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# Enforcement of Corporate Governance Codes

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## Abstract

Corporate governance codes have been published in several European jurisdictions. Most are of a self regulatory nature, others are rooted in the law. In both cases the provisions of the codes apply on a “comply and explain” basis. Enforcement mainly takes place through market mechanisms, including by shareholders using their legal and factual rights within the company. Moreover, the legal system will normally absorb these rules through blank norms, such as liability or contract rules. In states where the law has expressly referred to the code – in Germany and in the Netherlands, additional questions arise. The role of the market supervisors and of the auditors have expressly been discussed in these jurisdictions. The analysis concludes that market led enforcement, along with a strengthening of company law mechanisms constitutes the best equilibrium for developing adaptive but nevertheless effective corporate governance practices


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Keywords: corporate governance codes, enforcement, legal system, comply and explain, market supervisors, company law

JEL Classifications: K20, K22



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# Enforcement of Corporate Governance Codes

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## Introduction

1. Now that in many European jurisdictions, new corporate governance codes or guidelines have been introduced, the subject of their implementation and enforcement receives considerable attention[2]. Several approaches are followed: some pay more attention to the de facto implementation, drawing up comparative tables of the way companies have been dealing with the codes' provisions[3]. Others measure the relationship with market developments and attempt to analyse the monitoring of the codes by the market. Another line of analysis looks at the ways the codes can be enforced at law: here civil, penal and other remedies are considered. Finally, the enforcement by the market supervisors raises particular questions, i.a. about the relationship between self regulatory instruments and public law enforcement. In the present paper, only the last two mentioned aspects will be researched.

Corporate governance codes function within a given legal environment. The interaction with the legal system is a complex matter that differs considerably from state to state, both due to differences in the legal status of the codes, but also due to differences in the environing legal system. Enforcement techniques and efficiency will be directly dependent on the legal nature of the codes.

In several European jurisdictions, the codes have the status of mere recommendations, drawn up by professional associations, by academics, most of the time without the explicit support of the public authorities. One could identify these codes as self regulatory: implementation of the code is voluntary and based on self proclamation while its enforcement is based on the assessment by market forces. In some cases, enforcement may be based on the rules of an association supporting the code, or other similar instruments, e.g. contractual ones.

In other states the code will be close to the functioning of the stock exchange as it has a primary interest in presenting listed companies as adhering to "good" governance. Here the code may take the form of a stock exchange recommendation, or is part of the listing agreement, or may even be formulated as a listing condition[4]. Except in the first case, the idea of self regulation does not really apply.

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[1] Professor at the University of Ghent, and chairman of the Banking, Finance and Insurance Commission, Brussels. This paper only expresses personal opinions.

[2] See E. Berglöf and S. Claessens, Corporate Governance and Enforcement, www. Sept 2004, World Bank Policy Research Working paper, nr 3409; also in SSRN.

[3]. See In France: Rapport de l'AMF sur le gouvernement d'entreprise et les procedures de contrôle interne, January 13, 2005, Revue AMF, January 2005; A. von Werder, Kodex Report 2005: Die Akkeptanz der Empfehlungen und Anregungen des Deutschen Corporate Governance Kodex, Der Betrieb, 2005, 841, reporting annually on the implementation of the German Code by listed companies and illustrating the continuous adaptation of issuers to the new standards.

[4] The nature of these listing conditions may also be diverse and changing: in the UK, listing conditions were originally formulated by the exchange as listing authority. As that authority has now been transferred to the FSA, and as the rules have been maintained, one may wonder what are the consequences for the status of the UK Combined Code. This approach has also been considered in Germany, but declined by the Government Commission on Corporate Governance, see Th. Baums (ed) , Bericht der Regierungskommission Corporate Governance ,(O.Schmidt V. Cologne) 2001, nr. 9, p. 54

A third group relates to codes drawn up by a private body, but with the support of the public authorities[5]. In at least two cases the law – i.e. the companies act – has made explicit reference to the code, hence attaching express legal consequences to the code, or even to its provisions. In the Netherlands and Germany the code has been enshrined in the companies act. Numerous legal writers have attempted to identify the consequences of this hybrid of public and private law[6]: the notion of self regulation would probably not apply[7], although the text has been formulated in a wording that would be acceptable for a legal text. The debate in these states has focused on the remedies and sanctions for enforcing the code.

Finally, although in most national company laws, rules on specific aspects of the companies' governance have always been part of traditional company law[8], no European jurisdiction[9] has taken the path of formally laying down full, detailed corporate governance provisions in the law itself, as has happened in the US Sarbanes Oxley Act. This does not mean that European companies acts or financial regulation does not contain corporate governance provisions: there are numerous, but disparate specific national provisions dealing with board composition, with the obligation to introduce elaborate internal controls[10], the obligation to install audit committees[11] or spelling out detailed rules for conflicts of interests, including in a context of groups of companies. Increasingly however, ideas stemming from the Sarbanes Oxley Act are being adopted by European legislators as well[12].

In all European legal systems, a mix of the different types of regulation co-exist[13]. In fact the dividing line between self regulation and state regulation is a sliding one. On the longer term one sees a gradual incorporation of corporate governance rules that originally were good practice and formulated in the code into the statute. One can expect the

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[5] In the Dutch case, the code was drawn up "on the invitation of the ministers of finance and justice". It is unclear what this "invitation" means, the more so as an important role was played by the secretariat, delegated by one of the ministries. The German Code was proposed by the Baums Commission, installed on the proposal of the German Chancellor, see e.g. Baums, nt.4, ; M. Lutter, Deutscher Corporate Governance Codex,in: Hommelhoff, Hopt & von Werder (Eds) Handbuch Corporate Governance, 2003, 737. The Swedish Code also was drawn up by a committee that showed a considerable imput from the government. The Swedish code xx

[6] Leading to doubts about the constitutionality under German law: Bachmann, Der "Deutsche Corporate Governance Kodex": Rechtswirkungen und Haftungsrisiken, Wertpapiermitteilungen, 2002, 2137, 2142, and the further references; Berg and Stöcker, Anwendungs- und Haftungsfragen zum Deutschen Corporate Governance Kodex, WM ( Zeitschrift für Wirtschafts- und Bankrecht, 2002, 1569, at 1572.

[7] See for opinions on the Dutch text: W.J. Slagter, De invloed van de voorstellen van de Commissie –Tabaksblat op de rechtspleging,, NJB, 2004, 978 qualifying the code as "pseudo legislation". Critical: Huizink a.o., Klein Wassink & Zijlstra, De Nederlandse corporate governance code in de wet: statisch, dynamisch of problematisch ? NJB, 2004, 425 at 429.

[8] Striking examples of differences with e.g. US governance, are the usual European company law rules whereby the annual accounts of a company are adopted by the board, and approved by the general meeting; or the rule whereby directors are appointed by the general meeting.

[9] In Spain the Almade report pleaded for some provisions to be included in the law, such as the basic duty of transparency and disclosure including the "comply and explain" rule, the introduction of a general fiduciary duty and the requirement that companies developed internal regulations dealing with the functioning of the board and of the shareholders' meeting: Report by the Special Commission to Foster Transparency and Security in the Markets and in Listed Companies, 8 January 2003, ( Commission and Code de Almade)

[10] See art. 117 L.de Sécurité financière; comp. Art 2(2) of the revised proposal for a directive amending the 4th and 7th directives.

[11] See the Spanish and French companies acts

[12] The rules of the French law on Internal Controls (art. 117 L.de Sécurité financière; Art. Spanish Companies Act art 116.4 (d) as modified by L. 26/2003 of 17 July 2003; comp. s. 404, Sarbanes Oxley Act), are a good example .

[13] For a more general reflexion on the role of unwritten rules in company law, see L. Timmerman, Toetsing van ondernemingsbeleid door de rechter, mede in rechtsvergelijkend perspectief, Ondernemingsrecht, 2004, 558

requirement to establish an audit committee to be introduced in all company laws, as a consequence of the transposition of the European directive[14].

Apart from the diversity of the national codes, there is an even more complex issue of diversity at the level of the environing legal system. The codes may affect or be affected by different sections of the legal system: company law, liability rules, contract law, labour law, even criminal law are the fields shield that are the most likely to be touched by the governance codes. It is widely accepted that these codes – like many other self regulatory instruments – can under certain circumstances be absorbed by the general legal system. The entry points through which this absorption takes place most of the time refer to general negligence liability, directors' liability, specific remedies attached to gross negligence or mismanagement and so on. But other bodies of law are not to be excluded. Legal systems in Europe still show considerable differences in this matter, reflected in the rather rare case law applying these rules. For all these reasons the subject cannot be dealt with as an overview of applicable law, but as possible avenues along which the law could develop.

3. In order to structure the subject it is proposed to distinguish different steps depending on the legal context in which the corporate governance provisions could be called upon.

In a first series of cases, a code has been introduced on a voluntary basis, it is not legally biding, and there are no specific enforcement techniques. It is the prime responsibility of the board to ensure that the code is complied with. Enforcement will take place through a series of instruments, especially based on the company's reputation and standing in the financial markets. The general legal system will yield some enforcement instruments.

In a second case, there has been some "juridification", and enforcement instruments could be found in the external legal instruments.

The third group consists of the cases in which a reference to the code has been expressly laid down in the law, leading to legal consequences which however are not explicitly mentioned in the law, but flow from the general legal system.

Finally, the enforcement of the code might has been in the hands of the public authorities, or be made part of statute law. The latter is the case with the Sarbanes Oxley Act, but in Europe also many rules of corporate governance are scattered over company law provisions.

## 1. Corporate governance codes without an express legal basis.

4. In most legal systems, the corporate governance codes or statements have no specific legal basis and are not legally binding. They express the awareness of their draftsmen that financial markets attach increasing importance to corporate governance as a central touchstone in the evaluation of good management and hence of the company. Enforcement is put in the hands of the corporate bodies, especially the board of directors and the management. The general meeting and individual, "active" shareholders may also play a role in monitoring governance, especially when important transactions have to be decided. Although in most legal systems, it is not up to the general meeting to interfere with the management of the company, the pressure exercised by important shareholders may affect or even determine the position taken by the board[15].

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[14] Art 39, Proposal for a Directive on statutory audit of annual accounts and consolidated accounts and amending Council Directives 78/660/EEC and 83/349/EEC, http://europa.eu.int/comm/internal_market/auditing/officialdocs_en.htm

[15] See on the role of institutional investors in UK corporate governance: B. Black & J.Coffee, Hail Britannia? Institutional Investor Behaviour under limited Regulation, Michigan L. R.,(1993-1994), 1997; J. Coffee,

Enforcement is left to the market forces, what not only refers to their effect on price formation but also on decisions made by investment banks, by the rating agencies, the media, the public opinion, and so on[16]. Sometimes this approach is supported by a rather general mark of support by the market supervisor, however without committing itself to its enforcement. Whether market enforcement is a valid instrument for ensuring compliance with these codes is controversial: empirical evidence from Germany, based on a recent event study, shows a rather negative answer, at least not showing a significant positive correlation with market prices[17]. Other studies indicate that if the absence of credible governance structures and rules may have a negative impact on price formation, no such positive influence can be witnessed.

Also to be mentioned is the technique of the voluntary adhesion: market participants submit themselves voluntarily to certain conduct rules. In addition, this adherence may be published, e.g. by a mark in the stock exchange's price list. This approach has been attempted twice in Germany, first for the insider rules or later for the takeover rules, however without much success[18]. In some states, admission to the stock exchange is based on a contractual arrangement between the exchange and the issuer: the corporate governance code is then part of the agreement, and in case of non compliance may lead to contractual sanctions, such as contractual fines, name and shame, and similar techniques.

Other monitoring techniques have been developed in the Netherlands, where a government appointed commission will follow up the overall implementation of the Dutch code[19]. In Switzerland, the Stock exchange has imposed sanctions but obviously none seem to relate to a violation of the Swiss code[20].

Can these monitoring instruments be considered as efficient? Enforcement is always the crucial element in the controversy about the choice for self regulation rather than for state regulation.

It is useful to distinguish formal compliance from substantive compliance.

The formal requirement to adhere to a corporate governance code and to implement its individual provisions can be the subject of external monitoring by the auditor, a specialised committee or the market supervisor: the company can publish a declaration of adherence to the code, and motivate the items on which it prefers to derogate. Much more difficult is the monitoring of the substance of the provisions: here the liability should essentially lie with the company's bodies. Only in exceptional cases, especially when questionable conduct has come to light, will monitoring by the market and by the press become a predominant instrument. In these cases disclosure, if necessary monitored by the market supervisor, will become crucial.

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Liquidity versus Control: the Institutional Investor as Corporate Monitor, in Hopt & Wymeersch (eds) European Takeover, Law and Practice, 1992, 315; see more generally the studies by R. Romano and M. Faccio and M. Ameziane Lasfer, in McCahery a.o. (eds) Corporate Governance Regimes, Convergence and Diversity, (OUP, Oxford 2002), 507 e.s.

[16] This is the case for the Italian, French, Belgian, Swedish and Swiss codes.

[17] Nowak, Rott & Mahr, Wer den Kodex nicht einhält, den bestraft der Kapitalmarkt? ZGR (2005), 252; often reference is made to P.Coombes and M. Watson,Three surveys on corporate governance, McKinsey Quarterly, 4/2000 and to Pricewaterhouse, Shareholder value and corporate governance 1997 but these studies have no strict scientific aspiration.

[18] See Hopt, Rudolph & Baum (eds) Börsenreform, (Schäfer & Poeschel, Stuttgart, 1997) at 399.

[19] See infra nr.21

[20] See SWX Annual Report, 2004 at http://www.swx.com/trading/participants/sanctions_en.html . However, these do not concern corporate governance matters.

5. The absence of an express legal basis does not mean that the code's rules are without legal relevance. With corporate governance codes as with other soft law instruments, the legal system has a tendency to absorb these rules each time that the law allows for a blank norm. It is widely accepted that corporate governance codes- and soft law instruments in general - especially if they are widely accepted will serve as a source of inspiration for judges looking for yardsticks against which they can measure specific conduct of directors e.g. in liability or in negligence cases whether internally – i.e. for dealing with the relationship within the company – or in relation to third parties or for launching investigations into the company's conduct.

At present there are very few corporate governance cases illustrating this form of juridification. Developments are likely to take place along different lines depending on the member state's national law and precedents.

In a Dutch Supreme Court case, the court considered that the obligation to consult shareholders in support of the company's decision on a takeover or other private reorganisation has "no legal basis in present law, nor in views accepted on corporate governance in the Netherlands". A rule of that kind could not be accepted in the absence of a provision in the companies act or in the articles of association; and hence subscribe to such an obligation would lead to unacceptable uncertainty about the applicable law[21]. There is controversy in legal writing as to whether the Court's ruling allows taking into account generally accepted corporate governance rules[22], or whether it should be considered as an insufficient basis for absorbing corporate governance rules into the law[23]

6. In general, the absorption of soft law rules in the law by interpreting blank norms is a standard technique that has been used in many jurisdictions[24]. The "entry point" through which this absorption takes place depends on national law. Usually one refers here to the general rules on civil liability[25], to rules on directors' duties and liabilities[26], to general contract law rules, such as the Dutch law rules referring to the central notion of "redelijkheid

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[21] Hoge Raad, 21 February 2003, NJ, 2003, 182, nt.Ma (HBG case). Non litteral translation.

[22] Schouten, Toegang tot cassatie wegens schending van de Corporate Governance Code, V&O, 9, 142; also S. Bartman, De Code Tabaksblat: een juridisch lichtgewicht, PR, 2004, 125, referring to the Erdal decision. HR, 24 september 1976, NJ, 1978, 135, nt.BW.

[23] Slagter, nt.7 , 976

[24] K. Hopt, Unternehmensführung,, Unternehmenskontrolle, Modernisierung des Aktienrechts, in, Hommelhoff Lutter Schmidt Schön & Ulmer (eds) Corporate Governance, (V. Recht und Wirstchaft Heidelberg 2002) 52, mentions a series of other entry points taken from the commercial code, company law, and competition law. See for an extensive overview of the absorption of soft law rules: F. De Ly, De Lex Mercatoria. Inleiding op de studie van het transnationaal handelsrecht, *1989*.Also publisded in English The lex mercatoria. Introduction to the study of transnational trade law; H Braeckmans, Paralegale normen en lex mercatoria, Tijdschrift Privaatrecht, 1986, 1; E. Wymeersch, Règles professionnles et règles standardisées dans les opérations financières, in CDVA, Le droit des normes professionelles et techniques, (Bruylant, Brussels, 1985) 47 ; Cousy, H., Le rôle des normes non-juridiques dans le droit, Rapports belges au XIe Congrès de l'Académie Internationale de Droit Comparé (Bruylant, Brussels,,1982). More in general: A. Pitlo, De ontwikkeling van een gesloten naar een open systeem van verbintenissen in de rechtspraak van de Hoge raad, Tijdschrift Privaatrecht, 1973,163

[25] Through the general rules on the duty of care of directors. For the Belgian legal order : see art 1382 Fr and B. Civ.Code; see X. Dieux, "Corporate Governance" de la loi du 2 août 2002 au "Code Lippens", J. Tribunaux, 2005, 58 ; see e.g. for German law : St. Berg and M. Stöcker, nt 6, at 1576.

[26] art 2: 9 NBW (Dutch civil code)

en billijkheid" ("reasonable and equitable conduct"), an overarching notion in Dutch company law. [27]

In several jurisdictions there will be significant other entry points. Special mention should be made here of the powers of the Dutch specialised "enterprise chamber", a section of the Amsterdam Court of Appeal. On the basis of art 2:345 of the Dutch civil code, the court can mandate an investigation ("enquête") about the "management and state of affairs" ("beleid en gang van zaken') of any company, allowing the court to take measures in case of "mismanagement" ("wanbeleid"). One cannot exclude that grave violations of important principles or provisions of the corporate governance code be interpreted as constituting "mismanagement"[28]. This notion would include acting against the "elementary principles of responsible entrepreneurship" [29] Several other jurisdictions contain strengthened liability provisions for directors in case of "manifest gross negligence" or similar criteria coming close to "wrongful trading" [30].Whether corporate governance violations could qualify under the rather strict criteria will depend on the context: there is a widespread opinion that several of the great scandals of the early years of this century evidenced their boards' dysfunctioning, whereby the necessary check and balances were absent. By imposing sanctions, courts might usefully refer to the principles of "good" governance as laid down in the codes.

By referring enforcement of the code to the environing legal system, the problems are far from solved. There are significant differences between the national legal systems. A well know case is the general liability standard for negligence: where in the French legal tradition, according to article 1382 of the Civil code, any violation of any rule or any negligence can be the basis for liability against the injured party, a stricter standard is often considered to apply in German or Dutch law, where gross negligence or wilful conduct may be required [31]. There is controversy as to whether the plaintiff can only sue if the rule has been conceived for the protection of his interests[32]. ("Schutznorm" approach[33]) rather than being an instrument to protect the private business in general[34]. An even greater diversity can be expected for the rules governing liability of company directors, managers or auditors.

7. The corporate governance codes most of the time are based on a "comply or explain" approach. If companies adhere voluntarily because they consider that an elaborate corporate governance statement is in their interest for creating confidence in the markets,

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[27] See e.g. in art 2.8 NBW, applicable to all relationships within a legal person.. The concept is also used in general contract law: see art.6: 2 and 6.248 NBW.

[28] See for the analysis: L. Timmermans, nt. 12, 560. Slagter, nt 7, 980 on the consequences of the qualification in the Dutch "enquête"- procedure.

[29] "elementaire beginselen van verantwoord ondernemerschap". OK, 21 June 1979, NJ, 1980, 71 (Batco) and HR 10 January 1990, NJ, 1990, 446 ( Ogem)

[30] See Belgian Companies Act, art 530 ( "Faute grave et caractérisée") only applicable in case of insolvency ; comp. in French insolvency law: Art. 180, L.85-98 of 25 Jan.1985.

[31] In that sense: Hopt and Voigt, Grundsatz und Reformprobleme der Prospekt- und Kapitalmarktinformationshaftung (Morh Siebeck, Tübingen, 2005) in Hopt –Voigt (eds) Prospekt-und Kapitalmarktinformationshaftung (Mohr Siebeck, Tübingen, 2005) nt.31, 127

[32] art.6:162 NBW, comp. § 832 BGB., K. Hopt, nt.24, 52. and convincingly Hopt and Voigt, nt.31, 130.

[33] See art 6:13 NBW; Slagter, nt.7, 979 denies this qualification; also Seibt, Deutscher Corporate Governance Kodex und Entsprechens-Erklärung (§161 Akt-E), AG, 2002,256

[34] In general terms, see the Peter Paul decision ECJ,12 October 2004, Case C. 222/02; see M. Tison, Challenging the Prudential Supervisor: Liability versus Regulatory Immunity, Financial Law Institute, U. Ghent Working Paper 2003-4, and M. Tison Do not Attack the Watchdog: Banking Supervisor's Liability after Peter Paul, 42 Comm.Market L.R., 2005, 639) .

third parties – and especially investors, but also creditors - are entitled to rely on the honest and complete nature of the statements. The "comply or explain" technique therefore builds further on the idea of market enforcement: markets sanction both unsatisfactory governance arrangements and insufficient information. The latter matters are not specific to governance.

If the corporate governance statements appear untrue, or substantially incomplete or misleading, the sanctions may be in part factual – reputation damage for the company, loss of trust in the management, forcing some of the managers to quit – but also legal. From this angle, one has to deal with the question what is the liability of the company and its directors and managers for untrue, misleading or incomplete information.

The question may be dealt with from different angles. According to the directive on market manipulation, the diffusion of information which the company knew to be untrue or misleading falls under the definition of market manipulation[35]. Some of the voluntarily disclosed corporate governance information is embedded in a wider context of mandatory information. This applies both to annual or six-monthly disclosures, but also to price sensitive information. Here there is a legal basis for the disclosure of at least some of the information, and any violation of a statutory disclosure duty would trigger the legal enforcement tools that are available in the applicable regulation. According to the directives, the market supervisor should have adequate enforcement instruments at its disposal, mandating the necessary disclosures but also by being entitled to impose administrative fines[36].

Irrespective of these specific questions, the publication of untrue, misleading or incomplete information may also trigger liability sanctions, whether on the basis of a violation of company law, or of the general civil liability rules, depending on the applicable legal system. The liability could be determined on the basis of the general rules on negligence (e.g. in the French, or Belgian legal system). Injured parties would have to prove causation: the overall effect on the stock market price establishes the damage, but to what extent that would entitle individual shareholders to sue for damages is open to debate in most legal systems[37]. The company – eventually at the request of the minority shareholders - could sue the directors for the damage caused to the company[38].

In Germany it has been considered that the company could incur liability on the basis of the confidence created ("Vertrauenshaftung" according to German legal writing*)*[39]. It is not unlikely that a comparable legal basis would be accepted in several other member states. In extreme cases, criminal liability for false statements could attach. It has been proposed on the basis of BGH cases, that the liability would be based on the said principle, leading to the application of the rules on prospectus liability[40].

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[35] Art 1.2, C of the Market Abuse Directive 2003/6 of 28 January 2993, OJ L 96/16 of 12 April 200

[36] Art. 14, Market abuse directive 2003/6, nt.35; comp. Art**.** 28 transparency directive 2004/109 of 15 December 2004, L 390/38 of 31 December 2004, .

[37] Hopt and Voigt, nt.31, 112, stating that only the parties that have transacted may be entitled to sue.

[38] See C Seibt, Deutscher Corporate nt.31, 525; Hopt and Voigt,nt.31, 118.

[39] M. MLutter, Kodex für gute Unternehmensführung und Vertrauenshaftung, FS Druey, (Schultess V. Zürich 2002) 463; M. Lutter, Corporate Governance, Codex statt Gesetz ? In FS Soltyzinki,(U.Poznan, 2005) 466. points to the responsibility of both board members and the legal person, Lutter Die Erklärung zum Corporate Governance Kodex gemäss § 161 AktG, ZHR 16**6** (2002) 532 proposes liabilities on the basis of the companies act (§ 93); see further: K. Hopt, nt 24, 56-57; Berg and Stöcker, nt 6, &t 1580.

[40] See the previous footnote; Bachmann, nt.6, 2140 is not convinced of this extension of the rules on prospectus liability.

8. Enforcement might also take place through the intervention of the market supervisor[41]. In some jurisdictions, the market supervisor could step in if the information disclosed in the annual report or in any other documents addressed to the securities markets, is incomplete or insufficient and could oblige the issuer to publish additional or corrected information.[42] This type of intervention is not limited to information that has been imposed by public act, but might extend to any untrue or misleading information[43]. But supervisors are hesitant to act as enforcement agencies for private business rules: apart from the case that the information is false or misleading - in which case the supervisor would act within its statutory mandate to avoid false or misleading disclosures – supervisors are rather reluctant to intervene in the enforcement of corporate governance codes[44].

**2. Incorporating Corporate governance rules in other bodies of law.**

9. Enforcement of corporate governance rules could also be achieved by relying on other parts of the legal system to which these would be linked. Several parts of the legal system could be involved here.

As the codes often have been developed by business associations, one could imagine that the rules of the association allows enforcement to be organised by the association of which the listed company is a member whether directly or through a participating business association. The members may explicitly endorse the code[45] or be bound by a collective adhesion. It is however not clear how effective these membership techniques are. If sanctions would be imposed, and disclosed, the member may suffer reputation damage: however, expelling an important but unwilling member is likely to do more harm to the association than to that member.

10. Another and probably more significant case is the one in which the company's articles of association refer to the code, whether to all provisions of the code, or only to some or more of its most significant obligations[46]. Articles may contain the obligation to institute an audit committee, or impose a separation of the functions of chairman and CEO. In groups of companies, elaborate conflicts of interest clauses may be useful. Cases have been known whereby the parent restricted the activity of its listed subsidiary, e.g. by forbidding it from taking advantage of corporate opportunities that the group would prefer to reserve to another group entity, raising interesting corporate opportunity issues.

By writing these rules into the articles, they become part of the contractual relation between the company and its board members, become legally relevant and hence allow enforcement through existing internal company rules. Enforcement would take place by a decision of the

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[41] For price sensitive information, see art 6 of the Market Abuse Directive, nt.35.

[42] See e.g. art 16, Belgian RD of 31 March 2003 for information that "fait défaut ou pas suffisante" or "onvolledig of ontoereikend"

[43] To be relayed to the definition of market abuse, see directive nt 33;

[44] See the introduction to the Belgian Code, § 6."Monitoring and Compliance"

[45] This is the case for the Code of "Economie suisse" the federation of Swiss businesses regrouping several sectors of the Swiss economy, , drawn up by a panel of academics, businessmen and an exchange representative. The code was endorsed by the major Swiss business associations. It also mentions a list of major Swiss companies that were "represented in the "corporate governance panel" of experts. No cases of enforcement actions have been reported on the basis of violations of the code. See www.swx.com/trading/participants/sanctions_en.html

[46] Lutter, nt 36, ZHR, 2002 develops this "transformation "issue. A reference to this technique is found in the report of the Spanish committee, nt 86 p. 45.

general meeting, whether by declaring directors liable, or by way of imposing specific performance. The refusal to abide by clear provisions of the articles could also be a basis for the dismissal of board members for cause in cases in which they cannot be dismissed at will[47] In some cases one may wonder whether the lack of compliance with some of the corporate governance rules might result in nullity of the decision: might the appointment of a board member without a regular proposal by the nomination committee lead to nullity of the appointment? Could the validity of a transaction violating the internal conflicts of interest rules, laid down in the articles of association, be challenged on that basis? The answer will depend on national law.[49]

According to the Dutch corporate governance code, - but not mentioned in the law – corporate governance decisions may belong to the competence of the general meeting of shareholders. According to the Dutch Code the corporate governance statement may be submitted for approval to the general meeting. This may change the nature of the document and interfere with the distribution of competences between general meeting and supervisory board. This would not imply however that it is mandatory to submit the corporate governance statement to the general meeting, as the annual report is not submitted for decision to the general meeting that applies only to the annual accounts[50]. There is controversy to what extent that governance statement could influence the discharge of liability, that is voted upon at the annual general meeting[51].

As an alternative enforcement technique one might consider a rule whereby the law would mandate the listed companies to include in their articles of association a reference to the applicable corporate governance code, including to its "comply or explain" feature. This technique could be compared with the German-Dutch approach whereby the law imposes the board to take a position as to the applicable code, and allow it not to comply provided it publishes an explanation. It would allow the company to mould its governance requirements to its individual needs, but then backed with the full authority of the general meeting. However, one has to determine what would be the effect of this approach in the applicable

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[47]This might be the case under Dutch law for the members of the Supervisory board, as according to art 2:272(2) NBW, the Court can dismiss a board member for "just cause, including neglecting his duties" (« wegens verwaarlozing van zijn taak, wegens andere gewichtige redenen"). This would be the case e.g. for the member of the German Vorstand: see § 84 (1) AktG. « wichtiger Grund" and "grobe Pflichtverletzung", allowing revocation for just cause, including gross neglect of his duties: is breaching an article of association considered gross negligence and just cause for dismissal?

[49] If the nomination committee is consultative, the board's decision will prevail. Moreover directors are appointed by the general meeting. The conflicts of interest question is more tricky: it would not have an effect with respect to the validity of the transactions v.à.v. third parties. ( see the Mediasafe decision, ECJ, 16 December 1997 C 104/96, ECR, 1997, I 7219, Tijdschrift rechtspersoon en vennootschap, 1998, 41, nt. K. Geens,) but would constitute a violation of the articles of association and lead to internal and external liability of the directors.

[50] T. Raaijmakers, "Zelfregulering" van corporate governance van beursondernemingen, WPNR, 2004, nr. 6563, 67, at 75; nor could untrue statements be a reason for declaring the annual accounts null and void.

[51] T. Raaijmakers, nt. 48, at 76; P. Hommelhoff and M. Schwab, Regelungsquellen und Regelungsebenen der Corporate Governance: Gesetz, Satzung, Codices, unterrnehmensinterne Grundsätze, in: Hommelhoff, Hopt, von Werder (eds) nt. 5,, at 69; P. Ulmer, Der Deutsche Corporate Governance Kodex – ein neues Regulerungsinstrument für börsennotierte Aktiengesellschaften, ZHR (2002) 150, at 165.

legal system especially as it might result in heavier liability for the directors. Indeed, at least in some legal systems violation of the charter provisions call for stricter liability. This "charter" technique may also affect the balance of power between board and general meeting: the waiver of certain provisions of the code might become subject to a decision of the general meeting, unless the board has been empowered to do so.

11. Labour law may also offer a legal basis for certain corporate governance obligations: depending on national law and traditions, board members are subject to labour law[52]. Violations of essential provisions of good governance may be a reason for firing a manager. Some code provisions could be incorporated by contract: clauses could relate to conflicts of interest, to corporate opportunities and non compete clauses, to the disclosure of certain remunerations e.g. before the person was hired, etc. Here again, the effects of these clauses will have to be worked out on the basis of the applicable law.

12. A similar analysis can be made for corporate governance clauses in contracts in general: loan agreements can contain clauses on conflicts of interest or on corporate opportunities, or limit certain types of remuneration of executives. Again, enforcement will be a matter of performance of the contractual relationship and hence limited to contract parties. Apart from non-performance of the contract, one may accept that the clause would entitle the creditor to claim performance, accelerate the loan, or require the company to withdraw decisions that violated a contractual corporate governance clause. If e.g. the company has paid the executives a remuneration that was higher than what the creditor has expressly forbidden, would this violation entitle him to claim repayment of the excess remuneration? Under traditional civil law rules, the "action oblique[53]" might allow the creditor to sue on behalf of the debtor company against the director, the latter being a debtor to the company. Lenders may object again transactions with related parties that are likely to affect their position. The action of one creditor may seriously affect the future of the company, and hence determine the position of other creditors and shareholders as well[54].

Among the contractual techniques, one may mention the cases in which listing on the exchange is purely contractual. The listing agreement could contain provisions on corporate governance.

### 3. The law expressly refers to a corporate governance code.

13. According to a third series of hypotheses, the companies act contains an express provision stating that the – or a – corporate governance code has to be respected. Two states have followed this approach: according to the German and the Dutch law, stock exchange listed companies have to state that they apply the corporate governance code, or state the reasons for not doing so. A comparable provision is laid down in the proposed revision of the 4th and 7th directives. In the UK, the listing rules provide that the combined code is applicable to listed companies.

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[52] In Germany, members of the management board are held to a Dienstvertrag (§ 611 BGB) and enjoy the protection of § 84(3), AktG (no dismissal except for just cause). There is similar arrangement in the Netherlands: see for the consequences: Raaijmakers, in Pitlo, Vennootschaps en rechtspersonenrecht,(Gouda Quint, Deventer, 2000) 5.106 e.v.

[53] Art 1166 Belgian or French Civ code.

[54] See e.g. cross default clauses that often are part of loan agreements.

**(A) THE GERMAN – DUTCH APPROACH**

The relevant texts of the German and Dutch provisions – in their chronological sequence – are as follows:

According to § 161 of the German Company Law (AktG)

*"The management board and the supervisory council of stock exchange listed companies declare annually that the "Regierungskommission Deutscher Corporate Governance Kodex" which has been released by the German Federal Ministry of Justice in the official part of the Electronic Official Journal, has been and is respected and which recommendations have not been or are not followed. This declaration has to be accessible to shareholders on a continuous basis*".

The Dutch text is based on art 391(4) of the Civil Code, relating to the annual report of listed companies, the content of which has to be determined by decree. To article 391 the following was added in 2004: that

*"by way of general administrative order, specific provisions about the content of the annual report will be enacted. These provisions will specifically relate to the implementation of a code of conduct, designated by the administrative order".*

The implementing decree contains in substance that

"*the annual report of the companies limited contains a report about the respect of the principles and best practice provisions, provided for in the code, addressed whether to the management or to the supervisory council. If the company has not respected the principles or the best practice provisions, or is intending not to respect these in the current and the following accounting year, it states in the annual report its reason for so doing"*[55]

14. The two provisions present some similarities but also some differences. Both address the management board and the supervisory board as well, but not the company as a legal person[56]. The reference to the national code is very explicit in the German case, rather implicit in the Dutch one[57]. As to the time frame about which a report has to be presented, the German code relates to the past and to the present situation, but admittedly also to the future, allowing companies to diverge during the current accounting year, provided information is disclosed if it is price sensitive[58]. The Dutch approach makes it explicit that it refers to the situation during the past, present and future accounting year. In the Netherlands, it has been made clear that the disclosure relates to the annual report and to that only. In the German rule, the disclosure has to be made "currently available", e.g. on the company's website. It

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[55] The original text is as follows "De naamloze vennootschap doet in het jaarverslag mededeling over de naleving van de principes en best practice bepalingen van de in artikel 2 aangewezen gedragscode die zijn gericht tot het bestuur of de raad van commissarissen van de vennootschap. Indien de vennootschap die principes of best practice bepalingen niet heeft nageleefd of niet voornemens is deze in het lopende en daaropvolgende boekjaar na te leven, doet zij daarvan in het jaarverslag gemotiveerd opgave" . (Staatsblad 2004, 747 )

[56] Resulting in two statements, Strieder, Offene Punkte bei der Entsprechenserklärung zum Corporate Governance Kodex, Der Betrieb, 2004, 1325..

[57] See Huizink a.o., nt.7, 425. It refers to the code published in the Official Journal, without naming the Tabaksblat code explicitly. In case of future changes this would allow for more flexibility.

[58] P. Hommelhoff and M. Schwab, nt.43, at 61

[61] But according to Seibt, nt 31, this only consists of a formal check, not about the substance of the governance statement. "

could take place outside the annual report. The difference might affect the involvement of the auditor[61].

15. In both cases the fundamental philosophy is the same: companies should make a declaration that they adhere to the code. However, they may derogate for specific provisions of the code, provided they state their reasons for not applying the provision. There can be no doubt that the code as such is applicable, and in this point the approach differs substantially from the one followed in the states where the code is a mere recommendation. Indeed in the German-Dutch approach, companies could not "just say no", stating their reasons, what they can in the states where the code has a mere recommendation status. Not referring to the code would trigger liability.

Also, the declaration to adhere to the code constitutes not a self binding promise: the company can at any time change its position with respect to each of the provisions, provided this is explained[62]. This information should be published at once if it is price sensitive; if not in the next update of the company's corporate governance statement.

With respect to the individual rules, a certain flexibility is allowed, under the proviso that explanations are given. Derogations relate to individual provisions, and not to the code in general.

The legal consequences of making the corporate governance code mandatory should be clarified. It is useful to separate the internal consequences from the effect vis-à-vis third parties.

The obligation which the law puts on the boards both in Germany and in the Netherlands is only to report on the application of the code. Strictly speaking, the law does not directly mandate boards to apply the code. Indirectly, as a consequence of this reporting obligation, the substantive rules of the code become applicable and will become part of the internal functioning of the company. As to the substance of the rules, companies may derogate: therefore it would be misleading to state that the code as such becomes applicable[63]. It would be more precise to state that companies are legally obliged to adopt a position on the items that have been detailed in the code, and that these positions should be in conformity with the provisions of the code, unless the company makes use of its right to derogate in which case it must state its reasons. A declaration that the company adheres to the code, in general terms, would therefore seem sufficient and in that case the market will be entitled to presume that all provisions have been met. A declaration of adhesion would affect the board's liability: it will be assumed that by adhering to the code, the board has adequately discharged itself of its usual obligations, as laid down in the code[64].

16. In the philosophy of the system, it is very important that explanations are given in case of non-compliance. Normally boards will also inform the public as to the way it has discharged its disclosure duty. This information will be the basis for further monitoring and enforcement of the substantive rules, as described hereafter.

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[62] See about this Hommelhoff and Schwab, nt.43, 63 e.s.

[63] This analysis is different from the position by Bachmann, nt 6 , 2137, according to which the German code is a mere recommendation, without legal consequences, and without liability for misleading information

[64] This "safe harbour" function was mentioned by Bachmann, nt 6, 2143, but denied as he refuses to recognise legal effects to the code.

It has been discussed in the Netherlands to what extent the corporate governance statement, or its deficiencies could be invoked by shareholders to apply for a court ordered investigation ( “enquêterecht”)[65].

In the hypothesis that a company would not publish said statement, nor give any reasons for derogating, the board would expose itself v.à.v. its shareholders. The board – seen differently from the company - would be violating its legal duty. The general meeting could call on the board to adopt the code’s rules and publish a declaration whether of compliance, or of non- compliance. A refusal to take position might have a negative influence on the stock’s price. As this obligation is part of company law, the rules applicable for violating company law could be invoked only with respect to the adherence to the code, not to the individual provisions[66]. The decision whether or not to comply, and to explain non-compliance will normally lie within the competence of the board (management board or supervisory council) not of the general meeting[67]. However, a different pattern appears from the Dutch Code, although not from the companies act: the annual corporate governance declaration should be submitted to the annual general meeting. Significant changes should be discussed in the general meeting an a separate item of the agenda[68]

One could wonder how shareholders could enforce the board’s duty: could the general meeting require specific performance, and could a court enjoin the board to observe the code, or at least to make public its position? The general meeting could undertake such an action, and in case of refusal, could dismiss the members of the unwilling board. But the general meeting would not have the right to intervene in the board’s decision for non complying and about the reasons for derogating. A direct intervention by the general meeting in the company’s functioning would be contrary to the internal division of competences. Hence, shareholders could only call for having the board make a statement on the way it adheres to the code or states its reasons for non compliance. Individual shareholders a fortiori have no such right of intervention. In addition, it is likely that the board’s unwillingness to adhere to the code, including its comply and explain principle, could result in liability of the directors towards the company, raising difficult questions what part of the code is addressed to the management board and what part relates to the supervisory council.

17. If the company published no statement whatsoever one could conclude to a violation of a legal obligation[69]. Apart from liability – provided causation is proved – the real sanction would lie in the censure by the general meeting and the negative reaction of the market.

Another issue relates to the consequences of deficient corporate governance statements. In this case, the board adheres to the code, and where applicable has published reasons for not following the specific provisions. However, the motivation disclosed may be

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[65] See supra W. Slagter nt. 7, at 976 deems the violation not a manifest violation nor abuse; T.Raaijmakers, nt 48 , at 78 finds that the code has no “per se” legal force.
[66] See the texts of the respective articles, supra nr.13.
[67] At least with respect to those provisions that are addressed to the board. T.Strieder, nt.53, 1326, points to the requirement of having the board unanimously adopting points that affect individual board members (esp. conflicts of interest).
[68] See Item I.1 of the Tabaksblat Code. This would imply that the regular tools for an annulment action would be allowed: G. van Solinge and R. Nowak,, Een krabbend anker, WPNR, 2004, 6563, 66
[69] In some jurisdictions, violations of the companies act are sanctioned more severely than in case of mere negligent conduct.

deficient in several respects: it may be futile, or boilerplate, it may state untrue or incomplete reasons, or finally the information may be misleading or even false.

If the company publishes information that would be a formal explanation, but intrinsically insufficient to justify the derogation, there is no direct sanction applicable. Is it up to the general meeting to decide whether the board's statement is insufficient, and if so censure the board? But if the information is mandated by other provisions, e.g. of company law, or should be published according to financial regulation, there might be a violation of these provisions. In this context, one should recall the obligation to publish price-sensitive information. [72]

18. In case of untrue, or incomplete or even misleading information, basically the same rules on board liability for disclosure would apply[73]. Untrue or misleading statements would expose directors to liability both towards the legal entity and towards third parties on the basis of the general rules on negligence. Whether these would be effectively applicable, and what the consequences might be, depends on national law. In some legal systems, if the violated rules belong to the companies act, a stricter liability regime would apply: this would not be the case with a violation of the corporate governance code, as it is not part of company law. In other systems, only gross negligence or an intentional violation would lead to liability[74]

Both in Germany and in the Netherlands, legal writers have considered that the corporate governance provisions do not aim to protect the individual shareholders, who therefore have no stand to sue in damages. It was considered that the function of the corporate governance rules consists of protecting the company and the company system, not the individual shareholders. More specifically under German law § 161 AktG should not be considered as a Schutznormgesetz[75]. In German law, more specifically with respect to the information to be disclosed on the basis of § 161 AktG, the issue has been raised whether liability should not be based on the broad principle of public confidence in public statements (Vertrauenshaftung[76]), underpinning the more specific rules on prospectus liability[77].

It has been suggested that the damage to the buying or selling shareholders[80] is the consequence of the negative valuation of their shares due to the absence of a credible corporate governance statement: generally - but here again, national laws may differ- it is discussed whether this is to be viewed as an individual damage, or rather as a damage

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[72] See art 6 of the market abuse directive, nt 33

[73] For a very extensive study of these subjects, see Hopt and Voigt, nt. 31.

[74] Hopt and Voigt, nt. 31, at 127. Hommelhoff and Schwab, nt 43 at 69.

[75] Seibt, nt 31, at 256 is rather hesitant. There would liability to the buying or selling shareholder if the corporate governance statement contains untrue declarations about respecting the code or about the reasons for relying on a derogation; if however, due to non-publication of the statement, or of false assessements of certain elements, the stock exchange price would be negatively affected, all shareholders may suffer damages for which the board would be responsible, Seibt, nt.31, at 255 ; the same reasoning is followed in the Netherlands: see Slagter, nt. 7, 979; for further analysis see Hopt and Voigt, nt 31,, nt. 66.

[76] "Allgemeine Erklärungshaftung": Seibt nt. 31, 257.

[77] Hopt, nt.24, 56; the same would apply to voluntarily disclosed information, see supra nr.7.

[80] Hopt and Voigt, nt 31, 113

inflicted to the company, for which shareholders as such cannot recover. At least in some jurisdiction, the first alternative would apply[81].

The role of the statutory auditor has also been discussed in these two jurisdictions. Whether he will be called upon to review and report on the corporate governance statements depends on his role in general and more technically on the document in which his statement has to be included. This matter has not been analysed in great length in German and Dutch Law.

According to German law, it is mandatory to include the company's declaration in the annual report. This will render the auditor's review applicable but only to the mere formal corporate governance declaration[82]. His powers would not extend to the substance of the declaration: his intervention is limited to check whether the declaration has been delivered and whether it is accessible to the shareholders[83]. Some writers have referred to the question of a broader involvement of the auditor[84]. However, similarly as with the securities supervisor's role, it looks difficult to visualize to what extent an auditor could deliver a credible opinion on the items which are not reflected in the accounts and about relationships and developments about which he has only indirect evidence**.**

### (B) THE UK APPROACH: LINK WITH THE LISTING RULES

19. In the UK the Combined Code has made applicable by the conditions for listing securities on the regulated market. Lack of observance of the code would normally be a bar to admission. Later non-observance might lead to delisting: this remedy is impracticable, as it inflicts damage to the innocent shareholders. Before the FSA was created, there were legal opinions denying a private right of action for violation of self regulatory instruments. . It is not known whether that position has changed since the FSA took over the responsibility for the listing conditions: the legal nature of these has been changed from private rules to public ones. On its role on enforcement the FSA has declared :"The FSA as listing authority makes no judgement about the accuracy or adequacy of the compliance statement: it is up to the board of the company and for the shareholders to make such evaluation. If a company fails to include a statement in the required form, the FSA has announced that it may make use of its powers, including its fining powers against that company. The FSA will use its compliance powers by sampling a number of annual reports on a routine basis". This quote indicates that the FSA's review would be limited to a formal check, leaving the substantive evaluation to the shareholders and to the market. Up to now, and as far as is known it has not acted in this field.

The Financial Reporting Council, and independent regulator for corporate reporting and governance, created from 1 April 2004 is in charge of setting, monitoring and enforcing accounting and auditing standards. It task has been widened to the promotion of high corporate governance. standards by monitoring and maintaining the Combined Code and

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[81] On the basis of the general liability rules of art 1382 in the French or Belgian legal system. In Germany, in very few cases and if the damage exceeds that of the company: Seibt, nt. 31, at 255.

[82] Strieder, nt. 53, at 1228; Berg and Stöcker, nt 25, 1574 and further references, mentioning the hypothesis of an internal reporting duty by the auditor.

[83] Strieder, nt.53, at, 1128; Seibt, nt. 3 at, 257

[84] Hopt nt.24 *at 55*

associated guidance. The FRC acts without explicit statutory base, although reference is made to the rules on listing on the exchange, which require compliance with the Code[85].

The Code is applicable to listed companies, but also to other entities with a broad public interest, such as privately held, large companies, revision funds, large foundations, non-profit association, and so on.

The Committee on corporate governance follows up the corporate governance developments and practices, and may propose to the FRC changes to the Code. Enforcement of the code and of its individual provisions does not belong to the council's remit. This is considered to be the task of the market, of the institutional or other investors, if necessary acting in the general meeting. The Committee also can deliver interpretations about the code's provision, after suitable consultation.

c) **THE SPANISH COMPANIES ACT**

In Spain the "Almade" report pleaded for some minimal provisions to be included in the law, such as the basic duty of transparency and disclosure including the "comply and explain" rule, the introduction of a general fiduciary duty and the requirement that companies developed internal regulations dealing with the functioning of the board and of the shareholders meeting[86].

The Spanish companies act, as modified by L. 26/2003 of 17 July 2003 contains a description of the information that has to be included in the annual report. Among the items that have been included, the act refers to the degree of implementation of the recommendations on corporate governance and where applicable, the explanations in case of non compliance[87].

The securities commission has been mandated to follow up on these recommendations, and in case the company does not transmit its governance report, or the annual report with the governance chapter, or where the information is untrue, deficient or misleading the commission can request specific information to be published, with respect to the specific information as well as with respect to the degree of implementation[88]. The commission intervenes in cases of absence of any governance statement, and in case of gross deficiency in the governance statement.

## 4. THE ROLE OF THE SECURITIES MARKET SUPERVISOR

20. It is especially with respect to the Dutch code that a debate has sprung up about the role of the market supervisor in enforcing the corporate governance code. The subject is complex: on the one hand market supervisors are loath to enforce private guidelines, the more so as their legal status is unclear. When the case has received recognition by the legislator this perspective may change. The subject then becomes rather one of substance. By allowing the "comply or explain" rule, the law has recognized that the code's provisions

[85] Rule 12.43 A, FSA

[86] Report by the Special Commission to Foster Transparency and Security in the Markets and in Listed Companies, 8 January 2003, ( Commission and Code "de Almade") ,

[87] Art 116, 4 (f) Companies act. The law does not refer to a specific code. The text reads as follows " f. Grado de seguimiento de las recomendaciones de gobierno corporativo, o, en su caso, la explicacion de la falta de seguimiento de dichas recomendaciones".

[88] Art. 116 (5)

should not be considered as the sole answer to a given issue, but that they invite the board to reflect and find adequate answers to the issues identified. Therefore the codes are to be viewed more as containing a process, a search for the optimal solution, than a ready made answer. Administrative supervision can only relate to whether a code has been identified and explanation given in case a provision is not followed but without entering into the substance of that explanation. In many instances the administrative supervisor would not be able to determine whether the answer was satisfactory or even true. It cannot be the intention that on the occasion of enforcing corporate governance codes the supervisor gets involved in the actual functioning of the board of listed companies, especially as its competences are generally limited to a disclosure approach.

The subject has been actively debated in several states, but most explicitly in the Netherlands. Probably due to the fact that the code served as a response to the important cases that shook the Dutch stock market, the Dutch debate has always had a strong legal flavour.

End of 2004, a discussion took place whether the market supervisor, the AFM ("Autoriteit Financiële Markten") , would have a role to play in the follow up of the code. The AFM chairman, in a public speech held on November 2004, announced that he was considering exercising a "marginal review" of the application of the Code[89]. This was motivated by the fact that the code had been designated as a "legal obligation", and this by virtue of art 391, §§ 4 and 5, of Book 2 of the Dutch civil code. His statement provoked a rather angry reaction from a member of Parliament, who considered that the code as a self regulatory instrument developed by the private sector should not be the subject of government supervision. According to this parliamentarian the supervision of compliance with the code and of the information to be disclosed in the annual report is the task of the auditor, not of the markets' supervisor[90]. During the subsequent parliamentary debate the Minister of Justice clarified the role of both the AFM and of the auditor[91]. The AFM should, according to the minister, limit itself to determine whether the company has made reference in its annual report to the implementation of the code, and to verify whether that mention is consistent with the remainder of the annual report. The auditor on the other hand will check whether the board has mentioned in the annual report that it has complied with the code, and whether this mention is consistent with the remainder of the annual report and the financial statements[92]. It is, according to the minister, not the task of the auditor to check whether the firm has included all legally mandated information in whether the annual report or in the financials[93]. In case where the company would give no information on its compliance with the code, the auditor could mention this in his report [94]

One could conclude that both AFM and the auditor would be restricted to "external monitoring" i.e. on the fact that reference is made to the code, and that information is given in cases of non-compliance, but without checking whether that information is adequate, true or complete.

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[89] See A. Docters van Leeuwen, Wie houdt het raam schoon?, speech 13 October 2004, see AFM website

[90] See Financieele Dagblad, 1 december 2004

[91] See Meer uitleg over rol AFM en accountant bij naleving code, 1st december 2004, http://www.corpgov.nl/

[92] According to two planned laws, "wetsvoorstel toezicht accountantsorganisaties" en het "wetsvoorstel toezicht financiële verslaggeving".

[93] See "Meer uitleg over rol AFM en accountant bij naleving code", December 1st 2004, website of the Dutch corporate governance commission.: www.corpgov.nl/

[94] http://www.commissiecorporategovernance.nl/Nieuws#Nieuws_413

21. Recently it was decided that the so-called Tabaksblat Code will be monitored by a "Monitoring Commission Corporate Governance[95], the eighth members of which have been designated by the ministers of finance, justice and economic affairs chaired by Prof. Frijns. The commission will review the usefulness of the Code, and its up to date character. It will follow up the implementation of the code by the Dutch business world. To that purpose it will make an annual inventory of the way Dutch firms have respected the code, will follow up on international developments and business practice, and identify lacunae or insufficiently clear provisions of the code. It may make proposals to amend the code, without being empowered to effectively change it. From this description follows that the commission has no mandate to ensure the individual follow up of the code, nor the power to investigate whether the code has been complied with, nor further impose any sanctions.

## 5. THE PROPOSED AMENDMENTS TO THE 4TH AND 7TH DIRECTIVE.

22. Recently the EU Commission tabled a proposal for a directive amending the 4th and 7th Company law directives, and providing that listed companies should publish a "corporate governance statement", whether as part of their annual report., or in a separate report[96]. The content of the statement will be defined in the directive:

a) a reference to the mandatory corporate governance code; however a reference to a voluntary code may allowed by company law. In addition, the statement should contain "all necessary information about the corporate governance practices applied beyond the requirements under national law"[97].
b) the "comply or explain rule" for departures from a corporate governance code: This relates not only to specific provisions but to the code as a whole
c) Further information on internal controls and risk management systems; information about anti-takeover protections and on the way shareholders can exercise their voting rights.

The directive further calls for liability of the members of the boards for the corporate governance statement and by calling for penalties applicable to infringements of the implementing national provisions. Administrative sanctioning is not mentioned, but is likely constitute an effective enforcement instrument, provided it is clarified who will be entitled to impose the fines [98].

## 6. MANDATORY CORPORATE GOVERNANCE RULES - HARD LAW

23 Dealing with corporate governance as a field in which only self regulation is used would be very misleading. Governance is the product of many influences, part of them rooted in the law, others in tradition, best practices and codified conduct of business rules, while some be laid down in the companies articles of association, in contractual arrangements, and any other source of law. "Corporate Governance" necessarily is a mix of all these.

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[95] Composed of eight members, selected i.a. from business, institutional investors, academia, the audit profession. The commission is chaired by prof. Frijns, CFO of the ABP, the largest Dutch pension fund. See December 8, 2004 "Monitoring Commissie Corporate Governance Code ingesteld", website of the Dutch corporate governance commission.: http://www.corpgov.nl/

[96] See proposed art. 46 a, compromise proposal dated April 22, 2005,.

[97] This requirement seems rather unfortunate as it obliges companies to disclose what is voluntary practice thereby possibly triggering liability.

[98] See art 60 a, . compromise proposal dated June 2, 2005.

In many jurisdictions one witnesses an increasing migration from hard to soft law. This evolution which seems inevitable comes however at a price of cost, flexibility and risks. One of the advantages of the "comply or explain" approach is the possibility it offers to the company to draw up its governance according to its individual needs. By letting the best practices being transformed in hard law rules, the benefits of this evolutionary process are largely lost.

An increasing number of corporate governance rules are being including in legal instruments. It would require a very elaborate overview to list all of these, but some may be mentioned.

In France, the law on the "nouvelles regulations économiques" has introduced numerous changes on matters that would be found in corporate governance codes in other jurisdictions[99]

**Conclusion**

24. The enforcement of corporate governance codes is a complex matter. It creates a very special, and in many respects new relationship within the legal system, whereby in some jurisdictions the code can be analysed as akin to a default rule[100]: the code and all its provisions are applicable, but the company can derogate if it wants to In many jurisdictions the interplay between private and public law rules also constitutes a novum attracting intense academic interest.

Enforcement of corporate governance rules is a broader subject than enforcing the corporate governance codes: as there are many interconnections between the two, there will often be a certain mix of enforcement instruments applicable. Enforcing the codes will rely on the other instruments such as liability rules. These different levels of regulation – voluntary, charter provision, legal backing, and full legal provision – coexist and the dividing lines are unclear and are continuously shifting. The interaction between these levels should be highlighted.

In many jurisdictions the codes are voluntary, although not necessarily self regulatory: flexibility, adaptability, allowing experimentation and innovation are most of the time mentioned as the reasons for preferring voluntary instruments. Compliance is insured first and foremost by internal mechanisms: the board of directors and the management have to take responsibility for applying the code, under the guidance of the shareholders, acting individually or in the general meeting.

These codes are essentially market led, rather than self regulatory: effectiveness of their external monitoring will depend on the overall efficiency of these "markets" and on the leverage the markets can exercise. An active, investigative press can do wonders in enforcing a code provision. And active shareholders along with the increasing attention paid to governance ratings are powerful drivers for better governance. Effectiveness of these instruments will be stronger in case salient events have occurred ("scandals") but rather low for addressing formal observance, without substantive compliance.

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[99] See L 2001-420 of 15 May 2001
[100] Berg and Stöcker, nt. 25, 1571.

Outside monitoring may be considered: first one should determine what is to be monitored? Here it is useful to distinguish formal compliance from substantive one. It is widely admitted and practised that external monitors – be it the auditor, the supervisor, the regulated market, or any other body – could verify whether the company has formally declared to adhere to a code, has published its statement declaring which provisions it has not followed. A substantive review, this is whether the provisions have in fact been followed and whether the explanation for not complying is a credible one, is generally considered impossible, and creates unjustified expectations, while leading to a formalistic attitude. Where it appears that specific options should be imposed, they should be laid down in the law, and the price for the rigidity should be paid.

Formal compliance should not be considered on itself: it will support market enforcement, and where applicable legal enforcement. If markets do not necessarily value good governance, they put a negative premium on bad governance. The liability risk is not to be underestimated, while the awareness of the reputation risk is being increasingly perceived by the boards.

Is a legal backing of the code, as is the case in Germany and in the Netherlands a useful model? In order to avoid a flat refusal to apply the code, it certainly would be, but it is insufficient. Even in the two mentioned cases, the same outside monitoring remains necessary, as it offers no answer to the issue of weak implementation. It also adds very little with respect to the internal functioning of the board, what is the core of the corporate governance codes.

The law could step in and provide for appropriate sanctions. This is already the case for many specific governance rules that are part of the company laws. Should it be extended to the full range of governance rules? The American experience illustrates the burden and costs that th formally legal approach would create. But judicial enforcement is not necessarily stronger as one can witness with existing statutory governance rules. However, sometimes the law is needed to convince recalcitrant firms: the German case on director's remuneration illustrates the point. Notwithstanding many express calls to disclose individual management remunerations, business leaders continue to refuse, and the law finally has to step in.

As choices have to be made between several conflicting objectives, the preference goes to market led enforcement, but alongside with the strengthening of the internal company monitoring mechanisms. The role of the shareholders and of the general meeting deserve to be strengthened: the minority shareholders' right of action, a better voting system, with proxy or remote voting, better disclosure obligations are company law instruments that will contribute to better management of the company and to the accountability of the board. By establishing a stronger link between the market led enforcement and these internal governance instruments the overall governance system is likely to be strengthened more than by imposing formal legal requirements. Inspiration can be sought in the recent initiatives of the European Commission on shareholder rights[101].

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[101] see Fostering an Appropriate Regime for Shareholders, May 13, 2005, Second consultation.

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