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Abstract

Improving European corporate governance after Enron requires rethinking company and capital market regulation and law reforms. This article – which is an updated version (footnotes and references only, summer 2006) of an earlier one published in (2003) 3 *Journal of Corporate Law Studies* 221-268 – discusses shareholder decision-making; the choice between the one-tier and the two-tier board system; appointment, compensation and audit committees with a majority of independent members; checks on exorbitant payments to the directors; a special investigation procedure and wrongful trading. As to capital markets a European framework rule on prospectus liabilty is proposed. A key problem is the need for loyal and competent intermediaries. Since the 13th Directive is only a compromise solution, the hopes are pinned on the Court to continue its golden share case law. The German Volkswagen Act will be a test case.

Keywords: European corporate governance, company law, board structure, corporate disclosure, control by shareholders and auditors, capital markets law, corporate control, Enron, European corporate governance, 13th Directive

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Modern Company and Capital Market Problems: Improving European Corporate Governance After Enron

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* Professor and Director, Max Planck Institute for Comparative and International Private Law, Hamburg. This article was originally presented as the inaugural lecture of the Anton Philips Chair at Tilburg University on 6 September 2002. At that time, the Enron tragedy had happened hardly a year before and the Sarbanes-Oxley Act was just six weeks old. But not only this: the lecture was given before the publication of the Second Report of the High Level Group of Company Law Experts (A Modern Regulatory Framework for Company Law in Europe, Brussels, 4 November 2002). In this context, some the views expressed here were my own which were reflected later in the Group's Report; others deviated from the views of my fellow members in the Group or went further into areas not covered by the Report. For the publication in the *Journal of Corporate Law Studies*, the events and publications up to the spring of 2003 were taken into consideration. It is against this background that this article should be read. When the editors asked me to have the article reprinted in this book, it was clear that an actual updating was out of the question, since company and capital market law in Europe have developed rapidly in the meantime, as did the post-Enron law and legal literature in the United States and indeed all over Europe. It would have meant writing a completely new article, as I actually did and published at OUP in 2005 (Hopt, 2005; see also Hopt and Voigt 2005). On the other hand, leaving the article just as it was did not seem to be satisfactory either. So I chose a middle way, well aware of the delicacy of such an endeavour. Apart from a few instances, I made only minor changes in the text, in such a way that the reader could still see where, in hindsight, my assessments proved to be correct or else where law and politics in Europe moved in a different direction. But time and again I have referred in the footnotes to developments which have happened since and seem to me crucial for understanding where European Union company and capital market law is moving and why it is doing so. An earlier version of this chapter was published in (2003) 3 *Journal of Corporate Law Studies* 221–268.

I. ENRON AND COMPANY AND CAPITAL MARKET LAW IN EUROPE: THE NEED FOR IMPROVING CORPORATE GOVERNANCE

A. Financial Scandals and Legislation: The Case of Enron

IF ONE STUDIES the history of investor protection by company and capital market law since the Middle Ages,[1] the two prominent factors in shaping this history seem to be economic needs on the one side, and financial collapses and scandals on the other. Legislators seem to respond more to the latter events, the so-called bubbles. Instead of acting, they react and then very often overreact—a historical observation that supports modern public choice theory's doubts as to the rationality of regulation. Early prominent examples are the notorious South Sea Bubble in England, which led to the Bubble Act in 1720, and John Law's financial operations in Paris in the same year. Modern securities regulation—in particular the 1933 and 1934 US American blueprint, as well as the rules relating to auditors, bank and insurance company supervision, insider dealing, market manipulation, and prospectus liability—all trace their origins back to such events.

For the United States, it is beyond doubt that Enron[2] and its followers will go down in the history of American company and capital market law. Some observers have gone so far as to state that Enron will stand out as a marking point in the chronology of regulation: the time before and after Enron. The Sarbanes-Oxley Act passed in July 2002 is intended '(t)o protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws….' It contains far-reaching rules on accounting oversight, auditor independence, corporate responsibility, enhanced financial disclosure, analyst conflict of interest, and corporate and criminal fraud accountability. Some of these rules, such as the mandatory division between audit and non-audit services, have been debated for years and, for good or bad, simply would not have been passed without Enron. With others, especially the penal parts of the law and the rules on barring persons from serving as officers or directors, the legislators have once more resorted to the dubious panaceas of drastic criminal sanctions and quick professional

[1] See the survey and sources in Lehmann (1895); Hopt 1975: 15–50; 1980: 128–68; Merkt (2001); Davies (2003: 18–44); Frentrop (2003); Gepken-Jager *et al.* (2005).

[2] See Senate Committee on Governmental Affairs, The Role of the Board of Directors in Enron's Collapse, 107th Congress, 2nd Session, Report 107–70, 8 July 2002. In the meantime there has been a host of very different legal, economic, and political explanations and reactions to Enron and the ensuing Sarbanes-Oxley Act, among them Bratton (2002); Coffee (2002; 2004; this volume, ch 6); Brown (2005); Romano (2005); Davies (this volume, ch 12); Deaking and Konzelmann (this volume, ch 4).

disbarments, without giving enough credit to the mixed experiences with the prosecution of white-collar crimes and possibly even to the basic rights of freedom of profession.[3]

B. Consequences for European Company and Capital Market Law?

What follows from this for Europe? Enron and, in its aftermath, President Bush's ten-point program that led to the Sarbanes-Oxley Act, have been discussed widely all over Europe. Two irreconcilable patterns have emerged in this discussion. For many politicians as well as auditors and other professionals, Enron, WorldCom, and all the others are just an American phenomenon without direct relevance for Europe. According to them, Enron is a problem that is specific to US GAAP and so could not have occurred under the present EU or international accounting standards. Further, on this view, if there is an impact on Europe, it is in the improved chances of having the IAS/IFRS adopted universally and—what an illusion![4]—even in the United States in the form of a compromise between US GAAP and IAS. On the other side of the discussion, populist politicians who have a feel for public fears denounced 'greedy directors and crony auditors' and cried out for drastic reforms in Europe as well. Some proposals elaborated for the European Commission did run straight against the modern principles of facilitating the creation and running of companies and business and of deregulation and flexibilization of company and capital market law: proposals such as introducing outright state approval for newly formed companies or a waiting period of six months before a company can be created have been floated—as though every company were a potential vehicle for conspiracy against investors, tax fraud, money laundering, and even terrorism. Fortunately enough, these proposals were shelved very quickly.

As always, the truth lies somewhere between these extremes. Though there are major differences between the United States and 'The Control of Corporate Europe' (Barca and Becht 2001), Enron, WorldCom, and their

[3] This assessment from September 2002 reflects a widely shared feeling in Europe by 2006 which pertains not only to the Sarbanes-Oxley Act and its aftermath, but even more so to well-meaning but too bureaucratic legislative reform activities in Europe since 2003. *Cf.* for example from a Swiss perspective Zuberbühler (2004).

[4] The chances of a rapprochement have improved in the meantime, but I still do not believe in a full reciprocal recognition, as welcome as that would be. This makes the transatlantic corporate governance dialogue in the field even more crucial, both between the American and European supervisory bodies (see Hellwig 2005) as well as more broadly between practitioners and academics in the field; *cf.* The Transatlantic Corporate Governance Dialogue as started by the American Law Institute and the European Corporate Governance Institute (New York Conference on 27 September 2005).

associates are by no means just an American balance-sheet scandal; they can and should teach Europe a lesson (certainly at the latest after the fall of Parmalat (Ferrarini and Guidici this volume, ch 5) on how to act in a timely fashion—not just through reaction, perhaps even overreaction—but by well-thought-out company and capital market law reforms concerning corporate governance. There seems to be a consensus as to the need for reform in these fields, both in the Member States and at the EU level. What remains controversial is the concrete reform package, and there are a panoply of reform proposals indeed, in both fields and all over Europe.

Many Member States such as France, Germany, Italy, and others have already reformed or are about to reform their company laws and their capital market regulation.[5] The most prominent is Great Britain's upcoming centennial company law reform.[6] This is not just a reaction to certain scandals, but was prepared in such a broad, deep, and open reform discussion process that it can serve as an example for company and capital market law-making in other Member States as well.

As to Europe, the European Commission mandated the High Level Group of Company Law Experts (hereafter the Expert Group) with helping to set afloat again the 13th Directive on public takeovers and, more broadly, to come up with a vision on where the priorities of a European company law should be. In a direct reaction to Enron, the European Council's meeting on 21 and 22 June 2002 in Seville extended the mandate of the group to include:

> issues related to best practices in corporate governance and auditing, in particular concerning the role of non-executive directors and supervisory boards, management remuneration, management responsibility for financial information, and auditing practices.[7]

The Expert Group delivered its takeover report on 10 January 2002[8] and after extensive consultation[9] came up with its second report on 4 November 2002.[10] In its Action Plan of 21 May 2003, the European

[5] France: Nouvelles Régulations Economiques of 2001; Germany: KonTraG of 1998, Transparenz- und Publizitätsgesetz of 2002; Italy: Testo unico of 1998 and the reform proposals of the Mirone Commission and the Vietti Commission; see Hopt and Leyens (2004); High Level Group (2005).

[6] See DTI (2002), the Higgs Report (2003) and most recently Davies (this volume, ch 12).

[7] Presidency Conclusions, Seville European Council, 21 and 22 June 2002, SN 200/02, p. 15.

[8] High Level Group (2002a). Much—though not all—of what the High Level Group recommended in its first report was taken up by the European Commission in its draft of the 13th Directive of 2 October 2002, but the ultimate text of the 13th Directive as of 21 April 2004 deviated considerably from it by allowing options, see below Part IV.C.

[9] A summary of the comments submitted can be found in Annex 3 of the European Commission High Level Expert Group (2002b) p. 136 *et seq.*

[10] High Level Group (2002b).

Commission (2003) went along with many of the recommendations of the Expert Group.[11]

Identifying the key elements of, and most desirable reforms for, corporate governance is difficult enough, but the challenge reaches further: the fact that a rule may be good or even necessary for good corporate governance is not yet an answer to the question of whether such a rule is appropriate on the European level. This distinction is admittedly a fine one, and it has been neglected in most oral contributions to the group hearings as well as in many written comments in response to the consultative document. The group was well aware of the acute debate between the race-to-the-bottom and the race-to-the-top advocates[12] and has been carefully weighing whether rules at the European level are needed or rules in the Member States suffice. It has, for example, come to the conclusion that it is not recommendable to have one single European corporate governance code issued by the European Commission, but considers that it is better to have various national corporate governance codes that are embedded in the national corporate law and securities regulation and compete with each other.[13] This does not impede efforts of the European Commission to coordinate Member States' efforts on a non-binding basis.[14] Similarly, it has refrained from recommending a more far-reaching harmonization of core company law, for example of the duties of care of the board members or of substantive board member liability rules.[15] Instead it has singled out key areas and core rules that may seem better suited than national rules to protect investors and markets across the Member States by maintaining or raising confidence in the proper functioning of the internal market.[16] It has done so following the example of the Forum Europaeum Corporate Group Law (2000), of which I also was a member, that has rejected the idea of a 9th Directive on company groups, but has come forward instead with a number of more nuanced recommendations on European and/or national rules for specific problems created by groups in the internal market (See also Schneider 2005). Even if European rules seemed recommendable, the Expert Group preferred disclosure as a regulatory

[11] A comprehensive international discussion can be found in Ferrarini, Hopt, Winter, and Wymeersch (2004). See also Hopt (2005).

[12] See, for example, Romano (1993; 2002). At least for Europe, a more cautious position as to the workable competition of rules and regulators is rightly taken, for example, by Grundmann (2001) and by Merkt (1995). But see most recently Armour (this volume, ch 14) and Hertig and McCahery (this volume, ch 15) as well as McCahery et al (2002).

[13] High Level Group (2002b: ch. III.6).

[14] High Level Group (2002b: ch. III.6). The European Commission has convened a European Corporate Governance Forum to coordinate corporate governance efforts of Member States through a non-legislative Commission initiative.

[15] High Level Group (2002b: ch. III.4).

[16] As to the confidence argument, see Moloney (2003).

instrument to substantive rules, as described in more detail in Part III.A. Last but not least, even if European initiatives are recommended, it is open to further thought what kind of instrument is best suited—i.e., regulation, directive, recommendation, or further study by the European Commission—and what kind of priority should be given to the various initiatives. In its Action Plan, the European Commission has done exactly this and has specified the legal forms and priorities it intends to give to the various instruments proposed by the Expert Group (European Commission 2003).[17]

The host of reform problems faced in the various Member States makes rigorous selection unavoidable. Selection means focusing on what is essential and leaving aside everything else, as interesting or original as it may be. Therefore, the thesis for this inaugural lecture will be that *the lesson of Enron and the key to European company and capital market law reform* should be *the improvement of European corporate governance*. As to company law or, as some say, to internal corporate governance, in my view the focus is clearly on the board. There is a need to ensure that we have efficient, loyal, and competent boards (Part II). Of course, institutional and other rules aimed at instituting such boards are not sufficient without appropriate control mechanisms, in particular independent auditing (Part III). Corporate governance cannot succeed through company law alone, but needs capital market law rules as well. This is by no means a truism in all countries: in some, an older generation of company lawyers feels threatened by the wave of functional, market-driven, Anglo-Saxon securities regulation. Again, securities regulation or capital market law is a vast area, and so is capital market law reform. The focus of this article will be on information and intermediation problems where there is the key to investor protection and better corporate governance (Part IV). The main distinction will be between primary markets, secondary markets, and the market for corporate control. For primary market regulation, the ongoing discussion on European framework rules for prospectus liability will be picked up as an exemplary reform problem. In the secondary markets, the most urgent need of investor and investor protection is the need for loyal and competent intermediaries. As to the market for corporate control, the 13th Directive and the golden share judgments of the European Court of Justice are most relevant. The chapter will be concluded by Part V, which consists of a summary in the form of sixteen theses.

[17] On European company law, see Grundmann (2004).

II. IMPROVING CORPORATE GOVERNANCE BY COMPANY LAW: EUROPEAN RULES FOR EFFICIENT, LOYAL, AND COMPETENT BOARDS

A. Shareholder Decision-Making and the Role of the Board

The shareholders of a public company delegate the management and the control over the officers of the company to the board. This creates the well-known principal-agent problem between the shareholders and the board, and is the reason why the focus of internal corporate governance is on the board (Kraakman *et al.* 2004, 11 et s., 34 *et seq.*). This does not preclude corporate governance reform needs as to shareholder decision-making.[18] Such reforms are intricate for two obvious reasons: the average shareholder/investor is known for his rational apathy, and institutional investors tend to continue to follow the 'Wall Street rule', i.e., to move out of their investment rather than to monitor within the company. Though there are instances of internal monitoring activity by institutional investors,[19] primarily in the United States but also in Europe, and these activities should be fostered (Myners 2001: 89; Davies 2003b; see also Gerke *et al.*, Garrido and Rojo, and Garrido in Hopt and Wymeersch 2003: 357, 427 and 449),[20] the basic pattern seems to remain unchanged.[21]

Still, shareholder participation in the general assembly and voting should be facilitated as far as possible. It is at odds with corporate governance that in many listed companies, a majority of shareholders do not attend and are not represented by proxies at the general meetings. Modern technology allows much quicker and better shareholder information, communication, and decision-making. This is particularly true in the international context, where the shares are typically not held

[18] The European Commission plans to mandate a study of the consequences of an approach aimed at achieving full shareholder democracy (one share / one vote), at least for listed companies. See European Commission (2003). The concept of equality of shareholders (De Cordt 2004) and its application on the voting rights is highly controversial, politically as well as theoretically. Multiple voting rights are common in a number of Member States, in particular in Scandinavia and France. The economic argument is that the variations in voting rights are priced at the market. Nevertheless, Commissioner McCreevy has affirmed his intention to go ahead in late 2005.

[19] For the US *cf.* Romano (2001); she tries to explain why empirical studies suggest that corporate governance activism has an insignificant effect on targeted firms' performance. As to EC regulation, see Welch (2002) and the proposals of the High Level Group (2002b: ch. III.3.3). See also the contributions in Baums, Buxbaum, and Hopt (1994).

[20] The European Commission plans to require enhanced disclosure for institutional investors of their investment and voting policies through a directive. See European Commission (2003).

[21] Apart from this, the idea of agents watching agents has its shortcomings, in particular where institutional agents watching firm agents have conflicts of interest with other shareholders. See Woidtke (2002).

directly but via one or more domestic or foreign intermediaries. In many Member States, voting by company proxies has been permitted and modern technology has entered both the meeting rooms and the company laws.[22]

Facilitating participation and electronic voting is one thing. But *forcing* shareholders—even institutional shareholders—to make use of these modern facilities or even to vote at all, as is occasionally prescribed to institutional investors, is quite another thing. Such a rule could have the practical effect that the institutional votes would routinely be cast in favor of management, as we can observe in the proxy voting practice of German banks.[23] This would strengthen the board rather than enhancing control over it, apart from extremely bad situations where red lights are already flashing (and bank credits are in danger).

Despite these practical limitations, shareholder decision-making remains a basic principle of corporate governance. It is the shareholders who are the ultimate risk-bearers in the company. The creditors and particularly the employees of the company and other stakeholders have their own means to protect themselves; if not, they are to be protected by rules other than general company law rules, such as 'piercing the corporate veil,'[24] tort law, and insolvency law.[25] Labour co-determination in the board, at least in its far-reaching parity or quasi-parity German form, is a problematic exception.[26]

The apportionment of decision-making between the shareholders and the board is a classical question addressed by all company laws (Kraakman *et al.* 2004). Fundamental decisions and significant transactions, such as alterations of the company charter, mergers, and other reorganizations, are for the shareholders. Many other decisions, even far-reaching ones, are fully delegated to the board because of the advantage of a centralized management. It is true that the line between what is to be decided by the board and what should remain for the shareholders is difficult to draw and is drawn rather differently in national company laws. It suffices to mention the German judge-made

22 The European Commission intends to set up an integrated legal framework to facilitate efficient shareholder communication and decision-making (participation in meetings, exercise of voting rights, cross-border voting) through a draft directive of January 2006.

23 See Köndgen (1994). A comparative law survey on the proxy systems in Germany, the UK, Spain, France, and Italy can be found in Becker (2002). On the German financial system, see Krahnen and Schmidt (2005).

24 In Anglo-American corporate law this is seen as a general company law doctrine, while in German and other continental European laws this is considered to be part of general civil law, which applies to all kinds of legal personalities.

25 High Level Group (2002a).; See also the nuanced view of Davies (2002a: 266 *et seq.*). See generally Hansmann (1996).

26 See below II.D.

Holzmüller doctrine,[27] a godsend donation to company lawyers and company law professors because it is difficult to know in advance when a transaction is substantial enough to need the authorization of the general assembly. Nevertheless, in some critical fields, especially if the personal interests of the board are affected, corporate governance may be improved by devolving the decision to the shareholders.

Examples of two good candidates for shareholder decision-making—at least in listed companies—are the frustration of public takeover bids by the directors of the target company and payments to the directors, the latter at least as far as the framework for such payments is concerned. In these cases, the advantages of centralized management are outweighed by the conflict of interest of the board members. In its first report the Expert Group has recommended this solution for the frustration of public takeover bids, thereby following the British approach. In its second report the Expert Group considered whether European company law should also give the shareholders a role in fixing the principles and limits of board remuneration.[28] Both the European anti-frustration rule, as controversial as it is in Germany and some other countries and ultimately also under the 13th Directive of 2004, and shareholder decision-making on the principles and limits of board remuneration, seem beneficial for the European internal market: the first because of the impacts of takeovers as to synergies and disciplining management,[29] and the second because of the need to maintain public confidence in remuneration and decision- making on remuneration.[30]

B. Efficiency: Board Structure and Organization, in Particular the One-Tier/Two-Tier Board Debate and Board Committees

In public companies, centralized management by the board is the rule. It serves shareholders best, provided that the board is efficient, loyal, and competent (Kraakman *et al.* 2004; Böckli 2004: § 13). In most Member States, it is felt that not all of these three desiderata are generally fulfilled, and reform is under discussion. Efficient board structure and organization comes first, because even fully loyal and competent board members cannot fulfill their function without an adequate structural and organizational framework. As to board structure, there is an extensive and ongoing academic discussion about the pros and cons of the one-tier

[27] *Holzmüller* case, German Federal Bundesgerichtshof, *Entscheidungen des Bundesgerichtshofes in Zivilsachen (BGHZ)* (Köln Berlin, Heymanns 1982) 83, 122. Most recently the court has limited the Holzmüller doctrine.

[28] High Level Group (2002a: 27 *et seq*); High Level Group (2002b: ch. III.4.2).

[29] See below IV.C.

[30] See below II.C.

and the two-tier board system. Marcus Lutter (2000) and Paul Davies (2000) shed light on the superiority or inferiority of the German two-tier system in relation to the British one-tier system.[31] Of course, both are aware that, in practice, especially in listed companies, there is considerable convergence between both systems. But Paul Davies (2000: 455) concludes that:

> (t)he German supervisory board continues to be a rather ineffective monitor, whereas the U.K. board has not only taken on the monitoring task formally but is better placed to discharge it effectively in practice.

I tend to agree with Paul Davies, though, like him, I think less effective monitoring might be outweighed by gains in networking, and which finally benefits shareholders the most is an empirical question (Davies 2000: 453) that is hard to answer in a methodologically correct way.

As a consequence, board structure is a candidate for corporate governance reform.[32] Yet it is certainly not for European corporate governance law to make either one of the two systems mandatory, as was tried many years ago by the early draft 5th Directive. This is even more true since practitioners on both sides of the Channel—how surprisingly!—overwhelmingly believe that their own system is clearly the better one.[33]

But it would be worthwhile to introduce another European rule, namely that which requires the Member States to give companies the choice between the different systems.[34] France was the first to offer such a choice. Italy is following suit, and is even offering three models to choose from. Also on the European level, the statute of the European company has for the first time set an unexpected precedent for such a libertarian rule, though of course this is still confined to the European Company *(Societas Europaea)*.[35] The French experience was that whilst the vast majority of companies stuck to their traditional one-tier model, a significant number of listed and multinational companies preferred a structural division between management and control.[36] A European rule

[31] See also Maassen (2000). See also the Higgs Report (2003).

[32] In Germany a joint symposium of the two leading commercial and company law reviews, *ZHR* and *ZGR*, has dealt with this topic; see Hommelhoff *et al.* (2002).

[33] See Hampel (1998); Theisen (1998: 260).

[34] Hopt (1997a: 14); High Level Group (2002b: ch. III.4.1.a). As to France and Italy, see Hopt and Leyens (2004). The European Commission plans to give all listed companies a choice, through a directive, between the two types (monistic/dualistic) of board structures. See European Commission (2003).

[35] Council Regulation of 8 October 2001, OJ L 294/1, 10.11.2001, Art. 39 *et seq.* on the two-tier system, Art. 43 *et seq.* on the one-tier system.

[36] Only 4% of all public companies, but 20% of the companies making up the CAC 40-index (for example, Axa, Pinaut-Printemps-Redoute, PSA, Vivendi Universal and Aventis); see Cozian, Viandier, and Deboissy (2005: no.611); Le Cannu (2000); Guyon (2002).

requiring Member States to pass the choice between the two systems on to the companies themselves would allow the shareholders to tailor their board structure in conformity with their particular company size and market needs. It is true that German mandatory labour co-determination does not fit in easily with such a choice, but this is a particular German problem and will probably prevent the creation of any German one-tier board European companies.

Board structure extends to the questions of the composition of the members of the board. Here the labour co-determination issue comes in once more. It is well known that this issue has upheld progress in European company law harmonization for decades and has led to an uneasy compromise in the regulation of the European Company which may very well be a blueprint for dealing with this issue in future directives, quite to the detriment of German companies (Lutter 2003: 87; Hopt 1994; Pistor 1999). German-style labour co-determination also led to significant problems under the Sarbanes-Oxley Act (Krause 2003). It is telling that in the Netherlands, the traditional system of co-optation of the board under parity rights of the shareholders and labour (which anyhow never affected large multinational companies) is giving way to a more clear-cut one-third representation of labour in the board, while since 2002 in France there has been a mandatory representation of one or two representatives of employee shareholders if they hold at least three per cent of the stock. This is independent of the option for companies to appoint employees of the company as directors, at a rate of up to one-third of the total directors in office. It remains to be seen whether Germany will follow the international lead (Baums and Ulmer 2004) which has been advocated strongly by business and academia (Ulmer 2002a). Yet the chances for this under the new coalition government are slim.

In the Member States, there is also a certain tendency toward more separation between management and board. But again, this is either optional—as under the new regime in France, where the president director general no longer automatically combines the functions of Chief Executive Officer and Chairman/ President of the board—or it has been left to the codes or listing requirements, as in the UK under the Combined Code. This indicates that such a rule is no candidate for European harmonization. Quite another reform question is the role of non-executive directors, which will be treated separately in Part II.D.

As to board size and board organization, much has been improved during recent years by board reform in various Member States, though again in Germany, the matter of board size—typically twenty (!) in large co-determined companies—has proved to be a taboo for reform because of labour co-determination and the German trade unions. The German

Corporate Governance Commission, while coming up with hundreds of reform proposals, many of which are small and technical (though reasonable), has not even touched this problem, and it has been criticized for this.[37] Many of the possible improvements of board organization—such as committee structure, frequency, preparation and carrying- out of the meetings, and the role of the chairman—are not for the legislator at all but should be left either to the listing requirements of the stock exchanges or to the companies themselves. Even less should they be part of a European corporate governance rule.

A different answer may, however, be given to the question of whether European law should make audit committees mandatory. In the United Kingdom and in other countries with a one-tier board, audit committees are common. In large German companies audit committees are frequent, but overall they are much less common than in other Member States.[38] This is in part due to the two-tier system, and in part because the tasks of the audit committee are fulfilled by other committees such as the presidential committee or the finance committee. The 2002 German Corporate Governance Code recommended the establishment of such a committee by listed companies under the comply-or-explain system. In view of the two-tier board system, the German Code does not contain independence rules beyond the suggestion that the chairman of the auditing committee should not be a former member of the management board. This contrasts with the British Combined Code, according to which all or the majority of the members of the auditing committee (as well as of the remuneration and appointment committees) should be independent directors. In the United States, the American SEC already caused the stock exchanges in 1999 to require listed companies to have audit committees with special tasks and independent member requirements. In reaction to Enron, the Sarbanes-Oxley Act of 2002 further tightened the rules on public company audit committees, in particular as to their independence and responsibility.

In the light of Enron and the general confidence crisis that may also affect the internal market, there is a case for a European rule requiring listed companies to have audit committees that are responsible for the appointment (or at least the preparation of it), compensation, and oversight of the work of the auditors of the company with at least a

[37] Hopt (2002a). The recent decision of the Allianz Corporation to transform its legal form from a German corporation into a European corporation in early 2006 will have the highly welcome side effect of reducing the size of the board from 20 to 12. Labour co-determination at parity must be maintained for political reasons, but due to the future representation of foreign workers in the board, the influence of German trade unions will drop considerably.

[38] As to the board committees in Germany, see Hopt and Roth (2005: section 107 comments 228–450).

majority of independent members.[39] While the details are many and not easy to decide and should be left to the stock exchanges or listing authorities to decide, the question of independence is, of course, crucial and highly controversial.[40]

C. Loyalty, in Particular Payments to Directors

One suggestion, first made several years ago, is that the duty of loyalty of directors—in contrast to their duty of care—might be a good candidate for European harmonization (Tunc 1991: 211 *et seq.*). The argument brought forward is that virtually all company laws contain the duty of loyalty in one way or another, and that loyalty is an absolutely essential requirement for board members, as indeed for all agents. Yet this suggestion raises doubts for a number of reasons. On closer inspection, the extent to which the duty of loyalty is developed in the various Member States is very different. In general, it can be said that in the United States and the United Kingdom, the duty of loyalty and more generally the critical appreciation of conflicts-of-interest situations are highly marked, while in Germany, France, and some other civil law countries, this is much less so.[41]

Furthermore, while the principle of loyalty is generally agreed upon, the case situations of conflict of interest are manifold[42] and their treatment may be highly difficult and controversial indeed, in particular in groups of companies as well as in takeover situations.[43] It is true that the UK company law reform shows that the basic principle of how to treat transactions involving conflicts of interest can very well be codified.[44] But the details are still best handled by case law.

Finally, it would be odd to have a European company law rule dealing with the duty of loyalty while leaving aside the duty of care and other general principles by which directors are bound,[45] though in the vast majority of cases they are practically more relevant even if there is a business judgment rule.[46]

[39] The new European auditing directive, which is expected to be finally adopted in 2006, will require companies of public interest to have such an audit committee. While this would be mandatory, there is the recommendation of the Commission of 15 February 2005, according to which listed companies should have three key committees, namely for nomination, remuneration, and audit.

[40] See more detail in the context of independent directors below II.D.

[41] See Hopt (1996a: 917, 921 *et seq.*); Kraakman *et al.* (2004: 101 *et seq.*, 128 *et seq.*).

[42] Hopt (1985); Enriques (2000); Hopt and Roth (2005: § 100 comments 131–98).

[43] See Hopt (2002b) and more generally Hopt (2004).

[44] Schedule 2 para 5 of the British draft Companies Bill (DTI 2002).

[45] See Schedule 2 paras 1 *et seq.* of the British draft Companies Bill (DTI 2002).

[46] As to the hidden differences between the US and the German business judgment rules, see Hopt (1996a: 919 *et seq.*). In Germany the business judgment rule has been codified in 2005 in section 93 of the Stock Corporation Act.

These arguments do not hold for the payment of directors (Bebchuk and Fried 2004; Bebchuk, Fried and Walker 2002). There is no need to mention the many scandals that have come up in many of our countries and have been denounced at length in the financial press. For Germany, the 30 million Euros that the remuneration committee of the supervisory board of Mannesmann granted to the outgoing chairman of the management board, Klaus Esser, after the takeover by Vodafone was cleared continues to stir up public concern and envy. Because there is no way for single shareholders to attack this payment via a derivative action under present German company law, the case has been denounced to the public prosecutor, a criminal proceeding was started against the remuneration committee members for embezzlement of company assets, and after the 21 December 2005 decision of the Bundesgerichtshof which reversed the acquittal a final conviction has become rather probable. Although it has been observed with some justification that German society—in stark contrast to American society and much more than many other European societies—is an envy society, it is obvious that stock options and other forms of management remuneration open the door for exorbitant payments, which are of concern to the general public and threaten to make the whole system untrustworthy. This is of concern to the European internal market, too, since such payments tend to undermine the confidence of the shareholders and their willingness to invest in domestic and foreign companies. In conformity with its extended mandate, the Expert Group recommended European rules on management remuneration for listed companies,[47] and in the meantime the European Commission has come out with its recommendation of 14 December 2004. Three types of European rules may be particularly relevant: disclosure, shareholder decision-making, and accounting for share-based remuneration (on these proposed rules, see Hopt 2005,133–37; see also generally Ferrarini and Moloney 2004; as to accounting, Crook 2004)

D. Loyalty, Competence, and Non-executive Directors

As we have already seen, it is hard to find appropriate rules that define and solve the problem of board loyalty, particularly in cases of conflicts of interest. One way out may be to have persons on the board who are not subject—or are less subject—to such conflicts, i.e., independent non-executive directors. Indeed, in the last decades, in particular in the United States and in Great Britain but also in other countries, there has been a marked movement toward having non-executive directors on the board

[47] High Level Group (2002b: ch.III.4.2).

and especially on its key committees, though the initial enthusiasm for outside directors has been somewhat dampened, since no clear correlation has yet been found between having independent directors and firm welfare.

This tendency toward independent non-executive directors is less marked in countries with a two-tier board system such as Germany, because this system as such provides for mutual exclusivity of membership of the two boards. In Germany, therefore, some argue that the supervisory board members are per se outside or non-executive directors. Of course, this is only true insofar as there is a mandatory separation between the management board and the supervisory or control board, which both have to be comprised of different persons. But this neither precludes, as often happens, the movement of a former chairman of the management board into the supervisory board after retirement—typically assuming the role of chairman—nor does it touch upon the question of financial relations between the supervisory board members and the company. It is telling that the German Corporate Governance Code recommends only very cursorily that at any time the board must also comprise members who are sufficiently independent, and that no more than two former members of the management board should be members of the supervisory board.[48] As to the auditing committee, it contains the statement that the chairman of the auditing committee should not be a former member of the management board, but this statement is only a suggestion, not a recommendation for which the comply-or-explain rule would be valid.[49]

Attempts to formulate a European mandatory rule on non-executive directors are faced with two major difficulties: ensuring competence and ensuring independence.[50] The first difficulty is the trade-off between loyalty and competence. While non-executive directors do not face the same conflicts of interest as executive directors, they may be less familiar with the company's affairs and, depending on who is ineligible and who remains as a candidate, less competent than executive directors. This is already the case for many supervisory board members, particularly under labour co-determination. It may become even more so for non-executive directors if strict independence requirements are set up, although the problem is less pronounced in a one-tier board system, where non-executive directors are members of the same board and so

[48] German Corporate Governance Code 5.4.1, 5.4.2. For details, see Hopt and Roth (2005: § 100 comments 184 *et seq.*).

[49] German Corporate Governance Code 5.3.2.

[50] The European Commission has shied away from a mandatory rule by means of a directive and instead adopted a recommendation as of 15 February 2005. See also High Level Group (2002b: ch. III.4.1). On the recommendation, see Hopt (2005: 133 *et seq.*).

have better access to information. Therefore, ensuring competence becomes a real problem.

The tradition of directors' ex post liability does not help—certainly not under the traditional[51] English subjective standard of care, nor even under the objective Continental standard—if one takes into consideration the business judgment rule and, apart from this rule, the reticence of judges to interfere with the directors' business decision in liability suits.[52]

One possibility would be a rule requiring all directors to be competent or 'fit and proper,', similar to the regulation for bank and insurance company directors, but leaving the responsibility for checking competence with those who nominate the directors because of the lack of an authority corresponding to the banking or insurance supervisory agencies. Specifying what competence involves—for example, being able to read balance sheets or demonstrating 'financial literacy'—could help, but it may unduly restrict companies' choice of directors. Not all board members need to have financial expertise. Others might bring valuable experience, and others yet may simply have a talent for the business and for monitoring its conduct. Moreover, different businesses may benefit from different directors. The German Corporate Governance Code recommends that at any time, the supervisory board should comprise members who have the knowledge, skills, and experience necessary for fulfilling its tasks.[53] It seems that the commission which drafted the Code was not aware of how awkward this formula was, or that it may just have made allowances for labour co-determination: what it actually says is that it is enough if one or two members have the said faculties, while all the others do not need to have the knowledge, skills, and experience necessary to fulfil the board's tasks. What are they paid for then?

A way out of this dilemma may again be disclosure, that is, a rule requiring the company to disclose why each non-executive director is considered competent or fit and proper for his office, and to require the authority competent for listing on the stock exchange.

A better solution might be to require competence, but to give the listing authorities or stock exchanges the mandate to concretise this and to ask for training, including continuous professional education as in other professions. In addition to this, as mentioned before, the non- executive directors should have access to appropriate outside professional advice

[51] Over the past 10 years the standard has become somewhat more objective and there are now reform plans to change to an objective standard.

[52] See the figures for Germany in Hopt (1999: § 93 comment 16 *et seq.*), and in more detail in Ihlas (1997). As to the relationship between the business judgment rule and directors' liability, see M. Roth (2001).

[53] German Corporate Governance Code 5.4.1.

and to internal information from the company, as the British Combined Code requires.[54]

An even greater difficulty is independence. The concepts of what 'independence' is meant by and who or how many of the directors should be independent in the sense of the relevant rule differ widely. In the United Kingdom, for example, the Combined Code requires that at least one-third of the board as a whole should be non-executive directors, most of whom should be independent. Independent is defined as 'independent of management and free from any business or other relationship with the company which could materially interfere with the exercise of their independent judgment.'[55] Non-executive directors should be the only members, or a majority of the members, of the audit, remuneration and appointment committees. These requirements of the Combined Code strike a convincing balance between the necessity of having at least a majority of disinterested members in the three key committees, particularly in the audit committee, while leaving the necessary flexibility concerning the board as a whole.

Yet as a European rule for all Member States, this creates considerable difficulties for countries with labour co-determination, in particular for Germany.[56] In large companies there is a delicate ten to ten (in coal and steel industry ten to one to ten) balance in the board between capital and labour. If the independence requirement of the Combined Code were applied solely to the ten shareholders' representatives, this would weaken the shareholders' voice in the supervisory board even further. If the independence requirement is also applied to the labour side, as in the Netherlands, this would be even worse for the shareholders because the consequence would be weakening the voice of the employees, who know the company best and have a keen interest in its prosperity, for the sake of their own jobs and salaries. Instead, even more labour union representatives would move in, with interests that do not necessarily coincide with those of the particular company. Of course, it could be said—and is said by many in Germany (Ulmer 2002a: 271)[57]—that the actual regime of

[54] Combined Code, para A.1.3; Davies (2000: 440 *et seq.*).

[55] Combined Code, para A.3.2; Davies (2000). Compare also the Sec. 301 of the Sarbanes-Oxley Act with the new Sec. 10A(m)(3) of the Securities Exchange Act of 1934 defining independence for each member of the audit committee: 'may not ... (i) accept any consulting, advisory, or other compensatory fee from the issuer; or (ii) be an affiliated person of the issuer or any subsidiary thereof.'

[56] See the heated discussion in Germany on the Sarbanes-Oxley Act's independence requirements, which might be irreconcilable with German labour co-determination; *cf.* Institut der Wirtschaftsprüfer/Wirtschaftsprüferkammer (2002: 594). The former German Minister of Justice even protested that the American Act is being applied extraterritorially. This has been rightly refuted. For details, see Lanfermann and Maul (2002).

[57] But see also Davies (2002a: 274).

paritary labour co-determination in Germany is dated anyway, or at least needs to be overhauled. But this is not for the European Union to decide.

It might, therefore, be better to content oneself with a broader European principle[58] according to which, first, the board as a monitoring body should be independent of management and, Secondly, in the audit, remuneration, and appointment committees there should be at least a majority of members also independent from the company, in the sense of the Combined Code. Again, disclosure could help, i.e., a rule requiring the company to disclose which members it considers to be independent. In addition, these members should also file a personal declaration that they are (and continue to be) independent.

European rules for an efficient, loyal, and competent board as discussed so far may enhance corporate governance. But they need to be backed up by control and enforcement. Law in action is needed, not just law in the books. The experience with rules relating to the board, including liability rules, teaches that more than one control mechanism is needed, i.e., control from inside and from outside the company. In the next part, therefore, I shall briefly discuss three such mechanisms: control by the market via disclosure, control by the shareholders via better investigation and liability suit rules, and especially control by appropriate auditors.

III. CONTROLLING THE BOARD FROM INSIDE AND OUTSIDE: MARKETS, SHAREHOLDERS, AND AUDITORS

A. Control by the Market: The Case for Disclosure

Disclosure to the shareholders and to the market has long been a key mechanism in company and capital market law. The forerunners in company law were the Gladstonian reforms of 1844 and 1845. One hundred years later the US securities regulation of 1933 and 1934 gave the world a blueprint for the use of disclosure in securities regulation. Brandeis' dictum that the sun was the best disinfectant already had an early precedent in 1837 from the famous Prussian reformer Hansemann (1837: §109 at 104; Davies 2003a: 590 *et seq.*), who said:

> Among the means by which the management of a large company limited by shares can be kept law-abiding and efficient, is to be counted that it must be exposed to a certain degree to the public. This is the most effective control.

[58] See now in the same sense the recommendation of the European Commission of 15 February 2005.

Disclosure is also a powerful tool for improving corporate governance in Europe.[59] First and foremost, this type of regulation is most compatible with a market economy because it interferes least with freedom and competition of enterprises in the market. This is particularly relevant when, as seen before, there is considerable uncertainty and difference of opinion as to what the correct rules for European corporate governance. Under such circumstances, disclosure allows for greater flexibility, and in a way, can function as an experimental tool before the imposition of substantive legal provisions. Disclosure also avoids the well-known petrifying effect of European substantive law (Buxbaum and Hopt 1988: 241 *et seq.*).

It is true that there is considerable theoretical controversy as to the effectiveness of disclosure in efficient capital markets. Yet in reality, capital markets may not be that efficient; otherwise, Enron could hardly have happened the way it did. There is no need to go into the various forms of the efficient capital market theories here and to argue why the 'strong form' may be less than convincing. It suffices to record that modern theory justifies mandatory disclosure by its function of facilitating and enhancing corporate governance. According to this theory, corporate governance—not investor protection—provides the most persuasive justification for imposing on issuers the obligation to provide ongoing disclosure (via shareholder voting, shareholders enforcing management's fiduciary duties and capital allocation) (Fox 1999; Hopt 2001: 260).[60]

Some examples of how to promote corporate governance by disclosure have already been mentioned. If one accepts that shareholders of listed companies should have a say in the frustration of public takeover bids by the directors of the target company and in the principles and limits of payments to the directors, it is obvious that they need full disclosure in order to be able to make an informed decision of their own.[61] Disclosure may also be a useful tool for dealing with the problem of competence and independence of board members.[62]

The Expert Group has recommended that listed companies be required to disclose fully their capital and control structures, in particular possible defensive structures established in the company, in order to enable the market to react with discounts and a higher cost of capital.[63] The Expert

[59] The European Commission plans enhanced corporate governance disclosure requirements and increased disclosure of group structure and relations, both financial and non-financial, through directives amending existing legislation. See European Commission (2003). As to disclosure in securities regulation, see below IV.A.

[60] See more generally the comparative and interdisciplinary study by Fleischer (2001).

[61] See above II.A.

[62] See above II.D.

[63] High Level Group (2002a: 25 *et seq.*); see also SWX (2002: 18 *et seq.*) and Hofstetter (2002: 29 *et seq.*).

Group has gone further and recommended that listed companies should be required to describe briefly the key elements of their governance structure and practices, whether they arise from mandatory law, default provisions, articles of association, or whether they are based on particular codes.[64] In the answers to the questionnaire, there was overwhelming consent for using disclosure to improve corporate governance. Examples of what could be disclosed in this context include the following: major shareholders of the company; shareholders rights, especially minority rights; appropriate information about the board and the auditors, in particular as to their independence and remuneration; the risk management system within the company, etc. Disclosure should not be restricted simply to financial information, but should be extended to qualitative disclosure. A checklist of what to disclose should be developed, and presentation in one comprehensive statement could be required in order to help shareholders compare and evaluate companies throughout the internal market based on their corporate governance system.

Of course, non-disclosure and, even more, false disclosure must have consequences for the directors.[65] The Sarbanes-Oxley Act provides for drastic sanctions, both criminal and civil. As mentioned before, there are considerable doubts about the sections on criminal accountability. The most stringent civil sanction is forfeiture of certain bonuses and profits under section 304. Forfeiture is mandatory if the issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer, as a result of the misconduct, with any financial reporting requirement under the securities laws. If this is the case, the CEO and the CFO of the issuer shall reimburse the issuer for the amount of any bonus or other incentive-based or equity-based compensation received from the issuer during the last 12 months, and for any profits realized from the sale of securities of the issuer during that 12-month period. In my view, this rule as it is presently phrased is far too strict in its automatism and rigour and might not stand up to constitutional scrutiny in certain Member States of the EU. But it is true that it provides a powerful sanction that could also be considered as a European rule if there is not an automatic forfeiture, and if the individual contribution of the director to the non-disclosure and false disclosure can duly be taken into consideration.

[64] High Level Group (2002b: ch. III.2). The key items to be included in the annual corporate governance statement are listed un *ibid.*, 46 *et seq.*

[65] The European Commission plans confirmation of collective responsibility of board members for key non-financial statements through a directive amending existing legislation. See European Commission (2003).

B. Control by the Shareholders: Investigation and Liability

Control by mere disclosure may not be enough. Not only may disclosure not be observed, but the facts may be so complicated that they just cannot be grasped and understood easily by the shareholders and by the market. This is particularly the case for international groups with complicated structures.[66] The case of the BCCI insolvency, which led to the so-called 'BCCI Directive' of the European Union of 29 June 1995, on better supervision of banks, insurance companies, and investment firms,[67] gives an excellent example of how difficult it is for markets—as well as for supervisory agencies—to evaluate the dangers inherent in complicated international group structures. Under European bank supervisory law, the need to organise enterprises and group structures of the said enterprises in a way that complete, consolidated supervision remains possible has been clearly articulated.[68] Such requirements do not exist for all companies apart from banking, insurance business, and investment services. But it is clear that the shareholders of companies other than the latter may have to cope with similar difficulties as the supervisory agencies in the said special enterprise sectors. This is truer still when there is a suspicion that the management of the company or of its parent company has behaved incorrectly.

For such cases, the special investigation procedure is a means of shareholder protection that is provided for in many Member States, such as Germany (since 1897), France (*expert de gestion* since 1966), the United Kingdom, the Netherlands, Belgium, Denmark, and others outside the EU such as Switzerland (Forum Europaeum Corporate Group Law 2000: 207 *et seq.*) The core provisions are rather similar, but the details vary considerably. There are also clear differences as to the actual frequency of such special investigation procedures in the various states. In some they are quite rare, as in Germany and Switzerland, while in others they are more frequent; in some, such as the Netherlands (Germoth and Meinema 2000), the experience is definitely positive. Yet in most, even when there are only a few cases, there tends to be agreement that this is an instrument of considerable protective importance that performs a preventative function in the hands of minority shareholders. Usually the special investigation may be ordered by the general meeting or by a court on the application of a minority of shareholders of ten or five per cent, or even of one single shareholder alone. The investigation as such is

[66] The European Commission plans increased disclosure of group structure and relations, both financial and non-financial, through a directive amending existing legislation. See European Commission (2003) and later draft instruments.

[67] Directive of 29 June 1995, OJ L 168/7, 18.7.1995.

[68] Preamble 58 of the Consolidated Bank Supervision Directive of 20 March 2000, OJ L 126/1, 26.5.2000.

conducted by the court or an administrative body or by a professional under its supervision. Recently, the president of the German Federal Agency for Financial Services Supervision, which has no authority to supervise the auditors, has suggested that the agency be empowered to institute a special investigation if the balance sheet of a listed company is seriously flawed. A special investigation of the company organs was also envisaged for the European company in the draft statutes of 1970 and 1975. In the later—watered-down—versions, this rule was omitted. The Forum Europaeum Corporate Group Law (2000: 216 *et seq.*) has already suggested that there should be a European rule on this, albeit only a framework rule that would leave it to the Member States to fit the special investigation into their particular procedural laws. The Expert Group came forward with a similar proposal in its questionnaire and received much support for it in the answers it received. Indeed, as one British observer (Davies 1997: 701) remarked, the special investigation seems 'to be the most effective method yet devised to detect corporate misconduct and to bring to book the perpetrators of it'.[69] In a single market the special investigation seems to be indispensable, not only for companies active across borders, but for reasons of fair competition for all others as well. The European Commission agrees to this.[70]

A successful special investigation can serve as a basis for a court claim, and indeed in some countries the two sets of proceedings are closely linked. This leads to the issue of the liability of directors. All Member States have rules on directors' liability. Yet these rules vary enormously from one State to another, both in the company acts, and even more in their practical application. Relevant as general directors' liability rules may be for corporate governance, there is little chance of successfully harmonizing these rules, or even simply the core of them. Under the aspect of better corporate governance, such harmonization may not even be desirable because, as mentioned before, the business judgment rule that was developed in an exemplary way in the United States has already become, or is becoming, part of the company law of many Member States. It serves as a safe harbour for the business behaviour of directors, provided certain requirements concerning information and other issues are fulfilled. Therefore, harmonizing these rules may lead to less rather than more liability of directors (this should not be understood as a critique of the business judgment rule, which is vital for entrepreneurial behaviour and therefore serves the interests of the shareholders themselves).

[69] See High Level Group (2002b: ch. III.3.4).

[70] The European Commission plans to enhance the responsibilities of board members by a special investigation right through a directive or a directive amending existing legislation. See European Commission (2003). More specifically, the draft Auditing Directive includes a framework rule on special investigations and sanctions concerning insufficient audits.

This reserve in implementation does not, however, extend to certain rules creating a special liability for directors, namely the United Kingdom's 'wrongful trading' and the French and Belgian *action en comblement du passif*. Under these and similar concepts, the directors of a company may be held liable for parts of or all the outstanding debts of the insolvent company if they have not checked in time whether there are enough chances to keep the ailing company afloat. Once again, the details of the Member States' laws vary considerably. In some countries, the rule applies not only to the independent company, but, via the concept of the '*de facto*' or 'shadow' director of the subsidiary, also to the parent company in a group. Again, the Forum Europaeum Group Law (2000: 246) has made proposals for harmonization. The Expert Group shares this view[71] and the European Commission agrees.[72] The beauty of the rule consists in the fact that the law does not interfere with the ongoing business decisions of the directors. The business judgment rule remains fully intact. Yet the directors act at their own risk if they continue to do business for a company in crisis. If they foresee that the company will not be able to pay its debts, they must either try to rescue the company or put it into liquidation. Otherwise they may be held liable. Having a European framework rule on wrongful trading could be a considerable improvement for the functioning of companies and groups of companies.[73]

The action for wrongful trading or the *action en comblement du passif* would be brought by the official receiver in the bankruptcy proceeding. The problem of shareholder passivity or of shareholders not having the standing to sue does not exist in the case of this specific directors' liability suit. This is quite different for other cases of directors' liability. As stated above, the actual frequency of liability suits in the Member States varies considerably, sometimes despite the fact that the relevant company law provisions are the same or rather similar. The reason for this is differences in the standing of individual or minority shareholders and other

[71] High Level Group (2002b: ch. III.4.4, ch. IV.4).

[72] The European Commission plans to enhance the responsibilities of board members by a wrongful trading rule through a directive or a directive amending existing legislation. See European Commission (2003).

[73] See the reasons and citations given in *ibid.* It is true that there are few wrongful trading cases in the UK, and some observers doubt whether this would be a good candidate for export, for example Wood in a conference of the *Zeitschrift für Unternehmens- und Gesellschaftsrecht (ZGR)* on 13 January 2006 in Kronberg. Yet Wood and other City practitioners agree that liability for wrongful trading is indeed a major deterrent in practice once the survival of a company becomes doubtful. Apart from this, a European rule would not necessarily have to adopt the UK wrongful trading rule as it stands, but could shape it in a way to give it more teeth. *Cf.* Fleischer (2004: 393 et seq). On the other side, a European framework rule allowing the implementation of a group's policy might be helpful; see High Level Group (2002b: ch. V.3). The European Commission agrees and plans a framework rule for groups, allowing the adoption at subsidiary level of a coordinated group policy. See European Commission (2003).

procedural law rules. Of course, this is even truer in comparison to US law, the homestead of the derivative action and the class action. Therefore, it is hardly surprising that in civil law countries as well, including Sweden and most recently Germany, there has been research on whether the US and Canadian experiences could also be useful on this side of the ocean.[74]

As mentioned before, the fact that a rule is relevant for better corporate governance is not enough to recommend a European rule. Furthermore, we have said that European harmonization of directors' liability is not—or at least not yet—advisable. But things may be different for a procedural framework rule. It is true that liability is not a panacea, but it is one important building block of corporate governance. Liability may be less relevant for violations of the duty of care due to the business judgment rule, but it is certainly most relevant for violations of the duty of loyalty. As to such violations, including, as seen above, exorbitant payments to directors, there must be an effective means of control and sanctioning. The instrument of wrongful-trading liability may not be of much help in this respect because not all violations of directors' duties, in particular of the duty of loyalty, are bound to end up in the insolvency of the company (though in a number of the American cases which stood at the outset of this lecture this was ultimately the case). Nevertheless, the confidence of investors and creditors is most disturbed by such violations.

This might be a reason for recommending European framework rules on directors' disqualification[75] and on facilitating the bringing of an action for holding directors (and auditors) liable. The details of such a rule should be left to the Member States. They may approach the problem quite differently, be it through a derivative action of each shareholder or a small majority of shareholders, opening the possibility for bundling shareholder actions, introducing a kind of company and capital market class action,[76] or, last but not least, by giving the courts or a supervisory office the right to disqualify a person from serving as a director of companies (across the EU)[77] and to initiate restitution proceedings against a director (Fleischer 2002: F 115 *et seq.*).

[74] See the Hamburg Max Planck Institute study commissioned by the German Ministry of Justice: Basedow, Hopt, Kötz, and Baetge (1998). See also the comments by Koch (2001) and Stadler (2002). In August 2005 Germany introduced a statute allowing the bundling of capital market law actions insofar as the same issues are at stake.

[75] The European Commission plans to enhance the responsibilities of board members by a rule on directors' disqualification through a directive or a directive amending existing legislation. See European Commission (2003). *Cf.* Fleischer (2004: 408 *et seq.*); on the mixed British experience with disqualification, see also Ferran (2004b: 427 *et seq.*).

[76] See Hopt and Baetge in Basedow *et al.* (1998: 47 *et seq.*).

[77] Because of the constitutional problems, further review by the European Commission is needed; see High Level Group (2002b: ch. III 4.5).

C. Control by the Auditors: The Conflict-of-Interest Problem

The third and most prominent control mechanism is control by the auditors. There is no need here to reiterate the central role of the auditors for checking on companies' accounting and reporting, nor to describe their functions under company law. Important parts of this have already been harmonized by the 4th, 7th, and 8th Directives of 1978, 1983, and 1984. Since the mid-1990s, the European Commission has been preparing further action. In 1996, the 'Green Book' on the role, position, and liability of the statutory auditor within the European Union was published. In 1998, the European Commission made a communication concerning its future plans on auditing. On 16 May 2002, the lengthy Commission recommendation on the basic principles of auditors' independence in the European Union was passed. In the light of Enron, it is common opinion that all this is not sufficient. In many countries, dramatic failures and financial scandals have appeared without previous notice by the auditors. In some instances, only months before auditors had still given their certification of the financial statements of the company without any limitation. The watchdogs have just not barked. As a consequence, public confidence in accurate and impartial auditing has fallen dramatically. The auditing profession in the United States as well as in the European countries is well aware of this so-called expectation gap, which seems to be the most serious crisis in the profession since the international economic crisis in the 1930s. There is a consensus that legislators must react—not only those of the Member States, but also those of the European Union. The American Sarbanes-Oxley Act has come forward first with far-reaching reforms concerning auditing standards, quality control standards, rules of incompatibility between auditing and non-auditing services, audit partner rotation, conflicts of interest, and a study on mandatory rotation of registered public accounting firms.[78] Many of these reform proposals, including harsher auditors' liability and possibly also third-party liability, are discussed in many Member States as well as in the European Union (Kalss 2002). In the context of prospectus liability, which will be covered in Part IV.A, auditors' liability is also under discussion (Fleischer 2002: F 66).[79] This is not the place to deal with the role, tasks, and professional duties of the auditing profession in general. Only four reform measures that are possible candidates for a European rule shall be picked up and briefly treated:

[78] Sarbanes-Oxley Act Secs. 103, 201 *et seq.*

[79] The draft auditing directive which is expected to replace the 8th Directive in 2006 contains a provision requiring the Member States to have effective, reasonable, and deterrent sanctions for auditing failures, though it leaves it to the Member States to have civil, criminal, or administrative law rules on this.

appointment and remuneration of the company auditors by the auditing committee; the requirement of admission of auditors of listed companies by the financial supervisory authority; incompatibility between auditing and non-auditing services; and mandatory rotation like, for example, in Italy and in the future in Austria.

The first reform measure has already been mentioned above in the context of the auditing committee. While, for example, in Germany the auditors for the financial statements are chosen by the shareholders, it should be the task of the audit committee, not of the board, actually to appoint the auditors of the company and, more important, to decide on their remuneration.[80] This is clear for the one-tier board system because only the auditing committee is to consist fully or in its majority of independent members. In the two-tier board system, the nomination and the remuneration of the auditors is usually up to the supervisory board as a whole, though this task may be delegated to the auditing committee if such a committee exists. Such delegation is also recommended by the German Corporate Governance Code.[81] In view of the critical independence question mentioned above, the European rule on the auditing committee and the independence requirement for it should also reserve the decisions on the appointment and the remuneration of the auditors of the company to the auditing committee.

Furthermore, in the case of listed companies, the auditors should be required to be admitted by the financial supervisory authority. In a sense, the auditors of a listed company perform a financial service with clear relevance for the investors and the capital market. The admission and continuous control by the financial supervisory authority is just the logical consequence. Introducing such a European rule would have the additional advantage of mutual assistance and international supervision by the Member State agencies. This would clearly benefit the internal market.

Incompatibility between auditing and non-auditing services has long been a highly controversial issue. In the United States, the question is now decided by the Sarbanes-Oxley Act, and there is a good chance that it will be decided the same way in some European countries. Yet it may still be premature to recommend a mandatory European rule on auditor incompatibility. In several Member States there are still committee inquiries going on as to whether the advantages of such an incompatibility as to independence outweigh the disadvantages for the profession. This should also be done at the European level if such a rule is

[80] As to auditing practices and the tasks of the audit committee, see High Level Group (2002b: ch. III.5).

[81] German Corporate Governance Code 5.3.2.

considered. It is well known that auditing is financially much less rewarding than certain non-auditing services. If separation becomes mandatory, the question on how to secure adequate auditor remuneration becomes urgent. Already, 'low- balling,' i.e., the ousting of a competitor by considerable remuneration cuts, and even auditing activities without cost-covering is occurring as more than an exception. A determination should also be made of what consequences mandatory separation has on the market for the different services and on possible economic concentration. In the end, it may very well be that the better arguments are for separation, especially because the leading auditing firms active in the United States as well already had or have no alternative to separation now. But this needs to be prepared with caution and decided upon in full knowledge of all relevant facts and consequences.

Finally, another far-reaching reform measure is mandatory rotation of the audit partner, as well as of the audit firm. Again, the pros and cons of such a mandatory rule must first be established before it can be recommended. The benefit of mandatory rotation for more independence of the auditor from the company may be outweighed by the disadvantage of a loss of information and intimate knowledge of the company affairs as a consequence of the rotation. This could be particularly relevant if a company is already ailing. According to statements from the profession, in complicated cases and group structures, the new auditing firm may need a year before it becomes fully acquainted with the internal affairs and pitfalls of the company.[82]

D. *Quis Custodiet Custodes?*

Trust in the auditors is not enough. The perennial question continues to arise: who is watching the guardians? This is a highly complicated issue that cannot be treated here. In the international discussion, three models[83] stand out: peer review and supervision by the self-regulatory bodies of the profession itself; external quality control and supervision by a supervisory body (wholly or predominantly) consisting of professionals other than auditors and independent from the auditing profession; and supervision by a state supervisory agency, either the financial services supervisory agency or a specialized state body under the supervision of the former. It is certainly not the task of the European Community to decide this question. Different traditions in the various Member States

[82] *Cf.* also Arruñada and Paz-Ares (1997).

[83] Apart from the particular French system of the 'double commissariat,' i.e., of having a full double-check by two auditors. This is a rather far-reaching and costly system. But the French stick to it; see Rapport Bouton (2002: 18).

and path dependencies must be respected.[84] A single rule for all Member States is neither appropriate nor in sight.

IV. IMPROVING CORPORATE GOVERNANCE BY CAPITAL MARKET LAW: INFORMATION AND INTERMEDIATION PROBLEMS

A. Primary Markets: Toward European Framework Rules for Prospectus Liability

Corporate governance is not just a matter for company law, but also for capital market law, namely, securities regulation. Control of the board by the market via disclosure has already been touched on in the discussion above concerning mandatory disclosure of corporate capital and control structures.[85] But shareholders are protected by markets more generally: indirectly by competitive product markets; and much more directly by the capital markets, both primary and secondary as well as the market for corporate control. If a company needs fresh equity finance, its investors may hesitate to provide additional equity if the board is known for not paying enough attention to shareholders' interests, a reaction which will be anticipated by the board. The law may contribute to this corporate governance function of the primary market for securities of the company. The two key problems the law has to cope with are information and intermediation. Intermediation problems, in particular the conflicts-of-interest problems of various intermediaries, are more prominent in the secondary market and will be treated there,[86] though they are present also insofar as the issuer and the underwriters as distinguished from the actual investors are concerned. As to information, primary market law may help to alleviate the information asymmetry between the different sides of the market. On the European level, this is what the prospectus directive tries to achieve.

This is not the place to go into more detail on the well-known controversies about the reform of the Prospectus Directive which was finalized in November 2003.[87] These controversies concern, among others, the issuers concerned (exceptions for small and medium enterprises), the form and content of the prospectus (choice between one or two prospectus documents, information to be disclosed, continuous disclosure, etc.), and the prospectus regime of the supervisory authority of the state of origin or of the place where the securities are issued and a

[84] See Hopt (2002c: 183 *et seq.*). See also Esty and Gerardin (2001).
[85] Above Part III.A.
[86] See below Part IV.B.
[87] Prospectus Directive of 4 November 2003, OJ L 345/64 31.12.2003 fin.

possible choice of the issuer as to this supervision (Moloney 2002; Ferran 2004). As mentioned before, controversies also exist more fundamentally in economic theory as to whether mandatory prospectus disclosure is really necessary.[88] The arguments for prospectus disclosure are in essence the same as for disclosure in general: the lack of fully developed capital markets in the European internal market; the limited role of institutional investors who might have the market power to bargain for economically efficient market conditions, which then are available also to the investors in general; the historical experience of securities fraud, in particular with issuance and at the primary markets; and, more generally, the nature of information about the issue and the issuer as a public good.[89]

If one considers that a European prospectus is of key relevance for the internal market as a European passport for issuers and an essential means for shareholders to get the information they need to make their investment decision and thereby promote corporate governance, it is of course essential that the European prospectus be true and fair. A prospectus requirement goes hand-in-hand with prospectus control and prospectus liability. Among many regulatory problems concerning the primary market and its function for corporate governance, prospectus liability merits some remarks because it is new for European law.

The former Stock Exchange Prospectus Directive of 1980[90] did not contain a rule on prospectus liability; instead, it considered this to be a matter for the Member States. So did the Directive of 1989 on the requirements for the drawing-up, scrutiny, and distribution of the prospectus to be published when transferable securities are offered to the public.[91] This is due to the traditional view that—apart from antitrust law, for example—the sanctions and the enforcement of European directives are not under the competence of the European Community. This is strange, of course, since substantive rules and sanctions and enforcement are a system of corresponding tubes, with the best European rules serving little purpose if they remain only as 'law in the books'. In European capital market law, this issue was finally addressed when insider dealing was regulated. The Insider Dealing Directive of 1989 contains a compromise in Article 13: 'Each Member State shall determine the penalties to be applied for infringement of the measures taken pursuant to this Directive. The penalties shall be sufficient to promote compliance with those measures.[92] The 2001 draft of the Prospectus Directive contented itself with a similar provision in Article 23.

88 Above III.A.
89 See Fleischer (2002a: F 41 *et seq.*) with further references.
90 Stock Exchange Prospectus Directive of 17 March 1980, OJ L 100/1, 17.4.1980.
91 Sales Prospectus Directive of 17 April 1989, OJ L 124/8, 5.5.1989.
92 Insider Dealing Directive of 13 November 1989, OJ L 334/30, 18.11.1989.

Yet for prospectuses, the traditional means of sanctioning and enforcing compliance with the prospectus requirements is prospectus liability. This is so in practically all countries that have a capital market law, though the details vary considerably. The classic example is given once more by section 11 of the US Securities Act 1933. The British Financial Services and Markets Act 2000 contains a modern prospectus liability rule according to which those responsible for the prospectus are liable unless they 'reasonably believed (having made such enquiries, if any, as were reasonable) that the statement was true and not misleading.'[93] In other Member States, particularly France, Italy, and Spain, prospectus liability is part of the general tort law that is applied to untrue and incomplete prospectuses by the courts (Hopt and Voigt 2005). In Germany, matters are complicated by a dual development. Stock exchange prospectus liability is regulated in detail by legislation, as is prospectus liability in investment law. But despite patent abuses in the capital markets, German legislators failed to extend these statutory rules to non-listed securities and other investments. In this situation, the German courts intervened in response to the needs of the investing public and developed a general civil law prospectus liability (Assmann 1997; Hopt 2000; Ehricke in Hopt and Voigt 2005: 187). Although this was very helpful and, indeed, necessary, it has led to a complicated dualism of liability under which various forms of investment are treated differently without cause.

If harmonization of the prospectus requirement is considered necessary for the internal market in order to have a general European passport for issuers of securities, such harmonized rules need to be enforced appropriately so as to have their intended effect. General admonitions to Member States to provide for adequate enforcement are simply not enough. It is true that the European Commission could take steps to force Member States to comply with such a general rule, and the European Court of Justice could possibly be asked to examine whether a national law is sufficient to promote compliance. But all this is long, complicated, and not very effective. Accordingly, the quest for a European prospectus liability rule has been brought forward in the past (Grundmann and Selbherr 1996; Fleischer 2002: F 75). But it was not until 2002 after a detailed comparative law study[94] that the German

[93] See Financial Services and Markets Act 2000, 2000 Chapter c.8, Sec. 90 (1), (2), Schedule 10: statements believed to be true.

[94] The Hamburg Max Planck Institute for Private Law in Hamburg undertook a comparative study for the German Ministry of Finance on the law of all Member States and on an appropriate European framework rule. First results were available in November 2002; a more detailed publication has recently appeared (Hopt and Voigt 2005).

government officially took the position in Brussels that the Prospectus Directive should contain a general prospectus liability rule.

The Directive of 4 November 2003 followed these proposals and contains such a rule in Article 6. Para 1 states the principle:

> Member States shall ensure that responsibility for the information given in a prospectus attaches at least to the issuer or its administrative, management or supervisory bodies, the offeror, the person asking for the admission to trading on a regulated market or the guarantor, as the case may be.

These persons must be clearly identified in the prospectus together with a declaration that, to the best of their knowledge, the information is in accordance with the facts and there are no relevant omissions. Paragraph 2 says: 'Member States shall ensure that their laws, regulation and administrative provisions on civil liability apply to those persons responsible for the information given in a prospectus.' It adds that 'no civil liability shall attach to any person solely on the basis of the summary, including any translation thereof, unless it is misleading, inaccurate, or inconsistent when read together with the other parts of the prospectus.'

In my view, this marks real progress, though there are many theoretical and practical problems as to what such a European framework rule should contain and what problems the Member States face when transforming the rule into their national civil law. While the acute problem of harmonization of prospectus liability, i.e., primary market liability, has been tackled by the Prospectus Directive, another even more complicated problem not touched upon in the directive is whether primary and secondary market liabilities can remain totally separated as is traditionally the case, or whether a general rule in liability for information given to the financial market, whether primary or secondary, would be preferable, be it on the national level or even as a framework rule on the European level as well (Hopt and Voigt 2005).

B. Secondary Markets: The Need for Loyal and Competent Intermediaries (Issuers and their Directors, Broker-Dealers and Investment Advisers, Analysts, and Rating Agencies)

As to secondary markets, economic developments and regulatory challenges may be even more conspicuous than those at the primary markets. It suffices to mention such far-reaching processes as institutionalisation, disintermediation, technological change, segmentation, and demutualization (Merkt 2002b: G41 *et seq.*; Ferrarini 1999; 2002). As always, competition is a primary factor in this.[95] The reform problems resulting from these developments for secondary market regulation reform have been discussed broadly in many Member States and are under discussion for European law as well in the context of the Financial Services Action Plan and its aftermaths (European Commission 2005). The fundamental revision of the Investment Services Directive (now MiFID) which was finalized in 2004[96] is among them (Moloney 2002; Ferran 2004). Again, information and intermediation are also the two key problems the law faces for the secondary markets, though the need for loyal and competent intermediaries is more prominent here. This shall be my focus, leaving aside all the rest. For corporate governance of rules, the impact of ensuring loyal and competent intermediation has been best illustrated by the realisation, post-Enron, that deficiencies in corporate governance will be covered up, and even amplified, if the intermediaries in the secondary markets—such as broker dealers, investment advisers, analysts, and rating agencies—do not live up to the expectations set for them by the markets and the general public. The role of auditors has already been dealt with.[97] To improve European corporate governance after Enron, one must also look at these intermediaries (or gatekeepers) (Kraakman1986; Grundmann and Kerber 2001; Fleischer 2002: F 34 *et seq.*; for the US, see Choi 2004) and possible reform measures for keeping them loyal and competent. Keeping them loyal may be more difficult than keeping them competent, since the market may be more apt to reveal and penalize incompetence than disloyalty, which almost always tends to be hidden. Again, rules on the disclosure of conflicts of interests or, going further, on minimizing them to the extent that is economically feasible, may be the answer. As to disclosure, it should be mentioned that the need for gatekeeper rules is controversial in economic theory: the argument is that market forces and the need for maintaining a reputation at the market are sufficient and stronger constraints than legal rules.[98] The arguments for regulation are similar to those in support of disclosure discussed above.[99]

In a sense, issuers and their directors also have an intermediation function on the secondary markets. The prospectus they issue is not only relevant for the first placement, but also influences later dealings on the secondary market, so long as the prospectus remains valid and

[95] See Hopt, Rudolph, and Baum (1997: 222 *et seq.*, 361 *et seq.*, 375 *et seq.*); Merkt (2002b: G 58, 114).

[96] Directive on Markets in Financial Instruments (MiFID) of 21 April 2004, OJ L 145/1.

[97] See above Part III.C.

[98] As to market defects of gatekeeping (certifiers) and the need to rethink legal intervention, see Choi (1998; 2004).

[99] Above Parts III.A, IV.A.

continuous disclosure requirements are in place. While this has been dealt with in the treatment of prospectus liability, the modern discussion goes further and asks the question whether there should not be a more general responsibility borne by the issuer and its directors for public statements—whether orally or in written form, either before or after the issuance of securities—if the investing public is misled (Fleischer 2002: F 62 *et seq.*, F 101 *et seq.*; Hopt and Voigt 2005). In the context of instant disclosure statements, as required by the Prospectus Directive and most relevant for preventing insider dealing, the liability question has become acute particularly in the German reform discussion. The relevance of such liability rules for the board and for corporate governance is obvious. One of the many controversial issues is whether such duties and liabilities should be imposed on the issuer, or on the directors personally, or on both. Imposing them on the issuer usually gives the shareholders a more solvent debtor, but it amounts to having all existing shareholders carry the burden. Imposing them on the directors may tend to have a positive influence on their remaining loyal and attempting to be competent.

Of course, the key intermediaries between the company and its shareholders and holders of other securities of the company are the brokers and dealers and the investment advisers. There is a large body of rules on the duties and liabilities of this class of intermediaries, both in the Member States as well as on the European level.[100] The duties listed by the Market in Financial Instruments Directive for investment firms are basically appropriate. It is true that the directive contains rules on duties and their control by supervisory bodies, but leaves aside civil liability.[101] This has led to difficult questions concerning the relationship and mutual influence of administrative duties under the Directive and the national transformation acts and civil law duties and liabilities as developed by the courts.[102] Yet on the whole, this may not be a key concern for improving European corporate governance. The existing rules may not be fully satisfactory, but they do cover a good part of the ground. Furthermore, there is typically a contractual or precontractual relationship between these intermediaries and the investor client which gives rise to civil law duties and liabilities in favor of the investor.

Much more pressing and indeed keenly relevant for corporate governance are appropriate analysts and rating agencies, both of which

[100] In the 2003 version of this article, certain shortcomings of the Investment Services Directive were criticised. In the meantime, the Directive was modernized. Investment advice is no longer a mere non-core service, but is considered as investment service (Annex I Section A (5) of the MiFID). Therefore, independent investment firms are now covered by the Directive.

[101] There is only a rather general obligation on the Member States to monitor compliance with the rules of the regulated market and with other legal obligations (Art. 43 of the MiFID).

[102] See (for the Investment Directive) Bliesener (1998).

belong to the core institutions that support strong securities markets.[103] In most Member States there is no fully fledged body of law concerning these intermediary professions. Enron has taught the lesson that analysts are very often in a position that gives rise to serious conflicts of interest. They are employees of banks and other investment firms or independent contract partners without a direct contractual relationship with the investors. They can be on the 'selling' side as employees of investment banks, or on the 'buying' side as employees of investment companies or insurance companies. In both cases, they need to maintain a good relationship with the companies on which they report in order to get the relevant information, and as employees they must avoid endangering the interests of their employers. Herd behaviour may add to these dangers. Rules designed to ensure that analysts are both competent and loyal are indispensable. Fair presentation of the information they produce or disseminate and disclosure of their interests or indication of conflicts of interest are of key importance, as Article 6 (5) of the draft Market Abuse Directive rightly requires.[104] Yet this may not go far enough. More concrete rules on analysts' professional duties, and in particular on conflicts of interest, may be necessary, be it by stock exchange rules or professional codes of conduct. One part of such rules might be a provision against the analyst trading in securities that he analyses, at least for a certain period. The Market for Financial Instruments Directive of 2004 now includes investment research and financial analysis and other forms of general recommendation relating to transactions in financial instruments at least as an ancillary service,[105] thereby making certain rules of conduct also applicable to analysts. Imposing civil liability on analysts is more difficult, since they are not in a special contractual or precontractual relationship with the investor (Kalss 2001: 655; Fleischer 2002a: F131 *et seq*.).

Rating agencies are not covered at all by European law or by the law of most Member States (Kübler 1997; Peters 2001; Fleischer 2002: F 132 *et seq*.). In the United States, rating agencies can be recognized by the SEC as nationally recognized statistical-rating organizations. Switzerland has followed this example. There is much controversy over whether the regulation of rating agencies is economically sound, yet more recently the arguments in support of regulation have been growing stronger, in particular after the experiences with Enron. Nevertheless, the problems of the regulation of rating agencies are complex. They concern minimum requirements for their recognition, their possible liability toward

[103] See Black (2001: 812; 2000: 1590); Fleischer (2002a: F 131).

[104] See also Commission Directive of 22 December 2003 as regards the fair presentation of investment recommendations and the disclosure of conflicts of interest, OJ L 339/73 24.12.2003.

[105] See Annex I Section B (5) of the MiFID.

investors, and the optional or even mandatory use of ratings in the context of adequate capital requirements of investment firms, eligibility rules, and disclosure of ratings in prospectuses and investment advice. The discussion on whether and—if so—how to regulate is still in its initial stages, both in terms of economic theory and legal policy. Therefore, it would be premature to ask for European regulation. What could be recommended, however, is that the European Commission study the question of regulation.[106]

C. The Market for Corporate Control (The Role of Takeovers in the Internal Market, Mandatory Bids, Golden Shares, and the European Court of Justice)

The relevance of the market for corporate control for improving European corporate governance is even more direct and obvious than the relevance of the primary and secondary markets. Public takeover bids challenge the target's board and its performance and give the shareholders an exit option, especially if there is a provision for a mandatory bid to be made by the offeror if a certain control threshold—usually 30 per cent or more—is reached. Traditional research has underlined the disciplinary function of takeover bids, especially—but not exclusively—of hostile bids. It is true that more recent empirical literature has cast doubts on this function because both badly managed and well-managed companies with a bright future have been seen to be targets of public takeover bids (Franks and Mayer 1996; Franks, Mayer, and Renneboog 2001). One of the best examples of the latter was the—finally successful—takeover bid by Vodafone made to Mannesmann shareholders in 2001. In such cases, takeovers are more motivated by synergistic motives, though experience indicates that the expected synergies (or those that are said to be expected) are ultimately not attained in the majority of cases. One of the standard international treatises on corporate finance counts merger waves as one of the ten unsolved riddles of finance (Brealey and Myers 2000: 1015 *et seq.*). If economists have not solved it and cannot present convincing answers that are agreed upon in essence by the profession, lawyers and legislators must not pretend to be able to give *the* answer; instead, they must give *an* answer as best they can. In this sense it may be assumed that the threat of takeovers may have as much effect as actual takeovers on boards and that the takeover threat, though not inducing the board to maximize shareholder utility, may at least put a floor under board performance (Davies 2002a: 212). This is also the basis for the

[106] Most recently in January 2006, Commissioner McCreevey declared that the Commission will not undertake regulation.

recommendations of the Expert Group, which maintains that the availability of a mechanism for takeover bids is basically beneficial.

> Takeovers are a means to create wealth by exploiting synergies and to discipline the management of listed companies with dispersed ownership, which in the long term is in the best interest of all stakeholders, and society at large…. This is not to say that takeover bids are always beneficial for all (or indeed) any of the parties involved.[107]

This is not the place to go into the many problems of takeover regulation, to compare the various systems of the Member States, to question whether European rules are necessary for the internal market (of which I am convinced), or to analyse the 13th Directive of 21 April 2004 which is a typical political compromise.[108] Instead, I shall briefly take up two issues that even after the enactment of the 13th Directive are still controversial. I consider them to be crucial for a European takeover regulation, along with possible benefits resulting from it for improving corporate governance. These issues are the mandatory bid as provided for in Article 5 of the directive, and the possible role of the European Court of Justice in setting limits to defences against takeovers.

The mandatory bid rule, which is modelled on the example of the British Takeover Code, has gradually crept into nearly all modern European takeover legislation. Differences do exist, especially as to the level of ownership which must be reached before the bidder will be subject to the mandatory bid requirement, and as to the price which the bidder must then offer. But the basic assumption is that such a rule is useful both economically and for the shareholders.

Yet the wisdom of the mandatory bid rule is by no means undisputed. Economists tell us that the rule is costly and may prevent beneficial takeovers from taking place (Burkart and Panunzi, and Enriques in Ferrarini *et al.* 2004: 737 and 767; more generally McCahery *et al.* 2004). Comparative law teaches that the United States, apart from some states such as Pennsylvania and Maine, fares well without such a rule, though in practice it seems that in most cases bidders end up making a bid to all shareholders. Takeover lawyers know that such a rule is based on rather broad principles, such as equal treatment and sharing the control premium (under the corporate asset doctrine), and that it tends to lead to inconsistencies (Skog 1995; Wymeersch 1992; Davies 2002b: 20 *et seq.*; Hansen in Wahlgren 2003: 173).

In Paul Davies' and my view (Davies and Hopt in Kraakman 2004: 178 *et seq.*), a good rationale for a mandatory bid is the fact that such a rule

[107] High Level Group (2002a: 2).

[108] OJ 2004 L 142/12 30.4.2004. See Hopt (2002d); Dauner-Lieb and Lamandini (2003); Lehne and Haak (2003).

gives an early exit option to shareholders who fear they will end up with a majority shareholder having control and possibly exercising it to their detriment in the future. The second rationale put forward for the rule, i.e., that it protects shareholders who are not close to the market and who might not react in time to the opportunity afforded by the raid seems less convincing to me. The early exit option rationale anticipates that there is a strong likelihood of majority/minority conflicts after the acquisition of control. Experience shows that in many—though of course not all—cases, this turns out to be true. This is certainly the experience with the German law of groups, under which many cases of minority oppression become apparent and are brought before the courts. This may be different in other countries without a law of groups. But then the relative absence of publicly known cases of abuse of control may very well stem from the fact that there are no effective legal means of protection, and the shareholders realize this and do not go to court.

As to Germany, one remembers the stiff opposition of German industry and the German government to any kind of mandatory bid rule, with the argument that German law of groups already takes care of this. This position was never really convincing because the protective devices of the German law of groups are *ex post*, once control is reached, and lead to long judicial controversies, some of which can take more than ten years and are of uncertain outcome. It is interesting to see that Sweden was also originally against a mandatory bid rule, as evidenced by a long and impressive plea by Rolf Skog (1995), the secretary to the Swedish Company Law Committee, working within the Ministry of Justice. But in a well-known about-face, Sweden changed its position and introduced a mandatory bid rule itself. Some say that this was because leading industrialists reconsidered their own position and, for future takeover bids by foreign bidders, concluded that such a rule might benefit themselves after all.

The second issue on which I shall make some very brief comments is the difficult question of the possible role of the European Court of Justice in setting limits to defences against takeovers. The Commission and many observers, including the Expert Group, had feared that the court might follow the Advocate General in the Golden Share decisions,[109] and they were greatly relieved that it did not. There is no need to describe in more detail what the court decided (Grundmann and Möslein 2001–2002). In a nutshell, it is the following:

[109] European Court of Justice, Judgments of 4 June 2002, Case C-367/98, C-483/99 and C-503/99, *Commission of the European Community v Portugal/Commission v French Republic/Commission v Belgium*; see *Europäische Zeitschrift für Wirtschaftsrecht (EuZW)* 2002, 429, 433, 437. In the meantime there have been more decisions; for an example, see Judgment of 13 May 2003, Cases C-98/01 and C- 463/00, *Commission v UK/Commission v Spain*.

> The national rules in question constitute, *per se*, exceptions to the principle of free movement of capital and, consequently, to the principle of freedom of establishment, and can be justified, according to the Court, only if the objective pursued falls within the ambit of a general or strategic interest and the measures prescribed are based on precise criteria which are known in advance, are open to review by the courts and cannot be attained by less restrictive measures.[110]

This holding of the European Court of Justice is based on the same premises as those articulated by the Expert Group in its first report on takeover defences in January 2002.[111]

The most interesting question is the outcome of future cases, especially the German Volkswagen Act case. This act is a special law for the privatised Volkswagen company. It dates from 21 July 1960, and was revised on 31 July 1970. The Federal Republic and the State of Lower Saxony are to be protected by this act in a threefold way:

1. Section 2 provides for a voting cap, which under the 1970 Reform Act limits the votes of a single shareholder to 20 per cent. The transfer of shares of the company that would circumvent this prohibition is not only forbidden, but the shares so transferred may not be claimed back.
2. Under section 3, votes may not be exercised by a proxy in his own name. Powers of attorney must be in writing, and banks and other professionals who exercise proxies need specific instructions by the shareholders in order to vote. Representatives must disclose fully whom they represent, and nobody may exercise the votes in the general assembly for more than 20 per cent of the votes.
3. Finally, according to section 4, the Federal Republic of Germany and the State of Lower Saxony may each send two representatives to the supervisory board of the Volkswagen company, as long as they hold shares of the company (regardless of the amount of such shareholdings). For resolutions concerning the establishment and transfer of manufacturing plants, the supervisory board needs a majority of two-thirds instead of a simple majority. All resolutions of the general assembly, which—as in cases of changing the constitution of the company—are normally to be taken by a quorum of three-quarters of the capital present at the vote, need to be taken by a quorum of four-fifths.

As to the compatibility of the Volkswagen Act with the golden share cases of the European Court of Justice, predictions are very hard to make for the following reasons. The Volkswagen Act does not contain limits for the participation of non-nationals like the Portuguese golden shares, nor does it provide for an *ex ante* permission of the state as in France, and, indeed,

[110] European Court of Justice, Press release of 4 June 2002.
[111] High Level Group (2002a: 34).

not even for an *ex post* permission of the transfer of shares as in the Belgian case. Instead, there is a voting cap provision that applies not only to the state, but to all shareholders alike. It is true that in the 53 motives of the German Act of 1998, which deleted the former voting cap permission of the Stock Corporation Act, it is expressly stated that voting caps and double or multiple voting rights restrict the capital markets because takeovers are frustrated and therefore 'takeover fantasy' is lacking.[112] But treating voting caps and even multiple voting rights as exceptions to the principle of free movement of capital and, consequently, to the principle of freedom of establishment goes a full step further than the present golden share judgments. The same is true, though to a lesser degree, for the right to nominate a certain number of directors which is quite common in statutory practice.

Yet once this step is made—a decision that would require a lot of courage—the chances of the Volkswagen Act passing the second test—i.e., that the objective pursued falls within the ambit of a general or strategic interest—would be slim.[113] It is hardly conceivable that it might be proved that there is a convincing general or strategic interest in preventing any shareholder from getting control of the company. After all, the car industry is an industry like many others, not a strategic one such as armament, defence, or energy. It has been speculated that the interest of reserving the share to the general public, i.e., the structure of the shareholdings, would be protected under the property clause of Article 295 of the EC Treaty. But this would hardly be compatible with the holding of the golden share cases, in particular since the act at the same time secures a considerable role for the state as a major shareholder. Even less valid is the argument that the Volkswagen company has symbolic value in Germany. This relatively clear legal consequence under the second test might lead the court to check even more carefully whether voting caps—or indeed the other rules in the Act, taken separately, such as the right of the state to deputize representatives into the supervisory board regardless of the amount of shareholding—really suffice to cause a collision of the Act with freedom of establishment.

On the other hand, while mere rules on voting caps and so on might not be sufficient to be considered exceptions to the principle of freedom of establishment, this might be different for the Act as a whole.[114] Taken together, the combination of rules in the Volkswagen Act singles out this specific privatised company with the clear aim of making a takeover practically impossible, while maintaining, for the state, the right to

[112] German Stock Corporation Reform Act (KonTraG), Motives to the Draft, BT- Drucksache 13/9712, p. 20.

[113] See also Bayer (2002: 2291); Ruge (2002: 424); Krause (2002).

[114] See Hopt (1997b: 415 *et seq.*).

intervene by combining voting caps and other restrictive rules on voting and quorums with the rights of the Federal Republic and Lower Saxony to deputize four representatives to the supervisory board regardless of the number of shares these two public entities hold. Indeed, as experience shows, mere voting caps have in many cases proven insufficient to prevent takeovers completely. This may be different, or at least the legislators expect it to be different, with the full range of preventive rules as laid down in the Volkswagen Act. But it is exactly this that may bring the Volkswagen Act in Germany under the ban of golden shares as in France. Maintaining the full influence of the national public sector on a privatised company without further ado and court control may be sufficient to qualify the Act as an exception to the principle of freedom of establishment under the Treaty. And again, if this were accepted, the second test could still hardly be passed.

In 2003, when this article was first written, I concluded that is was hard to predict the further destiny of the 13th Directive. If it ultimately had failed to be enacted—which would be to the great detriment not only of the European takeover market, but also of European corporate governance—the only hope would have rested in the European Court of Justice to once more act as a motor of European integration, as far as a court can act. Now after the enactment of the 13th Directive, as short-winded and 'softly-softly' as it is, the need for the European Court to step in for the sake of the European takeover market is less acute. Furthermore, the situation at the Volkswagen Corporation has changed with the acquisition of a major share block by Porsche, Lower Saxony now being only the second largest blockholder. The threat of Volkswagen being taken over has vanished. Yet the question of state statutes blocking takeovers remains acute, and the decision of the Court could still be a landmark.

V. SUMMARY AND THESES[115]

A. Enron and Company and Capital Market Law in Europe: The Need for Improving Corporate Governance

1. Enron, WorldCom, and associates are by no means *just* an American balance sheet scandal. Rather, they can and should teach Europe a lesson on how to act in a timely manner—instead of just reacting like the US American Sarbanes-Oxley Act or even overreacting—by well-thought- out company and capital market law reforms.

[115] These theses were presented to the Tilburg lecture audience on 6 September 2002. They have not been changed, and I still stand fully behind each of them now in 2006.

2. One of the key concerns of European company and capital market law reform should be *improving European corporate governance*. For company law, the focus is clearly on the board. But corporate governance cannot function with company law alone; it needs the capital markets and capital market rules as well or, as some say, external corporate governance. The High Level Group of Company Law Experts is challenged to propose a coherent European reform package for corporate governance that makes allowance for both internal and external corporate governance rules and mechanisms.

B. Improving Corporate Governance by Company Law: European Rules for Efficient, Loyal, and Competent Boards

3. In some critical fields, especially if the interests of the board are affected, corporate governance may be improved if the shareholders are to make decisions. Two good *candidates for shareholder decision-making*, at least in listed companies, are the frustration of public takeover bids by the directors of the target company and the remuneration of directors by stock options. Apart from this, the participation of the shareholders in the general assembly and their voting should be facilitated as far as possible. Modern technology allows much quicker and better shareholder information, communication, and decision-making.
4. Regarding board structure, there is an extensive and ongoing academic discussion on the pros and cons of the *one-tier and* the *two-tier board system*. Whether the less effective monitoring of the two-tier board might be outweighed by gains in networking, and what ultimately benefits shareholders more, is an empirical question. While it is certainly not for European corporate governance law to make either one of the two systems mandatory, it would be worthwhile discussing a rule requiring the Member States to *give companies the choice* between the different systems, as was introduced recently for the European company.
5. Board size and board organization is up to the Member States, including the combination or separation of the functions of chief executive officer and president of the board. So is labour co-determination. But in light of Enron and the general crisis of confidence that may also affect the internal market, there is a case for a European rule *requiring listed companies to have audit committees* that are responsible for the appointment, compensation, and supervision of the work of the auditors of the company and are composed *of at least a majority of independent members*.
6. *Exorbitant payments* to the directors threaten to make the whole system

unreliable. This is of concern to the European internal market, too, since such payments tend to undermine the confidence of the shareholders and their willingness to invest in companies across the internal market. Shareholder decision-making on the principles and limits of board, full disclosure (also of the individual remuneration), and mandatory accounting of stock options under revised international accounting standards might be useful European rules. Non-executive directors should be remunerated appropriately, but neither directly nor indirectly in stock options, though holding shares of the company should remain possible.

7. Control needs *competent as well as independent controllers*. While the necessary board member competence varies from company to company, a European rule requiring the company to disclose which members it considers to be competent and for what reasons could be useful. As to independence, there is a case for requiring the board as a monitoring body to be independent of management (non-executive directors or supervisory board), and for the audit, remuneration, and appointment committees to have at least a majority of members that are also independent of the company.

C. Controlling the Board from Inside and Outside: Markets, Shareholders, and Auditors

8. Notwithstanding theoretical controversies as to the effectiveness of disclosure in efficient capital markets, *disclosure* is a *powerful tool for improving corporate governance in Europe*. It interferes least with freedom and competition of enterprises in the market and also avoids the well-known petrifying effect of European substantive law. Candidates for disclosure are—among others—the corporate governance regime of the company, including takeover defences, board remuneration, and competence and independence of the board. Non-disclosure and, even more so, false disclosure must have immediate consequences for the directors. Forfeiture of certain bonuses and profits will have most impact, but it cannot be automatic.

9. Control by the shareholders could be enhanced by better investigation and more serious liability. *Special investigation* seems to be the most effective method yet devised to detect corporate misconduct and to prepare liability suits. A European rule on *wrongful trading* that makes use of the British and the French and Belgian experience (*action en comblement du passif*) could improve the functioning of companies and groups of companies considerably. This might also be true for a European procedural framework rule on *facilitating the bringing of an action against directors (and auditors)*. The details, such as derivative

actions, bundling of claims, class actions, or specific rights and duties of the courts, would be left to the Member States.

10. *Control by the auditors* is the most common and prominent control mechanism. It should be the task of the auditing committee rather than the board to appoint the auditors of the company and to decide on their remuneration. Auditors of listed companies should need to be admitted by the financial supervisory authority. Incompatibility between auditing and non-auditing services has many pros and cons. The same is true for mandatory rotation not only of the audit partner, but of the audit firm as well. On both issues, recommending a mandatory European rule would be premature, but the European Commission should keep an eye on the needs for mandatory rules and the experiences with them. The international market for auditing services and the impact of the US American Sarbanes-Oxley Act may press leading firms to go this way even without such a European rule.
11. *Quis custodiet custodes?* As important as this question is, it is unsuitable for a uniform European rule. The traditions and path dependencies in the various Member States, in particular regarding self-regulation and state supervision, are too different. As to auditing listed companies, it may be wise to give a role to the financial supervisory body, whether state or self-regulatory.

D. Improving Corporate Governance by Capital Market Law: Information and Intermediation Problems

12. Shareholders are protected more generally by markets: indirectly by competitive product markets, and much more directly by the capital markets, both primary and secondary as well as the market for corporate control. For *primary markets*, the reform of the Prospectus Directive is under way. A European framework rule on *prospectus liability* (as contained in Article 6 of the European prospectus directive of 4 November 2003) is useful.
13. Regarding the *secondary markets*, a key problem is the need for loyal and competent intermediaries. Various reform measures are under discussion, both at the European and at the Member State level. They concern issuers and their directors, broker-dealers and investment advisers, and analysts as well as rating agencies.
14. As to the *market for corporate control*, public takeover bids may be motivated in many cases by synergistic motives, but the threat of them is also a challenge to the board of the target and its performance. Appropriate framework rules for this specific market (see now the 13th Directive of 21 April 2004) are definitely needed and may be an important contribution to corporate governance in the internal market.

15. The *mandatory bid rule* is common in Europe but not in the United States, and it is controversial in economic theory. The rule may best be justified on the basis that it gives an early exit option to the shareholders who fear to end up with a majority shareholder having control or exercising it to their detriment in the future. As such, the rule is necessary even in countries with a full-fledged corporate group law such as Germany.
16. The recent judgments of the European Court of Justice concerning *golden shares* are landmark cases for freedom of establishment and the internal market. It remains to be seen whether the court will go further in this direction. A test case could be the German Volkswagen Act case. If the 13th Directive ultimately had failed to be enacted—which would have been to the great detriment not only of the European takeover market, but also of European corporate governance—the only hope would have rested in the European Court of Justice to once more act as a motor of European integration, as far as a court can act as such.

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