

THE MONITORING DUTIES OF DIRECTORS UNDER THE EC DIRECTIVES: A VIEW FROM THE UNITED STATES EXPERIENCE

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The right of establishment and free movement of business and capital within the member states of the European Economic Community (EC) is considered one of the cornerstones of the Treaty Establishing the European Community (EEC Treaty).¹ However, the laws that apply to the public limited company, the most important business association within the EC, vary widely among the member states. These differences inhibit the free movement of business and the right to establish companies, and, therefore, the EC recently has taken steps to harmonize company law among its members.²

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1. TREATY ESTABLISHING THE EUROPEAN ECONOMIC COMMUNITY [EEC TREATY] arts. 52-58, 67-73. The EEC Treaty is also commonly referred to as the Treaty of Rome.

2. In doing so, the EC acts pursuant to Article 54(3)(g) of the EEC Treaty which provides that the Council and Commission carry out their tasks "by coordinating, to the extent that is necessary and with a view to making them equivalent, the guarantees demanded in Member States from companies . . ." EEC TREATY art. 54(3)(g).

"Companies and firms" as used in this article mean any business constituted under civil or commercial law, including cooperative societies, and other legal persons governed by public or private law, except those which are non-profit. See EEC TREATY art. 58. But as the public limited company is of paramount importance, the EC company law directives based on Article 54(3)(g) primarily regulate the public limited company, except the Seventh Council Directive 83/349 of 13 June 1983 Based on Article 54(3)(g) of the Treaty on Consolidated Accounts, 1983 O.J. (L 193) 1; Fourth Council Directive 78/660 of 25 July 1978 Based on Article 54(3)(g) of the Treaty on the Annual Accounts of Certain Types of Companies, 1970 O.J. (L 222) 11; First Council Directive 68/151 of 9 March 1968 on Coordination of Safeguards Which, for the Protection of the Interests of Members and Others, Are Required by Member States of Companies Within the Meaning of the Second Paragraph of Article 58 of the Treaty, with a View to Making Such Safeguards Equivalent Throughout the Community, 1968 O.J. (L 65) 41.

Directives are binding as to the result to be achieved, but they leave to national authorities the choice of methods to be used. EEC TREATY art. 189. Directives must be implemented through national law in each member state to be effective. For a detailed discussion of the EC's institutional organization and legislative process, see AUDREY WINTER ET AL., EUROPE WITHOUT FRONTIERS: A LAWYER'S GUIDE (BNA Corporate Practice Series, 1989). For a collection of EC legislation, see BLACKSTONE'S EEC LEGISLATION (Nigel G. Foster, ed., 1990).

Two highly controversial proposals are currently before the Council, the Fifth Company Law Directive (Fifth Directive)³ and the Thirteenth Directive on Company Law Concerning Takeovers and Other General Bids (Takeover Directive).⁴ The Fifth Directive concerns the structure of public limited companies, as well as their powers and obligations. This Directive authorizes two distinct corporate structures, a unitary board and a two-tier board. The Takeover Directive focuses on the tactics of the bidder and target corporations during a takeover attempt. Each of these proposed directives is examined here in terms of the importance they place on the role of outside directors. This article will illustrate that although both of these Directives embrace a monitoring role for company directors, neither clearly defines what that role should be.

Examining the development of the monitoring obligations of outside directors in the United States during the last quarter century offers important insight into the potential benefits and demands of a monitoring role for outside directors in the EC. Part I of this article traces the evolution of outside directors' monitoring obligations in the United States. This insight permits conclusions to be drawn in Part II about the overall commitment which the Fifth Directive makes toward a meaningful monitoring role for directors. This analysis includes an examination of whether the monitoring standards are the same for unitary boards as they are for two-tier boards. The analysis of the United States journey toward monitoring directors emphasizes the importance of each EC member state's perception of the role of directors and precisely what interests they are to serve when discharging their monitoring function. Part III presents a close analysis of the Takeover Directive's treatment of defensive maneuvers and concludes that the Directive has vast lacunae in this area. The

3. Proposal for a Fifth Directive to Coordinate the Safeguards Which, for the Protection of the Interests of Members and Others, Are Required by Member States of Companies Within the Meaning of the Second Paragraph of Article 58 of the EEC Treaty, as Regards the Structure of Sociétés Anonymes and the Powers and Obligations of Their Organs, 1972 O.J. (C 131) 49 [hereinafter Original Draft of the Fifth Directive]; Amended Proposal for a Fifth Directive Founded on Article 54(3)(g) of the EEC Treaty Concerning the Structure of Public Limited Companies and the Powers and Obligations of Their Organs, art. 4(b), 1983 O.J. (C 240) 2, 7-8 [hereinafter Amended Draft of the Fifth Directive]; Second Amendment to the Commission Proposal for a Fifth Council Directive Concerning the Structure of Public Limited Companies and the Powers and Obligations of Their Organs, 1991 O.J. (C 7) 4 [hereinafter Second Amended Draft of the Fifth Directive]. Minor changes to the 1983 proposal have been added. The 1991 amendment does not deal with the subject matter of this article, but with voting rights. These directives will be collectively referred to in the text as the Fifth Directive.

4. Proposal for a Thirteenth Council Directive on Company Law Concerning Takeover and Other General Bids, 1989 O.J. (C 64) 8 [hereinafter Original Draft of the Takeover Directive]; Amended Commission Proposal for a Thirteenth Directive on Company Law Concerning Takeover and Other General Bids, 1990 O.J. (C 105) 6 [hereinafter Amended Draft of the Takeover Directive]. These Directives will be collectively referred to in the text as the Takeover Directive.

argument is presented here that, in light of the emphasis in the United States on the role of outside directors in takeovers, a similar emphasis appears to be an appropriate manner to deal with the Takeover Directive's incomplete treatment of defensive maneuvers by target management. Part IV offers conclusions drawn from the foregoing analysis concerning the overall benefits that can be derived from a comparative analysis of company and takeover law reform proposals that are presently before the EC.

I. PERCEPTIONS INTO REALITY IN UNITED STATES BOARDROOMS

There has been a dramatic change in the composition of the boardroom in the United States over the past two decades. Once a distinguishing characteristic of the United States boardroom was the extent to which most directors were *not* financially independent of the corporation. Today, however, the prevailing practice is that outside directors occupy a majority of the board's seats.⁵ The change reflects the idea that the function of the board of directors is to monitor the managers' stewardship of the firm. This belief contrasts sharply with the older view that the board was a deliberative body of super-managers that developed grand policy designs and supervised their execution by the full-time managers.⁶ This perception was inconsistent with outside directors having a meaningful role because the inherent constraints on outside directors' time, as well as the information reaching them, assure that they could never function as a super-manager. In the late 1960s, the super-manager view began to give way to a new consciousness that good corporate practice needed not new managers but monitors of those that did manage. Those most capable of monitoring were directors who were financially independent of the corporation and its officers. At the same time, there has been a recognition that a critical mass of outside directors could provide much-needed discipline for the otherwise unsupervised managers.

The causes of these dramatic changes in the overall composition of boards and the functions of outside directors is revealed by a review of writings from the 1970s and 1980s on the role of corporate directors. Leading authorities in both business and corporate law expressed alarm

5. HEIDRICK & STRUGGLES, *THE CHANGING BOARD* 4 (1990) (reporting that 79% of surveyed corporations had a majority of their board positions occupied by outside directors).

6. For example, the New York Business Corporation Law formerly provided that "the business of a corporation shall be managed by its board of directors . . ." N.Y. CORP. LAW § 701 (McKinney 1963) (emphasis added). In 1977, the statute was amended to substitute "under the direction of" for "by" to reflect the emerging view that directors are not necessarily managers, but are expected to review those who are. See N.Y. CORP. LAW § 701 (McKinney 1986).

over the absence of independence in the boardroom.⁷ They condemned the then prevalent view that directors were managers and questioned whether they were instead “shut-eyed sentries.”⁸ This cause for concern was not simply a perception that shareholder interests were being poorly served by the status quo. They voiced a broader concern that weakness in corporate governance structures contributed to the directors’ failure to act in a socially responsible manner in areas ranging from product safety to the environment.⁹ The concerns found a rallying point in the 1970s when the Watergate Special Prosecutor revealed that more than four hundred publicly traded corporations in the United States had engaged in extensive bribery of foreign and domestic government officials.¹⁰ It is no coincidence, therefore, that the government responded to these revelations by entering into settlements requiring corporations to clean their own stables by empaneling a special investigatory committee comprised of outside directors.¹¹

Those concerned with legal reform urged that outside directors were not simply necessary, but that their role had to be something other than as consultants to management.¹² The leading commentator on this issue, Professor Eisenberg, argued persuasively that one function outside directors can effectively serve is that of reviewing the stewardship of management and policing those transactions.¹³ This is especially true when managers’ interests have the potential to conflict with the interests of the corporation and its shareholders.¹⁴

7. See, e.g., MYLES L. MACE, *DIRECTORS: MYTH AND REALITY* (1971). See also Donald Schwartz, *Towards New Corporate Goals: Co-existence With Society*, 60 GEO. L.J. 57 (1971); Arthur J. Goldberg, *Debate on Outside Directors*, N.Y. TIMES, Oct. 29, 1972, at F1.

8. There have been concerns about sleeping directors for some time. See, e.g., William O. Douglas, *Directors Who Do Not Direct*, 47 HARV. L. REV. 1305 (1934). The best collection and review of authorities on ineffectual directorial monitoring is John C. Coffee, Jr., *Beyond the Shut-Eyed Sentry: Towards a Theoretical View of Corporate Misconduct and an Effective Response*, 63 VA. L. REV. 1099 (1977).

9. See, e.g., RALPH NADER ET AL., *TAMING THE GIANT CORPORATION* 124-25 (1976); CHRISTOPHER D. STONE, *WHERE THE LAW ENDS: THE SOCIAL CONTROL OF CORPORATE BEHAVIOR* 152-83 (1975); Alfred F. Conard, *Reflections on Public Interest Directors*, 75 MICH. L. REV. 941 (1977).

10. An illuminating review of this historical period for United States’ corporations and a commentary in response to it appear in Deborah A. DeMott, *Reweaving the Corporate Veil: Management Structure and the Control of Corporate Information*, LAW & CONTEMP. PROBS., Summer 1977, at 182, 207-20.

11. See JAMES D. COX ET AL., *SECURITIES REGULATIONS CASES AND MATERIALS* 114 (1991).

12. See, e.g., MELVIN ARON EISENBERG, *THE STRUCTURE OF THE CORPORATION* 157 (1976).

13. *Id.* at 162-68.

14. *Id.* at 167. For example, consider the prevalent provision that conflict of interest transactions can be overcome through disinterested approval by the board of directors. See, e.g., DEL. CODE ANN. tit. 8, § 144(a)(1) (1983); N.Y. CORP. LAW § 713(a)(1) (McKinney 1986); MODEL BUSINESS CORP. ACT § 8.31(a)(1) (1984). Professor Eisenberg’s vision is the backbone of the ongoing Corporate Governance Project of the American Law Institute. *PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS*, Parts III & III-A (Tent. Draft No. 11, 1991).

Thus was born the aspiration that corporations in the United States depart from the inside-board model in favor of the outside-board model.¹⁵ Interestingly, this was a movement that found willing allies among chief executive officers (CEOs). For example, business publications of the time were filled with exhortations by managers to their fellow managers on the virtues of an outside board.¹⁶ But, as will be seen, merely impressing the outside directors into service on the board does not alone assure a fully independent view of management's stewardship.

A. Culture and Cohesion

The independence sought by the quest for outside directors may be superficial. To be sure, the outside directors who predominate on the boards of publicly traded corporations are not dependent upon the firm or its officers for their livelihood. Their principal income is derived from sources other than their boardroom fees.¹⁷ But, their cultural and psychological identity is not much different from that of the managers they are to oversee, and this can rob them of their independence.

The boardroom in the United States is primarily composed of white,¹⁸ wealthy,¹⁹ Protestant, Republican²⁰ males²¹ with college educations.²² Indeed, the cultural identity among corporate directors is well-documented.²³ There is little that distinguishes the typical outside director from the firm's managers, whose stewardship the outside directors are to monitor. This is evident from the fact that over ninety-three percent of corporate directors are themselves captains of industry or the close advisors to those who are.²⁴ Contributing to the cohesiveness of directors — among both inside and outside directors — is their sustained, intense association with one another. Inside and outside directors join together on a regular basis to share the common burdens and obligations of advancing the corporation's interests.²⁵ This assures that they are col-

15. See *supra* note 5 and accompanying text.

16. See, e.g., *End of the Directors Rubber Stamp*, *Bus. Wk.*, Sept. 10, 1979, at 72; Paul B. Firstenberg & Burton G. Malkiel, *Why Corporate Boards Need Independent Directors*, *MGMT. REV.*, Apr. 1980, at 26; Lee Smith, *The Boardroom Is Becoming a Different Scene*, *FORTUNE*, May 8, 1978, at 150.

17. HEIDRICK & STRUGGLES, *supra* note 5, at 4.

18. *Id.* at 3.

19. HEIDRICK & STRUGGLES, *DIRECTOR DATA 8* (1982).

20. HEIDRICK & STRUGGLES, *DIRECTOR DATA 8* (1980).

21. HEIDRICK & STRUGGLES, *THE CHANGING BOARD 4* (1983).

22. HEIDRICK & STRUGGLES, *supra* note 19, at 8.

23. See, e.g., G. WILLIAM DOMHOFF, *WHO RULES AMERICA NOW?: A VIEW FOR THE '80s* (1983); THOMAS R. DYE, *WHO'S RUNNING AMERICA: INSTITUTIONAL LEADERSHIP IN THE UNITED STATES* (1976).

24. HEIDRICK & STRUGGLES, *supra* note 5, at 9.

25. A well-documented characteristic looked for when recruiting new board members is their ability to work within the existing group of directors and share the managerial philosophy of the company. See, e.g., JEREMY BACON & JAMES K. BROWN, *CORPORATE DIRECTORSHIP PRACTICES: ROLE,*

leagues in the truest sense of the expression. It is not surprising that directors bring a unified view of the corporate interest to this task. Studies repeatedly document that the leading criterion for selecting a board nominee is his probable identification with, and acceptance of, the company's goals and methods of operation.²⁶ Indeed, a director is expected not only to work within the group's collective view of the corporate interest, but also to cooperate with other board members, whether or not they are also managers, in reaching decisions by group consensus.²⁷ In the face of psychological and sociological forces such as these,²⁸ serious questions may be raised about how well-equipped the outside directors are to discharge their monitoring obligations.

Outside directors are also connected to the firm's CEO through the active role that the CEO plays in making nominations to the board of directors. Director nominations and decisions to renominate a sitting director generally occur through a process that is dominated by the CEO of the corporation on whose board the nominee will serve.²⁹ Although directors must stand for election by the firm's stockholders, this ritual rarely causes the director to incur any hostility and, generally, nomination foreordains the outside director's election. Therefore, the outside director may feel disposed to the firm's CEO out of gratitude for his support in obtaining membership to the board of directors.

The above image of the social and psychological forces that constrain the outside directors' independence is not flattering. Those more cynical than we may harbor suspicions whether the evolution to outside boards was undertaken with the knowledge that mere changes in boardroom personnel would not introduce a revolution within the boardroom. Certainly, managers can more easily champion the need for outside directors if the end result is that the overall dynamics within the boardroom remain unchanged. This is especially true if the CEO is at the center of the deci-

SELECTION AND LEGAL STATUS OF THE BOARD 29, 33 (1975). The shared task of board members is inherent in this corporate structure whereby directorial tasks are carried out as a body, rather than as independent actors. Cf. *Hurley v. Ornsteen*, 42 N.E.2d 273 (Mass. 1942) (holding that individual approval by directors without meeting as a body does not constitute valid approval).

26. See, e.g., BACON & BROWN, *supra* note 25, at 30.

27. See, e.g., MACE, *supra* note 7, at 97-101.

28. For an expanded analysis of the social and psychological forces that inhibit the outside director from being an aggressive monitor of management, see James D. Cox & Harry L. Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, LAW & CONTEMP. PROBS., Summer 1985, at 83.

29. In a significant percentage of nominating committees, the chief executive officer chairs the nominating committee. HEIDRICK & STRUGGLES, *supra* note 19, at 4. Even when the nominating committee is staffed entirely by outside directors, the chief executive officer is free to attend its meetings. John Perham, *The Men Who Pick the Board*, DUN'S REV., Dec. 1978, at 57-58. In any case, there is ample reason to suspect that new nominees are advanced only when they are believed to be acceptable to top management. See *id.*

sion as to who serves on the board. As discussed earlier, the movement toward an outside board was driven by historical events, such as Watergate, that reinforced society's concern over who watches management.³⁰ Because of the above described social and psychological forces, we believe that society's perceptions of the outside director as a meaningful monitor would have remained aspirational but for the changes in the legal culture that are reviewed in the next section.

B. Historical Legal Context of Director Obligations

The monitoring obligation of outside directors is not a recent phenomenon. In the early case of *Barnes v. Andrews*, the court held that Andrews, an outside director whose tenure was less than nine months, breached his duty to inform himself adequately about the newly created company's operations.³¹ Even though it raised a substantial amount of capital through a public offering, possessed a well-equipped and staffed factory, and produced enough parts for starter motors, the firm encountered dramatic delays in the assembly of those starter motors and the company ultimately failed. The court held that Andrews breached his duty by failing to inform himself adequately about the firm's performance and position. There was no evidence that Andrews made even a minimal inquiry of the company's performance or financial position.³² The holding in *Barnes* is sharpened by the absence of any facts or circumstances known to Andrews imparting reasonable notice to him that the firm was experiencing problems. The duty imposed by *Barnes*, therefore, is more stringent than the typical case in which the director has failed to heed warnings that would prompt a reasonable director to act.³³ Moreover, *Barnes* is more demanding than those cases punishing directors who are habitually absent from board meetings.³⁴

Today's concerns for the monitoring director involve problems far more subtle than those involved in *Barnes*. The modern trend is to focus upon the extent of an outside director's obligation to militate the company's violation of federal and state laws against pollution, employment discrimination, bribery, unfair competition, and the like, rather than

30. See *supra* note 9 and accompanying text.

31. *Barnes v. Andrews*, 298 F. 614 (2d Cir. 1924).

32. *Id.* at 615-16.

33. In the leading case of *Bates v. Dresser*, 251 U.S. 524 (1920), Justice Holmes held that a teller's flashy lifestyle should have prompted the bank's president to inquire whether shrinkages in the bank's deposits were the result of the teller's embezzlements. *Id.* at 530. The bank's directors, however, not being similarly on notice, were held not to have breached their fiduciary duties. *Id.* at 529.

34. See *Bowerman v. Hamner*, 250 U.S. 504, 513 (1919) (holding that a director who had not attended board meetings for five years had breached his duty to inform himself).

upon why the firm failed during an outside director's watch. On questions such as these, the burden of inquiry is far more encompassing than that which *Barnes* imposed upon directors.

An important decision in the development of outside directors' monitoring duties is the Delaware Supreme Court's decision in *Graham v. Allis-Chalmers Manufacturing Company*.³⁵ In *Allis-Chalmers*, a derivative suit was brought against the company's directors to recover damages the company suffered because its employees engaged in massive bid rigging with competitors, a flagrant violation of United States antitrust laws.³⁶ One theory of the plaintiff's action was that the directors had acted unreasonably in failing to establish a system to detect and prevent antitrust violations by company employees.³⁷ The Delaware Supreme Court dismissed the action, reasoning that since *Allis-Chalmers* was a large multinational company with over 30,000 employees, it was unreasonable to consider that the directors would undertake an active investigation of each division of the firm. The court held that the directors acted reasonably in relying upon the reports and summaries of operations which they had no reason to believe untrustworthy.³⁸ More importantly, the court believed the directors had no responsibility to establish and maintain a system of surveillance unless there was suspicion of wrongdoing.³⁹

If the board is perceived as a body of super-managers rather than monitors of those that do manage, the reasoning in *Allis-Chalmers* is more understandable. As a manager and policymaker, delegation is not only desirable, but essential. Any other approach is not practical in light of the limits on the outside directors' time and information. But upon acknowledging that the role of outside directors is that of monitoring the managers' stewardship of the firm, concern arises whether *Allis-Chalmers* continues to be good authority. For example, *Allis-Chalmers* reasoning is inconsistent with the more recent decision in *Francis v. United Jersey Bank*,⁴⁰ where the court refused to allow a director to use ignorance as an excuse, the very defense upheld in *Allis-Chalmers*. The *Francis* court stated:

Directors are under a continuing obligation to keep informed about the activities of the corporation. . . . Directors may not shut their

35. *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125 (Del. 1963).

36. *Id.* at 127.

37. This theory found support in the fact that 19 years earlier, *Allis-Chalmers* had entered into two consent decrees with government regulators settling claims of price fixing. *Id.* at 129-30. The plaintiff also argued that the consent decrees put the current board members on notice so that they had a duty "to ferret out such activity and to take active steps to insure that it would not be repeated." *Id.* at 129.

38. *Id.* at 130.

39. *Id.*

40. *Francis v. United Jersey Bank*, 432 A.2d 814 (N.J. 1981).

eyes to corporate misconduct and then claim that because they did not see the misconduct, they did not have a duty to look. The sentinel asleep at his post contributes nothing to the enterprise he is charged to protect.

Directorial management does not require a detailed inspection of day-to-day activities, but rather a general monitoring of corporate affairs and policies.⁴¹

The difference between *Allis-Chalmers* and *Francis* is their placement in time.⁴² *Francis* emerged after the role of the outside director changed from that of an active manager to that of an active monitor. Moreover, since *Allis-Chalmers*, a solid perception has developed that the public corporation's board of directors should design and implement legal compliance systems such as those argued for by the plaintiff in *Allis-Chalmers*.⁴³ Because the content of the law is informed by prevailing practices, there are ample grounds to believe that the Allis-Chalmers board would today be pressed to justify the absence of any compliance procedures,⁴⁴ especially in view of the fact that the prevailing legal climate emphasizes the monitoring function of outside directors.⁴⁵

Any doubt about the role in which the Delaware Supreme Court has cast for the outside director is removed by its landmark decision in *Smith v. Van Gorkom*,⁴⁶ where the court held the outside directors breached their duty of care in approving the sale of Trans Union Corporation. The sale was approved by the board of directors at a meeting that lasted only two hours. The presentation was completely oral, no written drafts

41. *Id.* at 822 (citations omitted).

42. Two leading Delaware practitioners have persuasively reasoned that *Allis-Chalmers* would be decided differently today because of the changed perspective of the role of outside directors. See E. Norman Veasey & William E. Manning, *Codified Standard — Safe Harbor or Uncharted Reef? An Analysis of the Model Act Standard of Care Compared with Delaware Law*, 35 BUS. LAW. 919 (1980).

43. See, e.g., American Bar Association, Section on Corporation, Banking and Business Law, *Corporate Director's Guidebook*, 33 BUS. LAW. 1595, 1610 (1978); American Bar Association, Section on Corporation, Banking and Business Law, *The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation*, 33 BUS. LAW. 2083, 2101 (1978).

44. See Veasey & Manning, *supra* note 42, at 930. But see Rodman Ward, Jr., *Fiduciary Standards Applicable to Officers and Directors and the Business Judgment Rule Under Delaware Law*, 3 DEL. J. CORP. L. 244, 246-47 (1977-78) (reasoning that the decision to install compliance procedures is akin to an economic decision depending primarily upon the level of notice and risk of harm). This reasoning appears to overlook the cases such as *Barnes* and *Francis* that found a breach of the director's duty even though the director was not on inquiry notice.

45. This does not mean, however, that the directors in either *Allis-Chalmers* or *Bates* would be liable today for their subordinate's misbehavior. Even reasonably designed and superintended compliance programs will not detect or deter all misbehavior. The directors' technical breach in failing to install such a system may ultimately bear no causal relationship with the harm caused by the subordinate's wrongdoing. Even though Andrews breached his duty to inform himself, the court ultimately held he was not liable because there was no evidence that, had he inquired, he could have prevented the company's failure. *Barnes v. Andrews*, 298 F. 614, 618 (2d Cir. 1924).

46. *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

of the agreement were circulated, and Van Gorkom did not disclose that the \$55 sales price reflected the price Trans Union's own cash flow would justify if the purchase was a management buyout.⁴⁷ The board's approval can best be described as an uncritical acceptance of senior management's recommendations.

The Delaware Supreme Court held that the directors failed to inform themselves adequately and therefore acted with gross negligence in approving Trans Union's sale.⁴⁸ The court chastised the directors for failing to inquire how the sales price was determined and for failing to inform themselves of the intrinsic value of the firm.⁴⁹ The Delaware Supreme Court established that monitoring requires, at a minimum, an aggressive probing of management's reasons for supporting a proposal submitted to the board.

With the decision in *Van Gorkom*, the aspirations for monitoring directors that produced the movement toward outside boards of directors became fused into the directors' duty of care. *Van Gorkom* is a watershed decision representing far more than the most important corporate law court in the United States holding that directors breached their duty of care when they agreed to sell the corporation at a significant premium. Its call for the diligent pursuit of options and information, rather than reliance upon the recommendations of a trusted executive, underscores the independence that is the keystone of the monitoring role. The duty that Delaware and other courts impose upon the outside directors continues to grow, especially with respect to the pivotal role that they play in contests for corporate control.

C. Strain and Growth in the Duty to Monitor

Takeover targets are not without weapons for their own defense. Indeed, it is the creativity and resourcefulness of skillful takeover lawyers who undertake to equip the target board with a defensive arsenal that puts an independent director's monitoring role to its greatest test. The outside director may well be conflicted when the firm is the target of a takeover. Certainly when there is a hostile bid for the firm, natural psychological forces do not drive outside directors from their managers' side. The prior associations, shared experiences and aspirations for the firm, and continuing nonpecuniary awards if the firm remains independent, may well combine to cause outside directors to regard the bid as a threat. Not surprisingly, the board's response frequently is to assume a siege mentality in the face of a hostile takeover. The initiation of an outside

47. *Id.* at 874.

48. *Id.*

49. *Id.*

bid repeatedly results in a "we-they" attitude between the incumbent directors and the unwanted suitor.

The most significant jurisprudence on these questions is that of the Delaware Supreme Court. Certainly this is so in terms of molding the outside directors' performance to the prevailing perception that they are the monitors of the managers. The Delaware Supreme Court in *Unocal Corp. v. Mesa Petroleum Co.*,⁵⁰ held that the board of directors has the burden of proving that it acted in good faith and only after reasonable investigation when initiating a defensive maneuver. Importantly, *Unocal* also imposes the demanding requirement that the defensive maneuver "must be reasonable in relation to the threat posed"⁵¹ by the outside bidder or its bid.

By placing the burden of proof upon the directors to establish their good faith and the reasonableness of their investigation, and by requiring that the defensive maneuver not be disproportionate to the threat imposed, the Delaware Supreme Court dramatically changed the areas of inquiry in takeover contests. No longer is it permissible for the target board to "wage war at any price" once they have isolated a difference in business policy or practices between the incumbent board and the suitor.⁵² Also, the directors no longer enter the legal fray with a heady presumption of infallibility — they have the burden of persuasion under *Unocal*.⁵³

This long step in evolving doctrine is based on the courts' awareness that contests for control present managers and outside directors with inherent conflicts of interest.⁵⁴ Given such conflict, takeover defensive ma-

50. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

51. *Id.* at 955. The United States Court of Appeals for the Second Circuit has imposed a more rigorous standard of requiring an *independent*, nontakeover-driven basis to justify defensive maneuvers in which the target corporation transferred shares to its wholly owned subsidiary and a smaller block of shares to a newly created employee stock ownership plan. *Norlin Corp. v. Rooney, Pace Inc.*, 744 F.2d 255 (2d Cir. 1984).

52. *Contra* *Cheff v. Mathes*, 199 A.2d 548, 551-52 (Del. 1964) (allowing sweeping defensive maneuvers where the board learned, after a very scanty investigation, that the bidder would change the target's marketing practices, had liquidated several companies that he controlled, and may not have been successful in managing companies he previously acquired).

53. Commentators frequently emphasize the important presumptions concerning the propriety of director decisions in normal business transactions. See S. Samuel Arsht, *Fiduciary Responsibilities of Directors, Officers and Key Employees*, 4 DEL. J. CORP. L. 652, 660-64 (1979); S. Samuel Arsht & Joseph Hinsey IV, *Codified Standard—Same Harbor but Charted Channel: A Response*, 35 BUS. LAW. 947, 958-61 (1980); Veasey & Manning, *supra* note 42, at 930-42. See also Joseph W. Bishop, Jr., *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1099-1100 (1968) (finding just four cases where liability was imposed on directors of industrial corporations for mere negligence uncomplicated by self-interest).

54. Specifically, a conflict naturally arises in the takeover context between the traditional role of directors as defenders of the corporation and the role of outside directors as auctioneers. See *infra* note 60 and accompanying text.

neuers should not enjoy the presumption of propriety and deference that attends other decisions exercised by the board of directors. Rather than rendering the board totally incapable, Delaware has chosen the intermediate position of altering the burden in justifying the board's actions and placing great emphasis on the role and actions of the outside directors. In effect, courts in the United States have determined that outside directors can and should play an important part in refereeing contests for control.

In *Hanson Trust PLC v. ML SCM Acquisition, Inc.*,⁵⁵ the court reasoned that the outside directors have a special function to serve when asked by self-interested management to adopt a defensive maneuver. The court suggested that the outside directors must take some steps to independently assure that the proposed transaction is fair.⁵⁶ In the process, the court suggested that outside directors should distance themselves from management by securing their own advisors and positioning themselves as an independent negotiating committee to deal with their managers.⁵⁷ At a minimum, *Hanson Trust* requires outside directors to disabuse themselves of thinking that the interests of outside directors and stockholders are identical to those of managers. In short, monitoring requires the outside directors to assume a more adversarial role vis-à-vis the firm's managers.

In *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*,⁵⁸ Delaware added an important second dimension to the monitoring role of outside directors in contests for control by holding that at some point outside directors must cast aside their defensive aspirations⁵⁹ and assume an entirely new role, that of a proactive auctioneer of the firm.⁶⁰ In June, 1985, Pantry Pride, after its casual merger proposal to Revlon's board was rebuffed, launched a hostile tender offer. Pantry Pride commenced its bid at \$47.50, increased it to \$50 and, on October 7, raised it again to \$56.25. Revlon responded by enticing Forstmann, Little & Co. (Forstmann) to also bid for Revlon.⁶¹ On October 12, Forstmann raised its bid to \$57.25 per share conditioned, among other matters, upon the Revlon board granting Forstmann the option to purchase its Vision Care and National Health Laboratories divisions for \$525 million, approximately \$100-\$175

55. *Hanson Trust PLC v. ML SCM Acquisition, Inc.*, 781 F.2d 264 (2d Cir. 1986).

56. *Id.* at 276.

57. *Id.* at 277.

58. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

59. As previously discussed, the *Unocal* standard regulates the propriety of defensive maneuvers. See *supra* notes 50-51 and accompanying text.

60. *Revlon*, 506 A.2d at 182.

61. *Id.* at 177.

million below their appraised value.⁶² Rather than focusing upon the process by which Revlon's board determined the price at which to option these two divisions, the court challenged the board's ability at this stage of the contest to engage in any defensive maneuver:

[W]hen Pantry Pride increased its offer to \$50 per share, and then to \$53, it became apparent to all that the break-up of the company was inevitable. . . . The duty of the board had thus changed from the preservation of Revlon as a corporate entity to the maximization of the company's value at a sale for the stockholders' benefit. This significantly altered the board's responsibilities under the *Unocal* standards. . . . The directors' role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company.⁶³

The decisions in *Unocal* and *Revlon* are the dominant authorities in the United States when judging the propriety of director behavior in the context of a takeover.⁶⁴ After a good deal of refinement in subsequent decisions, *Revlon* can be reconciled with *Unocal*. Even though *Revlon* dictates when certain actions to defend control are prohibited, directors may still engage in steps that prefer one bidder over another, which, in other contexts, would be viewed as a defensive maneuver.⁶⁵ Such steps, even though taken when the directors are subject to *Revlon*'s auction duty, are judged by the enhanced standards of *Unocal*.⁶⁶ More significantly, later cases have shown that *Unocal*'s proportionality requirement does not entail a delicate balancing of the danger embodied in the suitor's bid against the relative height of the obstacle which the particular defensive maneuver places in the suitor's path. For example, in the famous case of *Paramount Communications, Inc. v. Time, Inc.*,⁶⁷ the Delaware Supreme Court upheld as proportional Time's acquisition of Warner Communications. Time's board of directors changed its acquisition of Warner from a stock to a cash transaction in order to avoid having to obtain shareholder approval. Such approval would almost certainly not have been forthcoming because Paramount was offering a much greater price than the expected value of the Time shares following its acquisition of Warner. In upholding Time's switch from stock to cash, the court reasoned that the response was proportional if it did not *preclude* the company's takeover.⁶⁸

62. *Id.* at 178.

63. *Id.* at 182.

64. See, e.g., *Cottle v. Stoerer Communications, Inc.*, 849 F.2d 570, 575 (11th Cir. 1988); *Edelman v. Fruehauf Corp.*, 798 F.2d 882, 887 (6th Cir. 1986); *NCR Corp. v. American Tel. & Tel. Co.*, 761 F. Supp. 474, 499 (S.D. Ohio 1991).

65. See, e.g., *In re J.P. Stevens & Co.*, 542 A.2d 770, 782 (Del. 1988).

66. See, e.g., *Mills Acquisition Co. v. MacMillan, Inc.*, 559 A.2d 1261, 1287 (Del. 1988).

67. *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140 (Del. 1989).

68. *Id.* at 1150-51.

The court observed that, even though the Time-Warner acquisition created a much larger company that would be more difficult to acquire, their combination did not preclude acquisition by Paramount.⁶⁹ Because few defensive maneuvers are preclusive, *Unocal's* ultimate contribution must be seen as its emphasis on the necessity for good faith and reasonable investigation, and especially the role of outside directors in meeting each of these requirements.⁷⁰

Thus, the response to defensive maneuvers in the United States is guided by two leading cases, *Unocal* and *Revlon*.⁷¹ Rather than offering crisp standards, each decision embraces a broader notion of the monitoring role of directors such that the pivotal concerns under both *Unocal* and *Revlon* are the actions of the outside directors. Absent proof that the outside directors acted in a truly independent fashion and with adequate information, the takeover defense fails. Upon a finding that the outside directors acted in good faith and after reasonable investigation, the defensive maneuver, even if undertaken when the company is in the *Revlon* mode,⁷² is valid.⁷³ Even though outside directors are not natural allies to the notion that the bids of outsiders should be dispassionately regarded or that such directors should eschew the advice of managers when the firm is under siege, the courts have announced standards that cast outside directors in this role. Certainly, takeover defenses and management buyouts have struck many as becoming increasingly out of control so that some change in judicial attitudes in response to these phenomena was not unexpected. What is significant is that the courts have chosen the outside directors to shoulder the burden of protecting stockholders' interests.

69. *Id.* at 1151.

70. See, e.g., *Mills*, 559 A.2d at 1287.

71. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

A related inquiry pertains to the standard that directors must satisfy when impeding stockholders from convening a meeting concerning directors' control. In a path-breaking decision, *Blasius Industries, Inc. v. Atlas Corp.*, 564 A.2d 651, 661 (Del. Ch. 1988), the court held that directors in such situations must establish a compelling justification for staggering the elections of the board of directors so as to frustrate the shareholders from obtaining a majority of the board seats. *But see Stahl v. Apple Bancorp, Inc.*, 579 A.2d 1115, 1123 (Del. Ch. 1990) (deferral of date of stockholders' meeting in face of a suitor's expressed intent to conduct proxy contest in order to acquire control held to be beyond *Blasius* because it did not preclude ultimate shareholder action).

72. See, e.g., *Barkan v. Amsted Industries, Inc.*, 567 A.2d 1279, 1286-87 (Del. 1989).

73. *Citron v. Fairchild Camera & Instrument Corp.*, 569 A.2d 53, 66-68 (Del. 1989); *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1341 (Del. 1987). *Unocal* has even been extended to permit courts to judge the impropriety when directors support a takeover bid they previously opposed. See *Gilbert v. El Paso Co.*, 575 A.2d 1131, 1144-45 (Del. 1990) (directors suddenly supported takeover bid allegedly based upon the suitor's offer of terms more beneficial to some of the directors than those originally offered).

The outside director's role is frequently a proactive one that is consistent with that of monitoring managers.⁷⁴

D. Message from the United States Experience

The revolution within the United States boardrooms that began over a quarter of a century ago is still occurring. The forces for structural changes came neither from sweeping statutory commands nor judicial decisions. Although there were statutory commands and judicial decisions that molded the monitoring role of directors, these regulatory changes built upon the collective view of those in business, government, and academia that we must discard the predominance of the inside board and replace it with substantial monitoring obligations for outside directors.

The perception of the monitoring director would still be aspirational without the landmark decision in *Smith v. Van Gorkom*.⁷⁵ The Delaware Supreme Court's sweeping condemnation of the outside directors' deference to the recommendations of management in *Van Gorkom* left no doubt that outside directors would be held to the standards that society believes they are capable of performing. Thereafter, in decisions such as *Unocal* and *Revlon*, the courts repeatedly place the outside director in a central role of protecting corporate and shareholder interests, so that it can now be said that the most significant state law protections of the shareholder interest are designed around the evolving obligations of outside directors. Clearly, no question of managerial prerogatives or shareholder interests is examined today without giving the outside directors' role dispositive weight.

74. In 1986, the Delaware legislature amended its General Corporation Law to allow the charters of Delaware corporations to include provisions that limit director liability for damages arising from a breach of their duty of care. See DEL. CODE ANN. tit. 8, § 102(b)(7) (1990). Since Delaware enacted its statute, a number of other states have enacted similar statutory provisions. See generally Deborah A. DeMott, *Limiting Directors' Liability*, 66 WASH. U. L.Q. 295, 297-310 (1988). The impetus for such legislative activity is provided by both the decisions that subject outside directors' judgments to closer scrutiny, such as *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985), and difficulties in obtaining adequate liability insurance. See Roberta Romano, *What Went Wrong with Directors' and Officers' Liability Insurance?*, 14 DEL. J. CORP. L. 1 (1989). The effect of such charter provisions is to focus attention upon the transaction itself through the medium of a prayer for injunctive relief, rather than the personal liability of the directors. While appearing to be a major retreat from directors' responsibilities, the irony of charter provisions such as Delaware's is that they may actually stimulate an increase in the amount of litigation that questions director judgments. Such an approach allows courts to proceed with scrutiny of a certain transaction without fear that their remedy may be draconian to the individual director. Furthermore, the elimination of damage recoveries does not erase the incentive for care-based suits. In the U.S., where contingency suits are the preferred medium for enforcing officer and director obligations, recovery of plaintiff's attorneys' fees may be conferred if the suit successfully establishes bad faith on the part of the directors. See *Tandycrafts, Inc. v. Initio Partners*, 562 A.2d 1162, 1164 (Del. 1989). The result, therefore, may be that plaintiffs will actually benefit most from charter provisions that limit directorial liability.

75. *Smith v. Van Gorkom*, 488 A.2d 858 (1985).

What appears most clear in the case of the evolving duties of outside directors is that perception has preceded changes in the law. Such an evolution is not new to the law. It has long been the view of legal historians that doctrine is neither rigid nor immune to changes within society. It must be remembered that the first step in the evolution of the monitoring duty was placing outside directors on the board, and doing so in significant numbers. This occurred because it was perceived as being good business practice to have an outside board. In the aftermath of this development, the common law has continued to complete its prescription of the outside directors' responsibilities by imposing obligations consistent with a monitoring role. Thus, the demands on outside directors in the United States are not dependent upon precise statutory commands, but upon more general societal forces.

Additionally, the role that representative suits play should not be overlooked.⁷⁶ Representative suits not only produce decisions that embody standards of conduct, but more significantly provide the "bully pulpit" from which to exhort outside directors to conform their conduct to society's aspirations. *Van Gorkom*, by condemning the Trans Union directors' passivity, touched all outside directors in the United States with its holding.

The next section examines the fabric of the Fifth and Takeover Directives for evidence of the EC's commitment to the monitoring role of outside directors. The question of whether these directives embrace a monitoring role for outside directors is examined. It is our thesis that, if there is evidence showing a meaningful monitoring standard for outside directors in the Fifth Directive, this command must rest upon a widely held perception within the EC that monitors are needed and that the outside directors should fulfill this role.

II. THE FIFTH DIRECTIVE'S UNITARY BOARD AND TWO-TIER SYSTEM

As first proposed in 1972, the Fifth Directive adopted exclusively the two-tier board system in which all companies were to have both a management board and a supervisory board.⁷⁷ As initially proposed, the Fifth Directive sought to achieve the twin objectives of independent monitoring of company management and employee participation in company decision making. This was to be accomplished through a supervisory board composed entirely of nonmanagement outside directors and employee

76. Representative suits are brought by shareholders for individual injury rather than injury to the corporation. For case law dealing with the distinction between representative and derivative suits, see *Eisenberg v. Flying Tiger Line, Inc.*, 451 F.2d 267, 269-71 (2d Cir. 1971).

77. Original Draft of the Fifth Directive, *supra* note 3, ch. II.

representatives.⁷⁸ The management board is responsible for implementing the company's goals and policies on a day-to-day basis. The supervisory board selects and removes management and has overall responsibility for supervising management's stewardship.⁷⁹ The supervisory board is constituted to assure its sensitivity to the interests of owners and workers and thereby to have the resolve to discharge its supervisory functions.⁸⁰ Due to a lack of experience with the two-tier board in the member states (other than The Netherlands and Germany where it is mandatory),⁸¹ the original draft of the Fifth Directive met with strong resistance, particularly from the Community's then newest member, the United Kingdom.⁸² After heated discussion and protracted negotiations within the European Parliament,⁸³ an Amended Draft of the Fifth Directive was proposed in 1983 which expands the structural options for corporations to include a unitary board.⁸⁴ The Amended Draft also allows a less radical medium for employee participation in company decision making.⁸⁵

78. *Id.* Under the Amended Draft of the Fifth Directive, employee representatives are selected in either of two ways. Under the German model, employees could directly elect between one-third and one-half of the supervisory board. See Amended Draft of the Fifth Directive, *supra* note 3, art. 4(b). Alternatively, under the so-called Dutch model, the supervisory board co-opts its own membership. However, objections to a supervisory board appointment can be made by the general meeting, by a committee of shareholders selected by the general meeting, or by representatives of the employees. Such objections must challenge proposed candidates on the grounds that they are unable to carry out their duties or would cause the board to be improperly constituted. See *id.* art. 4(c).

79. See *id.*

80. See Detlev F. Vagts, *Reforming the "Modem" Corporation: Perspectives from the German*, 80 HARV. L. REV. 23, 50-53 (1966).

81. On a voluntary basis, a two-tier system can be established in France. ROBERT R. PENNINGTON & FRANK WOOLRIDGE, *COMPANY LAW IN THE EUROPEAN COMMUNITIES* 51 (3d ed. 1982). Even though two boards are mandatory in Denmark, there is no clear separation between the duties of the two. *Id.* at 181.

82. For comments from the viewpoint of Irish and British law on the Original Draft of the Fifth Directive, see J. Temple Lang, *The Fifth EEC Directive on the Harmonization of Company Law*, 12 COMMON MKT. L. REV. 155 (1975). For the British viewpoint on the Amended Draft of the Fifth Directive, see Janet Dine, *Implications for the United Kingdom of the EC Fifth Directive*, 38 INT'L & COMP. L.Q. 547 (1989).

83. See Resolution Embodying the Opinion of the European Parliament on the Proposal from the Commission of the European Communities to the Council for a Fifth Directive to Coordinate the Safeguards Which, for the Protection of the Interests of Members and Others, Are Required by Member States of Companies Within the Meaning of the Second Paragraph of Article 58 of the EEC Treaty, as Regards the Structure of Sociétés Anonymes and the Powers and Obligations of Their Organs, 1982 O.J. (C 149) 17.

84. See Amended Draft of the Fifth Directive, *supra* note 3, art. 2.

85. See *id.*, chs. III-IV. It should be noted that the proposed European Company Statute also includes both the two-tier and the one-tier system. Proposal for a Council Regulation on the Statute for a European Company, arts. 62-67, 1989 O.J. (C 263) 41, 54-55 [hereinafter European Company Statute]. The rules in the European Company Statute are less detailed compared to the Amended Draft of the Fifth Directive. Employee participation in a European company is regulated separately in the Proposal for a Council Directive Complementing the Statute for a European Company with regard to the Involvement of Employees in the European Company, 1989 O.J. (C 263) 69. By this

The two draft directives utilize different means for accomplishing the objectives of monitoring of managers and employee participation in decision making. As originally proposed, two distinct bodies were required: a management board and a supervisory board. A significant and direct employee voice was assured through membership on the supervisory board where no fewer than one third of the supervisors were identified with the employees' interests.⁸⁶ Under the Amended Draft of the Fifth Directive, a unitary system is allowed, which permits the possibility that no seats on the board of directors will be set aside for representatives of labor.⁸⁷

Allowance of a unitary board substantially weakens the codetermination component. Overall, the effect of these changes may be seen, at least from a purely structural perspective, as merely embracing the status quo.⁸⁸ Those few countries where the two-tier system prevails can continue this corporate structure while their fellow member states may continue to operate with a unitary board. Employee representation in corporations utilizing the unitary board system can be provided by election of certain nonexecutive members to the board. The unitary board parallels the governance structure of public corporations in the United States such that it invites inquiry as to whether the monitoring duties of the nonexecutive members of the unitary board will rival those of their counterparts in the United States. It also raises the issue of whether the nonexecutive unitary board members' resolve to monitor is less acute than that of the members of the supervisory board in the two-tier system. The following analysis addresses these questions by exploring further whether the monitoring task is purely a function of structure, or whether, as discussed in Part I,

separation, it may be possible to agree upon and enact the European Company Statute without deciding the controversial issue of employee participation which faces opposition, especially in the U.K. For a discussion of British criticisms of the employee participation plan embodied in the Original Draft of the Fifth Directive, see Dine, *supra* note 82, at 555-56.

86. Original Draft of the Fifth Directive, *supra* note 3, art. 4(b). For the view that codetermination results in greater efficiency and that backing off from codetermination is therefore unwise, see Clark D. Stith, *Federalism and Company Law: A "Race to the Bottom" in the European Community*, 79 *Geo. L.J.* 1581, 1591-92 (1991). But, for overall praise for the EC taking an approach that reduces a race to the bottom in contrast to the lack of uniformity in corporate laws in the United States, see Alfred F. Conard, *The European Alternative to Uniformity in Corporation Laws*, 89 *MICH. L. REV.* 2150 (1991).

87. Amended Draft of the Fifth Directive, *supra* note 3, art. 2. Employee participation can be provided for in a collective agreement between the company and the employees' representative. *Id.*, arts. 4(e), 21(f). Otherwise, employee participation on a unitary board occurs through direct election of between one-third and one-half of the board's members, *id.* art. 21(d), or through a consultative council. *Id.* arts. 4(d), 21(e). An excellent analysis of the Amended Draft of the Fifth Directive's treatment of codetermination appears in Jane Welch, *The Fifth Draft Directive — A False Dawn?*, 8 *EUR. L. REV.* 83 (1983).

88. For a view critical of the compromises embodied in the Amended Draft of the Fifth Directive, see Dine, *supra* note 82.

the precise duties and rigor of monitoring is shaped by a society's perception of what directors ought to do.

A. The Monitoring Function of Nonexecutive Directors

A question that has been posed is whether the Amended Draft of the Fifth Directive not only dilutes the objective of codetermination, but also weakens the monitoring function of nonexecutive directors.⁸⁹ On closer analysis, it appears that the role with respect to monitoring by the supervisory board directors mandated by the Fifth Directive is identical to that of nonexecutive directors of the unitary board.⁹⁰ Like supervisory board directors, each set of nonexecutive directors enjoys absolute veto power over closure, transfer, extension, or curtailment of a substantial part of the business, as well as a veto over any substantial organizational changes or long-term cooperative undertakings.⁹¹ Moreover, the roles of supervisory board members and of nonexecutive unitary board members are both defined as that of supervising management.⁹²

Some may argue that these similar provisions are somewhat hollow since more important structural differences can be expected to cripple the nonexecutive members of the unitary board from discharging their monitoring function with the detachment and commitment of their supervisory board counterparts. It should be remembered that the nonexecutive members of the unitary board are co-participants in the formulation of all significant business decisions. As such, their involvement transcends the bare exercise of a veto and includes a proactive decision making role shared with the executive members of the board. Once established, such joint participation does not encourage detachment in monitoring business policies or decisions.⁹³ That is, the nonexecutive members of the unitary board are very much involved in corporate decision making and can be expected to view the executive members as their colleagues and identify with the executive actions. Their position is quite different from that of directors who serve on the supervisory board in the two-tier system, a system which does not entail such continuous interaction but rather permits periodic intervention. Indeed, there is little substantive

89. See, e.g., Welch, *supra* note 87, at 99-100.

90. The two-tier system of the European Company Statute prescribes that "[t]he supervisory board may not participate in the management." European Company Statute, *supra* note 85, art. 63(1). Under the one-tier system, "[t]he management . . . shall be delegated by the administrative board to one or more of it [sic] members. The executive members shall be fewer in number than the other members of the board." *Id.* art. 66(2).

91. Original Draft of the Fifth Directive, *supra* note 3, art. 12; Amended Draft of the Fifth Directive, *supra* note 3, art. 21(s).

92. Amended Draft of the Fifth Directive, *supra* note 3, arts. 3(1)(a), 21(a)(1)(a).

93. See Cox & Munsinger, *supra* note 28, at 99-104.

difference between nonexecutive members of the unitary board and the functions of members of the management board of the two-tier system.⁹⁴ Whereas, under the two-tier system, members of the supervisory board are not identified with the decision or policy in question, so there is every reason to expect that the supervisory board's members will exhibit greater detachment when called upon to review those transactions requiring their approval. A further factor that contributes to the supervisory board's greater detachment is that a significant portion of the supervisory board's composition is identified with labor, an interest that, at least historically, is antagonistic to management. In contrast, there is no such identifiable constituency to whom the nonexecutive unitary board directors are accountable⁹⁵ because employee representation is not assured on the unitary board.⁹⁶ Finally, there is the reality that nonexecutive unitary board members most likely will themselves be captains of industry and, as such, can be expected to be sympathetic to the views and positions of the company's executive personnel.⁹⁷ In combination, it would appear that members of the supervisory board in a two-tier system, from a structural perspective, are more likely to monitor managers than the nonexecutive members of a unitary board.

B. The Supervisory Board Under a Microscope

These observations may well overstate the presumed independence of the nonexecutive, nonemployee members of the supervisory board of the two-tier system. This group is most likely to supervise aggressively the managers in a company whose holdings are concentrated within a small group of stockholders. Where ownership is diffuse, the complaint against the supervisory board has been that it is too dependent upon management for information and too removed from operations to serve as knowledgeable and committed monitors of the managers.⁹⁸ It is no wonder, therefore, that the supervisory board's ability to fulfill its mission as a watchdog of management has long been doubted.⁹⁹ In fact, it is far more

94. Daniel T. Murphy, *The Amended Proposal for a Fifth Company Law Directive: Nihil Novum*, 7 Hous. J. INT'L L. 215, 231 (1985).

95. Having outside directors accountable to a distinct subset of owners or an intermediary has recently been suggested as a positive step toward improving the overall governance of the United States' corporation. See Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 890-91 (1991).

96. There is a limited role for codetermination in that it makes a vague allowance for some medium of worker involvement to be established through collective bargaining. See Amended Draft of the Fifth Directive, *supra* note 3, ch. IV.

97. See Cox & Munsinger, *supra* note 28, at 105-08.

98. See Vagts, *supra* note 80, at 52.

99. See *id.* at 52-53. A close analysis of the many factors that have nevertheless allowed the bank dominated supervisory board in Germany to nurture stability and long-range planning appears in

reasonable to conclude that nonexecutive members who share policymaking responsibilities with full-time managers on a unitary board are more likely to have greater experience and insight into the company than the members of the supervisory board whose task is to evaluate such decisions after their implementation by the management board.

Indeed, the existence of a supervisory board can be seen as addressing the weaknesses in local reporting requirements, not merely problems relating to a monitoring function or fulfilling a social agenda of worker coordination. The supervisory board flourishes in those countries that lack the highly developed independent reporting function and concomitant disclosure system that so distinguishes public corporations in the United States.¹⁰⁰ In light of the supervisory board's special mission to report to the stockholders under the Fifth Directive, and the different reporting obligations of the nonexecutive directors on the unitary board,¹⁰¹ it can be seen that perhaps the most significant distinction between the unitary and the two-tier paradigms advanced in the Fifth Directive lies in their respective approaches toward periodic disclosure. Under both the two-tier and unitary boards, nonexecutive directors enjoy the same rights to information and are empowered to carry out investigations of management as they wish.¹⁰² On the other hand, the nonexecutive directors of the unitary board are bound by the same duty of confidentiality as their executive counterparts.¹⁰³ Thus, they do not enjoy absolute freedom to share their information with the stockholders at a general meeting. Nor are nonexecutive directors under a duty to do so, as are the members of the management board in the two-tier system.¹⁰⁴ Thus, under a unitary system, it may be difficult for the nonexecutive members of a unitary board to curtail the errant ways of managers through the threat of ventilating concerns of management's behavior before the stockholders.

C. Social Perception of the Nonexecutive Directors' Functions

If weaknesses in reporting requirements are the source for the slightly different obligations and rights of the supervisory board's nonexecutive directors, these are differences that are likely to matter only in the extreme circumstances where the nonexecutive directors must consider a direct challenge to management. In such a case, those serving on a super-

Richard M. Buxbaum, *Institutional Owners and Corporate Managers: A Comparative Perspective*, 57 *BROOK. L. REV.* 1 (1991).

100. *Id.* at 59-60.

101. Amended Draft of the Fifth Directive, *supra* note 3, arts. 32, 60.

102. *See id.* arts. 11, 21(r).

103. *Id.* art. 21(g).

104. *Id.* art. 31.

visory board have greater freedom to use confidential information than do the nonexecutive directors of a unitary board. In all other situations, the differences between the two-tier and unitary boards are not significant in terms of their impact on the role of the nonexecutive directors. As discussed in connection with the evolution of the director as a monitor of management in the United States, the most important factor has been the widely held view that the outside directors are not merely participants in the formulation of corporate strategies, but, more significantly, are monitors of management's stewardship.¹⁰⁵ This role is as finely articulated in the amended draft of the Fifth Directive for the unitary board as it is for the two-tier board. Without question, the expansion of the range of permissible options in the Amended Draft of the Fifth Directive to include the unitary board is due to serious divisions within the EC on the formalization of employee participation in company decision making.¹⁰⁶ The role of nonexecutive and supervisory board directors as monitors is the same. This point is emphasized in Article 21(a), which states that "[t]he company shall be managed by the executive members . . . under the supervision of the nonexecutive members. . . ."¹⁰⁷ The supreme role of the nonexecutive members is underscored in Article 21(t), which authorizes a majority of the nonexecutive members to dismiss an executive member.¹⁰⁸ Finally, the preamble to the Amended Draft of the Fifth Directive states that one-tier systems may be maintained if the nonexecutive members of their unitary boards are "endowed with . . . characteristics designed to harmonize their functioning with that of the two-tier structures."¹⁰⁹ Hence, it is the objective of granting employee participation in company decision making that has been diluted in the amended draft and not the felt necessity or the structure for nonexecutive directors to discharge a monitoring role.¹¹⁰ In view of the force with which the amended draft of the Fifth Directive advances the monitoring role for nonexecutive directors, it would appear that the experience in the United States, discussed above, can be expected to provide acute insights into the obligations of EC company directors under the Fifth Directive. However, the interest protected may be quite different.

105. See *supra* note 15 and accompanying text.

106. See PENNINGTON & WOOLRIDGE, *supra* note 81; Dine, *supra* note 82; Lang, *supra* note 82.

107. Amended Draft of the Fifth Directive, *supra* note 3, art. 21(a).

108. *Id.* art. 21(t).

109. *Id.* pmb.

110. It should be further observed that the Fifth Directive does not itself articulate a standard of care and skill for board members. Of course, board members are jointly and severally liable for losses proximately suffered by a company as a consequence of the directors' wrongful acts committed in the course of performing their duties. In addition, board members may exonerate themselves from liability by proving that no fault is attributable to them personally. See *id.* arts. 14(1)-(2), 21(u).

As was seen, the dominant force shaping the contours of the outside directors' duty to monitor under United States law was not the structural component of that legal paradigm but the overall perception of what outside directors can and should do. There is every reason to believe that the monitoring role of the nonexecutive directors of EC corporations will, over time, also respond to local aspirations. However, it is not likely that these aspirations will either duplicate those in the United States or be equal among all twelve member states.

To illustrate, consider how different social attitudes toward plant closings and worker dislocation can affect the content of the monitoring duty. A clear difference exists between the United States and the EC on the question of plant closings. There is abundant evidence within the EC of a grave reluctance to embrace decisions or norms that make it more likely that plants will be closed, relocated, or that would otherwise cause broad disruption to workers' routines.¹¹¹ In contrast, plant closures have become frequent in the United States, and efforts to adopt the European approach have been largely unsuccessful.¹¹² To be sure, so-called constituency statutes¹¹³ have been enacted in more than half of the states in the United States and they may superficially appear to protect workers, communities, and tax bases from the ill-effects of those takeovers that could result in the closure of marginal operations.¹¹⁴ However, the analogy to European attitudes on such questions is not a strong one because constituency statutes do not compel managers to consider the effects of closures on local nonshareholder interests; the statutes merely permit these interests to be considered if the directors desire. Constituency statutes in the United States do not embody the same societal commitment to plant closings that exists in Europe. It is therefore reasonable to believe that while the manner in which European nonexecutive directors discharge their monitoring task will not be different from the practices of their counterparts in the United States, the interests they will be asked to serve are broader than those required in the United States. This, in turn, will demand that a greater range of information be considered when corporate decisions affect ongoing relationships with workers. The monitoring task

111. See, e.g., Robert B. Reich, *Who Is Us?*, HARV. BUS. REV., Jan.-Feb. 1990, at 53.

112. See Marleen A. O'Connor, *Restructuring the Corporation's Nexus of Contracts: Recognizing a Fiduciary Duty to Protect Displaced Workers*, 69 N.C. L. REV. 1189 (1991). See generally Joseph William Singer, *The Reliance Interest in Property*, 40 STAN. L. REV. 611 (1988).

113. See Alexander C. Gavis, *A Framework for Satisfying Corporate Directors' Responsibilities under State Nonshareholder Constituency Statutes: The Use of Explicit Contracts*, 138 PA. L. REV. 1451 (1990). See, e.g., KY. REV. STAT. ANN. § 271B. 12-210 (Baldwin 1991).

114. Committee on Corporate Laws, *Other Constituency Statutes: Potential for Confusion*, 45 BUS. LAW. 2253 (1990).

in such situations will require a skillful balancing of worker and owner interests, a consideration not present in the United States experience.

The commitment to worker and community interests is not equally strong in all twelve EC member states. For example, it is highly probable that, in those states carrying forward a two-tier system and its correlative commitment to codetermination, the duty of the nonexecutive director when discharging monitoring tasks will have a heavier worker-interest component to it than in a member state where codetermination has not been a feature of corporate law and the state has elected only the unitary board. Indeed, this appears to be the essence of the compromise embodied in the amended draft of the Fifth Directive.¹¹⁵ Thus, just as societal interests gave birth to the monitoring duty of outside directors in the United States, the content of that duty within the EC cannot be expected to be uniform across all member nations because differences do exist among the members on a range of social needs and values.

The Amended Draft of the Fifth Directive can therefore be seen as embracing a monitoring function for both two-tier and unitary board corporations.¹¹⁶ Political realities, however, have produced a structure that only envisions a monitoring role for nonexecutive directors. But as seen in the United States, perceptions, or more specifically societal aspirations, not structural commands, have given body to the monitoring function. Thus, the ultimate compromise of the amended draft of the Fifth Directive is that it permits local perceptions to complete the mosaic of the monitoring director so that varying social aspirations can be served by the content each country gives to the monitoring duty.

The willingness to compromise the role of nonexecutive directors as monitors so that local state interests may be fulfilled is also present in the Takeover Directive, discussed below. On close review, it is apparent that in its lacunae there is reason to believe that the United States experience may once again inform the EC on the proper role of directors in contests for control.

III. THE TAKEOVER DIRECTIVE

The impetus for the Takeover Directive is the many and significant differences that exist within the EC countries in their respective regulation of takeovers and defensive maneuvers. Not only does the frequency of takeovers vary across EC countries, but the extent to which takeovers are regulated by statutes, self-regulatory bodies, and case law differ sub-

115. Amended Draft of the Fifth Directive, *supra* note 3, arts. 2, 3.

116. *Id.* art 1.

stantially from country to country.¹¹⁷ Most takeover activity in the EC occurs in the United Kingdom, where the most detailed set of takeover regulations exists.¹¹⁸ Indeed, some have found the United Kingdom's regulation of takeovers to be a suitable comparison for efforts by the United States to reform its own takeover laws.¹¹⁹

Until recently, from a practical, as well as a legal point of view, takeovers have been much less of a concern in continental Europe.¹²⁰ Structural, legal, and economic differences among businesses all account for

117. For a general overview of the takeover problems and regulation in most EC Member States, see *THE REGULATIONS GOVERNING MERGERS & ACQUISITIONS ACROSS THE EUROPEAN COMMUNITY* (Josephine Carr, ed., Int'l Fin. L. Rev. Supp. 1989). See also a more detailed account in H. LEIGH FRENCH, *INTERNATIONAL LAW OF TAKE-OVERS AND MERGERS: THE EC, NORTHERN EUROPE, AND SCANDINAVIA* (1986); H. LEIGH FRENCH, *INTERNATIONAL LAW OF TAKE-OVERS AND MERGERS: SOUTHERN EUROPE, AFRICA, AND THE MIDDLE EAST* (1987).

118. For statistics concerning purchases of enterprises by EC companies, see *Europe Gears up for Takeovers*, in *THE REGULATIONS GOVERNING MERGERS & ACQUISITIONS ACROSS THE EUROPEAN COMMUNITY*, *supra* note 117, at 5-10.

Takeovers, mergers, and other acquisition activities related to quoted companies in the United Kingdom are policed by the City Panel on Takeovers and Mergers, a self-regulatory body established by various financial services and industrial bodies in the United Kingdom. The general principles on takeovers are laid down by the Panel in the City Code on Takeovers and Mergers, 3 PALMER'S COMPANY LAW D-001, at 4505 (Clive M. Schmitthoff, ed., 24th ed. 1987) (revised 1990) [hereinafter City Code]. For a general discussion of regulation in the United Kingdom on takeovers, see JOHN H. FARRAR ET AL., *FARRAR'S COMPANY LAW* (2d ed. 1988). Farrar notes that "[t]he United Kingdom is unique in that it still leaves a substantial part of regulation, including disclosure, to the City Takeover Code whose juridical basis is obscure." John H. Farrar, *Business Judgment and Defensive Tactics in Hostile Takeover Bids*, 15 CAN. BUS. L.J. 15, 17 (1989).

119. GEORGE J. BENSTON, *CORPORATE FINANCIAL DISCLOSURE IN THE UK AND THE USA 3-7* (1976). For a recent comparative study, see Deborah A. DeMott, *Comparative Dimensions of Takeover Regulation*, 65 WASH. U. L.Q. 69 (1987).

120. It must be noted that the movement toward a single market by 1992 has increased, and may even further increase, the number of takeovers, acquisitions, and other kinds of cooperation among companies in Continental Europe. See *Europe Gears up for Takeovers*, *supra* note 117, at 5. Most of these countries leave the problem to be solved under the general provisions of their company acts and case law, possibly in combination with general recommendations and rules regulating securities listed on the stock exchange. See Farrar, *supra* note 118, at 16.

In continental Europe, mergers may be the most common technique used when cross-border purchase is not involved. See Malcolm Nicholson, *European Community*, in *THE REGULATIONS GOVERNING MERGERS & ACQUISITIONS ACROSS THE EUROPEAN COMMUNITY*, *supra* note 117, at 19. Mergers between two companies registered in the same member state (national mergers) are harmonized through the Third Council Directive 78/855 of 9 October 1978 Based on Article 54(3)(g) of the Treaty Concerning Mergers of Public Limited Liability Companies, 1978 O.J. (L 295) 36. Article 9 of this Directive requires the board of directors to draw up a detailed report explaining the terms of and economic grounds for the merger. *Id.* art. 9. Generally, mergers require shareholder involvement; Article 7 of the Third Council Directive prescribes that a merger must be approved by two-thirds of the voters at a general meeting of each company involved. *Id.* art. 7. A directive on cross-border mergers has been proposed, but has not yet been enacted by the EC. See Proposal for a Tenth Council Directive Based on Article 54 (3)(g) of the Treaty Concerning Cross-Border Mergers of Public Limited Companies, 1985 O.J. (C 23) 11.

this situation.¹²¹ On the continent, there are relatively few companies listed on the stock exchange compared to the United Kingdom. Also, ownership of companies on the continent tends to be concentrated in the hands of a small group of families, banks, holding companies, operating companies, or mutual funds.¹²² For example, in Germany, where shares (as well as voting rights) may be deposited in banks or with other persons friendly to the present board,¹²³ one commentator reports that three banks own more than forty percent of all stock nationwide.¹²⁴ Moreover, recognition and use of voting agreements and other shareholders' agreements abound in many EC countries which frustrate *ex ante* takeover activity.¹²⁵ For example, a company may have different classes of shares with different voting rights, including shares with no voting rights at all. In some member states, this enables shareholders with a minority of the subscribed capital of the company to possess the majority of the votes at a

121. This is true even in company law where harmonization of national laws through directives is rather extensive and has, in comparison with other areas of commercial law, been fairly successful. Differences in company law among various member states may occur as directives can "bind any Member State to which they are addressed, as to the result to be achieved, while leaving to domestic agencies a competence as to form and means." EEC TREATY art. 189. However, differences are primarily due to the fact that EC company law directives are minimum directives, giving each member state different options, and allowing the member states to enact more stringent or additional rules provided that such rules are applied generally.

122. See, e.g., Roberto Casati & Fabrizio Arossa, *Italy*, in *THE REGULATIONS GOVERNING MERGERS & ACQUISITIONS ACROSS THE EUROPEAN COMMUNITY*, *supra* note 117, at 42. In France, substantial blocks of shares remain in such friendly hands as the companies' banks or major suppliers. James A. Kiernan et al., *France*, in *THE REGULATIONS GOVERNING MERGERS & ACQUISITIONS ACROSS THE EUROPEAN COMMUNITY*, *supra* note 117, at 32. Furthermore, a recent survey shows that 57% of the controlling interests of the 200 largest companies in France are held by family groups. *Id.* at 27.

123. Such a depot voting rights system is widespread in Germany and provides an effective barrier against hostile takeovers. See Ralph Kaestner et al., *West Germany*, in *THE REGULATIONS GOVERNING MERGERS & ACQUISITIONS ACROSS THE EUROPEAN COMMUNITY*, *supra* note 117, at 73-74. This is a feature which strongly distinguishes corporate governance in Germany. See Dirk Schmalenbach, *Federal Republic of Germany*, in *INTERNATIONAL CORPORATE GOVERNANCE* 109, 110 (Joseph C. Lufkin et al. eds., 1990). Schmalenbach's article contains the following passage:

with so many differences between the German capital markets and their transatlantic and cross-channel counterparts it is not surprising that corporate governance in Germany is totally different from that in the United States or the United Kingdom in that shareholder activism by large institutions, hostile takeovers and shareholder involvement in management are far less prominent in Germany.

Id.

Professor Roe suggests that United States' populism may constrain financial institutions from being an effective voice in corporate governance by limiting the amount of stock they can own. Because financial institutions can own only a limited amount of stock in a single company, an institution has little cause to involve itself in active monitoring of management. Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10, 11 (1991).

124. Bernhard Grossfeld, *Management and Control of Marketable Share Companies*, in 13 INT'L ENCYCLOPEDIA OF COMP. L. §§ 4-236 to -240, at 98-99 (Alfred Conard ed., 1973).

125. For example, some special shareholders agreements designed to discourage hostile takeovers exist in Spain. Garcia-Pita et al., *Spain*, in *THE REGULATIONS GOVERNING MERGERS & ACQUISITIONS ACROSS THE EUROPEAN COMMUNITY*, *supra* note 117, at 65.

general meeting. This result is heightened if the class of shares with the lesser voting rights is listed at the stock exchange and the shares with superior voting rights are not listed but closely held.¹²⁶ Furthermore, a company may adopt bylaws which allow it to enforce provisions limiting the voting rights that can be exercised by individuals and their affiliates.¹²⁷ In some member states, because bearer shares are impermissible, rules of notification exist for registered shares which tend to delay the takeover procedure.¹²⁸ Finally, national law varies in the measures a company may undertake to thwart a hostile takeover.¹²⁹ In contrast, shares of British public companies are often held by smaller investors or investors who do not have a long-term relationship with the company.¹³⁰ These different ownership patterns, as a practical matter, make the British public corporation a more fertile area for takeover activity than the continental public corporation.¹³¹

A. Defensive Maneuvers in the United Kingdom

In view of the above described difference that exists between the United Kingdom and the other member states, it is not surprising that the richest source of insights on target management's power to defend against a hostile takeover is in the United Kingdom. The leading British case is *Hogg v. Cramphorn Ltd.*,¹³² where substantial restrictions were imposed on the directors' ability to fight a suitor's bids without shareholder involvement. In response to a hostile bid for its common and preferred

126. Germany allows shares with no voting rights. Kaestner et al., *supra* note 123, at 75. Even though Denmark does not allow shares without voting rights, differences of up to ten times in voting rights among various stock classes provide an efficient defense against takeovers. Mikael Lunoe & Susanne Wibrand, *Denmark*, in *THE REGULATIONS GOVERNING MERGERS & ACQUISITIONS ACROSS THE EUROPEAN COMMUNITY*, *supra* note 117, at 20-22.

127. E.g., Garcia-Pita et al., *supra* note 125, at 65.

128. Italy provides one such example. Casati & Arossa, *supra* note 122, at 48.

129. Second Council Directive 77/91 of 13 December 1976 on Coordination of Safeguards Which, for the Protection of the Interests of Member and Others, Are Required by Member States of Companies Within the Meaning of the Second Paragraph of Article 58 of the Treaty, in Respect of the Formation of Public Limited Liability Companies and the Maintenance and Alteration of Their Capital, with a View to Making Such Safeguards Equivalent, art. 19, 1977 O.J. (L 26) 1, 7. Article 19 allows the member states to permit a company to acquire its own shares, provided that authorization by the general meeting is obtained and the value of the acquired shares does not exceed 10% of the subscribed capital. *Id.*

130. Usually more than half of the shares of a large company in the United Kingdom are held by such investors. Max Thorneycroft, *United Kingdom*, in *THE REGULATIONS GOVERNING MERGERS & ACQUISITIONS ACROSS THE EUROPEAN COMMUNITY*, *supra* note 117, at 67.

131. More specifically, directors in member states other than the United Kingdom enjoy relatively unbridled discretion under their country's laws to conduct defensive maneuvers should the structural impediments not be present to eliminate the likelihood of takeovers. See David J. Berger, *The Second Common Market: Developments of a Unified Standard for Reviewing the Actions of Target Directors in the United States and the Economic Community*, 9 INT'L TAX & BUS. LAW. 1 (1991).

132. *Hogg v. Cramphorn Ltd.*, 1 Ch. 254 (1967) (U.K.).

shares, the target board created a trust for the benefit of the employees of the company and provided that the board members would be the trustees. In addition, the target board transferred a large block of authorized but unissued preferred shares to the trust. Each of these preferred shares carried ten votes per share.¹³³ As a consequence, the board assured that over half of the voting power remained in friendly hands. The court held that this use of directors' power to allot shares was improper.

Interestingly, this holding was made despite the court's finding "that the directors were not activated by any unworthy motives of personal advantage, but acted as they did in an honest belief that they were doing what was for the good of the company."¹³⁴ The reasons for creating the trust and defending control were concerns for the unsettling effects that the potential bidder's takeover attempt could have on employee morale, the perceived benefits of according employees an equitable interest in the company, and the belief that the incumbents were better managers.¹³⁵ It is noteworthy that because the bid remained inchoate, the target management did not seek to justify its defensive maneuvers by concerns for the terms or structure of the hostile bid, such as that the price offered was unfair or that the bid was structured to be coercive. Hence, the conflict in *Hogg* was over the future stewardship of the firm. This no doubt qualifies the court's response, which emphasized the prerogatives of the majority versus the minority by reasoning that, provided the actions were those of the majority, it would not intervene unless the acts were found to be "oppressive."¹³⁶

The effect of this emphasis is that defensive actions, if approved by a majority of the shares at a general meeting, carry an extremely high presumption of validity. However, because the defensive maneuvers were undertaken only by the directors rather than by a majority, the court refused to investigate the rival merits of the bidder's versus the incumbent's control in deciding whether the defensive maneuvers were valid. The court viewed the directors' action as depriving the majority of their constitutional rights,¹³⁷ presumably referring to the shareholders' right to consider actions pertinent to control. Overall, the effect of *Hogg* is prophylactic, entrusting questions of defensive maneuvers to a shareholder plebiscite rather than following the United States approach of

133. On the question whether the preferred share could carry ten votes per share, the court ruled against the company's management, based upon an interpretation of the articles of association of the company which provided that every share would have only one vote. *Id.* at 263.

134. *Id.* at 265.

135. *Id.* at 265-66.

136. *Id.* at 268.

137. *Id.*

evaluating the appropriateness of the board's unilateral action.¹³⁸ *Hogg*, however, did not deal with the more troubling question of whether the directors may act unilaterally to thwart a bid where the directors have a bona fide belief that the bid is unfair or coercive to the shareholders.

Subsequent decisions in the United Kingdom continue to emphasize the narrow authority of the target company's directors to take initiatives that affect shifts in control. For example, the Privy Council in *Howard Smith Ltd. v. Ampol Petroleum Ltd.*,¹³⁹ struck down an issuance of shares that was approved for the ultimate purpose of reducing the current majority owners to a minority status so that a suitor could launch a bid for control. Even though the directors in *Howard Smith* acted to secure an above-market bid for the company's shares, the court held that the directors had acted beyond the sphere of their managerial authority by attempting to erode the power of the holders of a majority of the shares or to create a new majority stockholder.¹⁴⁰ In so concluding, Lord Wilberforce offered the following narrow description of the directors' powers in takeover contests:

Directors are of course entitled to offer advice, and bound to supply information relevant to the making of such a decision, but to use their fiduciary power solely for the purpose of shifting the power to decide to whom and at what price shares are to be sold cannot be related to any purpose for which the power over the share capital was conferred upon them.¹⁴¹

A significant influence today on the British jurisprudence of takeover defenses are the limits that the London City Code on Takeovers and Mergers (City Code) places on defensive maneuvers taken by public corporations.¹⁴² Once an offer is made or otherwise appears imminent, Rule 21 of the City Code requires that transactions which could frustrate the bid must be approved by the target company's shareholders.¹⁴³ Thus, little discretion appears to remain for the target company's directors, except to prefer openly, or to take modest steps to favor, one suitor over

138. This was the actual result reached in *Hogg*. The court suspended its order and permitted the matter to be considered at a general meeting. At the subsequently convened general meeting, the shareholders ratified each defensive maneuver previously undertaken by the management. *Id.* at 272.

139. *Howard Smith Ltd. v. Ampol Petroleum Ltd.*, 1974 App. Cas. 821 (P.C. 1974) (U.K.).

140. *Id.* at 837.

141. *Id.* at 838.

142. The City Code does not have legal binding force. However, both government and self-regulatory organizations require that those who "seek to take advantage of the securities markets in the United Kingdom conduct themselves in matters relating to takeovers in accordance with . . . the [City] Code." City Code, *supra* note 118, at 4517. Those who do not comply with the standard set by the City Code may be subject to administrative sanctions or revocation of authorization. *Id.* In practice, parties generally consult the executive before they start takeover transactions in order to prevent a breach of the City Code. *Id.* at 4519.

143. *Id.* Rule 21.

another when there are rival bidders.¹⁴⁴ Therefore, as a consequence of the City Code, there is little opportunity for target management to engage in defensive maneuvers, so that the frequency of litigation over the defensive maneuvers is greatly reduced.

The British experience, being the richest among the members of the EC, demonstrates little of the growth, tension, or retrenchment of the United States experience. The combination of cases such as *Hogg* and legislation like the City Code restrict the directors' ability to act without the prior approval of a majority of the shareholders. Additionally, with the impact of the City Code, the ambit within which such questions may arise is even more constricted and comes into existence whenever a bid exists or is imminent. Overall, it is unrealistic to expect that insight can be gained on the scope of the directors' monitoring duties in the context of takeovers on the same scale in the United Kingdom as in the United States. The British experience does, however, provide a reference point from which the incompleteness of the Takeover Directive can be appreciated, and the relevance of the United States experience in forecasting the potential role of directors and courts under the Takeover Directive can be understood.

B. The Takeover Directive's Gaps and the Need for Monitoring

The general principles of the Takeover Directive, as established in the Directive's preamble, recognize and underscore the need for shareholder protection when a company is subject to a takeover.¹⁴⁵ A correla-

144. See, e.g., *Dawson Int'l Plc v. Coats Patons Plc*, 1989 B.C.C. 405 (U.K.); *Heron Int'l Ltd. v. Lord Grade*, 1983 B.C.L.C. 244 (U.K.).

145. The style and content of the Amended Draft of the Takeover Directive, *supra* note 4, is very similar to the City Code, *supra* note 118. See FRENCH, INTERNATIONAL LAW OF TAKEOVERS AND MERGERS: THE EEC, NORTHERN EUROPE, AND SCANDINAVIA, *supra* note 117, at 5-10.

The five general principles of the Takeover Directive are that:

- (1) all holders of securities of the target company who are in the same position must be treated equally;
- (2) the addressees of a bid must have sufficient time and information to enable them to reach a properly informed decision on the bid;
- (3) the board of the target company must act in the interests of all the shareholders, and cannot frustrate the bid;
- (4) false markets must not be created in the securities of the target company, the bidder company or of any other company concerned with the bid;
- (5) the target company must not be hindered in conducting its affairs beyond a reasonable time by a bid for its securities.

Original Draft of the Takeover Directive, *supra* note 4, recital 5(a). See also *id.* art. 6(1). Article 6(1) outlines the principles of the supervisory authority's discharge of functions. The Original Draft of the Takeover Directive prescribes that each member state must designate a supervisory authority to ensure that the parties to a takeover fulfill their obligations. *Id.* art. 6. In contrast to the original draft of the Takeover Directive, the scope of the amended draft of the Takeover Directive is restricted. The amended directive applies only to companies whose securities are admitted for trading on one or more of the stock exchanges in the EC. See Amended Draft of the Takeover Directive, *supra* note 4, art. 1. As the Directive is a "minimum directive," each member state is free to apply its

tive standard reflecting concern for protecting shareholders is the Directive's philosophy that shareholders who are in like positions shall be treated equally. This leads to the requirement that a bidder who acquires more than one-third of a company's shares be obliged to make a bid to acquire all of the company's shares.¹⁴⁶ There are also disclosure requirements that the bidder must satisfy in connection with its bid, as well as numerous requirements pertaining to the structure of the bidding process.

The Directive's concern is not exclusively to safeguard shareholders against bidders.¹⁴⁷ The Directive also seeks minimal protection against decisions taken by the board of the target company. As previously discussed, takeover bids create the potential for conflicts of interest among directors. The target board's motives for launching a defense to a hostile takeover are usually unclear. Even if the defense is prompted by concerns for the best interests of a company, an important question arises as to whether it is appropriate for the board to interject itself between the bidder and the corporation's owners. The Takeover Directive provides a limited answer to this question.

The Takeover Directive's Article 8(1) modestly restricts the power of the board of the target company to act defensively. After being informed about a takeover bid,¹⁴⁸ and until the result of the bid is made public, the board cannot, without the authorization of the general meeting of the shareholders, decide:

- (a) To issue shares and other securities carrying or which can be converted into carrying voting rights;
- (b) To engage in transactions which would have the effect of altering significantly the assets or debts of the company or resulting in the company entering into commitments without consideration (such

own rules to companies whose securities are not listed. Further, under Article 1, the Commission shall, after a period of five years, submit to the Council a report on the extension of the scope of the Directive to some or all nonlisted companies. *Id.*

146. The percentage of ownership shares which triggers the requirement that a bid must be made for all shares of the company cannot be fixed at more than 33%. Amended Draft of the Takeover Directive, *supra* note 4, art. 4(1).

147. For further protection of the target company's shareholders, as well as investors in general, the Amended Draft of the Takeover Directive requires an extensive offer document which sets forth details of the economic and other conditions of the offer, as well as various information concerning the bidder. Additionally, the bidder's organization and intentions regarding the continuation of the business of the target company must be given. *Id.* art. 10. Such documentation must accord with Article 11. *Id.* art. 11. The acceptance must not occur less than four weeks nor more than ten weeks from publication of the offer document. *Id.* art. 12.

148. To reduce the risk of insider trading, the bidder is required not only to make the offer document public, but also to disclose his decision to make a bid. Prior to the disclosure to the public, the supervisory authority and the board of the target company shall be informed in accordance with Article 11. For details concerning the threefold disclosure procedure to be observed by the bidder, see *id.* art. 7.

transactions may, however, be carried out without a general meeting provided they are authorized by the supervisory authority);¹⁴⁹

(c) To have the company acquire its own shares.¹⁵⁰

Thus, once a bid is commenced, initiatives such as issuing shares, granting options on shares, purchasing the company's own shares, issuing debentures convertible into shares, selling material assets or entering into contracts or other business transactions of exceptional nature cannot be carried out unless approved by the majority of the shareholders represented at a general meeting;¹⁵¹ any such general meeting must be held within the period established for acceptance.¹⁵² Furthermore, even though prior to the announcement of a takeover bid, the board was authorized to increase the share capital of the company or was authorized to buy the company's own shares, once the bid is announced, the actual issuance or purchase of shares must be approved by the shareholders at a general meeting.¹⁵³

Article 8 does not exclude the board from taking all defensive steps. For example, the Takeover Directive does not prohibit the target board from initiating the purchase of an insignificant amount of assets that nevertheless place regulatory obstacles (e.g., antitrust) in the hostile bidder's path. The Directive also does not prohibit the awarding of golden parachutes,¹⁵⁴ provided they become the obligation of the firm acquiring the target company. Moreover, the prohibitions of Article 8 do not apply until the bidder has made disclosures to the target company's board, as required by Article 7(1).¹⁵⁵ Thus, a nimble board, when it believes or knows a bid is imminent, can erect substantial barriers in an unwanted suitor's path. Hence, significant defensive maneuvers can be undertaken in that crucial window of time when a bid is imminent, but not formally

149. In doing so, the five general principles of the Directive mentioned previously guide the supervisory authority. See *supra* note 145.

150. See Amended Draft of the Takeover Directive, *supra* note 4, art. 8(2).

151. The majority required is regulated by the company act in each EC member state and depends on the kind of decision proposed and the bylaws of the company. Decisions requiring alteration of the bylaws (for example, in order to increase share capital) must be decided by statutory majority. For a comprehensive view of the majority required in different EC countries, see PENNINGTON & WOOLRIDGE, *supra* note 81.

152. Article 8 of the Original Draft of the Takeover Directive was not explicit that a general meeting was to be held after announcement of the bid. Under the terms of the Amended Takeover Directive, the board of directors may call a general meeting before the expiration of the period of acceptance. See Amended Draft of the Takeover Directive, *supra* note 4, art. 8.

153. This is true even though the Second Directive permits prior authorization of the board's increase of share capital, *id.* art. 25, and purchase of the company's own shares, *id.* art. 19.

154. Golden parachute is a term commonly used to refer to contractual arrangements which provide substantial benefits to executives, managers, or other employees of a potential target company if they leave or are forced to leave the target company following a takeover. See LEWIS D. SOLOMON ET AL., *CORPORATIONS LAW AND POLICY: MATERIALS AND PROBLEMS* 1061 (1988).

155. Amended Draft of the Takeover Directive, *supra* note 4, arts. 7(1), 8.

undertaken. Finally, measures which from the very beginning may prevent takeovers in general can be decided by the board without shareholder approval, provided that such steps do not otherwise require a decision by the general meeting. Thus, Article 8 fails to reach poison pills¹⁵⁶ issued prior to a hostile bid being launched and does not prohibit various governance procedures from being adopted which may serve as barriers to a potential suitor's takeover. In sum, the Takeover Directive does not reach many defensive maneuvers and allows the target board of directors significant discretion in mounting an aggressive defense prior to the bid's formal commencement.¹⁵⁷

The approach taken by the Takeover Directive is far less restrictive than its counterpart in the City Code. To be sure, both Rule 21 of the City Code and the provisions of the Takeover Directive place conditions upon the issuance of shares, options and securities convertible into shares, as well as substantial dispositions and acquisitions of assets.¹⁵⁸ It is the proscription of "contracts otherwise than in the ordinary course of business" in the City Code that provides it with a breadth far greater than that of the Takeover Directive.¹⁵⁹ Through this provision, a wide array of defensive maneuvers can be prohibited by the City Code. In contrast, the Takeover Directive proscribes only those acts that fall within one of three distinct categories of defensive maneuvers: issuing securities,

156. Poison pills are devices intended to deter takeovers by making the swallowing of a target corporation unpleasant for the bidder. See Solomon, *supra* note 154, at 1137-38.

157. The scope of art. 8(b) of the Amended Draft of the Takeover Directive, which prohibits the board from undertaking a transaction that significantly alters the firm's assets or debts, seems to be less extensive than that of the original Takeover Directive. The latter covered "transactions which do not have the character of current operations included under normal conditions." Original Draft of the Takeover Directive, *supra* note 4, art. 8(1)(b). See also the fifth general principle of the Takeover Directive, *supra* note 145. The amended version covers "operations which would have the effect of altering significantly the assets or liabilities." Amended Draft of the Takeover Directive, *supra* note 4, art. 8(b).

The Commission of the EC has not explained this change in its published comments, but it seems to reveal concern that the original wording went too far by hindering the target company from continuing its day-to-day business during the time of the bid. Amended Draft of the Takeover Directive, *supra* note 4, art. 8(b). Therefore, it seems more likely that the board under the current version of the directive may, without shareholders' involvement, fulfill substantial obligations undertaken in contracts signed before the takeover bid was initiated.

158. Under the Original Draft of the Takeover Directive, the limit on asset dispositions applies to those that "have the effect of altering significantly the assets or liabilities" of the company. Original Draft of the Takeover Directive, *supra* note 4, art. 8(b). Rule 21 of the City Code more directly proscribes such transactions that involve "assets of a material amount." City Code, *supra* note 118, Rule 21. However, the materiality of the assets involved is relative to the overall size of the firm or its earnings. Thus, it appears that in this respect the proposed Takeover Directive and the City Code take a similar course.

159. City Code, *supra* note 118, Rule 21(e).

significantly altering the firm's assets,¹⁶⁰ or purchasing shares. Moreover, the prohibitions of the City Code arise earlier, because they apply not just when a bid is in process, but whenever "the board of the offeree company has reason to believe that a bona fide offer might be imminent."¹⁶¹ In contrast, the Takeover Directive's prohibitions arise only after a bid is formally commenced by making the disclosures required in Article (7)(1). Thus, the City Code regulates defensive maneuvers invoked in anticipation of a hostile takeover, whereas such acts escape regulation under the Takeover Directive.

A further concern regarding Article 8 of the Takeover Directive stems from the fact that it permits transactions that significantly alter a firm's assets or liabilities if the particular supervisory authority of the member state approves such a transaction. The more traditional corporate governance approach in member states to transactions involving potential self-interest is review and approval by the shareholders. The prophylactic effects of shareholder approval arise from the disclosure that accompanies such approval and the involvement of disinterested owners in the decision-making process. Each is a deterrent to harmful managerial self-interest. In contrast, some concern is warranted over the desirability of placing such an approval mechanism in the supervisory authority for transactions that not only will significantly affect the firm's assets and liabilities but could well discourage a hostile bid's continuance. The supervisory authority's normal experience lies in reviewing filings, assuring that disclosure requirements are met, and scrutinizing market trading for possible abuses and manipulation. The competence of the supervisory authority to consider matters more germane to the conduct of business is untested and therefore uncertain. Furthermore, permitting local officials to act without defining the range of their discretion invites a response to purely parochial interests. For example, we question just how free of local influence a Belgian supervisory authority will be when asked to opine on a transaction that will make a bidder's takeover more difficult if that bidder is a German corporation and the target of a Belgian corporation. On the other hand, the utilization of the supervisory authority can be seen as a necessary safeguard that may be resorted to in order to avoid the delay that would otherwise occur if a general meeting were required to approve a beneficial transaction. This may suggest how utilization of the supervi-

160. As discussed previously, the Original Draft of the Takeover Directive reached "transactions which do not have the character of current operations concluded under normal conditions." Original Draft of the Takeover Directive, *supra* note 4, art. 8(b). This language would appear to parallel that of the City Code's "ordinary course of business." City Code, *supra* note 118, Rule 21. The dropping of this language further demonstrates the retreat in the Amended Draft of the Takeover Directive from the original position. Amended Draft of the Takeover Directive, *supra* note 4.

161. City Code, *supra* note 118, Rule 21.

sory authority can be restricted so as to preserve the shareholders' traditional role of overcoming managerial self-interest; the supervisory authority's power to act should be confined to truly exigent situations.

IV. CONCLUSION

Based upon the foregoing analysis, it appears that the Takeover Directive leaves a wide area within which the directors may invoke a full panoply of defensive maneuvers. Unlike the City Code, the Takeover Directive does not constrain managerial discretion with respect to takeovers in such a way as to leave little for fiduciary duty principles to regulate. Under the Takeover Directive, there is as much need to resort to fiduciary duty principles to regulate defensive maneuvers as there is in the United States. The great question here is whether this need will be met. The Fifth Directive can be read as imposing duties on the directors similar to those that exist under United States fiduciary law. But in this respect, both the Fifth Directive and the Takeover Directive each raise as many questions as they answer because each, in its own manner, deals incompletely with the obligations of directors. This should be seen as inviting reference to the experience the United States has gained in grappling with similar questions.

The message from the experience in the United States is clear. The outside directors are not merely participants in the formation of corporation strategies, but are required to fulfill a role as monitors of management's stewardship. They must disabuse themselves of thinking theirs and the shareholders' interests are identical to those of the managers. A similar approach is found in the Fifth Directive. However, the standard of care and skill for board members is not articulated in the Fifth Directive and, otherwise, remains inchoate in the jurisprudence of most member states. When confronted with a takeover, the standard must be found in the Takeover Directive's general concerns for shareholder protection and involvement. The Takeover Directive, however, does not focus on the specific role to be played by outside directors in fundamental decisions such as takeovers, a situation where the interests of management and shareholders may collide.

If shareholder protection is to be effective within the EC, the different roles to be played by executive and nonexecutive directors must be reflected and stressed in the Takeover Directive and must find further elaborations in the Fifth Directive, as well. This necessary development appears unlikely to occur. Presently, neither the amended drafts of the Fifth Directive nor the Takeover Directive has been enacted. The Commission is engaged in bilateral negotiations with each member state concerning the two directives. The limited experience that most of the

members have had with takeovers and, in turn, defensive maneuvers, may deny the EC the experience to deal more directly with the issue. Their limited experience may well retard their embracing a rigorous approach such as that of the City Code, or prescribing more precisely monitoring duties of directors. If such steps are not taken, then reference to the experience and case law of the United States can light the path for the member states' courts to follow.