 Introduction to the duties of board members

The duties of management board members and supervisory board members in a two-tier system will be described in this section (4.6). In some instances, I will discuss the expected duties of non-executive directors under a one-tier board as opposed to supervisory board members in a two-tier system.

These matters will be dealt with in the following sections: the basis for duties according to the law, articles of association, agreements, the Frijns Code, other voluntary codes and court decisions (4.6.2); the Enterprise Chamber procedure (4.6.3); the Enterprise Chamber cases that raise standards (4.6.4); the regulation of conflicts of interest (4.6.5); and, finally, a summary of duties of directors (4.6.7).

4.6.2 Basis for the duties of board members

The hierarchy for the duties of board members is as follows: (1) legislation;[1239] (2) articles of association; (3) general internal guidelines, (4) agreements to which the company has explicitly adhered or joint venture agreements;[1240] (5) the Frijns Code[1241] and (6) other voluntary codes or guidelines. Court decisions deal with all these aspects and interpret the law.[1242]

Laws

The general duty of the management board is to "manage" (*besturen*) the company. This involves the general authority and duty to manage the company internally and the enterprise externally.[1243] Internal management duties include decision making by the management board, with or without the approval of other organs, and day-to-day management.[1244] The management board gives due information to the supervisory board and informs it at least once a year about the strategy and the risk management system it has developed and executed.[1245] The management

[1239] Relevant laws are Book 2 DCC, the Trade Register Act, the Works Council Act, the Bankruptcy Act, the Competition Act, the Act of Financial Supervision (which includes matters such as the supervision of institutions, securities and tender offers) and many other statutes such as environmental acts.

[1240] See for CSR generally, T.E. Lambooy, *Corporate Social Responsibility: Legal and Semi-Legal Frameworks Supporting CSR. Developments 2000-2010 and Case Studies*, thesis (2010) ("Lambooy (2010)"); *Batco* case, Amsterdam District Court, 9/3/1978, NJ 56890, where Batco had confirmed in its annual accounts that it undertook the obligations of the collective agreement and the UN Code of Multinationals, which said a board should consult with employees before deciding to close a factory. The board had not consulted employees when it decided to close a factory and was therefore blocked, because it had publically confirmed it would abide by the UN Code. Joint venture agreements to which the company is often party are also enforceable.

[1241] The Frijns Code ranks higher than other general voluntary codes or guidelines, because the Frijns Committee consisted of members broadly nominated and appointed and because the law confirms that it is a 'comply or explain' code in article 2.391, 5 DCC and a decree designating the Frijns Code as the relevant code.

[1242] The judgments of all civil courts deal with liability cases and nullification or suspension of decisions and the Enterprise Chamber cases are about whether or not there has been mismanagement and measures to be taken in companies.

[1243] Prof. J.M.M. Maeijer, *Vertegenwoordiging en Rechtspersoon* (1994), p. 363 ("Maeijer (1994)"); Van Solinge and Nieuwe Weme (2009), p. 473; Van Schilfgaarde and Winter (2009), pp. 150-151; Van der Grinten (1989), p. 446.

[1244] Article 2.129/239 DCC.

[1245] Article 2.141/251 DCC.

board will represent the company.[1246] The management board may not act *ultra vires*.[1247] Each management board member must act reasonably towards other board members and shareholders.[1248] In addition, each management board member must discharge his duties properly,[1249] and article 2.9 DCC, as amended by the Act, makes clear that these duties include not only those specifically allocated to him but also the general conduct of the company's affairs (*algemene gang van zaken*).[1250] The management board must keep proper accounts.[1251] It must prepare the annual accounts within five months of the end of the financial year and, in the case of a listed company, the annual accounts must be published within six months and also every six months.[1252] The management board members must file the accounts with the trade register within 8 days of the annual general meeting that has approved them.[1253] Most companies with a turnover or workforce above a certain limit must have an external auditor appointed by the general meeting. The board must hold this general meeting of shareholders before the end of the sixth month after the close of the relevant financial year.[1254] At this meeting it must present its reports and accounts to the shareholders.[1255] The management board must file the company's articles of association and forms for registering

[1246] Article 2.130/240 DCC.

[1247] Article 2.7 DCC.

[1248] Article 2.8 DCC, expresses the positive requirement of the consensus culture; the liability aspect of the consensus culture is joint and several liability.

[1249] Article 2.9 DCC is the main article determining the duty and therefore liability of management board members and, indirectly, supervisory board members towards the company. It is basically a joint and several liability and will recur in item 4.7 on the liability of directors and in the *Staleman v. Van de Ven* case. Article 2.9 DCC also provides for the possibility of a defence to liability if the default is caused by a matter that lies outside the specific remit of an executive director and he has not been negligent. However, as he is also responsible for the conduct of the general affairs of the company and has a double onus of proof, the defence will not often be allowed.

[1250] Van Solinge and Nieuwe Weme (2009), p. 542.

[1251] See article 2.10 DCC giving the general obligation for proper bookkeeping and articles 2.363/393 DCC which give all the stipulations for the annual accounts as well as the the serious sanctions in article 2.138/248 DCC (improper accounting is a presumption for serious management and liability in bankruptcy cases) and article 2:139/249 DCC (liability for misleading accounts).

[1252] Article 2:101/210 DCC and article 5:24 Act on Financial Supervision.

[1253] Article 2.394, 2 DCC.

[1254] Article 2.108/218, 2 DCC.

[1255] Article 2.101/210, 2 DCC.

directors as representatives with the Trade Register.[1256] These are the most important duties of the management board and they are among those mentioned in the DCC.

Shareholders have the right to decide on the issue of shares and on buy-backs (redemption of shares by the company), to call meetings of shareholders and decide on the agenda and to declare dividends, to adopt the accounts, to issue discharges to management and supervisory board members and to determine the remuneration of supervisory board members and the remuneration policy for management board members.[1257] On paper these rights certainly exceed those of shareholders in the US.

For vital decisions such as change of control of the company, acquisitions, disposals, mass redundancies, large loans and reorganisations, the management board must consult with the company’s works council (*ondernemingsraad*).[1258] The works council has from 3 to 15 members who are elected by and from among the employees. The works council has no veto right but there must be consultation. If the works council is not consulted, this may seriously endanger or delay the execution of the decision because the works council may have the decision reviewed by the Enterprise Chamber. The works council made use of this right in the *Organon* case.[1259] When considering terms and conditions of employment (*arbeidsvoorwaarden*) the board needs the works council's consent.[1260]
If the company is in serious financial problems and is close to bankruptcy management board members have the obligation to warn the bodies that collect social security contributions.[1261]
The management board must also comply with all securities regulations contained in the Act of Financial Supervision, which deals with many areas such as insider trading, the disclosure of controlling shareholdings (*melding zeggenschap*), the issue of prospectuses and offering documents.

[1256] Articles 19-23 Trade Register Act (*Handelsregisterwet*) and article 2.69/180 DCC.

[1257] These rights of shareholders have been described above in sub-section 4.5.2.

[1258] Section 25 Works Council Act.

[1259] See above in sub-section 4.4.2.2.

[1260] Section 27 Works Council Act.

[1261] Sections in the social securities laws, the income tax law and the value-added tax law.

The above is a fairly prescriptive list of duties. At present, the DCC does not make much difference in this respect between public and private companies (NVs and BVs), but a bill has been introduced allowing greater flexibility for BVs.

Supervisory board members have the duty to supervise the strategy developed and executed by the management board and to supervise the general affairs of the company.[1262] They assist the management board by providing advice,[1263] which is always given in the interests of the company and its enterprises.[1264] If they notice, or should notice, that the management board is seriously in default of its duties as outlined at the start of this section, the supervisory board members should take action. Their duties are different from those of a non-executive director in the proposed one-tier board. The *Bodam Jachtservice* case[1265] of 1996 clearly shows how the same set of facts results in liability for supervisory board members and management board members, albeit for different reasons. In this case a managing director had failed to keep proper accounts and to file them with the trade register. This constitutes serious negligence and can lead to liability to the liquidator under article 2.138/248 DCC. The Supreme Court ruled that the supervisory board members could not be expected to fulfil these duties of the managing director themselves, but should have either pressured him to perform them or arranged for him to be replaced. It was not sufficient to hold a shareholders' meeting to discuss the problem. However, if the same set of facts were to occur in the future in a company with a one-tier board, the non-executive directors would have to check in an early stage whether there was proper accounting and filing and take measures in advance to ensure that this happens, as they would be directors and not supervisory board members.[1266]

Articles of association

The articles of association of NVs and BVs are drawn up by a civil law notary in accordance with standard models. The rights and obligations of

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[1262] The monitoring duty of article 2:140/250 DCC.

[1263] The advice duty of article 2:140/250 DCC.

[1264] Their duties must be performed in the interests of the company. See detailed discussion in sub-section 4.2.5 above. Article 2.140/250 DCC confirms this.

[1265] *Bodam Jachtservice*, HR 28/6/1996, NJ 1997/58.

[1266] Strik (2010), p. 135 and Parliamentary Papers, Second Chamber 2008/09, 31763 nr. 3, 17 and nr. 6, pp. 13 and 25.

shareholders, management board members and supervisory board members are usually described in a fairly detailed way, including their powers to represent the company and the decisions for which the supervisory board and/or the general meeting has a veto right. The articles of association are important. If directors breach the provisions of the articles of association they are liable.

Two cases are mentioned here that show the importance of articles of association.

Wijsmuller (1968)[1267]
A director of Bureau Wijsmuller N.V. was dismissed by resolution of the company's general meeting of shareholders. Its shareholder, Wijsmuller Nederland N.V., voted for dismissal. However, under the articles of association of Wijsmuller Nederland N.V., the board of Wijsmuller Nederland N.V. could take such action only if authorised by a valid vote of the holders of a special class of priority shares. Although a meeting of priority shareholders had been called due notice of it had not been given. As a result, not all priority shareholders attended the meeting. It followed that this meeting of priority shareholders and the resolution it adopted authorising the board of Wijsmuller Nederland N.V. were invalid. The Supreme Court stressed the importance of the right of all shareholders to be consulted in a meeting.

In *NOM v. Willemsen* (2008) the Court of Appeal held that Willemsen, the managing director, was liable. He had asked for a payment moratorium for the company without the shareholders' consent, although the articles of association gave the shareholders a veto right. The Supreme Court held that although the veto right under the articles of association was important all circumstances should be considered, for example the fact that Willemsen had discussed the moratorium with shareholders, including NOM, who had raised no objections. The Supreme Court overturned the decision.[1268]

The articles of association are important to a one-tier board and should provide for a clear division of roles and duties between executive and non-executive directors. As a complete board all directors have the duty to manage the company.[1269] Managing means they have a duty to develop, implement and monitor all aspects of the company, the "general affairs of the company" (*algemene gang van zaken*). These include strategy, annual accounts, risk management and Corporate Social

[1267] *Wijsmuller*, HR 15/7/1968, NJ 1969, 101.

[1268] *NOM v. Willemsen*, HR 12/9/2008, JOR 2008, 297.

[1269] Article 2.129/239 DCC.

Responsibility (CSR). When they divide up their duties among themselves, they must take account of the executive and non-executive roles defined in the articles of association.[1270] The executive roles may also be divided into specialisms (CEO, CFO, COO – Chief Operations Officer, CRO – Chief Risk Officer, and CHO – Chief Human Resources Officer). Non-executives can devide tasks too. Any such division must be recorded in writing and be based on a provision in the articles of association.[1271]

As the duties of the executive directors of a one-tier board – and even a two-tier board for that matter – are divided among them, they have an obligation to perform a specialised management task on a day-to-day basis. Under the present article 2:9 DCC this is still called the director's area of work (*werkkring*), but the word used in the new article 2:9 DCC (Act) is task (*taak*). Article 2:129a/2:239a, paragraph 3 DCC (Act) gives executive directors the right to assume a specific task. This is worded as follows: "validly decide on matters that come within their remit". At the same time, however, they still have the general duty to manage, i.e. to develop, implement and monitor the general affairs of the company and hence also to monitor their colleagues. This second task of monitoring has also been discussed above in sub-section 4.5.9. The basic joint and several liability of executive and non-executive directors with the possibility of an exculpation defence for a director where the act or omission falls outside his area of responsibility (i.e. outside his "task") and there are no other serious grounds for holding him liable, is discussed below in sub-section 4.7.2.7.

Although the non-executive directors in a one-tier board specifically have the task of monitoring,[1272] this does not mean that this duty is confined to monitoring their colleagues. Besides monitoring generally, they also have a duty – as directors – to be active in relation to strategy development, the annual accounts (including the report of directors), risk management and corporate social responsibility as well as all aspects of general management. It is sometimes incorrectly thought that a non-executive director is a sort of "turbo" supervisory board member or an extra active monitor. While monitoring may be his specialised role, a non-executive director also has the general duty of a director.

[1270] Article 2:129a/239a, 3 DCC (Act)

[1271] Article 2:129a/239a, 3 DCC (Act).

[1272] Article 2:129a/239a, 1 DCC (as introduced by the Act).

In the example of *Bodam Jachtservice*, mentioned earlier in this section, where management had not kept proper books and had failed to file any accounts, it seems reasonable to assume that if the supervisory board members had been non-executive directors on a one-tier board they themselves would have had a duty to arrange for the accounting and filing. As the term for drawing up and filing the annual accounts had expired, they would have had to inquire how these formalities were going to be fulfilled and would have needed to keep their finger on the pulse. The same analogy as in the *Bodam* case could be applied in cases where risk management systems are non-existent or inadequate. Supervisory board members in a two-tier system should supervise and check, ideally in advance, whether systems are in place and take corrective action in the event of deficiencies. Non-executive directors in a one-tier system should ask in advance whether systems are in place and help to develop or challenge them. Hence there is a formal difference between the task of supervisory board members in a two-tier system and non-executive directors in a one-tier system, but in practice it is mainly a difference in timing and level of involvement.[1273]

This is comparable to the position of a UK executive director who has to manage the affairs of the company, develop general strategy and monitor, and to the position of a UK non-executive director who has to monitor and develop strategy, risk management systems, CSR etc.

In my view one of the Act's strengths is that article 2:129a/239a DCC (as introduced by the Act) provides that the division of tasks is to be described in the articles of association. When the Act becomes law anyone will be able to find which director is responsible for what by consulting the company's articles of association and the names of the executive and non-executive directors in the public registers. At this point it will no longer be necessary to rely on detailed facts to establish the different duties and responsibilities. It is clearly an advantage for the directors to describe their functions transparently for the case that they might need to seek exculpation from liability.[1274]

[1273] Strik (2010), p. 133 and Parliamentary Papers, Second Chamber 2009/09, 31763 nr. 3, p. 8.

[1274] Strik (2003), p. 374; Dortmond (2005), p. 265; Strik (2010), p. 132; Van Solinge and Nieuwe Weme (2009), p. 170.

General Internal Guidelines
Most companies have directors' regulations next to the articles of association. These can be general policies and/or guidelines. They can also be divisions of tasks as suggested by article 2:129/239a, paragraph 3 DCC. The *Staleman v. Van de Ven* judgement explicitly mentions division of tasks and general guidelines for the board as an important factor to determine directors' duties. See 4.7.2.1. Internal guidelines are important in case of legal disputes, because they are meant to be internally generally applicable and can be produced in court.

Codes and agreements the company has adhered to
Codes such as UN codes for multinationals to which a company has adhered, as mentioned above in the first lines of this sub-section 4.6.2 in the *Batco* case, rank higher in the hierarchy than the Frijns Code because the company has explicitly bound itself to such code. Joint venture and shareholder agreements governed by Dutch law are also binding. Many foreign enterprises choose the Netherlands as the *locus* of their joint venture because Dutch joint venture agreements are binding and enforceable internally in the long term.[1275] It is advisable to have the agreements countersigned by the company and even by the board members.[1276]

Frijns Code
The Frijns Code of 2008 describes in detail the duties of management board members and supervisory board members. It makes very clear that the management board has a duty to formulate and develop strategy, draw up annual accounts and develop and follow risk management systems and CSR plans,[1277] and that supervisory board members only

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[1275] Inaugural lecture of P.J. Dortmond, *Stemovereenkomsten rondom de eeuwwisseling*, oratie (2000) ("Dortmond (2000/O)") and Maeijer (1994), pp. 354-361; Van der Grinten (1989) no. 217.1 and Van Solinge and Nieuwe Weme (2009), nos. 381-388.

[1276] *Doetinchemse IJzergieterij*, HR 1/4/1949, NJ 1949, 405, in which the supervisory board members had issued shares to friends based on a right conferred on them by the articles of association to counter the threat of an unfriendly takeover. The supervisory directors did this to prevent a shareholder agreement to which they, as supervisory directors, were not a party. They did so in the interest of the company. The Supreme Court ruled in favour of the directors because they were not bound. See also *HVA/Socfin*, HR 19/3/1975, NJ 1976, 267 where an agreement was enforceable because it had been signed by the directors. The agreement gave 25% shareholder Socfin the power to make binding nominations of specific supervisory board members in a 'structure regime' company, where the supervisory board members would normally have had this right.

[1277] Frijns Code Principle II.1.

have the duty to supervise these activities.[1278] Both the Frijns Code and its predecessor – the Tabaksblat Code of 2004 – have been largely instrumental in raising the standard by which the duties of the managing directors and the supervisory board members are judged.[1279] Both Codes mention the possibility of a one-tier board.

Other codes or guidelines

There are many other codes and guidelines such as the Global Compact Rules,[1280] the draft Dutch Code of Conduct for Supervisory Board Members and the Observations for Chairmen,[1281] which will hopefully lead to further discussion.

Court cases

Civil cases for liability under articles 2:9 (the company), 2:138/148 (liquidator in the case of bankruptcy) and 6:162 (tort) DCC and criminal cases will be discussed in section 4.7. First, in sub-sections 4.6.3 and 4.6.4, I will consider the Enterprise Chamber procedures and some Supreme Court cases. These cases, and the media attention they have attracted, have since 1990 had a growing impact on the standard of duties of managing directors.

4.6.3 Enterprise Chamber procedure: right of inquiry

The right of investigation into the dealings of corporations was introduced into Dutch law in 1928, following the example of the UK Companies Act of 1862. In 1971 the specialised Enterprise Chamber was set up. This is a division of the Amsterdam Court of Appeal and consists of judges specialised in this field. There were a few lengthy proceedings between 1971 and 1994. Since 1994 shareholders, trade unions and the public prosecutor may request an order for an investigation and at the

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[1278] Frijns Code Principle III.1.

[1279] Den Boogert (2005); Langman (2005); Wezeman (2009/G); and Prof. H. Beckman, 'Enkele losse gedachten bij en over commissaris, toezicht en controle', column, *Ondernemingsrecht* 2005/8, p. 291 ("Beckman (2005)").

[1280] Global Compact Rules to which companies can adhere. See Preliminary advisory report to the Netherlands Lawyers' Association of June 2010, *Maatschappelijk verantwoord ondernemen*. Preadviezen van Prof. mr. A.J.A.J. Eijsbouts, Prof. mr. F.G.H. Kristen, mr. J.M. de Jongh, mr. A.J.P. Schild en Prof. mr. L. Timmerman (2010); and Lambooy (2010).

[1281] Draft code of conduct, of Prof. Auke de Bos and Dr. Mijntje Lückerath-Rovers and the observations of Schuit (2010).

same time seek an immediate temporary injunction, such as a blocking decision or agreement and the appointment or dismissal of directors. There is a right of appeal to the Supreme Court.[1282] The procedure is described in articles 2:345 to 359 DCC.

One of the first major cases was the *OGEM* case,[1283] which was decided in 1990. It described the aims of the right of investigation:

- curing and reorganising the company;
- finding evidence of possible mismanagement;
- allocating responsibility for proven mismanagement;
- prevention of further mismanagement.

The procedure in Enterprise Chamber proceedings takes place in two steps. First, someone – usually a shareholder – warns the company of mismanagement in a letter to the management board and, in the absence of a satisfactory response, applies to the Enterprise Chamber for a ruling on whether there are "good reasons to doubt that the company is being proper managed" (*gegronde redenen om aan het juiste beleid te twijfelen*).[1284] Often, an order for a temporary injunction is requested at the same time. The second step, after an investigation has been made by experienced businessmen, accountants or lawyers appointed by the Enterprise Chamber, is for the original applicant to ask the court to determine whether there has been mismanagement (*wanbeleid*)[1285] and to issue final injunctions. The threshold for mismanagement is a breach of "elementary principles of reasonable entrepreneurship" (*elementaire beginselen van verantwoord ondernemerschap*).[1286] These terms are broad enough to give management and supervisory board members a certain amount of discretion. This comes close to the "business judgment rule", except that in some cases (e.g. *HBG*,[1287] *ABN AMRO*[1288] and *ASMI*[1289]) the Enterprise Chamber has evidently broadened its remit to include correcting the business judgment of the board. However, in each

[1282] Sanders, Westbroek, Storm and Buyn (2005), p. 310, et seq., no. 310.

[1283] *OGEM*, HR 10/1/90, NJ 1990, 466.

[1284] Article 2:350 DCC.

[1285] Article 2:355 DCC.

[1286] *OGEM* case, HR 10/1/1990, NJ 1990, 466, described below in sub-section 4.6.4.

[1287] *HBG*, HR 21/2/2003, NJ 2003, 182.

[1288] *ABN AMRO in Sale LaSalle Bank*, HR 13/7/2007, NJ 2007, 434, described below in sub-section 4.6.4.

[1289] *ASMI*, HR 2/6/2010, NJ 2010, 544, described below in sub-section 4.6.4.

of these cases the Supreme Court reversed the Enterprise Chamber decision.

It is important to note that the Enterprise Chamber does not deal with liability of directors for which the claimant has to approach the regular District Courts. The Enterprise Chamber sometimes seems to apply a higher standard for good management than the ordinary courts do in liability cases. Owing to the media coverage of the cases mentioned above, the standard of behaviour expected of directors has risen, notwithstanding the final judgments of the Supreme Court. When the Enterprise Chamber declares mismanagement by the company, its decisions usually apply to all board members and no distinction is made between the management board and the supervisory board. In most Enterprise Chamber cases, whether an outside director is supervisory board member in a two-tier system or a non-executive director in a one-tier system is unlikely to make much of a difference. Although the standards of conduct for supervisory board members are different, they too are always subject to investigation.

4.6.4 Enterprise Chamber cases and standards

In ***OGEM*** (1990), which had gone bankrupt, both the Enterprise Chamber and the Supreme Court found seven instances of mismanagement: (i) the public announcement of a recent acquisition had stated a price lower than the real one, (ii) shares had been bought back without supervisory board consent, (iii) a building had been acquired in exchange for shares in OGEM without informing the board, (iv) overly optimistic information had been given to shareholders about results, (v) property mortgages had been provided to banks contrary to internal regulations (this occurred because none of the board members bothered to read the documents relating to mortgages), (vi) the supervisory board had refused to pay the former CEO his due indemnity, (vii) a consultancy agreement had been made with a critical shareholder to keep him quiet. In general, the executive directors acted independently of one another and had strong egos and no respect for the supervisory board, whose chairman blindly supported the CEO. Two memoranda from supervisory board members who objected to the course of events were swept under the carpet. The Hague District Court found the management board members and supervisory board members liable and the case was settled for fairly moderate amounts. None of the directors was insured.

In ***Bobel*** (1999)[1290] the management board members and supervisory board members had acted solely in the interests of one majority shareholder and had grossly neglected their tasks of management and supervision. This had gone on for over 25 years, until the company went bankrupt. The Enterprise Chamber held that this constituted mismanagement and ordered the directors to pay for the costs of the investigation. The order for costs was reversed by the Supreme Court.

Gucci (2000)[1291] was the first large case in a corporate power battle in which certain parties sought an interim injunction from the Enterprise Chamber rather than from the president of the District Court. Previously it had been customary to request injunctions from the president of a District Court, who usually issued prompt and clear temporary injunctions (*kort geding*).[1292] The French company, Louis Vuitton Moet Hennessy (LVMH), had built up a 34% shareholding in Gucci NV, which was the holding company of Gucci. It was a Dutch NV, listed on the Dutch stock exchange. Gucci reacted to the threat of LVMH by creating an employee stock owner plan (ESOP) under which employees would buy Gucci shares worth NLG 2.5 billion and would be lent the full amount by the company. Companies are forbidden to lend money to anyone wanting to buy their shares.[1293] The Enterprise Chamber decided the case holding the middle ground and issued a temporary injunction depriving both LVMH and the ESOP of the right to vote their extra shares. This *Gucci I* decision laid down obligations for controlling shareholders, stating that a 24.5% shareholder is a controlling shareholder and has obligations to other shareholders. Gucci quickly found another French company, Pinault Printemps Redoute (PPR), as a white knight. A month later the Enterprise Chamber ruled against Gucci, because the financing of the shares was illegal. The Supreme Court held that while the investigation is still pending the Enterprise Chamber may issue only temporary and not final injunctions.

RNA (2003)[1294] created 3 rather temporary defence mechanisms in reaction to the threat of Westfield’s tender offer for RNA shares, because RNA was against integrating with Westfield’s external management. The Enterprise Chamber blocked the defence mechanisms. However, the Supreme Court reversed this judgment and permitted the mechanisms, ruling that in this case temporary defence mechanisms were permitted.

[1290] *Bobel*, HR 19/5/1999, NJ 1999, 659.

[1291] *Gucci*, 27/9/2000, NJ 2000, 653.

[1292] For a typical preliminary injunction case before the president of a district court, see *Doetinchemse IJzerfabriek*, HR 1/4/1949, NJ 1949, 405. As noted previously, this involved a defensive issue of shares to friends in reaction to a threat.

[1293] The provision prohibiting financial assistance can be found in article 2:98c/208c DCC.

[1294] *RNA*, HR 18/4/2003, JOR 2003, 110.

In ***Stork*** (2007)[1295] the management and supervisory boards used a defence mechanism to block shareholders from voting to dismiss the supervisory board. The reason why the shareholders Paulsen and Centaurus were so adamant was that they disagreed with the management and supervisory boards about strategy. They wanted a split up, and management did not. Communication was bad and the Enterprise Chamber found that all sides were at fault and therefore froze the whole matter and appointed three super-supervisory board members. In the end Stork was taken over by a private equity group, which confirmed that it would not split up the company in the first four years. The Enterprise Chamber held that a defence mechanism cannot be used for the purpose of blocking a shareholder's vote and that the supervisory board should play a mediating role between shareholders and management, but that shareholders have an obligation to explain their views in more detail when they communicate with boards. These have become important standards of conduct.

The recent case of ***ASMI*** (2010)[1296] once again involved a dispute between management and shareholders – the UK activist pension fund, Hermes, was actively arguing with management – about splitting up the company. Here too the company used a defence mechanism to influence – not block – voting. The Supreme Court clearly held that the management board determines strategy and the supervisory board supervises strategy and is not obliged to discuss matters with individual shareholders outside the shareholders' meetings, nor is it under a legal obligation to mediate between management and shareholders (thereby differing from the Enterprise Chamber's opinion in the *Stork* case), but should try to help keep communication as good as possible. In this case the Supreme Court did not condemn the use of such a defence mechanism, and referred the case back to the Enterprise Chamber without ordering a further investigation and the Enterprise Chamber stopped the investigation.

ABN AMRO (2007)[1297] was engaged in strategically planned merger talks with Barclays. Under the proposed merger ABN AMRO would keep its identity and influence. It sold LaSalle, which it had planned to sell for a long time. LaSalle accounted for less than one third of ABN AMRO's business at about the time when a new consortium consisting of RBS, Fortis and Santander made an overture for a tender offer. In this important case the Supreme Court gave a clear opinion on several issues. The board should consider the interests of all stakeholders. Directors determine strategy, the supervisory board monitors this and the general meeting of shareholders can state its views and has rights given by law and the articles of association. Article 2:107a DCC about shareholder consent should

[1295] *Stork*, Enterprise Chamber, OK 17/1/2007, NJ 2007, 15.

[1296] *ASMI*, HR 2/6/2010, NJ 2010, 544.

[1297] *ABN AMRO in Sale LaSalle Bank*, HR 13/7/2007, NJ 2007, 434.

not be interpreted broadly and, even if such consent had been required, it would not affect the validity of resolutions in relation to third parties.

Landis (2005)[1298] was distributor of ICT products and had grown very quickly as the result of a series of acquisitions, some at a high price. It was an example of "overstretching". There was no accounting and the market had been given misleading information. Landis and many subsidiaries went bankrupt. It was held that there had been clear mismanagement. The important question was whether a shareholder can request an investigation of the management of unlisted subsidiaries. This was answered in the affirmative by the Supreme Court.

In ***HBG*** (2003)[1299] the Enterprise Chamber tried (i) to raise the standards of communication concerning important joint ventures, even though there is no legal requirement for consent by shareholders, and (ii) to oblige boards to provide information to shareholders in great detail. The Supreme Court reversed these efforts of the Enterprise Chamber by confirming that boards do not have to consult shareholders about decisions that do not require shareholder consent. On the point of detailed information, the Monitoring Committee has in the meantime introduced an obligation to give detailed information on a website. This has been confirmed in the Frijns Code.[1300] This means that now there is an obligation to provide detailed information and courts would rule against boards that fail to do so. See sub-section 4.6.2, third to last paragraphs.

Laurus (2007)[1301] is the most important case concerning the relationship between an Enterprise Chamber investigation resulting in a declaration of mismanagement and later liability cases before a District Court. The Supreme Court held that a district court

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[1298] *Landis*, HR 4/2/2005, RvdW 2005, 25.

[1299] *HBG*, HR 21/2/2003, NJ 2003, 182, see also Van Solinge and Nieuwe Weme (2009), p. 382, no. 326. *HBG*, HR 21/2/2003, NJ 2003, 182, a case known as 'the dredging war'. Boskalis made a tender offer for HBG. HBG refused the tender offer and the board discussed it in a general meeting of shareholders, but did not mention an alternative strategy. The meeting asked whether the board would have called the meeting for consultation purposes if it had an alternative. The chairman of the supervisory board answered: "Only if there were another offer or a change of the company profile". A week later HBG announced that it declined Boskalis' offer and entered into a dredging joint venture with Ballast Nedam. In a later general meeting HBG's CEO gave a presentation about the joint venture with slides, adding that HBG did not need consent for the joint venture. The Enterprise Chamber blocked the joint venture, holding that under the circumstances it was reasonable that HBG's board should consult the general meeting about the joint venture. The Supreme Court reversed the decision, confirming that there was no general rule obliging the board to consult with the shareholders' meeting or seek its consent for joint ventures.

[1300] Frijns Code IV.3.6.

[1301] *Laurus*, HR 8/4/2005, JOR 2005, 19.

liability case is a new case and that the declaration of mismanagement by the Enterprise Chamber should not influence the decision in the later case. Because the Enterprise Chamber investigation is informal and there is often no proper trial, the District Court is not bound by the investigation. Such an investigation might exercise some influence, but the Supreme Court was clear that the conclusion of the investigation does not form legal precedent. The facts were that Laurus had a very ambitious strategy. Neither the Enterprise Chamber nor the Supreme Court condemned the ambitious strategy as such. The courts also permitted a sale to Casino. The issue was whether there had been sufficient follow-up by the management and supervisory boards in their monitoring of the plan once it started to fail. Both courts held that there had been mismanagement by the management board, but clearly stated that this did not mean it had made any decision about liability. The supervisory board members won in the Supreme Court, because the arguments put forward by the plaintiff were insufficient to enable the supervisory board members to defend themselves. This was a case of insufficient follow-up to a failing strategy plan. These are very complicated cases and largely dependent on the facts.

Let us, for argument's sake, compare how these matters decided by the Dutch Enterprise Chamber and the Dutch Supreme Court would be approached by Delaware Chancellors and Justices.

First something about the procedures. Cases before the Dutch Enterprise Chamber start with a short hearing with possibly some preliminary injunctions and this is very often followed by an investigation and further hearings. The decision is a declaration of mismanagement or not. Liability is not declared by the Enterprise Chamber but by the District Courts.

Delaware case law can be distinguished between on the one hand director liability cases which are usually derivative cases which start with a motion to dismiss, which is a very quick procedure. If the case is not dismissed it is followed by a lengthy procedure where the courts carefully look at the facts and circumstances of each individual director and on the other hand there are injunctive relief cases such as takeover cases where the defendant is usually the board as a whole. Within the group of liability cases a division can be made between general supervision or "oversight" such as *Caremark*, *Stone v. Ritter*, *AIG* and *Citigroup* on the one hand and on the other hand care in individual transactions, such as *Van Gorkom*, *Disney* and *Lyondell*. The injunctive relief cases include the takeover poison pill cases, such as *Unocal*, *Time (Warner)* and *Revlon* and cases such as Blasius involving the manipulation of voting on the appointment of directors.

Of the Enterprise Chamber cases mentioned above, *OGEM*, *Bobel*, *Landis* and *Laurus* would be comparable liability cases in Delaware, even though in these cases the court only answered the question of whether there had been mismanagement and no injunctions were involved. The other Enterprise Chamber cases are comparable with Delaware injunctive relief cases.

Given the facts of Dutch mismanagement cases, the Delaware approach might be the following:

– in *OGEM*: the Delaware approach might be disloyalty and a lack of care shown by most inside directors and, possibly, also by some supervisory board members, because they did not try to monitor or read essential documents, misinformed the other board members and shareholders and refused to react to red flags;

– in *Bobel* the Delaware approach might be to establish how dependent each individual director was on the majority shareholder. Inside directors would probably be held more liable than outside directors. Some directors would probably be held liable, especially those who had committed gross negligence and/or shown disloyalty to the company, because disloyalty is not exculpable;

– in *Landis*, there was no accounting and the market had been given misleading information. By Delaware standards some of the directors would be liable for disloyalty and lack of care;

– in *Laurus*, the Delaware approach would be not to condemn an ambitious strategy since the Delaware vice-chancellor did not condemn Citigroup and applied the business judgment rule. I think in Delaware one would check whether the board was not disloyal and seriously consider the aspect loyalty in relation to the sale to Casino. I think that in Delaware as in the Netherlands these cases would depend on the facts. Delaware might possibly be slightly more lenient in liability cases, provided that the independent directors had not been guilty of disloyalty and had discharged their duty of care sufficiently not to have been guilty of intentional misconduct, because they would otherwise be exculpated.

In the Dutch Enterprise Chamber injunction cases, the Delaware approach might be as follows:

– in the *Gucci* poison pill case, the financing provided for the issue of shares under the ESOP was in breach of article 2:98c DCC forbidding financial assistance; the Delaware approach would be to also issue an injunction to block the pill if Delaware law included a statutory prohibition to this effect;

– in *RNA* the Delaware approach would be to accept the defence mechanisms as a proportionate reaction and would permit the defence in accordance their *Unocal* criteria;

– in *Stork*, the Delaware approach might be to apply the *Unocal* and *Blasius* criteria and not accept the issuing of shares to block the right to vote for the appointment or dismissal of directors, because this would be regarded as manipulating such voting rights;

– in *ABN AMRO*, I think that the Delaware approach would be to apply *Time (Warner)* and not *Revlon*, because the board had a developed strategy and the sale of LaSalle was part of that strategy. I therefore believe that the Delaware approach would be to rule in the same way as the Dutch Supreme Court and would not stay the sale of LaSalle. Another point is that in Delaware the threshold for the requirement of shareholder consent for disposals is much higher (50-100% of the value of the company, whereas in the Netherlands it is one third of the value of the company);[1302]

– in *HBG*, where the shareholders wished to be consulted on major transactions, the Delaware approach would be, like the Dutch Supreme Court, not to give a right of consultation to the general meeting if there were no legal requirement to do so.

4.6.5 Conflicts of interest

The main duty of management board members and supervisory board members under Dutch law is to act in the interests of the company.[1303] The present law is that where conflicts of interest involving management board members occur, the company should be represented by the supervisory board. Alternatively, the general meeting may always appoint another person as the representative.[1304] Codified Dutch law deals only with the issue of representation of the company by a management board member in the event of a conflict of interest. This can cause

[1302] See also the opinion of Advocate General Timmerman in the *ABN AMRO* case.

[1303] Article 2:140/250 DCC for supervisory board members and article 2:229, 5/238, 5 DCC (as introduced by the Act) for managing directors and executive directors, and see subsection 4.2.5 above.

[1304] Article 2:146/256 DCC.

surprises and legal insecurity. The rather complicated caselaw under present Dutch law, with its focus on representation, is discussed below. The legislator wishes to create more legal security in transactions by moving the question of conflict of interest to the decision fase, and basically making it possible for the conflicted person to opt out of the decision making.

The Act has added paragraphs concerning the loyalty of board members and provides that the management board members are to act in the interests of the company.[1305] The Act adds that if any board member has a conflict of interest he may not participate in the discussion and if all board members have a conflict the decision will be made by the supervisory board or, in the absence of such a board, by the general meeting of shareholders, unless the articles of association provide otherwise.[1306] In the same way a supervisory board member who has a conflict of interest may not participate in the discussions. If all supervisory board members have a conflict of interest or no decision can be made because a quorum is lacking, the decision will again be made by the general meeting of shareholders, unless the articles of association provide otherwise.[1307] Where a conflict of interest arises, the Act provides that the director concerned may not have any influence over the decision. The new Dutch arrangement is less flexible than the practical solution adopted in the UK and the US, where a director simply mentions that he has a conflict of interest at the beginning of the meeting and can get board or shareholder ratification. I have come across a UK-trained chairman who was in the habit of asking at the start of each meeting whether any board member had a conflict of interest in respect of any points on the agenda. The agenda point would be: "declaration of interest".

The new system of dealing with conflicts of interest during the decision-making stage as provided for in the Act is an improvement on the present Dutch system of focusing on the representation stage.

The case law of the last 15 years shows how complicated this focus on representation is.

[1305] Article 2:129/239, 5 DCC. This duty for supervisory board members was already laid down in article 2:140/250, 2 DCC.

[1306] Article 2:129/239, 6 DCC.

[1307] Article 2:140/250, 5 DCC.

The ***Mediasafe II*** case (1998)[1308] put an end to the old practice of permitting one person to represent many parties in a deal. An agreement was signed by one director for the parent and the subsidiary to give set-off and/or joint and several claim rights to a bank. As the bank could have known of this conflict of interest, it could be held against the bank, thereby invalidating the signature. This was notwithstanding the general rule that the signature of a registered management board member binds a bank.

This *Mediasafe II* case drew attention to the issue of conflicts of interest and resulted in a flurry of cases. ***Brandao*** (2002)[1309] dealt with a real material conflict of interest where Mr A.J. Maren, as director of Burgslot N.V., signed an agreement on behalf of Sundat N.V., a management BV company which he also represented. Sundat B.V. hired out Maren's two sons to Sundat N.V. on conditions that were very favourable for the sons. Brandao, as shareholder of Sundat N.V., asked the court to set aside the decision of Sundat N.V. to enter into this agreement. It argued that the director of Sundat N.V. had decided to give his sons (working via a management BV) favourable employment terms. The Supreme Court set aside the agreement. This case was comparable to the decision in the old case of ***Maas v. Amazone*** (1940)[1310] where father Maas, acting as director on behalf of the employing company, signed a favourable employment contract in favour of his own son. Here the Supreme Court judged the father to have a conflict of interest. I assume that the Delaware and UK courts would do the same, unless the board or shareholders had ratified the agreement. Dutch law does not have this ratification process.

Duplicado (2004)[1311] confirmed the *Mediasafe II* judgment. In this case, a director who owned 100% of the shares of two companies signed on behalf of both companies. His signature was held to be invalid.

Subsequently, the ***Bruil*** (2007)[1312] judgment gave a more nuanced and substantive answer to the question of conflict of interest. Mr Bruil was 100% shareholder and managing director of both Bruil Arnhem B.V. (BA) and Bruil-Kombex B.V. (BK). These companies were both fully owned by Mr Bruil. On behalf of these two companies Mr Bruil had signed contracts under which BA sold some but not all of its real estate to BK (the sale was good for both parties, the price was fair and BA got a contract to build a factory for BK). Each company gave the other a right of first refusal on its real estate. All the shares in BA were subsequently transferred to Ballast Nedam while Mr Bruil kept all the shares

[1308] *Mediasafe II*, HR 11/9/1998, NJ 1999, 171.

[1309] *Brandao*, HR 3/5/2002, NJ 2002, 393.

[1310] *Maas v. Amazone*, HR 14/11/1940, NJ 1941, 321.

[1311] *Duplicado*, HR 9/7/2004 NJ 2004, 519.

[1312] *Bruil*, HR 29/6/2007, NJ 2007, 420.

in BK. In due course BA sold its real estate to Fernhout B.V. without allowing BK to exercise its right of first refusal. BK claimed a penalty payment from BA for its breach of the right of first refusal. BA defended itself by arguing that the right of first refusal was invalid because Mr Bruil had signed on behalf of both companies and had a formal conflict of interest. The argument was rejected by the District Court, but accepted by the Court of Appeal. Before the Supreme Court gave judgment in favour of BK (thereby refusing to set aside the contract), Advocate General L. Timmerman gave a detailed opinion in which he discussed all the case law and literature as well as American law.[1313] He argued that all of the cited material favoured a nuanced case-by-case factual test of conflict of interest over a mere formal test. The bare possibility of a conflict of interest is not sufficient. He advised that a conflict should be deemed to exist where a personal interest prevails over a company interest, even when no one has suffered any damage. As his opinion was accepted by the Supreme Court, the existence of a conflict of interest now has to be judged on the facts of the case.

Since the *Bruil* decision of 2007 conflict of interest therefore has to be handled on a case-by-case basis and a nuanced decision taken on the issue of representation. As mentioned above, the Act shifts the focus to the decision making stage.

4.6.6 Summary of duties of directors

1. The duties of management board members and supervisory board members and of executive and non-executive directors are based on the following elements of the law: (i) statute law, (ii) articles of association, (iii) internal guidelines, (iv) agreements, including shareholder agreements which are enforceable and should preferably be countersigned by the company and its boards, (v) the Frijns Code, (vi) other codes. Decisions of the courts interpret the law.

2. The Enterprise Chamber cases and all the media coverage they have attracted have raised expectations for the conduct and duties of directors to a more aspirational and higher level than for the standards of liability. Generally Dutch law is converging with US and UK case law, except in some Enterprise Chamber decisions.

[1313] He cited, inter alia, Hamilton, *The Law of Corporations*, 5th ed., p. 468, *Corporations, including partnerships and limited liability companies, cases and materials*, 6th ed., p. 759 and Dennis Block and § 8.60 Model Business Corporation Act.

Although there has been no deliberate attempt to follow Delaware case law trends, the results of the decisions are not very different.

3. Conflict of interest has been dealt with in a more nuanced way on a case-by-case basis since the *Bruil* decision. The Act includes a practical solution for decision making.

4.7 **Liability of directors**

4.7.1 General

Directors are not generally held to be liable, except where “serious blame” (*ernstig verwijt*) attaches to them or they have been guilty of “manifestly improper management” (*kennelijk onbehoorlijk bestuur*). Case law gives some guidance on this point.

The principle of joint and several liability (*hoofdelijke aansprakelijkheid*) is characteristic of Dutch law and can be seen as a logical consequence of the tradition of consensus and collegiate boards.[1314] Joint and several liability was introduced in article 45 of the 1838 Commercial Code and repeated in article 47c of the 1928 Commercial Code, which was copied from section 31 of the 1876 Cooperative Associations Act. The text of article 2.9 DCC is still the same. The idea is that all management board members are equal and have open discussions with each other, and thus have a basic knowledge of what their colleagues are doing. The system of Dutch corporate liability law retains the joint and several liability model, but applies it on case-by-case basis and in a more nuanced way, with some exemptions and/or grounds for exculpation (*disculpatie*).

The concept of joint and several liability for all acts and omissions is based on articles 2.9 (liability to the company), 2:138/248 (liability in bankruptcy), 2:139/249 (liability for misleading accounts) and 6:162 (liability for tort) DCC. Basically, supervisory board members are held to the same standard of liability by way of articles 2:149/259 and 2.150/260 DCC, but only in their specific, different role of supervision. There is also a tradition of joint responsibility of both boards.

[1314] Molengraaff (1940), p. 255; Van der Grinten (1955), p. 420, no. 242; Van der Grinten (1989), p. 385, no. 385; Van Schilfgaarde and Winter (2009), no. 42; Van Solinge and Nieuwe Weme (2009), no. 417; and Beckman (1994).

All the articles mentioned provide for the possibility of exculpation as defined by case law. Case law on article 2:9 DCC is limited, because in the Netherlands the company rarely claims that its directors are liable. The main case is of 1997.[1315] There is concern in the Netherlands that non-executive directors on a one-tier board might possibly be held to a higher standard of liability than supervisory board members on a two-tier board. The *Staleman v. Van de Ven* case gives some guidance by listing circumstances that can be relevant for exculpation, including the "division of tasks and guidelines for the board". It is important to note that in his answer to questions of the Dutch Senate[1316] (the upper house of parliament) concerning the Act on one-tier boards the Minister of Public Safety and Justice referred to the importance of the *Staleman v. Van de Ven* case. He adds that in principle a director is not liable for damange caused by another director, except if there is also serious blame against him, because he took no measures or should have informed himself better. He adds that although there is a principle of joint and several liability directors should not be held liable too easily. There should be room for creativeity and risk taking. These answers are consistent with earlier answers to the Second Chamber.[1317] This helps to explain the text of the present and future articles 2.9 DCC, which exculpate a director who can prove that the default was committed in an area outside his remit and that serious blame does not attach to him. The discussion about this aspect and the relevance for a one-tier board as well as examples of divisions of tasks are described below.

It is therefore important to describe the tasks of inside and outside directors clearly in corporate documentation, as is customary in the UK and US, since this can be used as an argument for exculpation.[1318]

[1315] *Staleman v. Van de Ve*n, HR 10/1/1997, NJ 1997, 360.

[1316] Memorandum of Reply to the Senate, 31763, of 2 May 2011, p. 16.

[1317] Explanatory Memorandum, Parliamentary Papers 31763, 2008/09, nr. 3, pp. 3 and 9 and Memorandum of Reply, Parliamentary Papers 31763, 2008/09, nr. 6, p. 3.

[1318] Strik (2003), p. 374; Dortmond (2005), p. 265; Strik (2010) p. 132; Van Solinge and Nieuwe Weme (2009), p. 170, for the UK see end of sub-section 2.5.8 and for the US see sub-section 3.4.11.

4.7.2 Who can sue?

4.7.2.1 The company

Under article 2:9 DCC, which provides that each director has an obligation to perform his duties properly, only the company itself can make a claim. No shareholder or creditor is entitled to claim under this article. The Netherlands does not allow derivative suits[1319] as in the US and the UK, where shareholders can file a suit against the director in the name of the company with the leave of the court. The company may also sue a director on the basis of several specific prohibitions under the DCC, such as withdrawing shares, having the company buy back its own shares[1320] and/or unauthorized acquisition of the company's shares.[1321] As mentioned above the ***Staleman v. Van de Ven*** case (1997)[1322] is important in relation to claims by the company under article 2.9 DCC. It defines the test of "serious blame" or "serious personal culpability" (*ernstig verwijt*).

Messrs Staleman and Richelle were consecutive CEOs of the Van de Ven group of car sales and car rental companies. They had mismanaged the companies by making disadvantageous loans to Easy Rent at a rate of interest that was lower than the interest their own companies paid their bank (NMB, which is now part of ING). They let Easy Rent's debt run up too high and made many other lasting arrangements that were both chaotic and disadvantageous for the Van de Ven companies. In 1988 the general meeting had issued all the directors with a discharge from their obligations based on the accounts. However, the accounts were not clear on the loans to Easy Rent and their conditions. The Van de Ven companies held Staleman and Richelle liable for the losses of the companies (the equity had gone from NLG 2.3 million positive in 1988 to €5 million negative in 1990). The companies also sued the supervisory board members for damages. The District Court dismissed the claim against the members of both the supervisory board and the management board, because they had all received a discharge from liability. Discharge is

[1319] Prof. M. Kroeze, *Afgeleide Schade and Afgeleide Actie*, thesis (2004) ("Kroeze (2004)").

[1320] Article 2:95 DCC.

[1321] Articles 2:98a/207a and 2:98d/207d DCC.

[1322] In the *Staleman v. Van de Ven* case, HR 10/1/1997, NJ 1997, 360 the Supreme Court defined the standard of liability under article 2.9 DCC as serious blame. Another case in which the company filed a claim against management board members and supervisory board members was *Verto*, The Hague Court of Appeal 6/4/1999, JOR 1999/142. In this case both boards had been sloppy in an acquisition and Verto had lost a lot of money, but the Enterprise Chamber did not call this mismanagement and the courts did not hold any of the directors liable.

a typically Dutch company law concept. At the annual general meeting, after having discussed the accounts, shareholders are asked to give the directors a discharge from liability for their activities in the relevant year as disclosed in the accounts. After considering all the details and facts mentioned above, the Court of Appeal discerned a pattern of clearly disadvantageous arrangements with Easy Rent and concluded that all this added up to "serious blame". Management board members Staleman and Richelle were therefore held liable to the Van de Ven companies. The case against the supervisory board member was not really pursued seriously by the plaintiffs. The Court of Appeal held that the discharge for the directors could not exculpate them, as the accounts made no mention of the arrangements with Easy Rent.

The Supreme Court upheld this judgment and ruled that serious blame depends on the circumstances of the case, e.g. the nature of the company's activities, the general risks, the division of tasks, the general guidelines for the board, the information they should have had, the insight and diligence that can be expected of a director and how he has complied with this. The Supreme Court is not allowed to recheck the facts, but it did hold that serious blame attached to the directors for the disadvantageous arrangements.

The term serious blame certainly suggests that directors are granted a degree of discretion and comes close to the Delaware business judgment rule.

4.7.2.2 The shareholder

A breach of contract or a tort committed by a director may result in the admission of a claim for damages against the director by the company, but a claim made by the shareholders of that company will not be upheld.[1323] The damage suffered by the shareholders as a result of such breach of contract or tort is generally derived from and coincides with the damage suffered by the company.[1324]

[1323] *Poot ABP*, HR 2/12/1994, NJ 1995, 288. Mr Poot was managing director and 100% shareholder of Poot B.V., which had a project development contract with ABP, pension fund/investor. ABP withdrew from the contract. Poot B.V. went bankrupt and Mr Poot sued ABP in tort for his personal damages, i.e. the lost value of his shares in Poot B.V. The Supreme Court confirmed that as Poot B.V. was a separate entity it could make a claim, but not its shareholder Mr Poot.

[1324] An example is the *NOM v. Willemsen* case, HR 12/9/2008, JOR 2008, 297, where a director had requested a payment moratorium without the shareholders' consent, which was explicitly required by the articles of association. However, as Willemsen had consulted with NOM, the Supreme Court accepted his defence.

Shareholders may hold the members of the management and supervisory boards liable for damage suffered as a result of misleading annual accounts. If the annual accounts, the interim figures published by the company or the annual report misrepresent the condition of the company, the management board members will be jointly and severally liable to third parties for any loss suffered by them as a result.[1325] This is the only cause of action available to shareholders, but has not been much used to date. Class actions, which have been possible in the Netherlands since 2005 as discussed below in 4.7.3.2, might increase the number of claims brought.[1326] A management board member will not be liable if he proves that he is without blame.[1327]

A supervisory board member who proves that a misrepresentation of the condition of the company in the accounts is not due to any failure on his part to perform his supervisory duties will not be liable.[1328] It is important to note that this exculpation would not apply to non-executive directors on a one-tier board. Once the case law on this point develops, it is likely that they would be exempted only if they prove they are without blame in their duties. Case law might make a distinction between executive and non-executive directors.

4.7.2.3 Liquidator

Liquidators may claim compensation for the entire deficit upon liquidation from each management board member on the basis of articles 2:138/248 DCC, and from supervisory board members on the basis of articles 2:149/259 DCC, if the board in question has performed its duties in a "manifestly improper way" (*kennelijk onbehoorlijk*) and this is likely to have been an important cause of the company's bankruptcy. This also applies to a "shadow director" (*feitelijk bestuurder*), i.e. a person who has acted as if he were a director. If the

[1325] Article 2.139/249 DCC.

[1326] Jaap Winter, 'Corporate governance handhaving in de VS, EU en Nederland', in M.J. Kroeze, C.M. Harmsen, M.W. Josefus Jitta, L. Timmerman, J.B. Wezeman and P.M. van der Zanden (eds.), *Verantwoording aan Hans Beckman* (2006), p. 642 ("Winter (2006)"), a festschrift for Prof. Beckman. In practice, class actions have been brought against CEOs who have been unduly optimistic in their future projections, but such actions are normally based on general tort, article 2:162 DCC. A class action against Philips failed because the plaintiff used the wrong argument (unfair advertising).

[1327] Article 2.139/249 DCC.

[1328] Article 2.150/260 DCC.

accounting is insufficient or if the company has not filed its accounts with the trade register, the management board will be assumed to be liable.[1329]

Articles 2.138/248 DCC were introduced in 1987 as the so-called Third Insolvency Abuse Act. It was said that 10% of all bankruptcies were caused by fraud and often by fraudulent accounting. Initially, a liquidator always filed his claim against all members of both the management and supervisory boards because otherwise his claim would be regarded as inadmissible,[1330] as articles 2.138/248 DCC provide that the entire board is liable. Later it became possible to choose and only file claims against a few specific directors.[1331] Nonetheless, liquidators usually still file their claims against both full boards.

If there has been sloppy accounting and/or the accounts have not been filed there is an assumption that this is the cause of the bankruptcy. Poor accounting or failure to file in time are therefore very dangerous. Supervisory board members do not have to keep or file accounts themselves, but they can be held liable for the omission anyway.[1332] In ***Bodam*** (1996) it was held that supervisory board members must take some form of action. Holding a shareholders' meeting was not enough. If a board member or shadow director proves that sloppy accounting or failure to fail accounts was not the cause of the bankruptcy, he will not be liable.

In ***Mefigro*** (2001)[1333] the defendant argued that that the bankruptcy had not been caused by sloppy accounting or failure to file the accounts. Vlimeta B.V. traded in scrap metal. It was declared bankrupt in 1994. The liquidator sued W, one of the directors of Vlimeta B.V., who was registered as director in the trade register. The defendant argued he was not in fact a director and that an incorrect entry in the trade register did not make him a director for internal purposes (the liquidator being treated as an internal party). Although the District Court and Court of Appeal did not accept his argument, the Supreme Court did. Mefigro B.V. and its 100% shareholder Mr Mefigro had a different defence. They argued that neither Mr Mefigro nor Mefigro B.V. was a director, and that they were

[1329] Article 2.138/248 DCC.

[1330] *Van Haaften qq v. Timmer*, Zwolle District Court 14/4/1993, TVVS 93/7, pp. 181-182.

[1331] *Van Galen qq v. Bolasco*, Rotterdam District Court 26/6/1997, JOR 1997, 140, Arnhem Court of Appeal, 6 May 1997, JOR 197, 110, see J.B. Wezeman, *Aansprakelijkheid Bestuurders*, thesis (1998), pp. 325-326 ("Wezeman (1998)").

[1332] *Bodam Jachtservice*, HR 28/6/1996, NJ 1997/58, discussed in subsections 4.6.2 and 4.5.4.

[1333] *Mefigro*, HR 23/11/2001, NJ 2002, 95.

instead a shadow or de facto director of Vlimeta B.V. This argument was rejected by the District Court, Court of Appeal and Supreme Court, which held that shadow or de facto directors can be held liable. However, Mr Mefigro and Mefigro B.V. were permitted by the Supreme Court to prove that they had not been shadow directors in the last 3 years before the bankruptcy (which is the time bar) or to prove or make clear that the bankruptcy was caused by reasons other than sloppy accounting and failing to file the accounts.

In ***Van Schilt*** (2006)[1334] the court accepted the defendant's argument that the bankruptcy had been caused not by sloppy accounting or failure to file the accounts but by the death of a director, the sudden departure of another director, damage to products and the termination of the bank's credit. This case also confirmed that where accounts are filed without an auditor's report, the filing is incomplete. However, it was accepted that there was evidence of other causes.

Another important case concerning the liability of management and supervisory board members was the *Ceteco* bankruptcy mentioned above at 4.5.18.[1335] That was a case in which the company had pursued a risky strategy. The court found that this had been within the management board's discretion, but held that there had been a failure to heed red flags and to properly supervise the follow-up at a time when the company was overstretching itself. All members of the management and supervisory boards plus a shadow director/shareholder were held liable.

4.7.2.4 Creditors and third parties

Articles 6:194-196 DCC give creditors or other third parties the right to sue an individual director in tort. There are many examples of claims by creditors on the grounds of tort. Three important Supreme Court decisions are:

In ***Beklamel*** (1989) the Supreme Court confirmed that the criterion for director's liability was whether the director should have understood at the time of entering into a contract that the company would not be able to pay in the case of bankruptcy, see note 1204.

In ***Tax Collector v. Roelofsen*** (2006) [1336] the director had filed incorrect tax returns which resulted in lower tax payments than were due. After the company went bankrupt, it was

[1334] *Van Schilt*, HR 20/11/2006, JOR 2006, 288.

[1335] Ceteco, District Court of Utrecht, 12 December 2007, JOR 2008, 66, see subsections 4.5.6 and 4.5.18 above.

[1336] *Tax Collector v. Roelofsen*, HR 2/12/2006, NJ 2006, 659.

found that there had been underpayment of taxes. The tax collector sued the director who had been responsible for the filing. The Supreme Court did not hold the director liable. The test in tort was that the director (i) understood at the time that the company would not be able to pay, which was not the case and (ii) there was serious personal blame (*ernstig verwijt*), which was not the case either.

In the case of ***Eurocommerce*** (2009)[1337] the director of Kloosterbrink B.V., a company that owned shares in Vista B.V. had convinced another shareholder of Vista B.V., Eurocommerce B.V., to guarantee bank debts of Vista B.V. although the director in question could have known that Kloosterbrink B.V. was unable to discharge its obligations. He was held liable.

In certain circumstances third parties may have specific claims under the DCC, for example claims that an NV or BV does not exist, should exist or has no legal personality[1338] or is incorrectly entered in the trade register,[1339] and claims against founders who became directors for damages caused before the NV or BV obtained legal personality. During such a period, the NV or BV is said to be "in the course of formation" (*in oprichting*).[1340] Shareholders or others who have rights of first refusal on shares can claim for damages or specific performance.[1341] Finally, as mentioned above, third parties can claim for misrepresentation of accounts.[1342]

4.7.2.5 Government authorities

In the case of a corporate bankruptcy in the Netherlands, directors of the company can be held personally liable for various unpaid taxes and social security contributions under the second Insolvency Abuse Act.[1343] The following authorities may sue such director(s):

– the Tax Collector for taxes and national insurance premiums;
– the industrial insurance boards for employees' insurance premiums; and

[1337] *Eurocommerce*, HR 26/6/2009, NJ 2009, 148.

[1338] Article 2.4, 4 DCC.

[1339] Article 2.69/180, 2 DCC.

[1340] Article 2.93/203 DCC.

[1341] Article 2.98a/207a DCC.

[1342] Articles 2.139/249 and 2.158/260 DCC, see sub-section 4.7.2.2.

[1343] *Tweede Misbruikwet* as described clearly in Van Solinge and Nieuwe Weme (2009), p. 586.

– the industry pension funds for pension contributions.

The Netherlands Authority for the Financial Markets (*Autoriteit Financiële Markten*/AFM) can investigate matters such as insider trading, notification of financial holdings, prospectuses, offer documents and, especially, the annual accounts of listed companies and then take appropriate measures.

4.7.2.6 Who can be sued?

Each individual member of the management and supervisory boards can be held liable. There is no legal necessity to sue the members of the board of directors collectively, as directors may individually have recourse against their fellow directors. Usually plaintiffs start by claiming that all the members of the management and supervisory boards are jointly and severally liable.

4.7.2.7 Joint liability

The management board has a general reporting obligation. This is a collective responsibility and suits the Dutch concept of a consensus-seeking or collegiate board. Under such an obligation, each director is responsible for that part of company policy which falls within his specific remit as director. Moreover, each director has an obligation to the company to perform his general duties properly.

Under the present text of article 2:9 DCC, each director is responsible to the company for the proper performance of the duties assigned to him. If a matter falls within the remit of two or more directors, each will be jointly and severally liable for any shortcoming, unless he proves that it is not attributable to him and that he was not negligent in acting to prevent the consequences.

Another example of joint liability of directors under Dutch law is article 2:138/248 DCC, which states that in case of bankruptcy of a company, each director will be jointly and severally liable to the estate of the company for the total amount of the obligations and to the extent that these cannot be satisfied out of the liquidation of the other assets, but only if the management board has manifestly failed to perform its duties properly and this can reasonably be assumed to be an important cause of the bankruptcy. Improper accounting and failure to file accounts are regarded as important causes, but exculpation is possible even then if the director proves there was in fact a different cause (see the Supreme Court cases described above in sub-section 4.7.2.5).

It is clear that individual directors can exculpate themselves in certain circumstances. If an individual director can prove that a shortcoming in the performance of the board, which may have caused damage to the company or a third party, cannot be attributed to him and/or that he properly tried to prevent this damage, such exculpation may be successful. Under article 2.149/259 DCC this applies to supervisory board members too. Misrepresentation of accounts can also be held against both management board members[1344] and supervisory board members,[1345] each subject to the possibility of exculpation.[1346]

In keeping with Dutch corporate culture, management board members tend to make decisions jointly, as a collegiate board. This results in joint and several liability, with the possibility of exculpation.

Some authors argue that less stress should be put on the issue of joint and several liability. Others would prefer only an individual liability and for wider possibilities of exculpation. They reason that directors should feel free to work as entrepreneurs and should not be constrained by an increase in the specialisation of functions on supervisory boards and non-executive committees. Finally, there will be specialisation in the future one-tier board based on article 2.129a/239a, paragraph 3 DCC (Act), which states that directors can have specialised functions.[1347]

Professor J.B. Wezeman[1348] has made three proposals: first, to change article 2.9 DCC and take away the joint and several liability (this would

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[1344] Article 2.139/249 DCC.

[1345] Article 2.150/260 DCC.

[1346] Dortmond (2005), p. 265 argues that a non-audit committee member should, in certain circumstances, be less liable than the Audit Committee chair.

[1347] Maarten Kroeze, *Bange Bestuurders*, oratie (2005), also translated in English, *Frightened Directors*, available at: http://ssrn.com/abstract=960315 ("Kroeze, Speech (2005)"), Strik (2010), pp. 127-144., Wezeman (2009/G), pp. 93-107 and B.F. Assink and M.J. Kroeze, 'Ja, wij willen', *Ondernemingsrecht* 2010/6, pp. 246-277 ("Assink and Kroeze (2010)") in which they argue for a Dutch business judgment rule. See also Winter (2006) in festschrift for Beckman, who mainly worries about the class actions in misrepresentation cases and warns against derivative cases, Dortmond (2005), p. 265 and Wezeman (1998).

[1348] Wezeman (2009/G), pp. 100-106.

make each director liable only for his specific task and not for improper management by a colleague, although they would still all be liable for general management); second, to define the concept of liability more clearly and follow the Delaware business judgment rule as defended by Assink in his thesis of 2007;[1349] and, third, to introduce more possibilities of indemnification by the company, based on the argument that as article 2.9 DCC is not mandatory for BVs there could be indemnification even if there was serious fault. Indemnification by the company means it holds the director harmless for claims of the company itself and of any third party. Finally he also notes the emergence of a trend in certain cases. First, *Tax Collector v. Roelofsen* of 2006,[1350] where the tax returns filed by the director were too low and caused damage to the tax collector when the company went bankrupt. Second, *Nutsbedrijf Westland* of 2007,[1351] where the director had been dismissed because of incorrect accounting and the Supreme Court held that the serious blame test should also apply in tort cases. And, third, *NOM v. Willemsen* of 2005,[1352] where the director had asked for a payment moratorium without seeking the consent of the shareholders, although he had consulted with NOM, an investment company belonging to the northern provinces. In all these cases the director was not held liable by the courts. Wezeman interprets this as an indication that the Supreme Court is moving towards the Delaware business judgment rule, without actually copying it. In all those cases the director had not acted against the interests of the company and was not seriously culpable. Nor was there any bad faith. I agree with him as regards the last aspect of convergence with the Delaware business judgment rule test for liability as such, provided there is no disloyalty, no serious blame and no bad faith. I will discuss the other aspects of exculpation and indemnification below.

Mrs Strik proposes that article 2.9 DCC be changed in such a way as to clarify the issue of exculpation. For example, whether a director who finds out about mismanagement by a fellow director should be liable only for damage arising from the moment he discovers the problem.[1353] The changes she has suggested to the text of the new article 2.9 DCC as contained in the Act have not been introduced in the amendments to that

[1349] Assink (2007).

[1350] *Tax Collector v. Roelofsen*, HR 8/12/2006, NJ 2006, 659.

[1351] *Nutsbedrijf Westland*, HR 2/3/2007, NJ 2007, 240.

[1352] *NOM v. Willemsen*, HR 20/6/2008, JOR 2008/260.

[1353] Strik (2010), pp. 235-255.

article for one-tier boards, but the courts might follow her and apply broader grounds for exculpation of directors in line with the decision of the Supreme Court in of *Staleman v. Van de Ven* and the circumstances it mentions.

The only possible criticism of the Supreme Court's decisions is that they only give criteria for what a director should not do, i.e. not incur serious blame. Directors and corporate lawyers would be grateful to know how much freedom directors have. More clarity could help directors to adopt a more confident approach to their entrepreneurship.[1354] Another aspect is that the media and insurers like to exaggerate the liability risks and many risk-conscious lawyers are not very comforting either. This may be due to the fact that the law is not overly clear yet.[1355] To make it clearer is easier said than done. It requires a large volume of clear case law and good information about the law on directors at the courses that they follow. By comparison, the Delaware business judgment rule and the UK literature[1356] in a different way clearly state that directors who have seriously considered all aspects are free to take decisions as they see fit.

As to joint and several liability I would repeat that this is part of the Dutch corporate consensus-seeking or collegiate culture. It has the advantage that specialists on the board take the time to explain to the other directors, all of whom are responsible, what they do to perform their specialised duties. This stimulates internal communication and avoids compartmentalism. As regards exculpation, the *Staleman v. Van de Ven* case, the new text of article 2.9 DCC and the explanations of the Minister of Justice are starting to provide more clarity. This also applies to the position of non-executive directors in the proposed one-tier board.

Since the 1990s there has been debate about the exact text of article 2.9 DCC and especially about the possibility of exculpation mentioned there. The words task (*taak*) and area of work, also called "scope of responsibility" (*werkkring*) have been at the centre of the debate, but there is general agreement that if one board member fails in his specific task, his colleagues can exculpate themselves if they prove that it was outside their specialism, that they did not fail to take action as soon as they should have discovered it and that they were not seriously

[1354] Kroeze (2005), third reason, pp. 16-21.

[1355] Kroeze (2005), sixth reason, pp. 22-23.

[1356] Davies (2008), pp. 493 and 510; Mayo in Rushton (2008), p. 127.

culpable.[1357] Few examples have been given in the whole debate and examples are indeed difficult to give. However, as soon as a director becomes aware of a failure that falls outside his remit he should take action to avoid or mitigate its effects. This implies that any examples given are usually based on a failure to give information or fraud by one director that remain concealed.[1358] The explanation given by the Minister of Justice for the proposed article 2.9 DCC (Act) does give some examples of a separation of tasks: finance, purchasing, sales, directing a separate division, human resources, filing data with the trade register, filing of accounts.[1359] The Minister adds that directors with separate tasks must inform other directors at the next meeting what they have done. This, again, reconfirms the concept of the collegiate Dutch board. How this information is to be provided from time to time could be specified in internal bye-law or even in the articles of association.[1360]

Another example could be that a certain task is allocated to a director. Another director then discovers a mistake made by the first director. In such circumstances, he must immediately inform the complete board and discuss what solutions are possible and perhaps ask for the appointment of an expert. If he has done this, exculpation would apply.[1361]

So much for exculpation. The essential point is that a director is not liable if he cannot be seriously blamed for a fault that has committed. This is a high threshold for liability.

Increasingly, supervisory board members receive letters from lawyers of shareholders threatening that if they take a certain decision they will be held liable. This makes it all the more important for there to be a clear understanding of the test of serious personal blame (*ernstig verwijt*), as described in the above decisions of the Supreme Court. Directors should

[1357] Strik (2010), pp. 87-92; P.J. Dortmond, 'Misbruik van rechtspersonen'; Piercing Van Schilfgaarde (1990), pp. 17-22; Dortmond (1990); Dortmond (2000/A), pp. 67-71; Dortmond (2003), p. 118; Dumoulin (2005), point 3; Beckman (1994), pp. 54 and 115; Van Solinge and Nieuwe Weme (2009), no. 445; and Van Schilfgaarde and Winter (2009), no. 47.

[1358] Strik (2010), p. 101.

[1359] Strik (2010), p. 129 and Parliamentary Papers II 2008/09, 31763, nos. 3, p. 4, and 6, p. 5 (these include all the expanatory memoranda of reply and reports).

[1360] Strik (2010), p. 132 and Parliamentary Papers II 2008/09, 31763, nos. 3, p. 17, and 6, pp. 13 and 25

[1361] Beckman (1994), p. 115.

realize that courts give them entrepreneurial leeway that is fairly close to that of the Delaware business judgment rule.

The *Gispen v. Coebergh* case of 1999[1362] was an example of joint and several liability and exculpation. The District Court made clear that in article 2.9 DCC cases the plaintiff has the onus of proving serious blame and that an individual director has the onus of proving he was not culpable if he wishes to exculpate himself. Here the whole management board knew and accepted that a director had recklessly concluded a contract that was grossly unfavourable to the company. The District Court ruled that this was so obviously wrong that none of the directors succeeded in exculpating themselves. However, in the same case a double payment made by one director without telling the other director was so specific to the area of work of the paying director that the other director could exculpate himself.

4.7.3 Procedural complications

4.7.3.1 No derivative actions

Derivative actions, which are actions where shareholders take the initiative in having the company sue the directors, are possible in the UK and the US, as described above.[1363] Derivative actions are not known under Dutch law.[1364] A shareholder only has a cause of action against a director if the breach of contract or tort of the director affects the shareholder personally, i.e. where the act has been committed by the director with the intention of causing damage to that shareholder.

4.7.3.2 Class actions

Under current Dutch civil law, a foundation or association can institute an action intended to protect the collective interests of a variety of persons. This “class” or “collective” action covers both actions in which the individual interests cannot be identified (general interest actions), and actions in which individual interests can be identified (group actions). The law aims to offer efficient and effective legal protection in cases

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[1362] *Gispen v. Coebergh*, Rotterdam District Court 17/6/1999, JOR 1999/244.

[1363] For the UK see subsection 2.7.3 and for the US see subsection 3.7.2.1.

[1364] There is debate about this. Prof. M. Kroeze gives arguments in favour of this in his thesis in Utrecht, Kroeze (2004) and Kroeze (2005); Winter (2006), p. 641 is not in favour.

where individual interests are small, but general interests are large. However, unlike the US “class action” procedure, the object of such an action cannot be to seek specific determination of monetary compensation. A claim should be limited to a declaratory judgment, that establishes whether or not there is liability. Collective action against corporations or directors can be initiated by shareholders or third parties who have suffered damage, for example as a result of a tort committed by directors.

Legislation to have settlements of mass damages declared universally binding by the Amsterdam Court of Appeal entered into force in 2005.[1365] Under this legislation, a foundation or association representing the injured parties must first negotiate with the defendant in an attempt to reach a settlement. The second phase entails an order declaring the collective settlement to be binding. This procedure starts with a joint request of the foundation or association and the liable party to the Amsterdam Court of Appeal, a special section of which has exclusive jurisdiction in these procedures. The Court of Appeal must also decide upon a certain period during which an individual injured party may elect to be excluded from the collective settlement. The minimum duration of this so-called “opt-out” period is three months. Each individual injured party who has not explicitly informed the liable party within this term that he elects to be excluded is bound by the settlement.

The last phase covers the payment of compensation to the individual injured parties. Each injured party who has not exercised his right to opt out automatically becomes a party to the settlement by way of a third-party clause and loses his right to institute separate proceedings.

International shareholder class action cases have been settled against companies under Dutch law. An example is the action against Royal Dutch Shell that had started in the US.[1366]

[1365] Act of 2005: Collective Action (Financial Settlement) Act (*Wet Collective Afwikkeling Massaschade*) dealt with in the Code of Civil Procedure, articles 1013-1018, and articles 7.907-910 and 3:305a-d DCC. Together with article 2.139/150 DCC concerning misleading accounts, this creates a combination that resembles the threat posed by the US securities class actions. See also Ianika Tzankova and Daan Lunsingh Scheurleer, Annals, Aapss 1622, March 2009.

[1366] *Financieele Dagblad*, 3 March 2011, p. 11. The main cases are *DES*, Amsterdam Court of Appeal 1/7/2006, NJ 2006, 461, *Dexia*, Amsterdam Court of Appeal 25/1/2007, NJ 2007, 427, *Vie d’Or*, Amsterdam Court of Appeal 29/4/2009, NJ 2009, 440 and *Skele*, Amsterdam Court of Appeal 29/5/2009, NJ 2009, 506. See also

4.7.3.3 Costs and fees in liability proceedings

According to the rules of professional ethics of the Dutch Bar, Dutch lawyers may not, in principle, agree to a "no cure, no pay" arrangement. Contingency fees are therefore not applied under Dutch law. The former Minister of Justice, Mr Donner, who is presently Minister of the Interior, is against contingency fees because fee structures of this kind would promote more litigation. I agree. In this respect the US could learn from the Netherlands and the UK, where contingency fees are equally unenforceable.

In the Netherlands, orders for costs payable by the loser to the winner are based on a statutory scale, with fixed amounts for each stage of the proceedings. This results in lower compensation for costs than the winner has to pay to his lawyer. If the winner were awarded a more realistic amount for costs, as in the UK, this would provide a greater deterrent against frivolous cases.

4.7.4 Aspects of liability: difference between supervisory board member and non-executive director

This study has examined many different aspects of the various ways in which the management of companies is organised in the UK, the US and the Netherlands. Given the now pending choice between a two-tier and a one-tier board system in the Netherlands, there is a general worry that if supervisory board members become non-executive directors, they will be exposed to higher liability.[1367] Non-executive directors of a one-tier board will not merely be a more active version of supervisory board members; instead, they will have a different role as managing directors (*bestuurders*).

Non-executive directors in a one-tier board are described in the Frijns Code in III.8, which mentions the possibility of a one-tier board. "The composition and functioning of a management board comprising both members having responsibility for the day-to-day running of the company (*dagelijkse gang van zaken*), i.e. the executive directors, and members not having such responsibility, i.e. the non-executive directors

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Tekst en Commentaar Rechtsvordering (vierde druk), p. 1335.

[1367] Wezeman (2009/G), pp. 93-99; Strik (2010), pp. 125-131; and Timmerman, Two-Tier (2009), p. 26.

shall be such that proper and independent supervision by the latter category of members is assured."[1368]

Non-executive directors will not only supervise. They will have wider responsibility than supervisory board members, because they will not only monitor but also be involved in decision making and developing strategy. They will receive more information and receive it at an earlier stage. They will actively challenge management while it is developing strategy, risk management and CSR (as in the US), or even be actively involved in the development of these strategic items (as in the UK). This means that non-executives will have more chance to prevent mistakes and damage for the company and therefore avoid liability. The biggest problem for supervisory board members – and for the future non-executive directors as well – is to get good information. Non-executive directors will be better placed to obtain that information than supervisory board members in the traditional two-tier board system.

Below are some quotes of the Minister of Justice in explaining the new Act:

- "Non-executive directors must supervise the executive directors and each other. Executive directors must supervise each other and the non-executive directors."[1369]
- "All directors are jointly and severally liable even for specific tasks, subject to the possibility of exculpation."[1370] "Non-executive directors participate in the development of decisions concerning the day-to-day running of the company."[1371]
- "The tasks of non-executive directors are wider than supervising and advising. They have management board responsibility. They are involved in strategy to a greater extent than supervisory board members. They must not only take action when they see mistakes; the directors in a unitary, 'monistic' board have joint responsibility for board policy. They receive more information and receive it an earlier stage. As they should know of problems at an earlier stage, they are more likely to be held liable. Liability depends on the circumstances of the case."[1372]

[1368] Frijns Code Principle III.8.

[1369] Parliamentary Papers II 2008/09, 31763, no. 6, p. 26.

[1370] Parliamentary Papers II 2008/09, 31763, no 3, p. 8.

[1371] Parliamentary Papers II 2008/09, 31763, no. 3, pp. 8 and 14.

[1372] Parliamentary Papers II 2008/09, 31763, no. 3, pp. 4 and 6.

Clearly, there is a convergence with the roles of UK NEDs and US independent directors. Executive directors run the day-to-day business and develop and monitor the general strategy. Non-executive directors are not involved in the day-to-day affairs of the company, but develop and monitor the general strategy. Although there is joint and several liability, a non-executive director may be exculpated where he has received less information than an executive director and because he understandably spends less time on the specific point than an executive (see Schedule B to the UK Combined Code of 2008).

It is understandable that potential non-executive directors could be concerned about increased liability because of (1) the extra role of being a general director (*bestuurder*) and (2) the uncertainty caused by variable standards of liability.[1373]

But is this concern justified? In my view not. First, it is important to note that in his reply of 2 May 2011 to questions of members of the Senate (upper house of parliament) the present Minister of Safety and Justice states on three occasions that liability will depend on the specific facts of the case, with a reference to the *Staleman v. Van de Ven* decision (in which a much more nuanced view is expressed and a factor is the description of the function), which is consistent with earlier comments of his predecessor.[1374] Second, the Act on the one-tier board makes a clear distinction between executive and non-executive directors. Third, under the existing case law on the liability of management and supervisory board members, the latter have often been held liable in the same way as management board members, subject always to the proviso that they have incurred serious blame. As supervisory board members are already in many cases held liable together with management board members under the two-tier system, the concern that non-executive directors will have greater liability than supervisory board members is in practice not impending.

When managing directors are judged under the present two-tier system to have managed the company improperly and to have been seriously culpable, it is usually the case that the supervisory board has failed in

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[1373] Strik (2010), pp. 55, 74-75, 78 and 134

[1374] Parliamentary Papers II 2008/09, 31763, Memorandum of Reply to the Senate of 2 May 2011, pp. 5-6 and 16.

some way in the performance of its supervisory role.[1375] The same level of diligent supervision will be expected by the courts from the new non-executive directors of a one-tier board. The difference, however, is that they will be better informed and can and should take earlier action to avoid default and damage.

I believe that my view is supported by the following case law:

1. Mismanagement
   Mismanagement judgments by the Enterprise Chamber are never against specific directors but against the company. However, the Enterprise Chamber can naturally rule against a specific director or group of directors in the case of a tied vote or other deadlock in the running of the company, but in most cases of mismanagement the ruling is for or against the whole management board and supervisory board, albeit sometimes for different standards of conduct. I would mention the cases of *OGEM*, *Landis*, *Bobel* and *De Vries Robbé*, all of which were held by the Enterprise Chamber to have gone bankrupt because of mismanagement on the part of the directors of both boards. In *Textlite* and *Laurus* the supervisory board was regarded in a different light from the management board, but mainly for technical procedural reasons. In *HBG*, *RNA*, *DSM*, *ABN AM*RO and *ASMI* the Enterprise Chamber held that there had been mismanagement by the company and therefore by all members of both boards. The main point is that these rulings were relevant to the company and both of its boards.
2. Liability
   In liability cases (*Ceteco*, *Bodam*, *OGEM* and *Tilburgsche Hypotheek Bank*) the supervisory board members are nearly always held to be liable when the management board members are also liable.
3. Standard of conduct
   It is interesting to note that the standard of conduct for liability of supervisory board members is often slightly different from that

[1375] Wezeman (2009/G), p. 105, who quotes the *Tax Collector v. Roelofsen*, *Nutsbedrijf Westland* and *NOM v. Willemsen* and Prof. M.J. Kroeze, inaugural lecture about “Frightened directors”, in which he repeats the words of two ministers of justice: Donner (1928) and Korthals Altes (1987) “Bonafide Directors have nothing to fear”.

for liability of management board members; this is attributable to the different nature of their functions:

–	*Tilburgsche*:	management:	fraud
		supervisory:	failure to check the report they had ordered from the auditor
–	*OGEM*:	management:	fraud
		supervisory:	entrenched, i.e. always slavishly following whatever the CEO wished, not even reading documents
–	*Bodam*:	management:	no accounting or filing
		supervisory:	no action taken
–	*Ceteco*:	management:	no action taken despite red flags
		supervisory:	no action on red flags

4. Let me now return to the straightforward case of *Bodam*. Management had failed to provide proper accounting and to file accounts and was liable. The supervisory board members were also liable as they had taken no remedial action after discovering the failures of management, such as dismissing the responsible director and fixing the accounting and filing. In the case of a one-tier board system a non-executive director would be liable if he fails to inquire at the beginning of the year about how the company arranges its accounting and also fails to follow up on the answer. It is a question of timing and involvement. The same would apply to risk management systems.

   The supervisory board member must be active if he discovers something, the non-executive director must be proactive. At first sight this would imply that the non-executive director has a greater risk of being held liable than the present supervisory board member, but because he is a member of the one and only board he will also receive full and timely information, thereby enabling him to minimise the risk.

I would like to repeat that although the possibility of a difference of liability between a supervisory board member and a non-executive director exists in theory because of the formal difference in their functions, this is less so in practice because (a) directors are not easily held liable owing to the far off threshold of serious blame, and (b) if management board members are liable because it is so serious, the supervisory board members will usually be liable as well.

4.7.5 Indemnification and insurance

(a) *Indemnification*

The possibility of having the company indemnify its directors is not mentioned in Dutch legislation. In practice, certain companies have included such a possibility in their articles of association. This is a practice that has been borrowed from the US.

It is generally assumed that indemnification is not possible where a director has breached article 2:9 DCC. Likewise, under article 2:9 DCC and relevant case law, a director is liable towards the company only where there has been improper management (*onbehoorlijk bestuur*) on his part for which serious blame (*ernstig verwijt*) attaches to him. In other words, a director is not liable to the company and third parties for ordinary negligence, which is something that can be contractually excluded. It is questionable whether liability for an act involving greater culpability than ordinary negligence can be excluded by contract. On the other hand, a director will be able to rely on an indemnification where it covers legal defence costs for false claims.[1376]

Shell, Unilever and Philips have indemnification clauses for their directors in their articles of association.[1377]

Professor J.B. Wezeman suggests that more extensive indemnification should be possible in BV companies with the approval of a quorum of shareholders. This would be a further point of convergence with the US. It is also a subject for Dutch law studies to focus on, especially those that favour greater

[1376] G.H. Potjewijd, 'Vrijwaring voor bestuurders en commissarissen', *Ondernemingsrecht* 2003/16, p. 607 et seq. ("Potjewijd (2003)"), takes the view that indemnification for the results of gross negligence is possible; for more problems, see B.F. Assink and P.D. Olden, 'Over bestuurdersaansprakelijkheid: De Reikwijdte van de maatstaf ernstig verwijt, vrijtekening en vrijwaring nader bezien', *Ondernemingsrecht* 2005/1, p. 9 et seq. ("Assink and Olden (2005)").

[1377] Royal Dutch Shell Plc, article 136, Unilever N.V., article 19.10 and Koninklijke Philips Electronics N.V., articles 17.4 and 23.2.

protection for directors. The Delaware exculpation clauses have helped directors in the US.

In view of the legal constraints on indemnification, D&O insurance is preferable. In particular, it should be noted that a director will have no recourse under an indemnity in the case of the company's bankruptcy. However, it can be to the advantage of directors to have both, given the limits on the insurance coverage, the possibility that an insurer may unjustifiably refuse to pay out under the policy, termination of the policy, failure to pay premiums and the possible insolvency of the insurer.

(b) *Directors' and officers' insurance*
US, UK and other insurance companies issue D&O policies in the Netherlands. In addition, a so-called BCA policy ("*Bestuurders-Commissarissen Aansprakelijkheids-verzekering*" or Directors-Supervisory board members Liability Insurance) has been set up by 11 large insurance companies in the Netherlands.

The company concerned is the policyholder and pays the insurance premiums. The insured persons are the present, former and future management board members and supervisory board members of the company. In view of the collective responsibility of the boards, the members of such a board can usually only be insured collectively. The territorial applicability of the coverage, the size of the company, the number of directors, the financial situation of the company, the number of exclusions and the insured amount are factors that will determine the premium to be paid. It should be noted that the premium paid by the company is deductible for corporate income tax purposes. The insured amount is the maximum amount to be paid by the insurance company per claim and per insurance year for the insured parties individually and collectively.

If the insurance company is notified of circumstances that could lead to a claim but no claim is actually made until after the policy expires, this claim too will be covered.

It should be noted that coverage provided under a policy is composed of the description of the insured interest, the description of the insured parties and any inclusions and exclusions, all of this being read in its mutual context.

The coverage provided under the policy may be limited due to a large number of exclusions. Liabilities arising out of the accounting obligation and the obligation to file the company's annual accounts may be excluded from coverage. Liabilities resulting from the failure to notify or properly notify the competent authorities of the company's inability to pay taxes, social security premiums etc. under the Second Insolvency Abuse Act are also not covered. In accordance with the general rule of Dutch law, liability caused by an individual director's intent falls outside the scope of the insurance.

In the event of the company's bankruptcy, both the liquidator and the directors are entitled to buy extended coverage. During a period of three years starting from the date of bankruptcy, claims made against an insured party and filed within this period are covered if they are based on acts committed during the term of the original policy. An additional premium must then be paid.

4.7.6 Summary of liability

In the Netherlands there have been only a few cases where a company has filed a claim against its directors. An example is *Staleman v. Van de Ven*, which describes many circumstances that are important for serious blame to be applicable, such as internal guidelines and description of functions. The shareholder has direct claim for tort, including misrepresentation of accounts. The recent Dutch class actions legislation could widen the circle of plaintiffs and causes.

The liquidator has a good chance of collecting amounts from the directors if there has been sloppy accounting or a failure to file accounts. Creditors can claim if a director, when entering into a contract, knew the company would not be able to pay, as in the *Beklamel* case. The Netherlands has a tradition of consensus-seeking or collegial boards that keep each other informed. In consequence, joint and several liability applies to all directors. Usually the management and supervisory boards are held liable together. In cases, where management board members are seriously culpable the supervisory board members are often deemed to have known unless they can show that the relevant default was not part of their task and that they did not have to take any action. In such cases exculpation might be possible.

There is still concern that in a one-tier board system a non-executive director will be more readily held liable than a supervisory board member. This concern is exaggerated (a) because directors are liable only in cases of serious blame or obvious improper management and (b) in such cases not only non-executive directors but supervisory board members too should have known and taken action. The most recent reply of the Minister of Safety and Justice of 2 May 2011 reconfirms the importance of the *Staleman v. Van de Ven* doctrine, i.e. that courts should look at all the facts concerning a director's actions, including his job description.

5. CONCLUSION

5.1 Differences, changes, convergence, remaining differences, what can we learn from each other

Since the 1990s substantial changes have taken place in the composition and roles of boards of listed companies in all three countries – UK, US and the Netherlands. Because these changes took place at varying times the differences in the direction taken have seemed larger than they in fact ended up to be. Now that the changes have made their mark – and it is an ongoing process – we notice a substantial convergence in the three countries. Because of different backgrounds some notable differences remain.

We also find that there are areas in which the three countries can come closer to each other through continued discussion about better corporate governance. For the Dutch, now able to choose between a two-tier and a one-tier board, the most important question is the practical improvements they can make to their way of functioning by cherry picking from the UK and US, even if a company chooses to keep a two-tier board structure.

5.2 Boards before the 1980s

In all three countries up to the 1980s boards were led by strong managers, who in practice chose their outside or supervisory directors and used them as their trusted advisors. In all three countries shareholdings were spread out and there were hardly any shareholders with a substantial holding of shares, a situation which favoured managerial capitalism.

The main differences concerning corporate governance in the three countries can be expressed under the following captions:

Who?
In the US especially, and in the UK as well, there was an emphasis on the strong CEO/chairman, while the Netherlands favoured management by consensus. The cultural background of a greater hierarchy in the US and the UK and a lesser hierarchy and consensus boards in the Netherlands plays an important role here.

How?
The UK and the US had one-tier boards, which meant that from a formal point of view all directors were involved in decisions, while the Netherlands had and has two-tier boards, where the managing board decides and the supervisory board is limited to consent or veto. This is an important cultural and practical difference.

For whom?
While in all three countries the board had the duty to act in the interest of the company, this was generally interpreted to imply that in the UK and the US the board acted in the interest of shareholders, while in the Netherlands it acted in the interest of stakeholders. The Netherlands had workers' participation rules which the UK and the US did not have. In the UK boards were not able to use legal defence mechanisms against hostile takeovers, while this was the practice in the US and the Netherlands. UK shareholders had the legal power to dismiss directors, while US and Dutch shareholders in practice did not have such power. These differences have been part of the culture of each country.

Who is held liable?
While in the US there was substantial litigation and a large market, the UK and the Netherlands were less litigation prone and relied on social control in a small market where most influential players knew each other. These are important cultural differences, caused by the large size of the US and its appreciation for fair trial, free speech and debate. In liability cases the Netherlands works with the concept of joint and several liability of directors, because boards are deemed to be collegial. In the UK and the US a liability claim is usually instigated against individual directors and the courts weigh the facts concerning each individual director.

5.3 **Changes at different moments**

Corporate governance had been topical in the US in the 1970s and there were broad discussions about the need for truly independent directors and committee members, especially on audit committees, but in practice in most cases the imperial CEO was dominant in the choice and appointment of outside directors he trusted.

In 1992 the UK took the lead – upon instigation of leaders in the City and institutional investors supported by the government – with the trendsetting Cadbury Code of Best Practices, which set aspirational standards and introduced the concept of “comply or explain”.

Who? And how?
The UK emphasized balance, (a) by separating the function of *CEO* from the task of chairman and, (b) in the area of *Board functioning* by underlining the important roles of creative strategy and monitoring by Non-Executive Directors (NEDs) who are in a small majority so as to form a balanced board. The Cadbury Code and all its successor codes emphasized all elements of early and on-site information of NEDs, formal discussion on succession by the complete board, intense work, evaluation, committees, etc. The best practice codes system in the UK led to changes in all these areas.

For whom?
The UK Companies Act of 2006 introduced the concept of “enlightened shareholder value” in section 172, which emphasizes that the board must have regard to all aspects, including elements such as employees, customers and the environment and promote the success of the company for the benefit of its members as a whole.

In the US the first changes came in 1994 at large companies, such as General Motors, instigated by shareholder activists like CalPERS, but these initiatives dwindled as soon as share prices moved up and the conviction took root that better governance could be achieved by giving directors options and shares.

In the US the real changes came after the Enron scandal and the Sarbanes-Oxley Act in 2002. At that point the imperial CEO/chairman was still common. Since thenactivists fought for changes, which are continuing.

In the Netherlands, where boards are to act in the interest of the company, shareholders are able to wield more power since 2004, thanks to the Tabaksblat and Frijns Codes, the relaxation of the Structure Regime Act, the Enterprise Chamber jurisprudence and the substantial increase in foreign shareholders.

How?
In the US a counterbalance to strong management is achieved by a large majority of the board consisting of independent directors, where the only

officer on the board is the CEO. The roles of the independent directors include the task of co-deciding on strategy by intense challenging and monitoring. The Sarbanes-Oxley Act, stock exchange regulations, privately developed best practice codes and court decisions emphasize personal independence of directors, due process in board meetings, independent advisors, and early and on-sight information, succession procedures, intense involvement of all directors, etc. There are “executive sessions” where the independent directors meet separately. The committees are composed of only independent directors and have quite stringent procedures to assure that directors can form their opinions independently and can freely ask advice of outside specialists if they wish to do so.

Who?
In the US already 30% of listed corporations have separated the functions of CEO and chairman; shareholder activists are urging other corporations to follow this trend. In the other 70% lead directors are becoming stronger. Modesty is becoming a more important characteristic for CEOs.

These changes in the US were slower to come than in the UK, because they were a result of long discussions between shareholder activists and CEO supporters, such as the Business Roundtable, while the federal rule makers have not really taken the initiative. They have since taken drastic action with the enactment of some measures in corporate law through the Sarbanes-Oxley and the Dodd-Frank Acts.

In the Netherlands there has been debate about defence mechanisms from 1990 onwards. Litigation about corporate governance matters in the Enterprise Chamber became more frequent after 1995 with the introduction of the possibility of preliminary injunctions. In 1997 there was first the Peters Code; then came the Tabaksblat Code in 2004, which on many subjects followed the Cadbury Code for example by:

– Stressing more activity by supervisory directors in the Netherlands, such as evaluation, formal succession and separate board committees for auditing, nominating and remuneration; the Tabaksblat Code also mentioned the possibility of a one-tier board as an alternative to a two-tier board.

– Directing the focus more on shareholders, as in the Relaxation of the Structure Regime Act of 2004, which gave shareholders more powers in several ways.

In all three countries the influence of institutional investors and activists have increased considerably over the last twenty years – first in the UK, then in the US and in the last 9 years in the Netherlands also with 75% foreigh shareholders – and direct communication between board and strategic and vocal investors has become a common feature.

5.4 **Convergence**

With internationalisation, larger institutions and growing critical pressure of shareholders and with legal changes in the UK since 1992, the US since 2002 and the Netherlands since 2004, the board systems and roles of management and directors in these three countries are converging in many ways.

Who? CEO and chairman
Although this is not part of the consensus board culture of the Netherlands, the Dutch CEO has become stronger due to the centralization of conglomerates and stock market and media requirements, and the wishes of foreign investors. The UK and US CEOs have become less prominent because of the rise of a separate independent chairman, now the rule in most UK companies and increasingly so in the US.

The chairman in all three countries is increasingly playing a more important role, especially in the UK. In the US, and now also in the Netherlands the concept of the heavier-chairman and in the US of the lead director as well, is being promoted as a counterweight for the strong CEO. While UK chairmen are prominent and have direct contact with shareholders even in discussing strategy, the way the role of the chairman is developing in the Netherlands might show more similarities with the trend in the US.

Some questions will continue to be asked in the three jurisdictions.

Can a chairman, who spends so much time at the company, make sure that his colleagues on the board keep up with him so that he gets the best out of them?

Should he have an office next to the CEO?

Should he communicate directly with shareholders and how and on what topics? In any case he should not discuss strategy with shareholders without the CEO being present.

How? Boards work!
The job of outside or supervisory directors is becoming more demanding in all three countries. They all spend more time on strategy; in the UK by developing strategy together with management, in the US by challenging management at the earliest stages of setting the course. Netherlands law assigns to supervisory directors the duty of monitoring, but there is a growing tendency of supervisory directors wanting to become involved in developing strategy.

All three countries have introduced active, hard working, board committees, which implies that they are all getting used to the fact that the board does not always meet as a whole, but board members often have separate meetings of only a few. There are differences in who attends and who is a member. In the US only independent directors attend committee meetings, while in the Netherlands supervisory directors are the only formal members, but executives will often attend. In the UK, as well, non-executives are members and executives attend on invitation.

The Dutch two-tier board in its practical functioning is getting closer to UK and US one-tier boards. The practice of hands-on, working supervisory directors and separate committee meetings make the Dutch speak of "one-and-a-half-tier" boards, while the US boards with their executive sessions, where independent directors meet without the CEO or any other officer, could also be called one-and-a-half-tier boards.

All three countries have introduced formal nomination and succession procedures in nomination committees at full board level. For the Netherlands this substantial difference with the old practice of CEO prompted nominations of the past is changing the oligarchic old-boy atmosphere at the top of the Dutch corporate governance world. There are still some minor differences, e.g. in the UK and the Netherlands the chairman usually chairs the nomination committee, while in the US it is usually a senior independent director who chairs the nomination committee.

All elements of best practices, such as evaluation, diversity and early and on sight information, as well as more time required of non-executives which means less time for other functions receive a lot of attention in all three countries. The US is ahead on diversity because of its multicultural background tradition. The Dutch are behind in early and on site information, because of the two-tier board culture.

The US practice of executive sessions, where independent directors meet without the CEO or any other officer, is sometimes being followed by the Netherlands and occasionally in the UK.

For whom?
In all three countries boards are taking all factors and interests into consideration though in the end loyalty to the corporation prevails and especially to the long term shareholder interest, with elements of difference of nuance in each country.

As mentioned above there are many more institutional investors, more shareholder associations and activists, more foreign investors and hedge funds, but also more long term strategic investors. An increase in direct communication with these strategic long term investors permitted to a certain extent by the authorities – the UK FSA, the US SEC and the Dutch AFM – which have issued guidelines and letters in the form of questions and answers to assist participants in one-on-ones.

Who is liable?
In the US litigation on director liability continues at huge cost and time, but the Delaware courts persevere in producing leading opinions that give direction to aspirational best practices of directors by preaching the standards of liability and by giving judgments along the lines of the business judgment rule.
In the UK there is infrequent liability litigation, but the number of disqualification cases and criminal cases against directors is increasing.

The interpretation in Dutch jurisprudence of liability for serious blame (“ernstig verwijt”) in the district courts on the one hand and mismanagement in the Enterprise Chamber on the other hand is developing to a clearer set of tests. Certain law studies recommend following the direction of the tendency in the US and the UK to give directors leeway in their entrepreneurship by a methodical thought process comparable with the business judgment rule.

In the US companies usually indemnify directors against liability in their articles of association. In the UK this happens to a lesser extent and even less so in the Netherlands, but they may follow.

Convergence is to be found in the D&O insurance policies, although premiums do differ.

5.5 **Remaining differences**

Although there have been substantial changes for better corporate governance in the three countries and more and more convergence, there are still differences.

Who?

In the UK nearly all listed companies have a non-CEO chairman. The UK chairman is at the company offices 2 or 3 days a week; he is very prominent and speaks directly with shareholders.
In the US the non-CEO chairman is not yet the norm. At present about 30% of the listed companies have a separate chairman. Two reasons for the slowness of the US in introducing the non-CEO chairman are the strong CEO lobby that opposes the development as well as the culture of having respect for the exceptional individual and of giving him a chance. In US practice, lead directors in the 70% of the listed companies that still have a CEO/chairman as well as separate non-CEO chairmen in the other companies, will continue to be less visible than chairmen in the UK.
The Netherlands, with its two-tier boards, has always separated the function of CEO and chairman, but because a strong CEO is only a recent phenomenon and not natural to Dutch culture, the role of the chairmen has still to be strengthened to give counterweight.

Regarding the position of the chairman the three countries are in different phases of development. The UK is 15 years ahead, as a leading example. It may be that because of tradition and culture US and Dutch chairmen will remain less prominent. Americans like young leaders and have respect for the successful individual. Delaware jurisprudence puts emphasis on the complete board and not just on one chairman leader. Furthermore, US development over the last 20 years has favoured the rise of even more strictly independent directors in a large majority as counterweight rather than the emphasis on the non-CEO chairman or lead director. The Dutch culture of supervisory boards, limited to monitoring does not promote chairmen who are the public face of the company. But the Dutch will realize that if they want a strong supervisory board it needs a strong team leader.

How?
Although there is convergence in many elements of better corporate governance, such as committees, formal nomination and evaluation procedures, there remain differences between the three countries mainly in the organisation and composition of board, the degree of involvement in decision making, the role of the outside directors in strategy and in the way that the outside or supervisory board members receive information.

Composition and organisation
Difference in composition between UK and US
The main difference in composition between UK and US boards is that in the UK the typical board has around 4 executive directors, a chairman and a small majority of around 5 or 6 NEDs. The UK seeks balance.

In the US the board has only one executive – the CEO – and about 7 independent directors. The US seek counter balance. Other executive officers than the CEO do attend board meetings, but have no vote.

Why is the one executive, the CEO, in the US outnumbered to the tune of 1:7, where in the UK the four executives are only facing five or six outsiders at the boardroom table? The reason is often sought in the difference of how companies were run in the past. In the US there was the tradition of the powerful CEO/chairman. The forces that wished to check the dangers of a dominating corporate leader thought it wise to surround him at board level with an overbearing majority of independent directors. In Britain team spirit is admired. Companies would also be run best by a team, so all top executives are on the board only slightly outnumbered by non-executives; they all form part of a team and the captain, i.e. the chairman, is not the head of management. Besides in the UK the full board is involved in running the business, so it makes sense to have all top executives on the board; in the US the board is more at a distance from day-to-day management and looks at the big picture, where the views and advice of outsiders is useful and the views of management are sufficiently represented by its leader, especially if other officers attend the meeting.

Under the two-tier board system of the Netherlands, and its tradition of teamwork, there was no need for outnumbering. The board of management performed its tasks, the supervisory board monitored, but did not take part in decision making. They can only approve or veto decisions brought to the table. The fact that supervisory boards usually have more members than management boards is not a result of a need to create counterweights, but because the tasks of both boards are different.

In practice a Dutch combined meeting, of both supervisory and management boards, would resemble the meeting of a UK board, or to a lesser extent, the meeting of a US board to which all top officers have been invited, except for the different tasks and obligations of the various directors and executives present.

Hereunder follow the main differences between the Dutch two-tier system on the one hand and the UK, US and Netherlands one-tier system on the other.

Involved in decision making
In UK, US and the Netherlands one-tier boards all directors – executive and non-executive – are – that is the first main difference between a two- and a one-tier board –involved in decision making, including strategy and succession planning like US and UK boards and they – the executives and non-executives – will all have to monitor each other as a team. In a two-tier system supervisory directors are not involved in decision making. They only monitor.

Strategy
According to the law (DCC and jurisprudence) Dutch supervisory directors only monitor the strategy achievement. The DCC and the Frijns Code only mention achievement and do not mention strategy development. Supervisory board members are not involved in the development of strategy. This is the second main difference between a one-tier and a two-tier board.

There is also a difference of nuance between US and UK boards in strategy development. In the US the officers develop strategy and independent directors actively challenge and discuss alternatives. In the UK the whole board, including the NEDs, develops strategy. The background of this difference of approach is that the US board is slightly less hands on. If a Dutch company chooses to have a one-tier board it can choose whether it wishes to follow the US or UK example.

Early and on site information
Under the two-tier board system Dutch supervisory directors are not involved in decision making. For this reason they receive information at a later stage than outside directors in UK and US companies do. UK and US outside directors have more on-sight information and direct information from lower staff and division heads. This is, again, a consequence of the difference between a one- and a two-tier board. If a Dutch company would opt for a one-tier board, the non-executives would also get early information.

Whether a company chooses for a one-tier board or keeps a two-tier board I propose, as is mentioned in sub-section 4.5.5, that the board or boards have a special meeting once a year to discuss how supervisory or non-executive directors will have a role in strategy, development, which topics are included in strategy in any case, whether points of strategy will be discussed at most meetings, what the timing of providing information to outside directors will be, whether outside directors will receive on-site information and may communicate with middle management. My proposal will be worked out in detail in paragraph 5.6(b) hereafter.

Differences in the areas of evaluation and succession
When it comes to evaluation and succession planning the UK has developed rigorous and formal evaluation practices; discussion about succession is regular and formal. One tries to avoid “discussions in the corridor”.
The US have developed the practice for boards (in committees and the full board) to hold discussions about lower management succession and income.

In the Netherlands the nomination committee limits its work to directors' nominations. The remuneration committee limits its work to director's remuneration. Most Dutch remuneration committees stick to this limitation. Since 2008 only at banks these committees are obliged by law to check the remuneration policies of lower management. Still all nomination committees limit their succession interest to directors only.

I propose that the boards meet at least once a year on the rigorous and wider discussion about succession internally, as mentioned above and in sub-section 4.5.17 on succession and in 5.6(b), four pages hereafter on page 414.

Differences in written confirmation of roles
It is UK practice to describe the roles of non-executives and some chairmen in great detail. This is a consequence of the common law system and the freedom of shareholders in the UK and the board in the US to organize the company as they wish. In the Netherlands this has not been the custom, because of the greater amount of mandatory law on companies in the detailed Dutch Civil Code. However, there are many good reasons, e.g. for clear criteria when it would come to exculpation grounds for directors, to describe such roles in internal regulations and appointment letters in the Netherlands as well. See UK chapter, p. 87.

Executive sessions
Executive sessions, where independent directors meet without any officers, before or after each board meeting are a US invention first put in practice in 1993 at General Motors.
This idea finds its roots in the US emphasis on independence and the frustration of US outside directors serving with overly influential CEO/chairmen.
The example of holding executive sessions before and after each board meeting could be followed in the UK and in the Netherlands (both in one- or two-tier boards).

For whom?
In the three jurisdictions the concepts of whom the directors are working for are converging as well. In all of the three countries there is now a greater outside pressure exercised by large shareholders, foreign shareholders, shareholder activists, voting advisers, environmentalists,

employees, government supervisors and the media. Boards should consider, and in the Netherlands in many cases consult with, all interested parties and then decide on the direction that should be taken for ensuring the interest of the company and its enterprise, with a light tendency to long-term shareholder interest, see Dutch chapter, sub-section 4.2.5.

There are slight differences in the possibilities to have one-on-one meetings between directors and selected shareholders. Board members have to communicate directly with strategic long-term “stewardship” investors. The differences stem on the one hand from the opposition between the easy going UK city “clubbyness” and on the other hand US stricter laws on shareholder equality and insider trading and lastly for the Netherlands the lack of experience in communicating with shareholders. UK, US and Dutch law makers have developed question and answer letters or guidelines to facilitate these direct selective communications or one-on-ones.

Who is liable?

The US has more litigation, more indemnification as well as higher D&O insurance premiums, all of which are a consequence of a sue at the drop of a hat mentality and a different legal system in every state. The more limited possibility of indemnification for directors in the UK and the Netherlands lies in the law.

The UK has very few liability cases, because of the rule that the losing party pays all the costs of the winner and because of the absence of no cure no pay or large percentage of gain fee arrangements and a limited possibility of derivative actions; furthermore it is simply not part of British culture.

The Netherlands’ concept of joint and several liability is opposed to UK and US practice, where liability cases are directed at individual directors.

A vital question is whether the decision of a Dutch company to opt for a one-tier board would increase the liability of outside non-executive directors, above that of the present supervisory board member directors. In theory the answer is yes: more liability, because the Dutch have the concept of joint and several liability of directors and, from a formal point of view, managing directors, including every director on a one-tier board are more likely to be held liable than supervisory directors, as they have different functions. In practice the answer is no, because the Supreme

Court has decided in *Staleman v. Van de Ven* that liability is not a dogma, but is based on specific circumstances, including assigned functions and internal regulations and depends on the role of each director in a specific case. And also the answer is no, because supervisory directors do at present seldom avoid liability in the rare cases that managing directors are found liable. See cases like *Tilburgsche Hypotheek Bank*, *OGEM*, *Bodam* and *Ceteco*, where managing and supervisory directos were liable, because of serious blame. Managing directors are only liable in cases of serious default. In those cases even supervisory directors should have been aware of the problems and have taken action. It is to be hoped and expected that Dutch jurisprudence will accept scope for entrepreneurial judgment of directors in good faith and accept exculpation in such cases for non-executive directors, keeping in view the difference between inside and outside directors as the US and UK courts do; compare section 1157 of the Companies Act mentioned in sub-section 2.6.6, which gives the judge a mitigation right in connection with the function. The Dutch Parliamentary Papers to the Act refer to the *Staleman v. Van de Ven* case and seems to support the hope for different treatment of non-executive directors depending on the circumstances of the case and the assigned functions.

5.6 **<u>What should the Dutch take over from the UK and the US; cherry picking</u>**

When studying UK and US corporate governance the Dutch should keep an open eye for examples and instances for possibly following whether or not they opt for a one-tier board or stay with a two-tier board.

Who? CEO/chairman

I believe that the Dutch should foster a climate which favours a stronger and active team leader as chairman, both for the present supervisory board and the future optional one-tier board. One possible model is that of the strong, hands-on UK chairman. Another, the US example of a chairman with a lower profile. The choice will determine the answers to questions; should the chairman have direct contact with selected shareholders? And if so, should he only meet them together with the CEO? How can an active chairman keep his co-directors motivated and have them keep up with him? Taking the Dutch corporate tradition into consideration, a chairman with an inclination to the US lead director or a non-CEO chairman seems more likely to succeed. For instance, meetings with shareholders in the UK are regularly attended by the chairman (see

2.5.7) without the presence of any executive, while in the US non-CEO chairmen or lead directors rarely meet with shareholders and if they do, they are accompanied by an executive or at least the general counsel (see 3.5.5).

In any case it is a good idea to confirm clearly in writing what the role of the chairman should be and how he relates to the CEO and other directors. This is important in a two-tier board but even more so in a one-tier board, because the Civil Code leaves many points open. A clear description and distribution of the functions of board members is important from a liability point of view as well, as became clear in the Supreme Court decision in *Staleman v. Van de Ven* which indicated that a description of functions in internal regulations were going to be a factor for the courts in their judgments.

In the area of proper communication and behaviour it is important to keep in mind that the CEO and the chairman should share their thoughts and be open on the dilemmas between each other and the other directors.

Another point is that, if there is any lingering disagreement between two or more directors on either of the boards, this should be known to all directors and sorted out. In my view, there is more chance of outside directors finding out about such internal disagreement in a one-tier than in a two-tier board.

How?

Involvement in decisions, strategy, information

When looking at the UK and US practice, two points spring to attention: outside director involvement in strategy development, see sub-sections 2.5.3, 2.5.4, 2.5.5, 2.5.11, 3.5.3, 3.5.6 and 3.5.9 and early and on-site information, see sub-sections 2.5.8, 3.5.6 and 3.5.9.

The practice of early and on-site information includes direct access to lower staff. This can be laid down in an agreement among the directors, dealing with all the points to be discussed regularly also.

There is sometimes a misunderstanding about the independence of supervisory directors and their receiving limited and late information. Many Dutch CEOs and supervisory directors say that the value of the Dutch supervisory board lies in the fact that it is clearly and formally independent and should therefore not become involved in too many details of the business. I do not agree with this argument. Every director should be independent and courageous of mind, have a straight back, in Dutch "*rechte rug*", but should at the same time be fully informed and involved. Substance should be over form, see sub-sections 2.4.7 and 3.4.9.

The Dutch can benefit from the US argument and practice to have directors who really understand the business of the company and have early on-site information and training.

There are better arguments in favour of a supervisory board and two-tier boards, which are to be found in Dutch corporate culture, described in sub-section 4.1.5 and sub-section 4.1.6(c) above. The Dutch had independent, supervisory, persons to support the managers with an eye for other interests in a more distant role all through the corporate history of the Netherlands.

But, even if one would stick to two-tier boards, improvements can be made. Full outside director involvement in strategy should serve as an example for the Dutch to follow, either as is practiced in the US (intense challenging, see sub-section 3.5.3) or in the UK (involvement in strategy development, see sub-section 2.5.5) as well as early information. There is no legal obstacle for supervisory directors in a two-tier board to become more involved with the strategy of the business as long as they do not take over the tasks allotted to management. Dutch law gives management the task to decide on *"beleid"*, strategy, but I do not see why the two boards – the management board and the supervisory board – could not agree that the supervisory directors be informed at an early stage about strategy developments and are allowed to think along and co-pilot with management. This, of course, would require that both boards deal with each other tactfully and with respect for each other's duties. Such an arrangement would result in what is often called a one-and-a-half tier board. Further involvement on strategy should be a regular agenda item for board meetings.

The UK and US system, where the whole board decides, i.e. outside directors are involved in decision making, as opposed to the Dutch system where the management board decides and supervisory directors are not involved in decision making but only monitor, is the main difference between the nature of board activities in those two countries and the Netherlands. Whether outside directors are involved in decision making is also the main difference between the one- and two-tier board. However, it is imaginable to have a two-tier board, where it is agreed by the boards that the supervisory directors should have a substantial involvement.

I propose that the Monitoring Committee would make the following amendment to the Frijns Code as mentioned in sub-section 4.5.5:

II.1 “The management board has the entrepreneurial leadership indeveloping and achieving the aims, the strategy, the risk profile and CSR”;

III.1.1 Add a second sentence: “The supervisory and management boards will deliberate with each other at least once a year to adopt a procedure:

- for the provision of timely and relevant information to be given to the supervisory board; and
- for the possibility for supervisory directors to talk with lower management and visit premises of the enterprise; and

they will establish a timetable for regular meetings between the two boards in which entrepreneurial strategy, risk management and CSR are discussed; and

they will settle what the role of the supervisory directors will be in those discussions, and the ways and means of their functioning with each other.

If there is a one-tier board the whole board should hold these annual deliberations.”

Alternatively this text could be added to III.1.8 or III.1.9.

While in meetings of the supervisory board with the management board in many Dutch companies 90% of the time is spent on presentations with slides by management, more time should in my view be reserved for open discussion with and by all directors.

In my view an annual discussion about the involvement of supervisory directors as proposed above will be a step in the direction and will bring more involvement of supervisory directors in the development of strategy of the company in a one-and-a-half-tier board. I believe that such a step will ease the way for an eventual, later, change to a one-tier board. I favour step by step change of culture over abrupt change.

Executive sessions
The US example of executive sessions of independent directors only, before or after each board meeting, is a good example to follow, both in a one- and a two-tier board. It can be an institutionalized pre-meeting of all non-executive directors or supervisory directors, thus getting away from informal pre-meetings of 2 or 3 directors. The advantages of having regular executive sessions before or after each board meeting is that all outside directors speak up and that the fact that an executive session is scheduled regularly does not alarm the executive officers, see sub-section 3.4.7.

Evaluation and succession
The UK practice of formal and regular meetings on evaluation and succession is a good example, see sub-section 2.5.9, as is the US practice to include succession and compensation of lower management in the board and committee discussion, see sub-section 3.5.7.

I propose that the Monitoring Committee would add the following text to III.2 of the Frijns Code, as mentioned in sub-section 4.5.17: “The supervisory and management boards will deliberate with each other at least once a year about the ways and means of discussion, the frequency and timing of the evaluation and succession of the supervisory and management board members and about the desirability and, if so, the frequency, to ask outside advisers to assist in this process, as well as about the terms of office of all the directors, and which middle management persons should fall under the evaluation and succession process. If there is a one-tier board, the complete board should hold these annual deliberations.”

Company Secretary
The UK example of a senior and independent person as company secretary who is the conscience of the company and mainly supports the Chairman and the outside directors is worthwhile to keep in mind for Dutch companies. See sub-section 4.4.3.

Dutch example: co-pilot model
The co-pilot model, where the chief financial officer – “from number cruncher to co-pilot” – and other managing directors give counterbalance to the CEO on an equal level fits well in the Dutch culture of a consensus board and could be considered in other countries, where hierarchy is decreasing. See sub-section 4.5.2.

For whom?
The Dutch concept of “the interest in the company” as taking into account the interest of all stakeholders, but with a more important place for the long-term interest of shareholder value described above in sub-section 4.2.5, also underlies the UK section 172 of the Companies Act of 2006 mentioned in sub-section 5.3 and sub-section 2.6.3 and US literature and jurisprudence. At this stage the Dutch are slightly more a “stakeholder model” and the US and UK slightly more shareholder oriented. Dutch boards will continue to weigh all interests, but can improve on communication with long term shareholders.

The UK and US examples of shareholder one-to-one or one-on-one communication with stewardship shareholders are in my view useful, with due consideration of equality of shareholder rules and insider trading regulations, especially paying attention to the manner of conducting such meetings and the art of sounding out shareholders. The Dutch should emulate the British habit of listening quietly, without reacting, see sub-sections 2.5.7(viii) and 4.2.5.

Litigation and liability
Every country has its litigation culture which is difficult to change. Dutch lawyers study the Delaware cases and some argue that the business judgment rule is a good example. The Social Economic Council (SER) has noted that a strong point of the business judgment rule is that it brings judges to motivate their decisions according to several criteria. The Enterprise Chamber is giving more leeway to entrepreneurial decisions. There is hope that jurisprudence on non-executive directors’ liability will develop in the direction of leeway for entrepreneurial decisions, taking into account that there is an argument for less liability of outside directors than inside directors in some fact specific cases. The Dutch *Staleman v. Van de Ven* case has pointed in the same direction and mentions that factors for liability are the division of tasks and internal directors’ guidelines and the Parliamentary Papers of the Minister of Justice have repeatedly referred to this case. It is for this reason that it is advisable to have clear internal directors’ guidelines and descriptions of divisions of tasks. See the last sentences of sub-section 4.6.1 and sub-section 4.6.2.
Indemnification of directors by the company should be expanded in the Netherlands.
Insurance policies are already similar to the UK and the US. Apparently there is no difference in premium in the Netherlands between a one- and a

two-tier board. Premiums in the UK are higher, and in the US much higher, than in the Netherlands.

5.7 **One-tier boards should also be possible for financial institutions**

I propose to change article 3.19 of the Act on Financial Supervision (Wft) in the sense that there is a requirement for financial institutions to have at least 3 supervisory directors or 3 non-executive directors, see 4.4.2.4 above.

5.8 **Pros and ons of a one-tier board**

The main advantage of a two-tier board with supervisory directors for the Dutch is that they are used to it. This is part of their culture. One should be cautious not to change traditions abruptly.

A possible argument to stay with two-tier boards is that supervisory directors are held to a lighter degree of liability than if they were to become non-executive directors in a one-tier board. This argument is not supported by trends in case law.

Advantages of a one-tier board are more involvement of non-executive directors in strategy development and in decision making, giving them greater influence and more added value, also because they get earlier and on-sight information and therefore more knowledge about the business. They have a better feel for dilemmas and internal disagreement of management. They can furthermore be involved in the evaluation and succession of a wider group of management. All these advantages can by internal agreement be introduced in a two-tier board, which then tends to act as a so-called one-an-a-half-tier board. In a later stage the next step can be a one-tier board.

5.9 **One-tier board alternative inspiration for further discussion**

I hope that the Act introducing the alternative of a one-tier board will be an occasion for boards of Dutch companies to internally review their practice of corporate governance regularly and to find criteria how to test the way they operate and how to introduce improvements for what they find lacking and to strenghten what they find is working well. Often, an alternative helps to rethink current practice. Looking at foreign practices can equally inspire appreciation of the strenghts of the current system and thoughts as to improvements.

6. ANNEXES

6.1 Annex Summary in English

Subject of the study and why

This study investigates the one-tier board system. The reason for this inquiry is the introduction of the One-Tier Board Act, which was finally enacted on 6 June 2011 and which will probably become effective on 1 January 2012. This Act gives the option for NVs and BVs to organize themselves with a one-tier board as alternative to the traditional Dutch two-tier board system with a management board and a supervisory board. This alternative governance system is being adopted to facilitate foreign investors.

Looking over the borders is an effective way to accumulate ideas about better board practice. I have chosen for the comparison of the UK, the US and the Netherlands, because UK and US investors directly or indirectly own more than 50% of the Netherlands listed shares and because a lot of thought has been given to corporate governance in these two countries.

How

This study has five chapters:

1. Introduction
2. United Kingdom
3. United States
4. The Netherlands and
5. Conclusion

Each of the country chapters are composed of sections 1 – history and culture, 2 – who owns the shares, 3 – acts and informal codes, 4 – composition of boards, 5 – role of directors, 6 – duties and 7 – liability of directors. Each time the sections 4, 5, 6 and 7 are concluded by a summary.

Within the Netherlands' chapter there is also a comparison between the one- and two-tier board systems.

Findings

The history and culture of board systems is different in each country.

The UK has since the East India Company of 1600 had companies where the shareholders were powerful. British directors like to be pragmatic and creative and to be active in developing strategy of the company.

The US directors are used to free entrepreneurial activity. They are individualistic and assertive and give power to a strong CEO, who is in the majority of companies at the same time chairman.

The Netherlands has through its history developed a collegial non-hierarchical board system without strong CEOs or chairmen. This also entails a principle of joint responsibility for all directors. Through four centuries of corporate activities a system developed of managers and a separate body of supervisory directors who are at a distance and only monitor directors.

In the last 20 years there has been a strong development in corporate governance practice. From 1977 the word corporate governance was used in the US where audit committees were developed. In 1992 the British developed the Cadbury Code of Best Practices with the "comply or explain" rule. This Code was followed and partly copied by many of these Codes in other countries. In 1992 shareholder activists initiated changes in the US, but after Enron the real development started in 2002. In the Netherlands, after the Peters Code of 1997, big changes came about in 2004 with the Tabaksblat Code. These changes provide for a convergence to a certain extent.

While it is by now a joint characteristic of the three countries that the shareholdings of listed companies are spread out, there has been substantial change in the shareholdings in the last 30 years. In the 1970s UK investment institutions obtained important positions as large shareholders. The same happened in the 1980s in the US and from the 1990s in the Netherlands. The Dutch went through another drastic change after 2000 with a growth to 75% foreign shareholders.

The composition of the boards differ, while the number of people in the boardroom is about the same.

UK: 4 executive directors, 1 chairman, 5 NEDs (non-executive directors)

US: 1 CEO/chairman, 1 lead director, 5 independent directors, 3 officers (not board members but in the room)

NL: two-tier: 4 managing directors, 6 supervisory directors
one-tier: 4 executive directors, 6 non-executive directors.

They all have company secretaries, of which the UK ones have the strongest stature.

The role of the outside directors differs. UK NEDs are active in the development of strategy, see sub-section 2.5.5. US independent directors actively challenge and debate the strategy, see sub-section 3.5.3. UK chairmen are strong, see sub-section 2.5.7. US lead directors or non-CEO chairmen are less powerful.

Dutch supervisory directors are, save with some exceptions, not intensely involved in developing strategy or in decision making. The management board does that and supervisory board members are limited to monitor and have a veto on certain decisions. This means that Dutch supervisory board members do not get early information or on-site information and do not speak with lower management, as UK, US directors and Dutch one-tier board non-executive directors do.

Duties are converging. The UK enlightened shareholder value embodied in section 172 of the Companies Act 2006 is of interest, because of due consideration of all stakeholders as is the Dutch literature and jurisprudence on interest of the company and the attention for the shareholders' interest, see sub-section 4.2.5.

The litigation scenes in the three countries differ, with a lot of activity in the US, where the loser does not have to reimburse the winner and where directors can rely on the business judgment rule which is clearly developed in the Delaware chancery courts, on indemnification and D&O insurance. The UK, where the loser must pay the winner for all costs, has rare liability cases, but more disqualifications. The Netherlands has enterprise inquiry cases for mismanagement and measures in companies and a separate route to the district courts for liability cases. In each country there is different recognition in various degrees for the differences in functions. See section 1157 Companies Act 2006 and the *Dutch Staleman v. Van de Ven* case.

Conclusion and proposals

Examples that can be followed and proposals for the practice of two-tier and one-tier boards are:

– more active supervisory directors led by a stronger chairman and supported by an independent company secretary;
– more involvement in decision making and strategy and providing ofinformation for supervisory directors;
– more executive sessions;
– one-on-one meetings of the CEO and other executives, sometimes accompanied by the chairman, with selected long-term shareholders;
– confirmation of the role of each director in writing.

Furthermore I have the following proposals:

– I propose that the Monitoring Committee would make the following amendment in the Frijns Code as mentioned in sub-section 4.5.5:

  II.1 "The management board has the entrepreneurial leadership in developing and achieving the aims, the strategy, the risk profile and CSR";

  III.1.1 Add a second sentence: "The supervisory and management boards will deliberate with each other at least once a year to adopt a procedure:
  – for the provision of timely and relevant information to be given to the supervisory board; and
  – for the possibility for supervisory directors to talk with lower management and to visit premises of the enterprise; and

  they will establish a timetable for regular meetings between the two boards in which entrepreneurial strategy, risk management and CSR are discussed; and

  they will settle what the role of the supervisory directors will be in those discussions as well as the ways and means of their functioning with each other.

  If there is a one-tier board the whole board should hold these annual deliberations."

  Alternatively this text could be added to III.1.8 or III.1.9;

  Because supervisory directors according to Dutch law only monitor and do not decide, this practical way of working together can require tact from both managing and supervisory directors;

– I propose that the Monitoring Committee would add the following text to III.2 of the Frijns Code, as mentioned in sub-section 4.5.17:

> "The supervisory and management boards will deliberate with each other at least once a year about the ways and means of discussion, the frequency and timing of the evaluation and succession of the supervisory and management board members and about the desirability and, if so, the frequency, to ask outside advisers to assist in this process, as well as about the terms of office of all the directors, and which middle management persons should fall under the evaluation and succession process. If there is a one-tier board, the complete board should hold these annual deliberations."

– For one-tier boards I have the same proposals for these annual deliberations on process;
– I also propose that article 3.19 Wft should be changed so that banks and insurance companies can have a one-tier board.

In considering the pros and cons of a one-tier board, one sees that the good one-tier boards have a system where outside board members get earlier and better information and are involved in decision making and strategy development and know more about the business and its managers, but it still is useful to have the annual deliberation about process.

The pro of a two-tier board is that the independent supervisory board is part of the Dutch board culture, which implies that all directors know their role.

I propose as possibility to first change the activity and process of the boards and then, when the roles have changed, to consider to change to a one-tier board.

The One-Tier Board Act is important to spark the discussion about improvement of process and activity of outside directors and can with a good preparation be a good alternative board model.

6.2 Annex Samenvatting in het Nederlands

De one-tier board in de veranderende en convergerende wereld van corporate governance.
Een vergelijkende studie van besturen in het VK, de VS en Nederland

Onderzoeksvraag en waarom

Dit is een onderzoek naar de one-tier board (monistisch bestuur). De aanleiding voor dit onderzoek is de invoering van de wet betreffende wijziging van bestuur en toezicht, kort gezegd de One-Tier Board Wet, die uiteindelijk is aangenomen op 6 juni 2011 en waarschijnlijk van kracht zal worden op 1 januari 2012. Deze wet geeft de keuze aan NVs en BVs om haar bestuur te organiseren in een one-tier board (met uitvoerende en niet-uitvoerende bestuurders), als alternatief voor de traditionele Nederlandse two-tier board (met een directie en een raad van commissarissen). Dit alternatieve bestuursmodel wordt ingevoerd om buitenlandse investeerders te faciliteren.

Over de grenzen kijken is een effectieve manier om nieuwe ideeën te verzamelen voor beter bestuur. Ik heb gekozen voor de vergelijking tussen het VK, de VS en Nederland, omdat Britse en Amerikaanse investeerders direct of indirect ongeveer 50% van de Nederlandse genoteerde aandelen houden en omdat er in deze twee landen veel is nagedacht over corporate governance.

Hoe

Dit onderzoek heeft vijf hoofdstukken:

1. Inleiding
2. Verenigd Koninkrijk
3. Verenigde Staten
4. Nederland en
5. Conclusie.

Elk van de landenhoofdstukken bevatten onderdelen 1 – geschiedenis en cultuur, 2 – wie zijn aandeelhouder, 3 – wetten en informele codes, 4 – samenstelling van besturen, 5 – rol van bestuurders, 6 – verplichtingen, 7 – aansprakelijkheid van directeuren. In elk hoofdstuk wordt ieder van de onderdelen 4, 5, 6 en 7 afgesloten met een samenvatting. Binnen het Nederlandse hoofdstuk is er ook een vergelijking tussen de monistische en dualistische bestuursvormen gemaakt.

Bevindingen
De geschiedenis en de cultuur van de bestuursmodellen zijn in elk land verschillend.

Het VK heeft sinds de East India Company van 1600 vennootschappen gehad waar de aandeelhouders machtig waren. Britse bestuurders zijn graag pragmatisch en creatief en zijn veelal actief betrokken bij de strategievorming van de vennootschap.

De Amerikaanse bestuurders zijn gewend aan vrij ondernemerschap. Zij zijn individualistisch en assertief en geven graag een sterke CEO, die in de meerderheid van de vennootschappen tevens chairman is, de macht om de onderneming te besturen.

Nederland ontwikkelde door de geschiedenis heen steeds een collegiaal niet-hiërarchisch bestuurssysteem zonder sterke CEOs of voorzitters. Dit ging gepaard met hoofdelijke verantwoordelijkheid. Door al deze tijden ontwikkelde zich een systeem van actieve directeuren en daarnaast steeds een apart orgaan van commissarissen die op een afstand toezicht houden en adviseren.

In de laatste 20 jaar is er een sterke ontwikkeling geweest in de praktijk van corporate governance. Het woord corporate governance werd in de VS vanaf 1977 gebruikt, waar audit commissies werden ingevoerd. De Britten ontwikkelden in 1992 de Cadbury Code of Best Practices met de "pas toe of leg uit" regel. Deze Code werd opgevolgd en gedeeltelijk gekopieerd in veel andere landen. In 1993 initieerden aandeelhoudersactivisten veranderingen in de VS, maar na Enron begonnen de meeste veranderingen vanaf 2002. In Nederland kwamen, na de Peters Code van 1997, de grote veranderingen in 2004 met de Tabaksblat Code.

Terwijl het een inmiddels gemeenschappelijke eigenschap is dat er op de beurzen van de drie landen een gespreid aandeelhouderschap is, is er een grote verandering in het aandeelhouderschap geweest in de laatste 30 jaar. In de 70er jaren verkregen in het VK institutionele investeerders belangrijke posities als groot aandeelhouders. Dit gebeurde ook in de VS in de 80er jaren en in Nederland vanaf de 90er jaren. De Nederlanders maakten nog een drastische verandering mee na 2000 met een groei van buitenlands aandeelhouderschap tot 75%.

De samenstelling van de besturen verschilt, terwijl het aantal mensen dat in de bestuurskamer zit grofweg hetzelfde is:

VK: 4 uitvoerende bestuurders, 1 chairman en 5 NEDs (niet-uitvoerende bestuurders)

VS: 1 CEO/chairman, 1 lead bestuurder, 5 onafhankelijke bestuurders, 3 officers (die geen bestuursleden zijn maar wel mee vergaderen)

NL: two-tier: 4 directeuren, 6 commissarissen
one-tier: 4 uitvoerende bestuurders, 6 niet-uitvoerende bestuurders.

Zij hebben allen een vennootschapssecretaris, waarvan de Britse de sterkste statuur heeft.

De rol van de niet-uitvoerende bestuurders verschilt. In het VK zijn de NEDs actief in de ontwikkeling van strategie, zie 2.5.5. Britse chairmen zijn sterk en verdienen soms drie maal zoveel als de NEDs, zie 3.5.3. In de VS zijn lead directors of non-CEO chairmen minder machtig.

Nederlandse commissarissen zijn, op enige uitzonderingen na, niet sterk betrokken bij de ontwikkeling van strategie of het nemen van besluiten. Dat is voorbehouden aan het bestuur. De commissarissen zijn beperkt tot toezicht en hebben een veto op bepaalde besluiten. Dit betekent dat de Nederlandse commissarissen een gebrek hebben aan vroege informatie en informatie op de werkvloer van de onderneming en aan gesprekken met lager management, zoals Engelse, Amerikaanse en Nederlandse niet-uitvoerende directeuren dat wel hebben.

De verplichtingen convergeren. De Britse "enlightened shareholder value" van section 172 van de Companies Act 2006 is belangwekkend vanwege het rekening houden met "stakeholders" evenals de Nederlanse literatuur en jurisprudentie over het belang van de vennootschap en het mee laten wegen van het aandeelhoudersbelang, zie 4.2.5.

Op het procesrechtgebied zijn er in de drie landen grote verschillen, met heel veel activiteit in de VS, waar de verliezer de kosten van de winnaar niet hoeft te vergoeden en waar directeuren kunnen vertrouwen op de business judgment rule, die in de Delaware Chancery Courts helder is ontwikkeld, op vrijwaring en op D&O verzekering. Het VK heeft zelden directeursaansprakelijkheid zaken, maar meer diskwalificatie (d.w.z. uitsluiting van bestuursposities) zaken. Nederland heeft Ondernemingskamer zaken voor wanbeleid en maatregelen bij vennootschappen en separate rechtbankzaken voor aansprakelijkheid.

In alle landen is een zeker besef met nuanceverschillen voor het verschil in bestuurstaken en disculpatie mogelijkheden, zie in het VK section 1157 Companies Act 2006 en in Nederland het *Staleman v. Van de Ven* arrest.

Conclusie en voorstellen

Voorbeelden die opgevolgd kunnen worden en voorstellen voor de praktijk van two-tier en one-tier boards zijn:

– actievere commissarissen, geleid door een sterkere voorzitter en ondersteund door een onafhankelijke vennootschapssecretaris;
– meer betrokkenheid bij besluitvorming, strategie en meer en betere informatie van en voor commissarissen, geleid door een voorzitter;
– meer aparte vergaderingen voor de RvC en niet-uitvoerend bestuurders;
– meer one-on-one vergaderingen van bestuurders, soms begeleid door de chairman, met geselecteerde lange termijn beleggers;
- de taak van iedere bestuurder en RvC-lid goed vastleggen.

Voorts heb ik de navolgende voorstellen:

– Ik stel voor dat de Monitoring Committee het volgende amendement maakt op de Frijns Code als gemeld in sub-onderdeel 4.5.5.

  II.1 "Het bestuur heeft het ondernemende leiderschap in het ontwikkelen en uitvoeren van de doelstellingen, de strategie, het risicoprofiel en CSR van de vennootschap."

  III.1.1 Toevoegen de zin: "De raad van commissarissen (RvC) en het bestuur zullen tenminste eenmaal per jaar overleggen om een procedure vast te stellen:

  – voor tijdige en relevante informatieverstrekking aan de RvC; en
  – voor de mogelijkheid voor commissarissen om met lager leidinggevenden te spreken en om de werkvloer van de onderneming te bezoeken; en

  zij zullen daarbij een tijdschema vaststellen voor regelmatige vergaderingen van de directie en de RvC, waarin de ondernemingsstrategie, het risk-management en CSR worden besproken; en

  zij zullen de rol van de RvC bij deze besprekingen vaststellen, evenals de manier waarop het bestuur en de RvC met elkaar zullen omgaan.

  Indien er een one-tier board zou zijn zal het gehele bestuur dit jaarlijks overleg voeren."

  Het is ook mogelijk deze tekst toe te voegen aan III.1.8 of III.9.

Omdat commissarissen volgens de wet en de jurisprudentie alleen toezicht houden en niet besturen, kan deze praktische manier van samenwerking eisen stellen aan de tact van de bestuurders en commissarissen.

- Ik stel ook voor dat de Monitoring Committee de volgende tekst toevoegt aan III.2 van de Frijns Code zoals vermeld in sub-onderdeel 4.5.17:
  "Het bestuur en de RvC zullen tenminste eenmaal per jaar overleg plegen over de manier waarop zij met elkaar zullen vergaderen, over de frequentie en timing van de evaluatie en opvolging van bestuurders en commissarissen en over de wenselijkheid en, zo ja, de frequentie, om adviseurs van buiten te vragen hierbij te assisteren en over de zittingstermijnen van alle bestuurders en welke lagere leidinggevenden ook zullen vallen onder het evaluatie en opvolgingsproces.
  Indien er een one-tier board is, zal het gehele bestuur dit jaarlijkse overleg voeren."
- Voor one-tier boards heb ik dezelfde voorstellen voor dat jaarlijks overleg;
- Ik stel ook voor artikel 3.19 Wft zo te veranderen dat banken en verzekeraars ook een one-tier board kunnen hebben.

Bij de afweging van voor- en nadelen van een one-tier systeem, ziet men dat in de gunstige gevallen de niet-uitvoerende bestuurders in een one-tier bestuur eerdere en betere informatie krijgen en betrokken zijn bij de besluit- en strategievorming en meer weten van de onderneming en de managers, maar dat het ook nuttig is om daarbij jaarlijks overleg over de manier van omgang met elkaar te hebben.

Het voordeel van het two-tier systeem is dat de RvC met haar onafhankelijkheid een onderdeel is van de Nederlandse managementcultuur, waarmee men voorzichtig dient om te gaan.

Ik stel als mogelijkheid voor om eerst de activiteit en het proces te veranderen en dan te overwegen of men een one-tier board wil invoeren.

De One-Tier Board Wet is belangrijk om de discussie over verbetering van activiteit van commissarissen en/of niet-uitvoerende bestuurders aan te wakkeren en kan met een goede voorbereiding een goed alternatief bestuursmodel zijn.

ONE-TIER – TWO-TIER
DIFFERENCES FOR LISTED COMPANIES

Exec D = executive director in UK, US or NL
Sup D = supervisory director in the Netherlands
Ind D = independent director in US
Code = in the Netherlands: Tabaksblat/Frijns
in UK: Combined

Man D = managing director in the Netherlands
NED = non-executive director in UK or the Netherlands
SID = senior independend director in UK
GM = General Meeting
Cie = committee

	Dutch 2 Tier	Dutch 1 Tier	UK 1 Tier	US 1 Tier
Basis	2 separate boards	1 board	1 board	1 board
Divided members	5-10 supervisory directors 1-5 managing directors	2-4 Exec D, 1 chair, 3-9 NED, or 1 CEO, 1 chairman, 6-10 NED	3-4 Exec D, 1 chair, 6-9 NED	CEO/chair, lead director, 7-9 Ind D, or 1 CEO, 1 chair, 7-9 Ind D
Role NEDs Sup D Ind D	Sup D only supervise, not involved in decisions, sometimes veto	NEDs involved in decisions except if delegated to 1 executive	NEDs involved in decisions	Ind Ds involved in decisions
Decisions	Management board decides, on some items supervisory board agrees or vetoes	Board decides, except if delegated to 1	Board decides, due process,	Board decides, sometimes CEO strong, due process important
Info and access to staff	Late info, limited access	Early info, full access + visits	Early info, full access + visits	Early info, full access + visits

	Dutch 2 Tier	Dutch 1 Tier	UK 1 Tier	US 1 Tier
Days work; meetings for Sup Ds or NEDs or Ind Ds	15, no operational visits 6 meetings Chair 35 days, 6 meetings	30 → 50 days 8 → 10 meetings Chair → 70 days?	30 → 50 days, operational visits 8 → 10 meetings Chair 2-3 days a week, 100 days p.a.	30 → 50 days operational visits 8 → 10 meetings Chair 2 days a week, 80 days p.a.
Strategy	Sup Ds only supervise on strategy, in (10-20%?) they pro-actively participate	NEDs pro-active in strategy?? or NEDs only monitor??	NEDs pro-active in strategy	Ind Ds pro-active in strategy
Role chairman	Chairs supervisory board and combined board and GM but not of management board	Chairs one-tier board, stronger role Chair income 1.5 x NED	Chairs of the board Chair income 4 x NED	Chairs of the board, sometimes lead director Chair income 4 x Ind D
Separate chairman	Yes, but chair of supervisory board Management has own chair	Yes, by law	Yes, 99% since Cadbury Code	In 30% of listed companies, 70% have lead director
Role lead director vice-chair or SID	Lead director in US is comparable with chair of supervisory board in the Netherlands	Vice-chair can assist or replace chair and evaluates chair	SID can assist or replace chair, sound out shareholders about chair and evaluate chair	If no separate chair, lead director chairs executive session; if separate chair vice-chair can replace chair
Communication with shareholders	CEO, CFO, sometimes with Chair Some one on ones	CEO, CFO, more with Chair, some one-on-ones	CEO, CFO, Chair, SID!, many one-on-ones	CEO, CFO, Chair more one on ones, Reg. FD (Financial Disclosure)
Appoint executives	GM or supervisory directors	GM or NEDs	GM or board	GM (power board)
Nominate executives	Supervisory directors (after nomination Cie)	NEDs (after nomination Cie)	NEDs (after nomination Cie)	Ind Ds (after nomination cie), shareholders on proxy?
Appointment/ nomination Sup Ds, NEDs, Ind Ds	GM appoints sometimes upon nomination of supervisory directors suggested by Cie	GM appoints sometimes upon nomination of NEDs suggested by Cie	GM or board appoints upon nomination by Cie	GM appoints upon nomination of board, suggested by Cie

	Dutch 2 Tier	Dutch 1 Tier	UK 1 Tier	US 1 Tier
Term executives	4 years by Code	4 years by Code	3 years, changing to 1	3 years, changing to 1
Term NEDs	4 years by Code	4 years by Code	3 years, changing to 1	3 years, changing to 1
Say on pay	GM votes on policy	GM votes on policy	GM votes on policy	GM no vote, may change
Separate sessions for Sup Ds, NEDs, Ind Ds	Supervisory only meets separately once p.a., some co's always	Possibility, but not yet contemplated	Once or twice p.a., Cies prepare, board a whole team	Yes, before or after each board meeting; "Executive Sessions"
Committees decide or only prepare?	Cie only prepare	Cie only prepare	Only prepare, unitary board decides. A board can delegate decision to Cies.	Decides to large extent, board often rubber stamps
Duty	Aspirational level of Code norms; mismanagement case-by-case by Enterprise Chamber	Aspirational level of Code norms mismanagement case-by-case by Enterprise Chamber	Aspirational level of Code; duties of individual directors, articles 170-181 Companies Code 2006	Many aspirational shareholders activist directives, politics and voluntary moves e.g. Pfizer and Microsoft
Duty to whom	Interest of the company; all stakeholders + long-term shareholders	Interest of the company; all stakeholders + long-term shareholders	Success of company, members as a whole, "enlightened shareholder value", 172 Companies Code 2006	To company, therefore indirectly Shareholders but business judgment, some states: stakeholders
Liability	Case by case, serious reproach, no general rules, supervisory in different role; collective liability with exceptions	Case by case, serious reproach, NEDs in their function; collective liability with exceptions	Disqualification cases, liability only if subjective test + objective test; "collective" or individual	Business judgment rule provided loyalty and care (including good faith); individual; many cases

6.4 **Annex English translation of the Act**

Summarized translation of the One-Tier Board Act

Act of 6 June 2011 to change Book 2 of the DCC in connection with the rules for management and supervision of NVs and BVs expected to become law on 1 January 2012.

2.9 Duty of board members to the company (completely new)

1. Each board member is responsible to the company for duly performing his duties. These include all board duties not allocated to other board members by law or the articles of association.
2. Each board member is responsible for the overall management of the company. He is jointly and severally liable for improper management unless no serious blame attaches to him, taking into account the duties allocated to others and provided he has not failed to take measures to avoid the consequences of improper management.

2.129 Loyalty of board members (paragraphs 5 and 6 new)

1. Except for limitations in the articles of association, the board has the duty to manage the company.
2. The articles of association may confer more than one vote on a board member designated by name or function. Such a board member may not have more votes than all the other board members together.
3. Under the articles of association, board resolutions may only be subject to the consent of an organ of the company.
4. The articles of association may provide that the board should follow the directions of an organ of the company regarding policy in the areas designated in the articles.
5. In performing their duties the board members should be guided by the interests of the company and its business.
6. A board member may not participate in the discussion and decision making if he has a direct or indirect personal interest that conflicts

with the interest referred to in paragraph 5. If this means that no board decision can be made, the decision will be made by the supervisory board or, in the absence of a supervisory board, by the general meeting of shareholders, unless the articles of association provide otherwise.

2.129a One-tier board (completely new)

1. *The articles of association may provide that the duties of the board are to be divided between one or more non-executive directors and one or more executive directors. The task of supervising the performance of the duties of the directors cannot be withdrawn from the non-executive directors. Nor may responsibility for chairing of the board, nominating persons for appointment to the board and determining the remuneration of executive directors be allocated to executive directors. Non-executive directors must always be natural persons.*
2. *The executive directors may not take part in decisions on their remuneration.*
3. *The articles of association may directly or indirectly provide that one or more directors can validly decide on matters that come within their remit. Any such provision indirectly by way of the articles must be in writing.*

2.132 Appointment of directors (paragraph 3 new)

1. The first directors are appointed in the deed of incorporation. These appointments may be altered by the general meeting. If article 129a of Book 2 DCC (one-tier board) is applicable, the general meeting of shareholders determines whether a director is appointed as an executive or non-executive director. The two preceding sentences are not applicable if the appointment is made by the supervisory board pursuant to article 162 of Book 2 DCC (large company, structure regime).
2. The articles of association may limit the circle of persons from which appointments can be made. However, any such provision can be set aside by a resolution of the general meeting of shareholders passed by a two thirds majority representing over half of the paid-up capital.
3. **No employment relationship in listed companies.**

In listed companies the relationship between a director and the company will no longer be regulated by means of an employment contract.

2.132a Limitation on holding other positions (non-cumulation) (new)

1. Executive directors in large companies may not be

a) a supervisory director or non-executive director in more than two companies, or

b) chairman of another company.

2. This includes positions in large foundations and associations, but not other positions within the group itself.

2.133 Nominations (paragraphs 1 and 3 new)

1. The articles of association may stipulate that appointments by the general meeting of shareholders should be made on the basis of nominations.
2. The general meeting of shareholders may revoke the binding effect of a nomination by a two thirds majority of the votes cast that represent more than half of the paid-up capital.
3. Where there is only one nomination for a position, the nominated person will be appointed unless the binding character of the nomination has been revoked.
4. These paragraphs are not applicable in the case of appointments by the supervisory board.

2.134 Suspension and replacement (paragraph 1 second sentence and paragraph 4 new)

1. Every director may be suspended at any time by the organ that can appoint him. If article 129a of Book 2 DCC (one-tier board) is applicable, the board may at all times suspend an executive director.
2. If the articles of association stipulate a quorum for suspension by the general meeting, this quorum may not be more than a two thirds majority of the votes that represent over half of the paid-up capital.
3. A judge may not order the reinstatement of an employment contract between a director and a company.
4. The articles of association contain provisions regulating how the board should arrange for temporary replacements for directors if there are one or more vacancies on the board or one or more directors are incapable of performing their duties.

2.140 Duties of the supervisory board (paragraph 1 first sentence and paragraph 5 new)

1. If article 129a of Book 2 DCC (one-tier board) is not applicable, the articles of association may provide that there should be a supervisory board. Only natural persons may be members of such a board.
2. The function of the supervisory board is to supervise the strategy of the management board and the overall management of the company and its business. It assists the management board. In performing their duties the members of the supervisory board are guided by the interests of the company and its business.
3. The articles of association may add provisions concerning the duties and powers of the supervisory board and its members.
4. The articles of association may give more than one vote to a supervisory director specified by name or office. No supervisory director may have more votes than all the other supervisory directors together.
5. A supervisory director may not participate in the discussion and decision making if he has a direct or indirect personal interest that conflicts with the interest referred to in paragraph 2. If this means that no decision can be made, the decision will be made by the general meeting of shareholders, unless the articles provide otherwise.

2.142 Appointment of supervisory directors (paragraph 2 new)

1. Supervisory directors not appointed in the deed of incorporation are appointed by the general meeting of shareholders. The articles of association may limit the circle of persons from which appointments can be made. However, any such provision can be set aside by a resolution of the general meeting of shareholders passed by a two thirds majority representing over half of the paid-up capital.
2. The first two paragraphs of article 133 of Book 2 DCC (nominations) are applicable unless the ‘large company (structure regime) rules’ are applicable.
3. When a nomination is made or advice on a nomination is given, all the data on the supervisory director must be provided: i.e. his age, profession, shares in the company and other positions (positions with the group count as one) as well as reasons and, if the person is nominated for reappointment, his functioning.

2.142a Limitation on holding other positions (non-cumulation) (new)

1. *Supervisory directors of large companies may not be supervisory director or non-executive director of more than 5 companies (a chairmanship counts as two).*
2. *Positions in large foundations and associations are included, but not other positions within the group itself.*

2.164a Large (structure regime) company rules/Appointments (new)

1. *If article 129a of Book 2 DCC is applicable, the non-executive directors are appointed under articles 158 through 161a (rules for appointing supervisory directors: by the general meeting of shareholders upon nomination by the supervisory board, taking into account a pre-nomination by the works council for one third of the nominations).*
2. *In case a one-tier board, article 2.129a DCC, is applicable the non-executive directors appoint the executive directors. This power cannot be limited by any binding nomination. This also applies in large companies.*
3. *Important resolutions that require the consent of the supervisory board under large company rules cannot be delegated to one director as meant in article 2.129a(3) DCC.*
4. *In the case of a one-tier board, important resolutions that require the consent of the supervisory board under the large company rules must be decided upon also with the consent of the majority of the non-executive directors. If this consent is not given, however, this does not invalidate the power of executive directors to represent the company.*

2.166 Diversity in the composition of boards (new)

1. *To achieve a balanced composition of management and supervisory boards at least 30% must be women and at least 30% men, insofar as the board consists of natural persons.*
2. *Large companies will take the balanced division of positions between men and women into account when making appointments and nominations and drawing up profiles.*
3. *This paragraph 2 is also applicable where companies are appointed to board positions.*

(Article 391.7 on accounts gives 'apply or explain' rules for this balanced composition rule.)
(This article will be revoked with effect from 1 January 2016.)

All the above articles of Book 2 DCC are applicable to public companies (NVs). Similar provisions (from article 2.239 onwards) apply to private companies (BVs). The corresponding articles are as follows:
2.239 = 2.129
2.239a = 2.129a
2.242 = 2.132
2.242a = 2.132a
2.244 = 2.134
2.250 = 2.140
2.252a = 2.142a
2.274a = 2.164a
2.276 = 2.166

Articles 297a and 297b are new and introduce the non-cumulation clauses for foundations. First 6 paragraphs of article 391 have not changed, only paragraph 7 have been added (apply or explain diversity). This is an important provision. It describes all the aspects to be dealt with in the accounts, namely

- true and fair view on balance sheet date;
- changes and results in financial year;
- analyses of result indicators, including HR and the environment;
- main risks;
- in Dutch, unless the general meeting of shareholders decides otherwise, and in the annual report;
- expectations;
- R&D;
- important events that need not be in the accounts;
- listed companies: report on the policy for compensation of managing and supervisory directors and how the policy has been applied in the year under review;
- financial risk management;
- price, credit, liquidity and cash flow risks.

6.5 **Annex Act in Dutch**

Staatsblad
van het Koninkrijk der Nederlanden

Jaargang 2011

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Wet van 6 juni 2011 tot wijziging van boek 2 van het Burgerlijk Wetboek in verband met de aanpassing van regels over bestuur en toezicht in naamloze en besloten vennootschappen

Wij Beatrix, bij de gratie Gods, Koningin der Nederlanden, Prinses van Oranje-Nassau, enz. enz. enz.

Allen, die deze zullen zien of horen lezen, saluut! doen te weten:
Alzo Wij in overweging genomen hebben, dat het wenselijk is regels rond bestuur en toezicht voor naamloze en besloten vennootschappen aan te passen en daarbij een stelsel vast te leggen waarbij een vennootschapsorgaan zowel uitvoerende als toezichthoudende bestuurders kent;
Zo is het, dat Wij, de Raad van State gehoord, en met gemeen overleg der Staten-Generaal, hebben goedgevonden en verstaan, gelijk Wij goedvinden en verstaan bij deze:

ARTIKEL I

Boek 2 van het Burgerlijk Wetboek wordt als volgt gewijzigd:

A. Artikel 9 komt te luiden:

Artikel 9

1. Elke bestuurder is tegenover de rechtspersoon gehouden tot een behoorlijke vervulling van zijn taak. Tot de taak van de bestuurder behoren alle bestuurstaken die niet bij of krachtens de wet of de statuten aan een of meer andere bestuurders zijn toebedeeld.
2. Elke bestuurder draagt verantwoordelijkheid voor de algemene gang van zaken. Hij is voor het geheel aansprakelijk terzake van onbehoorlijk bestuur, tenzij hem mede gelet op de aan anderen toebedeelde taken geen ernstig verwijt kan worden gemaakt en hij niet nalatig is geweest in het treffen van maatregelen om de gevolgen van onbehoorlijk bestuur af te wenden.

B. Aan artikel 129 worden twee nieuwe leden toegevoegd, die luiden:
5. Bij de vervulling van hun taak richten de bestuurders zich naar het belang van de vennootschap en de met haar verbonden onderneming.
6. Een bestuurder neemt niet deel aan de beraadslaging en besluitvorming indien hij daarbij een direct of indirect persoonlijk belang heeft dat tegenstrijdig is met het belang bedoeld in lid 5. Wanneer hierdoor geen bestuursbesluit kan worden genomen, wordt het besluit genomen

door de raad van commissarissen. Bij ontbreken van een raad van commissarissen, wordt het besluit genomen door de algemene vergadering, tenzij de statuten anders bepalen.

C. Na artikel 129 wordt een nieuw artikel ingevoegd, dat luidt:

Artikel 129a

1. Bij de statuten kan worden bepaald dat de bestuurstaken worden verdeeld over één of meer niet uitvoerende bestuurders en één of meer uitvoerende bestuurders. De taak om toezicht te houden op de taakuitoefening door bestuurders kan niet door een taakverdeling worden ontnomen aan niet uitvoerende bestuurders. Het voorzitterschap van het bestuur, het doen van voordrachten voor benoeming van een bestuurder en het vaststellen van de bezoldiging van uitvoerende bestuurders kan niet aan een uitvoerende bestuurder worden toebedeeld. Niet uitvoerende bestuurders zijn natuurlijke personen.
2. De uitvoerende bestuurders nemen niet deel aan de besluitvorming over het vaststellen van de bezoldiging van uitvoerende bestuurders.
3. Bij of krachtens de statuten kan worden bepaald dat een of meer bestuurders rechtsgeldig kunnen besluiten omtrent zaken die tot zijn respectievelijk hun taak behoren. Bepaling krachtens de statuten geschiedt schriftelijk.

Ca. Artikel 132, eerste lid, komt te luiden:
1. De benoeming van bestuurders geschiedt voor de eerste maal bij de akte van oprichting en later door de algemene vergadering. Indien een vennootschap toepassing geeft aan artikel 129a bepaalt de algemene vergadering of een bestuurder wordt benoemd tot uitvoerende bestuurder onderscheidenlijk niet uitvoerende bestuurder. De voorgaande twee zinnen zijn niet van toepassing indien benoeming overeenkomstig artikel 162 geschiedt door de raad van commissarissen.

Cb. Aan artikel 132 wordt een lid toegevoegd, luidende:
3. Indien van een vennootschap aandelen of met medewerking van de vennootschap uitgegeven certificaten daarvan zijn toegelaten tot de handel op een gereglementeerde markt of een multilaterale handelsfaciliteit, als bedoeld in *artikel 1:1 van de Wet op het financieel toezicht*, of tot een met een gereglementeerde markt of multilaterale handelsfaciliteit vergelijkbaar systeem uit een staat die geen lidstaat is, wordt de rechtsverhouding tussen een bestuurder en de vennootschap niet aangemerkt als arbeidsovereenkomst.

Cc. Na artikel 132 wordt een artikel toegevoegd, luidende:

Artikel 132a

1. Bestuurder kunnen niet zijn:
a. personen die commissaris of niet uitvoerende bestuurder zijn bij ten minste twee rechtspersonen;
b. personen die voorzitter zijn van de raad van commissarissen van een rechtspersoon of van het bestuur van een rechtspersoon indien de bestuurstaken zijn verdeeld over uitvoerende en niet uitvoerende bestuurders.
2. Voor de toepassing van lid 1 wordt met een commissaris gelijkgesteld de persoon die lid is van een toezichthoudend orgaan dat bij de statuten van een rechtspersoon is ingesteld, wordt de benoeming bij een groepsmaatschappij van de vennootschap niet meegeteld en betreft de verwijzing naar rechtspersonen de rechtsvorm van de naamloze vennootschap, de besloten vennootschap met beperkte aansprakelijkheid en de

stichting die niet voldoen aan ten minste twee van de vereisten genoemd in artikel 397 lid 1.

D. Artikel 133 wordt als volgt gewijzigd:

1. Het eerste lid komt te luiden:
1. Bij de statuten kan worden bepaald dat de benoeming door de algemene vergadering geschiedt uit een voordracht.

2. Onder vernummering van het derde lid tot het vierde lid wordt een lid ingevoegd, dat luidt:
3. Indien de voordracht één kandidaat voor een te vervullen plaats bevat, heeft een besluit over de voordracht tot gevolg dat de kandidaat is benoemd, tenzij het bindend karakter aan de voordracht wordt ontnomen.

E. Artikel 134 wordt als volgt gewijzigd.

1. Aan het eerste lid wordt een zin toegevoegd, die luidt: Is uitvoering gegeven aan artikel 129a, dan is het bestuur te allen tijde bevoegd tot schorsing van een uitvoerend bestuurder.

2. Het vierde lid komt te luiden:
4. De statuten bevatten voorschriften omtrent de wijze waarop in het bestuur van de vennootschap voorlopig wordt voorzien in geval van ontstentenis of belet van bestuurders. De statuten kunnen deze voorschriften bevatten voor het geval van ontstentenis of belet van een of meer bestuurders.

F. Artikel 140 wordt als volgt gewijzigd.

1. De eerste volzin van het eerste lid komt te luiden:
Tenzij toepassing is gegeven aan artikel 129a kan bij de statuten worden bepaald dat er een raad van commissarissen zal zijn.

2. Er wordt een vijfde lid toegevoegd, dat luidt:
5. Een commissaris neemt niet deel aan de beraadslaging en besluitvorming indien hij daarbij een direct of indirect persoonlijk belang heeft dat tegenstrijdig is met het belang bedoeld in lid 2. Wanneer de raad van commissarissen hierdoor geen besluit kan nemen, wordt het besluit genomen door de algemene vergadering, tenzij de statuten anders bepalen.

G. In artikel 142 komt het tweede lid als volgt te luiden:
2. De eerste twee leden van artikel 133 zijn van overeenkomstige toepassing, tenzij de leden van de raad van commissarissen worden benoemd met inachtneming van artikel 158 of toepassing wordt gegeven aan artikel 164a.

Ga. Na artikel 142 wordt een artikel toegevoegd, luidende:

Artikel 142a

1. Commissaris kunnen niet zijn: personen die commissaris of niet uitvoerende bestuurder zijn bij ten minste vijf rechtspersonen, waarbij het voorzitterschap van de raad van commissarissen of het bestuur, indien de bestuurstaken zijn verdeeld over uitvoerende en niet uitvoerende bestuurders, dubbel telt.
2. Voor de toepassing van lid 1 wordt met een commissaris gelijkgesteld de persoon die lid is van een toezichthoudend orgaan dat bij de statuten van een rechtspersoon is ingesteld, wordt de benoeming bij een groeps-

maatschappij van de vennootschap niet meegeteld en betreft de verwijzing naar rechtspersonen de rechtsvorm van de naamloze vennootschap, de besloten vennootschap met beperkte aansprakelijkheid en de stichting, die niet voldoen aan ten minste twee van de vereisten genoemd in artikel 397 lid 1.

H. Artikel 146 vervalt.

I. Na artikel 164 wordt een nieuw artikel ingevoegd, dat luidt:

Artikel 164a

1. In afwijking van artikel 158 lid 1 kan toepassing worden gegeven aan artikel 129a. In dat geval is het bepaalde ten aanzien van de raad van commissarissen onderscheidenlijk de commissarissen in artikel 158 leden 2 tot en met 12, 159, 160, 161 en 161a van overeenkomstige toepassing op de niet uitvoerende bestuurders van de vennootschap.
2. Indien toepassing is gegeven aan artikel 129a, benoemen de niet uitvoerende bestuurders de uitvoerende bestuurders van de vennootschap; deze bevoegdheid kan niet door enige bindende voordracht worden beperkt. Artikel 162, tweede en derde zin, is van overeenkomstige toepassing.
3. Van de toepassing van artikel 129a lid 3 zijn uitgesloten de besluiten van het bestuur in de zin van artikel 164.
4. Indien toepassing is gegeven aan artikel 129a vereisen de besluiten in de zin van artikel 164 lid 1 de goedkeuring van de meerderheid van de niet uitvoerende bestuurders van de vennootschap. Het ontbreken van de goedkeuring tast de vertegenwoordigingsbevoegdheid van bestuur of bestuurders niet aan.

Ia. Afdeling 7 komt te luiden:

AFDELING 7. EVENWICHTIGE VERDELING VAN DE ZETELS OVER VROUWEN EN MANNEN

Artikel 166

1. Bij een evenwichtige verdeling van de zetels van het bestuur en de raad van commissarissen wordt ten minste 30% van de zetels bezet door vrouwen en ten minste 30% door mannen, voor zover deze zetels worden verdeeld over natuurlijke personen.
2. In een vennootschap, die niet voldoet aan ten minste twee van de vereisten genoemd in artikel 397 lid 1, wordt ten behoeve van een evenwichtige verdeling van de zetels van het bestuur en de raad van commissarissen, voor zover deze zetels worden verdeeld over natuurlijke personen, zoveel mogelijk rekening gehouden met een evenwichtige verdeling over vrouwen en mannen bij:

a. het benoemen en het voordragen van bestuurders als bedoeld in de artikelen 132 lid 1, 133 en 162;

b. het opstellen van een profielschets voor de omvang en samenstelling van de raad van commissarissen alsmede bij het aanwijzen, benoemen, aanbevelen en voordragen van commissarissen als bedoeld in de artikelen 142, 158 leden 3 tot en met 6 en lid 9, en artikel 159;

c. het opstellen van een profielschets voor de niet uitvoerende bestuurders alsmede bij het voordragen, benoemen en aanbevelen van niet uitvoerende bestuurders als bedoeld in artikel 164a lid 1 en 2.

3. Het tweede lid is van overeenkomstige toepassing op een naamloze vennootschap die tot bestuurder is benoemd in:

a. een naamloze vennootschap of een besloten vennootschap met beperkte aansprakelijkheid, die niet voldoet aan ten minste twee van de vereisten genoemd in artikel 397 lid 1; of

b. een naamloze vennootschap of een besloten vennootschap met beperkte aansprakelijkheid die tot bestuurder is benoemd in een naamloze vennootschap of een besloten vennootschap met beperkte aansprakelijkheid die niet voldoet aan ten minste twee van de vereisten genoemd in artikel 397 lid 1.

J. Aan artikel 239 worden twee nieuwe leden toegevoegd, die luiden:

5. Bij de vervulling van hun taak richten de bestuurders zich naar het belang van de vennootschap en de met haar verbonden onderneming.

6. Een bestuurder neemt niet deel aan de beraadslaging en besluitvorming indien hij daarbij een direct of indirect persoonlijk belang heeft dat tegenstrijdig is met het belang bedoeld in lid 5. Wanneer hierdoor geen bestuursbesluit kan worden genomen, wordt het besluit genomen door de raad van commissarissen. Bij ontbreken van een raad van commissarissen, wordt het besluit genomen door de algemene vergadering, tenzij de statuten anders bepalen.

K. Na artikel 239 wordt een nieuw artikel ingevoegd, dat luidt:

Artikel 239a

1. Bij de statuten kan worden bepaald dat de bestuurstaken worden verdeeld over één of meer niet uitvoerende bestuurders en één of meer uitvoerende bestuurders. De taak om toezicht te houden op de taakuitoefening door bestuurders kan niet door een taakverdeling worden ontnomen aan niet uitvoerende bestuurders. Het voorzitterschap van het bestuur, het doen van voordrachten voor benoeming van een bestuurder en het vaststellen van de bezoldiging van uitvoerende bestuurders kan niet aan een uitvoerende bestuurder worden toebedeeld. Niet uitvoerende bestuurders zijn natuurlijke personen.

2. De uitvoerende bestuurders nemen niet deel aan de besluitvorming over het vaststellen van de bezoldiging van uitvoerende bestuurders.

3. Bij of krachtens de statuten kan worden bepaald dat een bestuurder rechtsgeldig kan besluiten omtrent zaken die tot zijn taak behoren. Bepaling krachtens de statuten geschiedt schriftelijk.

Ka. Artikel 242, eerste lid, komt te luiden:

1. De benoeming van bestuurders geschiedt voor de eerste maal bij de akte van oprichting en later door de algemene vergadering. Indien een vennootschap toepassing geeft aan artikel 239a bepaalt de algemene vergadering of een bestuurder wordt benoemd tot uitvoerende bestuurder onderscheidenlijk niet uitvoerende bestuurder. De voorgaande twee zinnen zijn niet van toepassing indien benoeming overeenkomstig artikel 272 geschiedt door de raad van commissarissen.

Kb. Na artikel 242 wordt een artikel toegevoegd, luidende:

Artikel 242a

1. Bestuurder kunnen niet zijn:

a. personen die commissaris of niet uitvoerende bestuurder zijn bij ten minste twee rechtspersonen;

b. personen die voorzitter zijn van de raad van commissarissen van een rechtspersoon of van het bestuur van een rechtspersoon indien de bestuurstaken zijn verdeeld over uitvoerende en niet uitvoerende bestuurders.

2. Voor de toepassing van lid 1 wordt met een commissaris gelijkgesteld de persoon die lid is van een toezichthoudend orgaan dat bij de statuten van een rechtspersoon is ingesteld, wordt de benoeming bij een groepsmaatschappij van de vennootschap niet meegeteld en betreft de verwijzing naar rechtspersonen de rechtsvorm van de naamloze vennootschap, de besloten vennootschap met beperkte aansprakelijkheid en de stichting, die niet voldoen aan ten minste twee van de vereisten genoemd in artikel 397 lid 1.

L. Aan het eerste lid van artikel 244 wordt een zin toegevoegd, die luidt: Is uitvoering gegeven aan artikel 239a, dan is het bestuur te allen tijde bevoegd tot schorsing van een uitvoerend bestuurder.

M. Artikel 250 wordt als volgt gewijzigd.

1. De eerste volzin van het eerste lid komt te luiden:
Tenzij toepassing is gegeven aan artikel 239a kan bij de statuten worden bepaald dat er een raad van commissarissen zal zijn.

2. Er wordt een vijfde lid toegevoegd, dat luidt:
5. Een commissaris neemt niet deel aan de beraadslaging en besluitvorming indien hij daarbij een direct of indirect persoonlijk belang heeft dat tegenstrijdig is met het belang bedoeld in lid 2. Wanneer de raad van commissarissen hierdoor geen besluit kan nemen, wordt het besluit genomen door de algemene vergadering, tenzij de statuten anders bepalen.

Ma. Na artikel 252 wordt een artikel toegevoegd, luidende:

Artikel 252a

1. Commissaris kunnen niet zijn: personen die commissaris of niet uitvoerende bestuurder zijn bij ten minste vijf rechtspersonen, waarbij het voorzitterschap van de raad van commissarissen of het bestuur, indien de bestuurstaken zijn verdeeld over uitvoerende en niet uitvoerende bestuurders, dubbel telt.
2. Voor de toepassing van lid 1 wordt met een commissaris gelijkgesteld de persoon die lid is van een toezichthoudend orgaan dat bij de statuten van een rechtspersoon is ingesteld, wordt de benoeming bij een groepsmaatschappij van de vennootschap niet meegeteld en betreft de verwijzing naar rechtspersonen de rechtsvorm van de naamloze vennootschap, de besloten vennootschap met beperkte aansprakelijkheid en de stichting, die niet voldoen aan ten minste twee van de vereisten genoemd in artikel 397 lid 1.

N. Artikel 256 vervalt.

O. Na artikel 274 wordt een nieuw artikel ingevoegd, dat luidt:

Artikel 274a

1. In afwijking van artikel 268 lid 1 kan toepassing worden gegeven aan artikel 239a. In dat geval is het bepaalde ten aanzien van de raad van commissarissen onderscheidenlijk de commissarissen in artikel 268 leden 2 tot en met 12, 269, 270, 271 en 271a van overeenkomstige toepassing op de niet uitvoerende bestuurders van de vennootschap.
2. Indien toepassing is gegeven aan artikel 239a, benoemen de niet uitvoerende bestuurders de uitvoerende bestuurders van de vennootschap; deze bevoegdheid kan niet door enige bindende voordracht

worden beperkt. Artikel 272, tweede en derde zin, is van overeenkomstige toepassing.

3. Van de toepassing van artikel 239a lid 3 zijn uitgesloten de besluiten van het bestuur in de zin van artikel 274.

4. Indien toepassing is gegeven aan artikel 239a lid 1 vereisen de besluiten in de zin van artikel 274 lid 1 de goedkeuring van de meerderheid van de niet uitvoerende bestuurders van de vennootschap. Het ontbreken van de goedkeuring tast de vertegenwoordigingsbevoegdheid van bestuur of bestuurders niet aan.

Oa. Afdeling 7 komt te luiden:

AFDELING 7. EVENWICHTIGE VERDELING VAN DE ZETELS OVER VROUWEN EN MANNEN

Artikel 276

1. Bij een evenwichtige verdeling van de zetels van het bestuur en de raad van commissarissen wordt ten minste 30% van de zetels bezet door vrouwen en ten minste 30% door mannen, voor zover deze zetels worden verdeeld over natuurlijke personen.

2. In een vennootschap, die niet voldoet aan ten minste twee van de vereisten genoemd in artikel 397 lid 1, wordt ten behoeve van een evenwichtige verdeling van de zetels van het bestuur en de raad van commissarissen, voor zover deze zetels worden verdeeld over natuurlijke personen, zoveel mogelijk rekening gehouden met een evenwichtige verdeling over vrouwen en mannen bij:

a. het benoemen en het voordragen van bestuurders als bedoeld in de artikelen 242 lid 1, 243 en 272;

b. het opstellen van een profielschets voor de omvang en samenstelling van de raad van commissarissen alsmede bij het aanwijzen, benoemen, aanbevelen en voordragen van commissarissen als bedoeld in de artikelen 252 lid 1 tot en met 3, 268 leden 3 tot en met 6 en lid 9, en artikel 269;

c. het opstellen van een profielschets voor de niet uitvoerende bestuurders alsmede bij het voordragen, benoemen en aanbevelen van niet uitvoerende bestuurders als bedoeld in artikel 274a lid 1 en 2.

3. Het tweede lid is van overeenkomstige toepassing op een besloten vennootschap met beperkte aansprakelijkheid die tot bestuurder is benoemd in:

a. een naamloze vennootschap of een besloten vennootschap met beperkte aansprakelijkheid, die niet voldoet aan ten minste twee van de vereisten genoemd in artikel 397 lid 1; of

b. een naamloze vennootschap of een besloten vennootschap met beperkte aansprakelijkheid die tot bestuurder is benoemd in een naamloze vennootschap of een besloten vennootschap met beperkte aansprakelijkheid die niet voldoet aan ten minste twee van de vereisten genoemd in artikel 397 lid 1.

Ob. Na artikel 297 worden twee artikelen ingevoegd, luidende:

Artikel 297a

1. Bestuurder kunnen niet zijn:

a. personen die commissaris of, indien de bestuurstaken bij een rechtspersoon zijn verdeeld over uitvoerende en niet uitvoerende bestuurders, niet uitvoerende bestuurder zijn bij ten minste twee rechtspersonen;

b. personen die voorzitter zijn van de raad van commissarissen van een rechtspersoon of van het bestuur van een rechtspersoon indien de bestuurstaken zijn verdeeld over uitvoerende en niet uitvoerende bestuurders.

2. Voor de toepassing van lid 1 wordt met een commissaris gelijkgesteld de persoon die lid is van een toezichthoudend orgaan dat bij de statuten van een rechtspersoon is ingesteld, wordt de benoeming bij een groepsmaatschappij van de stichting niet meegeteld en betreft de verwijzing naar rechtspersonen de rechtsvorm van de naamloze vennootschap, de besloten vennootschap met beperkte aansprakelijkheid en de stichting, die niet voldoen aan ten minste twee van de vereisten genoemd in artikel 397 lid 1.

Artikel 297b

1. Indien een toezichthoudend orgaan is ingesteld, kunnen daarvan niet deel uitmaken: personen die commissaris of niet uitvoerende bestuurder zijn bij ten minste vijf rechtspersonen, waarbij het voorzitterschap van de raad van commissarissen of het bestuur, indien de bestuurstaken zijn verdeeld over uitvoerende en niet uitvoerende bestuurders, dubbel telt.

2. Voor de toepassing van lid 1 wordt met een commissaris gelijkgesteld de persoon die lid is van een toezichthoudend orgaan dat bij de statuten van een rechtspersoon is ingesteld, wordt de benoeming bij een groepsmaatschappij van de vennootschap niet meegeteld en betreft de verwijzing naar rechtspersonen de rechtsvorm van de naamloze vennootschap, de besloten vennootschap met beperkte aansprakelijkheid en de stichting, die niet voldoen aan ten minste twee van de vereisten genoemd in artikel 397 lid 1.

Oc. Aan artikel 391 wordt een lid toegevoegd, luidende:

7. In het geval de artikelen 166 en 276 op een vennootschap van toepassing zijn en in die vennootschap de zetels in het bestuur of de raad van commissarissen, voor zover deze zetels zijn verdeeld over natuurlijke personen, niet evenwichtig zijn verdeeld over vrouwen en mannen als bedoeld in de artikelen 166 en 276, wordt in het jaarverslag uiteengezet:

a. waarom de zetels niet evenwichtig zijn verdeeld;

b. op welke wijze de vennootschap heeft getracht tot een evenwichtige verdeling van de zetels te komen; en

c. op welke wijze de vennootschap beoogt in de toekomst een evenwichtige verdeling van de zetels te realiseren.

ARTIKEL II

Aan artikel 13 van de Uitvoeringswet verordening Europese coöperatieve vennootschap wordt een lid toegevoegd, luidende:

3. Voor de toepassing van artikel 46, eerste lid, van de Verordening geldt dat de leden van het bestuursorgaan die overeenkomstig een taakverdeling niet belast zijn met het uitvoerend bestuur, natuurlijke personen moeten zijn.

ARTIKEL III

Indien het bij koninklijke boodschap van 31 mei 2007 ingediende voorstel van wet tot aanpassing van het recht van besloten vennootschappen met beperkte aansprakelijkheid (Kamerstukken II 2006–07, 31 058, nr. 2) tot wet wordt verheven en in werking treedt voor de datum van inwerkingtreding van deze wet, wordt in artikel I de volgende wijzigingen aangebracht:

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A. Onderdeel Ka komt te luiden:

Ka. Aan artikel 242, lid 1, komt te luiden:
1. De benoeming van bestuurders geschiedt voor de eerste maal bij de akte van oprichting en later door de algemene vergadering of, indien de statuten zulks bepalen, door een vergadering van houders van aandelen van een bepaalde soort of aanduiding, mits iedere aandeelhouder met stemrecht kan deelnemen aan de besluitvorming inzake de benoeming van ten minste één bestuurder. Indien een vennootschap toepassing geeft aan artikel 239a wordt bij de benoeming van een bestuurder bepaald of hij wordt benoemd tot uitvoerende bestuurder onderscheidenlijk niet uitvoerende bestuurder. Op een statutaire regeling als bedoeld in eerste zin is artikel 228 lid 4, tweede volzin, van overeenkomstige toepassing. De voorgaande drie zinnen zijn niet van toepassing indien de benoeming overeenkomstig artikel 272 geschiedt door de raad van commissarissen.

B. Onderdeel L komt te luiden:

L. Artikel 244 lid 3 komt te luiden:
3. Is uitvoering gegeven aan artikel 239a lid 1, dan is het bestuur te allen tijde bevoegd tot schorsing van een uitvoerend bestuurder.

ARTIKEL IV

1. De algemene vergadering kan, indien een naamloze vennootschap of een besloten vennootschap met beperkte aansprakelijkheid voorafgaand aan de inwerkingtreding van deze wet is vertegenwoordigd door het bestuur of een bestuurder terwijl er een tegenstrijdig belang was met een of meer bestuurders, die vertegenwoordiging bekrachtigen door de vertegenwoordiger of vertegenwoordigers daartoe aan te wijzen op of na de datum van inwerkingtreding van de wet.
2. Tenzij uit de wet anders voortvloeit, kan geen beroep worden gedaan op een statutaire regeling die inhoudt dat de naamloze vennootschap of besloten vennootschap met beperkte aansprakelijkheid wordt vertegenwoordigd door een ander dan het bestuur of een bestuurder in alle gevallen waarin de vennootschap een tegenstrijdig belang heeft met een of meer bestuurders.

ARTIKEL V

Op arbeidsovereenkomsten gesloten voor de datum van inwerkingtreding van deze wet is artikel 132 lid 3 van Boek 2 van het Burgerlijk Wetboek niet van toepassing.

ARTIKEL VI

De artikelen 132a, 142a, 242a, 252a, 297a en 297b van Boek 2 van het Burgerlijk Wetboek zijn niet van toepassing op de benoeming of aanwijzing van personen tot bestuurder of commissaris die voor de datum van inwerkingtreding van deze wet heeft plaatsgevonden.

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ARTIKEL VII

Boek 2 van het Burgerlijk Wetboek wordt als volgt gewijzigd:

A. Artikel 166 vervalt.

B. Artikel 276 vervalt.

C. Artikel 391 lid 7 vervalt.

ARTIKEL VIII

Deze wet treedt in werking op een bij koninklijk besluit te bepalen tijdstip, met uitzondering van artikel VII dat op 1 januari 2016 in werking treedt.

Lasten en bevelen dat deze in het Staatsblad zal worden geplaatst en dat alle ministeries, autoriteiten, colleges en ambtenaren wie zulks aangaat, aan de nauwkeurige uitvoering de hand zullen houden.

Kamerstuk 31 763

Gegeven te 's-Gravenhage, 6 juni 2011

Beatrix

De Minister van Veiligheid en Justitie,
I. W. Opstelten

Uitgegeven de *veertiende* juni 2011

De Minister van Veiligheid en Justitie,
I. W. Opstelten

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6.6 Annex Definitions with reference to pages

Definitions

Managing director	:	Dutch director who runs the business in a Dutch NV or BV, usually on a two-tier board. He represents the company. In Dutch: "*directeu*r" or "*statutair directeur*". ***P 308, 314, 322, 335, 336***
Supervisory director	:	Dutch member of the supervisory board on a two-tier board. He only supervises and does not represent the company. In Dutch: "*commissaris*". ***P 280, 298, 308, 311, 314, 329-333***
Executive director	:	UK, US or Dutch director in a one-tier board who runs the business. He represents the company. In Dutch: "*uitvoerend bestuurder*". ***P 49, 51, 159, 305, 320***
Non-executive director	:	UK or Dutch director who is member of the board in a one-tier board. He has no management role, but is involved in monitoring and developing the plans and activities of the board and in decision making. In Dutch "*niet uitvoerend bestuurder*". In the UK they are usually called "NED". In the US most of the non-executive directors are called "independent directors", because the US emphasizes independence. ***P 48, 49, 59, 62, 63-71, 305, 320***
Independent director	:	US non-executive directors who also are independent of management, the company and affiliated companies, according to the requirements of NYSE and NASDAQ. In the US there is a strong emphasis on the requirement of independence of directors. ***P 53, 123, 159, 161, 163, 165, 167, 169, 177***
Board	:	In the UK, US and the Netherlands a group of directors who either run the business and/or

		monitor the activities. It can be a board in a one-tier board company or a management board and a supervisory board in a two-tier board company. ***P 49-50, 59-62, 155-160, 298***
Outside director	:	In the UK, US and the Netherlands any director who does not run the business. This can be a non-executive director or an independent director on a one-tier board or a supervisory director on a two-tier board system***. P 48, 49, 161, 303***
Chairman of the supervisory board	:	A Dutch chairman of a supervisory board in a two-tier system; in Dutch "*president commissaris*". ***P 338-343***
Chairman	:	In the UK, US and the Netherlands the chairman of a one-tier board and in the Netherlands the chairman of the supervisory board in a two-tier system. ***P 167, 185-191, 199, 338-343***
Non-CEO chairman	:	A chairman in a one-tier board system who is not also CEO. This term is used in the US to emphasize that the chairman is not also the CEO. ***P 178. 185-191, 338-343***
CEO	:	Chief executive officer, who is leader of the executive team that runs the business. He is always a board member, either of the board in a one-tier system or of the management board in a two-tier system. ***P 49, 143, 159, 166, 167, 308***
CFO	:	Chief financial officer, who manages the finance of the business. He is member of the board in the UK, usually not a member of the board in the US and a member of the management board in the Netherlands in a two-tier system and usually member of a Dutch one-tier board. ***P 56, 159, 167, 303, 314***
Officer	:	In the US each member of the executive or management team. Each officer in the US can

represent the company. Of the executive team in the US usually only the CEO is member of the board. In the UK and the Netherlands the term officer is not used in law codes, but appears as part of the terms CEO, CFO, CRO, etc. ***P 159, 160, 161, 167***

Executive session	:	In the US a meeting of all independent or non-executive directors, without any executives present. This name is remarkable, because it seems to say the opposite of what it is. ***P 160, 162***

6.7 Annex Abbreviations

A.	Atlantic Reporter, First Series
A.2d	Atlantic Reporter, Second Series
A.C.	Law Reports, Appeal Cases (Third Series)
Act	Act on the One-Tier Boards
AEX	De Amsterdam Exchange Index
AGM	Annual General Meeting of Shareholders
All E.R.	All England Law Reports
B.C.C.	British Company Law Cases
B.C.L.C.	Butterworths Company Law Cases
BOFI	Bank or financial institutions in the UK
BV	*Besloten Vennootschap*
C.A.	Court of Appeal
CC6	Combined Code of 2006 in the UK
CC8	Combined Code of 2008 in the UK
CEO	Chief executive officer
CFO	Chief financial officer
CG10	UK Corporate Governance Code 2010
Ch.	Law Reports, Chancery Division (3rd Series)
Ch.D.	Law Reports, Chancery Division (2nd Series)
CIO	Chief investment or relations officer or chief IT officer
COO	Chief operations officer
CRO	Chief risk management officer
CSR	Corporate Social Responsibility
D&O	Director and Officer
DCC	Dutch Civil Code
Del.	Delaware
Del. Ch.	Delaware Chancery Court
Del. Sup.	Delaware Supreme Court
Delaware GCL	Delaware General Corporation Law
DR	Dutch Depository Receipts, in Dutch “*certificaten*”
EIC	English East India Company
E.W.C.A. Civ.	Court of Appeal (Civil Division)
E.W.H.C. (Ch.)	England & Wales High Court (Chancery Division)
E.W.H.C. (Comm.	England & Wales High Court (Commercial Court)
FRC	Financial Reporting Council in the UK
Frijns Code	Dutch Code of 2008, drafted by the Frijns Committee
FSA	Financial Services Authority in the UK

FSMA	Financial Services and Markets Act 2000 (UK)
FTSE	Financial Times Stock Exchange Index
Hare	Hare's Chancery Reports
HR	*Hoge Raad (der Nederlanden)* (Supreme Court (of the Netherlands))
Ill.App.2d	Illinois Appellate Court Reports, Second Series
JOR	Jurisprudentie Onderneming & Recht
MBCA	Model Business Corporation Act
Mich.	Michigan Supreme Court Reports
NACD	National Association of Corporate Directors
NASDAQ	National Association of Securities Dealers Automated Quotations
NED(s)	A UK non-executive director(s)
NJ	Nederlandse Jurisprudentie
NV	*De Naamloze Vennootschap* (journal)
NYSE	New York Stock Exchange
OK	*Ondernemingskamer* (Enterprise Chamber)
Q.B.D.	Law Reports, Queen's Bench Division
R&D	Research and development
Regulation FD	Regulation Fair Disclosure
RM Themis	Rechtsgeleerd Magazijn Themis
SEC	Securities and Exchange Commission in the US
SER	*Sociaal Economische Raad* (Social Economic Council)
SID	Senior Independent Director
Tabaksblat Code	Dutch Code of 2004, drafted by the Tabaksblat Committee
TVVS	Tijdschrift voor vennootschappen, verenigingen en stichtingen (1962-1975)/Maandblad voor ondernemingsrecht en rechtspersonen (1980-1998)
U.S.	United States Reports
U.S.C.	United States Code
VOC	*Vereenigde Oost-Indische Compagnie* (Dutch East India Company)
WL	Westlaw, West's Law Research Database
W.T.L.R.	Wills & Trusts Law Reports

6.8 **Annex Cadbury Code 1992**

1. Board of Directors
   - should meet regularly;
   - should not have one person with too much power; if the chairman and chief executive are the same person, there should be a strong contingent of non-executive directors;
   - should have a formal list of matters to be decided by the whole board;
   - should have an arrangement whereby directors can obtain external advice independently, but at the expense of the company.

2. Non-Executive Directors
   - should express an independent view about strategy, results, appointments and company conduct rules;
   - should be independent from the executive directors and must not have a business relationship with the company, other than their remuneration as outside director;
   - should be appointed by a formal procedure for a fixed term and should not be automatically reappointed.

3. Executive Directors should have
   - no contract for a fixed term of longer than 3 years without the permission of the meeting of shareholders;
   - transparency about the total emoluments for all directors and individually for the chairman; the highest paid person should be mentioned explicitly and there should be information about salary, bonus and bonus systems;
   - a remunerations committee that determines the remuneration of the directors.

4. Financial Reporting and Control

The board should present a comprehensible valuation of the company:

- there should be an arm’s length relationship with the auditor;
- the audit committee should consist of at least 3 non-executive directors and should have written regulations;
- a confirmation that directors are responsible for the accounts and separately a confirmation about the responsibility of the auditor;
- reporting about the results of the internal audit;
- reporting about the enterprise as a going concern.

6.9 **Annex UK Acts**

The Companies Act of 2006 is quite extensive and contains the following provisions on the subject of corporate governance, which mention between brackets the aspects which are dealt with:

- directors binding the company, sections 40 and 44
- appointment and removal of directors, sections 154-169
- duties of directors, sections 170-174 (dealt with in detail in 2.6.6 above), including the important section 172 which gives directors the duty to act in the way he considers, in good faith, to promote the success of the company fot its members as a whole and have regard (amongst other matters) to: long-term consequences, employees, customers, environment, high standards, fairness between members
- duty to avoid conflicts of interest, sections 175-181 (dealt with in 2.6.6 above)
- conflicting transactions, sections 182-226
- directors’ service contracts, sections 227-231
- limiting directors’ liabilities, sections 232-239 (dealt with in 2.7.6 above)
- some definitions, including minutes and connected persons, sections 240-258
- derivative claims, sections 260-269 (dealt with in detail in 2.7.3 above)
- company secretaries, sections 270-279
- shareholders’ meetings, section 281-361
- accounts, sections 380-531
- share capital, sections 540-859
- company charges, sections 860-901
- mergers and divisions, sections 902-941
- the takeover panel, sections 942-973
- squeeze-out and sell-out, sections 974-991
- action for injunctions unfairly prejudiced, section 994, see 2.7.5
- mitigation liability directors, circumstances, section 1157, see 2.6.3.

The position of directors is also regulated in many other laws, such as

- the Corporate Manslaughter Act 2007;
- the Insolvency Act 1986 – fraudulent and wrongful trading;
- the Financial Services and Markets Act 2000 – prospectus, disclosure market abuse;
- the Pensions Act 2004;
- the Criminal Justice Act 1993 – insider dealing;
- the Health and Safety at Work Act 1974;

- the Environmental Protection Act 1990;
- the Environment Act 1995;
- the Listing Rules and Disclosure and Transparency Rules;
- the Takeover Code 2006;
- the Enterprise Act 2002;
- the Human Rights Act 1998;
- the Company Directors Disqualification Act 1986, under which the court can bar a person from being a director for 2 to 15 years; there is extensive case law on this subject, including an order against all directors of Barings for failure to control Mr Leeson;
- the Model Code on Directors' Dealings in the UK Listing Rules.

All these statutes and rules contain detailed provisions that set minimum standards for companies and therefore their boards. Contraventions under these Acts can lead to prison sentences, fines or liability for directors.

6.10 **Annex Peters Code 1997**

(a) Supervisory board

1 profile;
2 independent;
3 accounts: information about supervisory board;
4 in supervisory board: at maximum 1 retired executive;
5 independent, no mandate;
6 not automatic re-nomination;
7 withdraw in case of insufficient functioning or conflicts;
8 inform chairman about conflicts of interest;
9 amount of board positions limited, but stimulate employees to accept outside functions;
10 member supervisory board not also on supervisory board of subsidiary;
11 shares of supervisory board should be long term and must be mentioned in accounts;
12 remuneration supervisory board not dependent on result;
13 no conflicts of interest;
14 special tasks for chair;
15 nominations committee, audit committee;
16 meeting schedule;
17 supervisory board discusses its composition, strategy and risks with management;
18 supervisory board discusses separately about its own functioning and evaluation of management board;
19a annual accounts to be accepted or rejected by general meeting of shareholders (GM);
19b GM to accept policy and give discharge of the board as a separate point;
20 not allowed to have a permanent supervisory director with extra powers;
21 protocol for supervisory board for its relation to management board, works council and shareholders;

(b) Management board

22 report to supervisory board, aims, strategy, risks, risk management, this report in accounts;
23 salary of management board in accounts;

24 shares and options for long term, shares and options in accounts;
25 not even an apparent image of conflict of interest allowed;

(c) Shareholders
26 revaluation factor capital: also influence;
27 accountability to the general meeting of management and supervisory board;
28 supervisory and management board must enjoy trust of the general meeting;
29 discuss influence capital in general meeting;
30 request for agenda points;
31 investment analysis per sector;
32 efficient proxy system should be promoted;
33 if a party has acquired 50% there should be a mandatory bid for the remaining shares;

(d) Compliance of code
34 report in accounts;
35 see if accountant must investigate;
36 accountants advice on risk management;
37 supervisory board or audit committee discusses with accountant;
38 report rating agencies discussed in supervisory board;
39 committee suggests compliance to be monitored;
40 result of monitoring important for further discussion.

6.11 **Annex Frijns Code 2008**

Hereunder a short summary of the points of the Frijns code:

Preamble:
2 applies to Dutch listed companies, with influence on others;
4 comply or explain;
7 stakeholders important, while endeavours to create long term shareholders value (text cited above in 4.2.5);
8 taking account of stakeholders, including CSR, all stakeholders must be confident their interests are represented; good entrepreneurship, including integrity and transparency <u>and</u> effective supervision and accountability;
9 management weighs interests for strategy, while supervisory board oversees process; both are accountable for these roles; management and supervisory board guided by interests of the company and its affiliated enterprise, e.g. shareholders may have their own interest;
10 this can create tension and the code is designed to carefully handle the process and to help weigh the interests carefully; good relations and dialog with stakeholders are important;
11 in takeover situations this tension can be most pronounced, therefore special role of supervisory board.

Principles and best practice provisions:
P = Principle

I Compliance with Code
1.1 report in annual report;
1.2 changes discussed in AGM;

II Management board
1 P Role: achieving companies aims, strategy and risk profile and CSR; guided by the interests of the company and affiliated enterprise; provide supervisory board with information; responsible for compliance with law and risk management;
1.1 4 years;
1.2 submit to supervisory board for approval
(a) objectives
(b) strategy

(c) parameters for strategy
(d) CSR
1.3 risk management
(a) risk analysis
(b) code of conduct
(c) guides for financial reports
(d) system for monitoring
1.4 annual report
(a) risks to strategy
(b) effectiveness of risk management
(c) major failings in risk management
1.5 assurance that financial reporting not contain material errors;
1.6 annual report describes sensitivity to external factors;
1.7 internal whistleblower complaints possible to chairman;
1.8 not too many functions;
1.9 shareholders give 180 days waiting time to board to discuss any agenda point; management shall use the time for constructive consultation; the supervisory board shall monitor this;
1.10 if a takeover bid on the company's shares is being prepared, supervisory board must be involved;

II.2 Remuneration
2 P level and composition; fixed and variable; variable part must be transparent; long term shares held, long term;
2.1 long term;
2.8 dismissal 1 year salary max;
2.9 no loans;
P: supervisory board determines remuneration based on policy adopted by general meeting, remuneration full in report;
2.10 if conditional and new circumstance: supervisory board may determine downward or upward;
2.11 claw back;
2.12 report on policy on website;
2.14 contract public;
2.15 severance pay in report;

II.3 Conflicts of interest
3 P conflicting deals require approval supervisory board;
3.1 management may not
(a) compete
(b) accept gifts

(c) provide unjust advantages
(d) take business advantages for themselves

3.2 report any conflict to chairman and other management board members;
3.3 not take part in any discussion about conflicting deals;
3.4 conflicting deals entered into require consent of supervisory board and in annual report;

III Supervisory board

III.1 Role and procedure

P: supervise policy of management board and give advice;
1.1 division of duties within supervisory board described in terms of reference, in relation to management board, general meeting and works council on website;
1.2 annual accounts report on supervisory board;
1.3 data on each member including gender and other positions;
1.4 retire in event of inadequate performance or conflict;
1.6 supervision on
(a) objectives
(b) strategy
(c) risk management
(d) financial reporting process
(e) compliance law
(f) shareholder relationship
(g) CSR

1.7 at least once a year meet alone to evaluate itself, committees and management board;
1.8 at least once a year discuss with management corporate strategy and main risks, these discussions in report of supervisory board in annual report;
1.9 supervisory board members have own responsibility to obtain info from management board, auditor and officers and external advisors;

III.2 Independence

P: act critically and independently of one another, management board and any particular interest;
2.1 all independent but one;
2.2 not independent if
(a) employee within 5 years before
(b) receives other remuneration from company

(c) he or partnership he belongs to has had business relationship
(d) cross board membership
(e) holds 10% or more in company
(f) board member of company that holds 10% or more
(g) temporarily managed the company

III.3 Expertise and composition
P: each can assess overall + specific expertise role designated to him in company profile
3.1 profile;
3.2 at least one financial expert;
3.3 induction + further training if necessary;
3.4 max five, chairmanship counts double;
3.5 max 4 years term;
3.6 retirement ladder;

III.4 Chairman and company secretary
P: chair ensures proper functioning of supervisory board and committees and act on behalf of supervisory board with management and shareholders regarding the functioning of management and supervisory board members and ensure efficient general meeting; helped by company secretary;
4.1 chairman ensures that
(a) supervisory board members follow induction and education or training
(b) supervisory board members receive timely information
(c) sufficient time for decision making
(d) committees function properly
(e) evaluation management board once p.a.
(f) supervisory board elects vice-chairman
(g) supervisory board has proper contact with management and works council
4.2 chairman may not be former member of management board;
4.3 helped by company secretary;
4.4 vice-chairman replaces chairman and is contact for supervisory board and management board for functioning of chairmen (see UK SID);

III.5 Composition of 3 key committees
audit committee:
- not chaired by chairman or former manager
- at least one financial expert

remuneration committee:
- not chaired by chairman or former manager
- no more than one manager of other listed company
- consultant not also consultant to management nomination committee
- focus on selection of supervisory and management boards and senior management

III.6 Conflicts
6.1 immediately report to chairman;
6.2 not take part in discussion;
6.3 public transactions in accounts;
6.4-5 terms of reference;
6.6 limited delegated director;
6.7 if supervisory director takes on temporary management he has to resign as supervisory director;

III.7 Remuneration
by general meeting:
- no shares for supervisory directors by way of remuneration (different from US)
- any shares held must be long term
- no loans from company

III.8 One tier
P: in case of one-tier composition shall be of such that independence of non-executives is assured;
8.1 chairman not executive;
8.2 chairman check proper functioning of entire board;
8.3 committee requirements the same, committees only of non-executives;
8.4 majority of non-executives;

IV Shareholders

1 Powers

P: shareholders participate in decision making of general meeting; vote by proxy; general meeting should be able to influence management board decisions, major change needs consent;

1.1 general meeting may cancel binding nominations for management board;

1.2 votes on financing preference share votes limited;

1.3 threshold 2:107a Civil Code;

1.4 policy of reserves and dividends an agenda point;

1.5 decision dividends separate agenda point;

1.6 discharge voted separately;

1.7 determination of registration date;

1.8 chairman responsible for worthwhile discussion in general meeting;

2 DRs

trust office conditions; not to be used as anti-takeover device; issue proxies to vote as shareholders;

3 Information and logistics

management board provide press and analysts with carefully handled and structured info; management board and supervisory board provide general meeting in good time info for general meeting;

3.1 analysts meetings, presentations to investors and press conferences announced on website and by press releases; provisions for attendance by all shareholders.

6.12 **Annex DCC**

The summary of Book 2 DCC, including articles proposed in Act, is:

Title 1 General stipulations (applicable to all legal persons)

1	government legal persons;
2	church legal persons;
3	list of civil legal persons; associations, co-operative associations (like Rabobank), mutual guarantee associations, NV's, BV's and foundations;
4	required to be founded by a notary public;
5	equal to natural person;
6	publication;
7	not act against their aim as mentioned in articles of association;
8	all organs must act reasonably (important for duties and litigation);
9 (Act)	directors must act properly towards the company, would be liable in case of serious blame (important for duties and litigation);
10	board has obligations of bookkeeping (important for liability of directors in case of bankruptcy);
10a	calendar year;
12/16	voting rights, nullity and nullifiability of members decisions;
17	legal person for indefinite period;
18-23	change of legal person, unwinding, liquidation;
24	bookkeeping must be stored;
24a-d	subsidiary, including definition of control, group company, participation, determination of quorum;
25	company law is mandatory law unless stipulated otherwise;

Title 2 *associations*
Title 3 *Cooperative associations and neutral guarantee associations*

Title 4 *NV (art. 64-176) BV articles are 175-284 and are merely the same as the NV)*

Part 1	General
64	NV is company with transferable shares, shareholders are not liable for more than their contribution;
78a	organs are general meeting of shareholders, meetings of special shares, management board, supervisory board and the combined meeting of the management board and the supervisory board;

Part 2	Shares
79-91	definitions, issue, transfer, pledge, usufruct;
92	equality of shareholders (*DSM* case);
92a	squeeze out;
Part 3	Capital
93-100	foundation, issue of shares, redemption, repurchase;
98c	company may not guarantee or support the purchase of its shares;
101	accounts determined within 6 mo;
102	publication accounts (important for liability of directors in case of bankruptcy);
105	Dividends determined by shareholders;
Part 4	Shareholders meeting
107	has all power not given to board or others;
107a	consent needed of shareholders meeting for decisions of the board about an important change of the company or enterprise, which in any case are: i.e. examples: (a) sale of all assets; (b) important joint venture; (c) buying or selling subsidiary with value of more than 1/3 balance sheet total; if consent is missing this does not invalidate transactions towards third parties (*ABN AMRO* case) (part of act of 2004);
108	annual meeting of shareholders within 6 months;
108a	meeting in case of low capital;
109	management board and supervisory board can call meeting;
110	10% shareholder can call meeting;
111-114	calling of meeting;
114a	right to put points on agenda for 1% shareholders with 60 days notice;
115-116	term of notice and place of meeting;
117	participating in meetings: right of discussion;
117a-b	electronic meetings;
118	one share one vote;
118a	DR holders have automatic proxy to vote except if there is a hostile takeover pending (part of act of 2004; Tabaksblat unhappy that there is a exception for hostile takeovers; see Couwenbergh and Haenen, *Tabaksblat* (2008), p. 104);
119	registration date for shareholders short;
120-128	voting, changes in articles of association;

Part 5	Management board and supervisory board
129	board of management manages the company (see translation of one-tier board act task to act “in the interest of the company and its enterprise” added in Act);
129a (Act)	one-tier board to be added (Act);
130	board of management and each executive represents the company;
131	competent court;
132 (Act)	appointment;
132a (Act)	non-cumulation to be added;
133 (Act)	nominations;
134 (Act)	suspension;
135	remuneration: policy determined by shareholders meeting;
136	filing for bankruptcy;
137	special transactions;
138	liability of managing directors in case of bankruptcy (see *Van Schilt*, *Mefigro* cases) (caveat bookkeeping and publication);
139	liability for incorrect accounts;
140	duties supervisory board (see translation one-tier board);
141	information by management board to supervisory board in time; at least once a year about strategy;
142 (Act)	appointment;
142a (Act)	non-cumulation;
143	up to one third of management board appointed by others than general meeting (e.g. government);
144-151	suspension, remuneration, conflict of interest, liability as managing director;
Part 6	Supervisory directors in structure regime
152-157	technicalities of applicability and mitigated regimes;
158-160	nomination by supervisory board for one third based on nomination by works council; appointed by shareholders meeting (new in 2004);
161	dismissal by Enterprise Chamber;
161a	dismissal by shareholders meeting (new in 2004);
162	supervisory board appoints management board members (some will apply in one-tier board for appointment of executives);
164	list of important decisions for which management board needs supervisory board consent;
164a (Act)	same rule applies in one-tier board *mutatis mutandis*;
166 (Act)	new diversity article;

Title 5	*BVs (articles 175-284 of BV same as 64-175 for NV)*
Title 6	*Foundations (283-304)*
Title 7	*Mergers and splitting (308-334ii)*
Title 8	*Disputes in district courts and inquiry procedures in Enterprise Chamber and mandatory public bids (in connection with takeover directive) (335-359d)*
Title 9	*Accounts (360-453)* (This title is all worked out in further detail in the decree on model accounts of 1983, changed in 2005.)

6.13 **Annex Bibliography**

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6.15 Annex Acknowledgements

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6.16 **Annex CV**

Curriculum Vitae

Mr Willem J.L. Calkoen, born in Utrecht on 26 March 1946, went to junior school in Canada, high school in Bilthoven, where he reached Gymnasium Beta level.

He studied Netherlands' law at the University of Utrecht and finalized his studies on 4 July 1970, including the specialisation of comparative law.

From September 1970 to July 1972 he served in the Royal Dutch Navy.

Comparative law and corporate governance have always been the basis for his practice as advocate at NautaDutilh from August 1972 and as partner from 1980.

From 2010 he is consultant at NautaDutilh.

Pictures on back cover: Allegory of Good Government and Effects of Bad Government by Pietro E. Ambrogio Lorenzetti, painted 1337 to 1339 in Sala della Pace in the Palazzo Publico of Siena, Italy

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