Petri Mäntysaari

The Law of Corporate Finance: General Principles and EU Law

Volume I: Cash Flow, Risk, Agency, Information

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1 Introduction

”Wenn man eine Erkenntnis als Wissenschaft darstellen will, so muß man zuvor das Unterscheidende, was sie mit keiner andern gemein hat, und was ihr also eigentümlich ist, genau bestimmen können; widrigenfalls die Grenzen aller Wissenschaften in einander laufen, und keine derselben, ihrer Natur nach, gründlich abgehandelt werden kann.”[1]

1.1 What Does Corporate Finance Law Mean?

The law of corporate finance has been defined in a modern and more holistic way in this three-volume book. In this book, corporate finance law is studied from the *perspective of the firm*. Like modern commercial law in general, the law of corporate finance helps the firm to reach its *legal objectives* (management of cash flow and the exchange of goods, management of risk, management of agency relationships, and management of information). When trying to reach its legal objectives, the firm typically applies generic *legal tools and practices* (incorporation and choice of business form, contracts, regulation of internal processes through compliance and otherwise, typical ways to manage agency relationships, and typical ways to manage information problems) and takes into account legal rules that belong to different traditional fields of law (contract law, company law, banking law, tax law, competition law, and so forth).[2] In corporate finance law, these legal tools

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[1] Immanuel Kant, Prolegomena (1783), § 1. In English: “If it becomes desirable to formulate any cognition as science, it will be necessary first to determine accurately those peculiar features which no other science has in common with it, constituting its characteristics; otherwise the boundaries of all sciences become confused, and none of them can be treated thoroughly according to its nature.”

[2] There is a long list of what this book is not: a book on company law, banking law, English law, German law, the law of any particular country, EU securities markets law, corporate finance, and so forth. The details of English law, EU securities markets laws, and corporate finance have been discussed in specialist books like: Ferran E, Principles of Corporate Finance Law. OUP, Oxford (2008); Moloney N, EC Securities Regulation. OUP, Oxford (2008); and Tirole J, The Theory of Corporate Finance. Princeton U P, Princeton (2006).

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and practices are used in the *context* of all decisions that influence the firm's finances (investment, funding, exit, and existential decisions).

The three volumes of this book form a whole, and there are cross-references from one volume to another. The volumes are in the order of generality. The first volume contains the most abstract concepts. The third volume contains applications of concepts discussed in the previous volumes.

The *first volume* introduces certain concepts characteristic of the law of corporate finance: the management of cash flow, risk, agency relationships, and information. Key topics discussed in the first volume include: the definition of corporate finance law as an independent area of law, the management of agency relationships, corporate risk management, corporate governance, and the management of outgoing and incoming information. It will be argued that the management of agency relationships, corporate risk management, information management, and corporate governance are interrelated. The first volume also contains a new theory of corporate governance.

The other volumes deal with transactions that influence the firm's finances. Many investments are based on contracts which contain payment obligations. The *second volume* will therefore focus on contract law. It discusses the general legal aspects of any investment contracts and provides an introduction to the law of payment obligations.

Investment transactions can be somebody else's funding transactions. Particular investment transactions will be discussed in the context of funding in the *third volume*. In addition to funding transactions, the third volume will also discuss questions of exit and corporate takeovers. Corporate takeovers raise questions about the target firm's existence.[3]

A reader who is mainly interested in usual financial transactions can have a look at the third volume first. A practising lawyer can find drafting and risk management tips in the second volume. The first volume might interest academics and corporate governance practitioners. The rather abstract, general or organisational issues discussed in the first volume make more sense when read in the context of the concrete issues discussed in the other two volumes.

1.2 Why Was This Book Written?

This book was written because there is a gap between corporate finance books and books dealing with the legal aspects of corporate finance.

Books dealing with the legal aspects of corporate finance do not address questions which are common to most firms. One can say that they offer a piece-meal or meristic view of corporate finance law. First, the study of rules that apply to corporate finance tends to be limited to the laws of only one country or some countries. Second, those books tend to focus on one or more particular aspects of cor-

[3] Corporate insolvency and restructuring typically raise other existential questions. They will not be discussed in detail in this book.

porate finance. Popular topics include company law, mergers and acquisitions, securities markets laws, and tax. Third, the legal aspects of corporate finance may have been discussed from the perspectives of corporate outsiders rather than the firm. For example, a law book dealing with corporate finance might have been written for practising lawyers who advise banks in the City of London. Fourth, those books often discuss the interpretation of law by the courts rather than study the thinking and behaviour of those who buy legal advice and use legal tools.

This can be contrasted with the universal approach adopted in corporate finance books. Corporate finance is the study of the way firms are financed.[4] Corporate finance books attempt to provide a template for the analysis of any firm. Their subject matter is how firms should make decisions on investment and finance.

Because of different approaches to corporate finance, corporate finance books and law books dealing with corporate finance rarely meet.[5] This is unfortunate because the legal framework influences both return and risk.

From the perspective of legal science, the lack of general principles of corporate finance law is particularly unfortunate because corporate finance law as understood in this book is arguably the economically most important area of commercial law.

The purpose of this book is to complement corporate finance books by discussing the practice of corporate finance at the same level of generality as corporate finance scholarship, albeit from a legal perspective. The book thus contains "a theory of practice" and provides an overview of the legal aspects of corporate finance.

This approach brings obvious benefits to legal practitioners, law professors, and legal science. Practitioners who understand both the thinking of those who buy legal advice and the nature of different legal tools and practices can take a more active role as participants in corporate decision-making. Law professors benefit, because external norms have, to a very large extent, been replaced by self-practices in this area, and the study of the practices of users enables them to catch a wider range of legal phenomena. Legal science can benefit in many ways, because, at a high level of generality, the core interests of firms are the same everywhere and not jurisdiction-specific like laws.

1.3 What Are the Themes of This Book?

This book has six themes. The *first theme* is *the firm*. This book focuses on the interests of a non-financial firm.[6] Most firms in the world are non-financial. The firm can act as an investor, raise funding, and make payments to its own investors. The firm can also become a takeover target or act as an acquirer itself.

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[4] Zingales L, In Search for New Foundations, J Fin 55 (2000) p 1624.

[5] There are exceptions. See, for example, Bainbridge SM, Mergers and Acquisitions. Foundation Press, New York (2003).

[6] For the regulation of providers of investment services, see See Moloney N, EC Securities Law. OUP, Oxford (2008).

The firm is a unique combination of physical and human capital.[7] Its defining characteristic is that it substitutes authority for the price mechanism in determining how decisions are made (Coase).[8] The firm is thus understood as a business organisation, i.e. a group of people carrying out interrelated business activities in a coordinated way under common management and the resources that they have at their disposal.

The firm is not the same thing as its business form. The firm will require a business form (such as a partnership or incorporation as a limited-liability company) and legal personality (its own or that of its owners) in order to operate. The firm can consist of many legal entities or entities with different business forms, and the business form or forms of the firm may change over time. Under German law, a distinction is made between a legal entity acting as the carrier of the firm (Unternehmensträger) and the firm itself (das Unternehmen). The firm may change its business form or the legal entity within which it operates without changing its identity. For example, the public limited-liability company within which the firm operates may reincorporate as an SE. In a reverse takeover, the firm may continue to exist within another legal entity. Of course, the firm itself will be subject to constant change.

The firm is not the same thing as the shareholders of the legal entity within which it operates or its other stakeholders. It is assumed that the firm has its own interests and that its stakeholders have their own interests. Sometimes those interests are aligned, sometimes not (for the interests of the firm, see section 8.2.6).

The starting point in this book is thus not the same as in financial economics. Instead of the more holistic view represented in this book, financial economics tends to offer a narrower and mechanistic view of corporate finance. Financial economists usually ask how people can best spread their money over a range of assets, and their starting point is the investor rather than the firm. In practically all other books on corporate finance or corporate governance, shareholders of a company are regarded both as the firm's "owners" and as the most important principal. The firm is not deemed to have any interests whatsoever.[9] Like many other social theories, it has partly been self-fulfilling, and it has led to path-dependency in research.

In financial economics, the choice of shareholders as principal is a way to simplify the mathematics. It is clearly easier to calculate how the monetary flows of fictive "owners" are maximised on the basis of a number of assumptions than to explain how a real business should be managed in an unpredictable world.

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[7] Zingales L, In Search for New Foundations, J Fin 55 (2000) pp 1626 and 1641–1642.

[8] See *ibid*, p 1644.

[9] For a critique, see Blair MM, Stout LA, A Team Production Theory of Corporate Law, Virg L R 85 (1999) pp 247–328; Zingales L, In Search for New Foundations, J Fin 55 (2000) pp 1623–1653; Aglietta M, Rebérioux A, Corporate Governance Adrift. Edward Elgar Publishing, Cheltenham (2005). See also Wiedemann H, Auf der Suche nach den Strukturen der Aktiengesellschaft: The Anatomy of Corporate Law, ZGR 2/2006 pp 245.

However, there is no reason why the path-dependency of financial research should act as a constraint in law. Company laws and securities markets laws do not have to be aligned with the current research interests of financial economists.

For example, making shareholders rich is not the fundamental reason for the existence of company laws, and it is clearly not true that company laws worldwide would have been designed just to further the interests of shareholders. Laws and the legal framework of the firm are, to a large extent, based on the weighing of different interests.[10]

There can be conflicts between financial theory and the practice of corporate finance.[11] The difference between theory and practice can partly be explained by laws and the existence of competing interests.

The behaviour of firms can also reflect the interests of firms themselves and not just the interests of their shareholders or other stakeholders.

For the purposes of this legal study, the most important "principal" is the firm itself. Needless to say, changing the principal is a paradigm change that changes everything. For example, if short-term shareholders are regarded as the most important principal and managers as their agents, it can make sense to align the interests of managers with those of shareholders. This can make it meaningful to use, say, stock option rights designed to increase the share price in the short term. If the firm is regarded as the most important principal and the managers as their agents, it makes sense to align the interests of the managers with the long-term interests of the firm. In the latter case, the firm can use other legal tools.

The philosophical foundations of this approach can be traced back to Adam Smith, Max Weber, and Ronald Coase. (a) Adam Smith demonstrated that, in a free market, it is beneficial for each individual to promote his own self-interest, because an individual pursuing his own self-interest also tends to promote the good of his community as a whole. (b) According to Max Weber, firms are the most important players in modern capitalist society.[12] (c) It is therefore beneficial to society if each firm promotes its own self-interest. In The Wealth of Nations, Smith wrote: "It is not from the benevolence of the butcher, the brewer or the baker, that we expect our dinner, but from their regard to their own self interest. We address ourselves, not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages."[13] In the long run, shareholders and other stakeholders should expect something from the firm provided that that thing is in the self-interest of the firm. (d) Ronald Coase explained how the

[10] Philipp Heck, the founder of the "jurisprudence of interests", used this concept in his book Gesetzesauslegung und Interessenjurisprudenz (1914).

[11] For example, investors should in theory be indifferent about whether they receive money as dividends or buybacks, and it should make no difference whether a company decides to fund itself with shares or debt. In practice, however, there are differences.

[12] Weber M, Wirtschaft und Gesellschaft. Grundriß der verstehenden Soziologie (1922). See also Hansmann H, Kraakman R, Squire R, Law and the Rise of the Firm, Harv L R 119 (2006) p 1336: "Economic activity in modern societies is dominated not by individuals, but by firms that own assets, enter contracts, and incur liabilities that are legally separate from those of their owners and managers."

[13] Smith A, The Wealth of Nations (1776), Book I, Chapter I.

firm promotes its own self-interest in his 1937 essay The Nature of the Firm. Generally, the firm tends to do something with its resources until it is in the self-interest of the firm not to do any more of it. For example, Coase said that "a firm will tend to expand until the costs of organising an extra transaction within the firm become equal to the costs of carrying out the same transaction by means of an exchange on the open market or the costs of organising in another firm".[14]

This does not prevent investors from promoting their own self-interest. The firm will take their interests into account like any other relevant interests. The firm will also act as an investor itself, and any investor can act as a "firm".

The second theme. The second theme of the book is the focus on *four decisions*. One can distinguish between investment decisions, funding decisions, decisions on how to return funds to investors, and decisions on the existence of the firm.

Investment decisions are decisions on where to invest the resources or funds that the firm has raised. Funding decisions are decisions on where and how to raise funds to finance these investments. Dividend decisions are one of many alternative ways to return funds to shareholders, and the repayment of a debt is the most usual way to return funds to debt investors.

In practice, the firm may take any one of those decisions separately or combine it with one or more other decisions. For example, a firm that is in the course of planning a venture capital investment may seek a transaction structure that enables its new shareholders to cash in after five years. On the other hand, a firm can decide to buy a new machine without having to think about how to return funds to shareholders.

Business acquisitions can raise a wide range of questions relating to investment, funding, and exit, and even questions about the existence of the target firm. Other typical ways to end the existence of the firm include liquidation and bankruptcy. Such questions will not be discussed in this book in detail as they can better be discussed in specialist books.[15] This book will focus on the activities of firms that act on a going-concern basis.

The third theme. The third theme is the emphasis on the *universality* of the types of legal questions across different types of transactions. For example, the types of legal questions that should be addressed by the firm when the firm acquires a company are no different than the basic legal questions that apply when the firm invests in real estate.

By studying legal problems on the basis of function[16] rather than industry or a narrow transaction category, it is possible to understand how the same problem can have been solved in the same ways across different categories of transactions or different industries. Furthermore, the way to solve a problem in one industry or

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[14] Coase R, The Nature of the Firm, Economica, New Series, Vol 4, No 16 (November 1937) pp 386–405 at p 395.

[15] See, for example, Finch V, Corporate Insolvency Law. Perspectives and Principles. Cam U P, Cambridge (2002).

[16] See, for example, McCormick R, Legal Risk in the Financial Markets. OUP, Oxford (2006), para 12.02 on the risk-based approach to the analysis of law and regulation.

in the context of one transaction category can help to solve the same problem in other contexts.

There are of course legal differences between different categories of transactions. Different transactions can require the use of different legal tools due to their special characteristics. These differences can help to illustrate the universality of the applicable legal questions and tools.

This book will not focus on special questions of particular transaction categories in detail. Special questions of, say, aircraft finance or syndicated loans have been discussed in specialist books in the light of a certain governing law. On the other hand, the legal tools discussed in this book will be applied in all financial transactions and therefore also in aircraft finance and syndicated loans governed by the law of a certain country.

The same can be said of other fields of law. For example, special questions of company law have been discussed in company law books focusing on one or more jurisdictions and it is not necessary to discuss all of them here. However, certain questions of company law do influence the financial decision-making of the firm regardless of the governing law and have been included.

The fourth theme. The fourth theme is *commercial practice*. While corporate finance books discuss the template that helps any firm to make decisions affecting its finances, this book also discusses the legal tools and practices normally used by firms. Legal tools and practices are important both to firms and their legal advisers.

The book contains a large number of examples illustrating the practices of real firms.

The fifth theme. The fifth theme is *deconstruction*. In all major financial transactions, the firm needs to manage four things by legal instruments: cash flow, risk, agency relationships, and information. In this book, company law instruments, contract law instruments, and other legal instruments will be deconstructed on the basis of how these four components are managed by the firm.

There is a fine line between the law of corporate finance and commercial law in general. In commercial law, the firm typically manages not only cash flow but also the exchange of goods and services. In corporate finance, the main focus is on monetary flows.

The sixth theme. The last theme of this book is the *European Union*. Corporate finance law does not exist in a legal vacuum. It can only be understood in the context of one or more jurisdictions. For example, US books on corporate finance and corporate finance law tend to assume that the legal framework is that of the US. This means that US textbooks are less useful in Europe.

There is a European body of rules and practices forming the basis of EU law of corporate finance. In addition to the Member States of the EU, Community law applies to Member States of the European Economic Area (EEA) under the EEA Agreement between the Member States of the EU and three EFTA states (Iceland, Liechtenstein and Norway), and to Switzerland under bilateral agreements between Switzerland and the EU.

The approximation of laws in the EU has contributed to further convergence of Member States' laws. There is plenty of legislation adopted by Community insti-

tutions affecting the law of corporate finance. For example, there is a piece-meal approximation of contract laws, piece-meal approximation of company laws, and extensive harmonisation of securities market laws. The Financial Services Action Plan (FSAP) played an important role in the development of a common body of rules in European securities markets. EU securities regulation is based on the Treaty objective of constructing a common market.[17]

Community law is not the only reason for the existence of common rules. The company and commercial laws of many Member States share the same roots. A western European legal system belongs to one of four legal families: English (common law), French (civil law), German (civil law), or Nordic (civil law).

In addition, similar commercial practices are being adopted throughout the Community. It is normal to use Anglo-American legal practices and the English language in international commercial transactions. Anglo-American legal practices have therefore become increasingly popular in continental Member States over the years.

This body of rules and practices is highlighted here in order to demonstrate the intercourse between rules and practices and financial decision-making. For the same reason, there will often be references to Member States' national laws. However, this book is not intended as a complete account of all legal rules influencing corporate finance in Europe, because it would not be possible to write such a book.

Although this book will present not only rules adopted by EU institutions but even rules applied by the Member States, this book is not a comparative overview of Member States' laws as such. Rather, the book will focus on some main themes useful in financial decision-making. To achieve this, it is not necessary to discuss the laws of every Member State. There will be references mainly to English,[18] German and sometimes – the author being a Finn – Nordic law, but no complete comparative analysis. There are references to German language materials in addition to English language materials. After English, German is the second most popular foreign language studied in Europe.

1.4 General Principles and the Firm

The book will focus on the *general principles* of corporate finance law. As said above, the book will look at these general principles from the perspective of the firm rather than from the perspective of the legislator or the perspective of the established internal conventions of other fields of law.

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[17] Article 2 of the EC Treaty.

[18] In most cases, the same rules apply in the United Kingdom (UK). However, Scots law is a separate legal system. According to the Scotland Act, the Scottish Parliament has devolved powers within the UK. Any powers which remain with the UK Parliament at Westminster are reserved. Reserved matters were set out in Schedule 5 of the Scotland Act.

This approach is rare. It can be hard to find a book on the general principles of any field of law written from the perspective of the users of law. Practices have nevertheless been studied in social sciences.[19]

The choice of the perspective of the firm brings clear benefits. Each country has its own laws and its own terminology, and all laws can influence the behaviour and financial decision-making of firms in one way or another in a market economy. It would therefore be impossible to write a book on corporate finance law, if the purpose of the book were to describe the contents of all those laws, and just as impossible to write a book on the general principles of corporate finance law, because the general principles of all those other areas of law are different. In any case, the result would be local and hardly relevant outside the context of one jurisdiction. The choice of the perspective of the firm means that it is possible to identify a number of key questions that are identical, regardless of the jurisdiction. Firms must address the same key questions everywhere. The most important objectives of the firm and processes that the firm can employ to address those questions are not limited to one jurisdiction but are shared by most firms.

Although the focus is on the decision-making of the firm, the same general principles can be applied by other entities and individuals who participate in trade and finance as suppliers, buyers, contract parties or consumers.

Legal practices, general principles, behaviour, and legal policy. The usual legal practices of firms reflect the behaviour of a large number of market participants trying to act in a rational way. Like financial theory, the legal practices of market participants can therefore help to understand both the market and what is regarded as rational market behaviour.

In principle, such behavioural theories can also be useful for legal policy if they "predict (with reasonable success) the likely responses to legal rules of the particular classes of actors to whom the rules are geared, whether or not the responses of other classes of actors would likely be identical".[20]

One of the theories in this book that may or may not influence legal policy and may or may not be self-fulfilling is the recognition of the interests of the firm and the choice of the firm as the principal for the purposes of company law.

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19 For example, Bourdieu P, Outline of a Theory of Practice. Cambridge Studies in Social and Cultural Anthropology (No 16). Cam U P, Cambridge (1977). Michel Foucault studied self-practices.

20 Korobkin RB, Ulen TS, Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics. Cal L R 88(4) (2000) p 1072.

2 The Nature of Corporate Finance Law

2.1 Introduction

This volume will focus on the most abstract principles of corporate finance law. This chapter will explain the definition of corporate finance law presented in the preface. The nature of corporate finance law can be explained on the premiss that the law of corporate finance is regarded as an autonomous discipline. The law of corporate finance has a distinctive character which is based on the unique nature of the tasks it undertakes.

2.2 Key Objectives of Corporate Finance Law

For the firm, the law of corporate finance has one distinct objective separating it from other areas of law. The law of corporate finance should help the firm to make decisions regarding its finances in a rational way.[1] While corporate finance provides a framework that helps to make sense of the behaviour of all firms from an economic perspective, the law of corporate finance can help to make sense of the behaviour of all firms from a legal perspective.

Perspective of the firm. In the law of corporate finance, the starting point should be the firm. The choice of the perspective of the firm helps to better explain corporate reality.

This does not prevent investors from benefiting from corporate finance law in the same way as firms do. First, firms invest in all kinds of things themselves and can often act in the capacity of investors. Second, an investor - even a private person - can be regarded as a "firm" when making investment decisions. All investors can thus use the information provided by corporate finance law when making their own investment decisions. The same can be said of funding and exit decisions.

Context. The law of corporate finance is applied in the context of investments, funding, exit, and certain existential questions. All firms from small businesses to large multi-national companies weigh up alternative investments and alternative ways to obtain funding. The firm will also study different exit alternatives either in

[1] The rational choice theory is the prevailing theory of decision-making in microeconomics and much of the other social sciences that have been influenced by economics.

P. Mäntysaari, *The Law of Corporate Finance: General Principles and EU Law*,
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the role of an investor or a party that has raised external funding. Sometimes the firm can face existential questions. The firm can cease to be independent when it is taken over, and many firms will cease their activities through liquidation, bankruptcy, or otherwise.

Financial decision-making. Financial decision-making involves a choice between two or more possible courses of action. It has six steps: (1) define objective(s); (2) identify possible courses of action; (3) assemble data relevant to the decision; (4) assess the data and reach a decision; (5) implement the decision; and (6) monitor the effect of the decision.

Identifying the legal objectives of the firm. Generally, laws lay down the framework of specific “rules of the game” that define the constitution of the market.[2] The rules of the game will govern the market, the dealings of the firm with market participants, and intra-firm activities.

The law of corporate finance can help the firm to identify possible courses of action and to identify the best legal ways to meet the commercial objectives of the firm.[3] However, these cannot be identified unless the legal objectives of the firm have been identified first.

One can identify four fundamental legal objectives in the context of corporate finance: (1) the management of cash flow;[4] (2) the management of risk; (3) the management of agency relationships; (4) and the management of information. These four legal objectives can sometimes be at the core of the business model of the firm.

This can be illustrated by the case of the German subsidiary of Ebay. Ebay is the world’s largest auction site. In the past, German Ebay collected a fixed submission fee upfront and a commission as a percentage of the sale amount. Both sellers and buyers were information intermediaries that monitored each other. Buyers could rate sellers, and sellers could rate buyers. German Ebay changed those terms in 2008.[5]

As the fixed submission discouraged potential sellers who were not sure of whether their products would be sold, it was reduced, and the commission which depended on actual sales was increased. For professional sellers (“powersellers”), the fixed submission fee was reduced to reflect their margins. The new way to regulate Ebay’s income was designed not only to regulate the fees payable to Ebay but also to reduce the risk for potential sellers, provide them with more effective financial incentives to choose Ebay, increase trading, and increase Ebay’s income.

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2 For questions concerning the “constitution of the market” in general, see Hayek FA, The Constitution of Liberty (1960) p 229; Hayek FA, Studies in Philosophy, Politics and Economics (1967), 306; Friedman M, Capitalism and Freedom, U Chic P, Chicago and London (1962), Chapter II; Kerber W, Vanberg V, Constitutional Aspects of Party Autonomy and Its Limits – The Perspective of Constitutional Economics. In: Grundmann S, Kerber W, Weatherill S (eds), Party Autonomy and the Role of Information in the Internal Market. Walter de Gruyter, Berlin New York (2001) p 57.

3 John Pierpoint Morgan, a banker, famously said: ”I don’t … want a lawyer to tell me what I cannot do. I hire him to tell me how to do what I want to do.”

4 Generally, commercial law can help the firm to determine cash flows and the exchange of goods and services.

5 Ebay wirft seine Grundprinzipien über Bord, FAZ, 12 February 2008 p 13.

As a seller who got a bad rating from a buyer could take revenge by giving an equally bad rating to that buyer, sellers were no more given a chance to rate buyers. This was designed to abolish the moral hazard and negative incentives that made it more difficult for buyers to rate sellers, to increase the reliability of buyers as monitors and information intermediaries, to reduce the risk for buyers, to increase trading, and to increase Ebay's income.

Furthermore, when potential buyers searched for offers, sellers with good ratings were shown first and sellers with bad ratings last. This was designed to give buyers an incentive to try to obtain good ratings, signal the quality of some sellers, reduce the perceived risk for buyers, and finally increase Ebay's income.

German Ebay thus managed its *cash flow* by agreeing with sellers on payment obligations. The *agency* relationship between Ebay as principal and sellers as agents was managed by fee-based incentives, by using buyers as external monitors, and by showing good sellers first. This was also part of the *risk management* of Ebay, and a way to reduce the risk both for good sellers and buyers. An additional benefit of this system was that it provided useful *information* both to buyers and Ebay and prevented a market for lemons.

The firm does not require information about possible courses of action just for the purposes of its own decision-making. Information about other parties' legal objectives can help to convince them to accept better deals. It is obviously much easier to cut a deal when both sides know what the other wants – or at least one party knows what both parties should want.[6]

Why manage cash flow and risk by legal means? Return and risk are the most fundamental concepts in rational financial decision-making. Investors can be assumed to have two goals: to maximise return and to reduce the variance of return (where variance can be understood as a proxy for risk, Markowitz 1952).

Risk and return tend to be related. If there is no risk, the expected return is the risk-free rate. As risk increases, an increasingly large risk premium over the risk-free rate is expected. Much of corporate finance is concerned with striking the appropriate balance between risk and return.

Economists say that the firm should generally invest in projects that yield a return greater than the minimum acceptable hurdle rate. The returns should be based on cash flow, time-weighted, and reflect all side costs and benefits. The hurdle rate should be higher for riskier projects and reflect the financing mix used.

Management of cash flow. Corporate finance law helps the firm to determine and regulate cash flows in advance. The key objectives of corporate finance law are: (a) identification of cash flow related issues; (b) quantification of cash flow; and (c) choice and the reduction of uncertainty.

After identifying the effect of legal rules on income and costs, the firm can manage its cash flow by using a wide range of legal tools and practices. At a high level of abstraction, the generic ways to manage the effect of legal rules on income and costs are largely the same as when managing risk. The firm can: avoid them; transfer them; mitigate them; or accept them (for a comparison with accounting, see below).

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[6] Galinsky AD, Maddux WW, Gilin D, White JB, Why It Pays to Get Inside the Head of Your Opponent: The Differential Effects of Perspective Taking and Empathy in Negotiations, Psychological Science 19(4) (2008) pp 378–384.

Management of risk. The firm will always be exposed to some risk. Corporate finance law helps the firm to choose its risk exposure in particular as regards its cash flows.

The starting point is again the identification of risks. Corporate finance law focuses in particular on the identification of legal risks and contributory legal risks.

The identification of risk is complemented by the quantification of risk. In practice, however, the quantification of legal risks and contributory legal risks may be difficult. It is not a clear mathematical process, because it typically requires the assessment of a large number of rather vague qualitative factors.

After identifying risks and quantifying them, the firm can choose its preferred risk level and reduce uncertainty. The preferred risk level can be achieved by avoiding risk, transferring risk (allocating risk between different parties), mitigating risk, or keeping risk. The firm may choose exposure to some risk factors and exclude exposure to others by using a legal framework that either eliminates certain risk factors or transfers risk to appropriate parties.

For example, the firm can sell risk and buy security from insurance companies (insurance policies), banks (bank guarantees) or other financial counterparties (derivatives). An industrial enterprise selling factories can "buy risk" and sell security by delivering those factories on a turn-key basis for a lump sum.

The legal framework helps the firm to quantify and consider the acceptability of the residual risks that remain with it. The firm may also need to quantify and consider the acceptability of those risks that can be transferred to other parties.

Management of agency relationships. Whereas cash flow and risk can be quantifiable, agency relationships add a social dimension to the law of corporate finance. Agency relationships can increase costs and risk.

In a broad sense, there is an agency relationship whenever the welfare of one party (the "principal") depends upon actions taken by another party (the "agent").

Agency is a question of organisation. The principal can choose the scope of agency (A can decide to what extent it wants to rely on actions taken by another party instead of taking the actions itself), and the principal can choose the agent (A can decide that it will rely on actions taken by B). The fundamental cause of agency problems is thus the fact that the principal cannot take all actions itself.

Agency clearly raises questions of information, cost, and risk.

The principal needs information. The quality of decisions depends on the quality of information on which the decisions are based. Before taking the decision on agency, the principal needs information about its agency needs (to what extent it needs to depend on actions taken by another party in the first place) and the quality of potential agents (the likelihood that a certain potential agent will act in the intended way if chosen). After taking those decisions, the principal needs information about the actual behaviour of the agent (monitoring).

The quality of potential agents can even depend on information possessed by the agent. First, whether the agent can act in the intended way depends on whether the agent has useful information about the principal's requirements and the way to fulfil them. Too little useful information reduces the likelihood that the agent will act in the intended way. Second, where the agent has better information than the principal, the agent may have an incentive to benefit from information asymme-

tries. One of the usual reasons to rely on agency is that the agent can possess better information about certain circumstances.

An agency relationship gives rise to particular "agency costs" in addition to other costs. They can roughly be divided into: the agent's bonding costs (signalling, reporting, commitment); the principal's monitoring costs; and the principal's residual loss.[7] (a) There are thus information costs ex ante and ex post. (b) Furthermore, for one reason or another, the agent might not behave as intended. The agent might not want to do so. For example, the agent might act selfish ("opportunistically") because of a moral hazard. Alternatively, the agent might be honest but unable to live up to expectations. This might be caused by incompetence, bad luck, unfavourable circumstances, or other things. (c) The difference between the agent's intended and actual behaviour is partly caused by the existence of monitoring costs. (d) This means, in turn, that the value of the agent's performance to the principal is reduced. If the principal must monitor the agent, the value of the agent's performance to the principal will be reduced either indirectly (when the principal must engage in costly monitoring of the agent in order to assure the quality of the agent's performance) or directly (when the agent does not behave as intended or acts opportunistically) or both. The greater the complexity of the tasks undertaken by the agent, and the greater the discretion the agent must be given, the larger these "agency costs" are likely to be.[8]

The management of agency relationships is a special form of risk management. It is special, first, because it is necessary to manage all important agency relationships, whether or not it has an effect on quantifiable cash flows or risks and, second, because there are established legal tools and practices to decrease agency costs or manage the risk that agents will fail to do what the firm wants them to do. The management of agency relationships is particularly important in corporate governance and all contractual relationships.[9]

It is important to keep in mind that the agency theory has no legal relevance as such. It is an economic theory. Agency relationships do not exist in the normative world of laws.[10] However, as agency relationships are relationships that will have to be managed somehow in the real world, the agency theory can help to explain the contents of laws and the firm's choice of legal tools and practices.[11]

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7 Jensen MJ, Meckling WH, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, J Fin Econ 3 (1976) pp 305–360.

8 See, for example, Kraakman R, Davies PL, Hansmann H, Hertig G, Hopt KJ, Kanda H, Rock EB (eds), The Anatomy of Corporate Law. OUP, Oxford (2004) pp 21–22.

9 For the purposes of this book, stewardship is regarded as a way to manage agency problems. Davis JH, Schoorman FD, Donaldson L, Toward a Stewardship Theory of Management, The Academy of Management Review, Vol 22, No 1 (January 1997) pp 20–47.

10 Principal-agency relationships (economics) are thus not comparable with commercial agency or representation of the principal (law).

11 For an analysis of Swiss contract law from an agency perspective, see Hunziker S, Das Prinzipal-Agent-Problem im schweizerischen Vertragsrecht. Informationsasymmetrien und Verhaltenssteuerung. Schulthess, Zürich Basel Genf (2007).

For instance, it is usually assumed that shareholders are "owners" who become principals when they contract with executives to manage their firms for them; as an agent of the principals, an executive is responsible for maximising shareholder utility.[12] In the legal world, this is not so. Shareholders do not own the firm. There is no legal contract between the shareholders and executives of a limited-liability company. Executives do not have any legal duty to maximise shareholder utility. In fact, European company laws are designed to further the interests of firms rather than shareholders (see Chapter 8 and Volume III). In this book, the most important principal is the firm.

Management of information. Information plays a central role in corporate finance. Its role is not limited to disclosures made to investors when marketing securities to them. All financial decision-making is based on information about cash flow, risk, agency relationships and information itself. Information reduces uncertainty and enables the firm to choose the preferred cash flow and the residual risks that remain with it.

In ideal bargaining conditions, parties to a potential transaction would have complete information on its subject matter and would be able to compute the costs and benefits of the transaction accordingly. However, parties typically do not have complete information, and there are risks inherent in information that a party does have. (a) Information can be expensive and it can be hard or impossible to obtain complete information. The future can be unpredictable. A party may therefore have to face a degree of risk when entering into a transaction.[13] (b) For many reasons, information may not be accurate or useful. For example, in order to get better terms, a party to a contract may be tempted to benefit from asymmetric information by withholding information or misrepresentings risks that it knows about.

There are typical legal tools and practices designed to manage information. The law of corporate finance can help the firm to manage flows of incoming and outgoing information, the legal relevance of information, and its reputation.

The firm uses legal tools and practices to secure the fair presentation of useful information for its own decision-making purposes. However, the cost of obtaining information adds to transaction costs. The absence of useful information increases risk by making it more difficult to assess potential gains or losses. Increased risk in entering into a transaction increases the minimum return necessary for the transaction to be one worth making. Conversely, the availability of useful information at low cost would reduce transaction costs and risk.

The other side of the coin is the management of outgoing information. Legal tools and practices can help the firm to: (1) keep information secret; (2) benefit from superior information; (3) increase the perceived usefulness of information for

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[12] See already Adam Smith, The Wealth of Nations (1776), Book V, Chapter I, Part 3, Article 1: "The directors of such companies, however, being managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own."

[13] For contract law, see Griffiths A, Contracting with Companies. Hart Publishing, Oxford and Portland, Oregon (2005) p 41.

others; (4) manage the legal relevance of information; (5) establish communication; and (6) manage its reputation.

Like the management of agency relationships, the management of information is a special form of risk management. Information is managed not only in the context of particular transactions but generally, and there are particular legal tools and practices used for this purpose.

Guidance. To sum up, law can be used to increase return and reduce risk. The firm's legal framework helps to shape the firm's external and internal relationships.[14] Corporate finance law can direct the firm to choose those courses of action that will best work towards the achievement of its intended commercial objectives. It guides the behaviour of all firms by influencing the content of financial decisions either directely or indirectly. The law of corporate finance can sometimes help the firm to resolve seemingly contradictory requirements without tradeoffs, like increasing return without increasing risk.

2.3 Corporate Finance Law and Efficiency

If one defines the objectives of the law of corporate finance in this way, corporate finance law is basically utilitarian in nature. From the perspective of the firm, the law of corporate finance provides information that can be inserted into the corporate finance template. One must again distinguish between corporate finance law as such and the legal framework of the firm.

Neutral approach to the efficiency of laws. The law of corporate finance can have a neutral approach to the efficiency of laws. The efficiency of laws is just one of the many circumstances that the firm can take account of in its decision-making, and it would in any case be complemented by unilateral action on the part of the firm or by private contracting.

Different approach in other areas of law. This approach to the efficiency of laws differs from the approach adopted in other areas of law that are not merely utilitarian in nature. The efficiency of laws and especially their Pareto efficiency can be an important goal in other areas of law such as contract law, company law, or securities markets law.

Choice of an efficient legal framework by the firm. The firm's decision-making is expected to be directed at utility maximisation and to be rational.[15] The efficiency of the legal framework that governs each transaction belongs to the objectives of the firm's internal decision-making process.

Basically, the legal framework should contribute to the maximisation of the value of the firm in the long term and the minimisation of risks that threaten its survival in a changing and uncertain environment (dynamic efficiency). The firm should ensure that the legal framework helps to allocate the firm's resources and risks inherent in its activities in an efficient way (allocative efficiency). The legal

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[14] See, for example, Bagley CE, Winning Legally. Harv Bus S P, Boston (2005) pp 8–9.

[15] Rational choice theory is the prevailing theory of decision-making in microeconomics and much of the other social sciences that have been influenced by economics.

framework can reduce the costs that are involved in the use of the firm's resources (technical efficiency). The legal framework can also contribute to the efficient production of useful information for the firm's own purposes (information efficiency).[16]

2.4 Comparison with Other Fields of Law

There is a close connection between the law of corporate finance and many other fields of law. While the law of corporate finance is utilitarian in nature and helps to facilitate a rational decision-making process for any firm, it builds on substantive rules found in traditional fields of law. For the firm, their areas overlap. For the legislator, each of the traditional fields of law has its own functions and goals, and the preferences of the legislator in one area (say, company law) do not necessarily coincide with its preferences in another area (for example, fiscal interests) because the relevant interests very depending on the context.

The law of corporate finance as a field of law. Although there is a close connection between the law of corporate finance and many other fields of law, the law of corporate finance should be recognised as a field of law in its own right.

The utilitarian nature of the law of corporate finance, the identification of the generic legal objectives of the firm, the identification of generic legal tools and practices to reach those objectives, and the identification of the financial contexts in which those tools and practices are used, make the law of corporate finance a field of law distinct from other fields of law.

The study of the use of these legal tools and practices in the context of decisions affecting the firm's finances can lead to a better understanding of the behaviour of firms.

Furthermore, the behaviour of firms can partly be explained by the existence of legal rules, tools and practices. The use of similar legal tools and practices by many firms is likely to be based on rational behaviour. This means also that corporate finance law and law and economics can complement each other.[17]

Comparison with banking law. The law of corporate finance is different from banking law. In banking law, the focus of attention is on three things. First, it focuses on the banks themselves and on bank regulators and the central bank. The second theme in banking law is how the legal relationship between banks and their

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[16] See also Scottish Law Commission, Company Directors: Regulating Conflicts of Interests and Formulating a Statement of Duties [1998] SLC 105 (Discussion Paper) (August 1998) paragraphs 3.3–3.4.

[17] Compare Jolls C, Behavioral Economics Analysis of Redistributive Legal Rules, Vand L R 51 (1998) pp 1653–1677 at p 1654: "Where [behavioural law] disagrees with conventional law and economics is about the shape of the predictable patterns of human behavior. Its goal is to offer better predictions and prescriptions about law based on improved accounts of how people actually behave." The study of actual *legal* tools and practices of firms in corporate finance law can provide information about predictable patterns of human behaviour.

customers can be characterised as a matter of law. For example, banking law must analyse the legal problems related to payment through the banking system, lending and security. Third, as banks have become multifunctional institutions, banking has become associated with securities activities. These range from a traditional task of investment banks in advising, underwriting, and distributing new issues of securities, through to dealing on their own account on securities and derivatives markets.[18]

In the law of corporate finance, however, the focus of attention is on supporting the internal decision-making of the firm itself. The law of corporate finance is not limited to the relationship between a bank and its customer.

Sometimes banking law and the law of corporate finance overlap. Banking law is one of the circumstances that the firm will take into account before deciding on an investment project or its funding. For example, banks are a valuable source of funding, banks are often used as advisers, and banks provide many other services to firms.

Comparison with private law. There is a close connection between the law of corporate finance and contract law as well as company and securities markets law. Unlike those fields of law, the law of corporate finance is nevertheless utilitarian in nature.

For example, while contract law deals with the rights and obligations of contract parties, the law of corporate finance can help contract parties to understand why a contract would be necessary in the first place, how the contract should be structured, and what terms would be in each contract party's interests.

The law of corporate finance can therefore focus on those parts of contract law, company law and securities markets law that support the financial decision-making of the firm.

Comparison with tax law. Tax law is an important part of the legal framework. All economic transactions and many personal decisions have important tax implications. When managing costs and legal risk, adaptation of the project to tax laws and compliance with the applicable tax laws is crucial. There is nevertheless no room to discuss questions of tax in this book.

Comparison with accounting. There is a difference between the management of cash flow and financial reporting. The accounting treatment of transactions: does not influence cash flow as such; can make transactions that do involve cash flows necessary; and can influence the choice of transactions and their terms. One could also say that adapting the firm's business to accounting rules and complying with them is a particular form of information management. Questions of accounting will fall outside the scope of this book.

Comparison with commercial law. One can also ask whether the law of corporate finance is part of commercial law.

In countries like France and Germany with a civil code (Code Civil, Bürgerliches Gesetzbuch) and a commercial code (Code de Commerce, Handelsgesetzbuch), traditional commercial law cannot have general principles of its own. The

[18] See Cranston R, Principles of Banking Law. Second Edition. OUP, Oxford (2002) pp 131, 231, 300 and 325.

commercial code only complements the civil code by setting out particular provisions for enterprises. If commercial law has general principles, they are limited to the identification of the scope of enterprises or "merchants" to which the commercial code applies.

On the other hand, this book can function as an advanced introduction to commercial law in disciplines focusing on the interests of the firm.[19] The perspective of the firm, the identification of the generic legal objectives of the firm, and the identification of generic legal tools and practices used by firms to reach those objectives could in principle form the basis of *modern commercial law*. The law of corporate finance can form part of modern commercial law.

Table 2.1 Modern Commercial Law

Perspective	The perspective of the firm.
Generic legal objectives	Management of cash flow and the exchange of goods and services. Management of risk. Management of principal-agency relationships. Management of information.
Generic legal tools and practices	Incorporation and the choice of a business form. Contracts. Regulation of internal processes through compliance and otherwise. Typical ways tio manage agency relationships. Typical ways to manage information problems.
Different levels	Strategic level. Operational level. Transactions.
Different contexts	Different decisions depending on the context. Special legal tools and practices depending on the context.
Particular areas of law depending on the context	For example: The Law of Corporate Finance. The Law of Corporate Governance. The Law of HRM. Corporate Tax Planning. Management of IPR.

One can design other new areas of modern commercial law sharing the same perspective, the same generic legal objectives, and the same generic legal tools and practices. The decisions to which they are applied and the particular legal tools and practices will vary depending on the *context*, meaning that one can design

[19] For the role of the discipline in a discipline-based faculty and the difference between business schools and law schools, see Van Zandt D, Discipline-Based Faculty, J Legal Edu 53 (2003) p 332.

many new areas of modern commercial law (for a new definition of corporate governance law, see section 8.2.1).[20]

2.5 Key Tools and Practices in Corporate Finance Law

At a very general level, key legal tools in corporate finance law can be divided into general legal tools that will be used in practically all transactions, and special legal tools that will be used in particular situations depending on the nature of the transaction.

General and special legal tools and practices. General legal tools in corporate finance law include: (a) incorporation and the choice of the business form of the firm; (b) contracts; (c) the regulation of internal processes through internal rule-making ranging from articles of association to compliance programmes, internal guidelines, other policies and other corporate decisions; (d) typical tools and practices designed for the purpose of managing principal-agent relationships; and (e) typical tools and practices designed for the purpose of managing information.

Special legal tools depend on the transaction. For example, some rights such as intellectual property rights and many security rights will not exist without registration.

Importance of standard practices. There are established types of transactions and standard legal practices. The use of established legal tools and practices can help to reduce transaction costs and manage risk.

On the other hand, the existence of established legal tools and practices can also cause path-dependency and, in practice, limit the number of courses of action available to the firm. (a) Not all firms possess the necessary skills to develop new types of transactions or new legal tools. (b) Only some firms are sufficiently powerful in the market place to persuade other market participants to agree to their use. (c) The development of new types of transactions or legal tools can increase legal costs. (d) The use of new categories of transactions or legal tools that have not yet been tested in courts may increase the legal risks of the project.

[20] One could also say that the choice of one additional perspective (user perspective) makes the traditionally two-dimensional legal system ("a hierarchical chart") three-dimensional ("a cube"). While the existing legal system consists of areas of law like private law (which can further be divided into contract law, tort law, and other areas of law) and public law (which can further be divided into more precise areas of law), a legal area which is defined by the interests of the user can contain aspects of many areas of law.

3 Management of Cash Flow: General Remarks

3.1 The Scope of Legal Considerations

In the previous chapter, it was said that cash flow and risk are important concepts in corporate finance law. This chapter will explain the particular nature of the management of cash flow.

Basically, cash flow and risk are managed by using the same legal tools and practices. This is because of the nature of risk. Risk is defined as the variance of something, and legal tools and practices can be used to reduce variance and make that something more fixed. When choosing between different fixed states, the same legal tools and practices are available. Therefore, when managing cash flow, the legal tools available to the firm are the same legal tools and practices that the firm uses when managing the variance of cash flow (risk).

For this reason, the management of cash flow can be discussed very briefly in this book. What is said of the management of risk will usually apply even to the management of cash flow. Some general comments can nevertheless be made.

Scope of legal considerations. Laws lay down the framework of specific "rules of the game" that define the constitution of the market.[1] The scope of legal considerations is vast. Legal considerations influence the market, the interaction of the firm with market participants, and intra-firm activities.

The projected cash flow is based on the assumption that what the firm plans to achieve will actually happen. The legal framework can influence cash flow in many ways. At the most general level, the legal framework can support the project directly or indirectly.

The legal framework can facilitate the project by providing for private ownership rights, freedom of contract and the enforceability of contracts between the parties, the legal personality of companies and other business forms, and protection against unethical action by other parties.

The meaning of "private property" and "freedom of contract" depends on what the law says they mean. Whereas one market constitution determines the contents of property rights and what contracts should be enforceable in one way, another market constitution can determine

[1] For questions concerning the "constitution of the market" in general see Hayek FA, The Constitution of Liberty (1960) p 229; Hayek FA, Studies in Philosophy, Politics and Economics (1967) p 306.

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them in another way.[2] In the words of Hayek: "'Freedom of contracts', like most freedoms of this kind, does not mean that any contract must be permitted or be made enforceable, but merely that the permissibility or enforceability of a contract is to be decided by the general rules of law and that no authority has power to allow or disallow a contract on the basis of the merits of its specific contents."[3]

In addition, the legal environment has an effect on supply and demand, competition, and the market as a whole. Laws and administrative provisions can influence cash flow by increasing and reducing costs for transactions with market participants and costs for intra-firm actitivities. For example, a change in tax laws or mandatory provisions applicable to employment relationships can increase the firm's costs. The costs can also be triggered by the liability of the firm for loss or damage sustained by third parties.

Transaction costs. Some of the costs are transaction costs. Transaction costs are the various incidental costs incurred by parties in making a bargain and include "search costs", "bargain costs" and "enforcement costs".

3.2 Generic Ways to Manage Cash Flow

At a high level of abstraction, there are three overlapping categories of generic ways to manage cash flow. First, the firm can avoid income or costs, transfer them, increase or reduce them, or accept them. Second, when the firm or anybody else wants to control cash flow (in a cybernetic sense), three components of control must be present: information-gathering, standard-setting, and behaviour-modification.[4] Third, there are generic *legal* tools and practices used by firms when managing cash flow.

Generic legal tools and practices. The legal framework influencing cash flow consists of a wide range of legal background rules and rules chosen by the firm.

Laws influence cash flow indirectly (especially through the price mechanism as well as by permitting or prohibiting certain activities or regulating their terms) and directly (by creating statutory payment obligations).

The firm can *avoid* the indirect or direct effect of legal background rules on cash flow in two ways. First, the firm can avoid the *activities* to which they apply (opt-out). Alternatively, the firm can choose its activities and accept the effect of legal background rules on its activities (opt-in). Second, the firm can to some extent avoid the effect of legal background rules by choosing the applicable *legal*

[2] Hayek FA, Individualism and Economic Order (1948) p 113; Hayek FA, The Constitution of Liberty (1960) p 229; Kerber W, Vanberg V, Constitutional Aspects of Party Autonomy and Its Limits – The Perspective of Constitutional Economics. In: Grundmann S, Kerber W, Weatherill S (eds), Party Autonomy and the Role of Information in the In-ternal Market. Walter de Gruyter, Berlin New York (2001) p 56.

[3] Hayek FA, Studies in Philosophy, Politics and Economics (1967) p 306.

[4] See Hood C, Administrative Analysis. Brighton, Wheatsheaf Books (1986) p 112; Hood C, Rothstein H, Baldwin R, The Government of Risk. OUP, Oxford (2001) p 23.

background rules without adapting its activities as such. For example, the firm can incorporate the legal entity within which the firm operates in a certain jurisdiction and choose the law governing its contracts with third parties.

There are two main ways to *transfer* income or costs or to *accept* them in dealings with market participants. The first involves the use of *contracts* (which will be discussed in Volume II). Laws enable the firm to replace other parties' voluntary payments with legally enforceable obligations to pay (payment claims) and help the firm to assess its own obligations to pay. The second is through *incorporation* (section 4.4.3).

The choice between doing something internally or buying it from market participants raises a fundamental question about why firms exist in the first place. In his 1937 essay "The Nature of the Firm",[5] Ronald Coase tries to explain why the economy is populated by a number of business firms, instead of consisting exclusively of self-employed people who contract with one another. According to Coase, the firm should find a balance between two kinds of costs. First, Coase says that firms will arise when it is cheaper to produce something internally than to obtain it via the market. In addition to the price paid for the good or service, there are also transaction costs that increase the cost of obtaining something via the market. On the other hand, Coase also notices that there are "decreasing returns to the entrepreneur function" such as increasing overhead costs and costs for making wrong business decisions. Because of those decreasing returns, the firm cannot grow indefinitely. Therefore, at some point it can become cheaper to pay for goods or services (and let the vendor of goods or the provider of services to organise production) than to produce them internally (and organise production internally).

The firm can *reduce* costs (and increase income) in many ways. It can mitigate costs in intra-firm activities through internal action. The legal tools and practices include internal guidelines and standards and, generally, many tools and practices designed to manage internal agency relationships (Chapter 6) or used in corporate risk management (Chapter 7). In addition, it can reduce costs in its dealings with other market participants by information management (Chapter 10 and Volume II).

Community law. In the light of the definition of cash flow and risk, one can say that Community law influences cash flow in the same way it influences risk. Community law will be discussed in the context of risk in more detail. Some very general remarks can be made.

Cash flow is influenced by *market size and market structure*. The EU is committed to market economy. The regulation of the internal market is designed to increase access to markets and overall market size, and it influences both market structure and the relationships between market participants.

The regulation of the internal market and the principle of subsidiarity[6] (see section 4.2.3) facilitate a market economy, set restrictions on central planning that would dismantle the free market system, and should by doing so prevent the EU from following "the road to

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[5] Coase R, The Nature of the Firm, Economica, New Series, Vol 4, No 16 (November 1937) pp 386–405.

[6] Article 5 of the EC Treaty.

serfdom" (Hayek). However, the main rule is that Community law does not say what goods and services should be produced by the public sector and what by private institutions.

The four freedoms are designed to reduce transaction costs for firms and consumers. On the other hand, parts of Community law can increase transaction costs as Member States' earlier rules designed for each national market have been replaced by common rules designed for a much wider internal market. For example, the mandatory information management regime for issuers can increase costs for issuers (see Volume III), and public procurement or outsourcing by the public sector is governed by a complex legal framework which is likely to increase transaction costs for public-sector entities.[7]

Competition law is an example of the regulation of market structure. Competition is expected to encourage innovation and push down prices. In order to protect competition, the EC Treaty sets out two core prohibition rules. First, agreements between two or more firms which restrict competition are prohibited by Article 81 of the Treaty. The most obvious example of illegal conduct infringing Article 81 is a cartel between competitors (which may involve price-fixing or market sharing). Second, firms in a dominant position may not abuse that position (Article 82 of the EC Treaty). This, for example, is the case for predatory pricing aimed at eliminating competitors from the market. Another example of the application of Article 82 is the famous Microsoft judgment of the Court of First Instance dated 17 September 2007. In that judgment, the Court of First Instance confirmed the principles that must be respected by dominant companies as regards interoperability disclosures and the tying of separate software products.[8]

Like competition law, intellectual property law can influence market structure. The purpose of intellectual property law is to encourage innovation and economic growth by means of monopoly rights. There is thus a potential confict between competition law and free movement of goods and services on the one hand and intellectual property law on the other. For this reason, there is plenty of Community legislation and case-law in this area. The aim of EU intellectual property law is to: create unitary systems for the protection of such rights with Community-wide effect (Community trade marks, designs, and patents); and avoid such barriers of trade and restrictions on competition that are not necessary. For example, there is case-law on the exhaustion of intellectual property rights; a trade mark will therefore not entitle the proprietor to prohibit its use in relation to goods which have been put on the market in the Community under that trade mark by the proprietor or with his consent.[9] Another example is restrictive clauses in licensing agreements. If a license is regarded as beneficial to competition, terms that are necessary if a license is to be entered into at all will need to be permitted; on the other hand, terms that go beyond what is regarded as nececessary may be deemed restrictive of competition and prohibited.[10]

Community law influences cash flow also by providing for *mandatory obligations* which allocate costs for certain activities in particular areas of law (see also Volume II). One can say that such obligations belong to an extensive European *risk management regime* ranging from product safety to public disclosure.

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7 See Directive 2004/18/EC and Directive 2004/17/EC (Utilities Directive).

8 Case T-201/04 Microsoft v Commission.

9 The application of the principle of exhaustion of rights patents and trademarks were established in sister cases 15/74 Centrafarm v Sterling Drug [1974] ECR 1147 and 16/74 Centrafarm v Winthorp BV [1974] ECR 1183.

10 One of the first cases was Case 258/78 Nungesser v Commission [1982] ECR 2015 (Maize Seed).

Lastly, Community law influences the liability of firms for *tax*. Tax planning is important in all investment projects because taxes can generally reduce net return. It is not the purpose of this book to discuss tax issues. There are nevertheless some important European aspects to taxation. Harmonising taxation is a growth area of Community law.

There is a difference between direct taxation and indirect taxation. The Treaty establishing the European Community (the EC Treaty) contains no specific provisions on the alignment of direct taxation. Basically, direct taxation belongs to the competence of the Member States. For example, in the area of corporate taxation, only two directives and a convention are currently in force (all three approved at the same meeting of the Council on 23 July 1990).

For this reason, there is no across-the-board harmonisation of corporate tax rates and no common corporate tax base in the EU. There is nevertheless a growing body of case law by the European Court of Justice (ECJ) dealing with the division of competence regarding direct taxation. Unlike direct taxation, indirect taxation requires a higher level of harmonisation because of its impact on the free movement of goods and freedom to provide services.

It is settled case law that although direct taxation falls within the competence of the Member States, the Member States must exercise that competence consistently with Community law.[11] In particular, direct taxation has to comply with the four freedoms (free movement of goods, persons, services and capital) and the right of establishment of people and enterprises. The scope and implementation of these freedoms are essentially determined by three further principles: (1) the prohibition of tax discrimination; (2) the prohibition of tax restriction of the exercise of the freedoms; and (3) the "rule of reason" justifying the restriction by an imperative reason of public order. For example, the obligation to exercise that competence consistently with Community law includes the obligation to comply with Article 43 of the EC Treaty, which prohibits restrictions on the setting up of agencies, branches or subsidiaries by nationals of any Member State established in the territory of any Member State.[12] The ECJ has consistently held this prohibition to mean that national tax measures that restrict, or form obstacles to, the exercise of the freedom of establishment infringe Article 43 unless that restriction pursues a legitimate objective compatible with the Treaty and is justified by imperative reasons in the public interest. In addition, the application of the restriction must be appropriate to ensure the attainment of the objective pursued and must not go beyond what is necessary to attain it.[13] The Court also frequently uses the language of discrimination in the context of Article 43 EC applied to direct taxation measures. It has consistently held Article 43 EC to prohibit discrimination, whether direct discrimination (i.e. measures differentiating overtly on nationality grounds) and indirect or 'covert' discrimination (i.e. measures equally applicable in law, albeit with a discriminatory

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[11] See, for example, Case C-346/04 Conijn v Finanzamt Hamburg-Nord, paragraph 14, referring to: Case C-80/94 Wielockx [1995] ECR I-2493, paragraph 16; Case C-35/98 Verkooijen [2000] ECR I-4071, paragraph 32; and Case C-422/01 Skandia and Ramstedt [2003] ECR I-6817, paragraph 25.

[12] See the opinion of Advocate General Geelhoed in Case C-374/04 ACT Group Litigation.

[13] See, for example, Case C-446/03 Marks & Spencer [2005] ECR I-10837, paragraph 35; Case C-251/98 Baars [2000] ECR I-2787, paragraph 22; Case C-307/97 Saint Gobain [1999] ECR I-6161, paragraph 34; Case C-264/96 ICI [1998] ECR I-4695 and Case C-250/95 Futura [1997] ECR I-2471.

effect).[14] In this regard, it has defined the concept of discrimination as the ‘application of different rules to comparable situations or … the application of the same rule to different situations’.[15]

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[14] See, for example, Case C-311/97 Royal Bank of Scotland [1999] ECR I-2651, and cases cited therein.

[15] See Royal Bank of Scotland, *ibid*, paragraph 26, and the cases cited therein.

4 Management of Risk: General Remarks

4.1 Introduction

Much of corporate finance law is about the management of risk. This chapter will discuss the nature of legal risks as well as the most general ways to manage legal risks and other risks by legal means. For example, the importance of legal compliance programmes in the management of legal risks will be explained. It will also be argued that incorporation and contracts are the two most general ways to manage other risks by legal means in corporate finance law. The chapter on corporate risk management will provide a broader and more detailed account of the risk management processes of firms and the legal regulation of risk management. Volumes II and III will provide guidance on risk management in the context of contracts and particular financial transactions.

Risks. The firm is normally exposed to a large number of different risks. The exact nature of risks to which the firm is exposed depends on the nature of the project or transaction. Risks inherent in funding and exit will be discussed in Volume III. Typical risk categories in transactions involving investment in machines and equipment could include the following:

- Commercial risk. Commercial risks are those inherent in the project itself. For example, it may turn out that the purchase of a machine for the production of certain things is not commercially successful in the absence of sufficient demand for such products.
- Operational risk. Operational risk can be defined as "the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events."[1] Operational risk includes even many legal risks.
- Legal risk. Legal risk in the broad sense is the risk that the projected cash flow will not happen because of things attributable to the legal framework of the project. Legal risk will be discussed in section 4.2 in detail.
- Reputational risk. The activities of firms are constrained by reputational risk. Reputation is a key source of competitive advantage where products and services are less differentiated otherwise. Business reputation is gained over time but can be lost quickly.
- Counterparty risk. According to the traditional view, counterparty risk relates to the ability or willingness of the other party to the transaction to fulfil its con-

[1] Paragraph 644 of the Basel II Accord.

P. Mäntysaari, *The Law of Corporate Finance: General Principles and EU Law*,
DOI 10.1007/978-3-642-02750-5_4, © Springer-Verlag Berlin Heidelberg 2010

tractual obligations. In this book, a distinction is made between counterparty corporate risk, counterparty commercial risk, and counterparty credit risk.

- Third-party risk. The ability of the firm and its counterparties to fulfil their obligations can sometimes depend on whether third parties fulfil their own obligations. In many financial transactions, the parties may have to rely on asset managers, hedge counterparties, providers of external credit enhancements, and so forth. Third party risks are these kinds of performance risks.
- Event risk. The occurrence of a certain event may trigger legal obligations or release a party from them. There is also the risk of extreme events. The range of such events is wide. For example, a geopolitical risk can result in a sudden and large increase in oil prices or a global pandemic can reduce the number of people able to work. An extreme event can spread its effects in many ways.
- Macroeconomic risk. Macroeconomic risks relate to external economic effects not directly related to the investment project. These include, for example, inflation, interest rate changes, and changes in the exchange rates of currency.
- Political risk. Political risk (also known as country risk) relates to the effect of government action or important political events (such as war, civil disturbance, and labour unrest). Political risk is not limited to unstable countries or extreme events such as expropriation, foreign exchange availability and political force majeure events like war and civil disturbance.

There are also other risks. The risk exposure of a party depends on the context, and the categories of risk are neither prescriptive nor exhaustive. The risks that should be addressed in a manufacturing project are different to the risks that the firm would face in a financial transaction involving the issuing of securities, and the risks that the firm is exposed to in an internal manufacturing project are not the same as the risks that should be addressed in an outsourcing project (see section 9.7).

Management of risk. Like the management of cash flow, the management of risk belongs to the core functions of the firm. Risk is managed not only by the firm but also by the state, the firm's stakeholders, its contract parties, and other parties. Different risks can be managed in different ways because of their inherent nature and because of existing risk management by the state through laws.

Generic ways to manage risk. At a high level of abstraction, there are three overlapping categories of generic ways to manage risk. First, the firm can avoid, transfer, mitigate, or accept risk. Second, when the firm wants to control[2] risk, three components must be present: information-gathering, standard-setting and behaviour-modification. Third, there are generic legal tools and practices used by firms when managing risk.

[2] In a cybernetic sense, control means the ability to keep the state of a system within some preferred subset of all its possible states. See Hood C, Administrative Analysis. Brighton, Wheatsheaf Books (1986) p 112; Hood C, Rothstein H, Baldwin R, The Government of Risk. OUP, Oxford (2001) p 23.

Risk management by the state. Practically all commercial laws are forms of risk management by the state. Risk management by the state means government activity designed either to reduce or reallocate risk.[3]

There are many obvious examples. To begin with, there would be little business activity without the enforcement of property rights. Other typical examples of the reduction or reallocation of risk by the state could include: the limited liability of shareholders in company law; bankruptcy laws; banking and insurance laws, contract and tort laws; consumer protection and product liability laws; labour laws; and social security.

There is substantial variety in the way risks are handled in different countries. There is variation both between one country and another and between one domain of risk and another within a single country.[4] In the EU, numerous legislative instruments adopted by Community institutions can influence risk management directly or indirectly on a piece-meal basis depending on the context.

Risk management by the firm. The firm manages risk at the strategic, operational, and transactional level, as well as in the context of all four generic decisions influencing its finances. Practically all legal tools and practices employed by the firm also deal with risk management. Different risks can be managed in different ways. One can also distinguish between the management of risk by legal means and the management of legal risk.

In the following, the definition of *legal risk* (section 4.2) will be followed by the management of legal risk (section 4.3) and the management of any kinds of risks by *legal means* (section 4.4). *Corporate risk management* belongs to the core functions of the firm (Chapter 7). It requires the management of *agency relationships* (Chapter 6) and the management of *information* (Chapter 10).

4.2 Legal Risk

4.2.1 Introduction

Laws are a good thing. A separate legal entity can thank laws for its own existence as a legal person. Practically everything that the firm does is based on or influenced by laws. The existence of laws makes the behaviour of people more predictable. Depending on the country and the circumstances, people can be expected to try to comply with laws, and laws define and limit the set of choices available to people that try to comply with them. On the other hand, there are risks inherent in the legal framework. Many legal risks are caused by the nature of laws and many legal risks exist because laws tend to address other kinds of risks.

Laws further broad policy objectives. Generally, many legal risks can be explained by the existence of laws that further broad policy objectives. The six pri-

[3] Moss DA, When All Else Fails: Government as the Ultimate Risk Manager. Harv U P, Cambridge (2002) p 1.

[4] Hood C, Rothstein H, Baldwin R, The Government of Risk. OUP, Oxford (2001) pp 5, 23 and 45.

mary public policy objectives that underlie the regulation of business in the EU are: establishing a common market and an economic and monetary union; promoting economic growth; promoting consumer welfare; protecting employees; protecting the environment; and promoting social welfare.[5]

Flexibilility of the legal framework. Legal risk is different from other risks in that there is always a legal framework and part of legal risk is caused by the inherent flexibility of that framework. The interpretation of laws and contracts and the application of administrative practices always contain an element of uncertainty.

4.2.2 Different Categories of Legal Risk

Depending on the context, there are different perceptions of the meaning of legal risk. For example, financial regulators may have different ideas about legal risk and the terminology used by them can vary depending on the context.[6]

This can be illustrated by the definitions of legal risk used in the publications of Bank for International Settlements: (a) It has been assumed in the context of Basel II that legal risk "includes, but is not limited to, exposure to fines, penalties, or punitive damages resulting from supervisory actions, as well as private settlements".[7] (b) The Committee on Payment and Settlement Systems (CPSS) of the Group of Ten countries (G10) has defined legal risk in its recommendations for central counterparties (CCP) as "the risk that a party suffers because laws or regulations do not support the rules and contracts of a CCP or the property rights and other interests associated with a CCP".[8] (c) In the context of securities lending transactions, the CPSS has defined legal risk as: "the risk of loss because of the unexpected application of a law or regulation or because a contract cannot be enforced"; the risk that "certain provisions may not be enforceable"; and the risk that "the relevant insolvency law may impose a stay that prevents the collateral taker from quickly liquidating the collateral".[9]

A novel way to distinguish between different categories of legal risk is used in this book. There are different categories of legal risk from the perspective of the firm, because legal risks belonging to different categories are managed in different ways.

General, transaction specific and contributory legal risks. First, one can distinguish between different risks on the basis of the extent they are caused by the legal system. A distinction can thus be made between general legal risks, specific legal risks and contributory legal risks.

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[5] See Article 2 of the EC Treaty. For the US, see Bagley CE, Winning Legally. Harv Bus S P, Boston (2005) pp 26–28.

[6] See McCormick R, Legal Risk in the Financial Markets. OUP, Oxford (2006), paragraphs 4.05 and 4.11.

[7] Paragraph 97 of the Basel II Accord.

[8] BIS, Committee on Payment and Settlement Systems, Recommendations for Central Counterparties, CPSS Publications No 64 (November 2004), paragraph 3.11.

[9] BIS, Committee on Payment and Settlement Systems, Securities lending transactions: market development and implications, CPSS Publications No 32 (July 1999).

- General legal risks are dependent on legal considerations rather than other considerations. In addition, they are not transaction specific.
- Transaction specific legal risks are dependent on legal considerations rather than other considerations. In addition, they are transaction specific.
- Contributory legal risks are legal considerations that increase or decrease other risks. Some contributory legal risks are included in all non-legal risks, i.e. risks that are regarded neither as general legal risks nor transaction specific legal risks.

Legal risks caused by the parties. Second, one can distinguish between different legal risks on the basis of the extent they are caused by the parties. One can distinguish between legal risks that are not party specific, legal risks that depend on the conduct of the parties, and legal risks that are inherent in the identity of the parties.

- Legal risks that are not party specific can concern the legal system as a whole or specific legal matters. Legal risks that concern the legal system as a whole contain in particular the risk that laws are not applied (lack of the rule of law) and the inherent flexibility of law (risk inherent in interpretation). Legal risks that relate to specific legal matters contain in particular the risk that wanted terms are not binding as intended and the risk that unwanted terms are binding (for those risks, see Volume II).
- Legal risks that depend on the conduct of the parties contain in particular the interpretation of contracts risk and the risk that terms are too rigid (see Volume II).
- Legal risks that relate to the identity of parties to the transaction can concern the firm's counterparty or the firm itself (Volume II).

Legal risks relating to the counterparty. Third, one can distinguish between different categories of counterparty risks on the basis of the extent they are caused by laws. Whereas some counterparty risks can be regarded as legal risks, other counterparty risks are affected by contributory legal risks. Counterparty risk can therefore be divided into three categories: counterparty corporate risk; counterparty commercial risk; and counterparty credit risk.

- Of these three categories of counterparty risk, counterparty corporate risk (Volume II) clearly belongs to legal risks.
- Unlike counterparty corporate risk, counterparty commercial risk (Volume II) is a category that is not just related to law. Legal considerations are likely to increase or decrease counterparty commercial risk. Legal considerations can nevertheless play a very important role in this category. For example, legal instruments can help to mitigate risk.

- The same can be said of counterparty credit risk (Volume II). Although counterparty credit risk can hardly be described as a category of purely legal risks, legal considerations can be very important in this category.

Legal risks relating to the firm itself. From the perspective of the firm's counterparty, the firm is the counterparty. Similar questions will therefore be relevant to the firm indirectly. Furthermore, corporate risk is an important form of legal risk that will be managed by the firm even in the absence of a counterparty (Volume II). For example, the firm will need to ensure that it has taken all necessary corporate action in compliance with the applicable company laws.

4.2.3 The Effect of the EU on Legal Risk

Community law has reduced many risks. On the other hand, the approximation of laws has at the same time created new risks and increased some existing risks.

Risk reduction. Factors that reduce risk include: political stability; rule of law; the single market; approximation of laws; the approximation and mutual recognition of technical standards and marketing methods; the EMU; and economic stability.

Political stability. Membership in the European Union contributes to political stability in the Member States. The distribution of powers between the institutions of the EU and the Member States, the duty of the Member States to comply with their obligations,[10] the power of the European Court of Justice (ECJ) to interpret the founding treaties and the legal acts adopted by EU institutions, and the integration of European economics make radical political changes less likely in the Member States.

Rule of law. The EU is based on the rule of law. Community institutions are subject to judicial review of the compatibility of their acts with the EC Treaty and with general principles of law. The Member States of the EU must comply with the Community acquis. Acquis communautaire consists of primary and secondary legislation, legal instruments adopted within the second and third EU pillars, the jurisprudence of the European Court of Justice (and Court of First Instance), Community policies and the general principles of Community law.

The obligations of Community institutions and the Member States are complemented by the rights of individuals to judicial protection. Individuals are entitled to effective judicial protection of the rights they derive from the Community legal

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[10] See in particular Article 10(1) of the EC Treaty: "Member States shall take all appropriate measures, whether general or particular, to ensure fulfilment of the obligations arising out of this Treaty or resulting from action taken by the institutions of the Community. They shall facilitate the achievement of the Community's tasks."

order, and the right to such protection is one of the general principles of law stemming from the constitutional traditions common to the Member States.[11]

The single market. Creating the customs union in the EEC took away the most obvious barrier to free trade and competition. The purpose of the single market and the economic and monetary union (EMU) was to eliminate the barriers that still survived. Signed in 1986, the Single European Act set the end of 1992 as the target date for the creation of the European single market. The single market made it easier for companies to operate throughout the EU and to run their businesses as efficiently as possible.

As members of the European Economic Area, Iceland, Liechtenstein and Norway are part of the internal market under the EEA agreement. Switzerland is part of the internal market under bilateral agreements between Switzerland and the EU.

Approximation of laws. In order to remove internal market barriers, it was necessary to replace many of the Member States' divergent rules and legal principles. Putting the single market in place meant passing more than 1,000 pieces of legislation in seven years. Legal instruments adopted by EU institutions are complemented by a large number of international agreements.

The convergence of laws partly helps to decrease legal risk in Europe. The EC Treaty and legal instruments adopted by the institutions of the EU contribute to the convergence of laws and legal practices in the EU not only directly but also indirectly. The creation of the internal market for goods and services and the adoption of the euro force business to adapt to a larger market and more competitive business conditions, and Member States have changed their laws as a reaction to these changed circumstances. There are also other reasons such as historical and cultural reasons for the convergence of laws in Europe.

Technical standards and marketing methods. The approximation and mutual recognition of technical standards is an example of how legal obstacles to trade and legal risks have been reduced. It is also an example of how the risk of non-compliance with local technical standards has been reduced through action at the Community level.

Quantitative restrictions and measures having an effect equivalent to quantitative restrictions are prohibited under Article 28 of the EC Treaty. According to the *Dassonville* formula, all trading rules enacted by Member States which are capable of hindering, directly or indirectly, actually or potentially, intra-Community trade are regarded as measures having an effect equivalent to quantitative restrictions.[12]

Such a measure can nevertheless be permitted, if it is justified by an objective in the general interest (*Cassis de Dijon*)[13] and the prohibition is a necessary and

[11] See, for example, Case T-160/03, AFCon Management Consultants v Commission of the European Communities, judgment of the Court of First Instance 17 March 2005, paragraph 39.

[12] See, inter alia, Case 8/74 Dassonville [1974] ECR 837, paragraph 5; Case C-420/01 Commission v Italy [2003] ECR I-6445, paragraph 25; Case C-71/02 Karner [2004] ECR I-3025, paragraph 36; and Case C-441/04 A-Punkt Schmuckhandels GmbH v Claudia Schmidt [2006] ECR I-2093, paragraph 12.

[13] Case C-120/78 Rewe-Zentral [1979] ECR 649 (Cassis de Dijon).

proportionate means to attain that objective. Alternatively, it can be justified by one of the objectives listed in Article 30 of the EC Treaty.

The judgment of the ECJ in the *Cassis de Dijon* case introduced the principle of mutual recognition. In the absence of Community harmonisation, the possible technical obstacles resulting from national regulations related to the production and marketing of goods can only be justified by "mandatory requirements" such as the effectiveness of fiscal supervision, the protection of public health, the fairness of commercial transactions, and the defence of the consumer (in addition to the specific derogations listed in Article 30 EC). For example, consumer protection may constitute a justification for the prohibition, provided that the prohibition is appropriate to ensure the attainment of the objective pursued and does not go beyond what is necessary to attain that objective.

The judgment of the ECJ in *Cassis de Dijon* is authority for the proposition that goods lawfully produced and marketed in one Member State should be permitted to enter another Member State. There is a presumption that goods which have been lawfully marketed in another State will comply with the "mandatory requirements".

Directive 98/34/EC (as amended by Directive 98/48/EC) seeks to prevent the creation of new technical barriers to trade and lays down a procedure for the provision of information in the field of technical standards and regulations.

Member States are obliged to notify to the Commission, in draft, proposed technical regulations and to observe a three month standstill period before the regulation is made or brought into force. This is to provide an opportunity for the Commission and other Member States to comment if they consider that the proposed regulation has the potential to create a technical barrier to trade.

Joined cases *Keck* and *Mithouard*[14] were a departure from the *Cassis de Dijon* principle. In those cases, the ECJ specified that national provisions restricting or prohibiting certain selling arrangements are not such as restrictions to trade between Member States as long as those provisions apply to all relevant traders operating within the national territory and affect in the same manner the marketing of domestic products and of those from other Member States. The ECJ subsequently found that legal rules on certain marketing methods were provisions concerning selling arrangements within the meaning of *Keck* and *Mithouard*.[15]

Regulatory competition. Generally, regulatory competition will reduce risks for firms as they can opt out of a Member States' regulatory system and choose the regulatory system of another Member State. The approximation of laws makes it possible to apply the principle of mutual recognition of standards in Community law. In principle, this can increase regulatory competition. In many areas of law, the principle of home country control applies. Regulatory competition is then en-

[14] Joined Cases C-267/91 and C-268/91 Keck and Mithouard [1993] ECR I-6097, paragraph 16.

[15] See, in particular, Joined Cases C-401/92 and C-402/92 Tankstation 't Heukske and Boermans [1994] ECR I-2199, paragraphs 12 to 14; Case C-254/98 TK-Heimdienst [2000] ECR I-151, paragraph 24; and Case C-20/03 Burmanjer [2005] ECR I-4133, paragraphs 25 and 26.

sured by the freedom of firms to choose that home country like in cases *Centros*[16] and *Inspire Art*.[17]

The economic and monetary union. The single market is complemented by the economic and monetary union (EMU). 16 Member States have so far adopted a single currency, the euro.[18] The single currency has brought many benefits to firms.

There is less need for firms to protect themselves against the risks of exchange rate fluctuations, because more than 80% of the trade of euro-area countries is now with one another. It is also easier for many firms to protect themselves against variations in exchange rates by billing their customers in the new currency than it was to bill in the old national currencies.

The euro has contributed to the integration of European wholesale financial markets. Shares, bonds, loans and derivatives can now be bought across the euro zone without additional currency or interest-rate risk.

Membership in the EMU can also protect small economies in times of financial turmoil, as the resources of a small central bank – like that of Iceland or the central banks of Denmark or the Baltic states - are limited.

Economic stability. Both the single market and the econonomic and monetary union (EMU) contribute to economic stability in the Member States and reduce thus the risk of a sudden economic downturn.

The countries that want to adopt the single currency must meet five economic criteria (the Maastricht criteria). These criteria relate to: price stability; the budget deficit; public debt; the long-term interest rate; and exchange rate stability. In addition, the EMU means respecting a set of rules known as the Stability and Growth Pact. The Stability and Growth Pact commits all EU countries to the principle of budgets that are balanced or nearly balanced over the medium term. All EU central banks are now part of the European System of Central Banks (ESCB). The hub of the European System of Central Banks is the European Central Bank (ECB) headquartered in Frankfurt.

Interest rates. Expectations concerning the development of interest rates play an important role in financial markets. A large euro area and the mechanism of setting interest rates reduce the risk of interest rate changes.

The European Central Bank sets the interest rates it uses in its dealings with banks, and these in turn act as a baseline for all euro-zone interest rates. The ECB sets its rates at the level it believes will keep prices in the euro-zone stable.

In practice, the ECB makes only small changes to its interest rates at a time. The ECB also tends to drop hints of its future course of action. All this is likely to reduce the risk of interest rate changes, because market participants know relatively well what to expect.

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[16] C-212/97 Centros [1999] ECR I-1459.

[17] C-167/01 Inspire Art [2003] ECR I-10155.

[18] Article 106 of the EC Treaty. In 1999: Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain. In 2001: Greece. In 2007: Slovenia. In 2008: Cyprus and Malta. In 2009: Slovakia.

Risk increase. On the other hand, Community law has given rise to new kinds of legal risks in the EU and increased some existing risks. The most important new legal risks relate to: the Community acquis and a new layer of regulation; the convergence of laws and the use of legal transplants; the emergence of substantive areas of Community law (such as competition law, the regulation of public procurement, product safety law, and environmental law); the existence of substantive provisions of Community law that directly (by virtue of the principle of direct effect) or indirectly (through interpretation of national law in accordance with Community law) influence the legal framework of the firm's business; the application of a potentially unfavourable law as the governing law (Rome I Regulation); and the international jurisdiction of a potentially unfavourable forum (Brussels I Regulation).

New risks created by the Community acquis. By its mere existence, the Community acquis adds one or more new layers to the legal framework and increases its complexity. It has become increasingly difficult to determine the contents of existing law in the Member States.

First, Member States have a duty to comply with their own obligations under Article 10 of the EC Treaty and interpret national law in conformity Community law.[19] The Community layer of the legal framework will make it more difficult to interpret national law.

Second, the principle of direct effect makes some provisions of Community law part of the law of the land. Community law can contain substantive provisions that are directly applicable in the legal orders of the Member States and confer on individuals rights which are enforceable by them and which the national courts must protect.

The *Van Gend en Loos* case was the first decision by the ECJ on direct effect and one of the most important judgments by the Court.[20] The test of direct effect is as follows: the provision must be clear and unambiguous; it must be unconditional; and its operation must not be dependent on further action being taken by Community or national authorities.[21] In *Marshall*,[22] the ECJ limited the scope of the principle of direct effect by ruling against the horizontal direct effect of directives.

Obligations arising from Community directives are thus binding on bodies or entities which are subject to the authority or control of a public authority or the State.[23] They do not

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[19] Since the judgment in Case 14/83 Von Colson and Kamann [1984] ECR 1891, paragraph 26. See recently Cases C-397/01 to C-403/01, Bernhard Pfeiffer and others v Deutsches Rotes Kreuz, Kreisverband Waldshut eV, judgment of 5 October 2004, paragraph 110.

[20] Case 26/62 [1963] ECR 1.

[21] See, for example, Hartley TC, The Foundations of European Community Law, Fifth Edition. OUP, Oxford (2003) p 198.

[22] Case 152/84 Marshall v Southampton and South-West Hampshire Area Health Authority [1986] ECR 723.

[23] Case 152/84 Marshall [1986] ECR 723, paragraph 49; Case 103/88 Fratelli Costanzo [1989] ECR 1839, paragraphs 30 and 31; Case C-188/89 Foster and Others [1990] ECR I-3313, paragraph 18; order in Case C-297/03 Sozialhilfeverband Rohrbach [2005] ECR I-4305, paragraph 27.

impose obligations on individuals. National law does, and national law will have to be interpreted in the light of Community directives.

Third, some provisions of the EC Treaty are regarded as applications of some more general principle which is applied in its own right as a general principle of law (such as the prohibition of arbitrary discrimimation).[24]

Fourth, there is already a large body of Community law, and it has become increasingly difficult for firms to understand it. The Commission has at least formally recognised the need to apply better regulation disciplines and to simplify legislation. The simplification strategy was adopted for the first time in the Commission's Work Programme for 2006. However, the results have so far been modest.

Fifth, there can be different opinions on how to interpret Community law. For example, after the Commission had approved the combination of Sony and BMG in July 2004, the European Court of First Instance annulled that decision in July 2006.[25] The large body of case-law on the interpretation of Community law shows that Member States tend to interpret Community law in different ways depending on the Member State and its legal culture. Furthermore, there are often different views about whether the ECJ got its judgment right.[26]

Sixth, the approximation of laws in the EU does not mean the unification of laws. Some legal barriers between different Member States will remain in place. For example, a party who is in the process of negotiating a contract and choosing the applicable law might know that the laws of two Member States are mainly similar, but the party might not know precisely on what relevant point the laws of those two countries are different.

The principles of subsidiarity and proportionality set out in Article 5 of the EC Treaty prevent the complete unification of laws. Article 5 of the EC Treaty provides that the Community may adopt measures in accordance with the principle of subsidiarity where the objective cannot be sufficiently achieved by the Member States and can therefore be better achieved at the Community level.[27] According to the principle of proportionality, measures adopted by EU institutions should not go beyond what is necessary in order to achieve the objective. Furthermore, the

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[24] See Hartley TC, The Foundations of European Community Law, Fifth Edition. OUP, Oxford (2003) p 133.

[25] Case T-464/04 Impala [2006] ECR II-2289. Appeal: Case C-413/06.

[26] For an example of a difficult distinction between questions of law and questions of fact, see Case C-206/01 Arsenal Football Club plc v Matthew Reed [2002] ECR I-10273; Arsenal v Reed [2002] EWHC 2695 (Ch); Arsenal v Reed [2003] EWCA Civ 696.

[27] In the securities-regulation sphere, harmonisation is typically regarded as justified where markets interact such that intermediaries, investors, and transactions move between them, leading to the potential for cross-border externalities such as fraud, systemic risk, and costs in the form of regulatory and enforcement risk. Moloney N, EC Securities Regulation, OUP, Oxford (2008) p 27.

legal basis of harmonisation measures will limit their scope (*Tobacco Advertising*).[28]

There are other things that can hamper the convergence of laws. In many cases, EU directives do not preclude Member States from retaining or adopting provisions with a view to ensuring more extensive protection for the interests protected by the EC Treaty.[29] Very often there is a potential conflict between national laws and Community law, because the required national implementation rules are lacking or do not clearly fulfil the requirements of Community law in terms of substance.

Seventh, all these factors make it more time-consuming to analyse the legal framework governing the project or transaction and increase legal risk.

New risks created by the convergence of laws. The mere convergence of laws typically creates new risks. It can be difficult for a country to adopt foreign legal concepts and ideas without conflicts between these legal transplants and existing law.

Existing law is a thick web of rules and principles complementing each other. Legal transplants[30] that do not fit into the existing web of rules and principles can become legal irritants[31] making it more difficult to interpret the contents of existing law and apply these transplants and other rules, which the transplants should complement. Convergence can thus increase legal risk.

Legal risk can also be increased by regional standardisation such the standardisation of private law in the Nordic countries or de facto approximation through case law in common law countries. Regional standardisation increases the number of sources distributed across a wider geographical area with partly different cultures. It is more difficult for practitioners to apply these rules than purely domestic rules with an overseeable number of local sources reflecting the same legal culture.

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28 C-376/98 Germany v Parliament and Council [2000] ECR I-8419 ("Tobacco Advertising").

29 See Article 2 of the EC Treaty: "The Community shall have as its task, by establishing a common market and an economic and monetary union and by implementing common policies or activities … a high level of employment and of social protection, … a high level of protection and improvement of the quality of the environment …" Article 94(3) of the EC Treaty: "The Commission, in its proposals envisaged in paragraph 1 concerning health, safety, environmental protection and consumer protection, will take as a base a high level of protection … Within their respective powers, the European Parliament and the Council will also seek to achieve this objective."

30 Watson A, Legal Transplants: An Approach to Comparative Law, Second Edition. University of Georgia Press, Athens (1992); Watson A, Legal Transplants and European Private Law, Electronic Journal of Comparative Law, vol 4.4 (December 2000).

31 See Teubner G, Legal Irritants: Good Faith in British Law Or How Unifying Law Ends Up in New Divergencies, Modern L R 61 (1998) pp 11–12.

New risks created by substantive provisions of Community law. The substantive provisions of Community law increase the legal requirements that firms must comply with.[32]

New risks created by the emergence of directly applicable fields of Community law. Some areas of substantive Community law are directly applicable in the Member States. Like any legal rules, the firm will have to comply with them (see below).

4.2.4 Excursion: Directly Applicable Community Law

The legal risks created by the existence of directly applicable areas of substantive Community law can be illustrated with EU competition law, rules on public procurement, the precautionary principle in environmental law, and international private law. Those areas of law can be particularly relevant for industrial firms doing business in Europe.

New legal risks created by EU competition law. EU competition law is an important source of legal risks. EC competition law is an example of an area of law that is to large extent based on the direct application of the substantive provisions of the EC Treaty in the Member States. Competition law can have fairly dramatic implications for the firm.

Article 81 and Article 82 of the EC Treaty have direct applicability by virtue of the case-law of the ECJ. Council Regulation 1/2003[33] provides that a company that infringes Article 81 or Article 82 of the EC Treaty may be fined up to 10% of its total annual turnover.[34] Periodic penalty payments are possible.[35]

Article 81(1) of the EC Treaty prohibits agreements, decisions and concerted practices between two or more firms which restrict competition. They are prohibited automatically. No prior decision by the competent authorities will be required.[36] Article 82 prohibits the abuse of a dominant position. Again, no prior decision to that effect will be required.[37] The burden of proving an infringement of Article 81(1) or of Article 82 rests on the party or the authority alleging the infringement.

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[32] A very subjective top ten list of such legal risks in the London market was published on the website of a newspaper in 2007. It included the following sources of legal risks: (1) competition law; (2) data protection law; (3) copyright law; (4) rules on product and food safety and product recall (Directive 2001/95 and Regulation 178/2002); (5) work-related health and safety; (6) accounts of public companies; (7) tax law; (8) the regulation of the financial services industry; (9) legislation against money laundering; and (10) extradition laws. Blain J, Legal risks in full, Times Online, December 9, 2007. Of those areas, only extradition laws are not based on or influenced by Community law.

[33] Regulation 1/2003 on the implementation of the rules on competition laid down in Articles 81 and 82 of the Treaty.

[34] Article 23 of Regulation 1/2003.

[35] Article 24 of Regulation 1/2003.

[36] Article 1(1) of Regulation 1/2003.

[37] Article 1(3) of Regulation 1/2003.

Agreements, decisions or concerted practices that satisfy the conditions of Article 81(3) are not prohibited. Again, no prior decision by the competent authorities will be required.[38] However, the undertaking or association of undertakings claiming the benefit of Article 81(3) of the Treaty bears the burden of proving that the conditions of that paragraph are fulfilled.[39]

Council Regulation 1/2003 provides for a decentralised system in which the competition authorities and courts of the Member States have the power to apply Article 81(1) and Article 82 of the EC Treaty and grant exemptions under Article 81(3). The Commission and the competition authorities of the Member States form a network of public authorities applying the Community competition rules. As the system of parallel powers must comply with the principles of legal certainty and the uniform application of the Community competition rules, it has been necessary to clarify the relationship between Articles 81 and 82 of the Treaty and national competition laws[40] as well as the effects of Commission decisions and proceedings on courts and competition authorities of the Member States.

The Commission has adopted Guidelines on the method of setting fines to be imposed on companies that infringe Article 81 or Article 82.[41] Fines will be based on a percentage of the yearly sales in the relevant sector for each company participating in the infringement. The Commission may impose a fine representing up to 30% of such sales. This amount will be multiplied by the number of years of participation in the infringement. In order to deter companies from ever entering into seriously illegal conduct, the Commission may add to that amount a sum equal to 15% to 25% of the yearly relevant sales, whatever the duration of the infringement (an "entry fee"). In other words, the mere fact that a company enters into a cartel could cost it at least 15% to 25% of its yearly turnover in the relevant product.

Council Regulation 1/2003 empowers the Commission to adopt commitment decisions (Article 9).[42] The firm to whom the decision is addressed must respect the conditions of the decision. Otherwise the Commission can impose a fine. National courts must enforce the commitments by any means provided for by national law. Article 9 decisions are silent on whether there was or still is a breach of the EU competition rules and therefore do not influence the burden of proof in later proceedings. For the same reason, the firm may still face enforcement action before Member States' authorities and courts.

For participants in cartels, legal risk is increased by leniency programmes. Leniency programmes allow authorities to grant full immunity or a reduction in the

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[38] Article 1(2) of Regulation 1/2003.

[39] Article 2 of Regulation 1/2003.

[40] See Article 3 of Regulation 1/2003.

[41] Guidelines on the method of setting fines imposed pursuant to Article 23(2)(a) of Regulation No 1/2003, OJ C 210, 1 September 2006 pp 2–5.

[42] Article 9(1) of Regulation 1/2003: "Where the Commission intends to adopt a decision requiring that an infringement be brought to an end and the undertakings concerned offer commitments to meet the concerns expressed to them by the Commission in its preliminary assessment, the Commission may by decision make those commitments binding on the undertakings. Such a decision may be adopted for a specified period and shall conclude that there are no longer grounds for action by the Commission."

penalties that would otherwise have been imposed on a participant in a cartel, in exchange for freely volunteered disclosure of information on the cartel and continuous cooperation in the authorities' investigation. According to a Commission notice,[43] the Commission can grant the firm immunity from any fine which would otherwise have been imposed if: the Commission did not have sufficient evidence; the firm is the first to submit sufficient evidence; the firm cooperates fully; the firm ends its involvement in the suspected infringement; and the firm did not take steps to coerce other undertakings to participate in the infringement.

The basis of European merger control is the EC Merger Regulation. The Merger Regulation applies to the control of concentrations[44] between undertakings (see Volume III).

There is also a Commission proposal for a class action procedure (collective redress mechanism) for competition law cases.[45]

New legal risks created by constraints on public procurement. The importance of public procurement ranges between 11% and 20% of GDP depending on the Member State. Most of public procurement is subject to Community and international rules. The purpose of those rules is to ensure fair conditions of competition for suppliers.

Member States' contracting entities[46] must comply with the rules and principles of the EC Treaty whenever they conclude public contracts falling into the scope of the Treaty. Those principles include the free movement of goods (Article 28), the right of establishment (Article 43), the freedom to provide services (Article 49), non-discrimination and equal treatment, transparency, proportionality, and mutual recognition.[47]

The ECJ has developed a set of basic standards for the award of public contracts which are derived directly from the rules and principles of the EC Treaty. The standards derived from the EC Treaty apply only to contract awards having a sufficient connection with the functioning of the Internal Market. In its *Telaustria*

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[43] Commission notice on immunity from fines and reduction of fines in cartel cases, OJ C 45, 19 February 2002 pp 3–5.

[44] Article 3(1) of Regulation 139/2004 (EC Merger Regulation): "A concentration shall be deemed to arise where a change of control on a lasting basis results from: (a) the merger of two or more previously independent undertakings or parts of undertakings, or (b) the acquisition, by one or more persons already controlling at least one undertaking, or by one or more undertakings, whether by purchase of securities or assets, by contract or by any other means, of direct or indirect control of the whole or parts of one or more other undertakings."

[45] White Paper on Damages Actions for Breach of the EC antitrust rules, COM(2008) 165, 2.4.2008.

[46] Contracting authorities within the meaning of Article 1(9) of Directive 2004/18/EC and contracting entities within the meaning of Article 2 of Directive 2004/17/EC.

[47] See Commission interpretative communication on the Community law applicable to contract awards not or not fully subject to the provisions of the Public Procurement Directives (2006/C 179/02).

judgment, the ECJ stressed the importance of the possibility to review the impartiality of the procedure.[48]

The possibility of legal review is likely to increase legal risk for firms that supply goods or services to public authorities.

New legal risks created by the precautionary principle in Community law. Community law can increase even other particular legal risks. For example, the precautionary principle will increase legal risk for many industrial firms.

The precautionary principle is one of the key elements for policy decisions concerning the protection of human health and the environment. It is applied in circumstances where there are reasonable grounds for concern that an activity is, or could, cause harm but where there is uncertainty about the probability of the risk and the degree of harm.

This is well-known in international law. The Final Declaration of the United Nations Conference on the Environment and Development (Rio 1992) states that "to protect the environment, the precautionary approach shall be widely applied by States according to their capabilities. Where there is a risk of serious or irreversible damage, lack of full scientific certainty shall not be used as a reason for postponing cost-effective measures to prevent environmental degradation".[49]

The precautionary principle is usually understood to oblige a producer to prove the innocuousness of its product before putting it on the market, or the initiator of a project to prove that the project will not cause any harm.

The precautionary principle is also part of Community law. According to the EC Treaty, the Community shall have as its task the raising of the standard of living and quality of life.[50] The EC Treaty requires a contribution to the attainment of a high level of health protection.[51]

Also the Community policy on the environment shall and aim towards a high level of protection.[52] Community policy on the environment shall be based on the precautionary principle and on the principles that preventive action should be taken, that environmental damage should as a priority be rectified at source and that the polluter should pay.[53]

But although the precautionary principle is part of Community law, it has neither been defined in the EC Treaty nor in the case-law of the ECJ.[54]

In 2000, the European Commission adopted a Communication on the use of the precautionary principle.

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48 Case C-324/98 Telaustria [2000] ECR I-10745, paragraphs 61 and 62. See also Case 222/86 Heylens [1987] ECR 4097, paragraph 15.

49 Final Declaration of the United Nations Conference on the Environment and Development, Rio de Janeiro, 15 June 1992, principle 15.

50 Articles 2 and 174 of the EC Treaty.

51 Article 3(1)(p) of the EC Treaty.

52 Articles 2 and 174 of the EC Treaty.

53 Article 174(2) of the EC Treaty; Case C-9/00 Palin Grant and Vehmassalon kansanterveystyön kuntayhtymän hallitus [2002] ECR I-3533, paragraph 23.

54 See Cazala J, Food Safety and the Precautionary Principle: The Legitimate Moderation of Community Courts. ELJ 10 (2004) pp 539–554.

According to the Communication, the precautionary principle is triggered, if a preliminary scientific evaluation shows that there are reasonable grounds for concern that a particular activity might lead to damaging effects on the environment, or on human, animal or plant health, which would be inconsistent with the protection normally afforded to these within the European Community. Decision-makers would then have to determine what action to take.

Rather than defining the precautionary principle, the ECJ has focused on whether national measures are compatible with Community law, in particular with the principle of proportionality. The principle of proportionality, which is one of the general principles of Community law, requires that measures implemented through Community provisions be appropriate for attaining the objective pursued and must not go beyond what is necessary to achieve it.

According to the case-law of the ECJ, the compatibility of restrictions with Community law can depend on the level of scientific knowledge.

In *Agrarproduktion Staebelow GmbH v Landrat des Landkreises Bad Doberan*,[55] the ECJ applied the precautionary principle to rules that required the slaughter of cattle due to the assumption of a link between BSE (the mad cow disease) in cattle and the Creutzfeldt-Jakob disease in humans. On the one hand, the ECJ found the following: "[I]t must be accepted that, where there is uncertainty as to the existence or extent of risks to human health, the institutions, applying the principle of precaution and preventive action, may take protective measures without having to wait until the reality and seriousness of those risks become fully apparent …"[56] On the other, the ECJ said: "[W]hen new elements change the perception of a risk or show that that risk can be contained by less restrictive measures than the existing measures, it is for the institutions and in particular the Commission, which has the power of legislative initiative, to bring about an amendment to the rules in the light of the new information."[57]

The precautionary principle has been adopted in several EU directives and implemented into national law. For example, REACH (Registration, Evaluation and Authorization of Chemicals) is an EU regulatory framework for chemicals.[58] The Reach Regulation requires firms to register their use of 30,000 chemicals, including 1,500 substances of high concern that may be linked to reproductive diseases and cancers. The REACH Regulation gives greater responsibility to industry to manage the risks from chemicals and to provide safety information on the substances. The Reach Regulation requires Member States to adopt effective, proportionate and dissuasive penalties for non-compliance.[59]

New legal risks created by international private law. Rules on choice of law and the international jurisdiction of courts can increase legal risk by making it easier for some parties to bring proceedings against a firm established in the EU. Le-

[55] Case C-504/04 Agrarproduktion Staebelow GmbH v Landrat des Landkreises Bad Doberan [2006] ECR p I-679.
[56] Case C-504/04 Agrarproduktion Staebelow GmbH, paragraph 39.
[57] Case C-504/04 Agrarproduktion Staebelow GmbH, paragraph 40.
[58] Regulation 1907/2006 (REACH).
[59] Article 126 and recital 122 of Regulation 1907/2006 (REACH).

gal risk is increased expecially for those firms selling goods or providing services to consumers in the other Member States.

The Rome I Regulation[60] contains special rules for weaker parties such as consumers and workers. Depending on the circumstances, the choice of a law by the parties to the contract may not deprive consumers or employees of the protection of the mandatory provisions of the law which would be normally applicable to them.[61]

There are similar rules on the international jurisdiction of courts. The rules on jurisdiction under the Brussels I Regulation[62] are more favourable to the interests of the weaker party in insurance, consumer and employment contracts. In certain matters relating to consumer contracts,[63] a consumer may bring proceedings against the other party either in the courts of the Member State in which that party is domiciled or in the courts for the place where the consumer is domiciled.[64]

The same rules apply even in electronic commerce under the Electronic Commerce Directive.[65]

In practice, this means that it is legally easier for a firm to sell goods or provide services to consumer in its home country. If it sells goods or provides services to consumers in another Member State, consumers are protected by the mandatory provisions of their home country's consumer laws and they can sue the firm either in their home country or the firm's home country.

4.3 Management of Legal Risk

4.3.1 Introduction

On the one hand, the management of legal risk is governed by the same principles as the management of any risks. There are generic ways to manage risk (avoidance, mitigation, transfer, acceptance). In a cybernetic sense, the management of risk requires some degree of control (information-gathering, standard-setting and behaviour-modification).[66] There are also typical ways to manage both cash flow and risk in the law of corporate finance (choice of business form and the corporate

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60 Regulation 593/2008 (Rome I). The Rome I Regulation applies from 17 December 2009 to contracts concluded after the same date. It replaces the Rome Convention. Denmark is not bound by the Rome I Regulation. See recital 46. The UK is bound by the Rome I Regulation. See Commission Decision of 22 December 2008 (2009/26/EC).

61 Article 6 and 8 of Regulation 593/2008 (Rome I).

62 Regulation 44/2001 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters (Brussels I).

63 Article 15 of Regulation 44/2001 (Brussels I).

64 Article 16(1) of Regulation 44/2001 (Brussels I).

65 Articles 1(4) and 3 as well as Annex (derogations from Article 3) of Directive 2000/31/EC (Directive on electronic commerce).

66 See Hood C, Administrative Analysis. Brighton, Wheatsheaf Books (1986) p 112; Hood C, Rothstein H, Baldwin R, The Government of Risk. OUP, Oxford (2001) p 23.

structure of the firm, contracts, internal action such as the use of compliance programmes, management of agency, and management of information).

On the other hand, the management of legal risk is different from the management of other risks because of its nature. Because of the vast amount of laws in a market economy, the inherent flexibility of law, and the flexibility of interpretation of contracts, it is in practice impossible for the firm to have full information about the legal framework governing its business. There will always be a legal framework, and the firm cannot avoid legal risk completely.

Avoiding legal risk. Although the firm cannot avoid legal risk completely, the firm can avoid specific legal risks by avoiding certain activities and/or doing business in certain countries and ensuring that the laws that govern those activities do not apply to it.

For example, manufacturers of hazardous products such as asbestos or small aeroplanes can avoid legal risk caused by US product liability laws by never entering that business or by refusing to do business in the US.

Another example is the international scope of consumer laws in the EU under the Rome I Regulation and the Brussels I Regulation (see above). This may give the firm an incentive not to sell goods or provide services directly to consumers in other Member States without careful analysis of their consumer laws.

It would also be normal for the firm to limit the legal relevance of financial information disclosed by it. Unlimited disclosure of financial information could lead to an obligation to comply with foreign securities markets laws (such as the US Securities Act of 1933 and the Securities Exchange Act of 1934) (see Chapter 10 below).

Transfer of legal risk. There can be ways to transfer legal risk. Typically, legal risk can be changed into another form of risk but cannot be transferred as such. Instead, responsibility for the matter to which the legal risk relates can be fransferred to another party.

In an investment transaction, the parties agree on their mutual core obligations and the distribution of risk between the parties. The parties may agree that the other party is responsible for matters to which the legal risk relates. In that case, legal risk is changed into counterparty commercial risk.

Incorporation is another way to transfer legal risk. Where the matter to which the legal risk relates belongs to the business of a newly incorporated subsidiary rather than that of the parent, the legal risk of the parent is changed into a commercial risk or an operational risk.

Mitigation of risk. There are particular ways to mitigate legal risk. The firm can mitigate legal risk by: adapting to existing laws and influencing whether and how they will be applied to its activities (through choice of activities and location, legal compliance, or otherwise); and changing part of the legal framework (through contracts and the choice of its business form and corporate structure).

Acceptance of risk. The firm will have to accept exposure to some legal risk. Like any risk, the acceptance of legal risk depends on the firm's risk preferences. It can also depend on the legal and business culture of the country where the firm does business.

For example, it goes without saying that legal risk is very high in a country that does not enforce rule of law (this question will be discussed in Volume II in detail). Legal risk can be high for cultural reasons even in some countries that do enforce rule of law. For example, firms tend to be exposed to a higher legal risk in a country with a trust culture.

A trust culture is characteristic of *Japan*. Japanese companies regularly deal with long-standing partners, and reputational concerns rather than strictly legal ones are paramount. If the perceived counterparty risk is lower anyway, parties may assume that there is less reason to mitigate counterparty risk by reducing contributory legal risks.[67] In a country with a culture of implicit mistrust, firms tend to be exposed to a lower legal risk. If the perceived level of counterparty risk is higher, parties may assume that there is more reason to mitigate counterparty risk by reducing contributory legal risks.

Levels. Generally, the firm manages legal risk at the strategic, operational and transactional level. One can again distinguish between the management of *legal risk* and the management of risk by *legal means*.

4.3.2 Strategic Level

A distinction can be made between the management of *legal risk* at the *strategic level* and the management of risk at the strategic level by legal means. As regards the former, legal aspects influence corporate strategy in many ways.

First, many high level organisational choices have been *regulated* by laws. The regulation may cover their substance or the decision-making process. For example, the firm must have a business form and a basic organisation.

Second, the business strategy of the firm cannot be enforced without a *legal framework*, and many strategic business decisions are influenced by laws. The firm will have to choose the countries in which it does business, the businesses it is in, and whether it wants to be exposed to the laws of certain countries.

For example, the risk of product liability lawsuits in *the US* can keep firms away from the US market or move to businesses where the risk is lower. US securities markets laws can have the same effect. Compliance with US securities markets laws is difficult and expensive, and companies that market their securities in the US face the risk of class actions. This has kept many European companies from applying for a listing in the US and encouraged delistings by European companies in the US.

Third, legal issues can be at the core of the business *strategy* of the firm. For example, there are legal aspects to each of the business strategies that can be regarded as "generic":[68] low total cost, product leadership, complete customer solutions, and lock-in. Bagley has described those legal aspects roughly as follows:[69]

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67 See My bow is my bond, The Economist, April 2008.

68 Kaplan R, Norton D, Strategy Maps. Harv Bus S P, Boston (2004) p 322.

69 Bagley CE, Winning Legally. Harv Bus S P, Boston (2005) p 11.

Table 4.1 The Legal Aspects of Generic Business Strategies

Low total cost	Protect low-cost innovative production processes by using process patents and trade secret protection. Establish long-term relationships with excellent suppliers and distributors through contracts. Manage disputes. Reduce safety hazards and avoid accidents and environmental incidents by involving specialists (even legal specialists) in product development process and operations management.
Product leadership	Obtain rapid regulatory approval for new offerings. Maintain excellent government relations. Improve product safety. Obtain strong intellectual property protection. Protect customer lists as trade secrets. Protect customer data and privacy. Restrict employees' ability to compete.
Complete customer solutions	Use contracts to strengthen customer relationship. Avoid illegal tying but offer bundled products that provide greater functionality than two products bolted together. Secure intellectual property protection in order to prevent competitors from offering post-sale products and services.
Lock-in	Defend your proprietary position. Expand the use of the product's standard. Enforce contracts.

4.3.3 Operational Level

Introduction

This section will focus on the most important way to mitigate legal risk at the operational level – legal compliance and compliance programmes. The intoduction will list the key components of legal compliance. The introduction is followed by a section describing legal reasons to adopt a legal compliance programme and its normal contents. Finally, the contents of a legal compliance programme will be illustrated in more detail by the structure of a competition law compliance programme. The mitigation of legal risk will be discussed even in the context of corporate risk management (Chapter 7) as well as in the context of contracts (Volume II).

Organisation. It is characteristic of the management of legal risk at the operational level that it should be organised in some way. The firm will need to organise risk management *processes* and determine the *substance* of its transactions in general terms (i.e. under what terms it will enter into transactions). At the operational level, the management of legal risk will typically consist of organisational measures, corporate culture, internal guidelines, internal programmes, and a control system.

Management of agency, behaviour modification. In addition, the management of legal risk requires the modification of the behaviour of many agents (see Chapter 6).

Corporate culture. In practice, legal risk cannot be managed in an effective way unless risk management is supported by corporate culture and senior management.

The firm exists in a legal context. Its activities are governed or influenced not only by legal rules regulating its business form but also by a very large body of other legal rules. Those legal rules reflect public policy objectives as well as societal values and expectations. The firm should be sensitive not only to the wording of laws but also to the spirit of the law (those objectives, values and expectations). The firm can in general mitigate legal risk by being a good corporate citizen and acting according to the values and expectations reflected in laws and administrative provisions.[70]

Managers should clearly not engage in activities that are prohibited by law, and they should not engage in activities belonging to a grey area without obtaining prior legal advice.[71]

In order to mitigate legal risk, it is not enough to comply with the letter of the law and look for short-term benefits. Laws change, and either the law or the market or the government will force the company to comply with the spririt of the law in the long run. Short-term gains through unethical or illegal behaviour are normally outweighed by longer-term losses in highly-developed countries such as the Member States of the EU.[72]

This can be illustrated by a case from the US. General Motors was aware of problems with the fuel tank of the Chevrolet Malibu, a passenger car that it manufactured. GM engineers prepared a memorandum in which they calculated that it would cost more to recall the cars ($8.95 per car) than to pay damages to crash victims ($2.40 per car). In order to save money, GM chose not to redesign the fuel tank. That decision brought short-term benefits. In 1993, a fuel tank exploded during a rear-end collision, and six passengers were severely burned. In 1999, a jury ordered GM to pay $107 million in compensatory damages and $4.8 billion in punitive damages for the injuries the passengers suffered. A Los Angeles Superior Court judge later ruled that GM should pay the full compensatory award but reduced the punitive component to $1.09 billion. In any case, GM lost money as a consequence of failing to fulfil society's expectations that manufactures will not trade human safety for dollars.[73]

Programmes. The programmes that the firm might decide to introduce range from legal compliance programmes (see below) to programmes addressing other forms of operational risk (see below).

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[70] The German constitution, the Grundgesetz, provides that property rights should also be exercised in the general interest. Art 14(2) GG: "Eigentum verpflichtet. Sein Gebrauch soll zugleich dem Wohle der Allgemeinheit dienen."

[71] See Bagley CE, Winning Legally. Harv Bus S P, Boston (2005) p 80.

[72] See *ibid*, p 76.

[73] *Ibid*, pp 159–160.

Compliance programmes are typically necessary in areas with special government policies. A compliance programme consists of internal guidelines and the existence of a formal organisation.

In addition to compliance programmes, the firm will need other programmes. (a) For example, the firm needs contract management in order to: ensure that a sufficient contractual framework will always be in place; manage the contents of its contracts; and ensure that both parties fulfil their respective obligations. (b) The firm also needs customer credit management (see Volume III) to manage credit risk and working capital.

Internal guidelines. Internal guidelines are core components of compliance programmes, but the firm will have a large number of other guidelines as well. Internal guidelines will address two things. First, they will address special causes of concern. Second, they will also regulate special methods to mitigate risk.

The firm may need guidelines on acceptable contract terms, insurance cover, the management of currency risks, sexual harassment, and many other things. The firm will also have to organise the division of labour and flow of information inside the firm in order to ensure that decisions are taken in an organised way and on an informed basis.

Control system. Part of legal risk management is to put in place a control system. The firm needs information about the legal risks that it seeks to manage and how its risk management system works. The firm may also create incentives for its managers and employees to enforce the risk management system and punish failures to enforce it.

Separation of functions. The separation of functions is a key element of control systems and an important way to manage agency relationships. It is often necessary to separate the formulation of the contents of the decision from the actual approval of the decision and the execution of the decision. In addition, it is often necessary to separate risk management from such decision management. These questions will be discussed in Chapters 5 and 6 below.

Information management. The management of legal risk requires the screening of acts and the analysis of information by legal specialists. The firm's internal guidelines should set out under what circumstances decisions may not be taken before obtaining the prior opinion of legal advisers.

Procedure of making business decisions in the face of legal uncertainty. In any case, managers are frequently called on to make business decisions in the face of legal uncertainty, and managers must decide whether the benefits of the proposed project or transaction outweigh the risk.

Business decisions should thus be made in an organised way even in the face of legal uncertainty. The procedure of making such decisions should be addressed in the firm's internal guidelines. Important transactions should be decided on at a high level of hierarchy, and managers should turn to legal advisers before entering into major transactions. A lawyer should be involved in actions that may be illegal or unethical or lead to a high exposure to legal risk.

Analysing the legal pros and cons. When considering whether the benefits of a legal and ethical proposal outweigh the risk, managers can, according to Bagley, use the following framework:[74]

- Identify and assess the likely effect of the proposed action on others.
- Consider the nature of the relationship between the persons likely to be affected by the action (contract party or third party, fiduciary or third party acting at arm's length, employer/employee).
- Determine what standard of care applies depending on the relationship.
- Ask whether the action would satisfy this standard of care.
- Ask whether there would be strict liability for any harm caused.

Next, the manager should consider what could go wrong and evaluate the potential defences and the likely sanctions by asking the following question:

- Would the preventive measures taken by the firm satisfy the duty of care?
- Are there any other legitimate defences?
- What would the legal, financial, reputational, and other consequences be if the firm or the manager were found guilty of a crime or found liable for a civil wrong?
- Would the sanctions and consequences vary by jurisdicion or depending on other procedural matters, such as the choice of applicable law?

Managers should explore any possible risk mitigation strategies. If it is possible to take steps to mitigate the risks without incurring undue cost (in time, money, reputation, or opportunity), it is normally prudent to take these steps. If it is not possible to mitigate the risks of the proposed action, the manager should reevaluate the original proposal and decide whether the likely results outweigh the risks.

Legal Reasons to Adopt a Legal Compliance Programme

It is clear that the firm should comply with laws. However, there is no *general* legal requirement to adopt any general compliance programme under Community law or the Member States' national company laws.[75] Legal compliance programmes are nevertheless necessary for the following *particular* reasons.

First, compliance programmes can be *mandatory* in specific circumstances. The firm may have a duty to establish a compliance programme in certain areas. (a) Compliance programmes have traditionally been mandatory in *banking and insurance*, and Directive 2006/73/EC which complements the MiFID requires an inde-

[74] Bagley CE, Winning Legally. Harv Bus S P, Boston (2005) pp 78–80.

[75] See nevertheless Schneider UH, Compliance als Aufgabe der Unternehmensleitung, ZIP 2003 pp 645–650. Schneider identifies a general duty to adopt a compliance organisation.

pendent compliance function.[76] A compliance programme is also necessary for the purpose of preventing money laundering and combating terrorism.[77] (b) Compliance can be mandatory or recommended for *listed* companies. For example, companies listed in the US must develop an ongoing testing and certification process under sections 404 and 302 of the Sarbanes-Oxley Act which lay down permanent and ongoing requirements of corporate governance for public companies listed on US stock exchanges. (c) Compliance programmes can be required even in many other areas. For example, Community law in effect requires a compliance programme in product safety law.[78] The duty to adopt such a programme can also be based on corporate criminal law.[79]

Second, even if compliance programmes were not mandatory as such, there might be *strict legal requirements of compliance* in areas with special government policies making compliance programmes de facto mandatory.[80] The firm might have compliance programmes at least for: securities markets law; corporate governance; accounting, auditing and the disclosure of financial information; employment law; competition law and public procurement (sales to state entities); intellectual property rights; product safety; environmental safety, and consumer relations. The firm would not be able to cope with its obligations without a particular compliance programme.

For instance, there are such requirements in Community food safety law[81] and in chemicals legislation. The Reach Regulation[82] requires firms to register their use of 30,000 chemicals in the EU meaning that firms that have failed to adopt an adequate environmental law compliance programme are bound to breach the Reach Regulation.

In the US, the risk of punitive damages is a further factor that forces the firm to adopt compliance programmes. The firm may be liable for punitive damages if the firm proceeds with conscious indifference to the rights, safety, or welfare of others. Furthermore, punitive

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[76] Article 6(2) of Directive 2006/73/EC.

[77] Article 34(1) of Directive 2005/60/EC: “Member States shall require that the institutions and persons covered by this Directive establish adequate and appropriate policies and procedures of customer due diligence, reporting, record keeping, internal control, risk assessment, risk management, compliance management and communication in order to forestall and prevent operations related to money laundering or terrorist financing.” Article 11 of Directive 91/308/EEC contains a similar rule. For measures combating terrorism, see also Regulations 881/2002 and 2580/2001. For implementing measures, see, for example, § 34 of the German Foreign Trade Law (AWG) and § 130 OWiG.

[78] Article 8(1) of Directive 2001/95/EC (Directive on general product safety). For German law, see § 5(1) of the Geräte- und Produktsicherheitsgesetz.

[79] For German law, see § 130(1) OWiG; Bock D, Strafrechtliche Aspekte der Compliance-Diskussion - § 130 OWiG als zentrale Norm der Criminal Compliance, ZIS 2/2009 pp 68–81.

[80] See, for example, Hauschka CE, Klindt T, Eine Rechtspflicht zur Compliance im Reklamationsmanagement? NJW 2007 pp 2726–2729.

[81] Article 18(1) of Regulation 178/2002 (Regulation on food safety): “The traceability of food, feed, food-producing animals, and any other substance intended to be, or expected to be, incorporated into a food or feed shall be established at all stages of production, processing and distribution.”

[82] Regulation 1907/2006 (REACH).

damages might not be recoverable from the firm's insurer if they result from the insured firm's own intentional misconduct in failing to follow industry safety standards.

Third, the firm, its board and people belonging to its organisation have a *duty of care*. Not only can the firm be liable for failure to comply with legal requirements and the applicable standards. Some risk regulation regimes make board members, the managing director, certain senior executives, or other persons, personally responsible for compliance. If enforced by the firm, effective compliance programmes generally help them to mitigate the risk of liability for negligence.

The duty to ensure compliance or to adopt certain measures can be based, directly or indirectly, on a corporate governance code. According to the German Corporate Governance Code, the management board should ensure compliance in the group.[83] According to the UK Combined Code, the board of directors should, at least annually, conduct a review.[84] On the other hand, the liability is usually mitigated by the existence of a business judgment rule.

Compliance programmes that are effective and enforced by the firm can also be used to mitigate the risk of *prosecution* or administrative sanctions and as a *defence* in civil, criminal or administrative proceedings. The regulatory background is likely to play an important role in litigation wherever it takes place, and compliance with regulatory standards will be an important barometer of liability. A firm that has complied will regulatory requirements will use that fact as a shield. If there has been a failure to comply, the aggrieved party will use that fact as a sword.

According to one opinion, liability can usually be triggered in the following contexts or areas of law: competition law; company law; financial transactions and securities markets law; mergers and acquisitions; labour law, employment related tax law, and social security payments; environmental law, product liability; damage sustained by third parties; industry-specific obligations; transactions in corporate crisis; corruption; and white-collar crimes committed by employees.[85]

Fourth, the *risk of infringment* of public policy objectives and mandatory laws is particularly high in large international firms with relatively independent local subsidiaries which the firm has acquired. In those firms, unsound or corrupt local practices can survive the change of ownership and taint the reputation of the firm. Multinational companies are therefore likely to adopt more compliance programmes and more detailed compliance programmes than domestic firms.

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[83] See sections 4.1.3 and 3.4 of the German Corporate Governance Code and §§ 76(1) and 93(1) AktG.

[84] Provision C.2.1 of the Combined Code.

[85] Hauschka CE, Compliance, Compliance-Manager, Compliance-Programme: Eine geeignete Reaktion auf gestiegene Haftungsrisiken für Unternehmen und Management? NJW 2004 pp 257–261.

For example, KONE Corporation had acquired central European companies in the lift and escalator market. In 2004, the European Commission started an investigation concerning anticompetitive practices in that market. The Commission found that companies that were now KONE's subsidiaries had been involved in local anticompetitive practices and imposed a €142 million fine on KONE. KONE did not receive a fine in relation to Belgium and Luxembourg, as KONE was the first company to cooperate with the Commission regarding those countries.

Contents of Legal Compliance Programmes

As a function of the firm, compliance is much more than merely complying with laws and administrative regulations. Compliance is part of the risk management of the firm. It requires the organisation and modification of the behaviour of people who belong to the firm's organisation. The typical tools of compliance are those applied to manage internal agency relationships and information.[86]

The contents of compliance programmes vary depending on the business area and the area of law. Furthermore, the existence of a business judgment rule increases the freedom to design these programmes. One can also distinguish between general legal compliance programmes and more specific programmes made necessary by the existence of mandatory regulation in certain areas of law.[87]

However, all compliance programmes typically consist of many complementary components.[88] The key features of a compliance programme are: a compliance culture; documented guidelines for policy and procedures; organisation; management of information; training; incentives; and regular evaluation.

Culture. At the most general level, the firm should have a culture of compliance. The firm's compliance culture should be shared and supported by its senior management.

The firm should adopt a code of ethics in order to manage corporate culture and to signal consistent and sincere company commitment to compliance with all the laws governing its business.

Employment contracts. The duty to comply with the firm's ethical code and compliance programmes can be made part of the firm's employment contracts. This can help to: provide information about the existence of compliance programmes; and increase incentives to comply with them (see below).

Information management. The management of information is at the core of a compliance programme.

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86 For the relationship between business ethics, corporate governance, and compliance, see Hefendehl R, Corporate Governance und Business Ethics: Scheinberuhigung oder Alternativen bei der Bekämpfung der Wirtschaftskriminalität? JZ 2006 pp 119–125.

87 For legal compliance in general, see section 4.3.3. For the information regime for companies whose shares have been admitted to trading on a regulated market, see Volume III. The Sarbanes-Oxley Act of 2002 requires a particular compliance regime. See, in particular, sections 301(4), 302, 401, 404, 409, 802, and 906 of Act. For risk management and the MiFID, see Chapter 7. For competition law compliance programmes, see below.

88 See Bagley CE, Winning Legally. Harv Bus S P, Boston (2005) p 72.

This requires organisation. The firm should put in place a monitoring and screening system that enables it to identify particular causes of legal concern. Furthermore, a cause of concern should be dealt with by a competent person ("the man on the spot", see section 10.2.2).

The gathering of information requires monitoring the activities of people belonging to the firm's organisation. There may be a duty to put in place such systems and to monitor activities (see above).

However, these activities are constrained by provisions of law protecting the personal integrity of people belonging to the firm's organisation and third parties.[89]

In Community law, monitoring is constrained by the European Convention on Human Rights[90] and the Data Protection Directive. (a) The main rule under the Directive is that Member States must protect "the fundamental rights and freedoms of natural persons, and in particular their right to privacy with respect to the processing of personal data".[91] According to the Directive, personal data may nevertheless be processed provided that "the data subject has unambiguously given his consent".[92] There are some exceptions to this requirement. One of them is compliance with certain legal requirements.[93] (b) Furthermore, there are restrictions on the transfer of personal data to a third country.[94] (c) Depending on the Member State, monitoring may also be constrained by the right of employees to be informed or consulted.

In England, the Data Protection Act 1998 is complemented by the Information Commissioner's Employment Practices Data Protection Code. In broad terms, what the Act requires is that any adverse impact on employees is justified by the benefits to the employer and others. Part 3 of the Code contains recommentations on monitoring.

In Germany, there is no specific legislation on the screening of existing employees. The general provisions of the Federal Data Protection Act (Bundesdatenschutzgesetz) apply. This has caused problems for compliance officers.

Information to people inside the firm. Without proper information, the people belonging to the firm's organisation will not be able to comply with the required standards of behaviour. The requirements should therefore be known and understood by them. This will require continuous education, the adoption and commu-

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89 See Sahin A, Heikle Gratwanderung eim Kampf gegen Korruption, FAZ, 18 February 2009 p 19.

90 Article 8(1) of the ECHR creates a right to respect for private and family life and for correspondence. See also Article 7 of the Charter of Fundamental Rights of the European Union.

91 Article 1(1) of Directive 95/46/EC (Data Protection Directive).

92 Article 7(a) of Directive 95/46/EC (Data Protection Directive).

93 See Article 7 of Directive 95/46/EC (Date Protection Directive).

94 Articles 25 and 26 of Directive 95/46/EC (Date Protection Directive). See also Article 29 Data Protection Working Party, Working Document setting up a framework for the structure of Binding Corporate Rules, 24 June 2008 (WP 154), and Working Document setting up a table with the elements and principles to be found in Binding Corporate Rules, 24 June 2008 (WP 153).

nication of documented internal rules and guidelines, and the distribution of duties.[95]

Organisation. The compliance function thus requires organisation in many respects. The contents of the compliance organisation depend on general company law aspects (or the law governing the entity) and industry-specific requirements.[96]

First, there should be a body responsible for organising compliance, a body responsible for enforcing that decision, and a body responsible for monitoring that the compliance function has been adequately organised and adequately enforced. It is to be noted that the main rule is that there is no "group compliance". As each group company has separate legal existence, each company belonging to the group will be responsible for its own compliance function.[97] At the end of the day, the ultimate responsibility must lie with the board of each company (see section 8.3 below). The appointment of a compliance officer can help to manage information.[98]

Second, a general code of ethics should be complemented by a specific code of conduct setting out the rights and duties of people belonging to the organisation of the firm. For risk management purposes, there should be a separation of functions. There should be a procedure for the screening of decisions in advance and for the analysis of the legal requirements by a competent person or entity such as legal counsel or the legal department.

Third, the code of ethics and the code of conduct can further be complemented by organising the work of board members, managers, and employees technically in such a way that is likely to increase compliance and prevent non-compliance. For example, tasks requiring a certain level of training should only be carried out by sufficiently qualified people, or tasks should be organised in such a way that even unqualified people can perform them in the proper way.[99] Where laws require information to be kept secret, Chinese walls should be used to ensure that information will be disclosed only on a need-to-know basis inside the firm (section 10.5).

Fourth, a global code of ethics and a global code of conduct can be enforced more effectively if local subsidiaries are integrated into the global organisation of the firm and their activities are controlled in a centralised way rather than by powerful local or country managers. The firm should be particularly careful to enforce its global code of ethics and global code of conduct after mergers and takeovers.

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[95] Schneider UH, Die Überlagerung des Konzernrechts durch öffentlich-rechtliche Strukturnormen und Organisationspflichten – Vorüberlegungen zu „Compliance im Konzern", ZGR 1996 p 231. See also recommendation 3.1.3 of the Information Commissioner's Employment Practices Data Protection Code.

[96] See Schneider UH, *op cit*, pp 227–229.

[97] *Ibid*, p 232.

[98] See Hauschka CE, Compliance, Compliance-Manager, Compliance-Programme: Eine geeignete Reaktion auf gestiegene Haftungsrisiken für Unternehmen und Management? NJW 2004 p 259.

[99] This can be illustrated by manufacturing firms like Toyota which generally try to reduce the number of individual items that have to come together for final assembly and to make sure that these items can only be put together in the correct way.

Fifth, compliance should be documented. Anything can happen in the future, and the firm might need to show that it had adopted adequate compliance processes many years after it took compliance action.

Incentives. In addition, the firm can establish an appropriate evaluation and reward system, internal audits and policing, and proactive legal education. One of the purposes of these systems should be to signal that illegal or unethical behaviour will not be tolerated.

Whistle-blowing by insiders. The programme should make it possible for employees and managers to report violations of the programme without adverse effects to themselves. Many firms put in place a anonymous whistle-blowing hotlines. Whistle-blowing can be made easier by the appointment of an independent Ombudsman.

The Sarbanes-Oxley Act requires publicly traded companies to establish a whistle-blowing system.[100] In addition, the Act protects employees who provide evidence of fraud from retaliatory measures taken against them for making use of the reporting scheme.[101] These provisions are mirrored in the Nasdaq[102] and NYSE rules.[103]

However, such systems can be legally problematic in Europe. First, they are not necessarily supported by labour and data protection laws, because the law protects even the rights and integrity of alleged wrong-doers.[104] Second, there is no specific Community legislation on whistle-blowing.[105] A recommendation had to be adopted because of the US Sarbanes-Oxley Act, but anonymous whistle-blowing is not encouraged. Whistle-blowing schemes must be implemented in compliance with EU data protection rules.[106] Third, few countries have adopted specific legislation protecting whistle-blowers against retaliation.[107] Fourth, labour laws do not really protect the whistle-blower from adverse effects. What can make matters

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[100] Section 301(4) of the Sarbanes-Oxley Act: "Complaints. Each audit committee shall establish procedures for - (A) the receipt, retention, and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters; and (B) the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters."

[101] Section 806 of the Sarbanes-Oxley Act.

[102] Nasdaq, Rule 4350(D)(e): Audit Committee Responsibilites and Authority.

[103] NYSE, Section 303A.06: Audit Committee.

[104] Directive 95/46/EC (protection of individuals with regard to the processing of personal data).

[105] See nevertheless Article 33 of Regulation 45/2001 which might enable Community staff members to complain to the EDPS about matters which do not affect them directly. Hilmans H, The European Data Protection Supervisor: The Institutions of the EC Controlled by an Independent Authority, CMLR 43 (2006) p 1319.

[106] On 1 February 2006, the Article 29 Working Party (Article 29 of Directive 95/46/EC) gave an opinion allowing the use of anonymous whistle-blowing mechanisms, subject to additional rules for record management and rights for those implicated. Article 29 Data Protection Working Party, Opinion 1/2006.

[107] In England, some whistle-blowers can rely on the Public Interest Disclosure Act 1998. The Act also provides protection for the worker against unfair dismissal or any other detriment as a result of making a protected disclosure.

worse is that employment contracts often contain confidentiality clauses effectively prohibiting employees from discussing matters of importance arising from their employment.[108]

Whistle-blowing by other stakeholders. Many of the firm's stakeholders have a monitoring role (section 9.2). In practice, a large part of the unethical behaviour is reported by the firm's customers, suppliers, and other stakeholders. This should also be facilitated by the compliance programme.[109]

Compliance officer. Many firms have appointed a particular compliance officer to manage the compliance function. This will also help to gather and process information about causes of concern. Typically, a compliance officer will only be able to police compliance effectively where he is independent of the rest of management and he is given full access to all people and all information inside the firm. Alternatively, depending on the business of the firm, there can be different persons responsible for different areas of compliance.[110]

Example: Competition Law Compliance Programmes

How compliance programmes work can be illustrated with competition law compliance programmes. The purpose of a competition law compliance programme is to: raise the awareness of competition law throughout the firm (educate and train); avoid infringement; help the firm deal with an investigation, if it faces one; and mitigate the consequences of previous infringement.

Particular reasons to adopt a compliance programme. EU competition law gives an incentive to adopt a competition law compliance programme. (a) After the modernisation of Community competition law, both Regulation No 1/2003 and the Commission's Notice on immunity from fines and the reduction of fines in cartel cases[111] impose increasing responsibilities on undertakings to perform self-assessments of their compliance with those rules. (b) Breach of EU competition law can cause serious harm to the firm. It can result in substantial fines. Moreover, the anti-competitive aspects of agreements can be void and unenforceable.[112] Depending on the governing law, the agreement as a whole can fail to have any legal force. There is also a possibility that any third party which has suffered loss as a result of the breach of EU competition law may seek damages or an injunction. (c) The threat of so-called dawn raids and the threat of other investigatory powers of competition law authorities give a further incentive to comply with competition

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[108] Palmer S, Human Rights: Implications for Labour Law, CLJ 59 (2000) pp 168–200 at p 195.

[109] For investment firms, see recital 3 of Directive 2006/73/EC.

[110] See Hauschka CE, Compliance, Compliance-Manager, Compliance-Programme: Eine geeignete Reaktion auf gestiegene Haftungsrisiken für Unternehmen und Management? NJW 2004 p 261: "Die sachgerechte Bestellung eines (beispielweise) Kartell-, Korruptions-, Umweltschutz-, Betriebssicherheits-, Produktsicherheits-, Qualitätssicherungs-, Datensicherheitsbeauftragten oder Ombudsmanns wird in vielen Fällen ausreichen."

[111] OJ 2002 C 45, p 3.

[112] Articles 81(2) and 82 of the EC Treaty.

law. (d) In addition to a big stick, EU competition law provides for a carrot. If the firm is the first to confess it can benefit from immunity or clemency.

In the past, the Commission could take the adoption of a compliance programme into account as a mitigating circumstance in setting the amount of fines. The Commission changed its policy after the *British Sugar* case.[113] The change of policy has been approved by the Court of First Instance which has held that "the mere fact that in certain cases the Commission took the implementation of a compliance programme into consideration as a mitigating factor does not mean that it is obliged to act in the same manner in any given case".[114] The ECJ has held that efforts to bring other behaviour into line with competition law do not diminish the justification for imposing fines in relation to an infringement.[115]

The role of legal advisers. The firm should seek the advice of a competition lawyer when preparing a compliance programme. This can ensure the quality of the programme and signal it to outsiders. Competition lawyers and other competent legal advisers also play an important role as educators, and they act as persons responsible for screening cases that raise competition law concerns.

Contents. A competition law compliance programme consists of various elements.[116] First, the firm will adopt an internal policy to ensure its complete compliance with competition rules in all its business actions. Second, the programme will provide for a separation of functions in order to ensure the proper enforcement of the programme. Third, the firm will educate and train its personnel on competition rules and provide guidance on how to comply with competition rules and how to avoid agreements or practices that infringe them. Fourth, the firm will adopt documented compliance guidelines. Fifth, competition law compliance programmes can also set out what action needs to be taken if managers or employees find out that an agreement or practice, to which the firm is a party, infringes competition rules.

Reasons to comply with the compliance programme. The firm should comply with its own compliance programme. Failure to do so can potentially make the persons responsible for compliance liable for breach of duty of care and be used as evidence of culpa. Depending on the circumstances, it can also increase the fine.

Ethical code. Compliance with competition laws should be an essential part of the firm's general ethical code.

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[113] Commission Decision of 14 October 1998 [1999] OJ L76/1, paragraph 209. See Wils WPJ, The European Commission's 2006 Guidelines on Antitrust Fines: A Legal and Economic Analysis. World Competition: Law and Economics Review, Vol 30, No 2, June 2007 at note 119.

[114] Case T-53/03 BPB plc v Commission, paragraph 423; Case T-224/00 Archer Daniels Midland and Archer Daniels Midland Ingredients v Commission [2003] ECR II-2597, paragraph 280; Case T-7/89 Hercules Chemicals v Commission [1991] ECR II-1711, paragraph 357.

[115] Joined Cases 240 to 242, 261, 262, 268 and 269/82 Stichting Sigaretttenindustrie and others v Commission [1985] ECR 3831, paragraphs 97 and 98.

[116] See, for example, Office of Fair Trading, How your business can achieve compliance. A guide to achieve compliance with competition law (2005); ETSI Guidelines for Antitrust Compliance. Endorsed by ETSI's General Assembly on 28 March 2007.

Education and training. A programme will not work unless the firm's personnel is educated and trained on a continuous basis, i.e. the firm can subsequently reduce the risk of infringments through education.

Anyone in contact with competitors, suppliers or business customers should be required to take training. This would not only help employees to follow competition laws but also to strengthen the culture of compliance and signal to the competition authorities that the firm has taken its compliance obligations seriously.

The firm should also prepare a competition compliance manual. The manual should lay down the steps which are to be followed in the negotiation and performance of transactions as well as communication with others in the company's industry so as to ensure that competition law is not infringed. The manual normally prescribes routines, timetables, and checklists, and sets out a document retention programme.

Screening. One of the purposes of education is to enable the firm's personnel to identify cases that will have to be passed on to legal counsel for analysis. Legal counsel should work with the people who are in day-to-day control of the business and have access to relevant information. While most of those people may operate below board level, members of the statutory board or boards will be more involved in merger cases since the board is responsible for strategic decisions.

Monitoring. The firm should introduce internal monitoring or auditing of the compliance programme in order to ensure that the manual is used. Internal monitoring is a way to signal to the competition authorities that the firm takes compliance seriously. For example, the Commission can impose lower fines where a company has monitored compliance with its compliance manual (although unsuccessfully), and higher fines where a similar company has failed to introduce a system of policing observance of the compliance manual (and infringes competition rules in the same way).

Disciplinary action. For the same reason, the programme should signal to employees that infringement of competition law will not be tolerated. For example, an employee who engages in illegal discussions with competitors should face disciplinary action up to and including dismissal subject to mandatory provisions of labour law.

The role of the board. The board can have various functions in a competition law compliance programme. (a) Board members have a general duty of care, and the adoption of a compliance programme is an important part of corporate risk management. (b) Depending on the distribution of power in the company, the adoption of the programme may be instigated or decided on by the board. (c) In any case, the programme will not be enforced effectively unless the board gives support to it and makes it part of the corporate culture. The board should preferably give high-level support to effective sanctions against managers and employees who do not follow the programme and high-level protection for those who report about infringements. (d) In some countries, there are civil or criminal sanctions against board members, the CEO or the persons responsible for the infringment. For example, conspiring to rig markets is punishable by prison in Germany,

France, Ireland and Britain, as well as Japan, Canada and the US.[117] Breaches of competition law can sometimes be regarded as other crimes.

4.3.4 Transactional Level

The management of legal risk at the transactional level should be influenced by the contents of legal compliance programmes. However, because of the very wide scope of transactions, the management of legal risk at the transactional level depends largely on the transaction. Many risk management methods are transaction specific and will be discussed later in this book in the context of each type of transaction. On the other hand, some methods to manage legal risk can basically be used in all transactions. For example, the firm can manage risks caused by the flexibility of law and risks inherent in the interpretation of contracts in the context of all contracts (those questions will be discussed in Volume II).

Information. Legal risk cannot be managed effectively without useful information. The firm needs information not only about the legal framework but also about the transaction, its own internal affairs, the relevant contract parties and stakeholders, as well as about the market and the society as a whole.

For example, the liability for the safety of products manufactured by the firm cannot be mitigated effectively without information management. The firm needs information both ex ante and ex post. (a) When designing a product, a manufacturer needs information about users, its existing products and its competitor's products, in addition to information about legal rules. (b) There will be a design evaluation process based on that information. One of the purposes of the design evaluation process is to ensure that the product will be safe.[118] On the other hand, the design evaluation process should also make actions taken by the firm look sound and defensible in the face of future litigation. (c) After delivering the product, the manufacturer needs early and accurate information about actual product performance.[119] Rapid feedback about the actual performance of the product can help to mitigate the firm's liability. For example, warranties may be used as a means of gathering experience with the product. Warranties can encourage purchasers and users to complain and tell the firm about problems.

Review of relevant law. The firm should try to ensure that the project or transaction has a sound legal basis. It goes without saying that the firm needs information about the relevant laws. The firm should review relevant laws at all stages of financial decision-making and on an ongoing basis.[120] Review of the legal basis of

[117] Well-dressed thieves, The Economist, February 2008.

[118] Articles 3 and 5 of Directive 2001/95/EC (General Product Safety Directive, GPSD). The purpose of GPSD is to protect consumer health and safety and to ensure the proper functioning of the internal market. The Directive provides a generic definition of a safe product.

[119] Article 5 of Directive 2001/95/EC (General Product Safety Directive).

[120] See BIS, Committee on Payment and Settlement Systems, Recommendations for Central Counterparties, CPSS Publications No 64 (November 2004), paragraph 3.32 at p 12.

the project or transaction can be far from easy and require expertise in numerous legal disciplines.

Legal opinions. For this reason, firms often rely on opinions of legal advisers. From a legal perspective, the basis of this reliance is the legal liability in tort or contract of a lawyer who rendered an incorrert opinion. From the perspective of information management, the reliance can be based on the reputation of the lawyer or law firm giving the opinion.

However, there are general legal factors reducing the reliability of most legal opinions. A lawyer is typically responsible for his work process rather than the result (see Volume II) and legal opinions are not an exact science. In assessing legal risk, legal advisers must usually take into account several vague qualitative criteria. Furthermore, legal opinions are typically based on what the likely outcome would look like in court proceedings, but legal rules and contract terms are often untested in the court.[121]

In addition, the legal relevance of a particular legal opinion may have been diluted in many ways.

First, the opinion can be limited to a small number of criteria. A legal opinion provided by a law firm will always be limited to the laws of a certain country. If the country is Switzerland, the opinion would contain the following waiver: "This legal opinion is expressed only with respect to the laws of Switzerland." Such an opinion would not say much about the laws of other countries. Foreign laws would govern important aspects of the transaction, for example where the firm's counterparty is incorporated in a country other than Switzerland. The legal opinion can be limited to certain fields of law (say, company law and contract law) and exclude other fields of law (say, insolvency law). Furthermore, the legal opinion will be given to a certain party.

Second, the opinion is typically given to the law firm's contract party and contains a statement according to which no third party is entitled to rely thereon (ratings give rise to similar questions, see section 10.7.5).[122]

Third, the opinion is often qualified with phrases like "to the best of our knowledge". There are also other ways to dilute a legal opinion (for dilution, see also sections 10.4.9 and 10.5.6 below).

Fourth, there are limitations of liability based on express contract terms and the legal background rules. For example, a lawyer is responsible for the quality of her work process rather than the result of her work, and the lawyer giving the opinion will try to ensure that she gives it on behalf of her employer rather than in her personal capacity.[123]

Members of the legal department of a German bank have used the following clause in legal opinions to reduce their personal liability: "Furthermore, this opinion is issued in Germany

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[121] *Ibid*, section 4, Explanatory notes, 2 at p 16.

[122] For third-party legal opinions, see Pfenninger M, Giger G, Die Verantwortlichkeit des Anwalts für Third Party Legal Opinions, SZW/RSDA 1/2001 pp 1–12.

[123] See Gruson M, Liability of Inside Counsel for Legal Opinions, JIBLR 19(4) (2004) pp 143–145; Gruson M, Persönliche Haftung deutscher Unternehmensjuristen für die Richtigkeit einer legal opinion nach US-amerikanischem Recht, RIW 2002 pp 596–608.

and being rendered by the signing in-house counsels in their capacity as employees of the Bank acting as representatives of the Bank. Consequently, this opinion is exclusively issued by the Bank and the undersigned shall have no personal liability hereunder."[124]

Due diligence. A further way to obtain information about legal matters is to screen legal risks by means of a due diligence. Due diligence is practically always done in major transactions such as takeovers, real estate transactions, major loan agreements, and so forth (see Volume III).

Approvals and consents. To limit some of the uncertainties, the transaction can sometimes be made subject to the consent of the relevant regulatory and oversight authorities who confirm that the transaction complies with the relevant laws and administrative provisions.

An official approval or consent is needed for some transactions, and the transaction can be made conditional upon such approvals or consents being obtained. In mergers and acquisitions (concentrations), the firm tries to obtain an official announcement from the competition surveillance authorities that the concentration is approved unconditionally; in any case, the firm will ask for a conditional clearance on favourable terms for the concentration to go ahead (see Volume III).

In some cases, the official approval or consent needs to be issued by the relevant authorities in many states affected by the project. In the EU, there is often a framework for cooperation and coordination between the relevant authorities. Such a framework may include provisions on information sharing and the division of responsibilities in the event of any need for joint regulatory action. For example, the MiFID provides that the "competent authorities of different Member States shall cooperate with each other whenever necessary for the purpose of carrying out their duties" under the Directive.[125]

The legal relevance of approvals and consents may vary. Some are final while others may be challenged, withdrawn or annulled.

For example, in July 2004, the European Commission approved the combination of Sony and Bertelsmann's recorded music businesses. Impala - an international association of independent music production companies - sought judicial review. In July 2006, the European Court of First Instance annulled the approval (T-464/04). This was the first time the ECJ annulled an approval given by the European Commission in a merger case. The Commission then asked the parties to update their notification.

Contingency plans. Contingency plans may have to be developed in important projects. Contingency plans are a way to manage the risk that some parts of the legal framework will not support the project. For example, it may turn out that a takeover is not possible for competition law reasons unless certain assets are sold

[124] Gruson M, Persönliche Haftung deutscher Unternehmensjuristen für die Richtigkeit einer legal opinion nach US-amerikanischem Recht, RIW 2002 pp 596–608, footnote 89.

[125] Article 56(1) of Directive 2004/39/EC (MiFID). See also BIS, Committee on Payment and Settlement Systems, Recommendations for Central Counterparties, CPSS Publications No 64 (November 2004), paragraph 4.11.7.

to a third party. Parties should take such a risk into account in the legal documentation of the transaction and ensure that the transaction makes sense even if the risk materialises.

Avoiding jurisdiction. The firm can to some extent manage legal risks by choosing the governing law. In business-to-business contracts, the parties are generally allowed to choose the governing law.

However, as regards legal aspects that are not characterised as contractual, the main rule is that the firm may not choose the governing law as such. Instead, the firm can take the choice of law rules applied in the relevant jurisdictions into account in its decision-making and adapt its activities so as to ensure that the preferred law or laws will govern the project.

For example, if the laws of a certain place apply to all firms that have a permanent place of business in that jurisdiction, the firm can ensure that its activities will not amount to a permanent place of business in that jurisdiction, and if a company is governed by the law of the country in which it is incorporated, the firm may choose to incorporate in one country instead of another.

Firms often try to ensure that their activities will not fall within the scope of the laws of a certain country by using legally separate intermediaries. Incorporation of a subsidiary, the use of a special purpose vehicle, the use of an independent distributor, and outsourcing belong to this category of methods (for incorporation, see section 4.4; for outsourcing, see also section 9.7 below).

Contractual provisions. The contract is both a source of legal risk and one of the most important ways to manage legal risk. For example, the contractual framework should determine the legal framework of the transaction in such a way that the firm can determine its rights and obligations as well as the risks inherent in the transaction.

Contract parties can in principle decide how to distribute legal risk between the parties. One can distinguish between compliance with legal requirements as such and the distribution of risk inter partes. For example, the parties might be allowed to agree on the distribution of activities to which compliance obligations relate. This could be a way to transfer the compliance obligations. Parties to a contract can also allocate the responsibility for compliance with laws and administrative provisions inter partes.

For example, a loan agreement with a German company might contain the following covenant or condition precedent (see Volume II): “The borrower shall obtain, maintain in full force and effect and comply with the terms of all authorisations, approvals, licences, exemptions, notarisations and consents required in or by the laws and regulations of Germany to enable it lawfully to enter into and perform its obligations under this agreement or to ensure the legality, validity, enforceability or admissibility in evidence of this agreement in Germany.”

However, a mandatory compliance obligation cannot normally be transferred as such. The party originally responsible for compliance with certain laws and administrative provisions will typically continue to be responsible in its relations with public authorities.

For example, parties to a distributorship contract can agree on the safety of products delivered by one party to the other and on the distribution of this risk inter partes, but neither party can limit mandatory product safety obligations based on law. If the products are unsafe, the right of a person who has suffered injuries to sue is determined by the applicable product safety laws.

Management of political risk in general. Legal risk can sometimes be said to overlap with political risk.

Political risks (also known as country risks) relate to the effect of government action (such as changes in laws or administrative practices, expropriation, and the lack of rule of law) or important political events (such as war, civil disturbance, and labour unrest). Although not limited to projects involving cross-border financing or investment, political risk is likely to be higher in such projects than in domestic projects because an investment project that has connections to more than one country can be affected by government action or important political events in more than one country.

As a rule, political risk cannot be eliminated by legal tools. It is, for example, hardly ever possible to eliminate this risk by concluding binding agreements with public authorities or to transfer this risk to the government or the ruling political class.

In an article about securitisation in Russia and Dubai, The Economist gave an example of such a transaction: "Like securitisations in Britain or America, the assets are sold in different slices, or 'tranches', according to risk: the first losses are borne by the most junior or 'equity' tranche. Unlike British or American deals, in which the most senior tranches have a glossy AAA credit rating, in Russia even the top slices are marked no better than BBB, a mere couple of notches above junk. The main reason is that Russia itself is BBB, creating what is known as a 'sovereign ceiling' for any security that involves Russian risk. The sovereign ceiling can sometimes be pierced if the securities are sufficiently sweetened with excess collateral. An extraordinary example of ceiling-piercing appeared [in 2005] in Dubai, where the Emirates National Securitisation Corporation (ENSEC) issued $350m of notes against property leases in the Palm, a spectacular development on islands shaped like a palm tree. The notes were rated an astonishing AAA, but only because ENSEC, which is backed by the Dubai royal family, provided a cash reserve for the full amount."[126]

Management of problems caused by lack of rule of law. The mitigation of legal risk becomes more difficult in jurisdictions with a weak rule of law. In such countries, the firm can be exposed to extreme legal risks such as expropriation or the physical harassment of the firm's people.

For example, *Yescombe* described the risk of creeping expropriation as follows: "A government has many ways to take action against a Project Company ... State agencies can be slow and obstructive in issuing Permits, imports or exports can be held up at the docks, the Project Company can be accused of tax offences and subjected to lengthy investigations, Project Company personnel can be accused of criminal offenses such as corruption, or harassed in other ways, and so on. The cumulative effect of such actions may be to deprive the Project Company or its investors of the real benefit of the project, even though each action,

[126] Buttonwood, Where angels fear to tread, The Economist, April 2006.

taken by itself, would not have this result. This is a 'creeping expropriation' of the project – very difficult to define in advance, or to reconise until it has actually taken place, although some potential issues (such as Permits) may be addressed in a Government Support Agreement. A complex project must rely on the good faith and fairness of the state, but the government may use political pressure in bad faith and unfairly as a way of obtaining commercial concessions from the Project Company, or even taking the project over. There is no clear boundary between a legitimate use of state power ... and deliberate harassment of the project. Moreover, it may be difficult to prove that the project would not have defaulted on its debt or failed to pay dividends to the investors if these acts of creeping expropriation had not taken place, and hence to make a claim on any political risk cover. Creeping expropriation has been recognised in the last few years as one of the most difficult problems in political risk insurance, and political risk insurers are still struggling to draw precise boundaries for this risk ..."[127]

In Europe, Russia has used many such methods in order to gain full control of its energy industry. In the case of TNK-BP, a joint venture of BP and a consortium controlled by a number of Russian billionaires, BP representatives were harassed by the failure of the Russian authorities to renew their visas, among other things.

4.4 Management of Risk by Legal Means

4.4.1 Introduction

It was explained above that the firm can manage *legal risk* at different levels (strategic, operational, transactional). The management of legal risk is one thing and the management of risk by *legal means* is another. The firm can manage any risks – legal and other risks - by using legal tools and practices at the strategic, operational, or transactional level.

The legal tools and practices used to manage risk depend on the level of risk management and the context. *Corporate risk management* will involve the use of a mix of risk management practices as will be discussed later in this book. Corporate risk management belongs to the core functions of the firm and the most important tasks of a company's board.

Risk management typically requires the management of agency relationships and information. Other general risk management methods might include: transfer of risk through incorporation and contracts; mitigation of risk through diversification; and the acceptance of risk.

There is also a large number of particular legal tools that can be applied depending on the context. *Contractual* risk management practices will be discussed in Volumes II and III in more detail.

[127] Yescombe ER, Principles of Project Finance. Academic Press, San Diego London (2002) § 10.7.3.

4.4.2 Living with Risk

One of the most popular ways to manage risk is to accept or ignore it. This can be done for many reasons. In general, the firm should take informed decisions about the acceptance of risks. There can also be other reasons to accept or ignore risk.

Trust and culture. Much of economic life is based on trust. There are reciprocal ties between people who meet and trade frequently. Much of trust is based on culture; each society has habits of thinking and rules of behaviour. This makes it possible to weigh up the costs and benefits of trusting others.[128]

For example, not all contract terms complied with by the parties in real life are legally binding and enforceable. The firm may think that its counterparty and other parties are likely to further the firm's interests for other than purely legal reasons.

The importance of trust became clear in 2008 when the absence of mutual trust between banks led to the drying up of the interbank market and caused problems for non-financial firms that could not raise funding from banks.

Contradictory criteria. It is normal to take business decisions without complete information about the legal framework or without a proper legal framework in place. The firm can live with many legal and other risks.

When managing risk, the firm will often need to weigh different contradictory criteria against one another. There can be tension between risk against cost, risk against risk, or risk against time and convenience. For example, legal risk is sometimes ignored because it can be very difficult to quantify the risks caused by laws and the political process.

Procedure of making business decisions in the face of legal uncertainty. On the other hand, business decisions should be made in an organised way even in the face of uncertainty.

To some extent, the procedure of making important decisions is governed by external rules. External rules nevertheless tend to be too general. Typically, they focus on the liability of board members or executives but do not say how to deal with legal uncertainty.

The firm might therefore address this risk by adopting internal guidelines on the firm's internal decision-making process. One of the most important questions in those guidelines is access to information. The firm should therefore ensure that its managers have useful information about the issue and its legal aspects.

Behavioural economics. It is usually presumed that the firm's managers act in a rational way. The theory of rational choice is the basis of neoclassical information economics. However, there are exceptions. Systematic cognitive errors can lead to a different form of decision-making.[129] The acceptance or ignoring of risk can sometimes be explained by behavioural economics.

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[128] See Seabright P, The Company of Strangers: A Natural History of Economic Life. Princeton U P, Princeton (2004).

[129] Tversky A, Kahneman D, Availability: A heuristic for judging frequency and probability. Cognitive Psychology 5 (1973) pp 207–232.

Such reasons to accept or ignore risk can be illustrated by: bounded rationality; responding to fear of a negative event occurring; availability bias; overconfidence bias; beliefs and prejudice; and fashion. In such cases, the firm can typically mitigate risk by employing an information intermediary that acts in a more rational and less biased way (see section 10.1).

Bounded rationality. The firm's managers are only "boundedly rational". They price only a small number of circumstances in their decision-making.[130]

Fear of a negative event occurring. A person might respond to the fear of a negative event occurring rather than to risk. When the firm responds to a negative event occurring, it does not calibrate its response to the added or reduced risk it faces. Once the firm has come to terms with the possibility of the negative event occurring in the context of a certain transaction category, it makes little difference to the firm whether it does the transaction once or twice.[131] The firm can overcome the fear of the negative event occurring in many ways depending on the circumstances.

For example, a firm that regularly carries out certain types of transactions can be undeterred by legal risk when the legal risk has not yet materialised. This can partly help to explain why many transactions are executed without complete documentation.

This kind of behaviour can also help to explain market bubbles. Although there is a high risk that the overvaluation of assets will end and a market bubble will burst, or that a very high leverage will lead to insolvency in an economic downturn, managers can be less afraid of the occurrence of such negative events and comfortable with risk, where the overvaluation has continued for some time and the bubble has not burst yet, or where firms have been highly leveraged and no economic downturn has materialised.[132]

Overconfidence. Generally, the "availability bias" means that a party is likely to regard an event that has just happened as more likely compared with other events.[133] Empirical research in behavioural economics has also found evidence of overconfidence. The "overconfidence bias" means the belief that good things are more likely and bad things are less likely than average to happen to us.[134] Related to the overconfidence bias is the "confirmatory" or "self-serving" bias. This bias

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[130] Korobkin RB, Bounded Rationality, Standard Form Contracts, and Unconscionability, U Chic L R 70 (2003) pp 1203–1295.

[131] See Becker G, Rubinstein Y, Fear and the Response to Terrorism: an Economic Analysis (August 2004).

[132] Generally, Hyman Minsky argued that the financial system plays a big role in exaggerating the economic cycle.

[133] Sunstein CR, What's Available? Social Influences and Behavioral Economics, Nw L R 97 (2003) pp 1295–1314.

[134] See generally Jolls C, Behavioral Economics Analysis of Redistributive Legal Rules, Vand L R 51 (1998) pp 1653–1677 at p 1642 and note 22 (claiming nearly 200 studies support this descriptive claim); Ulen TS, Information in the Market Economy – Cognitive Errors and Legal Correctives. In: Grundmann S, Kerber W, Weatherill S (eds), Party Autonomy and the Role of Information in the Internal Market. Walter de Gruyter, Berlin New York (2001) p 117.

means that parties often interpret information in ways that serve their interests or preconceived notions.[135]

For example, it has been assumed that undue confidence in the ability of firms to overcome obstacles and a self-serving perception of information that might objectively signal future problems could lead firms to mislead those who would invest in their securities. For this reason, securities laws often require third parties such as lawyers and accountants who are potentially less likely to suffer from such biases to verify information that firms disclosure to the public.[136]

Beliefs and prejudice. Sometimes the risk as such ceases to be relevant because of beliefs such as prejudice. For example, EU countries that trust each other for cultural reasons tend to trade with each other more than with other EU partners; the same is true of cross-border investment. Germans trust the British more than the French do; most nationals of the EU trust Germans, but fewer trust Italians.[137]

Fashion and tolerance of risk. Fashion, the overconfidence bias, responding to the fear of the negative event occurring rather than to risk, and similar behavioural reasons influence the tolerance of risk. The sense of risk and the tolerance of risk change over time and influence asset prices. Well-known examples of this effect range from the Tulip mania (the first speculative bubble which occurred in 1636–1637) to the fall of LTCM[138] and the global financial meltdown of 2007–2009 following the subprime mortgage crisis. Stock market market declines are normally provoked by steep rises in perceived risk.

[135] Ulen TS, Information in the Market Economy – Cognitive Errors and Legal Correctives. In: Grundmann S, Kerber W, Weatherill S (eds), Party Autonomy and the Role of Information in the Internal Market. Walter de Gruyter, Berlin New York (2001) p 119.

[136] See Langevoort DC, Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (and Cause Other Social Harms). In: Sunstein CS (editor), Behavioral Law and Economics. Cam U P, Cambridge (2000) pp 144–167; Ulen TS, Information in the Market Economy – Cognitive Errors and Legal Correctives. In: Grundmann S, Kerber W, Weatherill S (eds), Party Autonomy and the Role of Information in the Internal Market. Walter de Gruyter, Berlin New York (2001) p 122.

[137] See Guiso L, Sapienza P, Zingales L, Cultural Biases in Economic Exchange (May 2005).

[138] Roger Lowenstein's account of the fall of LTCM can illustrate how the sense of risk can change over time. Lowenstein described the market practice of May 1998 by citing a banker who said that "people weren't distinguishing among risks" and that "everything was a Treasury bill." There was nevertheless a change in fashion. According to Lowenstein, "arbitrage spreads began to widen" in May. In June, "credit spreads continued to widen ... The trouble wasn't specific to any security; it was a general pulling back of credit, a pervasive sense that markets had been undercharging for risk. Investors wanted safety; now they would pay any amount to buy a Treasury (meaning that they would accept any lower yield, as long as they got out of riskier bonds)." Lowenstein R, When Genius Failed. The Rise and Fall of Long-Term Capital Management. Fourth Estate, London (2001).

4.4.3 Transfer of Risk Through Incorporation

Introduction

Incorporation is one of the basic ways to manage risk in the law of corporate finance. It is used by firms and their owners alike. This section will briefly discuss the nature of incorporation, introduce the most important ways to use incorporation as a risk management tool (like the use of special purpose vehicles), and discuss how Community law enables the firm to choose the governing law. Incorporation raises questions of corporate governance which will be discussed later in this book. The use of companies as funding tools as well as the legal aspects of shares and shareholders' capital will be discussed in Volume III.

Incorporation protects the assets of the firm from claims by the firm's individual shareholders and other stakeholders, and from claims against the firm's individual shareholders. The firm can benefit from incorporation also in the capacity of an investor. The effect of incorporation on risk depends on the company form and the proximity of the owners to the company and to the company's business.

Modern firms consist of a fleet of incorporated companies, and an increasing numner of companies are owned as a subsidiary by a parent company rather than by the traditional individual or institutional shareholder.

The legal characteristics of incorporated companies. There are five basic legal characteristics of the business corporation: legal personality, limited liability, transferable shares, delegated management under a board structure, and investor ownership. A principal function of company law is to provide business enterprises with a legal form that possesses these five attributes.[139] Company law can be seen as being essentially concerned with making available the corporate form, facilitating and regulating the process of raising capital, and imposing controls on persons whose power is derived from the finance that the use of the corporate form has put at their disposal.[140]

Benefits to the firm. Incorporation brings benefits to the firm. This can explain its huge success as a business form.

First, the fundamental attribute of corporate personality is that the corporation is a legal entity distinct from its shareholders. This can help the firm to *protect* its assets against claims by shareholders and stakeholders. It can also help the firm to protect its assets against the creditors of shareholders ("entity shielding") and, vice versa, the assets of shareholders against the firm's creditors ("owner shielding").[141]

Second, incorporation can be used for *funding* reasons. The benefits of incorporation to investors (see below) can help the firm to raise larger amounts of equity capital at a lower cost. The protection of the assets of the firm against shareholders

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[139] Kraakman R, Davies PL, Hansmann H, Hertig G, Hopt KJ, Kanda H, Rock EB (eds), The Anatomy of Corporate Law. OUP, Oxford (2004) pp 1–2 and 5.

[140] Ferran E, Company Law and Corporate Finance. OUP, Oxford (1999) p 3.

[141] For the latter case, see Hansmann H, Kraakman R, Squire R, Law and the Rise of the Firm, Harv L R 119 (2006) pp 1337–1339.

and other creditors reduces creditor monitoring costs and helps the firm to raise debt capital.

Third, incorporation can also make it easier to raise funding for a specific *asset pool* or a separate part of the firm's business in a more efficient way.

Fourth, the company form can increase *operational efficiency*. Incorporation provides a legal framework within which the firm's business can be carried out in an organised way. (a) The use of larger corporate entities can bring further benefits. For example, an industrial enterprise can sometimes increase operational efficiency and cut costs by choosing to merge subsidiaries with the parent.[142] The larger size of the corporate entity can also make it easier for the firm to raise finance in the capital market, because the existence of a network of legally independent entities can make the firm less transparent and increase investors' perceived risk. (b) On the other hand, incorporation can provide a legal framework for a separate part of the firm's business.

The case of Keiper Recaro Group, a German family firm, can illustrate how incorporation can be used for reasons of operational efficiency. This firm consists of two businesses, Keiper and Recaro. Keiper and Recaro were two divisions of the same legal entity until 1996. But as their size grew, they were incorporated as legally independent family-owned sister companies each with its own management. In 2006, Keiper and Recaro established a joint management body in order to coordinate their activities in areas that bring synergy benefits. The two companies were nevertheless kept separate.[143]

Fifth, incorporation helps the firm to *manage agency* relationships in a more efficient way. Board members owe their legal duties to the company, while managers and employees owe their legal duties to the company as their employer. Contract parties rely on the incorporated company as contract party. This gives all of them an incentive to further the interests of the company (for the relationship between the firm and the company, see section 8.2.5).

Benefits to shareholders. Like the firm, shareholders can benefit from incorporation and the separate legal personality of companies in many ways.

A separate corporate personality enables shareholders to transfer some risks to the company. Shareholders subscribe for shares in the company, and the company can invest funds in different investment projects. Whereas the company is subject to risks relating to these investment projects, shareholders' risks relate to the ownership of shares in the company.

Separate corporate personality can be complemented by the limited liability of shareholders, and if it is, shareholders can limit their risks further. However, lim-

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[142] The shareholders of Elcoteq Network Corporation, a Finnish listed company, decided to convert Elcoteq into Elcoteq SE (a European Company, Societas Europaea, SE) in 2005. Elcoteq explained the conversion as follows: "In the longer term Elcoteq's aim as an SE is to increase efficiency and reduce administrative costs. An SE will be able to merge its subsidiaries throughout the 28 countries of the European Economic Area (EEA), generating savings in administrative costs and making decision-making processes faster and more efficient." Elcoteq, Press release, 30 September 2005.

[143] Keiper und Recaro kommen sich wieder näher, FAZ, 28 August 2006 p 12.

ited liability does not follow automatically from separate corporate personality. For example, a form of partnership can be regarded in some jurisdictions as a legal person distinct from the partnership's owners, in other jurisdictions not. The owners, in both cases, can be personally liable for its debts, but some partnership forms have silent partners whose liability is limited to their capital investment. The limited liability of shareholders is nevertheless one of the core characteristics of limited-liability companies.

Separate corporate personality and the limited liability of shareholders enable shareholders to separate ownership and management. If shareholders were liable for the debts and other obligations of the company, it would in practice be necessary for them to take a more active role in its management or at least in the supervision and control of management. But if the liability of shareholders for the debts of the company is limited to their capital investment in the company, they can leave management to others and act as passive investors.[144]

The existence of an established legal framework for the management of the company makes it possible for the owners to further reduce transaction costs and operational risk.

Moreover, the separate legal personality of companies enables shareholders to choose many of the legal rules that govern their investment projects. For example, incorporation enables shareholders to choose much of their overall tax treatment.

Management of Risk by Using Separate Corporate Personality and Limited Liability

The firm can thus limit risks: by incorporating itself; by carrying out business indirectly through incorporated companies with separate corporate personality; and by investing in the shares of companies whose shareholders are not liable for the company's obligations.

Main rule. According to the main rule, a company is a corporate entity distinct from its shareholders. This means that a subsidiary will not be identified with its parent company in company law.

For example, the potential treatment of groups of companies as a single economic entity in English company law ("the group theory") was rejected in the case of *Adams v Cape Industries plc.*[145] The fundamental rule in British law remains that laid down in *Salomon v Salomon:* the treatment of a group of companies as a single economic entity is excluded by the principle of separate corporate personality.[146]

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[144] See, for example, Kaisanlahti T, Extended Liability of Shareholders? JCLS 2006 (April) pp 139–163.

[145] Adams v Cape Industries plc [1990] Ch 433 at p 536.

[146] Salomon v A Salomon & Co Limited [1897] AC 22 (House of Lords). See also Gramophone and Typewriter Co Ltd v Stanley [1908] 2 KB 89 where the Court of Appeal declined to "lift the veil" of separate corporate personality, partly on the grounds that the control of the affairs of the subsidiary was confided to its directors.

Limits. There are limits to how much incorporation, separate corporate personality, and limited liability can reduce the risks of owners.

First, shareholders are responsible for their *own obligations* regardless of the company form.

They can owe duties as a contract party. In practice, a small company owned and managed by an entrepreneur may not be able to borrow money from banks unless the entrepreneur gives a personal guarantee for the repayment of the loan.

Shareholders are also responsible for their own obligations to the company. The most important of these obligations is the obligation to pay up the amount payable for the shares. These obligations are often based on mandatory provisions of law.

Depending on the area of law, there can also be particular rules setting out that shareholders must make payments to the company. For example, it is a fundamental and long-standing principle underlying the Federal Reserve's supervision and regulation of bank holding companies in the US that bank holding companies should serve as sources of financial and managerial strength to their subsidiary banks.

In the US, the Bank Holding Company Act of 1956, which governs most big deposit-taking institutions (although not broker-dealers), provides that a voting stake in a bank of 25% or above constitutes control. Control of a bank brings responsibilities such as more supervisory oversight and the "source of strength" obligation that can require a holding company to inject capital into ailing bank subsidiaries. The Act also stipulates that a holding of less than 5% does not constitute control. Between the thresholds of 5% and 25% is a grey area that the Federal Reserve has interpreted conservatively, taking into account, for example, whether the owner can appoint directors or owns non-voting capital too. On 22 September 2008, the Federal Reserve issued a new policy statement that expanded the ability of private equity funds, hedge funds, and other investors to make investments in bank holding companies and banks without subjecting themselves to regulation under the Bank Holding Company Act. Voting stock ownership was permitted up to 14.9% of the total outstanding voting shares and total equity investments (voting common and preferred stock) was permitted up to 33.2% of equity. – In practice, responsibilities based on the Bank Holding Company Act can make it more difficult to acquire European banks doing business in the US.

In some cases, shareholders owe fiduciary duties or similar duties. Under German law,[147] a shareholder owes a duty of loyalty towards the company and other shareholders (Treu und Glauben, § 242 BGB). In addition to such a general duty, particular provisions apply where one company controls another. Under Delaware law,[148] a shareholder owes a fiduciary duty only if it owns a majority interest in or exercises control over the business affairs of the corporation. Under English law,[149] the main rule is that a shareholder owes no fiduciary duties to the company

[147] BGHZ 65, 15 (ITT).

[148] Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1344 (Del. 1987).

[149] See Lower M, Good faith and the partly-owned subsidiary, JBL 2000 pp 238–239; Prentice D, The closely-held company and minority oppression, OJLS 3 (1983) p 417 at p 419; Mäntysaari P, Comparative Corporate Governance. Shareholders as a Rule-maker. Springer, Berlin Heidelberg (2005), Chapter 4.

or other shareholders, but like in other countries, their actions are constrained by laws.

Second, shareholders are responsible for obligations or *fictive obligations* that are interpreted as their own obligations. Sometimes it is a matter of interpretation whether there is an obligation that somebody is responsible for in the first place and, if there is such an obligation, who is responsible for it.

In the US, a study found that 42% of piercing the corporate veil cases were based on a contractual obligation and 31% on liability in tort.[150]

It is thus not difficult for courts to find it reasonable to allocate the responsibility for a contractual or non-contractual obligation to a shareholder. The risk that a shareholder is construed to be responsible for an obligation in contract or tort can be increased by the proximity of the shareholder to the company and its business, and especially by functional control that exceeds the normal capitalist control.[151]

For example, if a person has sustained loss or damage in the course of a company's business and a controlling shareholder has effectively taken care of the management of the company, the court may hold that the loss was caused by the company (in which case the shareholder is not liable) or that it was caused by the shareholder (in which case the shareholder can be liable). The choice between these two alternatives can depend on the governing law, the circumstances, and the preferred outcome. The court may also be able to choose between a fictive non-contractual obligation and a fictive contractual obligation. In addition to the preferred outcome, the choice between these two alternatives can again depend on the governing law and the circumstances of the case, for example by differences regarding the burden of proof, the threshold of liability, the extent of liability, the losses to be reimbursed, statutes of limitation, and other circumstances.

The existence of open general principles can increase the risk of shareholder liability. For example, the protection of legitimate expectations can give rise to parent liability (Konzernhaftung) under Swiss law.

In the Swiss case of Wibry v Swissair, a subsidiary (IGR Holding AG) had reproduced the group's logo (Swissair) on its letterhead. The subsidiary also openly tried to benefit from the reputation of the group. The parent company (Swissair Beteiligungen AG) had allowed the subsidiary to hold itself out as a group company and to benefit from its reputation. The parent was held to have created legitimate expectations in relation to the creditors of the subsidiary. The legitimate expectations were protected according to the doctrine of constructive fiduciary duty of care (Vertrauenshaftung). [152]

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[150] Thompson RB, Piercing the Corporate Veil: An Empirical Study, Cornell L R 76 (1991) pp 1036–1074, cited in Merkt H, Spindler G, Fallgruppen der Durchgriffshaftung und verwandte Rechtsfiguren. In: Lutter M (ed), Das Kapital in Aktiengesellschaft in Europa, ZGR, Sonderheft 17. De Gruyter Recht, Berlin (2006) p 260.

[151] Farrar JH, Hannigan B, Farrar's Company Law (1998) pp 70–71.

[152] BGE 120 II 331 (Wibru v Swissair). See von der Crone HC, Walter M, Konzernerklärung und Konzerverantwortung, SZW/RSDA 2/2001 pp 53-68; Duery JN, Misstrauen in die Vertrauenshaftung? SZW/RSDA 4/2001 pp 190-194; Roger Groner, Wann haftet ein Aktionär- und warum? SJZ 101 (2005) pp 1–10.

Moreover, one of the possibilities of seeing through the corporate form is afforded by the concept of agency. One can distinguish between two situations. (a) Depending on the governing law, a shareholder can be regarded as an agent of the company where the shareholder has acted as its representative by taking care of its management or otherwise. For example, depending on the governing law, a shareholder can be regarded as a shadow or de factor director (for "shadow directors" and "faktische Geschäfsführung", see section 10.6.2 of Volume II). (b) In addition, the courts can "pierce the corporate veil" when it is established that the company is an authorised agent of its controllers or its shareholders.[153]

Shareholders of a limited-liability company are nevertheless not automatically liable for the obligations of the subsidiary. For example, it was held in the case of *Kodak Ltd v Clark* that a 98% controlling interest in a company does not in itself give rise to an agency relationship under English law.[154]

A particular risk belonging to this category is the potential liability of a parent company for the actions of the board members of its subsidiary. A parent company typically puts its own representatives onto the boards of its subsidiaries, with the intention that these directors look after the interests of the parent company. Where the subsidiary or a third party sustains a loss through their actions, the subsidiary or the third party may attempt to pursue the parent company to recover its losses.[155] This raises the question of parent liability for appointment and difficult questions of identification.

Now, the purpose of identification rules is to determine the scope of a company's liability in three respects. Since a company is a legal fiction, it is necessary to identify: the group of people whose actions can be attributed to the company; the actions that can be attributed to the company; and the standard of care.[156] According to main identification rules applicable in tort law, a shareholder can well be made liable for some actions of its own employees or agents. Even board members can fall within the category of the shareholder's "own people". This is particularly true where the director is also its employee or agent. But when those employees are board members, there tends to be a conflict between tort and company law. Unlike tort law, company law seeks to give primacy to the company-director relationship and to resist attempts to render the shareholder liable for the actions of the company and its officers. Which interests prevail depends on the governing law. Depending on the governing law, company law rules (or rules that belong to other fields of law) can contain special identification rules that complement the general rules by excluding a subsidiary's board members from the group of people whose actions are attributed to the parent com-

[153] See Modern Company Law: Completing the Structure, para 10.6. See also the British cases of Smith, Stone & Knight Ltd v Birmingham Corpn [1939] 4 All ER 116; Adams v Cape Industries plc [1990] Ch 433 (Court of Appeals).

[154] Kodak Ltd v Clark [1905] 1 KB 505; see also Dine J, The Governance of Corporate Groups. Cam U P, Cambridge (2000) p 45.

[155] Generally, see Grantham R, Liability of Parent Companies for the Actions of the Directors of Their Subsidiaries, Comp Lawyer 18(5) (1997) pp 138–148.

[156] See, for example, Mäntysaari P, Osakeyhtiön vahingonkorvausvastuu ja identifikaatio (2), Defensor Legis 2000/1 pp 3–35.

pany (shareholder), or by excluding certain acts done by them in that capacity from the acts attributable to a shareholder, or both.

One can nevertheless say that the liability of a shareholder for the actions of board members representing his interests is exceptional and limited in various ways depending on the governing law.

Third, there are *exceptions* to the main rule that shareholders are not liable for the debts of the company. Exceptions to the main rule can be based on a statute or special facts or – as already explained - on the flexible use of the concept of contract or tort liability.[157]

For example, it was said in the English case of *Adams v Cape Industries plc* that there are cases "where the wording of a particular statute or contract has been held to justify the treatment of parent and subsidiary as one unit, at least for some purposes".[158] Undercapitalisation and causing the subsidiary company's insolvency can belong to this category. The under-capitalisation of subsidiaries, and their operation in a way which creates undue risks of insolvency, have often been dealt with by provisions of insolvency law.[159]

Fourth, shareholders cannot always separate the ownership of shares from the business activities of the company. There are legal rules which allocate the responsibility for a certain activity on the basis of *function* (on the basis of who is regarded as doing it) rather than on the basis of asset partitioning, representation, or vicarious liability (for corporate governance, see also section 9.3). The responsibility may thus be allocated to the "person responsible", "operator", "user", "person having control", or a similar person.[160] In addition, laws and administrative provisions can require companies to have shareholders that fulfil certain qualitative criteria.

For example, the MiFID which regulates the provision of investment services in regulated markets in the EU[161] provides that: (a) "the competent authorities shall not authorise the performance of investment services or activities by an investment firm until they have been informed of the identities of the shareholders or members, whether direct or indirect, natural or legal persons, that have qualifying holdings and the amounts of those holdings"; (b)

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[157] For British law, see Modern Company Law: Completing the Structure, para 10.6: "The courts have been willing from time to time directly to 'pierce the corporate veil' by imposing company liabilities on the real controllers of the enterprise. Gower concludes that there are three circumstances in which the court may do so: i when construing a statute, contract or other document; ii when the company is a mere façade, concealing the true facts; and iii when it can be established that the company is an authorised agent of its controllers or its members, corporate or individuals."

[158] Adams v Cape Industries plc [1990] Ch 433 at 536.

[159] See Completing the Structure, para 10.59. See generally Hofstetter K, Parent Responsibility for Subsidiary Corporations: Evaluating European Trends, ICLQ 39 (1990) pp 576–598.

[160] See Schneider UH, Die Überlagerung des Konzernrechts durch öffentlich-rechtliche Strukturnormen und Organisationspflichten – Vorüberlegungen zu „Compliance im Konzern", ZGR 1996 pp 225–246.

[161] Article 1(1) of Directive 2004/39/EC (MiFID).

"the competent authorities shall refuse authorisation if, taking into account the need to ensure the sound and prudent management of an investment firm, they are not satisfied as to the suitability of the shareholders or members that have qualifying holdings"; and (c) "where close links exist between the investment firm and other natural or legal persons, the competent authority shall grant authorisation only if those links do not prevent the effective exercise of the supervisory functions of the competent authority".[162]

Fifth, in some cases the limited liability of shareholders is not in force because of rules seeking to prevent *abuse*. In addition to particular provisions of company and insolvency laws, such cases are typically governed by doctrines such as Durchgriff or lifting the corporate veil.[163]

In Switzerland, the basis of the doctrine of Durchgriff is the principle of good faith (Treu und Glauben) and the prohibition of abuse under the Swiss Civil Code. [164]

In Germany, most cases falling within the scope of the doctrine of Durchgriff could just as well be covered by a large number of detailed provisions of company law and insolvency law as well as by rules on the interpretation of contracts and the attribution of acts. In effect, the doctrine is not really necessary. The most important situation covered by the doctrine of Durchgriff is when the assets of the company have been mixed with the assets of a shareholder (Vermögensmischung).[165] Liability for putting the existence of the company in danger (Existenzvernichtungshaftung under § 826 BGB) is often a functional equivalent of the doctrine of Durchgriff.[166] Both the doctrine of Durchgriff and insolvency laws can cover the situation that the company does not have enough equity (under-capitalisation, Unterkapitalisierung), and both the doctrine of Durchriff and particular company law rules can cover the situation where the company is dependent on another company (Abhängigkeits- und Konzernverhältnisse).

Under English law, some important cases of fraud (fraudulent and wrongful trading) have been dealt with by insolvency laws (sections 213–215 of the Insolvency Act 1986). The separate legal existence of a company[167] is complemented by the doctrine of "lifting the veil" or "piercing the corporate veil".[168] In the area of corporate finance, it is interesting

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[162] Article 10(1) of Directive 2004/39/EC (MiFID).

[163] Generally, see Merkt H, Spindler G, Fallgruppen der Durchgriffshaftung und verwandte Rechtsfiguren. In: Lutter M (ed), Das Kapital in Aktiengesellschaft in Europa, ZGR, Sonderheft 17. De Gruyter Recht, Berlin (2006) pp 207–276. See also Hüffer U, Aktiengesetz (1999) § 1 numbers 19–22; Lutter M, Hommelhoff P, GmbH-Gesetz (2000) § 13 numbers 9–12.

[164] Article 2 ZGB; BGE, judgment of 14 April 2000, 5C.275/1999; BGE 102 II 170; BGE 98 II 99; BGE 97 II 293. Cited in Groner R, Wann haftet ein Aktionär - und warum? SJZ 101 (2005) pp 1–10 at p 4.

[165] BGHZ 95, 330, 334; BGHZ 125, 366, 368.

[166] BGHZ 149, 10 (Bremer Vulkan); BGHZ 151, 181 (KBV).

[167] Salomon v A. Salomon & Co. Ltd. [1897] AC 22.

[168] See, for example, Re Polly Peck International plc [1996] 2 All ER 433, 447. The veil of incorporation has been lifted in cases where the company had been used as a "device, stratagem or mask" to the effective carrying on of business by an individual. Gilford Motor Co. Ltd. v Horne [1933] Ch 935. It has also been applied where the company was used by an individual as "a device and a sham, a mask which he holds before his face in an attempt to avoid recognition in the eye of equity". Jones v Lipman [1962] 1 WLR 832.

that the doctrine of lifting the veil can be applied to blatant asset stripping provided that there is sufficient evidence of an improper motive.[169]

In the US, a list of factors that must be taken into account before the doctrine of piercing the corporate veil can be applied was set out in the case of *Laya v Erin Homes, Inc*.[170]

Management of Risk Through Special Purpose Vehicles

"Special purpose vehicles" (SPVs), "special financing vehicles" and similar entities are an extreme form of managing risk through incorporation. Whereas shareholders in a traditional company bear part of the risk inherent in the firm's activities, the ownership of an SPV or a similar vehicle is not typically combined with any risk bearing function. Beneficial ownership is a mere formality.

The bulk of securities issuance by non-monetary financial corporations in the EU is carried out by what are called "special financing vehicles". These are institutions which engage in financial activities, the main purpose of which is to raise money on behalf of a third party such as a credit institution, a non-financial corporation, an investment fund or the general government. Such vehicles can be legally owned by the companies to which they are providing funds, or can be without capital links to those companies.[171]

In continental Europe, special financing vehicles existed until very recently in only a few countries - particularly in the Netherlands, where they started their activities at the end of the 1970s. Initially, they were typically established in that country by foreign multinationals and limited to collecting funds and lending or investing them within their own group. They were pure holding companies or companies managing licences, patents or film rights. When exchange controls were relaxed, these special entities were also able to raise money from non-resident investors external to their group.[172]

"Special financing vehicles" can also be established to facilitate a particular financial transaction. In this case, they are known as "special purpose vehicles" (SPVs). SPVs act as a "conduit" for the sole purpose of channelling funds fom lenders to borrowers.[173]

SPVs are often used in asset-backed finance such as securitisation. The term "securitisation" refers to the transformation of non-marketable assets into marketable securities. Assets such as car loans or mortgage loans can be packaged into securities and sold to investors. In the legal sense, securitisation means that assets are sold by the original owner of the assets (the originator) to a separate legal entity (the SPV).[174] The use of the SPV should make investors immune to the poten-

[169] Ord v Belhaven Pubs Ltd [1998] EWCA Civ 243; [1998] 2 BCLC 447.

[170] Laya v. Erin Homes, Inc., 352 S.E.2d 93, 97–98 (W.Va.1986).

[171] ECB, Annual Report 2003.

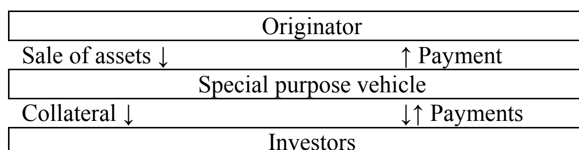
[172] Recent developments in financial structures of the euro area. ECB, Monthly Bulletin, October 2003 pp 47–49.

[173] ECB, Annual Report 2003.

[174] Recent developments in financial structures of the euro area. ECB, Monthly Bulletin, October 2003 pp 47–49.

tial bankruptcy of the originator.[175] To finance its purchase, the SPV issues marketable securities. These securities are backed by assets; the sale of assets to the SPV means that the originator has diverted assets or cashflow from a part of its business into the SPV. Holders of securities should receive the value of the securities at maturity on the basis of the designated cashflows, regardless of what happens to the originator.[176]

Table 4.2 Creation of an Asset-backed Security



Originator	
Sale of assets ↓	↑ Payment
Special purpose vehicle	
Collateral ↓	↓↑ Payments
Investors	

Thanks largely to securitisation, global private-debt securities are now far bigger than stockmarkets.[177]

As a way of raising funds, securitisation can bring many benefits to the originator. First, an SPV can in principle obtain cheaper funding since it can be assigned a higher credit rating than the originator. Second, institutions with a low rating, or no rating at all, can gain access to institutional investors, including banks, insurance companies and pension funds, which are often restricted to investment in high-rated bonds. Third, as an off-balance-sheet funding technique, securitisation is also aimed at reducing a company's leverage by selling assets and using the proceeds, for example, to repay more expensive long-term debt.[178] Banks have pushed much of their lending business off-balance-sheet, so that loans are bought by specialist entities like structured-investment vehicles (SIVs) and conduits.

Securitisation is nevertheless legally complicated (Volumes II and III). (a) According to the agreed terms of the transaction, the SPV should not engage in activities other than the transaction for which it was established. (b) Shares in the SPV should not be held by the originator. They are typically held by a neutral entity, distinct from the originator, or on trust for charitable purposes. The reason is that there is then no chance of the SPV being treated as a subsidiary of the originator under the applicable company laws.[179] (c) The conveyance of assets from the originator to the SPV generally should be concluded in a manner that results in a "true sale". This is necessary to remove the assets from bankruptcy or insolvency estate of the originator (the "bankruptcy remote principle"). (d) The transaction should also be feasible in the light of accounting rules, because one of the purposes of the transaction is to free capital. (e) The securities issued by the SPV will

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[175] ECB, Annual Report 2003.

[176] Recent developments in financial structures of the euro area. ECB, Monthly Bulletin, October 2003 pp 47–49.

[177] When it goes wrong, The Economist, September 2007.

[178] Recent developments in financial structures of the euro area. ECB, Monthly Bulletin, October 2003 pp 47–49.

[179] Cranston R, Principles of Banking Law. Second Edition. OUP, Oxford (2003) p 373.

also need credit enhancement. The SPV has no creditworthiness in itself, and the credit enhancement provides a cushion to investors to reflect potential losses and uncertainty.[180] (f) The special purpose vehicle is often incorporated in a tax haven. Special finance vehicles are thus usually set up in jurisdictions which are more favourable in terms of the bankruptcy remote principle, the security arrangements provided for the investors and the tax treatment.[181]

Sometimes these legal requirements are not met. (a) There is a risk that bankruptcy laws or other laws will allow courts to recharacterise transactions done by the SPV, or the SPV itself.[182] Before the subprime mortgage crisis, a change in the law was perceived as a bigger threat than corporate failure.[183] (b) There is also a risk that the transaction is not supported by accounting rules. After Enron hid losses in off-balance-sheet vehicles, the use of off-balance-sheet vehicles such as SPVs is one of the areas that accounting regulators and standard-setters have been focusing on.[184] A comprehensive set of International Financial Reporting Standards (IFRS) came into effect in 2005. Under IAS 32, many hybrid securities are classified as debt rather than equity. IAS 39 affects debt factoring and securitisation. Where a company has sold receivables into a special purpose vehicle set up specifically to acquire those receivables, that vehicle will generally be brought on to the balance sheet of the company, increasing total assets and total liabilities. The IFRS also requires the use of the consolidation of strategic equity participations and private equity interests. After the subprime mortgage crisis, stricter rules were proposed in order to limit the use of conduits. (c) Transactions can be attacked even in the insolvency of the SPV. Credit enhancement is important in order to reduce the risk of the SPV becoming insolvent.[185] One of the proposals after the subprime mortgage crisis was to align the interests of the originator and investors by forcing the originator of receivables to subscribe part of the securities issued by the SPV.

The Netherlands is a traditional jurisdiction in which to establish special finance vehicles in Europe. In the euro area, the Netherlands accounted for around

[180] *Ibid*, p 370.

[181] Recent developments in financial structures of the euro area. ECB, Monthly Bulletin, October 2003 pp 47–49.

[182] See, for example, Go with the flow, The Economist, September 2002 (on the effects of the proposed "Employee Abuse Prevention Act" in the US).

[183] The Economist described such a case in 2002: "If the special-purpose vehicle is not considered distinct from the [originator], its financing advantages will be lost. [In December 2000], LTV, a steel company, filed for bankruptcy and tried to retain money it received on inventory and receivables that it had already in effect sold to two special-purpose vehicles for $650m." According to The Economist, LTV argued in court that it could use as it liked the money got from receivables (that is, not necessarily to repay interest and principal on the asset-backed loans). LTV claimed that the original transfer of the receivables to the special-purpose vehicles was not a sale but a "disguised finance transaction". A local judge gave a preliminary ruling in LTV's favour. Go with the flow, The Economist, September 2002.

[184] The future of accounts, The Economist, April 2003; Badly in need of repair, The Economist, May 2002.

[185] Cranston R, Principles of Banking Law. Second Edition. OUP, Oxford (2003) p 373.

60% of the amount outstanding of euro-denominated debt securities issued by non-monetary financial corporations at the end of 2003. This is to some extent attributable to tax laws. The actual ultimate beneficiaries in many cases are residents of other euro area countries, which use special financing institutions in the Netherlands only as a dedicated financing vehicle.[186] Other common jurisdictions used for establishing special finance vehicles (in particular SPVs) in the euro area are Ireland, Italy and Luxembourg. In addition, securitisation entities are established in the same jurisdiction as the originator in Spain, France and Italy.[187]

Sometimes the mitigation of risk requires the use of two or more SPVs. This may be necessary in order manage the uncertainties relating to the laws of the originator's home country. For example, the securitisation of Polish mortgages may involve two SPVs: one in Poland acting as intermediary and another in Britain issuing the securities. The securitisation of debit-card receivables from the Czech Republic may require the creation of two Dutch SPVs, one to transfer the eligible receivables to the other, which issues the bonds.[188]

4.4.4 Community Law, Incorporation, Governing Law

Introduction

Community law makes it easier to manage risk through incorporation. A company formed in a Member State will usually be governed by the company law of that state and recognised in the other Member States (Article 43 of the EC Treaty), provided that the company also has its registered office, central administration or principal place of business in the same or another Member State (Article 48 of the EC Treaty). It is therefore possible to choose the law that governs the company by registering the company in the preferred jurisdiction.[189] In addition, Community law makes it easier to change the law that governs the company.

However, the freedom to choose the company form is, in practice, constrained by transaction costs, the signalling effect, and other factors. It can be costly to use a foreign business form, because domestic company forms are usually part of a legal platform (for legal platforms, see Volume II). Furthermore, the use of a company form perceived as unusual - a foreign company form or a company form for small businesses (such as the German UG) - can signal the lack of sufficient funding and other problems.

[186] ECB, Annual Report 2003.

[187] Recent developments in financial structures of the euro area. ECB, Monthly Bulletin, October 2003 pp 47–49.

[188] Buttonwood, Where angels fear to tread, The Economist, April 2006.

[189] For registration see Article 3(1) of Directive 68/151/EEC (First Company Law Directive). For the freedom to choose the governing law see, for example, Mäntysaari P, *op cit*, Chapter 3.

Recognition of Foreign (EU) Companies

National company laws set out the circumstances under which a company is recognised as a company, and rules of private international law (conflict of law rules) designate the national company law that shall govern the matter. Both rules – rules of national company law and rules of private international law – may vary depending on the jurisdiction.

Incorporation and real seat doctrine. As regards the private international law of companies, the Member States apply either the incorporation doctrine (like the United Kingdom, Ireland, the Netherlands and the Nordic Countries) or the real seat doctrine (like Germany, France and most continental Member States). Some Member States apply a combination of both doctrines (Italy and Portugal).

The incorporation doctrine regards the place of registration as the decisive factor connecting the company to national company law. According to the real seat doctrine, the central administration or principal place of business is the decisive connecting factor.[190]

However, refusal to recognise the legal capacity of a company would raise questions as to consistency with the freedom of establishment of companies. The real seat doctrine especially tends to prevent companies from moving their business undertakings between states without serious risk of being seriously disabled in law.

Case law on recognition and governing law. The real seat doctrine has been under examination by the ECJ in *Centros*,[191] *Überseering*,[192] and *Inspire Art*.[193]

In *Centros*, the ECJ confirmed that the right of establishment allows foreign investors to incorporate a business under a more attractive foreign company statute and operate that business in another Member State in the form of a branch. The extent to which Member States may enact specific rules to regulate pseudo-foreign companies is thus severely limited.[194] This led to fears in many countries that the real seat doctrine is contrary to Community law as far as companies established in the EU are concerned.

In *Überseering*,[195] the Court seems to have confirmed this by holding that a "necessary precondition for the exercise of the freedom of establishment is the

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[190] For the benefits of the real seat doctrine see Schmidt K, Sitzverlegungsrichtlinie, Freizügigkeit und Gesellschaftsrechtspraxis, ZGR 1999 pp 23–24; Roth WH, From Centros to Ueberseering: Free Movement of Companies, Private International Law, and Community Law, ICLQ 52 (2003) pp 181–182.

[191] Case C-212/97 Centros [1999] ECR I-1459.

[192] Case C-208/00 Überseering [2002] ECR I-9919.

[193] Case C-167/01 Inspire Art [2003] ECR I-10155.

[194] Timmermans CWA, Company Law as Ius Commune? First Walter van Gerven Lecture, Leuven Centre for a Common Law of Europe (2002) p 11.

[195] Paragraph 59. Further Leible S, Hoffmann J, „Überseering" und das deutsche Gesellschaftskollisionsrecht, ZIP 2003 pp 926 and 929 after footnote 42; ibid, p 13; Zimmer D, Ein Internationales Gesellschaftsrecht für Europa, RabelsZ 67 (2003) p 310; Roth WH, From Centros to Ueberseering: Free Movement of Companies, Private International Law, and Community Law, ICLQ 52 (2003) pp 206–207.

recognition of those companies by any Member State in which they wish to establish themselves".

In *Inspire Art*, the ECJ went on to hold that the registered office, central administration or principal place of business of the company are "connecting factors" under Article 48 of the EC Treaty.[196] The ECJ applied the "connecting factors" based on Article 48 of the EC Treaty to provisions that, in light of their effect, could be classified as "company-law rules".[197]

Accordingly, the application of substantive "company-law" rules in Member State A to a company established in Member State B can constitute a restriction on freedom of establishment as guaranteed by Articles 43 and 48 of the EC Treaty under the Inspire Art principles. The classification of rules in Member States A and B is not relevant, because the "company-law" nature of rules is determined by Community law.[198] In a Member State, "company-law" rules covered by the Inspire Art principles can belong to other fields of law such as contract law, tort law, insolvency law or criminal law.[199] Restrictions on freedom of establishment caused by the application of substantive "company-law" rules in Member State A to a company established in Member State B are permitted only to the extent that they can be "justified". There is plenty of case-law on when restrictions on the fundamental freedoms under the EC Treaty can be justified.

The limits of the Insire Art principles were discussed in a German case in which the BGH held that a prohibition to carry on business activities in Germany could not be circumvented by incorporating an English company and opening a branch office in Germany.[200]

SE. Risks inherent in incorporation can also be reduced by choosing the SE (Societas Europaea, European Company) as the company form of the firm.

An SE founded in a Member State must be recognised as a public limited-liability company in all Member States under the SE Regulation. An SE is governed by the law of the Member State in which it has its registered office.[201].

The SE Regulation nevertheless requires that the registered office of an SE must be located within the Community and in the same Member State as its head office.[202] The latter requirement is contrary to the case-law of the ECJ. Both the transfer of the registered office and the transfer of the head office have been regulated and limited by the SE Regulation.[203]

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[196] Paragraph 97.

[197] Paragraph 100.

[198] See Spindler G, Berner O, Der Gläubigerschutz im Gesellschaftsrecht nach Inspire Art, RIW 1/2004 p 9.

[199] See *ibid*, pp 11–13 and 15; Schön W, Zur "Existenzvernichtung" der juristischen Person, ZHR 168 (2004) pp 290–295.

[200] BGH, judgment of 7 May 2007 – II ZB 7/06.

[201] Article 3(1) of Regulation 2157/2001 (SE Regulation).

[202] Article 7 of Regulation 2157/2001 (SE Regulation).

[203] Article 8 of Regulation 2157/2001 (SE Regulation).

For many reasons, this company form has not become very popular. The Commission tried to learn from past mistakes when presenting a proposal for a Statute on a European Private Company (Societas Privata Europaea, SPE).

SPE. Whereas the SE is an alternative to an AG or an SA, the SPE can be chosen instead of a GmbH or SARL. The SPE enables small- and medium-sized enterprises (SMEs) to do business throughout the EU. Like the SE, the SPE is recognised in all Member States. This reduces the need to establish subsidiaries in many Member States. In practical terms, the SPE also means that SMEs can set up their company in the same form, no matter if they do business in their own Member State or in another.

Freedom of establishment and tax laws. Articles 43 and 48 of the EC Treaty do not mean that foreign subsidiaries or permanent establishments should be treated like domestic subsidiaries or permanent establishments under tax laws.

For example, in *Marks & Spencer*,[204] the ECJ applied rules on the freedom of establishment to group tax relief. The ECJ said first that the direct taxation falls within the competence of Member States which must exercise that competence consistently with Community law.[205] According to the ECJ, the exclusion of group tax relief in respect of losses incurred by a subsidiary established in another Member State could constitute a restriction on the freedom of establishment.[206] However, such a restriction was justified by imperative reasons in the public interest.[207] In *Lidl Belgium*,[208] the ECJ further held that "Article 43 EC does not preclude a situation in which a company established in a Member State cannot deduct from its tax base losses relating to a permanent establishment belonging to it and situated in another Member State, to the extent that, by virtue of a double taxation convention, the income of that establishment is taxed in the latter Member State where those losses can be taken into account in the taxation of the income of that permanent establishment in future accounting periods".

Information about incorporation. Community law makes it easier to find information about the existence of limited-liability companies and restricts their nullity.

The First Company Law Directive applies to all (private and public) companies with limited liability. The First Directive requires the compulsory disclosure of basic information about companies. The means of disclosure are threefold: the opening of a file on every company in an official register; publication in a national official gazette;[209] and an indication, on all business documents, of the legal form

[204] Case C-446/03 Marks & Spencer [2005] ECR I-10837

[205] Case C-446/03 Marks & Spencer [2005] ECR I-10837 paragraph 29.

[206] Case C-446/03 Marks & Spencer [2005] ECR I-10837 paragraph 33.

[207] Case C-446/03 Marks & Spencer [2005] ECR I-10837 paragraphs 35 and 39: "In a situation such as that in the proceedings before the national court, it must be accepted that by taxing resident companies on their worldwide profits and non-resident companies solely on the profits from their activities in that State, the parent company's Member State is acting in accordance with the principle of territoriality enshrined in international tax law and recognised by Community law (see, in particular, Futura Participations and Singer, paragraph 22)."

[208] Case C-414/06 Lidl Belgium.

[209] Article 3 of Directive 68/151/EEC (First Company Law Directive).

and registered place of business of the company and the register in which the file on the company is kept, together with the number of the company in that register.[210] The First Directive also lays down when such official documents and particulars may be relied on by the company as against third parties or by third parties.[211]

Validity of obligations, nullity of companies. In addition, the First Directive contains a set of rules on the validity of obligations entered into by a company and on the nullity of companies.

The main rule is that transactions entered into by the organs of the company are binding, "unless such acts exceed the powers that the law confers or allows to be conferred on those organs" (this question will be discussed also in Volume II).[212]

However, there is a special rule on acts done in the name of the company before the company has acquired legal personality. The persons who acted in the name of the company are jointly and severally liable therefor, unless the company assumes the obligations arising from such action or the parties have agreed otherwise.[213]

The nullity of companies must not be automatic. Nullity requires a decision by a court of law.[214] There is an exhaustive list of circumstances in which nullity may be ordered.[215]

Changing the Governing Law or the Business Form of the Firm

Community law makes it easier to change the law that governs the company. This will usually mean changing the business form of othe firm. In domestic cases, the business form of the firm can be changed without changing the governing law.

Changing the governing law. The governing law can be changed in many ways. First, an SE (and in the future an SPE) can change its registered office from one Member State to another. Second, it is arguable that other companies enjoy a similar right by virtue of the freedom of establishment guaranteed by the EC Treaty. Third, a company registered in one Member States can merge with a company registered in another Member State. Fourth, shareholders of a company incorporated in one country can become shareholders of a company incorporated in another country through a share exchange. And lastly, there are a number of legislative proposals that might make it easier to change the governing law and thus may increase "corporate mobility".

Transfer of the registered office of an SE or an SPE. Now, an SE is regarded as a public limited-liability company governed by the law of the Member State in which it has its registered office.[216] Every SE must be registered in the Member

[210] Article 4 of Directive 68/151/EEC (First Company Law Directive).
[211] Article 3 of Directive 68/151/EEC (First Company Law Directive).
[212] Article 9(1) of Directive 68/151/EEC (First Company Law Directive).
[213] Article 7 of Directive 68/151/EEC (First Company Law Directive).
[214] Article 11(1) of Directive 68/151/EEC (First Company Law Directive).
[215] Article 11(2) of Directive 68/151/EEC (First Company Law Directive).
[216] Article 3(1) of Regulation 2157/2001 (SE Regulation).

State in which it has its registered office.[217] However, the SE regulation provides that the registered office of an SE may be transferred to another Member State provided that the SE follows a certain procedure. The transfer of the registered office of the SE will not result in the winding up of the SE or in the creation of a new legal person.[218] A Member States may have retained the right to oppose the emigration of SEs registered in that Member State on grounds of public interest.[219]

Like the SE Regulation, the SPE Regulation will provide for a procedure according to which the registered office of an SPE may be transferred to another Member State.

Transfer of the registered office of companies under the freedom of establishment. There is no other specific secondary Community legislation on the right of companies to change the law that governs the company. Whether companies have such a right depends on the interpretation of the freedom of establishment guaranteed by the EC Treaty.

In this context, one must distinguish between the application of the law of the initial country of incorporation (for which the transaction is an "outbound" one) and the destination country of incorporation (for which the transaction is "inbound" one).

As regards the transfer of the real seat of the company, the ECJ used to accept restrictions by the initial country of incorporation. In *Daily Mail*, the ECJ indicated that incorporations and reincorporations depend on Member States' laws rather than Community law because companies are "creatures of the law".[220] The judgment was not internally coherent in this respect, because the ECJ also said that freedom of establishment under Community law applies to companies.[221] Daily Mail concerned a situation in which a company wanted to transfer its real seat without changing its place of incorporation.

However, it is now clear that freedom of establishment covers both outbound and inbound situations.[222] In *de Lasteyrie du Saillant*, the ECJ said that the EC Treaty prohibits the Member State of origin from hindering the establishment in another Member State of one of its own nationals.[223]

As a result, the mere fact that the company uses its freedom of establishment should not lead to the liquidation of the company in the initial country of incorporation. Refusal to recognise a company just because it uses its freedom of estab-

[217] Article 12(1) of Regulation 2157/2001 (SE Regulation).
[218] Article 8 of Regulation 2157/2001 (SE Regulation).
[219] Article 8(14) of Regulation 2157/2001 (SE Regulation).
[220] Case C-81/87 Daily Mail and General Trust [1988] ECR 5483, paragraphs 19 and 23.
[221] Case C-81/87 Daily Mail and General Trust [1988] ECR 5483, paragraphs 15–16. See also Roth WH, Die Wegzugsfreihet für Gesellschaften. In: Marcus Lutter (ed), Europäische Auslandsgesellschaften in Deutschland. Verlag Dr. Otto Schmidt, Köln (2005) p 388.
[222] See the opinion of AG Colomer in Case C-208/00 Überseering, paragraphs 25–26; Roth WH, *op cit*, pp 385–386.
[223] Case C-9/02 de Lasteyrie du Saillant [2004] ECR I-2409, paragraph 42.

lishment must be regarded as a restriction on freedom of establishment incompatible with the EC Treaty.[224]

There is nevertheless a difference between the subsequent transfer of the real seat of the company and the subsequent transfer of its registered office (statutory seat).[225] The latter requires reincorporation in the destination country, where the initial country of incorporation requires a statutory seat in the country of incorporation.[226] Should the destination country permit the (inbound) transfer of the statutory seat and reincorporation? Should the initial country of incorporation permit the (outbound) transfer of the statutory seat without liquidation of the company?

According to one view, reincorporation in the destination country may still be governed by the *Daily Mail* rules and the company law of the destination country,[227] because it does not raise questions of discrimination between foreign companies and domestic companies, and because companies can choose a cross-border merger to transfer their statutory seat if they want.[228] This would require two steps. First, the company that wants to change its statutory seat establishes a new company in the designated country. Second, this new company merges by acquisition with the existing company so that - without going into liquidation - the latter ceases to exist.[229]

Reincorporation is governed by similar rules in the US. In the US, a direct change of the corporate domicile is not possible, but reincorporation is possible; it is a well-established procedure for a new corporation to be founded in the destination country of incorporation and to merge it with an existing corporation.[230]

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[224] Compare Case C-212/97 Centros [1999] ECR I-1459, paragraph 21; Case C-208/00 Überseering [2002] ECR I-9919, paragraphs 81–82; Case C-81/87 Daily Mail and General Trust [1988] ECR 5483, paragraph 16. See also Roth WH, Die Wegzugsfreihet für Gesellschaften. In: Marcus Lutter (ed), Europäische Auslandsgesellschaften in Deutschland. Verlag Dr. Otto Schmidt, Köln (2005) p 391.

[225] For differences, see Roth WH, Die Wegzugsfreihet für Gesellschaften. In: Marcus Lutter (ed), Europäische Auslandsgesellschaften in Deutschland. Verlag Dr. Otto Schmidt, Köln (2005) pp 380–383.

[226] For example, § 7(1) GmbHG.

[227] Case C-81/87 Daily Mail and General Trust [1988] ECR 5483, paragraph 24: “Under those circumstances, [the EC Treaty] cannot be interpreted as conferring on companies incorporated under the law of a Member State a right to transfer their central management and control and their central administration to another Member State while retaining their status as companies incorporated under the legislation of the first Member State.” See also Case C-208/00 Überseering [2002] ECR I-9919, paragraph 70; Roth WH, Die Wegzugsfreihet für Gesellschaften. In: Marcus Lutter (ed), Europäische Auslandsgesellschaften in Deutschland. Verlag Dr. Otto Schmidt, Köln (2005) pp 388–390.

[228] Siems MM, SEVIC: Beyond Cross-Border Mergers, EBOLR 2007 p 313.

[229] *Ibid*, p 312.

[230] *Ibid*, p 313.

On the other hand, although this question was not examined by the ECJ in *Centros*, *Überseering* or *Inspire Art*,[231] the SE Regulation and the proposed SPE Regulation show that it can be technically possible to transfer the registered office of a company and change the law that governs it while maintaining its legal personality. Depending on the case, the firm and its stakeholders may have an interest in the continuity of the company's legal personality.

It can therefore be assumed that the automatic prohibition of the (inbound or outbound) transfer of the company's registered office (or the requirement that the company cannot maintain its legal personality during the process) would be regarded as a restriction on the freedom of establishment (like the prohibition of cross-border mergers)[232] and that particular restrictions would need to be justified.[233]

At the same time, changing the registered office of the company and reincorporation in the destination country should lead to derecognition of the company in the initial country of incorporation. Obviously, a legal entity should not continue to be governed by the company laws of two countries.[234]

Cross-border merger. A company can change the governing law through a cross-border merger (for mergers, see Volume III).

In Community law, cross-border mergers have been made possible in three ways. (1) Cross-border mergers are permitted by virtue of the freedom of establishment and the case-law of the ECJ (Case C-411/03 *Sevic Systems*).[235] The decision of the ECJ in Sevic Systems left open two questions on how the law should deal with cross-border mergers. The first problem was whether not only inbound mergers but also outbound mergers have to be allowed under the freedom of establishment. The second was how the cross-border merger should be under-

[231] Case C-167/01 Inspire Art [2003] ECR I-10155, paragraph 103; Case C-208/00 Überseering [2002] ECR I-9919, paragraph 62.

[232] Case C-411/03 Sevic Systems [2005] ECR I-10805, paragraph 23.

[233] Case C-411/03 Sevic Systems [2005] ECR I-10805, paragraph 27–30.

[234] Case C-167/01 Inspire Art [2003] ECR I-10155, paragraphs 97 and 99; Roth WH, „Das Wandern ist des Müllers Lust …“: Zur Auswanderungsfreiheit für Gesellschaften in Europa. In: Festschrift für Andreas Heldrich zum 70. Geburtstag, C.H.Beck, München (2005) p 975.

[235] Case C-411/03 Sevic Systems [2005] ECR I-10805, paragraph 22: "In so far as, under national rules, recourse to such a means of company transformation is not possible where one of the companies is established in a Member State other than the Federal Republic of Germany, German law establishes a difference in treatment between companies according to the internal or cross-border nature of the merger, which is likely to deter the exercise of the freedom of establishment laid down by the Treaty." Paragraph 23: "Such a difference in treatment constitutes a restriction within the meaning of Articles 43 EC and 48 EC, which is contrary to the right of establishment and can be permitted only if it pursues a legitimate objective compatible with the Treaty and is justified by imperative reasons in the public interest. It is further necessary, in such a case, that its application must be appropriate to ensuring the attainment of the objective thus pursued and must not go beyond what is necessary to attain it (see Case C-436/00 X and Y [2002] ECR I-10829, paragraph 49; Case C-9/02 De Lasteyrie du Saillant [2004] ECR I-2409, paragraph 49)."

taken.[236] The open questions were answered when the provisions of the Directive on cross-border mergers were implemented in the Member States. (2) The Directive on cross-border mergers[237] facilitates mergers between limited-liability companies governed by the laws of different Member States.[238] (3) A company can also participate in the formation of an SE under the SE Regulation. There are four ways of establishing an SE. For example, an SE may be formed through the merger of public limited-liability companies governed by the laws of different Member States;[239] the formation of a holding SE is an original way to create a public limited-liability company in the EU.[240]

Cross-border mergers as a method of changing the governing law can be illustrated by the case of Mittal Steel. In 2006, Mittal Steel, a naamloze vennootschap incorporated under Dutch law, made a hostile bid for the shares of Arcelor, a Société Anonyme incorporated under Luxembourg law. The representatives of those companies finally agreed to cooperate and create Arcelor Mittal, a company domiciled in Luxembourg. In September 2006, 93.7% of Arcelor shareholders tended their shares to Mittal Steel.

In 2007, a two-step merger process followed. First, Mittal Steel, a Dutch company, was transformed into a company governed by Luxembourg law. This was achieved through the merger of Mittal Steel with its wholly-owned non-operating subsidiary ArcelorMittal, a Société Anonyme incorporated under Luxembourg law.[241] The shareholders of Mittal Steel received one ArcelorMittal share for each Mittal Steel class A or class B common share. Second, ArcelorMittal and Arcelor merged. The second merger was legally less complicated because both companies were governed by the law of the same country (Luxembourg law).

Share exchange. With the exception of cross-border mergers under the freedom of establishment and the Community's secondary legislation, formal cross-border mergers are usually not permitted. However, a share exchange can be executed even without the formal merger of the participating companies.

For example, a tanker firm incorporated as a Swedish company and having its shares listed on the Stockholm Stock Exchange can choose to be incorporated in Bermuda and have its shares listed on the Oslo Stock Exchange instead. The change of registered office and the

[236] Siems MM, SEVIC: Beyond Cross-Border Mergers, EBOLR 2007 pp 308–309.

[237] Directive 2005/56/EC on cross-border mergers of limited liability companies.

[238] Article 1 of Directive 2005/56/EC (Directive on cross-border mergers).

[239] Article 2(1) of Regulation 2157/2001 (SE Regulation). See also Title II, Section 2 (Formation by merger).

[240] Article 2(2) of Regulation 2157/2001 (SE Regulation). See also Title II, Section 2.

[241] The merger documentation comprised in particular: a merger proposal required by Dutch and Luxembourg corporate law; an explanatory memorandum; a European prospectus (for European shareholders under the Prospectus Directive 2003/71/EC in connection with the ArcelorMittal shares that were to be issued in the first-step merger and admitted to trading on regulated markets); and a US proxy statement and prospectus (for US shareholders).

law that governs the company can be executed through an exchange offer (for example, share for share) by a newly formed company in Bermuda.[242]

Legislative proposals. There are two important legislative proposals that might increase corporate mobility. The first is the SPE Regulation (see above). The second is a proposal for a Directive on the transfer of registered office. However, such a directive looks less necessary after the judgment of the ECJ in *Sevic Systems* and after the adoption of the Directive on cross-border mergers.

One can also mention the European Model Company Act (EMCA) project.[243] A European task force set out in 2007 to create a model act comparable to the MBCA in the US. The purpose of the model act would be to increase convergence of rules applicable to public limited-liability companies.

In Germany, the Federal Ministry of Justice has submitted a proposal for an Act on the International Private Law of Companies, Associations and Legal Persons.[244] According to the proposal, traditional company law questions would be governed by the law of the country where the company is incorporated.

Co-determination. Employee co-determination is regarded as a question of company law. For example, when the connecting factor is changed from the company seat to the country of incorporation, it becomes easier for German and foreign companies to opt out of co-determination under German law.[245]

Questions not classified as company-law matters. Questions not classified as "company-law" matters will not be covered by the *Inspire Art* rules.[246]

For example, questions of insolvency law will be governed by the law governing the insolvency proceedings under *Gourdain v Nadler*[247] and the Regulation on insolvency proceedings,[248] provided that the centre of the debtor's main interests is located in the Community.

Generally, the firm may be able to change the law governing insolvency questions or questions of tax without changing the law governing company law mat-

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[242] In another Swedish case, a newly-formed Swiss company made a public share exchange offer to shareholders of a listed Swedish company. Aktiemarknadsnämnden 2002:17. See Kristiansson B, Avnotering efter ansökan av bolaget, NTS 2006:3 p 33.

[243] Baums T, Krüger Andersen P, The European Model Company Law Act Project (March 1, 2008). ECGI - Law Working Paper 97/2008. Available at SSRN.

[244] Gesetzentwurf zum Internationalen Privatrecht der Gesellschaften, Vereine und juristischen Personen, January 2008.

[245] Roth WH, Unternehmensmitbestimmung und internationales Gesellschaftsrecht. In: Gedächtnisschrift für Meinhard Heinze, C. H. Beck, München (2005) pp 709–729. See pp 720–721 for the Treaty of Friendship, Commerce and Navigation between the United States of America and the Federal Republic of Germany (especially Article XXV(5) on the recognition of companies), the most-favoured-nation principle under Community law (prohibition of discrimination), and ordre public under German law.

[246] C-167/01 Inspire Art [2003] ECR I-10155, paragraph 97.

[247] Case 133/78 Gourdain v Nadler [1979] ECR 733, paragraph 4.

[248] Regulation 1346/2000 on insolvency proceedings.

ters. Changing the law that governs company law matters may indirectly influence the law governing questions of insolvency or tax.[249]

The distinction between company-law matters and other matters can lead to difficult questions of interpretation.[250]

Changing the business form without changing the governing law. The legal entity within which the firm operates can be changed without changing the governing law. This will mean changing the legal framework that regulates both the organisation of the firm and its relationship with its stakeholders. The usual ways to change the firm's business form include:[251] reincorporations (changing the form of the legal entity within which the firm operates), so-called asset deals (selling the firm to another legal entity), other forms of asset transfers (transferring the firm to another legal entity without selling it, mergers and divisions are forms of asset transfers), mergers (transferring the firm to the entity that survives the merger), and divisions (transferring the firm as a whole or in part to a new or an existing legal entity).

4.4.5 Transfer of Risk Through Contracts

The firm can manage risk by transferring it to somebody else. The firm can transfer risk in two main ways: through incorporation (see above); and by means of contractual transfer between two or more parties. The government can also introduce legislative measures that allocate risk to one of the parties to the contract, a third party, or members of the public.

In perfect markets, the contractual transfer of risk would only be possible at a cost. As there are parties that sell protection and buy risk, the firm can to some extent outsource its risk-bearing functions. The cost of transferring risk may be reduced if the market is not perfect or the other parties do not have sufficient information.

Legal tools and practices. The firm can use a wide range of legal tools in order to transfer risk.

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[249] See, for example, *ibid*, p 551.

[250] See, for example, Trunk A, Grenzüberschreitende Insolvenz von Gesellschaften im Verhältnis EG-Schweiz: Folgerungen aus Centros, Überseering und Inspire Art, SZIER/RSDIE 4/2004 pp 531–557 at pp 540–543: "In der Literatur werden … aus Inspire Art zum Teil weiterreichende Folgerungen gezogen. So wird vertreten, auch die Insolvenzverschleppung (im deutschen Recht: § 823 II BGB in Verbindung insbesondere mit § 64 GmbHG) sei künftig allein nach dem Gründungsrecht der Gesellschaft zu beurteilen. Hier sind zwei Fragen zu unterscheiden: zum einen die Abgrenzung von Gesellschaftsstatut und Deliktsstatut, zum anderen die Abgrenzung zum Insolvenzstatut … Es verbleibt ... bei der deliktsrechtliche Qualifikation des § 823 II BGB; lediglich die Insolvenzantragspflicht (§ 64 GmbHG als Schutzgesetz) ist der lex fori concursus zu entnehmen."

[251] For German law, see § 1(1) UmwG: "Rechtsträger mit Sitz im Inland können umgewandelt werden 1. durch Verschmelzung; 2. durch Spaltung (Aufspaltung, Abspaltung, Ausgliederung); 3. durch Vermögensübertragung; 4. durch Formwechsel."

First, risk can be transferred to banks, insurance companies and similar providers of financial services. The firm can thus isolate a particular risk and use financial products to transfer risk to somebody else who profits by bearing it. That somebody (for example, an insurance company) may want to retain a portion of the risk and transfer a portion of the risk to a third party (for example, a reinsurance company). This method of risk transfer will be discussed in Volume II in more detail.

Second, risk can be transferred horizontally to other investors such as co-shareholders or co-owners of the project. Such projects range from commercial joint ventures to loan syndicates.

Third, risk can be transferred vertically in the supply and delivery chain. (a) The firm can thus transfer risk to its customers. For this the firm needs a contractual framework that includes at least: contract terms that define the maximum scope of its obligations and limitations of warranty that exclude its other responsibilities; and advance payments or other instruments that enable the firm to use customers as a source of funding. (b) The firm can also transfer risk to its suppliers. For example, the firm can transfer the risk of the occurrence of unwanted events to suppliers of goods or services required for the production of the firm's own goods or services. The firm can transfer risk relating to workers to staffing firms. (c) The firm can outsource not only peripheral activities but also core functions. For example, the firm can use a systems integrator and transfer a larger part of the risk inherent in the production of the firm's goods or services to the systems integrator.

A car manufacturer can deal with the cyclical nature of its business by outsourcing part of its business or by using outsourced teams instead of employing its own personnel. Business outsourcing and the use of outsourced teams is also a way to manage risk. It might be expensive for the firm to reduce its capacity in an economic downturn because of high transaction costs caused by mandatory labour laws and other reasons. If the firm can reduce its capacity at lower cost by reducing business outsourcing and the use of outsourced teams, the firm can transfer part of the risk of an economic downturn to its outsource provider. In that case, the firm might pay the outsource provider a premium for bearing that risk; the cost of outsourcing should therefore include even the cost of risk transfer.[252]

Summary. It can be seen that the options available to the firm range from the transfer of an isolated risk to outsourcing of risk-bearing functions on a large scale (business outsourcing) or sharing the risk with other investors. What is common to all of them is that they give rise to agency problems (see below). In addition, the large scale outsourcing of risk-bearing functions can give rise to several typical problems that are usually mitigated when the investment project is carried out within one corporate entity.

[252] See, for example, Volkswagen kündigt harte Einschnitte an. Der größte Automobilkonzern Europas fährt die Produktion zurück und will sich von einem Großteil seiner 25 000 Leiharbeiter trennen. FAZ, 24 October 2008 p 11.

Table 4.3 Transfer of Risk

	Firm	
Protection ↑		↓ Premium
	Financial service providers	

	Customers	
Protection ↓		↑ Lower price
	Firm	
Protection ↑		↓ Higher price
	Suppliers	

	Firm	
System	↑↓	Price
	Systems integrator	
Components	↑↓	Price
	Suppliers	

	Firm	
Share of investment	↑↓	Share of profits
	Co-investors	

4.4.6 Mitigation of Risk Through Diversification

Some risks can be mitigated by holding a diversified portfolio of assets. While the risk of being in the asset market (systemic risk) cannot be be diversified away, the risk that is specific to the firm's fortunes (unsystemic risk) can be mitigated through appropriate diversification.

Firm. The main rule is that the legal framework of the firm does not prevent the firm from moving into different business areas or different markets, or from holding a diversified portfolio of assets. There can be exceptions and constraints.

Some industries are subject to special government supervision. It is possible that a firm that has obtained a government permit to carry on business in such an area is not permitted to carry on business in other than closely related areas. For example, there are restrictions on the business activities of financial institutions and providers of investment services. Firms that are public entities are subject to more stringent regulation.

The statutes of a limited-liability company must always set out the company's field of activity (objects).[253] The objects of the company may limit diversification to other areas, unless the objects clause is changed.

In principle, diversification can be limited by contract terms such as covenants or non-competition clauses (Volume II).

[253] Article 2 of Directive 77/91/EEC (Second Company Law Directive).

Shareholders of a limited-liability company. Limited liability and the separate legal personality of the company make it easier for shareholders to manage risk by diversification.

Moreover, the degree of diversification can change shareholders' preferences. Very diversified and distant shareholders tend to be more interested in the maximisation of the value of their shares in the short term rather than the management of the company or its profitability as such.[254]

In regulated industries, the diversification of controlling shareholders to other industries can be subject to constraints.

[254] See, for example, Roe MJ, Political Preconditions to Separating Ownership from Corporate Control, Stanf L R 53 (2000) p 545.

5 Agency, Risk, Transparency, Governance

5.1 Corporate Risk Management v Corporate Governance

Questions of agency, corporate risk management, information management, and corporate governance are in many ways interrelated in the law of corporate finance.

Corporate governance and corporate risk management. As will be explained in the chapter on corporate governance, it takes four steps to connect corporate risk management with corporate governance.

First, certain matters must be regulated, if a business enterprise is an artificial person having an organisation. Second, one should choose the principal, i.e. the party whose interests one should further when regulating these questions. Third, one should identify the interests of the most important principal. Fourth, corporate risk management either is or is not in the interests of the most important principal.

Now, in this book, the most important principal from a legal perspective is the firm itself (rather than its shareholders), and the highest objective of the firm is its own survival (meaning that the maximisation of shareholder value is not the highest objective). This leads to the fourth step.

Corporate risk management can increase the firm's long-term survival chances. (a) At the strategic level, the firm manages its general risk level (see section 7.2). (b) There is also an operational level. Corporate risk management is a way to manage the firm's costs directly and indirectly as risks that have materialised can give rise to direct costs and many stakeholders price their goods on the basis of their own risk exposure when dealing with the firm. On the other hand, some stakeholders such as the state do not take decisions on the basis of risk and costs but require strict compliance. Ensuring compliance is therefore part of corporate risk management. Corporate risk management must cover even the management of agency relationships because agency relationships give rise to numerous risks. The same can be said of the management of information.

5.2 Partly the Same Legal Tools

The same legal tools and practices can often be used in the management of questions related to agency, risk, information, and corporate governance. This can be illustrated by the following general comments.

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Behaviour modification. The management of agency relationships is a tool used when managing risk and questions of corporate governance. At a high level of abstraction, the management of agency relationships is about changing individual and organisational behaviour. There are generic legal tools and practices designed to change the behaviour of agents and make them act in the principal's interest. Those legal tools and practices will play an important role both in operational risk management as well as in corporate governance.

Agency tools, risk management tools. The legal tools and practices designed to manage agency relationships in general can thus be used when designing a risk management programme. For example, increasing the transparency of agents' acts is both an important way to manage agency relationships and an important risk management tool which can give board members, executives, and employees an incentive to further the risk management objectives of the firm.

Agency tools, corporate governance tools. It goes without saying that the legal tools and practices designed to manage agency relationships in general play an important role in corporate governance. The management of agency problems has been the most important topic in corporate governance since Berle and Means. Behaviour modifying tools have therefore been used from the toolbox of the management of agency relationships and from the toolbox of risk management.

As will be explained below, one of the most important tasks of the board (or another corporate body entrusted with furthering the interests of the firm) is to decide on the allocation of value generated by the firm and the allocation of risk between the firm and its stakeholders as well as between the firm's stakeholders inter se. The board should choose the risk level of the firm. This brings risk management to the core of corporate governance.

Typically, legal tools designed to manage agency relationships, to be used in operational risk management, or to increase transparency, tend to be introduced to corporate governance by the government after serious corporate failures. After the crash of the Ivar Kreuger empire in 1932, the Securities Act of 1933 was passed strengthening disclosure requirements for all companies selling stock in the US. After the crash of Enron, new federal legislation followed in the form of the Sarbanes-Oxley Act of 2002. Both influenced European laws.

Information. Increasing transparency and the management of information in general are an important part of the regulation of corporate governance. Information asymmetries between the agent and the principal belong to the causes of agency problems and increasing information is one one of the generic ways to manage agency relationships. Furthermore, the management of information forms one of the most important areas of corporate risk management.

Contents. In the following, the general legal aspects of the management of agency relationships will be discussed first. This will be followed by a chapter on corporate risk management. Both will influence the chapter on the management of agency relationships in the context of corporate governance. The management of information will be discussed last.

6 Management of Agency in General

6.1 Introduction

The purpose of this chapter is to identify the most common legal ways for the principal to manage agency relationships. They will be applied in the chapter on corporate risk management and the chapter on corporate governance.

Principal-agency relationships. The firm may have ideas about what different people and parties should do in order to further its interests, but the firm cannot be sure that they will actually do what they are supposed to do. The firm can use legal tools and practices to reduce this risk and make them more likely to act in the intended way. The management of agency relationships by legal means belongs to the most important questions of the law of corporate finance.

Reducing agency costs is in the interests of all parties. For obvious reasons, it is always in the interests of the principal, but even the agent can benefit. First, the principal may be prepared to offer greater compensation to the agent when the expected quality of the agent's performance is higher and the risk of failure to perform in the expected way is reduced. Second, the principal may be prepared to accept a lower price for its own performance when the agent can be expected to fulfil its own part of the deal. – For example, rules that protect creditors from opportunistic behaviour on the part of a debtor company are likely to reduce the interest rate that the company must pay for credit, thus benefiting the company as well as its creditors.

The problem lies in motivating the agent to act in the principal's interest rather than simply in the agent's own interest.

Generic strategies. There are generic and partly overlapping ways to reduce agency costs. The degree of the use of any agency tool can influence the use of other agency tools as complements or substitutes.

At a high level of abstraction, agency tools and practices include at least: behaviour modification; choosing the scope of agency; the alignment of interests; and monitoring (transparency). At a more concrete level, they include tools and practices such as: choosing the agent (setting the terms of entry and exit; selection and removal); the use of rules and standards; initiation and ratification of decisions; as well as the use of trusteeship and rewards.

Legal strategies used by states. Now, as the legal framework is multi-layered, one should start by studying the default legal framework. What would apply if the principal did nothing?

One can say that states use various legal strategies to address agency problems because of the nature of laws: laws are about the weighing of different interests.

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One can also say that similar countries – say, democratic market economies that enforce the rule of law – tend to turn to a similar pool of legal strategies in addressing agency problems, but there can be substantial variety in the way particular agency relationships are handled in different countries.[1] Different countries can employ these strategies in different ways according to their prerefences.

First, there is a high-level strategy of changing the behaviour of firms and/or people and making them further *public policy objectives*.[2] This requires standard-setting. For example, the legal *entity* within which the firm operates can have a duty to comply with laws that protect, say, consumer welfare. Some of the *people* that belong to the firm's organisation can be personally responsible for compliance with legal rules that further this policy objective and can be punished for non-compliance. To what extent legal rules penetrate the separate legal personality of a legal entity and the different hierarchical levels of its organisation depends on the policy objective in question.[3] Behaviour-modification and standard-setting are two of the three components of control.[4]

Second, there is the generic strategy of *monitoring and transparency*. This strategy plays a major role in the law of corporate finance. For example, disclosure is the most fundamental principle in UK company and securities markets law, and increasing transparency and disclosure is the most important strategy adopted in EU company and securities markets law (see section 10.7 below). According to the Basel Committee, a bank "should be governed in a transparent manner".[5]

Monitoring and transparency (information-gathering) form the third component of control.

Third, there are more specific generic legal strategies that *facilitate* the changing of behaviour through monitoring and transparency, standard-setting, or otherwise. They can range from rules on rule-making and standard-setting to strategies designed to facilitate the change of behaviour by aligning interests.

Legal strategies used by firms. Basically, the firm can use the same legal strategies as the government. The difference is that the firm will either choose a passive approach and rely on legal background rules or adopt an active approach which includes the use of contracts as well as internal guidelines and programmes. This chapter will focus on legal strategies that can be used by the firm.

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1 In one study, this was found to apply to agency problems in company law in the leading market economies. See Kraakman R, Davies PL, Hansmann H, Hertig G, Hopt KJ, Kanda H, Rock EB (eds), The Anatomy of Corporate Law. OUP, Oxford (2004) p 23.

2 See Bagley CE, Winning Legally. Harv Bus S P, Boston (2005) p 47 ff.

3 For the concept of penetration see Mäntysaari P, Comparative Corporate Governance. Shareholders as a Rule-maker. Springer, Berlin Heidelberg (2005), Chapter 2.

4 In a cybernetic sense, control means the ability to keep the state of a system within some preferred subset of all its possible states. See Hood C, Administrative Analysis. Brighton, Wheatsheaf Books (1986) p 112; Hood C, Rothstein H, Baldwin R, The Government of Risk. OUP, Oxford (2001) p 23.

5 BIS, Basel Committee on Banking Supervision, Enhancing corporate governance for banking organisations (February 2006), principle 7.

Table 6.1 Examples of the Management of Agency Problems in Contracts[6]

Principal-agent problem	Adverse selection	Moral hazard (1)	Moral hazard (2)	Hold-up
Information asymmetry	Hidden characteristics.	Hidden action.	Hidden information.	Hidden intentions.
Time of the agent's actions	Before the conclusion of the contract (ex ante).	After the conclusion of the contract (ex post).	After the conclusion of the contract (ex post).	After the conclusion of the contract (ex post).
Way to manage the problem	Information management (screening, signaling, self-selection). Alignment of interests (collateral, guarantees).	Alignment of interests (rewards).	Reduction of information asymmetries (monitoring, reporting obligations).	Alignment of interests (collateral, vertical integration).

6.2 Behaviour Modification

At a very general level, the management of agency relationships is about changing individual and organisational behaviour. Agency problems may be caused by the preferences and incentive structures of agents and their attitudes and beliefs. For this reason, the starting point is what people are doing voluntarily or without thinking: "In both games and society … no set of rules can prevail unless most participants most of the time conform to them without external sanctions …"[7]

Societal, regulatory, and risk cultures. The choice of legal tools for this purpose can depend on cultural factors.[8] There are different levels of culture.

Societal (national) cultures differ mostly at the deep level, i.e. the level of values. Generally, one can identify five or more dimensions of societal values.

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[6] For a more detailed table, see Hunziker S, Das Prinzipal-Agent-Problem im schweizerischen Vertragsrecht. Informationsasymmetrien und Verhaltenssteuerung. Schulthess, Zürich Basel Genf (2007) p 97. See also Kraakman R, Davies PL, Hansmann H, Hertig G, Hopt KJ, Kanda H, Rock EB (eds), *op cit*, p 23; Thomsen S, An Introduction to Corporate Governance. DJØF, Copenhagen (2008) p 41.

[7] Friedman M, Capitalism and Freedom, U Chic P, Chicago and London (1962), Chapter II.

[8] For a survey of the economic theory of ethics, see Hausman D, McPherson M, Taking Ethics Seriously: Economics and Contemporary Moral Philosophy, J Econ Lit 31 (1993 pp 671–731; Thomsen S, An Introduction to Corporate Governance. DJØF, Copenhagen (2008) pp 135–150.

They are: power distance; uncertainty avoidance; individualism v collectivism; masculinity v feminity; and long-term v short-term orientation.[9] They correspond with the personality dimensions.[10]

Such values can influence even risk and regulatory cultures. One can can distinguish between compliance, opportunistic, and defiance *risk* cultures.

Within a compliance culture, official bans or warnings about dangerous products or practices can be expected to discourage the consumption or activity in question. Within an opportunistic culture, such policy tools will work only if accompanied by a substantial investment in detection and the application of sanctions. Within a defiance culture, they may produce the reverse of the intended effect, by increasing the attractiveness of the product or practice to those who wish to defy authority.[11] – The existence of a compliance culture can reduce direct monitoring costs. In contrast, the existence of an opportunistic culture can increase them.

In addition, there are compliance-oriented and deterrence-oriented *regulatory* cultures as well as cultures with a hybrid approach.

Hood, Rothstein, and Baldwin describe how compliance doctrines rely heavily on diplomacy, persuasion, or education rather than the routine application of sanctions to produce a compliance culture on the part of those affected by regulation. For example, European regulatory regimes are often believed to be more compliance-oriented than the more deterrence-focused US system. Deterrence doctrines rely on the credibility of penalties or punishment, expressed in the "expected cost" of non-compliance to violators, to prevent them from breaking the rules in the first place. Some regulatory designers argue for a hybrid approach, advocating compliance responses towards the poorly-informed or morally concerned and deterrence approaches to those who are opportunistic or amoral.[12]

The less compliance-oriented the risk culture is, the more deterrence against wrong-doing one tends to need to modify individual and organisational behaviour. The level of "*sleaze*" will thus play a role.

The firm should also ensure that its agents will be punished for non-compliance and rewarded for compliance rather than the other way round. In countries with low levels of sleaze, the typical societal norm is that people get punished for non-compliance. In countries with an opportunistic or defiance culture and high levels of sleaze, the societal norm can be that people get punished by their peers for compliance. For example, it is part of Britishness and the German way of life that wrong-doers will get punished (one only has to think about queuing as the social norm in both countries). In some other countries, however, the social norm can be to punish social do-gooders.

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[9] Hofstede G, Bond MH, The Confucius connection: from cultural roots to economic growth. Organizational Dynamics 16(4) (1988) pp 4–21. A sixth dimension (indulgence v restraint) was added by Michael Minkov.

[10] Hofstede G, McCrae RR, Culture and personality revisited: Linking traits and dimensions of culture. Cross-cultural Research, 38(1) (2002) pp 52–88.

[11] Hood C, Rothstein H, Baldwin R, The Government of Risk. OUP, Oxford (2001) p 27.

[12] *Ibid*.

Typically, the firm cannot change societal culture, but it can choose the countries in which it does business (section 9.2.4).

Societal culture can also be expected to influence corporate culture. In a multinational firm, the relative weight of the societal culture of a certain country can depend on the location of the parent company, the level of centralisation within the firm, the size and location of operations; the cultural background of people at different levels of corporate hierarchy; and other factors.

Corporate culture. Like societal cultures, organisational cultures can be described by a number of dimensions.[13] Organisational cultures differ mainly at the level of practices. Practices can be changed.

Generally, the agency tools used by the firm contribute to its corporate culture and the firm's corporate culture can influence the choice of the agency tools. As corporate culture is partly self-enforcing, it is the most important way to modify behaviour within the firm.

The firm will usually try to ensure that its values and practices are shared by its management, divisions, and subsidiaries. As the firm grows and develops into a multinational corporation with several different national cultures, this will become more difficult.[14] A common corporate culture across borders is what holds a multinational corporation together.

High-level objectives of the firm. The high-level objectives of the firm influence its corporate culture. Changing the high-level objectives can change the firm's culture (see section 8.1).

The firm's high-level objectives can usually be found in its statutes, code of ethics, or other internal guidelines (as rules or standards, see below).

Depending on the firm and the legal nature of the objectives, the objectives can be applied to different categories of people ranging from a very narrow part of the firm's organisation (such as its board) to its organisation in the broadest sense (including even its network partners and their employees).

Statutes, articles of association. The statutes of the company tend to reflect legal requirements. A limited-liability company usually has a purpose based on law (for example, to make a profit) or the company's statutes (for example, to function as a non-profit organisation), and the statutes of the company contain an objects clause (for example, manufacturing).[15]

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[13] They are: process-oriented v results-oriented; job-oriented v employee-oriented; professional v parochial; open systems v closed systems; tight v loose control; and pragmatic v normative. Hofstede G, Neuijen B, Ohayv DD, Sanders G, Measuring organizational cultures: A qualitative and quantitative study across twenty cases. Administrative Science Quarterly 35 (1990) pp 286–316.

[14] See Björkman A, Towards Explaining the Use of Control Mechanisms in Foreign Subsidiaries of MNCs. Swedish School of Economics and Business Administration, Helsinki (2007) pp 3–4.

[15] See Article 2 of Directive 77/91/EEC (Second Company Law Directive): "The statutes or the instrument of incorporation of the company shall always give at least the following information: ... (b) the objects of the company ..." For the effect of the objects clause on contracts see Article 9(1) of Directive 68/151/EEC (First Company Law Directive).

The statutes usually bind only persons who are members of the company's statutory bodies and whose activities thus have been regulated by company law (for example, members of a statutory board and statutory auditors).

The statutes are complemented by internal codes and guidelines that can reflect broader objectives within the limits of the law and the company's statutes. The scope of the internal codes and guidelines of the company can be much broader than the scope of its statutes.

Internal guidelines. Whereas a small domestic firm can benefit from the more homogeneous culture in its home state, it is particularly important for large international firms to adopt internal guidelines that set out the basic internal practices and the most important ethical values and rules of the firm.

The contents of these internal guidelines are likely to be influenced by the culture, practices and values of the firm's home country.

Internal guidelines differ in terms of whether they are complemented by formal incentives. It is usual to encourage compliance with internal guidelines by making them binding as a contract and by punishing non-compliance as a breach of contract. It is also possible to encourage whistle-blowing.

For example, General Electric (GE) and Nokia a large international corporations. Both have adopted general ethical guidelines. But whereas the guidelines used by Nokia, a Finnish company, were about six page long in 2009,[16] those of GE, a US company, were 62 pages long.[17]

GE has adopted ethical guidelines in a document called The Spirit & The Letter. At the heart of The Spirit & The Letter is GE's Code of Conduct. Compared with Nokia's guidelines, the ethical guidelines of GE are more prescriptive and give the impression that they are legally binding and complemented by effective sanctions. GE's employees – and even the employees of GE's affiliates – are required to sign the The Spirit & The Letter.

GE's Code of Conduct starts with a requirement that all employees obey the applicable laws and regulations governing GE business worldwide. Additionally, the Code of Conduct requires GE employees to: be honest, fair and trustworthy in all of their GE activities and relationships; avoid conflicts of interest between work and personal affairs; foster an atmosphere in which fair employment practices extend to every member of the diverse GE community; strive to create a safe workplace; protect the environment; and sustain a culture where ethical conduct is recognized, valued and exemplified by all employees.

Sometimes formal incentives are not necessary because of cultural reasons. In some countries, managers and employees generally try to do what their superiors ask them to do, and in some companies, managers and employees generally try to comply with internal guidelines.

The fact that formal incentives are not necessary can also be caused by other reasons, in particular the contents of the guidelines. If the guidelines are simple and clear enough, there is no need to ask what to do. Technical solutions can have the same effect. Technical solutions can make the cultural background of employees less important, and they can make it less necessary to educate employees in company culture.

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[16] Code of Conduct.

[17] The Spirit and the Letter. See also the 2007–2008 Citizenship Report.

For example, if the employees of a hotel chain are told to act in an environmentally-friendly way, they are likely to act in different ways in different countries. But if they are told what steps to take when cleaning a room and given the necessary tools to do so, they are more likely to clean the room in the same environmentally-friendly way.

One of the most important parts of the production system of Toyota is that car parts are designed in such a way that employees can put them together only in the right way. This is more effective than asking employees to put quality first or avoid waste.

6.3 Choice of the Scope of Agency

Choosing the *scope* of agency means that it can be decided: whether a party will act as another party's agent; the context to which acting as an agent is limited; and the means to which acting as an agent is limited.

The existence of an agency relationship requires the existence of a *position* in which a party (B) can further the interests of another party (A). There is no principal-agency relationship between party A and party B when A as principal does everything himself without relying on B to further his interests, or when A relies on the actions of C, a third party, rather than those of B.

Typically, the existence of an agency relationship is limited to certain *interests*. The principal (A) may assume that B will further A's interests in some matters without simultaneously assuming that B would further A's interests in other matters. Acting as an agent can also be limited to the use of certain *mechanisms* or to abstaining from doing certain things.

From a *legal* perspective, the regulation of the scope of agency between A (the principal) and B (the agent) requires the existence of a *legal relationship* between those two parties. The scope of agency depends on the scope of B's *rights* or de facto rights (legal position). Obviously, there is not much to regulate, if there is no legal relationship in the first place, or if B is already prohibited from doing anything that could further A's interests. Furthermore, the scope of agency depends on the interests or mechanisms to which acting as an agent is limited.

Choosing the scope of agency by means of legal rights can be distinguished from managing agency costs in an agency relationship by means of legal duties which tell the agent how to exercise those rights.

The scope of agency can therefore be defined by using particular legal norms (mandatory provisions of law, dispositive provisions of law, or contracts). For example, the legal norms can facilitate a legal *relationship* between A and B but not between A and a certain third party. The legal norms can also provide for the existence of *rights* which the agent can use in one way or another but, from the perspective of A, should preferably use to further the interests of A. The legal norms can also require B to further the *interests* of A when using the rights.

An example of limiting agency to the use of certain mechanisms is that shareholders have only limited rights in a limited-liability company; if shareholders are

expected to act as the firm's agents, they are assumed to use the mechanisms made available to them.

Example: foreign subsidiaries and divisions. The relevance of the scope of agency can be illustrated by the use of control mechanisms in foreign subsidiaries and divisions.

Basically, there are five usual control mechanisms that the head office can use to steer a foreign subsidiary or a division: centralisation, output control, formalisation, socialisation, and expatriate control.[18] The degree of the use of any control mechanism can influence the use of other mechanisms as complements or substitutes.[19]

From a legal perspective, one of the most important choices of the head office affecting the level of centralisation/autonomy is that of the incorporation of subsidiaries. As each subsidiary is regarded as a separate legal entity, the incorporation of a subsidiary is designed to reduce centralisation, increase the autonomy of the entity, and increase the *scope of agency*.

The overall degree of centralisation of decision-making and the scope of agency affect the use of output control. Output control means, for example, reporting duties (profits, productivity, sales etc).[20]

Obviously, if a subsidiary has plenty of autonomy in its decision-making, more output control will be necessary. If the head office takes decisions on the subsidiary's or the division's behalf, it also has more information about the performance of the subsidiary or the division and has less need for the use of output control.[21]

6.4 Alignment of Interests

Again at a very general level, agency problems can be mitigated by aligning the interests of the agent with those of the principal. Alignment of interests means that it is in the self-interest of the agent to further the interests of the principal. This can be achieved in many ways.

Behaviour modification. Any particular legal tools that modify the behaviour of the agent and make the agent act in the interests of the principal will naturally help to align interests.

Stewardship. Sometimes interests can be aligned without using hard legal tools. Interests can be aligned for social reasons. In stewardship theory, the "steward" perceives greater utility in cooperative behaviour and behaves accordingly" (see section 9.2). There are a number of "soft" factors influencing the behaviour of

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[18] Björkman A, Towards Explaining the Use of Control Mechanisms in Foreign Subsidiaries of MNCs. Swedish School of Economics and Business Administration, Helsinki (2007) pp 30–31.

[19] *Ibid*, pp 51–52.

[20] *Ibid*, p 116.

[21] *Ibid*, p 50.

stewards.[22] Such social pressures can be complemented by other tools and practices.

Role of culture. Societal and regulatory culture will play a role. (a) In a deterrence-oriented regulatory culture, the principal is more likely to: increase proximity to the agent; increase monitoring; and apply sanctions for non-compliance. (b) In a compliance-oriented culture, reputational constraints and positive rewards play a bigger role.

Michael Corleone represented a deterrence-oriented culture in Godfather II when he said:[23] "Keep your friends close, but your enemies closer."

Other than financial incentives, reputation. There is a wide range of non-financial incentives that can be used to align interests. Non-financial incentives can be material or immaterial.

For example, reputational constraints are important between people who often deal with each other. Reputational constraints can be even more important where failure to observe a certain standard in one relationship is likely to reduce the agent's future business prospects in many relationships (for the management of reputation, see section 10.5.5).

Financial incentives. Financial incentives belong to usual ways to align interests. Financial incentive schemes can be particularly useful when the agent has a significant informational advantage and monitoring is impossible. Financial incentives can be positive (rewards) or negative (sanctions, see Volume II). Furthermore, they can reward or punish behaviour (rather than the result of the behaviour) or be linked to a result (rather than behaviour as such).

Property rights. Property rights are one of the ways to align interests by financial incentives. According to the property rights theory, property rights provide the basic economic incentive system that shapes resource allocation.[24] (a) The sole trader is an example of an extreme business form that aligns the interests of owners and managers. (b) In contrast, common ownership of resources is an example of a model that gives no one a strong incentive to preserve the resource and is likely to lead to overuse (such as the over-drilling of oil fields with two or more producers, overfishing, and the free-rider problem in limited-liability companies with dispersed ownership). (c) The risk of overuse can be reduced by the unitisation of property rights.

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[22] For factors that differentiate between agency and stewardship theories, see Davis JH, Schoorman FD, Donaldson L, Toward a Stewardship Theory of Management, The Academy of Management Review, Vol 22, No 1 (January 1997) pp 20–47.

[23] A film adaptation of Mario Puzo's crime novel, The Godfather, was directed by Francis Ford Coppola.

[24] For classical property rights theory, see Alchian AA, Some Economics of Property Rights, Il Politico 30 (1965) pp 816–829; Alchian AA, Demsetz H, The Property Rights Paradigm, J Econ Hist 33 (1973) pp 16–27; Coase R, The Problem of Social Cost, J Law Econ 3 (1960) pp 1–44.

For example, ownership of fish (quotas) can be assigned to people with an interest in both exploiting and preserving them for a very long time.[25] In a limited-liability company, the firm's resources are owned by the legal person within which the firm operates; there is thus no common ownership of the resources of the firm (for the role of shareholders, see section 8.7).

Reducing conflicts of interest. Better alignment of interests means that conflicts of interests are reduced. Many legal rules are designed to reduce conflicts of interests. In Community law, market gatekeepers are a category of market participants whose activities are typically governed by rules reducing conflicts of interest.

As regards investment firms, the MiFID requires a conflicts of interest policy.[26] Investment firms must "establish, implement and maintain an effective conflicts of interest *policy* set out *in writing* and appropriate to the size and organisation of the firm and the nature, scale and complexity of its business".[27]

The conflicts of interest policy "must include the following content: (a) it must *identify*, with reference to the specific investment services and activities and ancillary services carried out by or on behalf of the investment firm, the circumstances which constitute or may give rise to a conflict of interest entailing a material risk of damage to the interests of one or more clients; (b) it must *specify* procedures to be followed and measures to be adopted in order to manage such conflicts".[28]

The procedures to be followed and measures to be adopted must include "such of the following as are necessary and appropriate for the firm to ensure the requisite degree of independence: (a) effective procedures to prevent or control the *exchange of information* between relevant persons engaged in activities involving a risk of a conflict of interest where the exchange of that information may harm the interests of one or more clients; (b) the *separate supervision* of relevant persons whose principal functions involve carrying out activities on behalf of, or providing services to, clients whose interests may conflict, or who otherwise represent different interests that may conflict, including those of the firm; (c) the removal of any direct link between the *remuneration* of relevant persons principally engaged in one activity and the remuneration of, or revenues generated by, different relevant persons principally engaged in another activity, where a conflict of interest may arise in relation to those activities; (d) measures to prevent or limit any person from exercising *inappropriate influence* over the way in which a relevant person carries out investment or ancillary services or activities; (e) measures to prevent or control the simultaneous or sequential *involvement* of a relevant person in separate investment or ancillary services or activities where such involvement may impair the proper management of conflicts of interest".[29]

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[25] Costello C, Gaines SD, Lynham J, Can Catch Shares Prevent Fisheries Collapse? Science, Vol 321, no 5896 (2008) pp 1678–1681; An Icelandic success, The Economist, December 2008.

[26] Articles 13(3) and 18(1) of Directive 2004/39/EC (MiFID).

[27] Article 22(1) of Directive 2006/73/EC.

[28] Article 22(2) of Directive 2006/73/EC.

[29] Article 22(3) of Directive 2006/73/EC.

6.5 Monitoring (Transparency)

The monitoring of the agent and the transparency of the agent's actions are an important component of the management of agency. Monitoring will be discussed in the context of corporate risk management and transparency in the context of the management of information.

6.6 Choice of Agents

Choosing the agent is an important way to manage agency relationships. The choice of the agent can follow directly or indirectly and include two pairs of decisions: selection and removal; and setting the terms of entry and exit. The choice of agents requires information management (for screening, signalling, and self-selection, see section 10.1.3; for investment in information, see section 10.3; for contracts, see Volume II).

Selection and removal. The right to select or remove agents is a powerful way to mitigate agency problems. The firm may have a right to choose its agents directly.

Because of freedom of contract, the main rule is that the firm may freely choose its contract parties. On the other hand, it does not have any automatic right to choose the people responsible for fulfilling its contract party's obligations to the firm. Contract terms that provide for limited selection and removal rights are more likely to be used in investment projects the completion of which is to a very high degree dependent on the personal involvement of certain people employed by the firm's contract party or the participation of certain subcontractors.[30]

When the firm has invested in another company, its legal powers to select the people entrusted with the management of the target company can depend on the contractual framework of its investment and the law governing the company. Usually, the firm will not have a right to choose the managers and board members of another company. Such a right can exist by virtue of a large block of shares giving voting rights. It can, to some extent, be based on a contract between the firm and the target company.

For example, venture capital firms typically require a right to select and remove board members and senior executives. If they appoint their "agents" ex ante, they can screen for loyalty. If they can remove their agents ex post, they can punish disloyalty.[31]

Setting the terms of entry and exit. The firm can mitigate counterparty risk in advance by determining the terms of entry and exit.

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[30] See Kraakman R, Davies PL, Hansmann H, Hertig G, Hopt KJ, Kanda H, Rock EB (eds), The Anatomy of Corporate Law. OUP, Oxford (2004) p 26.

[31] See *ibid*, pp 27–28.

The purpose of the entry strategy is to screen out unwanted contract parties directly and in advance. By choosing its contract parties directly, the firm indirectly chooses the people that belong to the contract party's organisation.

In financial markets, the firm should use processes that establish, in advance, the overall parameters of counterparty relationships: the approval of counterparties and the core terms of the contractual framework. The firm may require some form of disclosure to obtain an adequate supply of information regarding the counterparty. In addition, the firm can use standard legal agreements to document transactions; this will help the firm to avoid counterparties who do not belong to its preferred target group and for which the standard legal documentation has not been designed. In other words, the counterparty (customer) is not supposed to "be the king".

The exit strategy allows the firm to escape opportunistic agents ex post. Broadly speaking, there are two kinds of exit rights (for a fuller account, see Volume III). The first is the right to withdraw the value of one's investment. The second type of exit right is the right of transfer (Volume II). For example, the terms of the contract can provide that a shareholder has the right to sell the shares that it has bought (right of transfer), or award to a creditor the right to call on a loan (withdrawal right).[32]

Increasing the number of agents. Using two or more independent agents is a further way to mitigate agency problems. First, it can give the firm more information about what can be expected from an agent (provided that there is no collusion). Second, the right to select and remove additional agents can be a way to spread risks more widely (diversification).

For example, this can be important in supply chain management when the firm uses a lean and highly outsourced supply chain (like Toyota, one of the largest car manufacturers in the world) rather than vertically integrated production methods (like Zara, one of the largest fashion companies in the world). In order to prevent disruptions and to increase efficiency, the firm may choose to increase flexibility in the supply chain by maintaining a number of different sources for its raw-materials and components.

6.7 Rules and Standards

One of the basic strategies to address agency problems is to tell the agent what to do. This can be done in advance by using either rules or standards. In this context, rules are sufficiently detailed and exact to prescribe the behaviour of the agent ex ante. In contrast, standards are open. They specify the general norm against which an agent's actions will be judged ex post. Their contents can thus only be determined ex post.[33]

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[32] *Ibid*, pp 24–25.

[33] See *ibid*, pp 23–24; Kaplow L, Rules Versus Standards: An Economic Analysis, Duke L R 42 (1992) pp 557–624.

For example, when the agent is a contract party, the firm can use: either very detailed contract terms ("rules"); or open clauses such as the duty to act in "good faith" ("standards").

If there is a similar amount of rules and standards of equal quality and applicable to comparable things, standards tend to be more costly to interpret when deciding how to act and for an adjudicator to apply to past conduct. On the other hand, a standard tends to have a broader scope compared with a rule. Usually, a standard cannot be replaced by rules unless there are many rules. It can be more costly to create many rules instead of one standard if one wants to cover the same scope. Furthermore, the existence of very many rules applicable to the same things can increase interpretation costs – the notoriously complicated German labour laws and tax laws provide a good example. If the the legal framework is complicated, its contents are not communicated effectively to those who should comply with it. Therefore, the greater the frequency with which a detailed legal command will apply, the more desirable rules tend to be relative to standards.[34] However, the larger the amount of detailed legal commands, the more desirable it becomes to communicate their common aspects by standards. Standards are necessary also for the purposes of gap-filling because it can cost too much to cover the same scope by many rules.

Usually, the firm uses a combination of both. (a) The firm should make sure that the agent (contract party) knows what is expected from it. The firm should use clear (contract) terms that lay down with sufficient precision the core duties of its agent ("rules"). For this reason, the strategy chosen by the firm is basically a rule-based strategy. (b) However, it is in many cases neither possible nor cost-effective for the firm to regulate everything in advance. To do so would make the legal framework (for example, a contract) too complicated and rigid. It is usual to complement the rule-based strategy and core (contract) terms by relatively open terms and a standard-based strategy. These open terms can, for example, include catch-all terms such as the duty to act in "good faith".

The firm should tell the agent what to do, but the firm should also ensure that its rules and standards are perceived as binding. This can be done in many ways. (a) The firm can ensure that the rules and standards are legally enforceable. For example, this can be achieved by contracts signed by the addressees of the rules and standards. (b) There can be even other ways to signal that the rules and standards are binding, although they would not be legally enforceable as such.

6.8 Initiation and Ratification

Corporate decision-making typically includes the following steps: initiation; ratification; implementation; and monitoring.[35] Initiation of a decision means the right

[34] Compare Kaplow L, *op cit,* p 577.

[35] Fama EF, Jensen MC, Separation of Ownership and Control, J Law Econ 26 (1983) pp 303–304.

to determine the contents of a proposal submitted for acceptance. Ratification means the right to accept the proposal or reject it.

Initiation and ratification rights play a big role in the governance of companies. Block-holding is a typical way to obtain either initiation or ratification rights or both (see Chapter 9).

Alternatively, these strategies can be based on contract. For example, the use of these strategies can expand the firm's rights to intervene in its contract party's management. Investment contracts often contain covenants or terms according to which large and fundamental corporate decisions (such as mergers and charter amendments) require the prior written consent of the investors (see Volume III).[36]

6.9 Trusteeship and Reward

The purpose of the trusteeship and reward strategies is to alter the incentives of agents rather than expanding the powers of principals. The firm can therefore use them as incentive strategies.

Reward. The reward strategy can reward the agent for successfully advancing the interests of the firm. There are two principal reward mechanisms. The first reward mechanism is a sharing rule that motivates loyalty by tying the agent's monetary returns directly to those of the firm. The second reward mechanism is the pay-for-performance regime, in which the agent, although not sharing in the firm's returns, is nonetheless paid for successfully advancing the firm's interests.

The reward mechanism will not help to align the interests of the firm and the agent if the mechanism has been designed to make the agent further the interests of somebody else, a wrong principal. This can be illustrated with executive share option rights.

In corporate practice, managers often propose the alignment of their own interests with those of shareholders through the issuance of share option rights. If the proposal is accepted, their interests can be aligned with those of short-term shareholders or those of long-term shareholders, or the programme can just be designed to provide a windfall profit. However, from the perspective of the firm, only the firm is the right principal. A reward strategy designed to align management interests with those of the firm would not work in the same way. One of the ways to make share option programmes behave less badly from the perspective of the firm is to use long-term lock-ins to reduce the temptation to do reckless deals that can harm the firm in the long run.

Trusteeship. The trusteeship strategy seeks to eliminate conflicts of interest ex ante and to ensure that "bad" behaviour by the counterparty will not be rewarded. This strategy assumes that, in the absence of strongly focused – or "high-powered" – monetary incentives to behave opportunistically, agents will respond

[36] See Kraakman R, Davies PL, Hansmann H, Hertig G, Hopt KJ, Kanda H, Rock EB (eds), The Anatomy of Corporate Law. OUP, Oxford (2004) p 26.

to the "low-powered" incentives of conscience, pride, and reputation, and are thus more likely to manage in the interests of their principal.

For example, an investment contract may provide that certain things may not be done by the counterparty without a favourable opinion given by an independent party (a bank, an auditor).[37] The terms of the contract may also lay down procedures for disclosure and management of information and for internal controls.

6.10 The Role of Legal Background Rules

Legal background rules support the generic ways to manage agency relationships. Different legal background rules can reflect different strategies. When choosing the legal framework for the agency relationship, the firm can adapt the relationship so that it falls within the scope of the intended legal background rules and the intended strategies, and complement the legal background rules. Both can usually be done through the choice of business form (for incorporation as a way to manage agency, see also section 9.4.5) and through contracts (for contracts as a way to manage agency, see generally Volume II).

For example, the choice of business form will provide a set of legal background rules designed to manage agency. The legal background rules are very different for partnerships, limited-liability companies that resemble partnerships, and public limited-liability companies (see Volume III).

After choosing its business form, the firm may choose whether to organise something internally or purchase it from the market. When organising something internally, the firm will employ people. Under legal background rules applicable to employment contracts, the employee has a duty to work according to the directions of the employer. The employer may therefore use both the initiation strategy and the ratification strategy to reduce agency costs. However, because of mandatory provisions of labour law, it may be difficult to fire employees and use the removal strategy, and the use of monetary incentives as part of an alignment of interests strategy and a reward strategy may be constrained by mandatory provisions of law and collective agreements.

When purchasing resources from the market, the firm will negotiate the terms of the contract. In most cases, a supplier does not undertake to carry out work according to the directions of its contract party. Instead, the parties agree on a result (Werkvertrag) or the terms of work to be done (Dienstvertrag, see Volume II for the core commercial terms of a contract). This means that the firm will use a rule-based and a standard-based strategy in the contract and reduce agency costs further by easy exit from the contractual relationship and free choice of other contract

[37] See Kraakman R, Davies PL, Hansmann H, Hertig G, Hopt KJ, Kanda H, Rock EB (eds), *op cit*, pp 26–27. For the terms "high-powered incentives" and "low-powered incentives", see Williamson OE, The economic institutions of capitalism. The Free Press, New York (1985). Williamson's idea was developed by Holmström and Milgrom. See Holmström B, Milgrom P, The Firm as an Incentive System, Am Econ R 84 (1994) p 972.

parties. In principle, the principle of freedom of contract means that the parties have plenty of discretion to agree on monetary incentives as part of an alignment of interests strategy and a reward strategy.

7 Corporate Risk Management

7.1 Introduction

7.1.1 General Remarks

Risk is one of the main concepts in corporate finance and helping the firm to manage risk belongs to the core functions of corporate finance law.

Managing risk belongs to the most fundamental aspects of management. The firm will typically try to eliminate risks or mitigate their effects. On the other hand, the firm also wants to be exposed to some risks in order to make a profit. Business is about calculated risk-taking.

Risk management has become more important in recent years partly because of a change in business environment, partly because of increased legal requirements. After Enron, there has been alignment between debates about corporate governance and those focusing on risk management.[1]

The purpose of this chapter is to explain the various levels of corporate risk management (CRM), the role of corporate risk management from the perspective of the firm, the regulation of corporate risk management in Community law, and the typical contents of risk management policies. The question of corporate risk management will be discussed further in the context of corporate governance (Chapters 7 and 8).

7.1.2 Financial Theory, Strategy, and the Firm

In the past, there have been divergent ideas of risk management in strategy literature and in financial theory.

Financial theory. In financial theory, the CAPM differentiates between two components of risk, market risk (systemic risk) and business risk (unsystemic risk). Whereas market risk represents the ultimate risk a shareholder has to bear for investing in the equity market, the CAPM suggests that business risk can be elimininated in perfect capital markets by holding a properly diversified portfolio of securities. In perfect capital markets, investors should therefore only worry about the market risk of securities (after diversifying their securities portfolio). This risk is measured by its beta. Financial theory has also suggested that manag-

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[1] See Gilligan G, Managing Risk in Financial Services Contexts, Comp Lawyer 26(11) (2005) p 341.

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ers should not care about business risk, if capital markets are perfect, because company specific risks can be managed more efficiently by the owners.[2]

On the other hand, the management of business risk lies at the heart of strategic management. There is thus a conflict between the CAPM and strategic management.[3]

Financial economists have found ways to explain why this practice is not wrong. First, capital markets are not perfect. It is not always in the interests of the owners – or possible for them - to hold a properly diversified portfolio of securities. Second, the management of business risk is in the interests of stakeholders. Stakeholders demand compensation from riskier firms to maintain relations with them. Higher corporate risk means higher payments to stakeholders because of the increased probability of financial distress. Higher payments, in turn, can lead to a reduction in the value of the firm's assets. For this reason, the management of business risk is said to be in the interests of shareholders as well.[4]

The firm. In any case, one of the factors that has made the practice of corporate risk management more difficult for financial economists to explain is their choice of principal. Economists study corporate risk management from the perspective of shareholders or investors. In a legal study, it is easier to explain the practice of corporate risk management if the firm is chosen as the most important principal (see Chapter 8). This will also make it easier to align the legal study of corporate risk management with strategic management.

7.1.3 Corporate Risk Management as a Business Discipline

Corporate risk management is a relatively new discipline. It has its roots in corporate insurance buying.

Roots. One of the earliest references to the concept of risk management in literature appeared in the Harvard Business Review in 1956.[5] Corporate risk was then understood as the occurrence of accidental losses or the financial impact of

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[2] See, for example, Tirole J, The Theory of Corporate Finance. Princeton U P, Princeton and Oxford (2006) p 214.

[3] This was first pointed out by Bettis RA, Modern Financial Theory, Corporate Strategy and Public Policy: Three Conundrums, The Academy of Management Review 8 (1983) pp 406–415 at p 408: "Unsystematic risks obviously are associated with firm specific resources and competencies and with the relationship of the environment to the firm. In fact, strategic adaptation by skillful, rigorous, and continuous management of unsystematic risk lies at the very heart of strategic management."

[4] Shapiro AC, Titman S, An Integrated Approach to Corporate Risk Management. In: Stern JM, Chew DH Jr (eds), The Revolution in Corporate Finance. Blackwell, Oxford (1986) pp 215–229 at p 221.

[5] See Gallagher RB, Risk Management: New Phase of Cost Control, Harv Bus R, September-October 1956 pp 75–86.

the losses that did occur, and insurance was the standard approach to deal with this type of corporate risk.[6]

High-level goals of corporate risk management. Risk management is essentially the art of balancing two opposing forces: risk and opportunity. The firm typically wants exposure to some risk factors, because these risk factors offer a potential for profit.

At a general level, one can distinguish between two main forms of corporate risk management. (1) Strategic risk management is the highest level of corporate risk management. Strategic risk management deals with the overall risk level of the firm and the high-level allocation of risk. Strategic risk management raises fundamental questions of strategy and corporate governance (Chapters 8 and 9). (2) Operational risk management focuses on the tactical dimension of risk management, individual risks, or risks inherent in individual transactions. Modern corporate risk management tries to close the gap between corporate strategy and operational risk management.

One can also distinguish between two main forms of risk in this context. (1) Strategic risks are risks that need to be taken into account in decisions about the medium- and long-term goals of the firm. (2) Operational risks are risks that managers will encounter in the daily course of their work. Operational risks can relate to the processes of the firm or particular categories of transactions. They can also relate to individual transactions. Much of this book will deal with the management of risk in the context of individual transactions.

Tactical goals of corporate risk management. The goals of corporate risk management have changed in the course of the evolution of this discipline. Modern corporate risk management is a broad concept, and it can be understood in many ways.

At the most basic level, the purpose of the firm's risk management practices could be, in addition to compliance with legal minimum requirements, "to protect the firm's human and physical resources, including its revenues, against potential loss and minimize the adverse effects should a loss occur".

That would nevertheless just be a basic level. The usual goals of corporate risk management can range from modest to more ambitious and reflect the stage of evolution of the firm's risk management strategy. They can include, for example, the following (here from modest to more ambitious):

- compliance with legal minimum requirements;
- protection against accidental losses;
- the quality of the firm's performance;
- the availability and cost of debt capital;
- the maximization of the firm's cash flow;
- the value of the firm; and

[6] For the traditional view, see Vaughan EJ, Vaughan TM, Essentials of Risk Management and Insurance. Second Edition. John Wiley & Sons, New York Chichester Weinheim Brisbane Toronto Singapore (2001) p 17.

- the goals of the firm's shareholders and stakeholders.

The practice of corporate risk management reflects its goals (here from traditional to modern):

- compliance with legal minimum requirements;
- management of the firm's insurance coverage;
- evaluation of the risk level of different activities;
- achievement of the firm's business goals by using a trade-off between risk and return;
- management of the risk level of the firm as a whole;
- growth-oriented use of risk management;
- strategic risk management; and
- ethically oriented risk management.[7]

7.1.4 Costs, Risk Level, Compliance, Agency, Information

In practice, corporate risk management focuses on certain key things at the tactical level: costs, compliance, the management of agency relationships, and information.

Costs. The first is reducing the firm's costs. At least some stakeholders take decisions on the basis of return and risk. A stakeholder may require a risk premium. For example, banks demand a higher interest rate, if the risk level of the loan is high, shareholders demand a higher return, if the risk level of the company's shares is high, and new qualified employees demand higher wages, if the firm has a bad reputation.

The overall risk level of the firm[8] and the particular risk exposure of each stakeholder thus affect the price that the firm must pay for resources such as labour, goods, services, funding, and management resources. The firm can use corporate risk management: to increase share price and reduce the cost of equity capital; to increase the creditworthiness of the firm and reduce the cost of debt capital; to increase the quality of the firm as an employer and reduce labour costs; as well as to increase the quality of the firm as a long-term customer and reduce the price that the firm pays to its suppliers.[9]

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[7] See Denk R, Exner-Merkelt K (eds), Corporate Risk Management. Unternehmensweites Risikomanagement als Führungsaufgabe. Linde, Wien (2005) p 55.

[8] Shapiro AC, Titman S, An Integrated Approach to Corporate Risk Management. In: Stern JM, Chew DH Jr (eds), The Revolution in Corporate Finance. Blackwell, Oxford (1986) pp 215–229 at p 221: "The true cost of higher corporate risk is the reduction in the value of the firm's tangible and intangible assets caused by the presence (or probability) of financial distress." For example, the value of "tracking shares" is influenced even by the financial performance of the whole firm. See Volume III.

[9] See Easterbrook FH, Fischel DR, The Economic Structure of Corporate Law (1991) pp 6–7.

Generally, stakeholders' perceived risk can also be influenced by managing the firm's reputation.The firm can signal its financial stability and low counterparty risk to stakeholders by: retaining profits and holding cash; choosing a capital structure with a low leverage ratio; increasing its dividends in a stable way over a long period of time; and in other ways.[10]

Corporate risk management can also help to reduce the cost of risks that have materialised (their impact), reduce the likelihood of the occurrence of a negative event that triggers those costs, and influence the cost of mitigating risks in advance.

Risk level. The second key objective is determining the firm's own risk preferences and managing the firm's risk exposures at different levels ranging from the enterprise-wide to transaction levels.

Compliance. The third key objective is compliance. Some stakeholders do not take decisions on the basis of return and risk. For example, the government and public authorities can demand the avoidance or mitigation of certain risks and that certain risks do not exceed a certain previously determined level. There are mandatory laws that support public policy objectives such as the protection of human health, the environment, and economic welfare. Failure to comply with mandatory provisions of law tends to increase costs in the long run.

For example, BP tried to increase its profits by cutting fixed costs. Those budget cuts were intended to increase the share price. BP's executives achieved this goal by reducing maintenance costs, among other things. In 2005, a blast at BP's Texas City refinery killed 15 people and injured 170. The US Chemical Safety Board (CSB), an independent federal agency charged with investigating industrial chemical accidents, found a catalogue of internal BP reports highlighting maintenance backlogs and poor infrastructure at the site. BP put $1.6 billion aside to resolve legal disputes. In January 2007, a separate independent report into the blast found that while BP emphasised personal safety, it was weak on process safety. In other words, BP tried to increase share price by allocating more risk to other stakeholders such as employees and the environment, and assuming that the increased business risk caused by lower maintenance costs could be diversified away by shareholders themselves. This turned out to be unwise, because BP's because non-compliance and accidents lead to higher costs. BP's share price decreased in 2006 because of higher safety costs.

Management of agency. The fourth key objective relates to the management of principal-agency relationships. There are four key principal-agency relationships that will be addressed in corporate risk management.

The firm should manage traditional agency relationships inside the firm. The goals of the firm's corporate risk management will not be achieved unless the people that form the organisation of the firm contribute to the achievement of those goals. For example, senior managers should create incentives and controls to induce employees to act according to the firm's preferences.

Another traditional agency relationship is that between the firm and its contract parties. The firm should manage traditional counterparty risks.

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[10] See, for example, Wentges P, Corporate Governance und Stakeholder-Ansatz: Implikationen für die betriebliche Finanzwirtschaft. DUV, Wiesbaden (2002).

The firm should also manage reversed agency problems, i.e. agency problems that the firm causes to others. From the perspective of shareholders, banks, the government, and other stakeholders, the firm's managers and organisation can be regarded as agents. A minimum requirement in this respect is legal compliance with mandatory laws supporting the government's fundamental policy objectives. Compliance is necessary because other parties require the firm to observe particular minimum standards of behaviour. As compliance should normally reduce the firm's costs in the long run, the firm does this basically in order to further its own interests.

The firm should also manage risks caused by the fact that stakeholders and third parties indeed may regard the firm's managers as their own agents and manage that agency relationship. (a) Stakeholders can try to align the interests of the firm's managers with their own interests. If stakeholders are succesful, managers may start furthering those and their own interests rather than the interests of the firm. (b) On the other hand, the firm does have its own interests to protect as principal. The firm should therefore try to align the interests of its managers with the interests of the firm rather than with the competing interests of its stakeholders. (c) The management of conflicting agency relationships can be difficult. The remuneration of board members and executives with stock options provides a good example. Short-term shareholders can prefer to reward board members and executives for furthering the interests of short-term shareholders rather than the long-term interests of the firm. In addition, short-term shareholders can exert pressure on board members and executives to make them sell assets, buy back shares, and pay dividends, or to sell the firm to the highest bidder, rather than invest in production equipment or acquisitions.

Information. To manage risk, the firm's managers must ensure that they have the necessary information. Information gathering and analysis requires an appropriate organisation and appropriate policies as well as robust methods for identifying and measuring risks. Furthermore, part of corporate risk management consists of the management of reputational risk (section 10.5.5).

7.2 Strategic Risk Management

Strategic risk management focuses on: the overall risk level of the firm; the allocation of risk between the firm and its stakeholders; and the allocation of risk between stakeholders inter se. Strategic risk management is about the high-level objectives of risk management. It raises fundamental questions of corporate governance.

Responsibility for strategic risk management. In a limited-liability company, such questions will not be decided on by shareholders. Because of the potential conflict of interest between the firm and its stakeholders and the stakeholders inter se, the main rule is that questions of strategic risk management belong to the responsibilities of the board. There are some exceptions (see sections 9.4 and 9.5 for matters that must be decided on by shareholders).

One main objective, five main forms of strategic risk management. The main objective of strategic risk management is the long-term survival of the firm in a competitive environment (see Chapters 8 and 9). There are five main forms of strategic risk management.

First, the various *resource allocation (investment)* decisions made by the firm clearly influence its risk profile. At the most general level, the risk profile of the firm depends on the choice of *business areas* and the *number* of business areas (conglomerate structure).

For example, a conglomerate structure enables better diversification of risks. Private equity and venture capital firms are a modern example of the use of the conglomerate structure for risk management purposes. One can also mention "bancassurance" which enables better diversification of risks compared with banking or insurance.

How resource allocation decisions influence the risk profile of the firm can be illustrated by the role of calculated risk-taking in "entrepreneurial marketing". According to Morris, Schindehutte and LaForge, the entrepreneurial marketer can be seen as "a risk manager" who is "enhancing the firm's level of control over its destiny". They write: "Towards this end, the marketer attempts to redefine elements of the external environment in ways that reduce environmental uncertainty, lessen the firm's dependency and vulnerability, and/or modify the task environment in which the firm operates. Further, resources are managed in ways that they can be quickly committed to or withdrawn from new projects, thereby enhancing the firm's flexibility. Examples of efforts that can achieve one or more of these outcomes include collaborative marketing programmes with other firms, joint development projects, test markets and staged product roll-outs, working with lead customers, strategic alliances, outsourcing of key marketing activities, and resource expenditures that are tied to performance."[11]

Second, even the *funding mix* of the firm will influence its risk profile.[12] A practical example of that kind of corporate risk management is the firm's choice of leverage and retainment of profits. (Volume III).

Debt can increase return in all investment projects. Borrowing can multiply the investment project's potential for profit but also its potential for loss. In addition to debt, derivative instruments can be used either to increase the potential for profit or to hedge against risk. The debt-to-equity ratio of the firm is also influenced by the decision to issue shares or return funds to shareholders. Retaining profits will increase liquidity and reduce the likelihood of insolvency. The distribution of all profits to shareholders would have an opposite effect.

Third, the *allocation of value* generated by the firm will play a role. Like risk, value will be allocated between the firm and its stakeholders as well as between the stakeholders inter se. The firm will also choose whether to retain profits, distribute them to shareholders, or allocate value in other ways.

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[11] Morris MH, Schindehutte M, LaForge RW, Entrepreneurial Marketing: A Construct for Integrating Emerging Entrepreneurship and Marketing Perspectives, Journal of Marketing Theory and Practice 10(4) (2002) p 7.

[12] See, for example, BIS, Basel Committee on Banking Supervision, Proposed enhancements to the Basel II framework. Consultative Document (January 2009), Supplemental Pillar 2 Guidance, paragraph 10.

This question is often combined with corporate strategy. For example, the strategy of the firm can be to offer the lowest prices (and allocate value to customers); alternatively, one of the aspects of corporate strategy can be to pay the highest wages (and allocate value to employees or managers). Some companies have tried to maximise payments to shareholders.

This can be illustrated by three extreme cases. (1) The first is Ryanair. Low fares are one of the key elements of the strategy of Ryanair. This would not be possible without very low operating costs and other costs. (2) The second case is Drexel Burnham Lambert. When Michael Milken was employed by Drexel in the 1980s, he was regarded as the person who created the junk bond market. In 1986, the net profits of Drexel were $545.5 million. In 1987, Milken was paid executive compensation of $550 million for the year. (3) Before the financial meltdown of 2007–2009, the business model of private-equity firms consisted of extremely leveraged buyouts combined with extremely high distributions by the target to private equity investors (see Volume III).

Fourth, those two decisions are complemented by the *allocation of risk* inherent in the firm's activities between the firm and its stakeholders as well as between the stakeholders inter se.

For example, the firm can transfer risk: to lenders by incorporating a limited-liability subsidiary with a high debt-to-equity ratio (this is what private equity funds have done); to suppliers by outsourcing production and services (this is what modern manufacturing firms do); to employees by using short-term employment contracts or contracts that can be terminated at will (this can be done by firms in countries with lax labour laws); and to providers of temporary staffing services (this can be done by firms in countries with inflexible labour laws).

Fifth, the tools of strategic risk management typically include *generic risk management* tools and can include the same risk management tools as operational risk management (see below). Risk can thus be avoided, transferred, mitigated or accepted.

As can be seen, the five main forms of strategic risk management can be applied in many ways.

For example, an aircraft-maker may pay for insurance policies to take aircraft-leasing risks off its balance sheet, after which its profits depend to a larger extent on how the aircraft-maker builds aircraft, and any firm may reduce its risk level by laying off any risk that is not intrinsic to its core business.

The wide range of ways to reduce the likelihood of *financial* distress include: diversifying into other lines of business; using real options; altering the firm's capital structure by increasing equity; retaining profits; increasing the sustainability of revenue by increasing the level of customer satisfaction; and using financial hedging contracts.[13]

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[13] See Wang HC, Barney JB, Reuer J, Stimulating Firm-Specific Investment through Risk Management, Long Range Planning 36 (2003) pp 49–59.

Legal aspects. All corporate decisions are influenced and constrained by laws. One can nevertheless say that strategic risk management is influenced by legal aspects in two main ways.

First, there are particular legal aspects relating to corporate decision-making. Although the risk that the company makes bad strategic choices is too general to be avoided or transferred as such, there are usual legal ways to mitigate that risk by improving the firm's internal decision-making processes (for corporate governance, see Chapters 7 and 8).

Second, the strategic choices of the firm typically cannot be executed without transactions or other actions which involve the use of legal tools and practices (for transactions, see Volumes II and III).

7.3 Operational Risk Management

Operational risk management means the management of risks in the firm's processes.

Operational and legal risks. Operational risk can be defined as "the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events"[14] or "the risk of unexpected losses as a result of deficiencies in systems and controls, human error, management failure, or disruptions from external events such as natural disasters, terrorism or health crises".[15] Operational risk includes many legal risks.[16]

The BP case is an example of how various forms of operational risk can materialise. Three incidents happened to BP in 2004–2006.

In 2006, BP faced legal action in the US over charges that it tried to manipulate propane prices in 2004. Regulators alleged that its BP Products North America subsidiary artificially forced up prices by buying up huge propane stocks only to withhold them from the market. BP defended itself, denied civil charges, and said that market manipulation did not occur. BP also added that following an internal investigation, the firm found that several employees had failed to adhere to BP policies governing trading activities. Those employees were dismissed.

In 2005, a blast at BP's Texas City refinery killed 15 people. The Chemical Safety Board (CSB) found a catalogue of internal BP reports highlighting maintenance backlogs and poor infrastructure at the site. Plaintiffs' lawyers argued that senior managers of BP had known of significant safety problems at its Texas City refinery well before the explosion, but ordered budget cuts anyway. BP agreed that the accident was preventable and put $1.6 billion aside before the trial to resolve legal disputes.

In 2006, BP had to close part of its Prudhoe Bay oil field in Alaska, after leaks were discovered in one of its pipes. The cause of the leaks was pipe corrosion. In August 2006, BP

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[14] Paragraph 644 of the Basel II Accord.

[15] BIS, Committee on Payment and Settlement Systems, Recommendations for Central Counterparties, CPSS Publications No 64 (November 2004), paragraph 3.10 at p 9.

[16] Paragraph 644 of the Basel II Accord. See also McCormick R, Legal Risk in the Financial Markets. OUP, Oxford (2006), paragraph 4.12 and Intro paragraph 1.24.

shareholders brought legal action against senior managers of BP seeking compensation for allowing BP's assets to decay.

Objectives. In order to manage risks in its processes, the firm needs to: identify the risks; analyse them (in particular their likelihood and consequences or impact); profile them (according to their likelihood and severity); prioritise them; decide on action (risks can be avoided, reduced, transferred to a contract party, or accepted); control the risks (this involves taking action to minimise the likelihood of the risk occurring and/or reducing the severity of the consequences should it occur); and monitor progress in managing the risks.

Legal means. Operational risk is often managed by legal means, i.e. by using legal instruments and practices. The objectives of operational risk management determine which individual risks the firm's managers should address, which legal tools they should choose when addressing those risks, and how they should use those legal tools.

Management of legal risk. The management of operational risk by legal means can be distinguished from the management of legal risk as such.

Whereas *contributory* legal risk will often be addressed indirectly when the firm addresses the main risk, *general* legal risk and *transaction-specific* legal risk can be addressed separately (for the distinction between different forms of legal risk, see section 4.2.2 and Volume II).

Organisation. Operational risk management requires organisational measures. Somebody should be responsible for it and tell the others what to do. Typically, this will require standard-setting and the adoption of internal programmes.

Responsibility for operational risk management. In a limited-liability company, operational risk management is a management matter. The responsibility for operational risk management depends on the distribution of power in the company.

At the end of the day, board members owe a duty of care to the company. New legislation has been adopted to increase the responsibility of the board for risk management.

Programmes. The firm should identify sources of operational risk and mitigate risk through the development of appropriate systems, controls and procedures. This is done, in practice, by executives responsible for the operations of the firm.

Typical safeguards include programmes to ensure adequate expertise, training and supervision of personnel, compliance with accepted standards and work processes, as well as establishing and regularly reviewing internal control procedures. Other safeguards will be discussed in the following section.

Choice of standards. The management of operational risk can require the choice of standards. There is a basic distinction between "homeostatic standards" and "collibration standards".[17]

A homeostatic standard involves specifying an acceptable risk level in quantitative or qualitative terms. For example, there can be upper or lower limits for certain activities. Such acceptable-risk standards consist of a threshold or maximum

[17] Hood C, Rothstein H, Baldwin R, The Government of Risk. OUP, Oxford (2001) pp 25–26.

to be observed. For example, managers can address potential trouble spots by benchmarking product liability claims, worker injuries, customer complaints, consumption of natural resources, and releases of waste.[18]

By contrast, a collibration standard consists of a process in which rival principles are balanced in every case. For example, there can be tension between risk against cost, risk against risk, or risk against time and convenience. This problem can be solved through a balance-tipping or optimisation mechanism, for example by discussing the risk in a committee.

The Basel II framework is an example of homeostatic standards. Recent regulatory developments in the area of corporate governance often favour a process of collibration.[19]

7.4 Fundamental Organisational Measures

Organising corporate risk management means that the firm must put in place a risk regulation system and choose its content (size, structure, style)[20] from a legal toolbox. The organisational measures can be divided into three partly overlapping categories. (1) Again, there are generic ways to manage risk (risks can be avoided, transferred, mitigated, or accepted). (2) From the perspective of the firm, the people responsible for putting the system in place or applying it are agents. The risk regulation system will therefore contain methods used to manage agency relationships in general (behaviour modification, alignment of interests, monitoring and transparency, selection and removal, rules and standards, initiation and ratification, trusteeship and reward). (3) There are also particular legal tools and practices applied, in particular, for the purpose of putting in place a risk regulation system within the firm.

The choice of a risk management system depends not only on strictly legal aspects but also on societal and corporate culture and other factors.[21] Those aspects have been discussed earlier in this book.

They also depend on the business of the firm. For example, a report published in March 2008 by a group of supervisory agencies from France, Germany, Switzerland, the UK, and the US (the Senior Supervisors Group, SSG)[22] identified four

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[18] Bagley CE, Winning Legally. Harv Bus S P, Boston (2005) p 64.

[19] Kirkbride J, Letza S, Regulation, Governance and Regulatory Collibration: Achieving an Holistic Approach, Corporate Governance: An International Review (2004) pp 85–92.

[20] See Hood C, Rothstein H, Baldwin R, The Government of Risk. OUP, Oxford (2001) p 30.

[21] *Ibid*, p 27 and pp 30–32.

[22] The Senior Supervisors Group, Observations on Risk Management Practices during the Recent Market Turbulence (6 March 2008). See also Ben S Bernanke’s speech at the Federal Reserve Bank of Chicago’s Annual Conference on Bank Structure and Competition, Chicago, Illinois, 15 May 2008.

firm-wide risk management practices that were characteristic of *financial firms* which coped more successfully with the market turmoil in 2007. They included:

- effective firm-wide risk identification and analysis (robust dialogue among members of the senior management team, business line risk owners, and control functions);
- consistent application of independent and rigorous valuation practices across the firm;
- effective management of funding liquidity, capital, and the balance sheet (alignment of treasury functions with risk management processes, global liquidity planning, including actual and contingent liquidity risk); and
- informative and responsive risk measurement and management reporting and practices (adaptive risk measurement systems, reliance on a wide range of measures of risk).

Communication of the risk management policy internally. Generally, the firm should be able to communicate its existing risk management policy to those responsible for putting it into effect (and may have to communicate it even to others, see below). The firm will typically have internal guidelines and policies containing clear core rules and general risk management standards.

Corporate culture. Those policies and practices will not be effective unless they are supported by corporate culture and senior management: risk management must be embedded in the culture of the firm.[23] Some spectacular corporate collapses like Enron and WorldCom were partly caused by members of senior management deliberately seeking to avoid the spirit of their own legal obligations.[24]

Fundamental principles of risk management organisation. In addition to the general need to communicate the risk management policy and to have a sound corporate culture, the most fundamental principles of risk management organisation include: (a) the transparency of required standards of behaviour and the transparency of compliance and non-compliance; (b) the use of documented processes and compliance programmes; (c) the documenting of decisions; (d) the documenting of transactions; (e) distinguishing between different acts on the basis of their impact and the likelihood of their occurrence (such as the risk of abuse); (f) the separation of decision management and decision control; (g) the requirement that some decisions are taken or acts done jointly by two or more persons; (h) rotation of people who have an opportunity to abuse their position; (i) automating the processing of transactions in order to mitigate operational risk; and (j) centralisa-

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[23] See, for example, BIS, Basel Committee on Banking Supervision, Proposed enhancements to the Basel II framework. Consultative Document (January 2009), Supplemental Pillar 2 Guidance, paragraph 20.

[24] Gilligan G, Managing Risk in Financial Services Contexts, Comp Lawyer 26(11) (2005) p 342.

tion of risk management activities. These fundamental principles can be applied, for example, in the following ways.[25]

Transparency and monitoring. Transparency means three things in this context: transparency of requirements; the use of documentation and records; and monitoring activities.

According to the principle of transparency, risk management policies and procedures should be communicated to those who should comply with them.

The firm can mitigate risk by adopting written guidelines that describe the work processes of the firm. (a) To the extent not already defined by mandatory laws, the competent corporate body (in most countries the board of directors) should clearly define the authorities and key responsibilites for the board and for senior management. (b) The existence of documented work processes makes it easier for the firm to comply with legal requirements. For example, the use of documented work processes can ensure that the firm meets its contractual obligations when they fall due. (c) Documented work processes should also cover the overall parameters of counterparty relationships. For example, these parameters can include the use of preformulated contract terms or the negotiation of master agreements. If the firm extends credit, these parameters can include the setting of counterparty credit limits. While the firm would benefit administratively by avoiding the creation of documentation ab initio for each transaction, the greatest advantage from standardised documentation is consistency in contract terms, particularly covenants and events of default. Such consistency should reduce internal monitoring costs for the firm and reduce the risk of the firm defaulting the contract.[26]

The documenting of decisions is a key component in risk management. In addition, risk can be mitigated by ensuring that: all transactions are accurately recorded in internal systems; the details of transactions are agreed as soon as possible and documented; any disagreements are resolved and documented. For example, in derivative transactions, it is usual to record telephone conversations between traders and some firms also record back office conversations; the recording can provide potentially valuable evidence of the existence and terms of a trade. Brokers can be used in some transactions. In many financial transactions, standard legal agreements (such as the 2002 ISDA master agreement) and confirmations are used to document transactions.

In addition to the communication of risk management policies and procedures to those who should comply with them and the documenting and recording of acts done by people that belong to the firm's organisation, transparency requires some control activities. Control activities involve three steps: establishing control policies and procedures; verifying that the control policies and procedures are being

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[25] See, for example, BIS, OTC Derivatives: Settlement procedures and counterparty risk management, Report by the Committee on Payment and Settlement Systems and the Euro-currency Standing Committee of the central banks of the Group of Ten countries. Basle (September 1998).

[26] Day JFS, Taylor PJ, Loan Contracting by UK Corporate Borrowers, JIBL 11(8) (1996) pp 318–325 at p 319.

complied with; and assessing the effectiveness of the control policies and procedures. There can be several independent monitoring systems.

For example, the MiFID and Directive 2006/73/EC require an independent compliance function,[27] an independent risk management function,[28] an independent internal audit function,[29] and monitoring by "senior management" or "the supervisory function" of compliance with all those requirements.[30]

The Basel Committee on Banking Supervision has published risk management guidance.[31] For example, principle 6 of the 1998 Framework for the Assessment of Internal Control Systems[32] published by the Basel Committee on Banking Supervision deal with control acticities (principle 6): "An effective internal control system requires that an appropriate control structure is set up, with control activities defined at every business level." According to the Committee, control activities should include: top level reviews;[33] appropriate activity controls for different departments or divisions;[34] physical controls;[35] checking for compliance with exposure limits and follow-up on non-compliance;[36] a system of approvals and authorisations;[37] and a system of verification and reconciliation.[38]

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[27] Article 6(2) of Directive 2006/73/EC.

[28] Article 7(2) of Directive 2006/73/EC.

[29] Article 8 of Directive 2006/73/EC.

[30] Article 9 of Directive 2006/73/EC.

[31] The second pillar of Basel II contains risk management guidance. Paragraphs 719–807 of the Basel II Accord. The Basel Committee on Banking Supervision has also published of other risk management guidance. See, for example, Principles for the Management of Credit Risk (September 2000).

[32] BIS, Basel Committee on Banking Supervision, Framework for the Assessment of Internal Control Systems, Basel Committee Publications No 40 (September 1998).

[33] Paragraph 24: "... Questions that senior management generates as a result of this review and the ensuing responses of lower levels of management represent a control activity which may detect problems such as control weaknesses, errors in financial reporting or fraudulent activities ..."

[34] Paragraph 24: "... Department or division level management receives and reviews standard performance and exception reports on a daily, weekly or monthly basis ..."

[35] Paragraph 24: "... Physical controls generally focus on restricting access to tangible assets, including cash and securities. Control activities include physical limitations, dual custody, and periodic inventories."

[36] Paragraph 24: "... The establishment of prudent limits on risk exposures is an important aspect of risk management. For example, compliance with limits for borrowers and other counterparties reduces the bank's concentration of credit risk and helps to diversify its risk profile. Concequently, an important aspect of internal controls is a process for reviewing compliance with such limits and follow-up on instances of non-compliance."

[37] Paragraph 24: "... Requiring approval and authorisation for transactions over certain limits ensures that an appropriate level of management is aware of the transaction or situation, and helps to establish accountability."

[38] Paragraph 24: "... Verifications of transaction details and activities and the output of risk management models used by the bank are important control activities. Periodic reconciliations, such as those comparing cash flows to account records and statements, may identify activities and records that need correction. Consequently, the results of these verifications should be periodically reported to the appropriate levels of management."

Typically, a bank's trading activities may be subject to three independent monitoring systems. Trades would automatically and electronically be notified to (a) the competent authorities,[39] (b) the bank's risk management and (c) the bank's controlling. In addition, trading activities would be monitored by (d) the bank's line management, and the chief risk officer would report to (e) the chief executive officer and the board.[40] Barings (1992), Daiwa Bank (1995), Sumitomo (1996), China Aviation Oil (2004), and Société Générale (2008) are spectacular examples of monitoring systems that failed.

Statutory audits are an example of the outsourcing of monitoring (section 9.3.3).

Limits. As regards internal decision-making and the representation of the firm in its dealings with others, decisions and acts have been divided into various categories. The firm's risk management processes can distinguish between different acts on the basis of their impact and the risk of abuse. Generally, approval and authorisations should be required for transactions over certain limits in order to ensure that an appropriate level of management is aware of the transaction or situation and to establish accountability.

This can be illustrated by customer credit. The firm's credit department typically imposes a customer credit limit vis-à-vis each customer or the category of customers to which the customer belongs. The size of the limit is based on an assessment of the customer's creditworthiness. There can be an overall limit for the customer and different limits for different categories of the firm's own representatives dealing with customers. The firm's representatives can thus be expected not to execute transactions with a counterparty if doing so would create a credit exposure in excess of the customer's limit or the representatives' own limit. Furthermore, the procedure of decision-making can depend on the size of the credit. There can also be further constraints on the terms of transactions with specific customers. For example, a maximum maturity may be set on transaction with a relatively weak customer or transactions with such a customer may be authorised only if the customer agrees to provide collateral to cover any credit exposure. Compliance with limits can generally be monitored by independent risk managers.

Separation of management and control. Management and control can be separated in many ways.

There should be a segregation of duties. If possible, a person belonging to the firm's organisation should not be given conflicting responsibilities.[41]

The separation of decision management and decision control belongs to the most important tools in this respect. It is generally applied in corporate governance. In some countries, the company may have a statutory two-tier board struc-

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[39] See Article 17(1) of Directive 2004/39/EC (MiFID): "Member States shall ensure that the competent authorities monitor the activities of investment firms so as to assess compliance with the operating conditions provided for in this Directive. Member States shall ensure that the appropriate measures are in place to enable the competent authorities to obtain the information needed to assess the compliance of investment firms with those obligations."

[40] BIS, Basel Committee on Banking Supervision, Proposed enhancements to the Basel II framework. Consultative Document (January 2009), Supplemental Pillar 2 Guidance, paragraph 19.

[41] See Recital 15 of Directive 2006/73/EC complementing the MiFID.

ture with mandatory separation of decision control and decision management (the German Aktiengesellschaft, AG). In other countries, the company would have a one-tier board structure with no mandatory separation of decision control and decision management (the UK public limited-liability company, plc). In the latter case, the use of committees can help to create two-tier structures inside the one-tier board.

Another example of the separation of decision management and decision control is the "principle of four eyes" (Vieraugenprinzip) according to which a person whose activities cause payment obligations (such as a person managing a project) should not be permitted to certify payments.

The representation of the company in its dealings with outsiders can generally be separated from internal decision-taking. It is usual to separate "back office" from "front office". Whereas deals are negotiated by front office staff, confirmations and other documentation can be prepared by back office staff who are independent of front office staff.

For example, Barings Bank collapsed, because huge losses were incurred by reason of unauthorised and concealed trading activities within Barings Futures Singapore. The true position was not noticed early, because the same person was responsible for both trading and back office. There was also a serious failure of controls and managerial confusion within Barings.

Joint decision-making and joint representation of the firm. There are many examples of the requirement that decisions are taken jointly by more than one person. It is possible to distinguish between internal decision-making and the representation of the company in its dealings with others. In both cases, the proper way to act on behalf of the company can be regulated by means of: provisions of law, especially company law; the company's articles of association; internal guidelines; or other decisions taken by company representatives.

Typically, some matters might have to be decided on by the statutory board of directors acting as a collegiate body, or by sub-board management committees. In addition, some decisions can be initiated by a company officer and ratified by a superior officer (for example, the CEO), or taken by a company officer (say, the CEO) and confirmed by another officer (for example, the CFO). Some decisions must be taken by two officers acting jointly. According to the MiFID, Member States must require that the management of investment firms is undertaken by at least two persons who are of sufficiently good repute and sufficiently experienced so as to ensure the sound and prudent management of the investment firm.[42]

As regards the representation of the company in its dealings with others, the use of limits and the application of the "principle of four eyes" to the making of contracts and recording them in internal systems can prevent abuse and mitigate other risks. Some of these restrictions can be included in the company's articles of association. The company may decide that the company may only be represented by two or more persons acting jointly as regards certain categories of transactions. According to the First Company Law Directive, such a limitation may be included

[42] Article 9 of Directive 2004/39/EC (MiFID).

in the articles of association if permitted by national law.[43] For example, the articles of association (Satzung) of Daimler AG provide that: "The corporation may be represented by two members of the Board of Management or by one member of the Board of Management jointly with one holder of general commercial power of attorney (Prokura)." The company may also adopt other internal limitations.[44]

Rotation. The firm can decide to rotate people who have an opportunity to abuse their position where such abuse would have a large impact on the firm. Common examples of rotation include the rotation of people responsible for purchasing and the rotation of auditors. The rotation of both has become more important in recent years.

The rotation of purchase managers has become more important because of the increased levels of outsourcing. The use of outsourcing increases the size of deals that purchase managers are responsible for and increases the risk of abuse and business corruption.

In the EU, the Directive on statutory audits provides for auditor rotation. Audit rotation applies to "public-interest entities" such as listed companies: "Member States shall ensure that the key audit partner(s) responsible for carrying out a statutory audit rotate(s) from the audit engagement within a maximum period of seven years from the date of appointment and is/are allowed to participate in the audit of the audited entity again after a period of at least two years."[45]

A rotation policy can nevertheless cause problems. There are transaction costs. A further problem is the risk of short-termism where a person is rotated before it has been possible to verify the quality of that person's actions. This is often the case in business management or fund management. Rotating people too soon is therefore not the right way to mitigate the risk of abuse or the risk of a status quo bias (endowment effect).

Automated processes. The firm can aim to reduce operational risk by ensuring that the processing of transactions is as automated as possible, thereby reducing the risk of error due to manual intervention and the risk of abuse. Whereas the processing of mass transactions or "plain vanilla" transactions is often automated,

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[43] Article 9(3) of Directive 68/151/EEC (First Company Law Directive): "If the national law provides that authority to represent a company may, in derogation from the legal rules governing the subject, be conferred by the statutes on a single person or on several persons acting jointly, that law may provide that such a provision in the statutes may be relied on as against third parties on condition that it relates to the general power of representation; the question whether such a provision in the statutes can be relied on as against third parties shall be governed by Article 3."

[44] At its website, the Bank of Finland notifies third parties of officials authorised to sign for the bank. All documents that are binding on the Bank of Finland must be signed by two Bank of Finland officials, one of whom must be an official mentioned on a list disclosed by the bank. Authorisation to sign is either based directly on the official's position or on a Bank of Finland decision.

[45] Article 42(2) of Directive 2006/43/EC (Directive on statutory audits). See also recital 26: "... Where a Member State considers it appropriate in order to attain the objectives pursued, that Member State might, alternatively, require a change of audit firm, without prejudice to Article 42(2)."

more complex transactions can require significant manual intervention at many stages of the processing.

Communication of risk management to outsiders. The firm can have legal reasons for communicating some of its risk management policies to outsiders.

Communication of risk management policies can signal a will to comply with laws and the standards of behaviour required by laws. In a crisis situation, acceptable risk management policies may be used as evidence of the firm acting as a good corporate citizen. This can keep not only the firm but even its managers and board members safe from legal liability. The firm may need to communicate similar things to its contract parties and business partners for commercial or legal reasons.

Siemens AG, a German company, is an example of a firm that had to take extreme steps to communicate its risk management policy to outsiders in general, and US federal authorities in particular. A wrong corporate culture supported by poor supervision and control had led to a corruption scandal in 2006. Siemens had to react by signalling that it was determined to change both its culture and its practices and that it had already done so.

Siemens tried to show that it was taking appropriate action. It announced the formation of a "task force" to clarify and standardise its employees' business practices. The company appointed an ombudsman to encourage internal whistle-blowing. It also appointed an anti-corruption expert and one of the founders of Transparency International to review anti-corruption controls and training at Siemens.[46]

As Siemens was listed on the NYSE, this was not enough. The US Foreign Corrupt Practices Act of 1977 (FCPA) applies to all companies listed in the US. The Act gave the US Department of Justice and the SEC powers to launch investigations and to punish wrongdoings.

The US Department of Justice and the SEC had investigations running against Siemens. In fact, the company was the biggest FCPA case of all time. Legal proceedings in the US alone could have cost Siemens billions of dollars in legal costs and fines. Siemens therefore had to convince the US federal authorities that its corporate culture was now sound and that it took past corruption cases very seriously.[47]

Siemens therefore announced further measures to show how determined it was to change its culture. It appointed a law firm to investigate the company's compliance and control systems. For signalling reasons, the law firm had to be a well-known US law firm with a good reputation in the US (Debevoise & Plimpton). In addition to a US law firm, the company asked forensic auditors from a well-known international auditing firm (Deloitte) to look for evidence of more irregularities.[48]

A number of board decisions were screened by the law firm for the purpose of mitigating legal risks in the US. Two examples can be named here. (a) In May 2007, a new CEO (chairman of the managing board) was brought in from outside the firm in order to signal to US federal authorities that the firm was serious about changing its old ways. This was nec-

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[46] Too little, too late? Siemens belatedly wakes up to reputation risk, The Economist, December 2006.

[47] See, for example, Löscher und Cromme bitten die SEC um Milde, FAZ, 18 December 2007 p 16.

[48] Generation game. The conglomerate's new boss may rearrange more than the furniture, The Economist, October 2007.

essary even though the previous CEO had an excellent track record and a good reputation. (b) According to German law, the general meeting can ratify the past acts of two boards (Entlastung).[49] This is usually a formality. In January 2008, however, the two boards of Siemens jointly recommended the postponing of the ratification of the acts of the Siemens managing board and referred to a memorandum by Debevoise & Plimpton.[50]

As a result of these and other actions, Siemens AG was able to limit the fines and penalties payable to the US Department of Justice and the SEC to USD 800 million and the total amount of fines and penalties to about €1 billion.[51]

Centralisation. Last but not least, the most important risk management activities can be centralised. This will make it easier to manage information.[52] The board plays a central role in corporate risk management. Furthermore, the firm can have a risk department.

7.5 Excursion: Dealings with Third Parties

By whom and how the firm is represented in its dealings with outsiders is an important aspect of contract management and risk management (for attribution and communication, see sections 9.4.9 and 9.5.6 below). Article 9 of the First Directive[53] and other rules on the representation of the company (see Volume II) can also influence corporate governance.

Representation and corporate governance. The right to represent a limited-liability company is usually subject to several constraints. Some constraints are rule-based. These rules can be found in internal sources or external sources.

External sources of rules contain laws or non-state rules such as listing rules, guidelines, corporate governance codes, and so forth. Companies typically need to adapt to those rules. Companies often do so by adopting internal guidelines and policies on the representation of the company.

Internal sources of rules consist of the company's constitutional documents (articles of association, statutes), guidelines, internal decisions, and so forth. Such internal rules can allocate power to represent the company and ensure that powers are subject to adequate constraints. A company will take into account powers conferred by legal background rules and legal constraints on the exercise of these powers when it decides: (1) how the company should be represented as regards acts belonging to different categories; (2) by whom the company should be represented; and (3) under what terms these persons may conclude contracts on behalf of the company.

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[49] § 120 AktG.

[50] Siemens AG, Ad-hoc annoumcement according to § 15 WpHG (Securities Trading Act), 16 January2008.

[51] Siemens AG, Siemens AG reaches a resolution with German and U.S. authorities, Press Release, 15 December 2008.

[52] This is not easy. See Confessions of a risk manager, The Economist, August 2008.

[53] Directive 68/151/EEC.

The legal powers used to represent a company thus depend on the company's own choices: choices that are influenced by legal background rules. Companies established in different Member States may therefore need to regulate this question in different ways. On the other hand, Article 9 of the First Directive can influence internal decisions in all Member States.

Article 9 of the First Directive purports to make acts made by the "organs of the company" binding (see Volume II). There is more reason for the company to ensure that the representation of the company by its "organs" is subject to sufficient constraints. The company can achieve this in many complementary ways.

Different categories of transactions. As a rule, different categories of transactions or acts require different internal rules on the representation of the company.

Delegation of power. The company can delegate authority to represent the company to persons who are not regarded as "organs". Usually this is achieved by adopting internal guidelines and taking internal decisions according to which certain sub-board executives or employees are responsible for representing the company as far as certain categories of acts are concerned.

As regards top management, this can be meaningful in countries like England where the law governing the company (1) vests large powers to represent the company in the "organ" or "organs of the company" (2) without providing for sufficient constraints. As a rule, the articles of association of an English company vest all management powers in the board of directors. The Companies Act 2006 contains few rules on how these powers should be exercised. In order to ensure that sufficient constraints are in place, the actual representation of the company can be delegated to a managing director, an individual board member or sub-board executives (Table A). As these persons are not regarded as "organs of the company", their activities are governed by the law of agency and the terms of their appointment.

Representation by at least two persons jointly. The company may decide that the company may only be represented by two or more persons acting jointly in certain categories of transactions. Such a limitation may be included in the articles of association if permitted by national law.[54] The First Directive does not prohibit internal guidelines or decisions limiting the authority of company representatives in this way.

In practice, the articles of association should contain such constraints especially in countries like Germany where individual persons can be regarded as "organs of the company" for the purposes of Article 9. For example, the articles of association (Satzung) of Daimler AG and BMW AG provide for such a constraint. These kinds of constraints are naturally meaningful for the purposes of risk management even in other countries.

Control activities and segregation of duties. Companies should always put effective internal control systems in place. As Article 9 restricts the grounds that make acts done by the company's "organs" invalid, these internal control systems become even more important where the company is represented by its "organs".

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[54] Article 9(3) of Directive 68/151/EEC (First Company Law Directive).

These control activities can include the mandatory disclosure of information concerning the exercise of powers, physical controls restricting access to tangible assets, and approvals and authorisations. As regards approvals and authorisations, the company can, for example, establish prudent limits on risk exposures, require approval and authorisation for transactions over certain limits, and verify transaction details.

These activities are particularly important in those Member States where legal background rules do not provide for control activities and the segregation of duties. For example, in England the control activities and the segretation of duties depend to a large extent on the articles of association and internal decisions of the company (listed companies are nevertheless governed by stricter rules).

In contrast, the German Aktiengesetz provides for the separation of supervision and management by making the two-tier board structure mandatory: the activities of the management board are supervised by the supervisory board. In addition, both boards are collegiate organs: the activities of an individual management board member are also supervised by other board members.

Appointment. Basically, the company can choose reliable organ members. For example, the board should ensure that it does not appoint a managing director who is likely to burden the company with unauthorised contracts, or at least not with unauthorised contracts that prove onerous.[55]

Sanctions. The company can mitigate the risk of bad contracts becoming binding also by ensuring that organ members and senior executives have good reasons for not exceeding their actual authority, in particular personal liability to their company for breach of their terms of employment.[56]

7.6 The Regulation of Corporate Risk Management

7.6.1 Introduction

The firm can regulate corporate risk management voluntarily and internally by using the techniques described earlier in this chapter or in other ways. On the other hand, there are legal rules on corporate risk management.

Corporate risk management has become increasingly important because of several parallel legal developments in addition to the obvious financial scandals. The legal developments include, in particular: new minimum capital requirements for banks (Basel II), new accounting rules (IFRS), new rules on the risk management process and the disclosure of risk management practices (the Sarbanes-Oxley Act, the Transparency Directive, corporate governance codes, the MiFID, and sectoral legislation that makes compliance programmes necessary); and new liability rules.

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[55] Griffiths A, Contracting with Companies. Hart Publishing, Oxford and Portland, Oregon (2005) p 17.

[56] *Ibid*, p 18.

For example, both Basel II and the IFRS may require an infrastructure of risk monitoring, stress testing, control and disclosure.

The applicable rules depend on the company type. For example, a limited-liability company can be governed in practice by different risk management rules depending on to which of the following categories it belongs:

- a small private limited-liability company exempted from certain disclosure requirements;
- a private limited-liability company;
- a private limited-liability company belonging to a group (as a parent or subsidiary);
- a public limited-liability company (such as an AS, AG or plc);
- a public limited-liability company belonging to a group (as a parent or subsidiary);
- a public limited-liability whose securities have been admitted to trading on a regulated market in the EU (a listed company);
- a public limited-liability company listed in the US;
- a public limited-liability company listed in the EU and in the US;
- an investment firm governed by the MiFID.

The scope of risk management rules also depends on the business area. Financial institutions must comply with more stringent rules. More stringent rules are generally applied to activities that give rise to a high risk of serious harm to persons or property. A legal compliance programme is an important component of a risk management regime.

In any case, there are four important categories of corporate risk management rules applicable to all companies or particular categories of companies in the EU. (1) Firms are punished or rewarded for their corporate risk management choices because of the banks' capital requirements. (2) Disclosure rules make risk and corporate risk management more transparent and enable outsiders to monitor firms. (3) In addition, substantive rules on corporate risk management tell managers how to establish and maintain corporate risk management policies. (4) Liability rules punish managers for breach of legal requirements.

Whereas there is plenty of detailed regulation in the first two areas, the last two areas are not subject to very detailed regulation. Managers are therefore not told what exactly they should do in order to manage risk and to avoid personal liability.

7.6.2 Basel II and Ratings

The implementation of Basel II means that firms will – at least in principle - be punished or rewarded by banks on the basis of the banks' own or standardised assessment of the risk-level of the firm. The risk level of the firm influences the availability and cost of debt capital.

Basel II and the EU. The EU has passed legislation to implement Basel II. The Capital Requirements Directive applicable to credit institutions and investment firms[57] introduced a supervisory framework which reflects the Basel II rules. Technically the Capital Requirements Directive recast two previous Directives (2000/12/EC and 1993/6/EEC).

Institutions have been able to apply the Capital Requirements Directive since 2007. The most sophisticated approaches (Advanced IRB approach and AMA approach for operational risk) have been available since 2008. All EU credit institutions and investment firms have applied Basel II since 2008.

In the EU, the Basel II requirements are applied to all banks and not only to international banks.[58] This can be contrasted with the US approach. In the US, Basel II will be implemented later and only to a handful of very large, internationally active banks; there is a three-year transition period from 2009 to 2011. In the US, the Basel II framework is complemented by a leverage ratio restriction (see Volume III).

Purpose. The purpose of Basel II is to secure the international convergence of supervisory regulations governing the capital adequacy of internationally active banks.[59] This means that: banks have to deposit cash to cover default risks; and bank customers will have to subject themselves to a rating in order to obtain credit.

While the first "Basel Capital Accord" (Basel I) of 1988 required all banks to hold capital resources according to the same criteria for possible loan defaults, Basel II lays down significantly more risk-sensitive capital requirements.

Basel II provides a range of options for determining the capital requirements for credit risk and operational risk to allow banks and supervisors to select approaches that are most appropriate for the operations and their financial market infrastructure.

Ratings. In particular, Basel II requires the use of ratings. Compared with Basel I, Basel II makes greater use of assessments of risk provided by banks' internal systems as inputs to capital calculations and permits banks to choose between two approaches when calculating credit risk and capital allocation.[60]

The simpler method, the so-called "standardised approach", is designed for smaller banks with less sophisticated risk-modelling and risk-management systems. It requires banks to use the risk assessments provided by accredited credit-rating agencies when giving a risk weighting to their loans and investments.

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[57] Directive 2006/48/EC relating to the taking up and pursuit of the business of credit institutions (recast); Directive 2006/49/EC on the capital adequacy of investment firms and credit institutions (recast).

[58] See recital 5 of Directive 2006/48/2006: "Measures to coordinate credit institutions should, both in order to protect savings and to create equal conditions of competition between these institutions, apply to all of them ..."

[59] Basel II is formally called the "International Convergence of Capital Measures and Capital Standards". It has been drafted by the Basel Committee on Banking Supervision, an offshoot of the BIS. Basel II is a gentlemen's agreement among leading bank regulators and relies on national law for its implementation.

[60] See also Articles 75–76 of Directive 2006/48/EC.

Bigger banks with more sophisticated risk-modelling and risk-management systems can opt for what Basel II calls the "internal ratings-based approach", or IRB. The IRB allows a bank to use its own internal historic data to calculate the riskiness of its loans and investments. To do this calculation, the bank needs to be able to estimate: the probability of default within one year for each borrower; the bank's potential exposure at a default; the bank's potential loss from a default; and, in the absence of a default, when the borrower will repay.[61]

While Basel I provided for the same rules for all banks, Basel II favours sophisticated banks. Sophisticated banks can increase return on capital by extending more loans with the same capital resources.

A better rating. The amount of capital resources for the loan are determined by four criteria: (1) the probability of default; (2) exposure at default (the amount of credit at the time of default); (3) loss given default (the actual rate of loss); and (4) maturity (the duration of the loan agreed with the borrower).

The firm can obtain a better rating by observing the facts influencing the rating under Basel II. The rating is influenced by quantitative criteria (hard criteria, "Hard Facts") and qualitative factors (soft criteria, "Soft Facts").

Part of the rating judgment is determined by quantitative criteria found in the company's balance sheet. The most important single hard fact influencing the rating is the capital resources rate (or the debt-to-equity ratio). A high gearing increases the risk of default and should lead to a worse rating. A low gearing reduces risk and should result in a better rating. The company can decrease gearing by (a) using capital in a more effective way and reducing working capital (factoring, leasing, sale and lease back of real estate, securitisation) (see Volume III) and (b) by increasing its equity (see Volume III).

Qualitative criteria – "soft facts" – receive greater emphasis under Basel II than under Basel I. The weight of qualitative criteria varies. Soft facts can include, for example, facts concerning the firm's market, the quality of management, operations, and risk management.

Ratings and IFRS. In principle, the choice of the accounting standard should not influence the firm's rating as such. The ratings-based approaches are in principle neutral as to whether the firm should adopt IFRS or continue to apply national accounting standards.

However, the ratings-based approaches take into account the profitability of the firm, and the firm's profitability depends on the accounting standard. Even the amount of equity capital depends on the applicable standards. The amount of debt and equity capital can influence: the application of legal rules; the actions of the firm's contract parties and stakeholders; and the actions of the firm. In practice, it is therefore possible that the choice of the accounting standard will, indirectly, influence the firm's rating.

[61] See Article 84 of Directive 2006/48/EC.

IAS 32[62] establishes basic principles for the classification of instruments as liabilities or equity. The capital investment of the firm's owners can sometimes be regarded as debt capital under IAS 32 but as equity capital under national accounting standards.

7.6.3 Fair Value Accounting of Financial Assets

The firm's reported earnings can also be influenced by the fair value accounting of financial assets.

Leading accounting standard setters in the world are moving away from the historical cost model for the valuation of financial instruments towards a model of fair value accounting.[63]

Fair value accounting can make the reported earnings of firms subject to greater fluctuations in the market. It can thus increase the perceived risk level of the firm. It can also increase losses caused by adverse market conditions.

In the EU, the fair value accounting of financial assets is based on IFRS and - as regards certain financial instruments - the Accounting Directives (see sections 9.3.4 and 10.7.3).[64]

IFRS. IFRS do not require that *all* assets and liabilities should be measured at fair value. Neither do IFRS require *all financial* assets and financial liabilities be measured at fair value.

IFRS require or allow the use of fair value in financial statements in four main ways:[65] (1) for the measurement of transactions (and the resulting assets, liabilities and equity items) at initial recognition in the financial statements (this is particularly important in more complex transactions, for example, the exchange of financial instruments on the refinancing or restructuring of debt or a sale and leaseback transaction); (2) for the allocation of the initial amount at which a transaction is recognised among its constituent parts (for example, assets and liabilities acquired in a business combination are measured at the date of acquisition at the same amount at which they would have been measured if they had been acquired separately); (3) for the subsequent measurement of assets and liabilities; and (4) in the determination of the recoverable amount of assets (it is a general accounting principle in most jurisdictions that assets must not be carried at more than the amount that the entity expects to recover from their use or sale).

Financial assets are divided into three categories according to IFRS. Some financial assets are "held to maturity" and valued according to their *nominal* value. Fi-

[62] IAS 32 applies in the EU from 1 January 2005. Commission Regulation 2237/2004. Originally, the institutions of the EU intended to adopt all international accounting standards in existence on 14 September 2002 and the related interpretations with the exception of IAS 32 and IAS 39. IAS 32 and IAS 39 deal with financial instruments and their adoption was believed to have amounted to very considerable amendments. Recital 4 of Commission Regulation 1725/2003. Accounting standards for financial instruments (such as IAS 32, IAS 39 and IFRS 7) were nevertheless adopted in 2006. See Commission Regulation 108/2006.

[63] Recital 7 of Directive 2001/65/EC.

[64] Directives 78/660/EEC, 83/349/EEC, and 86/635/EEC.

[65] Cairns D, The Use of Fair Value in IFRS, Accounting in Europe 3(1) 2006 pp 5–22.

nancial assets not "held to maturity" will be *fair* valued ("marked-to-market"). The third category is assets that are "available for sale".

According to IFRS, the use of fair value thus depends on the category to which assets (or liabilities) belong:

- IFRS require the use of fair values for the subsequent measurement of assets and liabilities when those assets or liabilities are derivatives, other held-for-trading financial assets or financial liabilities, or available-for-sale financial assets.
- IFRS prohibit the use of fair values for most intangible assets, goodwill, inventories, and virtually all liabilities.
- For all other assets, an entity may use historical cost-based amounts. The vast majority of entities reporting under IFRS choose to do this. IFRS allow the use of fair values for some other assets and a few liabilities.

Accounting Directives. In order to maintain consistency between internationally recognised accounting standards and the Accounting Directives, it was also necessary to amend those Directives.

Directive 2001/65/EC[66] required Member States to introduce a system of fair value accounting for some (but not all) financial instruments. Member States can permit or require the adoption of that system by all companies or any classes of companies to which the Accounting Directives apply.[67] Member States are allowed to exempt small companies from this disclosure requirement.

In practice, this system must be applied to banks and to firms that use derivatives. According to Directive 2001/65/EC, the derogation from the historical cost model for the valuation of financial instruments applies only to liabilities that are: (a) held as part of a trading portfolio; or (b) derivative financial instruments. This means that the system of fair value does not apply to: (a) non-derivative financial instruments held to maturity; (b) loans and receivables originated by the company and not held for trading purposes; and (c) interests in subsidiaries, associated undertakings and joint ventures, equity instruments issued by the company, contracts for contingent consideration in a business combination as well as other financial instruments with such special characteristics that the instruments, according to what is generally accepted, should be accounted for differently from other financial instruments.

Directive 2001/65/EC provides that the notes on the accounts should include certain information concerning financial instruments in the balance sheet, which have been measured at fair value. The annual report should give an indication of the company's risk management objectives and policies in relation to its use of financial instruments.

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[66] Directive 2001/65/EC amending Directives 78/660/EEC, 83/349/EEC and 86/635/EEC as regards the valuation rules for the annual and consolidated accounts of certain types of companies as well as of banks and other financial institutions.

[67] Article 42a(1) of Directive 78/660/EEC, as amended.

Problems. The marking of financial assets to market can increase market volatility. In good times, it can contribute to increasing indebtedness and rising market values. For example, banks can take on more debt when the mark-to-market value of their assets increases.[68] In bad times, it can increase losses for market participants.[69]

Fair value accounting standards requiring financial institutions to mark many of their assets to market value can contribute to a downward spiral in prices in two ways. First, they can give an incentive to sell financial assets quickly. Second, they can cause financial institutions to require borrowers either to provide more collateral or to repay their debts, and borrowers may need to sell financial assets to repay their debts. Third, a downward spiral can increase the illiquidity of financial assets; illiquidity will make market values harder to set and push them even lower.

For these reasons, international standard-setting bodies have permitted companies not to apply the mark-to-market values in some circumstances.

In September 2008, the SEC and the Financial Accounting Standards Board (FASB) issued new guidance on fair value in order to reduce the negative effect of the collapse of market prices in the US. FAS 157, which sets out the Financial Accounting Standards Board's (FASB) standard on fair-value measurements, distinguishes between three levels of information or assumptions on which the valuation is based. In level 1, the value of an asset or liability stems from a quoted price in an active market. In level 2, it is based on "observable market data" other than a quoted market price. In level 3, which often applies to asset valuations in illiquid markets or in "distressed" sales (or "fire sales"), fair value can be determined only by inputs that cannot be observed or verified objectively.

In October 2008, the European Commission adopted amendments to accounting standards to mitigate the consequences of the financial meltdown. The amendments made it easier for companies to reclassify assets held-for-trading into the held-to-maturity category. As a result, financial institutions in the EU would no longer have to reflect market fluctuation in their financial statements for such assets.[70]

In April 2009, the FASB issued three Final Staff Positions (FSPs) intended to provide additional application guidance.[71] The new guidance allowed banks to shift toxic and impaired securities from level 2 to level 3.

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[68] See Black mark, The Economist, May 2008. The article cites research by Tobias Adrian of the Federal Reserve Bank of New York and Hyun Song Shin of Princeton University (Liquidity and Leverage).

[69] See, for example, Neue Bilanzierungsregeln verschärften die Krise, FAZ, 19 March 2008 p 19.

[70] Regulation 1004/2008 amending Regulation 1725/2003 adopting certain international accounting standards in accordance with Regulation 1606/2002 as regards International Accounting Standard (IAS) 39 and International Financial Reporting Standard (IFRS) 7.

[71] FSP FAS 157–4 relates to determining fair values when there is no active market or where the price inputs being used represent distressed sales. See also FASB Statement No 157, Fair Value Measurements.

7.6.4 Basel II and the Governance of Banks

Whereas Basel II and the Capital Requirements Directive influence the risk management and governance of borrowers indirectly, they influence the risk management and governance of banks directly. Some of their rules apply to the management of credit risk.[72] Other rules apply to firm-wide risk management and governance.

Credit risk. Basel II and the Capital Requirements Directive rely to a large extent on the banks' own models of the risks that they are carrying. Alternatively, they rely on credit-rating agencies.

IRB Approach. Member States' competent authorities may permit credit institutions to calculate their risk-weighted exposure amounts using the Internal Ratings Based Approach (IRB Approach). Explicit permission is required in the case of each credit institution.[73]

Permission may not be given unless the competent authority is satisfied that the credit institution's systems for the management and rating of credit risk exposures are sound and implemented with integrity and that they meet the other standards laid down in the Capital Requirements Directive.[74]

In particular, they must meet the following standards: (a) the credit institution's rating systems provide for a meaningful assessment of obligor and transaction characteristics, a meaningful differentiation of risk and accurate and consistent quantitative estimates of risk; (b) internal ratings and default and loss estimates used in the calculation of capital requirements and associated systems and processes play an essential role in the risk management and decision-making process, and in the credit approval, internal capital allocation and corporate governance functions of the credit institution; (c) the credit institution has a credit risk control unit responsible for its rating systems that is appropriately independent and free from undue influence; (d) the credit institution collects and stores all relevant data to provide effective support to its credit risk measurement and management process; and (e) the credit institution documents its rating systems and the rationale for their design and validates its rating systems.

Standardised approach. Credits institutions may use the standardised approach. In this case, they may use an independent credit-rating agency. Management and corporate governance issues affect the assessment of the required independence of the credit-rating agencies that financial institutions are permitted to use (External Credit Assessment Institutions, ECAIs).[75]

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[72] See, for example, BIS, Basel Committee on Banking Supervision, Principles for the Management of Credit Risk (September 2000).

[73] Article 84 of Directive 2006/48/EC.

[74] Annex VII, Part 4.

[75] Annex VII, Part 2, Section 1.2, Nr. 3: "Independence of the ECAI's methodology shall be assessed by competent authorities according to factors such as the following: (a) ownership and organisation structure of the ECAI; (b) financial resources of the ECAI; (c) staffing and expertise of the ECAI; and (d) corporate governance of the ECAI."

Governance. The second pillar of Basel II contains firm-wide risk management guidance.[76] The Basel Committee has also published corporate governance guidance.[77] The common theme of both guidances is that board members owe a duty of care to the bank and that both the board and senior management must focus on long-term capital maintenance.

The Capital Requirements Directive also lays down the minimum requirements as to corporate governance.[78] They relate to decision-making,[79] disclosure of information and reporting within the company,[80] and the qualifications of senior management.[81] These requirements are complemented by the MiFID.

7.6.5 The MiFID and Risk Management

The MiFID[82] and implementing legislation lay down the most comprehensive risk management framework based on Community law. The MiFID establishes the framework for a regulatory regime for financial markets in the Community.

It applies to investment firms and governs operating conditions, organisational requirements, reporting requirements, transparency requirements, and other issues. Although it will not apply to non-financial firms like manufacturing companies directly, the framework might influence the duties of senior managers and members of supervisory bodies in the long run. One can expect that the risk management duties will converge as the interpretation of those duties in one area of law is influenced by the regulation of similar duties in other areas of law (analogy). As will be seen later in this chapter, similar rules can be based on existing legislation that applies to large non-MiFID companies.

The MiFID is complemented by Directive 2006/73/EC. The purpose of Directive 2006/73/EC is to "specify concrete organisational requirements and procedures for investment firms". In particular, "rigorous procedures should be provided for with regard to matters such as compliance, risk management, complaints handling, personal transactions, outsourcing and the identification, management and disclosure of conflicts of interest".[83] Its rules are quite detailed in order to ensure "the uniform application of the relevant provisions" of the MiFID.[84]

[76] Paragraphs 719–807 of the Basel II Accord; BIS, Basel Committee on Banking Supervision, Proposed enhancements to the Basel II framework. Consultative Document (January 2009), Supplemental Pillar 2 Guidance.
[77] BIS, Basel Committee on Banking Supervision, Enhancing corporate governance for banking organisations (February 2006).
[78] Annex VII, Part 4, Section 5.1.
[79] Paragraph 124.
[80] Paragraphs 125–127.
[81] Paragraph 126.
[82] Directive 2004/39/EC (MiFID).
[83] Recital 3 of Directive 2006/73/EC.
[84] Recital 4 of Directive 2006/73/EC. See nevertheless recital 9.

The Directive requires an investment firm "to establish, implement and maintain an adequate risk management policy".[85] Generally, Chapter II of Directive 2006/73/EC lays down detailed organisational requirements for investment firms.

General organisational requirements. To begin with, investment firms must comply with general organisational requirements.[86]

First, the Directive requires an acceptable organisational *structure* and acceptable organisational *procedures*. An investment firm must comply with the following requirements:[87] "(a) to establish, implement and maintain decision-making procedures and an organisational structure which clearly and in documented manner specifies reporting lines and allocates functions and responsibilities; (b) to ensure that their relevant persons are aware of the procedures which must be followed for the proper discharge of their responsibilities; (c) to establish, implement and maintain adequate internal control mechanisms designed to secure compliance with decisions and procedures at all levels of the investment firm; (d) to employ personnel with the skills, knowledge and expertise necessary for the discharge of the responsibilities allocated to them; (e) to establish, implement and maintain effective internal reporting and communication of information at all relevant levels of the investment firm; (f) to maintain adequate and orderly records of their business and internal organisation; (g) to ensure that the performance of multiple functions by their relevant persons does not and is not likely to prevent those persons from discharging any particular function soundly, honestly, and professionally."

Second, the Directive requires the management of *confidential information*: "Member States shall require investment firms to establish, implement and maintain systems and procedures that are adequate to safeguard the security, integrity and confidentiality of information, taking into account the nature of the information in question."[88]

Third, an investment firm must have an adequate *business continuity* policy.[89]

Fourth, the Directive lays down substantive requirements as to its *accounting process*. The Directive requires an investment firm "to establish, implement and maintain accounting policies and procedures that enable them, at the request of the competent authority, to deliver in a timely manner to the competent authority financial reports which reflect a true and fair view of their financial position and which comply with all applicable accounting standards and rules".[90] Instead of a mere information rule ("true and fair view"), an investment firm will thus have to comply with a substantive rule ("policies and procedures"). This is designed to increase the responsibility of the investment firm's board and management and make it more likely that financial reports fulfil the minimum requirements as to quality.

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[85] Recital 14 of Directive 2006/73/EC.
[86] Article 5 of Directive 2006/73/EC.
[87] Article 5(1) of Directive 2006/73/EC.
[88] Article 5(2) of Directive 2006/73/EC.
[89] Article 5(3) of Directive 2006/73/EC.
[90] Article 5(4) of Directive 2006/73/EC.

Fifth, there are particular rules on *personal transactions* which are likely to raise conflicts of interest.[91]

Sixth, such obligations are complemented with a *monitoring* obligation. Investment firms are required "to monitor and, on a regular basis, to evaluate the adequacy and effectiveness of their systems, internal control mechanisms and arrangements … and to take appropriate measures to address any deficiencies".[92]

Furthermore, according to a Commission Recommendation, financial undertakings should adopt a risk-focused *remuneration policy*, which is consistent with effective risk management and does not entail excessive risk exposure.[93]

Compliance. Directive 2006/73/EC also regulates compliance for investment firms. An investment firm must have "adequate" compliance *policies and processes* for MiFID.[94] It must also "establish and maintain a permanent and effective compliance *function* which operates independently".[95] In addition, the Directive lays down minimum requirements for the *organisation* of the compliance function.[96]

Risk management. The risk management obligations of an investment firm under the MiFID and Directive 2006/73/EC consist of a general requirement to adopt an adequate risk management *policy*[97] and specific obligations to *monitor* compliance and risk management.[98] Furthermore, the firm should have an independent risk management *function*.[99]

Internal audit. The investment firm's compliance organisation and risk management organisation should be complemented by an independent internal audit function.[100]

Responsibility of senior management. According to Directive 2006/73/EC, "senior management" or "the supervisory function" are responsible for ensuring that the firm complies with its obligations under the MiFID.[101] This reflects the fact that there is no general harmonisation of the governance structure of limited-

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91 Articles 11 and 12 of Directive 2006/73/EC.

92 Article 5(3) of Directive 2006/73/EC.

93 Commission Recommendation on remuneration policies in the financial services sector, C(2009) 3159.

94 Article 6(1) of Directive 2006/73/EC.

95 Article 6(2) of Directive 2006/73/EC.

96 Article 6(3) of Directive 2006/73/EC: "… (a) the compliance function must have the necessary authority, resources, expertise and access to all relevant information; (b) a compliance officer must be appointed and must be responsible for the compliance function and for any reporting as to compliance required by Article 9(2); (c) the relevant persons involved in the compliance function must not be involved in the performance of services or activities they monitor; (d) the method of determining the remuneration of the relevant persons involved in the compliance function must not compromise their objectivity and must not be likely to do so ..."

97 Article 7(1)(a) and (b) of Directive 2006/73/EC.

98 Article 7(1)(c) of Directive 2006/73/EC.

99 Article 7(2) of Directive 2006/73/EC.

100 Article 8 of Directive 2006/73/EC.

101 Article 9 of Directive 2006/73/EC.

liability companies in Europe. The body responsible for compliance will therefore depend on the law governing the company.

7.6.6 Disclosure of Risk

Introduction

There is plenty of other legislation that applies even to firms which do not fall within the scope of the MiFID. Some of the legislation regulates various disclosure obligations.

The disclosure of risk *factors*, risk management *objectives* and risk management *policies* makes it easier for banks, shareholders and other investors to monitor the risk level of the firm. The existence of a duty of disclosure forces the persons responsible to find information about those questions and gives them an incentive to ensure that acceptable risk management procedures are in place.

Disclosure of Risk Factors

In the EU, the disclosure of risk factors can be based on IFRS, the Accounting Directives and the Transparency Directive. In addition, it is governed by Member States' national rules.

IFRS. IAS 1 (revised 1997) deals with the presentation of financial statements. It applies to all types of enterprises including banks and insurance enterprises. According to IAS 1, the objective of general purpose financial statements is to provide information about the financial position, performance and cash flows of an enterprise that is useful to a wide range of users in making economic decisions. To meet this objective, financial statements must contain a certain minimum amount of information.

IAS 1.8 recommends the general disclosure of relevant risks and the firm's risk management policy: "Enterprises are encouraged to present, outside the financial statements, a financial review by management which describes and explains the main features of the enterprise's financial performance and financial position and the principal uncertainties it faces. Such a report may include a review of: (a) the main factors and influences determining performance, including changes in the environment in which the enterprise operates, the enterprise's response to those changes and their effect, and the enterprise's policy for investment to maintain and enhance performance, including its dividend policy; (b) the enterprise's sources of funding, the policy on gearing and its risk management policies; and (c) the strengths and resources of the enterprise whose value is not reflected in the balance sheet under International Accounting Standards."

IFRS 7 applies to financial instruments and is more binding. IFRS 7 adds certain new disclosures about financial instruments to those required by IAS 32 and

puts financial instruments disclosures together in a new standard on Financial Instruments: Disclosures.[102]

According to the disclosure requirements of IFRS 7, an entity must group its financial instruments into classes of similar instruments and, when disclosures are required, make disclosures by class.

The two main categories of disclosures required by IFRS 7 are: (1) information about the significance of financial instruments; and (2) information about the nature and extent of risks arising from financial instruments. The latter contains both qualitative disclosures (IFRS 7.33) and quantitative disclosures (IFRS 7.34).

The qualitative disclosures cover: (a) the exposures to risk and how they arise; (b) its objectives, policies and processes for managing the risk and the methods used to measure the risk; and (c) any changes in (a) or (b) from the previous period.

As regards quantitative disclosures, an entity shall disclose for each type of risk arising from financial instruments for example: (a) summary quantitative data about its exposure to that risk at the reporting date;[103] (b) quantitative information about credit risk, liquidity risk, and market risk; and (c) quantitative information about concentrations of risk.

Accounting Directives. Directive 2001/65/EC that amended the Accounting Directives provided for the disclosure of financial risk and risk management policies regarding certain financial instruments such as derivatives (see above).[104]

Transparency Directive. The Transparency Directive requires issuers of listed securities to make a statement on risk in the annual financial report and in half-yearly financial reports.

In addition to the statement of risk, the annual financial report must also contain “statements made by the persons responsible within the issuer, whose names and functions shall be clearly indicated, to the effect that, to the best of their knowledge, the financial statements prepared in accordance with the applicable set of accounting standards give a true and fair view of the assets, liabilities, financial position and profit or loss of the issuer and the undertakings included in the con-

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[102] The remaining parts of IAS 32 deal only with presentation matters regarding financial instruments.

[103] This disclosure shall be based on the information provided internally to key management personnel of the entity (as defined in IAS 24 Related Party Disclosures), for example the entity’s board of directors or chief executive officer.

[104] Article 46(2)(f) of Directive 78/660/EEC (as amended): “... in relation to the company’s use of financial instruments and where material for the assessment of its assets, liabilities, financial position and profit or loss, - the company’s financial risk management objectives and policies, including its policy for hedging each major type of forecasted transaction for which hedge accounting is used, and - the company’s exposure to price risk, credit risk, liquidity risk and cash flow risk.” Article 36(2)(e) of Directive 83/349/EEC (as amended): “... in relation to the use by the undertakings of financial instruments and, where material for the assessment of assets, liabilities, financial position and profit or loss, - the financial risk management objectives and policies of the undertakings, including their policies for hedging each major type of forecasted transaction for which hedge accounting is used, and - the exposure to price risk, credit risk, liquidity risk and cash flow risk.”

solidation taken as a whole and that the management report includes a fair review of the development and performance of the business and the position of the issuer and the undertakings included in the consolidation taken as a whole, together with a description of the principal risks and uncertainties that they face".[105]

The Transparency Directive also containts some rules on half-yearly financial reports. For example, the half-yearly financial report must contain an interim management report:[106] "The interim management report shall include at least an indication of important events that have occurred during the first six months of the financial year, and their impact on the condensed set of financial statements, together with a description of the principal risks and uncertainties for the remaining six months of the financial year. For issuers of shares, the interim management report shall also include major related parties transactions."[107]

Member States' laws. IFRS, the Accounting Directives and the Transparency Directive have forced Member States to amend their laws. The impact of the amendments in a Member State depends on the previous regulation of corporate governance issues in the Member State. For example, whereas corporate governance issues have traditionally been regulated by mandatory provisions of law for German listed companies, they have been based on recommendations and corporate governance codes for English listed companies. As the new rules are based on mandatory provisions of law, they reflect a change towards the German way of regulating corporate governance.

German law. In Germany, the rules on the disclosure of risk by public limited-liability companies (AG) can be found in the Aktiengesetz (AktG, the company act that applies to public limited-liability companies) and the Handelsgesetzbuch (HGB, the German Commercial Code). The German Corporate Governance Code applies to listed companies. The Aktiengesetz and the Handelsgesetzbuch were amended by the "Act on Control and Transparency in Enterprises" (Gesetz zur Kontrolle und Transparenz im Unternehmensbereich, KonTraG) in 1998 and have been subject to later amendments.

According to a rule of the Aktiengesetz inserted by the KonTraG, the management board (Vorstand) of a public limited company has to establish an adequate risk management system, i.e. "to take appropriate measures and in particular to implement an early recognition system in order to detect existence threatening developments in time".[108]

In addition, there are rules on disclosure. The risks and future developments of a public limited company must be disclosed in the annual report under § 289 HGB as amended by the KonTraG.

[105] Article 4(2) of Directive 2004/109/EC (Transparency Directive).
[106] Article 5(2) of Directive 2004/109/EC (Transparency Directive).
[107] Article 5(4) of Directive 2004/109/EC (Transparency Directive).
[108] § 91(2) AktG: "Der Vorstand hat geeignete Maßnahmen zu treffen, insbesondere ein Überwachungssystem einzurichten, damit den Fortbestand der Gesellschaft gefährdende Entwicklungen früh erkannt werden."

The management board (Vorstand) has an on-going duty to keep the supervisory board (Aufsichtsrat) informed about the company's financial status.[109] The German Corporate Governance Code reflects the statutory duties: "Providing sufficient information to the Supervisory Board is the joint responsibility of the Management Board and Supervisory Board. The Management Board informs the Supervisory Board regularly, without delay and comprehensively, of all issues important to the enterprise with regard to planning, business development, risk situation and risk management. The Management Board points out deviations of the actual business development from previously formulated plans and targets, indicating the reasons therefor."[110]

English law. In England, the Companies Act 1985 was amended[111] to require a directors' report for each financial year. The directors' report had to contain: (a) a fair review of the business of the company; and (b) a description of the principal risks and uncertainties facing the company. Quoted companies were required to publish an Operating and Financial Review (OFR) and to publish an auditor's opinion on the consistency of the OFR and the accounts.[112]

The Companies Act 2006 lays down more detailed disclosure rules. Like the earlier Act, the 2006 Act requires a directors' report.[113] Unless the company is subject to the small companies' regime, the directors' report must contain a business review.[114]

The purpose of the business review is to inform members of the company and help them assess how the directors have performed their duty to promote the success of the company.[115]

The business review must contain: (a) a fair review of the company's business; and (b) a description of the principal risks and uncertainties facing the company.[116]

The review must be a balanced and comprehensive analysis of: (a) the development and performance of the company's business during the financial year; and (b) the position of the company's business at the end of that year, consistent with the size and complexity of the business.[117]

In the case of a quoted company the business review must, to the extent necessary for an understanding of the development, performance or position of the

[109] § 90 AktG.

[110] Section 3.4 of the German Corporate Governance Code.

[111] Section 234ZZB of the Companies Act 1985; the Companies Act 1985 (Operating and Financial Review and Directors' Report etc.) Regulations 2005.

[112] The Companies Act 1985 (Operating and Financial Review and Directors' Report etc.) Regulations 2005. The Accounting Standards Board has issued Reporting Standard (RS) 1 'The Operating and Financial Review'.

[113] Section 415 of the Companies Act 2006.

[114] Section 417(1) of the Companies Act 2006.

[115] Sections 417(2) and 172 of the Companies Act 2006.

[116] Section 417(3) of the Companies Act 2006. See nevertheless section 417(10): "Nothing in this section requires the disclosure of information about impending developments or matters in the course of negotiation if the disclosure would, in the opinion of the directors, be seriously prejudicial to the interests of the company."

[117] Section 417(4) of the Companies Act 2006.

company's business, include: (a) the main trends and factors likely to affect the future development, performance and position of the company's business; and (b) information about (i) environmental matters (including the impact of the company's business on the environment), (ii) the company's employees, and (iii) social and community issues, including information about any policies of the company in relation to those matters and the effectiveness of those policies; as well as (c) information about persons with whom the company has contractual or other arrangements which are essential to the business of the company.[118]

The review must, to the extent necessary for an understanding of the development, performance or position of the company's business, include: (a) analysis using financial key performance indicators, and (b) where appropriate, analysis using other key performance indicators, including information relating to environmental matters and employee matters. "Key performance indicators" means factors by reference to which the development, performance or position of the company's business can be measured effectively.[119]

The same rules apply to a group directors' report.[120] Rules on group directors' reports are complemented by the Combined Code on Corporate Governance, which applies to listed companies, and related guidances.[121] For example, the board should, at least annually, conduct a review of the effectiveness of the group's system of internal controls and should report to shareholders that they have done so. The review should cover all material controls, including financial, operational and compliance controls and risk management systems.[122] For groups of companies, the review of effectiveness of internal control and the report to the shareholders should be from the perspective of the group as a whole.[123]

Disclosure of Risk Management Policies

There is no clear line between disclosure rules and rules on substance. Disclosure rules can in practice force the firm to adopt risk management policies. The Sarbanes-Oxley Act and rules implementing it are a good example of how disclosure rules force firms to adopt risk management policies and procedures.

In any case, rules on the disclosure of the firm's risk management policies are based on various sources. (a) As said above, firms that have adopted IFRS must disclose their financial risk management policies and are recommended to disclose

[118] Section 417(5) of the Companies Act 2006.
[119] Section 417(6) of the Companies Act 2006.
[120] Section 417(9) of the Companies Act 2006.
[121] See provision C.2.1 (review of the effectiveness of the group's system of internal controls, report to shareholders) complemented by the Turnbull Guidance (Guidance on Internal Control, September 1999), paras 3 and 14 (the review and report should be from the perspective of the group as a whole) and para 41; the Smith Guidance (Guidance on Audit Committees, July 2003), para 1.12 (necessary for the audit committee of the parent company to review issues that relate to particular subsidiaries or activities carried on by the group).
[122] Provision C.2.1.
[123] The Turnbull Guidance, paragraphs 3 and 14.

other risk management policies. Also the Accounting Directives contain rules on the disclosure of financial risk management policies. (b) Corporate governance codes contain recommendations and the Sarbanes-Oxley Act of 2002 contains further rules on the disclosure of risk management policies. (c) Sometimes acceptable risk management policies are a condition of authorisation or permits. (d) On the other hand, the Transparency Directive does not regulate the disclosure of risk management policies.

Sarbanes-Oxley Act. Section 404 of the Sarbanes-Oxley Act of 2002 contains rules on management assessment of internal controls. It requires each annual report of an issuer to contain an "internal control report", which shall: (1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and (2) contain an assessment, as of the end of the issuer's fiscal year, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting. In addition, (3) each issuer's auditor shall attest to, and report on, the assessment made by the management of the issuer.

SEC rules. Section 404 of the Sarbanes-Oxley Act is complemented by implementing measures by the Securities & Exchange Commission (SEC).[124]

According to the SEC, the term "internal control over financial reporting": means a process; is designed by, or under the supervision of, the registrant's principal executive and principal financial officers, or persons performing similar functions; is effected by the registrant's board of directors, management and other personnel; and seeks to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

That process includes those policies and procedures that: pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the registrant; provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and receipts and expenditures of the registrant are being made only in accordance with the authorisations of management and directors of the registrant; and provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the registrant's assets that could have a material effect on the financial statements.

The management's annual internal control report must contain: a statement of the management's responsibility for establishing and maintaining adequate internal control over the financial reporting for the company; a statement identifying the framework used by the management to evaluate the effectiveness of this internal control; the management's assessment of the effectiveness of this internal control as of the end of the company's most recent fiscal year; and a statement that its auditor has issued an attestation report on the management's assessment.

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[124] Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, http://www.sec.gov/rules/final/33–8238.htm.

Furthermore, the management: must disclose any material weakness; may not conclude that the company's internal control over financial reporting is effective if there are one or more material weaknesses in such control; must use a suitable, recognised control framework that is established by a body or group that has followed due-process procedures, including the broad distribution of the framework for public comment.

The implementing rules by the SEC also provide for quarterly evaluations. Companies are required to perform quarterly evaluations of changes that have materially affected or are reasonably likely to materially affect the company's internal control over financial reporting. Quarterly evaluations are thus not as extensive as the annual evaluation.

Under the Sarbanes-Oxley Act, the Public Company Accounting Oversight Board (PCAOB) was granted authority to set auditing and attestation standards for registered public accounting firms to use in the preparation and issuance of audit reports on the financial statements of issuers. The PCAOB is required to set standards for registered public accounting firms' attestations to, and reports on, the management's assessment regarding its internal control over financial reporting.[125]

Foreign companies and the Sarbanes-Oxley Act. Section 404 of the Sarbanes-Oxley Act increases the costs of listed firms. It is applied also to foreign issuers. This has made other international stock exchanges look more attractive. The number of IPOs of foreign firms on the NYSE has gone down partly because of the Sarbanes-Oxley Act. SOX is said to have caused many firms to list their shares in London rather than New York (for listings, see Volume III).

IFRS and the Accounting Directives. Unlike the Sarbanes-Oxley Act, IFRS and the Accounting Directives contain few detailed rules on the disclosure of financial risk management policies.

IFRS 7 applies to financial instruments. The two main categories of disclosures required by IFRS 7 are: (1) information about the significance of financial instruments; and (2) information about the nature and extent of risks arising from financial instruments. The latter contains both qualitative disclosures (IFRS 7.33) and quantitative disclosures (IFRS 7.34). The qualitative disclosures cover: (a) the exposures to risk and how they arise; (b) its objectives, policies and processes for managing the risk and the methods used to measure the risk; and (c) any changes in (a) or (b) from the previous period.

Directive 2001/65/EC[126] allowed for certain financial assets and liabilities to be valued at fair value and amended the Accounting Directives.[127] The Directive also inserted a requirement that the notes on the accounts should include information concerning financial instruments in the balance sheet, which have been measured at fair value. The annual report should give an indication of the company's risk management objectives and policies in relation to its use of financial instruments.

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[125] Section 404(b) of the Act.

[126] Directive 2001/65/EC amending Directives 78/660/EEC, 83/349/EEC and 86/635/EEC as regards the valuation rules for the annual and consolidated accounts of certain types of companies as well as of banks and other financial institutions.

[127] See recital 9 of Directive 2001/65/EC.

IAS 1.8, however, is a recommendation. IAS 1.8 recommends the general disclosure of relevant risks and the firm's risk management policy: "Enterprises are encouraged to present, outside the financial statements, a financial review by management which describes and explains the main features of the enterprise's financial performance and financial position and the principal uncertainties it faces. Such a report may include a review of: (a) the main factors and influences determining performance, including changes in the environment in which the enterprise operates, the enterprise's response to those changes and their effect, and the enterprise's policy for investment to maintain and enhance performance, including its dividend policy; (b) the enterprise's sources of funding, the policy on gearing and its risk management policies; and (c) the strengths and resources of the enterprise whose value is not reflected in the balance sheet under International Accounting Standards."

Authorisation or permits. Sometimes the existence of acceptable risk management policies is a condition of obtaining government authorisation of permits. Such requirements are most likely to be applied in business areas in which business failure would be likely to have an unusually large impact outside the firm. They are common in banking regulation,[128] insurance regulation,[129] the regulation of investment firms and regulated markets,[130] and the regulation of payment systems.[131]

Member States' laws. Generally, Member States' national laws do not require companies to disclose their risk management policies. Companies that apply IFRS must disclose some information according to IFRS 7 and are recommended to disclose more information under IAS 1.8. Regulated industries can be subject to a duty to disclose information about risk management policies to competent authorities.

7.6.7 The Contents of Risk Management Policies

In addition to disclosure rules, there are also substantive rules on the content of risk management policies. Substantive rules can regulate corporate actions or the organisation of risk management. Substantive rules are often disguised as disclosure rules, rules on duty of care, or liability rules.

For example, the disclosure rules set out in Section 404 of the Sarbanes-Oxley Act in effect require management to establish and maintain "an adequate internal control structure and procedures for financial reporting", the contents of which are defined by the SEC.[132] The rules of the SEC in effect require internal controls that are "effective" and contain no "ma-

[128] Article 22 of Directive 2006/48/EC (Capital Requirements Directive).

[129] Articles 8 and 10(3) of Directive 2002/83/EC (Directive concerning life assurance).

[130] Articles 13 and 39 of Directive 2004/39/EC (MiFID).

[131] See Articles 5 and 10 of Directive 2007/64/EC (Directive on payment services).

[132] Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, http://www.sec.gov/rules/final/33–8238.htm.

terial weaknesses". Management must use a suitable, recognised control framework to evaluate the effectiveness of internal control over financial reporting.

Duty of care. As discussed above, board members and managers owe a general duty of care to the company. Effective compliance programmes and effective risk management policies help them to mitigate potential liability for breach of duty.

Rules on duty of care tend to be open. Their exact contents can usually be determined only after the fact by the court, supervisory authorities, or similar bodies.

Member States laws. In addition to the general duty of care, Member States' laws can contain particular rules on the content of risk management policies. However, such particular rules on the content of risk management policies must be very general indeed. This can be explained by the nature of risk management. Any corporate activity gives rise to multiple risks, but the particular risks to which the firm is exposed are largely firm-specific, and balancing risk and cash flow is at the core of the firm's business. One would therefore assume that decisions on the contents of the firm's risk management policies must necessarily be governed by the business judgment rule.

For example, neither the board of a company nor its executives can have a general duty to take out insurance protection against risks.[133] In some companies, members of the board or executives may nevertheless have a duty to take out an insurance policy as part of due care. For example, where all riding clubs always take out a certain insurance policy in order to manage risk, failure to do so may amount to breach of due care.[134] On the other hand, failure to obtain commercial credit insurance protection will not generally be regarded as breach of a person's duty of care[135] as the risk can be acceptable or there can be alternative ways to manage it. Depending on the governing law, the board may be responsible for deciding on questions of strategic risk management and have a duty to ensure that the company has a risk management policy, a risk management organisation, and a body monitoring both the policy and the organisation.

Germany. In Germany, the management board (Vorstand) of an AG is required to ensure appropriate risk management within the company as part of its general duty of care.[136] The management board must also establish an internal monitoring system and take other action that makes it possible to "detect at an early stage developments that endanger the existence of the company".[137]

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[133] See nevertheless Koch R, Geschäftsleiterpflicht zur Sicherstellung risikoadäqueten Versicherungsschutzes, ZGR 2/2006 pp 184–212. Koch argues that the management has a duty to ensure that the company has adequate insurance protection.

[134] For German law, see BGH NJW-RR 1986, 572, 574 ("Tierhalterhaftpflichtversicherung"), § 833 BGB and § 27(3) BGB.

[135] For German law, see OLG Zweibrücken NZG 1999, 506. See Koch R, Geschäftsleiterpflicht zur Sicherstellung risikoadäqueten Versicherungsschutzes, ZGR 2/2006 pp 187–188.

[136] § 93(1) AktG.

[137] § 91(2) AktG inserted by the KonTraG: "Der Vorstand hat geeignete Maßnahmen zu treffen, insbesondere ein Überwachungssystem einzurichten, damit den Fortbestand der Gesellschaft gefährdende Entwicklungen früh erkannt werden."

German company law (in particular, the KonTraG) is not very specific about the contents of risk management policies. They have been left to the discretion of the management board. German company law therefore does not prevent the board from establishing risk management policies that comply with the risk management provisions of the Sarbanes-Oxley Act. The German Corporate Governance Code only repeats the statutory duty: "The Management Board ensures appropriate risk management and risk controlling in the enterprise". [138]

As rules on the content of risk management policies are complemented by disclosure rules, the risk management policies adopted by the management board must provide an improved "true and fair view" on the financial situation of the firm and enable the management board to comply with its other duties to disclose risk related information to the public[139] or the supervisory board.[140]

The rules on the disclosure of risk are quite detailed.[141] Similar rules and recommendations can be found in England.

England. In the past, the general contents of risk management policies were largely regulated by means of recommendations. The Combined Code requires companies to evaluate the effectiveness of their controls.

Section 1 of the Combined Code requires that the board should maintain a "sound system of internal control" to safeguard shareholders' investment and the company's assets (C.2). According to the Code, the board should, at least annually, conduct a review of the effectiveness of the group's system of internal controls and should report to shareholders that they have done so. The review should cover all material controls, including financial, operational and compliance controls and risk management systems (C.2.1).

Guidance for companies on how this should be approached can be found in the Turnbull Guidance published in September 1999 and revised in 2005.[142] The Turnbull Guidance is a SEC approved framework for management to show that they have adequate internal control structures and financial reporting procedures in place and comply with section 404 of the Sarbanes-Oxley Act.

Section 417 of the Companies Act 2006 regulates the contents of the directors' report and requires a business review that contains certain information. In the light of this disclosure requirement, the risk management policies of the company must meet certain minimum requirements:

- They must be designed to give the board of directors a true and fair view of the company's business,[143] knowledge of the principal risks and uncertainties fa-

[138] Section 4.1.4 of the German Corporate Governanc e Code.
[139] See § 289 HGB.
[140] See § 90 AktG.
[141] § 90 AktG and § 289 HGB.
[142] Internal Control: Guidance for Directors on the Combined Code.
[143] Section 417(3)(a) of the Companies Act 2006.

cing the company,[144] and an understanding of the development, performance or position of the company's business.[145]

- There should be a balanced and comprehensive analysis of the development and performance of the company's business during the financial year, and the position of the company's business at the end of that year, consistent with the size and complexity of the business.[146]
- The analysis should cover the main trends and factors likely to affect the future development, performance and position of the company's business.[147]
- The analysis should cover environmental matters (including the impact of the company's business on the environment), the company's employees, and social and community issues, including any policies of the company in relation to those matters and the effectiveness of those policies.[148]
- The analysis should cover "key performance indicators", i.e. factors by reference to which the development, performance or position of the company's business can be measured effectively.[149]
- The analysis should cover financial key performance indicators.[150]
- The analysis should cover other key performance indicators, including information relating to environmental matters and employee matters.[151]

In a listed company, the board should, at least annually, conduct a review of the effectiveness of the whole group's system of internal controls. The review should cover all material controls, including financial, operational and compliance controls and risk management systems.[152] For groups of companies, the review of effectiveness of internal control and the report to the shareholders should be from the perspective of the group as a whole.[153] The board of a listed parent company should ensure that there is adequate cooperation within the group (and with internal and external auditors of individual companies within the group) to enable the parent company audit committee to discharge its responsibilities effectively.[154]

Audit committee. The Directive on statutory audits requires each "public-interest entity" such as a company whose shares have been admitted to trading on a regulated market to have an audit committee (section 9.3.4; for organisational requirements according to the MiFID, see section 7.6.5).

According to the main rule, the audit committee has a monitoring role. The audit committee shall: "(a) monitor the financial reporting process; (b) monitor the

[144] Section 417(3)(b) of the Companies Act 2006.
[145] Section 417(5) of the Companies Act 2006.
[146] Section 417(4) of the Companies Act 2006.
[147] Section 417(5)(a) of the Companies Act 2006.
[148] Section 417(5)(b) of the Companies Act 2006.
[149] Section 417(6) of the Companies Act 2006.
[150] Section 417(6)(a) of the Companies Act 2006.
[151] Section 417(6)(b) of the Companies Act 2006.
[152] The Combined Code, Provision C.2.1.
[153] The Turnbull Guidance, paragraphs 3 and 14.
[154] The Smith Guidance, paragraph 1.12.

effectiveness of the company's internal control, internal audit where applicable, and risk management systems; (c) monitor the statutory audit of the annual and consolidated accounts; and (d) review and monitor the independence of the statutory auditor or audit firm, and in particular the provision of additional services to the audited entity."[155]

However, this rule is optional depending on the structure of the statutory board. Member States do not have to apply it "to any public-interest entity that has a body performing equivalent functions to an audit committee, established and functioning according to provisions in place in the Member State in which the entity to be audited is registered".[156]

Furthermore, the rule on audit committees is "without prejudice to the responsibility of the members of the administrative, management or supervisory bodies, or of other members who are appointed by the general meeting of shareholders of the audited entity".[157]

In other words, the use of an audit committee will not limit the duties of the members of the supervisory board of a German AG.[158] It is still open whether the Directive on statutory audits will mean that the monitoring duties of the supervisory board will be increased. In the past, the management board has played a central role in risk management (see above).[159] According to the Directive on statutory audits, either the audit committee or the members of a body whose members are appointed by the general meeting should play an active role.

Compliance in general, risk management under the MiFID. As discussed above, compliance programmes belong to the key ways to manage legal risk. The MiFID which applies to banks and other firms providing investment services requires the adoption of risk management programmes and compliance programmes.

[155] Article 41(2) of Directive 2006/43/EC (Directive on statutory audits).
[156] Article 41(5) of Directive 2006/43/EC (Directive on statutory audits). There are also optional exemptions for certain companies. See Article 41(6).
[157] Article 41(2) of Directive 2006/43/EC (Directive on statutory audits).
[158] §§ 111 and 107(3) AktG; section 5.3 of the German Corporate Covernance Code.
[159] § 91(2) AktG.

8 Agency and Corporate Governance

8.1 Introduction

The purpose of this book is to study corporate finance law from the perspective of the *firm*. As discussed earlier in this book, there is always a risk that the firm's agents will not act in the interests of the firm. The management of agency relationships is therefore an important part of the firm's risk management. The management of agency also plays an important role in corporate governance. This chapter will discuss how company laws regard the firm as the most important principal whose interests managers have a legal duty to further.

Traditional views. The question of corporate governance is connected with theories about the firm. In the wake of Ronald Coase's seminal piece on the nature of the firm, the literature on this question has developed along three main paths, each of which focuses on a different aspect of organising productive activities: the principal-agent problem; the property rights approach;[1] and the team production approach.[2]

As regards principal-agency relationships, traditional views about corporate governance usually support either a stakeholder-oriented model (the principles said to be found in Germany and Japan) or a shareholder-oriented model (the Anglo-American model).[3]

Mainstream view. Adolph Berle and Gardiner Means found in 1932 that the separation of the ownership and control of large US firms allowed managers considerable discretion.

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[1] See Aglietta M, Rebérioux A, Corporate Governance Adrift. A Critique of Shareholder Value. The Saint-Gobain Centre for Economic Studies Series. Edward Elgar, Cheltenham Northampton (2005) p 28: "Pioneered by the work of Coase (1960), and later developed by Demsetz (1967), Alchian (1969), Furubotn and Pejovic (1972), [the property rights theory] set out to modify the neoclassical framework by connecting all behaviour to the property rights system, while accounting for transaction costs."

[2] Blair MM, Stout LA, A Team Production Theory of Corporate Law, Virg L R 85 (1999) pp 257–258.

[3] See Ireland P, Company Law and the Myth of Shareholder Ownership, Modern L R 62(1) (1999) p 32.

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Since Berle and Means, the management of agency problems has been the core topic in corporate governance, with shareholders as the main principal and management as their main agent (the shareholder primacy model).[4]

Economists have identified numerous areas of potential conflict between managers and "owners" in large firms. They can be grouped into four categories: insufficient effort; extravagant investments; entrenchment strategies (actions that are costly to shareholders and make it harder to remove managers); and self-dealing (from legally consuming perks to promoting friends or even outright theft).[5]

The mainstream view is complemented by the positive agency theory according to which the duty of the board of directors is to guarantee the quality of managers' services.[6]

The mainstream corporate governance studies have usually focused on large listed firms. This can partly be explained by practical reasons: there is less variation between the governance models of such firms; information about the price of their shares is easily accessible; and SMEs are more difficult to study.

According to Sumantra Ghoshal, the mainstream view of shareholders as "owners" and managers as their agents can be explained by the fact that this assumption helps in structuring and solving nice mathematical models.[7]

One can therefore say that the mainstream view is mechanistic and narrow: shareholders basically have no particular function in the firm apart from being "owners"; the objective of the firm is reduced to maximising the utility of the group of shareholders; managers are assumed to act selfish and to do everything in their power to misappropriate value (hypothesis of opportunism); and shareholders are expected to ensure that incentive contracts are signed in order to reduce such conflicts of interest to the lowest possible level.[8]

Problems. The mainstream view nevertheless gives rise to several problems. In addition to Sumantra Ghoshal's critique of the choice of shareholders as principals,[9] the following comments can be made: the mainstream view is too narrow; it does not explain the role of shareholders; shareholders do not share the same interests inter se; and shareholder value cannot be used as a basis for performance measurement internally.

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[4] See, for example, Tirole J, The Theory of Corporate Finance. Princeton U P, Princeton and Oxford (2006) p 15; Blair MM, Stout LA, A Team Production Theory of Corporate Law, Virg L R 85 (1999) pp 262–263.

[5] Tirole J, The Theory of Corporate Finance. Princeton U P, Princeton (2006) pp 16–17.

[6] See Aglietta M, Rebérioux A, Corporate Governance Adrift. A Critique of Shareholder Value. The Saint-Gobain Centre for Economic Studies Series. Edward Elgar, Cheltenham Northampton (2005) p 31.

[7] Ghoshal S, Bad Management Theories Are Destroying Good Management Practices, Academy of Management Learning & Education, Vol 4/1 (2005) pp 75–91.

[8] For a description of the mainstream view, see, for example, Ireland P, Shareholder Primacy and the Distribution of Wealth, Modern L R 68(1) (2005) p 49 (critical view); Hansmann H, Kraakman R, The End of History for Corporate Law, Georgetown L J 89 (2001) pp 439–441 (mainstream view).

[9] Ghoshal S, *op cit*.

Too narrow. The nice mathematical models ignore several fundamental problems. What model should you apply in situations in which part of the "agent's" job is to figure out what needs to be done? How do you get the mainstream "principal" to perform her end of the deal?[10] And finally, what is the function of shareholders in the first place?

The role of shareholders. The mainstream view does not explain the company law duties of shareholders. Neither does it explain their company law rights. Generally, it does not explain the main function of shareholders. The main function of shareholders cannot be that of being residual claimants.

For example, the main function of shareholders during the life of the company cannot be that of being residual claimants that have some sort of rights at the end of a company's life, whenever that may be. The company can exist for hundreds of years, but a company is liquidated only once.

The company law rights and duties of shareholders can only be explained if shareholders are not regarded as principals but are regarded as *agents* with an important function in the governance of the company during its life (see below).

One can say that the focus on investors or shareholders as the main principal in corporate governance has meant that scholars have failed to identify key agency relationships without which the nature of company law cannot be understood properly.

The interests of shareholders. The interests of shareholders as a class are a fiction because: shareholders can have different interests; shareholders can prefer to profit from the firm in different ways; the importance of different shareholder categories can change over time; and the preferences of the same shareholders can change over time.

If the interests of shareholders are a fiction, one can take the high-level objectives and goals to which that fiction leads, provided that they are reasonable (like long-term profitability), and stop using the interests of fictive shareholders as an argument.

Furthermore, not even the advocates of the shareholder-oriented model believe that the company would be able to neglect the interests of other stakeholders.[11] The shareholder-oriented model thus does not exist in its purest form.

Performance measurement. Internally, the firm needs a clear basis for the measurement of performance and financial decision-making. A conflict between internal performance measurement and the measurement of the performance of the organisation as a whole would not make any sense in the long run.

Firms have so far applied advanced methods of internal performance measurement such as Discounted Cash-flow (DCF), Cash-flow Return on Investment (CFROI), Cash Value Added (CVA), or Economic Value Added (EVA). Whereas these advanced methods are applied in a systematic way, in practice the meaning

[10] Blair MM, Stout LA, A Team Production Theory of Corporate Law, Virg L R 85 (1999) p 259.

[11] See Ireland P, Company Law and the Myth of Shareholder Ownership, Modern L R 62(1) (1999) p 53.

of shareholder-orientation is vague and unclear. In the real economy, methods of internal performance measurement are more important as a management tool.[12]

Other critical views. There have been other critical views in the past. Generally, one can say that there have been attempts to design a more holistic view of corporate governance.

Some have advocated the adoption of the *stakeholding* conception of the company[13] or advocate a "*socially responsible* corporation" which consciously makes decisions that reduce overall profits.[14] According to the French "*institutional theory of the firm*" (théorie institutionelle de l'entreprise),[15] the firm displays the characteristics of an institution: it is autonomous in relation to its members, and its objective defined by its management must be to satisfy the general interest: "the common good of all the people who cooperate in the firm".[16] The *team production* theory is a similar theory. According to this theory, "boards exist not to protect shareholders per se, but to protect the enterprise-specific investments of all the members of the corporate team, including shareholders, managers, rank and file employees, and possibly other groups, such as creditors".[17] Even others have mentioned the *independent business interest* of the company.[18] Some have defined the interest of the corporation as its *long-term success* as a business enterprise.[19]

The firm as principal. However, there do not seem to be views according to which *the firm* is and should be regarded as the most important principal, distinct from the company's stakeholders.

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[12] See also Guerrera F, Welch condemns share price focus, FT.com, 12 March 2009: "Jack Welch, who is regarded as the father of the 'shareholder value' movement that has dominated the corporate world for more than 20 years, has said it was 'a dumb idea' for executives to focus so heavily on quarterly profits and share price gains … 'On the face of it, shareholder value is the dumbest idea in the world,' he said. 'Shareholder value is a result, not a strategy … Your main constituencies are your employees, your customers and your products."

[13] See Kay J, Silberston A, Corporate Governance, National Institute Economic Review 84 (August 1995) pp 84, 86–91. Cited in Ireland P, Company Law and the Myth of Shareholder Ownership, Modern L R 62(1) (1999) pp 51–52.

[14] So defined by Tirole J, The Theory of Corporate Finance. Princeton U P, Princeton and Oxford (2006) p 58.

[15] See Aglietta M, Rebérioux A, Corporate Governance Adrift. A Critique of Shareholder Value. The Saint-Gobain Centre for Economic Studies Series. Edward Elgar, Cheltenham Northampton (2005) pp 41–43.

[16] Ripert G, Aspect juridique du capitalisme moderne. Paris, LGDJ (1951), cited in Aglietta M, Rebérioux A, Corporate Governance Adrift. A Critique of Shareholder Value. The Saint-Gobain Centre for Economic Studies Series. Edward Elgar, Cheltenham Northampton (2005) pp 42–43.

[17] Blair MM, Stout LA, A Team Production Theory of Corporate Law, Virg L R 85 (1999) p 253.

[18] Kay J, Silberston A, Corporate Governance, National Institute Economic Review 84 (August 1995) p 91; John Kay, The Stakeholder Corporation, in Kelly et al (eds), Stakeholder Capitalism. Macmillan, London (1997) p 132.

[19] Lipton M, Rosenblum S, A New System of Corporate Governance, Chic L R 58 (1991) pp 187–253 at p 189.

From a legal perspective, this is surprising. It is quite clear that a limited-liability company's board members and managers owe their general legally enforceable duties first and foremost to the company. It is not new to define the interests of the company as those of the firm. For example, the doctrine of *Unternehmensinteresse* ("the interest of the business enterprise") is regarded as self-evident in German company law.[20] The *intérêt social* ("the interests of the association") is a similar doctrine in French company law. In a market economy, one cannot exclude the possibility that the existence of such legal rules is based on rational legislative choices and designed to reflect the reasonable default behaviour of most market participants. It would therefore have been possible to try to align the agency theory with existing laws. However, such attempts do not seem to have been made – on the contrary, there have been numerous attempts to align existing laws with the mainstream view.

As will be discussed in this chapter, many problems can be solved if board members and managers are regarded as having a legally enforceable duty to further the interests of the firm (rather than the interests of some stakeholders like shareholders or all stakeholders).

The law. The mere fact that the choice of the firm as the principal cannot be elegantly modelled by present-day economists should be irrelevant in the context of company law and normative legal rules in general. Whereas laws are normative, economic theories are not.

From a legal perspective, it is particularly wrong to assume that shareholders "own" the firm. The separate legal personality of a limited-liability company and the limited liability of shareholders for its obligations of the company mean exactly the opposite. Like any stakeholders, shareholders have only limited enforceable rights against the company. Although shareholders typically have a right to the residual cash flows of the company, even those rights are extremely limited in the legal sense and the actual making of payments to shareholders during the life of the company depends on many internal choices made by the firm.

There is a wide range of questions that must be addressed by legal means in the context of corporate governance. Basically, they have absolutely nothing to do with the agency theory.

At the most fundamental level, these questions are caused by the very *nature* of companies, in particular by the need of firms to have a *legal form* and an *organisation*.[21] These questions must be addressed not only in large listed limited-

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[20] This rule was originally based on the Aktiengesetz of 1937. According to § 70, the management board had to manage the company "wie das Wohl des Betriebes und seiner Gefolgschaft und der gemeine Nutzen von Volk und Reich es erfordern". See, for example, Loewenstein MJ, Stakeholder protection in Germany and Japan, Tul L Rev 76 (2002) p 1676. The earlier codification of the duty to act in the interests of the firm was dropped in the 1965 company law reform, because it was regarded as obvious. Although there is no similar express provision in the present Aktiengesetz, this rule applies as a general uncodified principle.

[21] Mäntysaari P, Comparative Corporate Governance. Shareholders as a Rule-maker. Springer, Berlin Heidelberg (2005) pp 16–18, 30–33.

liability companies but also in small firms and non-profit organisations not incorporated as companies.

Agency relationships. Regardless of the legal regulation, the firm, in practice, will have to manage agency relationships.

The firm needs to manage them as the principal. For example, its contract parties can be regarded as agents (see Volume II). The following agency relationships are particularly important in corporate governance. The agency relationship: (a) between the firm as principal and shareholders as the agent; (b) between the firm as principal and banks as the agent; (c) between the firm as principal and any stakeholders with a monitoring role as the agent; and (d) between the firm as principal and management as the agent.

Again, from the perspective of the firm, the firm may need to manage the agency relationship where investors and stakeholders regard the firm or its executives as their agents. For instance, this will happen in all contracts which the firm will conclude with third parties (Volume II).

The firm. When the *firm* is regarded as the most important principal, the role of corporate bodies can be seen in a new light.

While each stakeholder may further its own interests, somebody should further the interests of the firm. Because of obvious conflicts of interests, there are decisions which cannot be left to the discretion of shareholders or other stakeholders.

When the firm is regarded as the most important principal, the separation of residual risk bearing from decision functions (also called the separation of "ownership" and "control") is not the fundamental cause of corporate governance problems. In this book, the separation or combination of ownership of shares and control is regarded as an answer to certain corporate governance problems rather than as their fundamental cause.

In fact, the separation of ownership and control cannot be the fundamental cause of corporate governance problems, because those two things have not been separated in most firms of the world (most firms are SMEs) and it would be too much to say that most firms in the world do not face any corporate governance problems. Furthermore, some legal entities are foundations, associations, or non-profit organisations which lack residual risk bearers that would resemble shareholders in for-profit firms.[22]

About this chapter. The next topic discussed in this chapter is how three-level choices can lead to a new theory of corporate governance. This can help to define corporate governance in a broader way. For example, it will be argued that the separation of "ownership" and "control" is not the fundamental cause of corporate governance problems.

This will be followed by sections on the role of the board and the function of shareholders. There is a rather general section on the management of agency relationships in corporate governance and an introduction to the regulation of those issues in Community law.

[22] Hansmann H, The Role of Nonprofit Enterprise, Yale L J 89 (1980) pp 835–902.

The final sections of this chapter will discuss the corporate governance tools of controlling shareholders and those of non-controlling shareholders as well as outsourcing as a corporate governance tool.

8.2 Three-level Choices, Theory of Corporate Governance

8.2.1 General Remarks

In the regulation of corporate governance, one first has to answer preliminary questions at three levels. The first question relates to what is rational (Zweckrationalität). The second and third questions relate to what is reasonable (Wertrationalität).

First level. There are things that must be addressed by the firm and the rule-maker because of the fundamental nature of limited-liability companies. A limited-liability company (1) is an artificial person that (2) has an organisation. (3) The real organisation of the firm is not usually the organisation held out by the firm as its organisation for legal purposes.

Similar questions must be addressed in any other business forms and legal entities. "Corporate" governance is thus not limited to corporations or the large listed corporations studied by Berle and Means.

At the first level, the firm must thus address questions relating to the firm's relationship with its stakeholders or to its internal organisation. That these questions exist has nothing to do with the agency theory.

Second level. The agency theory can nevertheless become useful at the second level. It remains open whose interests one should further when regulating the first level questions. The second level choice is the choice of the principal or principals. Most people would choose shareholders as the most important principal. In this book, the firm is the most important principal.

Third level. At the third level, one should define the interests of the most important principal. Those who choose shareholders as the most important principal would perhaps choose profit maximation. In this book, the firm's own long-term survival is the highest objective of the firm.

Fourth level. One can also add a fourth level. At the fourth level, one can design answers to specific first level questions in the light of the interests of the principal.

Definition of Corporate Governance Law. One can here define the law of corporate governance as a field of law which, for the purpose of ensuring the long-term survival of firms in a competitive environment, addresses fundamental legal questions caused by separate legal personality and the existence of business organisations. As this definition does not result from the separation of ownership and control, it can be regarded as a departure from the research path started by Berle and Means. – These questions will now be developed further.

8.2.2 First Level, Artificial Person

Many corporate governance rules are necessary in a limited-liability company because the company is an artificial person.

To whom do assets linked to the company belong? Some form of "asset partitioning" is necessary. It is necessary to designate a separate pool of assets that are associated with the company, and that are distinct from the personal assets of the company's shareholders and managers. The second component of asset partitioning is the assignment of rights in this distinct pool of assets.[23] The assets of a limited-liability company do not belong to the shareholders in their capacity as shareholders; only shares do.

Who is to be regarded as acting as or on behalf of the company? A company cannot act on its own in the physical sense. Somebody must represent it by taking care of its internal decision-making, somebody must represent it in its dealings with company outsiders (such as customers, suppliers and persons providing finance) and company insiders (such as organ members, directors, managers, employees and shareholders) and somebody must represent it by taking care of its internal supervision and control. A company must have an organisation if it is to carry out business.

How should the persons acting as or on behalf of the company act? It may be necessary to make these persons act in a certain way. For example, it may be necessary to prevent *internal* abuse and waste (abuse and waste in relation to the company itself), *derivative* abuse and waste (internal abuse and waste which affect stakeholders and society as a whole), *stakeholder* abuse and waste (abuse and waste in relation to the various stakeholders), and *general* abuse and waste (abuse and waste in relation to the society as a whole). There are rules telling these persons what to do and what not to do. In addition to clear rules or general standards, one of the legislative strategies dealing with this problem is to set out in whose interests these persons must act.

How should the various stakeholders act? It may also be necessary to make stakeholders act in a certain way. Even their behaviour must be modified.

How are these persons and stakeholders motivated? The self-interest of all these parties may not always lead them to act in the desired way. Managers, employees, board members, shareholders, creditors, suppliers, and other parties will not provide the resources that the company needs and will not further its interests unless they are motivated to do so.

Motivation is affected by legal matters (such as legal corporate governance norms) and non-legal matters (such as societal values and corporate culture) as well as monetary and non-monetary issues (which range from those that are aligned with the interests of the company to neutral ones and those that are contrary to the interests of the company). Motivation can be influenced both at an individual and direct level as well as on an organisational and indirect level.

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[23] See Hansmann H, Kraakman R, The Essential Role of Organizational Law, Yale L J 110 (2000) pp 392–393; Fleischer H, Gesetz und Vertrag als alternative Problemlösungsmodelle im Gesellschaftsrecht, ZHR 168 (2004) p 679.

At an individual and direct level, legal corporate governance rules usually deal with monetary returns, duties, and the enforcement of sanctions. At an organisational and indirect level, motivation is affected by legal rules that are necessary because of the organisation of the firm (i.e. by rules on the allocation of power, the allocation of risk, and the distribution of information).

8.2.3 First Level, Organisation

The following types of corporate governance rules are necessary because the firm has an organisation. The most fundamental of these rules relate to the allocation of power, allocation of risk and distribution of information.

How is power allocated in a limited-liability company? Many people and other parties may act as or on behalf of the company in some way but somebody must (a) actually run the company (formulate and decide on the company's policy; decide on the organisation of the firm; put the company's policy into effect and carry it out; and enter into related contracts with third parties on behalf of the company);[24] (b) appoint the persons who run the company; (c) monitor the persons who run the company; and (d) provide information to shareholders and other stakeholders to enable them to act in a rational way.

How is risk allocated in a limited-liability company? Risk can be allocated in many ways between the company, its stakeholders, and company representatives acting as, or on behalf of, the company. Power and risk do not necessarily coincide.[25] For example, employees risk losing the social capital they have invested in the company; however, their chances of influencing the most important decisions of the company may be very limited.

As regards the regulation of the risk exposure of company representatives acting as, or on behalf of, the company and the risk exposure of its stakeholders, legal duties and the existence of remedies for breach of duty or otherwise go hand in hand. Without effective remedies for breach of duty or otherwise, the risk exposure of a party is limited, in spite of the existence of legal or other duties.

How is information distributed and disclosed in a limited-liability company? In a public company, the flow of information is important in four respects. First, it is important to persons who act as or on behalf of the company because it enables them to take decisions on a rational basis. Second, investors and other stakeholders also need to make decisions on a rational basis. For example, the disclosure of information is necessary in order to facilitate external financing and the efficient allocation of resources through external capital markets. Third, the flow of information is closely connected with how the governance of companies is monitored and how effective different monitoring systems are. There can be either proximity or objectivity in monitoring, but only well informed monitors perform

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[24] Davies PL, Gower's Principles of Modern Company Law, sixth edition (1997) p 178.

[25] See, for example, Easterbrook FH, Fischel DR, The Economic Structure of Corporate Law (1991) pp 29–30, 37 and 53; Ong DM, The Impact of Environmental Law on Corporate Governance, EJIL 12 (2001) pp 702–707.

well.[26] Fourth, the flow of information is connected with the observability of the actions of managers and employees. While limited observability is a source of motivation problems, increased observability makes it possible to motivate them.[27]

8.2.4 First Level, Legal Organisation v Real Organisation

The same questions must be addressed in company groups and networks. Furthermore, the legal organisation of the firm is not necessarily the same as its real or relational organisation.

How are those questions answered in company groups and networks? When the firm consists of several legally independent companies, there is a potential conflict between the firm's functional organisation and the regulation of its legal organisation, between functional asset partitioning and the regulation of the firm's legal asset partitioning, and so forth. The firm can benefit from the legal rules. For example, incorporation is one of the key risk management tools in the law of corporate finance. On the other hand, legal requirements can also increase costs and make it more difficult to manage a fleet of companies as one business undertaking.

How are the firm's legal organisation and its real organisation different? It is necessary to distinguish between different organisations: the organisation held out by the firm as its formal organisation v its internal formal organisation; and the firm's formal organisation v its de facto organisation.

In principle, those organisations could sometimes be the same. For example, a listed company must have a legal organisation under the applicable company laws. That legal organisation might be the organisation held out by the firm as its formal organisation, the formal organisation the firm uses internally, and its real (de facto) organisation. Furthermore, a listed company must disclose its corporate governance structure according to the applicable securities markets rules,[28] and that information might sometimes be accurate.

Such firms are nevertheless the rare exception. An extreme example of an organisation functioning in a completely different way is the organisation of a Chicago-style mafia family in the 1920s and 1930s. A mafia family had a legal front that was operated by dummies. A network of people and organisations existed behind the legal front. The ultimate decision-making power was vested in a person who functioned as a godfather. Brokers allocated resources in the network, dis-

[26] Boot AWA, Macey JR, The Role of Objectivity, Proximity and Adaptability in Corporate Governance, Cornell L Rev 89 (2004) pp 357–358: "Monitors are crucial to effective corporate governance and assume a variety of forms: directors, auditors, credit-rating agencies, stock market analysts, takeover firms, arbitrageurs, large shareholders, and outside lenders. Even customers and suppliers act as monitors when they exercise their ability to observe management quality and to send effective signals to the market about management's performance."

[27] See Roberts J, The Modern Firm. OUP, Oxford (2004) pp 123–128, 135–137 and 161.

[28] See, for example, recitals 10 and 11 and Article 1(7) of Directive 2006/46/EC.

tributed information, and took care of contacts with similar networks. Warlords were responsible for enforcement and violence.[29]

The organisations of most firms tend to contain elements of both of those two extremes. It is difficult or not possible to describe in detail the enormously complex legal, economic, and social issues related to the governance of large companies. For example, the real function of the board can depend on the charisma and de facto power of the CEO, among other things, and having a controlling shareholder means that a certain shareholder can exercise de facto powers regardless of the formal distribution of power in the company.

8.2.5 Second Level, the Firm as the Principal

One of the key corporate governance rules in company law is the rule that sets out in whose interests board members and managers must act. Must they act in the interests of shareholders or somebody else?

To begin with, law and economics are not the same thing. Law is normative, whereas economics is not. There are legal sanctions for board members and managers who fail to live up to legal expectations, but failure to comply with a textbook in economics or an economic theory will not trigger any enforceable legal sanctions as such.

For this reason, there is a distinction between the legal duties of board members and managers on the one hand, and the agency theory on the other. Only the former are normative. The agency theory is not. The agency theory can nevertheless help to understand normative issues and sometimes even influence their interpretation depending on the governing law.

Aglietta and Rebérioux put it this way: "The connection of interests in the firm is codified by three sources of law: financial market, corporate and labour. Their relative influence differs greatly between the United States and continental Europe. Any serious study must therefore distinguish between the rhetoric of shareholder value and the governance principles that are actually implemented by firms. It is the legal rules underlying these principles which give each country its dominant characteristics."[30]

Now, the agency theory is capable of very wide application. Anybody can be regarded as a principal depending on the perspective. From the perspective of a shareholder, the company and its managers can be regarded as agents. From the perspective of an employee, managers and shareholders can be regarded as agents.

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[29] Welskopp T, Die im Dunkeln sieht man nicht. Systematische Überlegungen zu Netzwerken der organisierten Kriminalität am Beispiel der amerikanischen Alkoholsyndikate der Prohibitionszeit. In: Berghoff H, Südow J (eds), Unternehmerische Netzwerke. Eine historische Organisationsform mit Zukunft? Kohlhammer Verlag, Stuttgart (2007).

[30] Aglietta M, Rebérioux A, Corporate Governance Adrift. A Critique of Shareholder Value. The Saint-Gobain Centre for Economic Studies Series. Edward Elgar, Cheltenham Northampton (2005) p 75.

As the rights and duties of board members and senior executives are based on legal rules, it is obviously necessary to understand in whose interests they are expected to act according to the law. To whom are their core legal duties "owed"? Who is thus regarded as the legally relevant principal as far as these legal background rules are concerned? In company law, the choice of principal is not just a matter of ideology, philosophy, or economic theory. It can be a normative question and a question of interpretation of law. This leads us back to the nature of legal entities and the firm.

Duty to act in the interests of the company. Board members and managers owe general legal duties to the *company*. Because of the separate legal existence of a company, *somebody* should owe a duty to further its interests. Board members and managers do not owe any general legal duty to further the interests of the company's shareholders or other stakeholders directly.

The main rule is that stakeholders have a right to further their own interests and are assumed to do so. They are not legally required to delegate their powers to anybody. Many stakeholders benefit *indirectly*, when board members and managers further the interests of the company. At a general level, the existence of board members' and managers' general legal duties can increase the transparency and predictability of their behaviour. This can enable stakeholders to manage their own relationship with the company in a more effective way and to reduce transaction and monitoring costs. Stakeholders can, for example, assume that board members and managers are less likely to do things that will clearly harm the company. Furthermore, stakeholders can benefit where the company is more likely to continue as a going concern, avoid becoming insolvent, and make a profit.

Board members have a general duty to act in the interests of the company under both English and German company law.[31] (a) In a German AG, members of the two statutory boards have a duty to act in the "interests of the firm" (Unternehmensinteresse). (b) In England, the leading authority is *Percival v Wright*[32] in which it was held that directors owe duties to the company and not to individual shareholders. The duties of directors are owed to "the company as a whole". The general principle that governs the exercise of the fiduciary powers of directors was reinstated in the phrase that directors must exercise their powers "bona fide in the interests of the company" and "not for any collateral purpose" (*Re Smith & Fawcett Ltd*[33]).

It is clear that neither German nor English law prevents managers from taking into account interests that are important to the company, for example environmental considerations, the interests of creditors, and the preferences of investors. This is because stakeholders will not provide the resources that the company needs and act in the interests of the company unless they are motivated to do so. For example, employees will not work unless they get paid and like their job, investors will not invest unless they are rewarded, and the

[31] See Mäntysaari P, *op cit*, Chapter 6.

[32] Percival v Wright [1902] 2 Ch 421.

[33] Re Smith & Fawcett Ltd [1942] Ch 304, [1942] 1 All ER 542. See also Lord Wilberforce in Howard Smith v Ampol Petroleum [1974] AC 821, [1974] 1 All ER 1126 (Privy Council).

state will not support the activities of the company unless the company complies with laws.[34]

The same principles can be found in Community law. For example, the Directive on takeover bids provides that "the board of an offeree company must act in the interests of the company as a whole" (for the contents of this duty, see Volume III).[35]

Finally, similar principles can also be found in the US. In *Credit Lyonnais*,[36] the board of directors of a still solvent corporation refused to undertake a high-risk strategy that was strongly favoured by the firm's shareholders on the grounds that the strategy harmed the firm's creditors. In upholding the board's refusal, the Delaware Chancery Court observed: "[A] board of directors is not merely the agent of the residue [sic] risk bearers, but owes its duty to the corporate enterprise … [I]n managing the business affairs of a solvent corporation in the vicinity of insolvency, circumstances may arise when the right (both the efficient and the fair) course to follow for the corporation may diverge from the choice that the stockholders (or the creditors, or the employees, or any single group interested in the corporation) would make if given the opportunity to act … [The board] had an obligation to the community of interest that sustained the corporation, to exercise judgment in an informed, good faith effort to maximize the corporation's long-term wealth creating capacity."

Like in England, the status of the corporate director in the US is that of a "fiduciary". While the term "fiduciary" and the concept of fiduciary duty are widely used, precise definition of that duty is anything but clear.[37] In the US, the classic definition of the duty was stated by Layton CJ in *Guth v Loft*:[38] "While technically not trustees [the corporate directors] stand in a fiduciary relation to the corporation and its stockholders." It can therefore be said that directors stand in a fiduciary relationship to the corporation and its shareholders and have a duty to protect both (and not only the corporation). However, that principle is diluted by the business judgment rule which protects directors against liability.[39] It is presumed that in making a business decision, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interest of the company (meaning that the interests of the company prevail). According to the

[34] See, for example, Ong DM, The Impact of Environmental Law on Corporate Governance, EJIL 12 (2001) p 718; Keay A, The Duty of Directors to Take Account of Creditors' Interests: Has It Any Role to Play? JBL 2002 pp 380 and 385; Keay A, Directors Taking into Account Creditors' Interests, Comp Lawyer 24(10) (2003) pp 300–306; Micheler E, Gläubigerschutz im englischen Gesellschaftsrecht. Reformvorschläge mit Implikationen für Europa, ZGR 2004 p 329.

[35] Article 3(1)(c) of Directive 2004/25/EC (Directive on takeover bids).

[36] Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corporation, Civ. A. No. 12150, 1991 Del. Ch. LEXIS 215 (Del. Ch. Dec. 30, 1991). See Blair MM, Stout LA, A Team Production Theory of Corporate Law, Virg L R 85 (1999) pp 296 (Credit Lyonnais) and 301 (Dodge v. Ford Motor Co., 170 N.W. 668 (Mich. 1919)).

[37] Judge Frankfurter put the issue in this way in a frequently quoted passage: "But to say that a man is a fiduciary only begins analysis, it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respect has he failed to discharge these obligations? And what are the consequences of his deviation from duty?" Securities and Exchange Commission v. Chenery Corporation, 318 U.S. 80, 85–86 (1943).

[38] Guth v. Loft Inc 23 Del. Ch. 255, (1939); 5A. 2d 503 (1939).

[39] See also Blair MM, Stout LA, A Team Production Theory of Corporate Law, Virg L R 85 (1999) pp 299–300.

Unocal standard,[40] the interests of the company usually prevail over the interests of shareholders (for *Unocal*, see section 8.4 and Volume III).

In special cases, board members and managers may have a special duty to further the interests of stakeholders *directly*. Whereas duties owed by them to the company can be based either on law or contract, duties owed to the company's stakeholders tend to be based on law only. Such duties are more common in areas where the state has strong public policy objectives which have given rise to mandatory provisions of law and sanctions for non-compliance applied to people acting as, or on behalf of, the company (for compliance programmes and the management of legal risk, see section 4.3).

Interests of the company? On the other hand, the company is a legal tool and a legal fiction which has no particular interests of its own.[41] The company as a legal person may change, cease to exist or continue its existence in another form. This can be caused by external circumstances or internal decisions (for example, changes in laws) or internal decisions (such as changes in business form or mergers). No such actions can be explained by the interests of the company as an abstract legal fiction.

Therefore, it is suggested that the duties of board members and managers to act in the interests of the company are actually duties to act in the interests of the firm (Unternehmensinteresse) and enforceable by the legal person to which the firm belongs (Unternehmensträger) in the legal person's own name and on its own behalf. The firm does the doing and the legal entity is a way to keep score.

8.2.6 Third Level, the Interests of the Firm

There can be monetary interests and non-monetary interests. In this context, interests are defined in the broadest possible way. The most fundamental interest of the firm is that of its own survival. The interests of the "company" can thus be defined as the interest of the firm to survive in a competitive environment in the long term.

Obviously, firms that try to maximise their own long-term survival chances are more likely to survive than firms that have other objectives (such as maximising the share price or the benefits of a certain stakeholder category).

The mainstream view does not recognise this objective. For example, The Turner Review, which tried to explain why things went wrong in the banking sector, recommended increased shareholder discipline over corporate strategies.[42] However, giving largely short-

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[40] Unocal Corp. v. Mesa Petroleum Co., 493 A.2d at 946 (Del. 1985).

[41] Compare recital 6 of Commission Recommendation complementing Recommendations 2004/913/EC and 2005/162/EC as regards the regime for the remuneration of directors of listed companies: "The structure of directors' remuneration should promote the long term sustainability of the *company* …"

[42] FSA, The Turner Review. A regulatory respone to the global banking crisis (March 2009), Section 2.9.

term shareholders more say in questions of long-term corporate strategy would be designed to reduce the survival chances of the firm and to increase the risk of corporate failure.

The interests of the firm matter in the legal world, because the society at large has interests in the firm.[43] Most goods are produced and distributed by specialised firms. Because of industrialisation and specialisation, most people work for a firm owned by somebody else, and relatively few people are self-employed. A large part of goods produced by firms are consumed within other firms. In order to do all this, each operating firm has a business infrastructure consisting of an organisation, production technology, network of contracts, silent knowledge of employees, reputation, customer contacts, and so forth. To build this infrastructure from scratch would be expensive or impossible. In other words, it would not be possible without high transaction costs (Coase).

Therefore, the long-term survival of business organisations (firms) in a competitive environment is very important to the society at large.[44] For example, a community will not be better off if its only factory is closed and its inhabitants made redundant. The community will be better off if that organisation can survive and grow in the long term. In contrast, short-term shareholders benefit from short-term changes in share price rather than long-term changes in the company's business. Whether that factory will be closed or not, and whether the firm will have a chance to survive in the long term, is basically irrelevant to the company's short-term shareholders.

The benefits of the long-term survival of firms help to explain why all market economies must facilitate the existence of limited-liability companies distinct from their shareholders in the first place.

In England, the Combined Code on Corporate Governance reflects a different philosophy. According to the Code, "good corporate governance" is what helps a board discharge its duties in the best interests of shareholders,[45] and the performance-related elements of board

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[43] One can distinguish between the firm (Unternehmen) and the legal person chosen for its legal framework (Unternehmensträger).

[44] See also Ireland P, Company Law and the Myth of Shareholder Ownership, Modern L R 62(1) (1999) pp 52–53; Lipton M, Rosenblum S, A New System of Corporate Governance, Chic L R 58 (1991) p 187 at p 189; Kay J, Silberston A, Corporate Governance, National Institute Economic Review 84 (August 1995) p 91; John Kay, The Stakeholder Corporation, in Kelly et al (eds), Stakeholder Capitalism. Macmillan, London (1997) p 132. Ireland cites Kay: "Like many others, Kay's concern is with furthering the independent business interest of the company; with what Lipton and Rosenblum call 'the interest of the corporation in its long-term success as a business enterprise'. He therefore advocates managers who will further 'the broad purposes of the corporation, and not simply ... the financial interests of shareholders'. For him, the choice between different governance structures 'ultimately depends not on legal theory but on economic performance' and the purpose of the corporate manager should be to 'build a good business' which is internationally competitive."

[45] The Combined Code, Preamble 1.

members' remuneration should be designed to align their interests with those of shareholders.[46]

8.3 The Function of the Board

From a legal perspective, the existence and core functions of a *statutory body* consisting of one or more persons can largely be explained by the two most fundamental determinants of corporate governance (separate legal personality, organisation) and the most fundamental objective of the firm (survival). The benefits of a board-type body consisting of many people rather than one person can largely be explained by risk management and the management of agency (section 7.4). In the following, it is assumed that the statutory body is a board. While this reflects the legal requirements applicable to public limited-liability companies in Europe, a very large number of SMEs neither have nor need a board.[47]

Separate legal personality. Separate legal personality requires compliance with certain minimum formalities in relation to the state. For the sake of good order, there are even many continuing obligations in relation to the state. It must be somebody's statutory duty to comply with those minimum obligations. Such duties are typically based on detailed and *mandatory provisions* of law. The board is a statutory body designed to allocate those duties to people whose identity is known in advance. Members of the board have a duty to comply with those obligations either as a collegiate body or in their personal capacity as members of that body.[48]

Survival of the firm. Somebody should decide what should be done. In order to survive, the firm must prosper (make a profit). The firm needs a business model and a strategy. The firm will have to choose its core stakeholders. There must be allocation of value generated by the firm and allocation of risk inherent in the firm's activities between the company and the firm's stakeholders as well as between stakeholders inter se.

Now, the law cannot set out the substance of these choices in a market economy. The law can only provide that such choices should be made and require a certain procedure to be followed when making those decicisions. Clearly, somebody should have the power and a duty to decide on the most fundamental questions necessary for the survival of the firm. Company law typically allocates that power to one or more of the statutory bodies of the company, and it is meaningful to allocate it to one or more statutory bodies that have a duty to protect the inter-

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[46] The Combined Code, B.1.1.

[47] The existence of a board will not be mandatory for the European Private Company (SPE).

[48] See, for example, Article 5 of Directive 68/151/EEC (First Company Law Directive).

ests of the firm rather than to a body that does not have such duties and can do whatever it likes. It is therefore allocated to the unitary or two-tier board.[49]

As the law cannot set out the substance of the fundamental choices of the firm, the law contains very *open provisions* on the duties of the board (such as "the management of the company") and leaves plenty of discretion.[50]

For example, the managing directors (Geschäftsführer) of a German GmbH are responsible for the management (Leitung) of the company. The directors of an English limited-liability company are responsible for "the management of the affairs of the company". Under the model articles, the directors' functions are to manage the company and to use all its powers.[51]

Some of those open provisions can be in the form of very *open standards* (such as the "duty of care").

These open provisions are typically complemented by *dynamic provisions* of law, i.e. legal rules which set out how that discretion must be exercised and make the exercise of that discretion more dynamic (for open clauses and dynamic terms, see Volume II). In other words, the powers vested in the board must be given objectives.[52]

In company law, there are two basic dynamic provisions. First, there is a rule setting out whose *interests* members of the board must further. For example, in order to comply with their general company law duty of care, they should typically try to further the interests of the *firm*.[53] Second, there is a general principle according to which the purpose of a limited-liability company is to make a *profit*. If the firm prospers, it is more likely to survive in the long term.

Many dynamic provisions are in the form of *general duties*. Depending on the governing law, board members may have general fiduciary duties (like in common law countries) or a general duty of loyalty (§ 242 BGB) in addition to the general duty of care, or their duties may, in practice, be formulated by a business judgment rule which restricts the application of sanctions for breach of duty. The main rule is that such general legal duties are owed to the company (the legal person representing the firm).

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[49] For German law, see § 91(2) AktG: "Der Vorstand hat geeignete Maßnahmen zu treffen, insbesondere ein Überwachungssystem einzurichten, damit den Fortbestand der Gesellschaft gefährdende Entwicklungen früh erkannt werden."

[50] Compare Blair MM, Stout LA, A Team Production Theory of Corporate Law, Virg L R 85 (1999) p 259: "[The principal-agent analysis does not] address situations in which part of the agent's job is to figure out what needs to be done (a situation we suspect is the norm rather than the exception in most public corporations)."

[51] For German law, see § 37(1) GmbHG. For English law, see sections 215(2), 216(1) and 714(3) of the Companies Act of 2008.

[52] Aglietta M, Rebérioux A, Corporate Governance Adrift. A Critique of Shareholder Value. The Saint-Gobain Centre for Economic Studies Series. Edward Elgar, Cheltenham Northampton (2005) p 47.

[53] For problems relating to the interests of the *group*, see, for example, Mäntysaari P, Comparative Corporate Governance. Shareholders a Rule-maker. Springer, Berlin Heidelberg (2005), sections 4.8 and 5.9.

To earn the protection of the business judgment rule in the US, directors must show that a challenged decision satisfied three requirements: (1) The decision was made "on an informed basis"; (2) the directors acted "in good faith"; and (3) the directors acted "in the honest belief that the action taken was in the best interests of the company".[54] Similar principles have been adopted in the German Aktiengesetz.[55]

In the Nordic countries, the actions of all corporate bodies are constrained by almost identical prohibitions of "measures that are conducive to conferring an undue benefit to a shareholder or another person at the expense of the company of another shareholder". According to its wording, this prohibition does not prevent the corporate bodies of the company from furthering the interests of the company (the firm) at the expense of shareholders in general as much as they see fit provided that no shareholder or third party will at the same time receive an undue benefit.[56] According to another rule, the purpose of a company is "to generate profits for shareholders". However, company law cannot and does not regulate the question of how much profit a company should generate, how the profit should be generated, or when the profit should be generated.

Depending on the governing law and the company, there are usually dynamic provisions which set out particular and more *detailed duties* in the interests of the firm. Such duties may be based on legal background rules, the company's articles of association, or - directly or indirectly - external rules such as provisions of a corporate governance code that the company has a duty to comply with.

This can be illustrated by the description of the board's role according to the Combined Code. The board should: "provide entrepreneurial leadership … within a framework of prudent and effective controls which enables risk to be assessed and managed"; "set the company's strategic aims"; "ensure that the necessary financial and human resources are in place"; "review management performance"; "set the company's values and standards"; and "ensure that its obligations to its shareholders and others are met".[57]

Members of the company's board can also have a large number of *specific duties* designed to further the firm's interests or other interests. Compliance with general standards typically requires compliance with these specific duties.

Organisation. The company cannot function without an organisation. It needs people to act on its behalf. This will give rise to agency relationships between the firm and those who belong to its organisation. As said above, there are generic legal ways to *manage agency*: behaviour modification in general; the alignment of interests; monitoring and transparency; choice of agent; the use of rules and stan-

[54] Smith v Van Gorkom, 488 A.2d 858 (Del. 1985). See, for example, Blair MM, Stout LA, A Team Production Theory of Corporate Law, Virg L R 85 (1999) p 300.

[55] § 93(1) AktG.

[56] Finland: Chapter 1, section 7 of the Limited Liability Companies Act (osakeyhtiölaki 624/2006). Sweden: Chapter 7, section 47 and Chapter 8, section 41 of the Limited Liability Companies Act (Aktiebolagslag 2005:551). Norway: Chapter 5, § 21 and Chapter 6, section 28 of the Public Limited Liability Companies Act (allmennaksjeloven). Denmark: sections 63 and 80 of the Limited Liability Companies Act (lov om aktieselskaber).

[57] The Combined Code, Provision A.1, supporting principles.

dards; initiation and ratification strategies; as well as trusteeship and reward strategies.

Some decisions are so important that mere transparency is not enough. Instead, the statutory body that has a duty to act in the interests of the company may have to decide on the matter. The separation of decision management and decision control (or initiation and ratification) leads to a hierarchical system with several layers of monitors and employees and requires the board of directors to function as a high-level monitoring body.

Whereas the law can neither set out what conclusions the board of directors should draw nor lay down detailed rules on the structure of the firm, the law can partly provide for rules on the hierarchical structure of the organisation of the firm as well as rules on the required procedure of monitoring.

For example, the regulation of board structure is characteristic of the German Aktiengesetz. Furthermore, there are often public policy reasons to require a company to comply with a certain monitoring framework (see the chapter on corporate risk management, the Sarbanes-Oxley Act and the MiFID).

The board will not necessarily need to manage the firm on a day-to-day basis (unless this is caused by mandatory provisions of company law; if the company has a statutory two-tier board, the management board can be the body that actually runs the firm). Neither will the board have to initiate all important decisions. One could say that the governance of the firm is largely *self-enforcing*. On the other hand, as the board serves at the top of the pyramid of authority as the body that has a duty to further the interests of the firm, it will remain the duty of the board to ensure that the governance model of the firm indeed is self-enforcing and that the board will ratify the most important decisions.

The core components of a self-enforcing governance model include: a strong corporate culture that helps to modify the behaviour of people belonging to the organisation of the firm and align their non-monetary incentives with the interests of the firm (cultural norms);[58] structural constraints such as the separation of decision management and decision control (initiation and ratification);[59] as well as simple, bright-line rules and strong sanctions for violating the rules.[60] It should be noted that a self-enforcing governance model requires the restriction of the powers of the board and effective constraints on their use.

Under German law, the duties of members of the two-tier board have, to a very large extent, been regulated in the Aktiengesetz. While the duties and powers of the management board have been regulated by open provisions on management,[61] those of the supervisory board are more specific in order to ensure that there is effective separation of management and

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58 Compare Black B, Kraakman R, A Self-Enforcing Model of Corporate Law, Harv L R 109 (1996) p 1928.
59 Compare *ibid* p 1933.
60 Compare *ibid* p 1934.
61 § 76(1) AktG.

supervision and to prevent the supervisory body from managing the firm.[62] The German Corporate Governance Code reflects the mandatory statutory provisions.[63]

There can be a difference between formal and de facto powers regardless of the jurisdiction. Management may not have the formal rights to decide on core questions of stakeholder structure, shareholder structure, and funding mix. However, as management has superior information, it has substantial real control over such decisions. The board will nevertheless decide on such questions. Management has de facto power to initiate the decision-making and submit proposals.[64]

A self-enforcing governance model becomes even more important where the firm does not have shareholders (foundations, mutual insurance companies, NGOs, state-owned universities, and many other organisations can exist without shareholders). In such a case, shareholders in general meeting cannot be used as a last resort to avoid self-dealing or dead-lock situations. If shareholders do not exist, another body should have those functions. Furthermore, it becomes even more necessary to use two-tier structures and vest initiation and ratification rights in different bodies.

There is an agency relationship between the board and the firm. Usual ways to manage agency relationships and usual components of a corporate risk management policy will therefore be applied to the board as a whole and individual board members (see the chapters on the management of agency and corporate risk management). Again, the regulation of the board should preferably be self-enforcing (see above), and it should support a strong corporate culture and a high ethical standard.[65]

Different models have been adopted in Germany and the UK for the governance of public limited-liability companies.

The German model relies on consensus-based decision-making and mixed monitoring.[66] Co-determination (Mitbestimmung) and the now diminishing role of banks as "house banks" (Hausbank) are some of the contributing factors. However, their role should not be exaggerated. Even more important is the mandatory two-tier board structure with mandatory provisions of law regulating the balance of power between the management board, the supervisory board, and the general meeting. The statutory purpose of the company – to make a profit (also called the interest of the firm or Unternehmensinteresse) – and other mandatory provisions of law add a dynamic component and tell members of each corporate body for what purpose or how they must exercise powers vested in that body. Compared with the UK model, the German model is relatively stable and self-enforcing.

In the UK, the regulation of corporate governance does not lead to a stable self-enforcing system. Instead of being self-enforcing, the UK model relies on monitoring by

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[62] § 111 AktG.

[63] For the duties of the management board, see section 4.1 of the German Corporate Governance Code. For the duties of the supervisory board, see section 5.1 of the Code. For their cooperation, see section 3 of the Code.

[64] See Tirole J, The Theory of Corporate Finance. Princeton U P, Princeton and Oxford (2006) pp 239, 368 and 399.

[65] See Blair MM, Stout LA, A Team Production Theory of Corporate Law, Virg L R 85 (1999) p 316.

[66] See Mäntysaari P, *op cit*, Chapter 6.

the market. So-called independent non-executive directors have been added to the traditional model in order to create two-tier structures inside the unitary board.

Control. The board controls the organisation of the company in the interests of the firm. Stakeholders can try to influence the board and the organisation of the company and make them further competing interests.

Sometimes company laws give stakeholders particular control or monitoring rights. Such rights are typical in three situations.

First, as the board of directors is at the top of the pyramid of authority, there may be situations where particular control rights are necessary to facilitate the separation of decision management and decision control (for organisational risk management measures, see section 7.4).

Second, there may be situations where the existence of effective sanctions requires that rules are enforced by others as monitors of monitors. In order to be effective, such enforcement rights do not have to be given to all stakeholders. Typically, shareholders may in some situations have a right to bring derivative actions.

Third, some enforcement rights can be vested in supervisory authorities or public prosecutors in order to further particular public policy objectives of the state.

Generally, however, company laws do not and should not facilitate stakeholder/shareholder control (see sections 8.7.1 and 8.7.2).

8.4 Particular Remarks: Extreme Cases

The conflict between the interests of existing stakeholders, the interests of existing shareholders, and the long-term survival of the firm becomes more serious in extreme situations ranging from hostile takeover bids (such as the one made by Microsoft for Yahoo!) and financial transactions which can endanger the existence of the company to corporate insolvency. The regulation of those situations shows that, from a legal perspective, the long-term survival of the firm (rather than the maximisation of shareholder value) is the strongest policy objective.

Hostile takeover bids. In 2008, Microsoft made a hostile takeover bid for Yahoo! Microsoft's final offer for Yahoo! was about $47.5 billion and some 70% more than Yahoo!'s market valuation at the time of the opening bid. The board of Yahoo! nevertheless rejected the bid. This reduced the market valuation of Yahoo! to $34 billion. Yahoo's board was immediately criticised by shareholder activists such as Carl Icahn who said that the board's behaviour was "irresponsible" and "unconscionable". The board's behaviour was nevertheless legally defensible.

Now, Yahoo! Inc. is a US corporation incorporated in California, but more than 50% of all US publicly-traded companies are incorporated in Delaware. The board could have reacted in the same way if Delaware law had been the governing law (or if the target had been European; see Volume III for the Directive on takeover bids).

There are three standards of judicial review of directors' decisions under Delaware law: the business judgment rule; the Unocal standard; and the Revlon test.

The basic standard is embodied in the business judgment rule. Under the traditional business judgment rule, "directors' decisions are presumed to have been made on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company".[67] Generally, the board of the target company has a right to say no to an acquisition proposal. If it does, the traditional business judgment rule will apply.

There are situations in which Delaware courts will not defer to board conduct under the traditional business judgment rule.[68] These include: the adoption of a defensive mechanism in response to an alleged threat to corporate control or policy, such as in the *Unocal* case,[69] and approval of a transaction involving a sale of control and/or a break-up of the company, as in the *Revlon* case.[70] The standards articulated by the Delaware courts in the Unocal and Revlon cases are often referred to as the Unocal standard and the Revlon test.

When directors unilaterally adopt defensive measures in reaction to a perceived threat, they carry the burden of proving that their process and conduct satisfy the enhanced Unocal standard. This standard requires that the board meet a two-pronged test. First, the board must show that it had "reasonable grounds for believing that a danger to corporate policy and effectiveness existed". This may be shown by the directors' good faith and reasonable investigation. Second, the board must show that the defensive measure chosen was "reasonable in relation to the threat posed". This may be demonstrated by the objective reasonableness of the course chosen.[71] If the directors can establish both prongs of the Unocal test, their actions receive the protections of the business judgment rule.

Transactions involving a sale of control of a corporation will also be subject to enhanced judicial review under the Revlon test. Once the directors have decided to sell control of a company, "[t]he directors' role change[s] from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company".[72] In Revlon, the Delaware Supreme Court defined directors' duty in a sale of control context as achieving the highest value reasonably available for stockholders.[73] A court will require a reasonable decision, but not a perfect decision, in this regard.

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[67] See Cole J Jr, Kirman I, Takeover Law and Practice. In: PLI, Doing Deals 2008: Understanding the Nuts & Bolts of Transactional Practice.New York City (2008) p 43, footnote 20, citing the following cases: Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1341 (Del. 1987). Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 360–61 (Del. 1993) ("Technicolor"); Pogostin v. Rice, 480 A.2d 619, 624 (Del. 1984); Aronson v. Lewis, 473 A.2d 805, 811–12 (Del. 1984); Panter v. Marshall Field & Co., 646 F.2d 271, 293–95 (7th Cir. 1981), cert. denied, 454 U.S. 1092 (1981); Treadway Cos. v. Care Corp., 638 F.2d 357, 382–83 (2d Cir. 1980); Johnson v. Trueblood, 629 F.2d 287, 292–93 (3d Cir. 1980), cert. denied, 450 U.S. 999 (1981).

[68] See Cole J Jr, Kirman I, *op cit*, pp 45–46.

[69] Unocal Corp. v. Mesa Petroleum Co., 493 A.2d at 946 (Del. 1985).

[70] Revlon Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d at 173 (Del. 1986).

[71] See Cole J Jr, Kirman I, *op cit*, p 46, citing Unocal, 493 A.2d at 955.

[72] Paramount Communications Inc. v. QVC Network, Inc., 637 A.2d at 46.

[73] See Cole J Jr, Kirman I, *op cit*, p 47, citing Revlon, 506 A.2d at 182.

However, the main rule is that the board of the target company has a right to say no to an acquisition proposal. If it does, the traditional business judgment rule will apply. The Revlon test is applied only where the target has subjected itself to Revlon duties, for example by having previously agreed to enter into an acquisition involving a change of control.[74]

Financial transactions endangering the existence of the company. In Germany, the Federal Supreme Court (Bundesgerichtshof, BGH) has in many cases recognised that a limited-liability company has a legitimate interest in its own existence and that this interest should be protected by provisions of company law.

A sole shareholder who fails to take the legitimate interests of the company into account is liable for damage sustained by the company (TBB).[75] Company law protects not only the legal capital of a company but also its existence and requires a sole shareholder to take the company's own interests into account (Bremer Vulkan).[76] For example, a sole shareholder may not endanger the existence ("existenzvernichtender Eingriff") of the company by giving its own lenders security rights in the company's assets (KBV).[77] The judgment of the BGH in KBV means that the target's company's assets cannot freely be used as security for the indebtedness of the acquisition vehicle in an LBO.[78]

Corporate insolvency. The regulation of corporate insolvency indicates that the strongest policy objective is the long-term survival of the firm.

There have been different ideas on whose interests should prevail in corporate insolvency.[79] Countries vary on the priority they give to rescue and the balance they affect between creditor and debtor interests.

According to one view, the main objective of insolvency law is to maximise the collective return to creditors. For example, Germany's Bankruptcy Act (Konkursordnung) was based on the notion of creditor wealth maximisation.

According to another view, to see insolvency as a sale of assets for creditors fails to recognise the legitimate interests of managers, suppliers, employees, and the community at large. It is therefore believed that keeping firms in operation should be an independent goal of insolvency law. For example, Chapter 11 of the United States Bankruptcy Code is a reorganisation procedure whose policy objective is strongly oriented to the avoidance of the social costs of liquidation and the retention of the corporate operation as a going concern.

In the past, bankruptcy laws across Europe did not grant companies much protection from creditors in order to restructure. A legal declaration of insolvency

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[74] As in Paramount Communications Inc. v. QVC Network, Inc., 637 A.2d 34, 46 n.17 (Del. 1994). See Cole J Jr, Kirman I, *op cit*, p 115.

[75] BGH, 29 March 1993 - II ZR 265/91, BGHZ 115,187 (TBB).

[76] BGH, 17 September 2001 - II ZR 178/99, BGHZ 149, 10 (Bremer Vulkan).

[77] BGH, 24 June 2002 - II ZR 300/00 (KBV). See also Bicker ET, Creditor Protection in the Corporate Group (July 2006). Available at SSRN.

[78] See Schrell TK, Kirchner A, Fremdfinanzierte Unternehmenskäufe nach der KBV-Entscheidung des BGH: Sicherheitenpakete als existenzvernichtender Eingriff? BB 2003 pp 1451–1456.

[79] See generally Finch V, Corporate Insolvency Law. Perspectives and Principles. Cam U P, Cambridge (2002) pp 28–29, 188–189, 195–196 and 205–207.

typically ended in liquidation. However, there is a move towards a system more like Chapter 11 even in European countries.

For example, Germany's Insolvency Act (Insolvenzordnung) that replaced the Konkursordnung in 1999 enables debtors to be reorganised under provisions modelled on Chapter 11.[80] Until the Insolvenzordnung, the only method of "reorganising" a bankrupt entity was by liquidating its assets through an asset deal.

Italy enacted what is known as the Marzano Law following the collapse of Parmalat in 2003. Until the Marzano Law, insolvency procedure in Italy didn't facilitate a "going concern" reorganisation. The new legislation sought to make the process of restructuring an insolvent firm quicker and easier.

French law on restructuring is directed towards the securing of jobs by keeping troubled firms alive. The older judicial reorganisation process (redressement judiciaire) was already described as hard on creditors. The Perben Law that came into effect in 2006 introduced an additional process that has been called the French version of Chapter 11. The new procédure de sauvegarde spéciale is applied to companies that have a large enough turnover or workforce.

The ways of rescuing a company may vary. The company may be reorganised, restructured, refinanced, downsized, subjected to sell-offs, or taken over. A distinction can be made between the company (the legal entity) and its business. Even where a company is liquidated, steps may be taken to rescue its business.[81] The long-term survival of the firm may require that either shareholders or creditors or both lose their investment (for forum shopping under Community law, see Volume II).

The US approach is more favourable to shareholders. The US Code gives the shareholders an important role in rescue proceedings. It produces an emphasis on preserving not merely the business but the troubled company itself. In addition, rescue often produces an agreed composition between the company and its creditors with the former equity owners keeping some ownership. Preservation of the company may reflect a US concern to encourage investment in entrepreneurial enterprises.

The UK approach is more favourable to creditors.[82] It has been said that UK insolvency law, faced with a conflict between risks to the company and risks to the business, will tend to opt for the route that favours the business. It is usual that the business is sold to a new owner. It is assumed that prior shareholders are at least in part to blame for the company's troubles.[83]

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[80] The number of reorganisations under the InsO used to be relatively low. However, their number can be expected to grow after high-profile cases such as the pharmacy chain Ihr Platz and the financial meltdown of 2007–2009.

[81] See Finch V, *op cit*, p 188.

[82] See Schedule B1 to Insolvency Act 1986, paragraph 3.

[83] See generally Finch V, *op cit*, pp 198 and 204.

8.5 The Function of Stakeholders

A stakeholder in an organisation is by definition any group or individual who can affect or is affected by the achievement of the organisation's objectives. From the perspective of the firm, stakeholders able to influence the achievement of the firm's objectives can be regarded as its agents (see section 9.2 below).

Most stakeholders are not altruistic but further their own interests. On the other hand, the firm can, to some extent, choose stakeholders that contribute to the achievement of its objectives. In order to motivate its stakeholders, the firm must take their interests into account.

As the firm and its managers are disciplined by the stakeholders anyway, there is no reason to lay down detailed legally enforceable rules on the relative importance of each stakeholder category.

Company laws therefore give management plenty of discretion. For example, neither German nor English law prevents board members from taking into account the interests of customers and creditors, environmental considerations, and other interests that are important to the company (see also section 8.2.5).[84]

This means that company law gives management plenty of discretion to choose between "orientation towards the long-term survival of the firm", "stakeholder-orientation", or "shareholder-orientation".

The use of management discretion can result either in a firm that is competitive and will survive for a long time, or a firm that is not competitive and will not survive. The firm is more likely to survive for a long time if it chooses whatever best serves its long-term interests.

Managers and board members can have a limited legal duty to act in the interests of shareholders or other stakeholders depending on the circumstances. (a) To begin with, they may have a duty to take the interests of non-shareholder constituencies into account when deciding how to further the interests of the company. (b) Sometimes they may have a more direct duty to act in the interests of certain stakeholders. This duty is usually based on the mandatory provisions of law.

For example, members of the management board (Vorstand) of a German AG have a duty to take into account the interests of shareholders, employees and creditors and also the public interest according to the doctrine of *Unternehmensinteresse*.

Creditors are protected by rules that tell managers and board members what to do when the company is insolvent, and rules designed to prevent the company from becoming insolvent in the first place (for the US case of *Credit Lyonnais*, see section 8.2.5).

On the other hand, all laws can, under some circumstances, influence the behaviour of companies and the managers and board members in a market economy. There is therefore a vast amount of laws and admininistrative regulatations that act as constraints to governance without regulating the governance of companies as such.[85]

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[84] See, for example, Mäntysaari P, *op cit*, Chapter 6. See also Recitals 8–9 of Commission Recommendation of 15 February 2005 on the role of non-executive or supervisory directors and on the committees of the (supervisory) board (2005/162/EC).

[85] See Mäntysaari P, *op cit*, Chapter 2.

Stakeholders are becoming increasingly important as a monitoring mechanism. For example, new rules on credit risk and ratings under Basel II require banks to monitor borrowers. Consumers of branded goods and branded services have become an important monitoring mechanism because of the value of brands as well as the emergence of a global market and global communication.

8.6 Allocation of Value and Risk

The firm would not be able survive in the long term without profitability. In order to increase its long-term survival chances, the firm should also choose an optimal stakeholder structure and give an optimal weight to the interests of each stakeholder category. The balancing of different interests means allocating value and risk.

First, the firm should of course decide what to do to generate value. It should choose its business targets and the ways to reach them. It should allocate resources (invest).

Second, the firm should decide how value generated by the firm is allocated between the firm and its stakeholders as well as between the stakeholders inter se. The firm should provide value for important stakeholders which the firm is dependent on.

Third, the same applies to risk. The firm should choose its risk level and the allocation of risk between the firm and its stakeholders as well between the stakeholders inter se (for corporate risk management, see Chapter 7).

The answer to the optimal allocation of value depends on the relative importance of each stakeholder category – shareholders, banks, customers, the workforce, and so forth. For example, the level of total shareholder remuneration and the mix of different remuneration components will depend on the relative importance of shareholders as a class and the relative importance of each shareholder category.

This can be illustrated by the US and German markets. Obviously, the growth of the share price and shareholders' income streams from the company is important to a large listed company with dispersed ownership and mostly short-term shareholders. In Germany, however, companies have traditionally relied more on banks as a source of external funding. Furthermore, it is characteristic of the German market that even large companies can be privately-owned or controlled by a large industrial or family shareholder. One can therefore espect that a greater amount of value will be allocated to shareholders in the US market than in the German market.

If shareholders are given a too large share of the value generated by the firm, other stakeholders may protest. For example, the firm's customers might move their business to competitors. This can be illustrated by the car industry. General Motors (GM) is a very large listed company. For years, it had focused on its share price and quarterly performance. On the other hand, Toyota had focused for years on its production technology (it is the world leader in its field), the quality of its products (its cars usually top the reliability surveys) and fuel consumption (it is the world leader in hybrid engines). This resulted in GM

losing customers to Toyota and other Asian and European manufacturers. In 2009, GM was a loss-making company with poor survival chances and a low share price.

Duties of the board. The allocation of value and risk between the company and its stakeholders and between stakeholders inter se (the balancing of the interests of the firm and its stakeholders) belongs to the core questions of strategy. This decision should clearly not be left to shareholders or their representatives as there can be a conflict between the interests of shareholders (many of which only have short-term interests in a large company) and the interests of the firm (which has an interest in its own long-term survival).

Company laws of different countries usually provide that questions of corporate strategy will be decided on by the statutory board rather than shareholders in general meeting, and that the distribution of funds to shareholders must normally be initiated by the statutory board (see Volume III).

In contrast, Fama and Jensen argue that the separation of decision and risk-bearing functions has survived at least in part because of the benefits of, first, specialisation of management and risk bearing and, second, a common approach to the management of agency problems caused by the separation of decision and risk-bearing functions.[86]

From a company law perspective, board decisions on the balancing of different interests are business decisions governed by the same rules as business decisions in general.

8.7 The Role of Shareholders

8.7.1 The Interests of Shareholders

Why cannot shareholders be regarded as the most important principal in company law? What is the role of shareholders? To sum up: shareholders' company law rights and obligations can only be explained if shareholders are *not* regarded as the most important principal in company law; there is no such thing as the common interests of real shareholders in a large company; and shareholders have a special function for the long-term survival of the firm.

The regulation of core corporate governance issues and the choice of principal. As was said above, certain types of corporate governance rules are necessary, if the entity is an artificial person that has an organisation. For example, it is necessary to decide on the allocation of power and allocation of risk in a limited-liability company.

It would be impossible to adopt meaningful company law rules on these and other core corporate governance issues, if shareholders were regarded as the most important principal in company law. A principal exists, enjoys the fruits of its agents' labour, and does not have to have any particular function. In company law,

[86] Fama EF, Jensen MC, Separation of Ownership and Control, J L Econ XXVI (2) (1983) pp 301–302.

however, shareholders have functions as well as some limited powers, duties and responsibilities. Those rules can only be explained if shareholders are not the principal.

This is one of the basic reasons why shareholders cannot be regarded as the most important principal in company law. Company law would not make sense otherwise.

Board duties owed the company. In company law, board members owe their duties to the company directly, and shareholders typically benefit from the existence of these duties indirectly. This leads to the question regarding what owing duties to the company means.

Different interests of shareholders. Board members and managers cannot owe any general legal duty to act in the interests of shareholders, because different shareholders have different interests. In practice, it would be difficult or impossible to act in the interests of all shareholders at the same time, unless the company were owned by a sole shareholder.

The interests of some shareholders may conflict: with the interests of other shareholders; with the interests of the company's other stakeholders; with what is required for the company to continue its existence as a legal person; and with what is required for the long-term survival of the firm.

For example, shareholders with a very short investment horizon can prefer a takeover bid for the company if the bid helps them to obtain a good price for their shares immediately. These shareholders are likely to vote for the bid even if, as a result of the takeover, the company ceases to exist as a legal person, and even where the takeover wipes out the company's whole business organisation. Furthermore, securities lending enables a share borrower to benefit from a reduction in the market value of shares.[87]

Some shareholders look for private benefits. For example, a shareholder may want enough influence to gain access to technology, raw materials and skills.

For these reasons, board members and managers could, in principle, owe a general legal duty to act in the shareholders' interests only provided that these shareholders were only fictive rather than real.

Although board members do not owe a general legal duty to act in the interests of shareholders, they may under specific circumstances owe a special duty to act in the interests of a particular shareholder or shareholders.

Senior managers, other managers and employees do not owe any duties to shareholders. As employees of the company they owe duties only to their employer.

Are there long-term shareholders? The main rule is that there is no such thing as a long-term shareholder in a listed company with very dispersed ownership. Financial investors are free to sell their shares.

Typically, long-term shareholders are shareholders who have other than merely financial interests in the company (non-monetary private benefits; provision of an-

[87] This can be illustrated by the case of Perry and Mylan Laborities. See Hu HTC, Black BS, The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership, Southern Cal L R 79 (2006) pp 811–908 at pp 828–829.

cillary services). Long-term shareholders can therefore be found in family-owned firms, inside corporate groups, and inside networks of industrial firms. They can also be found in business entities used by states to further their own policy objectives.

Table 8.1 The Interests of Shareholders in Privately-owned Companies

Shareholder	Investment horizon (shorter or longer)	Preferred volatility of share price (high or low)	Private benefits of share ownership	Typical preferred board actions
Minority shareholder, social investor	longer	-	private benefits (monetary or non-monetary)	corresponding to expected private benefits
Minority shareholder, financial investor	shorter	-	none	exit, increase in the value of shares during investment period
Minority shareholder, business partner	longer	-	private benefits (monetary)	profitable business relationship as a whole
Controlling shareholder	longer	-	private benefits (monetary and non-monetary)	corresponding to expected private benefits

Table 8.2 The Interests of Shareholders in Listed Companies

Shareholder	Investment horizon (shorter or longer)	Preferred volatility of share price (high or low)	Private benefits of share ownership	Typical preferred board actions
Index-tracker	-	low	none	-
Stock-picker, undiversified	longer	low	none	stable growth of profits, stable distribution of funds to shareholders
Stock-picker, diversified	longer	-	none	trend of profit growth and growth of distributions
Stock-picker	shorter	high, from high to low	none	actions that cause windfall profits, large and rapid increase in share price
Stock-picker	longer	-	private benefits (monetary or non-monetary such as social or emotional)	corresponding to expected private benefits
Business partner	longer	-	private benefits (monetary)	profitable business relationship as a whole
Controlling shareholder	longer	-	private benefits (monetary and non-monetary)	corresponding to expected private benefits

8.7.2 The Function of Shareholders

Shareholders nevertheless have a special role. Generally, all investors can be providers of funding and/or ancillary services (Volume III). Shareholders contribute to the long-term survival of the firm in six main ways.

Equity capital. First, some shareholders (but not necessarily all, see section 8.7.6) can be a source of funding. Furthermore, investors who subscribe for new shares in the company (or buy the company's own shares from the company) are a source of equity capital. Shareholders' capital allows the firm to obtain funds without incurring debt or having to repay a specific amount of money at a particular time. The availability of equity capital can increase the long-term survival prospects of the firm.

Cost of debt capital. Second, equity capital makes it easier for the firm to raise debt capital. Equity capital decreases lenders' risks, helps the firm to obtain a better credit rating, and decreases the interest rate lenders charge for debt capital.

Monitoring of profitability. Third, shareholders are a mechanism to monitor the profitability of the company. Profitability is important to the firm, because the company's business activities are not sustainable in the long term without profitability. As residual claimants, self-interested shareholders can be expected to demand better profitability. Good shareholders should therefore demand better profitability as residual claimants.

There is nevertheless an agency problem. Shareholders do not always do what is expected of them. (a) Bad shareholders are led by private benefits. For example, state-controlled companies can be badly run if the controlling shareholder is represented by politicians that are interested in their personal political gain rather than the profitability of the firm; it goes without saying that state control can make it politically awkward to fire workers or to shrink capacity when times are tough.[88] Bad shareholders can also try to benefit from limited liability and the separate legal personality of the company by extracting payments that endanger the long-term survival of the firm. (b) Short-term shareholders can prefer to maximise their own short-term benefits. (c) Many shareholders - and in large listed companies almost all shareholders - are only passive investors.

In order to manage this agency problem and decrease risks caused by bad shareholders and the risk of too large rewards for shareholders, company laws provide for: restrictions on the distribution of funds to shareholders; rules on the distribution of power between shareholders and the board or managers; restrictions on the power of shareholders to give binding directions on how the company should be managed (for example, shareholders are not regarded as the proper corporate body to decide on management matters in a listed company under English and German laws);[89] and rules according to which the duties of the board and managers are owed to the company and not to shareholders.

In other words, the fact that shareholders are holders of certain subordinated claims makes them residual claimants. The company may have received equity capital from some shareholders. It does not follow that this would make shareholders "the true masters of the company".

This mechanism is sometimes supported by company law provisions according to which the purpose of the company nevertheless is to make a profit for shareholders (see below).

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[88] Patriot games, The Economist, June 2006: "Successful French firms, such as L'Oréal and AXA, tend to be the ones the state has left alone. The companies it backed were the ones that eventually needed rescuing: Alstom, an engineering group; Bull, a computer firm; Air France, the national airline; Crédit Lyonnais, a big bank. A state guarantee allows managers to run companies irresponsibly without fear of being disciplined by shareholders or banks."

[89] See Mäntysaari P, *op cit*, Chapter 6.

Pricing mechanism. Fourth, shareholders are a pricing mechanism for shares and the company. Shares issued by the company have a value for investors, because shareholders are residual claimants and shares are transferable.

The pricing of shares is important to the company. As shares are transferable, the company can issue shares as a means of payment (somebody may want to subscribe for shares in exchange for assets). This has enabled companies to finance large transactions such as takeovers. In addition, the company can also issue shares for the purpose of raising cash (somebody may want to subscribe for shares and pay for them).

The long-term survival chances of the firm are increased if the market valuation of the company is continuously high rather than continuously low. A low valuation of the firm means that the company must issue more shares if it uses them as a means of payment, or turn to lenders instead and pay more for external funding. Issuing too many shares can depress share price even more, because it will dilute existing shareholdings and dividend rights.

The firm can therefore use the mechanism of shareholders to obtain a high market valuation. As different shareholder categories have different interests and the relative weight of their interests varies over time, the firm may use different methods to obtain an optimal market valuation over time.

To simplify the matter, shareholders can assess the value of shares in two ways. This can influence the firm's choices.

First, an investor can decide how much he wants to pay for shares in the light of future income streams and future changes in share price. (a) The price that investors are willing to pay for shares depends on expected return and perceived risk. The company can increase its market valuation by increasing the expected value of future distributions to shareholders and by decreasing shareholders' perceived exposure to risk. (b) Their perceived exposure to risk is lower if shareholders believe that: there will be growth of distributions to shareholders; the growth of distributions to shareholders will be stable; there will be an increase in share price; and the increase in share price will be stable. (c) The company can increase the value of distributions and its own market valuation by promising to make growing dividend payments in the future and by share buybacks. As growing dividend payments and growing share buybacks both require growing profits in the future (i.e. funds that can be distributed freely to shareholders under the applicable laws, see Volume III), the perceived risk to which shareholders are exposed depends on shareholders' confidence in management and the company's business. (d) The company can also increase its market valuation by increasing shareholders' confidence in the ability of management to deliver higher profits.

For example, US corporate law typically protects managers against investors, and the legal rights of shareholders in listed US companies are weaker than those of shareholders in listed English or German companies. For this reason, US companies try to report increasing profits each quarter. This, and a stable increase in

share price that follows the stable growth of profits, will reinforce investor confidence. In addition, share buybacks are widespread.[90]

As said above, shareholders do not always do what is expected of them. Bad shareholders make it more difficult for the company to obtain a sufficiently high market valuation and maintain it in the long run. For this reason, the efficiency of the share ownership structure is an important goal for the company's board and managers.

Second, an investor can assess how much others will want to pay for his shares. (a) In this case, the firm can influence the market valuation of the company by increasing demand for its shares. For example, many investors prefer companies that are not only listed but also belong to a certain index. The firm can increase demand by applying for a stock exchange listing and doing whatever is necessary in order for it to be included in the preferred index (company size, field of activity, the number of outstanding shares, the turnover of shares, and so forth).[91] The firm can also decrease investors' perceived risk (see above) by increasing the turnover and liquidity of shares or otherwise. (b) In addition to increasing the demand for its shares generally, the firm can signal that it is on the market for control. This can be complemented by: the application of the principle of equal treatment of shareholders; the duty of a shareholder to make a mandatory bid after obtaining control or minority shareholders sell-out rights, and rules on the minimum price that the controlling shareholder must pay for minority shares. The firm can signal that it is on the market for control: when the company does not yet have a controlling shareholder with a controlling block that prevents anybody else from obtaining control; when the controlling shareholder signals that it will sell its controlling block; or when business reasons force competitors to start merging (economies of scale, synergy effects).

The market valuation of the company can change quite radically when it is perceived to have entered or exited the market for corporate control. (a) If the company is not on the market for control, its valuation depends basically on the future income streams from the company to shareholders and estimated future changes in share price. (b) If the company is on the market for control, its valuation can depend on the pecuniary and non-pecuniary benefits available to any investor obtaining control or the additional synergy benefits available to industrial investors obtaining control. The market for control can thus increase the price that

[90] See Buy means sell, The Economist, October 2000: "Share buybacks were pioneered by Henry Singleton, the long-time head of Teledyne, a conglomerate. Despite consistent criticism, his repurchases cut the number of outstanding shares of the company by 85% between 1972 and 1984, as he simultaneously increased its profitability and its stockmarket value. Mr Singleton's secret? He bought back shares when they were cheap, thus increasing the value of the company for the shareholders who remained, among them himself. After the 1987 stockmarket crash, numerous companies followed suit, with, until recently, similarly good results."

[91] See, for example, Die Postbank vor der Aufnahme in den Dax, FAZ, 2 September 2006 p 21: "Nach Berechnungen der DZ Bank konnten Anleger in der Vergangenheit mit Dax-Aufsteigern in den vier Wochen vor ihrer Index-Aufnahme eine durchschnittliche Überrendite von 18 Prozent erzielen."

shareholders expect other investors to be prepared to pay for shares. In practice, it is usual for bidders to pay a "premium" for a block that enables them to obtain control.

Putting the company on the market for control can also function as a takeover defence. There is a risk that the company is taken over by an investor who is interested in short-term financial benefits at the expense of the survival of the firm. For this reason, the long-term survival chances of the firm can be increased: (a) by increasing the costs of takeovers by mandatory bid rules (see above) and other takeover defences; (b) by decreasing controlling financial shareholders' pecuniary benefits through mandatory provisions regulating the use of assets and the distribution of assets to owners; (c) by decreasing controlling financial shareholders' pecuniary benefits by reducing the amount of assets that can be distributed to shareholders (dividends, share buybacks); and (d) by decreasing controlling financial shareholders' private pecuniary benefits through mandatory provisions on the equal treatment of shareholders.

Separation of control and management, avoidance of dead-lock situations. The governance system of the firm is not self-enforcing unless it can avoid dead-lock situations. In addition, it is a general objective of corporate risk management that decision control and decision management should be separated at all levels; a self-enforcing governance system would thus require a mechanism to prevent self-dealing by the board. For those two reasons, shareholders in general meeting can be given particular decision rights. While the board monitors shareholders and other stakeholders as well as the organisation of the firm in the name of the company and on behalf of the firm, shareholders can, in limited cases, be given limited decision rights which enable them to monitor the monitors.

This can be illustrated by Norwegian company law. Certain contracts are not valid unless ratified by the general meeting under the Limited-liability Company Act[92] or the Public Limited-liability Company Act.[93] The scope of that requirement depends on the other party to the contract (a shareholder, the parent company of a shareholder, a board member, a CEO) and the size of the remuneration payable by the company (there is a threshold corresponding to one-tenth or one-twentieth of share capital). Some contracts are exempted. According to the Company Acts, the board must submit a report to the general meeting according to the same rules that apply when a company issues shares for a consideration other than in cash.[94]

Other ancillary services. Depending on the case, a certain shareholder can provide even other ancillary services. Typically, ancillary services include signalling, management services, takeover defences, access to markets, access to technology, or rescue in corporate crisis.

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[92] Chapter 3, section 8 of aksjeloven.

[93] Chapter 3, section 8 of allmenaksjeloven.

[94] Chapter 3, section 8 of aksjeloven. Chapter 3, section 8 of allmenaksjeloven. See Bråthen T, Selskapers avtaler med sine aksjonærer og medlemmer av ledelsen, NTS 2007:3 pp 65–89.

In some cases, ancillary services are based on particular contracts (joint-ventures, venture capital, project finance, and so forth).

Typically, however, ancillary services are not based on enforceable contracts. For example, one can assume that the state will not let a state-owned bank fail.

Share ownership structure. The effectiveness of shareholders as providers of funding and ancillary services depends on the share ownership structure. The provision of many ancillary services is usually combined with the ownership of a relatively large block of shares (for block-ownership, see section 9.4.2; for structural takeovers defences, see Volume III).

Shareholder control. Because of the potentially conflicting interests of shareholders and the firm, company laws generally should not facilitate shareholder control as the main rule (for the role of the board, see section 8.3).

There are also particular firm-specific ways to separate share ownership and control. The most usual of them include dual-class share structures and other control-enhancing mechanisms (see section 9.4.2). In addition, the firm can use firm-specific voting caps and other restrictions.[95]

However, the mainstream view is that company laws should facilitate shareholder control.[96]

8.7.3 The Relative Importance of Shareholders

For the above reasons, shareholders are not functionless investors even when they remain passive.[97]

Funding and monitoring. To begin with, the relative importance of shareholders as a source of funding and a monitoring mechanism depends on: (a) the availability and cost of other sources of funding; (b) the availability and cost of equity; (c) the existence of a market for control; (d) the transaction; and (e) whether the company has a controlling shareholder (ownership concentration).

Availability and cost of other sources of funding. The effect of the availability and cost of other sources of funding can be illustrated by the German financial system.

Bank loans have traditionally been the primary source of external funding in Germany. The strength of the German economy contributed to a low interest rate in the latter half of the 20th century. The availability of bank loans at low cost was made easier by the traditionally close relationship between the firm and its Hausbank ("house bank"). In addition, German accounting laws required firms to build large reserves and hidden reserves.

As a result, the share of equity in the balance sheet of German firms has traditionally been lower than in other European countries and the US.[98] One can also

[95] Faccio M, Lang L, The Ultimate Ownership of Western European Corporations, J Fin Econ 65 (2002) pp 365–395.

[96] See OECD Steering Group on Corporate Governance, Law of Proportionality between Ownership and Control: Overview and Issues for Discussion (December 2007).

[97] For critical views, see, for example, Ireland P, Company Law and the Myth of Shareholder Ownership, Modern L R 62(1) (1999) p 55.

assume that this has made the market valuation of the company less important to the firm.

Availability and cost of equity capital. The availability and cost of equity influences the relative importance of shareholders in two ways.

If equity is not easily available or scarce, the ownership of firms is likely to be less dispersed and more concentrated. This is likely to lead to a closer relationship between shareholders and the firm, and to active shareholders having a more important monitoring role.

On the other hand, if capital markets are effective and the firm has easy access to equity, the ownership of firms is likely to be less concentrated and more dispersed. This will probably lead to shareholders being more passive. On the other hand, reliance on the capital market will make market valuation more important to firms.

Existence of a market for control. The existence of a market for control makes potential investors and shareholders contemplating to obtain control more important as a monitoring mechanism.

If the company is on the market for control, there will be more pressure on the board and managers to ensure that the market valuation of control is high enough to render the company unattractive as a takeover target.

Sometimes there is no market for control because of the business form of the firm or the share ownership structure of the company, in particular the existence of a controlling shareholder.

Transaction. Different transactions need to be financed in different ways.

Large investments such as takeovers are often paid for with shares issued by the company. In this case, the role of shareholders is crucial, because the pricing of these shares depends on the market valuation of the company. In addition, shareholders often have a veto right regarding the issue of new shares because of their pre-emptive rights.

On the other hand, the opinion of shareholders is less important as regards decisions on internal growth and modest investments, because these investments are usually not funded by issuing new shares.

Share ownership concentration. The concentration of share ownership affects the role of shareholders.

Controlling shareholders have legal or de facto powers to decide on management matters and the future of the company. This makes the valuation of shares less important as a monitoring mechanism. Controlling shareholders' private pecuniary and non-pecuniary benefits can make them accept lower dividends and lower growth of the market valuation of the company. For example, many controlling shareholders, and family shareholders in particular, are long-term investors that would be unwilling to exit the company in spite of temporarily low profits.

Controlling shareholders can work for a higher market valuation of the company if the company must turn to other investors for equity. This would be in their own interest. A higher market valuation will increase the price that outsiders pay for the company's shares, decrease the number of new shares that the company

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[98] See for example, Deutscher Sparkassen- und Giroverband, Diagnose Mittelstand 2005.

must issue, dilute the holdings of controlling shareholders less, and help controlling shareholders to retain control.

For example, Bertelsmann AG, a German company and one of the largest media firms in the world, is controlled by the Mohn family. Bertelsmann AG has decided to remain private for several reasons. Its operative management is controlled by its supervisory board and controlling shareholder. It does not need external equity investors, because it is very profitable and can finance its growth internally. As the company has no external minority shareholders, the family that controls it can accept smaller distributions. This also contributes to a high credit rating and relatively low interest rate for debt capital. If necessary, the company can finance growth and reduce indebtedness by divesting parts of its business.[99]

The role of ancillary services. The relative importance of shareholders is also influenced by the provision of ancillary services. A certain shareholder – typically, a block-holder – can be an important provider of ancillary services. This can also mean that the relative importance of other shareholders is influenced by the ancillary services provided by one or more shareholders. For example, the existence of a controlling shareholder changes the monitoring mechanism and the control market.

8.7.4 Should the Share Price Be Maximised?

Maximising the share price is not the fundamental objective of the firm. From the perspective of the firm, its fundamental objective is its own survival. As explained above, the importance of shareholders and the importance of the share price depend on the firm.

Large listed companies. Typically, large listed companies which both have a dispersed ownership and are on the market for control need a high share price for their own survival. A high share price helps the firm to prevent a change of control through hostile takeover bids or otherwise and to use its shares as a means of payment.

Small privately-owned firms. A small privately-owned firm will ensure its long-term survival in other ways. It has no market valuation. It is nevertheless expected to create value to its stakeholders.

Non-profit organisations. The long-term survival of independent non-profit organisations is based on the same principles as the long-term survival of commercial firms. Non-profit organisations are just as dependent on their stakeholders as commercial enterprises are. However, there is an important difference. If a non-profit organisation does not generate profits, it is more dependent on external funding for its survival. It cannot convince its sponsors or the public to support its activities, unless it can create value for its stakeholders. That value can consist of moral or economic benefits to those who pay (value to sponsors or the public) or results in its actual business (value to the cause or the recipients of the organisa-

[99] Interview of the chairman of Bertelsmann's management board in Aust S, Schulz T, Tuma T, Wir wollen kein fremdes Geld, Der Spiegel, 28 August 2006 p 66.

tions's services). Typically, there tends to be a positive spiral of good results and increased funding.

8.7.5 What Does Making a Profit for Shareholders Mean?

At this point, if not earlier, the critical reader probably thinks that the statutory purpose of a limited-liability company is "to make a profit for shareholders" and that this is what the law says in many countries. However, it was indicated above that the ultimate purpose of the firm is survival. Is there a conflict between these two notions? The answer is no.

What does making a profit for shareholders mean? The rule that the purpose of a limited-liability company is to make a profit for shareholders makes it easier for investors to become shareholders and residual claimants, because it is designed to decrease their risk. This rule can better be understood in its context.

First, the rule is a company law rule. In company law, the rule that the purpose of a limited-liability company is to make a profit for shareholders acts as a constraint on actions by company representatives. It means that acts done by company representatives may not be done for an improper purpose. This rule thus helps to prevent the expropriation of company assets. Its effect depends on whether effective sanctions are enforced for its breach. Sanctions may vary depending on the jurisdiction. For example, breach of this rule can make decisions of company organs void or voidable. It can also limit the validity of contracts concluded by the company's organs, and some Member States of the EU have adopted such sanctions by virtue of the First Company Law Directive.[100]

Second, this rule increases sustainability. It means in effect that acts should be motivated by things that contribute to the long-term survival of the firm. Shareholders as a class can benefit from sustainability indirectly.

Third, the rule complements the rule that shareholders are typically residual claimants. The rule states the obvious. If the company actually does make a profit and survive, shareholders are likely to benefit from it as residual claimants. In other words, the substance of this rule is that the purpose of the company is to make a profit. The reference to shareholders is meaningless. If the company does make a profit, shareholders benefit in any case.

Fourth, the rule only lays down a general objective. It leaves plenty of business discretion. The rule does not say how the company should go on with its business. Company law leaves board members and managers plenty of discretion to manage the company within the limits of these and other legal constraints. This rule does not say how the company should make a profit, how much profit the company should make, and how shareholders should benefit from these profits.[101] Company

[100] The first sentence of Article 9(1) provides that "acts done by the organs of the company shall be binding upon it even if those acts are not within the objects of the company, unless such acts exceed the powers that the law confers or allows to be conferred on those organs".

[101] See also Aglietta M, Rebérioux A, Corporate Governance Adrift. Edward Elgar, Cheltenham Northampton (2005) p 34.

law does not prohibit companies from making a loss, and many companies fail without anybody breaching any company law rule. In addition, different shareholders intend to benefit from the company in different ways (see above).

Fifth, the rule is connected to a monitoring mechanism. The rule that the purpose of the company is to make a profit makes it legally easier for shareholders to act as monitors (it sets a general standard against which corporate actions can be measured) and gives them an economic incentive to fulfil their intended monitoring role (it acts as a legal constraint on corporate decision-making and reduces shareholders' perceived risk).

Sixth, the rule is in particular connected to the market valuation of the company as a monitoring mechanism. The profitability of the firm influences its market valuation (see below). A constantly too low market valuation can reduce the long-term survival chances of the firm by making it more costly for the firm to finance its growth and by making the company an easier takeover target. A higher market valuation makes it easier to use the issuing of shares as a source of equity funding and easier to defend the firm against hostile takeovers.

Finally, the interests of shareholders are not the only interests that board members and shareholders can take into account. Shareholders are an important group of stakeholders, but there are also other important stakeholders. The rule that the purpose of a limited-liability company is to make a profit says nothing about how much value the company should allocate to shareholders or to other stakeholders.

Although the firm can benefit from a constantly high market valuation of the company by shareholders, the firm can also benefit from the value it provides to other stakeholders. From the perspective of the long-term survival of the firm in a competitive environment, there can be a tradeoff between a higher market valuation of the company and higher value provided to other stakeholders than shareholders.

8.7.6 What Are Shareholders Paid For?

The fact that shareholders are residual claimants does not say anything about how much should be paid to shareholders and why the company should make any payments to shareholders in the first place. For example, it is understandable that the company repays a sum that the company has borrowed from somebody, and it is possible for the company to agree with a lender that the loan will be repaid only after all other debts have been repaid (subordinated loan). However, it is not as easy to understand why shareholders in large listed companies should be regarded as "contributors of the company's capital".[102] The great majority of share dealings involve not issues raising capital for new investment but the buying and selling of shares issued long ago: "As a whole the stock market today does little to raise capital for new investment. Between 1981 and early 1996, for example, US nonfi-

[102] Parkinson J, Corporate Power and Responsibility. Clarendon Press, Oxford (1993) p 34. Cited in Ireland P, Company Law and the Myth of Shareholder Ownership, Modern L R 62(1) (1999) p 49.

nancial corporations retired more stock ($700 billion) than they issued, thanks to takeovers and buybacks."[103] In addition, many shareholders are rentier investors that have contributed little to the company apart from lucky birth.

Function of shareholders. Now, shareholders nevertheless have some important functions, and different shareholders can have slightly different functions. The relative importance and function of shareholders or different categories of shareholders can vary over time.

As said above, shareholders can contribute to the long-term survival of the business organisation in a competitive environment by being a source of equity capital and ancillary services. Shareholders can be regarded as: a mechanism that helps the company to raise debt capital at a lower cost; a mechanism to monitor the profitability of the company; a pricing mechanism for shares and the company; a mechanism to separate decision control and decision management and to avoid dead-lock situations; and a source of other ancillary services.

Furthermore, the relative importance of shareholders as a class depends on: the availability and cost of other sources of finance; the availability and cost of risk capital; the existence of a market for control; the transaction; and whether the company has a controlling shareholder. The relative importance of shareholders can also depend on the provision of ancillary services.

Like the function and relative importance of shareholders, the function and relative importance of different categories of shareholders depend on: the share ownership structure of the company (e.g. controlling shareholder v small investor); the life cycle of the company (e.g. new company in need of seed finance; new company in need of venture capital; established company, listed company); and how business is financed (e.g. capital market v banks).

Interests of the firm. It is in the interests of the firm that shareholders are remunerated for their services. Shareholders need to be remunerated because of the capital tied up in shares. Shareholders are contributors of capital that is used in the interests of the firm, but shareholders are not the owners of the company's assets as a matter of law, and many shareholders are not contributors of the company's capital (shareholders who have subscribed for new shares in the company are contributors of the company's capital).[104]

Remuneration package. Shareholders' remuneration package can consist of many components. The level of remuneration of shareholders can change over time depending on what the company believes is necessary to ensure the long-term survival of its business organisation. The company can be expected to design this mix on the basis of the relative importance of each category of shareholders and their preferences.

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[103] Ireland P, Company Law and the Myth of Shareholder Ownership, Modern L R 62(1) (1999) p 54–55, referring to Henwood D, Wall Street. Verso, London (1997) pp 246–300

[104] Compare Parkinson J, Corporate Power and Responsibility. Clarendon Press, Oxford (1993) p 34. Parkinson recognises that "shareholders are not the owners of the company's assets as a matter of strict law", but quickly adds that "they are in substance the owners by virtue of being the contributors of the company's capital". Cited in Ireland P, Company Law and the Myth of Shareholder Ownership, Modern L R 62(1) (1999) p 49.

For example, a start-up may be financed by a venture capital firm looking for an opportunity to charge fees for services rendered to the company, an IPO, and exit after 5–7 years (see Volume III). An industrial shareholder can be looking for access to useful technology or new customers, long-term synergy benefits, and other private benefits, rather than mere profits. A controlling short-term financial shareholder can be looking for refinancing (see Volume III) and windfall profits. A short-term financial investor can be looking for a fast change in the price of the company's securities. A long-term financial shareholder can be a debenture holder in disguise and look for steady growth in the share price and steady growth in income streams.

8.7.7 How Can the Board Increase the Value of Shares?

As said above, the company law rule that the purpose of the company is to make a profit is connected to the valuation of shares as a monitoring mechanism. Actions by board members and managers can influence the valuation of shares by shareholders.

Valuation methods used by shareholders. Basically, each shareholder is free to use any valuation method he likes for his own purposes.

For example, short-term financial investors might look for short-term profits on whatever grounds regardless of what is good for the firm in the long term.

Some shareholders use the discounted cash flow method.[105] The discounted cash flow method is a tool that enables management to choose between different courses of action. It is often used by large investment banks and consulting and accounting firms in order to value acquisitions.

Fashion and herding can play a role. For example, many activist shareholders argue that a conglomerate structure is not a good thing. There is a conglomerate discount for shares issued by listed conglomerates in Europe.

How individual shareholders value shares is nevertheless not the main question from a legal perspective. From a legal perspective, board members and managers should focus on the long-term survival of the firm in a competitive environment. A constantly high market valuation of the company can help more than a constantly low one.

Legal means to increase valuation. Shareholders can, in principle, increase return by leverage and decrease risk for example by diversification.

Board members and managers can increase the market valuation of the company in many ways.

Some methods reflect fashion. Even the preferred *corporate structures* can reflect fashion. However, fashion and shareholder preferences change.

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[105] Rappaport A, Creating Shareholder Value. The New Standard for Business Performance. New York (1986); Tom Copeland, Tim Koller, Jack Murrin, Valuation (3rd Edition). John Wiley & Sons, New York (2000).

For example, where shareholders dislike the firm's conglomerate structure, the firm can concentrate on one or more business areas and sell the rest. In the long term, however, the use of a conglomerate structure can increase the survival chances of the firm (see section 7.2).

According to a study by The Boston Consulting Group, the popular belief that conglomerates would generate higher shareholder returns if they focused on fewer businesses is unfounded. According to the same study, the conglomerate discount is almost exclusively a European phenomenom.[106]

Furthermore, many institutional investors are happy to invest in private equity funds or venture capital funds which are basically conglomerates. Many of the activist shareholders critising a company's conglomerate structure are funds (conglomerates) themselves.

Some of these methods relate to the company's *operations*. Factors that contribute to a higher market valuation include, for example: a high level of value creation; high growth of value creation; stable growth of value creation; a sufficient level of distributions to shareholders; and stable growth of distributions to shareholders.

Other methods relate to the company's *share ownership structure* and the *market for takeovers*.

Basically, shareholders can be divided into four groups on the basis of how much they are willing to pay for shares: (1) Financial non-controlling shareholders do not decide on actions that influence share price and distributions to shareholders (most minority shareholders). (2) Non-controlling shareholders that own shares because of private benefits can pay more for their shares (suppliers, customers, shareholders who own shares for emotional reasons such as family reasons). (3) Financial controlling shareholders can pay more because their formal and de facto powers enable them to decide on the use and distribution of company funds (private-equity firms, unserious investors that want to loot the company). (4) Industrial controlling shareholders also benefit from industrial synergy effects and may therefore be able to pay more than others for shares in a company they want to control.

Therefore, managers of a company that does not have a controlling shareholder can increase the company's long-term market valuation and the firm's long-term survival chances: (a) by changing perceptions of risk (investor relations)[107] and adding emotional content to share ownership (branding); and (b) by seeking industrial shareholders that offer synergy benefits and by applying the principle of equal treatment of shareholders.

Managers can also *decrease* the company's short-term market valuation by taking decisions that benefit the firm and *increase* its valuation in the long term. Short-term financial investors benefit from short-term changes in the value of securities regardless of the long-term interests of the firm.

For example, if the expected changes in the profitability of the firm remain the same, short-term financial investors benefit from unexpected reduction of the risk level of the firm, be-

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[106] The Boston Consulting Group, Managing for Value: How the World's Top Diversified Companies Produce Superior Shareholder Returns (2006).

[107] In addition to other things, listed companies typically use transparency, disclosure and investors relations when trying to achieve a higher market valuation.

cause a lower perceived risk level can increase share price in the short term. Therefore, short-term financial investors dislike acquisitions that bring benefits only in the long term but increase the risk level of the firm in the short term. For example, it would be expected that pension funds would not support the acquisition by Ryanair of shares in Aer Lingus or the acquisition by Porsche of shares in Volkswagen. In industrial takeovers, the share price of the buyer tends to fall. Short-term financial investors may prefer mergers and acquisitions that bring short-term financial benefits (for example, in the form of using the assets of the target in order to refinance the transaction).

Managers can *increase* the company's short-term market valuation but *reduce* the firm's long-term survival chances and long-term valuation in many ways. For example, they can: take long-term decisions on the basis of the interests of short-term financial investors (such as vocal hedge funds); or invite a financial investor to make a takeover bid and permit the financial investor to loot the company and load it with debt after obtaining control.

Short-term financial investors can prefer financial transactions such as share buybacks and dividend payments and one-off transactions such as mergers and acquisitions to internal research and development, because financial transactions and one-off transactions can influence share price immediately, whereas the benefits of internal research and development lie in the future. However, a company that focuses on the interests of short-term financial investors but neglects its customers is likely to lose customers in the long run.

8.7.8 Why Should the Firm Use Takeover Defences?

When the shares of the company are freely transferable, anybody can become its shareholder. On the other hand, investors can become shareholders for different reasons. This makes it reasonable to use takeover defences (for takeover defences, see Volume III).

It is reasonable to prevent some investors from obtaining control or becoming shareholders in the first place. (a) There are investors whose private interests are not compatible with the objective of long-term survival of the firm. For example, some investors may want to obtain control in order to sell off the assets of the firm, make a fast profit and disappear. It is reasonable to prevent such investors from becoming shareholders. (b) There are also investors whose membership would make it more difficult for the firm to meet this objective. Some investors may be such that they can cause the firm problems by their mere existence. For example, many people would not regard a company partly-owned or controlled by a rogue state or an enemy state as a reliable business partner. (c) Generally, different shareholders may require different levels of remuneration, and their time perspectives may be different. This can influence the cost of shareholders' capital and equity, the risk level of the firm, and the cost of other resources. (d) Furthermore, sometimes ownership is connected with a business relationship such as co-operation in production or marketing and membership in a business network. The choice of shareholders must then be done on the basis of the whole package of benefits that the investor can bring into the company and the effect of sharehold-

ing on other business relationships of the firm. (e) Takeover defences can make it easier for the firm to choose its controlling shareholders, establish long-term business relationships, and become a member in business networks. Good controlling shareholders increase the firm's long-term survival prospects.[108] A sound share ownership structure with a low risk of change of control can decrease its business partners' and finance providers' counterparty and commercial risks, make the firm a more valuable business partner, and reduce the firm's costs.

Whether the board of the target company in fact is allowed to employ takeover defences depends on the governing law (see section 8.4 and Volume III). Where the use of takeover defences is more or less prohibited, the board may be more likely to act with a short-term perspective because a takeover bid can be made the following day and neither the board nor the firm's employees will be able to enjoy the fruits of their work in the long term.[109] In contrast, the availability of takeover defences can give the board, the management and employees an incentive to run the firm with a long-term perspective and in a more sustainable way.

This can be illustrated with the car manufacturing industry. In England, institutional investors dominate. As a consequence, English car brands have mostly disappeared. The few niche car brands that are left are owned by foreign companies. In Germany, the car manufacturing industry has been more or less safe from hostile takeovers. This has resulted in the growth of very successful car brands such as Audi, BMW, Mercedes-Benz, Porsche, and Volkswagen. German car manufacturing companies have also been able to take over struggling English brands like Bentley, Rolls-Royce, and Mini. Indeed, Honda and Nissan, the most successful large volume car manufacturers in England are safe from hostile takeovers in their home country.

8.7.9 Why Are Shareholders Protected by Laws?

There are several company and securities markets rules protecting shareholders. On the other hand, a shareholder can manage risk by diversification, i.e. by shifting her proprietary interests among different firms or assets. A shareholder can manage return by gearing, i.e. by multiplying her bet by borrowing. A shareholder also has the option of taking control of the company herself by buying a sufficiently large block that gives its holder legal or de facto powers to tell managers what to do. Why do shareholders need to be protected?

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[108] The ties that bind, The Economist, January 2009 (about Investor, the Wallenberg family's main holding company): "Sweden's business dynasty is weathering the financial crisis pretty well … The chief reason was that [Investor] could resist pressure from outside investors, because it is almost impossible to take over. A dual-shareholding structure gives the Wallengberg family and their charitable foundations more votes per share than other shareholders, and allows them to maintain control of Investor even though they own only about a quarter of its shares."

[109] See Davies PL, Gower and Davies' Principles of Modern Company Law, Seventh Edition. Sweet & Maxwell, London (2003) p 750.

Importance of firms. There are legal background rules protecting shareholders, because firms are an important means to increase welfare in society.

The long-term survival chances of the firm are influenced by its equity capital. If the firm has too little equity, it is more likely to fail in times of crisis than a firm that has more equity, and it is less likely to grow at a minimum pace that enables it to remain competitive in the market. Legal background rules are used in order to reduce investors' transaction costs and risk, and to make it easier and less costly for firms to raise the necessary minimum amount of equity that enable them to survive in the long term.

The long-term survival chances of the firm will also be increased if it has monitors who ensure that the firm's activities are profitable and sustainable in the long run.

No direct legal duty to increase shareholder value. Usually, neither board members nor managers can have a statutory legal duty to increase "shareholder value" as such. There is no generally accepted definition of "shareholder value" in company law. In addition, "shareholder value" can mean different things to different shareholders.

For example, short-term financial investors are likely to prefer a short-term change in the price of the company's securities in either direction depending on the instruments they hold. Short-term financial investors favour transactions that cause the price of securities to change regardless of how the transaction will affect the company's chances of survival in the long term. Typically, short-term financial shareholders prefer the company becoming a takeover target (because in this way they may get paid for part of the bidders anticipated private benefits of control immediately) to the company making a takeover bid itself (because the possible benefits will materialise in the future and are not certain). Perverse company law rules that always forced board members to sell the company in order to please short-term financial investors would hardly support a working economy in the long term.

No direct legal duty to increase the value of the company. Neither can board members and managers have a direct legal duty to increase the value of the company under company law. There is no one method to value companies in company law. The method may depend on the circumstances. For example, the valuation of companies may depend on the applicable accounting rules.

Whereas board members and managers generally owe a duty of care to the company, the valuation of the company is at the discretion of shareholders. Different shareholders can value the company in different ways. Sometimes shareholders choose to be irrational and use valuation methods that are not linked to the real economy. This often happens in times of stockmarket bubbles.

Indirect duty to increase the value of the company. Board members and managers are nevertheless likely to increase the value of the company if they try to comply with their general obligations owed to the company and their decisions turn out to be successful.

As said above, the firm is unlikely to survive in the long term unless it provides value to its shareholders and other important stakeholders. This objective, combined with board members' and managers' duty of care and fiduciary duties owed

to the company, will thus contribute to increasing the value of the company. If compliance with legal duties can increase the value of the company indirectly, it can also increase shareholder value indirectly, depending of course on how shareholder value is defined.

Indirect duty to increase the value of the group. In addition to the value of the company, compliance with board members' and managers' direct legal duties can increase the value of the group. However, to what extent board members and managers should focus on the group as a whole rather than an individual company can depend on whether the country has laws on the governance of corporate groups.

For example, German company law contains many provisions on the governance of groups. This is reflected in the German Corporate Governance Code which contains the following recommendations: "The Management Board and Supervisory Board cooperate closely to the benefit of the enterprise" (3.1). "The Management Board is responsible for independently managing the enterprise. In doing so, it is obliged to act in the enterprise's best interests and undertakes to increase the sustainable value of the enterprise" (4.1.1). The term "enterprise" means here not only the listed company itself but also its group companies.

But while German company law contains many provisions on the governance of groups, one of the main rules in English company law is that companies are independent of their shareholders and that a group of companies cannot be treated as a single economic entity.[110] This is reflected in the Combined Code on Corporate Governance which provides that the board is "responsible for the success of the company" (A.1) rather than the success of its group.

8.7.10 Should Shareholders Have Formal Powers?

The fact that shareholders are residual claimants does not say anything about their formal powers in the company. As a rule, shareholders have only limited formal powers under company law in large listed companies, but shareholders enjoy larger formal powers in small private companies. The holder of a large block of shares has both formal and de facto powers that enable the shareholder to control the company.[111]

In a large listed company with dispersed ownership, shareholders could, in principle, fulfil their monitoring role without any formal powers under company law by pricing the company's shares. Shareholders may get rewarded for their role as its agents (i.e. for pricing the company's shares) and for providing risk capital, but decision rights are not a necessary ingredient of being a residual claimant.

Shareholders v creditors. Shareholders nevertheless have some decision rights. To some extent these rights resemble the rights of creditors, but there are impor-

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[110] Salomon v A Salomon & Co Limited [1897] AC 22 (House of Lords); Adams v Cape Industries plc [1990] Ch 433 at p 536.

[111] See, for example, Mäntysaari P, *op cit*, Chapter 6.

tant differences depending on the jurisdiction. There is now a difference between the US and the Member States of the EU.

Shareholders typically decide on the change of rights attaching to their shares, and creditors typically decide on the change of their contractual rights. Whereas some changes require the consent of each individual shareholder/creditor, other changes can be made by a majority decision (see sections 9.4 and 9.5 for block-ownership).

In the EU, shareholders also decide on the emission of new shares. This rule is based on the Second Company Law Directive which also lays down a threshold of two-thirds for derogations from existing shareholders' rights of pre-emption (see Volume III). In the US, however, there is no similar rule on shareholders' pre-emption rights and the power of shareholders to decide on the emission of new shares. These questions are determined by the company's statutes, which usually vest large powers in the board, or through contracts. In both the EU and US, debtors are usually free to incur new debt without the consent of prior creditors, but parties are usually free to contain restrictions on new debt in credit agreements.

These differences between Community law and US law reflect differences in how firms raise funding and differences in ownership concentration. (a) In the US, companies raise funding to a larger extent from the capital market, and companies have more dispersed ownership than in the EU. In the EU and especially in continental Europe, debt finance from banks is the norm and companies generally have more concentrated ownership than in the US. (b) For these reasons, shareholders have a closer connection to the company in the EU than in the US, and it is more important to protect minority shareholders against expropriation by controlling shareholders in the EU than in the US. For example, it is easier for a shareholder to exit a listed company with a large market capitalisation than a small private company with few shareholders (c) This can partly explain why shareholders, according to Community law, decide on many transactions that affect legal capital and why Community law contains many rules on legal capital in the first place (see Volume III). In the US, rules on legal capital are to a larger extent dispositive, and changes in capital are, to a larger extent, decided on by the board. (d) One could say that "shareholder ownership" is a "myth" rather than reality in large listed companies with dispersed ownership.[112] Ownership becomes more "real" for controlling shareholders in both Europe and the US. Non-controlling shareholders typically enjoy wider formal powers in continental European private companies than in private companies incorporated in the US.

Why are some matters decided on by shareholders? As said above, company laws reserve some decision rights to shareholders, but the extent of these rights can vary depending on the jurisdiction and how companies typically raise funding in the jurisdiction. At a general level, one can say that shareholders have rights because of the real economy and because the company needs the equity capital and ancillary services provided by shareholders.

[112] See Ireland P, Company Law and the Myth of Shareholder Ownership, Modern L R 62:1 (1999) pp 32–57.

Real economy. First, shareholders must have some decision rights because of the real economy. One of the main policy objectives of company law is to make it easier for large long-term industrial investors to carry on business. The lack of formal control rights would increase the legal risk inherent in industrial investment. For this reason, even passive financial shareholders that prefer not to vote have voting rights,[113] and any shareholder that obtains a sufficient majority of shares and voting rights can control the company.

Equity. Second, the company needs equity capital. The existence of decisions rights can decrease the risk for equity investors.

There is a difference between providers of debt capital and providers of shareholders' capital, although both do have some decision rights.

Debt capital is based on contract, and the terms of this contractual relationship typically cannot be changed to the detriment of the creditor without his consent (unless they are changed by the legislator). For example, debt capital will be repaid according to its terms. The parties may agree on larger decision rights. For example, the agreement may contain covenants that make certain transaction subject to the prior written consent of the lender or prohibit certain transactions (for covenants, see Volume II). The main rule is nevertheless that creditors do not decide on matters influencing the value of their contractual rights. For example, creditors do not decide on the issue of new debt. Creditors do not decide on the capital structure of the company or its management unless such decision rights are vested in creditors under insolvency laws or under specific terms of the contract.

In companies established in the EU, shareholders have some decision rights that resemble decision rights vested in providers of debt capital. The rights attaching to their shares cannot be changed without their consent (unless they are changed by the legislator).

However, unlike creditors, shareholders can have decision rights that influence the value of their company law rights. These rights are conferred on shareholders although few shareholders bother to attend general meetings in a listed limited-liability company with dispersed ownership.

[113] For a critical view see Ireland P, Company Law and the Myth of Shareholder Ownership, Modern L R 62(1) (1999) p 48: "... company law has failed fully to recognise the implications of the depersonification of the company and the reduction of the corporate shareholder to the status of a rentier investor with an interest very similar to that of a debenture holder. It has tried instead to hang on to the (always rather artificial) characterisation of corporate shareholders as 'insiders', 'members' and 'owners', continuing to grant to them exclusive residual 'ownership' rights - most crucially, of course, the right to vote in general meetings. It has done this notwithstanding the true economic nature of the share; notwithstanding the absence of any property nexus between shareholders and the company's assets; notwithstanding the radical externality of shareholders to 'the company' and their superfluousness to and disinterest in the process of production; notwithstanding the fact that there are serious question marks over the legitimacy of their residual control rights, as well as over their desire, competence, and practical ability to exercise them; and notwithstanding the fact that company law itself has done so much to demote them from the status of owners."

These decision rights are necessary. The rights of shareholders are part of the price that the firm has to pay for investor lock-up.[114] A limited-liability company needs a sufficient amount of shareholders' capital to: reduce the risk of corporate failure; increase access to debt capital; reduce the cost of debt capital; and reduce the cost of new equity capital. As shareholders' capital generally will not be repaid according to its agreed terms, shareholders must have a right to decide on the distribution of capital. Without such a right, entrepreneurs and controlling shareholders would provide the company with debt capital instead of equity capital to reduce their own risk. This would be contrary to the public policy objectives that have made limited-liability companies necesssary in the first place, and it is not the purpose of company law to hamper real economy.

In addition, entrepreneurs and controlling industrial shareholders must be able to decide on fundamental management matters. As said above, entrepreneurs and controlling industrial shareholders need these decision rights in the real economy. Typically, holders of a sufficiently large majority of shares and voting rights can decide on matters relating to the company's capital and its management. Even other controlling shareholders or block-shareholders can benefit from these rules. For example, a private-equity firm that has obtained control of a company can, in practice, decide on "recapitalisation" (Volume III).

Ancillary services. Third, the firm needs ancillary services provided by shareholders (section 8.7.2). Many of shareholders' rights facilitate the provision of ancillary services.

For example, one of the reasons to give shareholders limited decision rights is ensuring that the governance system is self-enforcing. This requires the separation of decision management and decision control as well as avoiding dead-lock situations. There may not always be other suitable corporate bodies that would be able decide on the matter.

Scope of rights. The extent of shareholders' decision rights depends on the jurisdiction. For example, shareholders' pre-emptive rights belong to the most fundamental principles of continental European company laws. This was not the case in England. Prior to 1980, shareholders of English companies were legally entitled to pre-emption rights only if this was expressly provided for in the company's articles. It was a requirement under the Stock Exchange's listing rules that equity shares of listed companies should be offered in the first instance on a pro rata basis to existing equity shareholders. When the Second Company Law Directive was implemented in England by the Companies Act 1980, it introduced a system whereby existing shareholders had to be afforded pre-emptive rights. Another example is the power of shareholders to decide on the distribution of dividend to shareholders. Provisions of the Second Company Law Directive restrict the amount of distributions that can be made to shareholders[115] but do not say by whom the payment of dividends must be decided.

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[114] See Hansmann H, Kraakman R, Squire R, Law and the Rise of the Firm, Harv L R 119 (2006) p 1343.

[115] Article 15 of Directive 77/91/EEC (Second Company Law Directive).

9 Management of Agency in Corporate Governance

9.1 Introduction

This chapter will give an introduction to how the firm can manage its own agency relationships. This chapter will also explain the legal corporate governance tools available to a controlling shareholder who wants to change the behaviour of its own agents and how even a non-controlling shareholder can use some corporate governance tools to manage agency relationships. Such tools are important because it is usual for firms to invest in the shares of subsidiaries and other limited-liability companies and because the firm's own share ownership structure will influence the allocation of power in the firm.

Now, there are many questions that must be addressed because of the *nature* and *organisation* of firms. The application of legal strategies to manage agency relationships also depends on the choice of *principal* and agent. Agency relationships are not limited to those between, say, shareholders and managers. Legal strategies designed to manage agency relationships can be applied by different principals depending on the perspective. Even the *firm* can be chosen as principal by a third party. It is characteristic of firms that they have a complex organisation with many potential internal and external agents.

In the following, it is first assumed that the choice of principal is free. Both the *firm* and any *stakeholder* can be regarded as principal depending on the perspective (the perspective of the firm or the perspective of the stakeholder). It is therefore possible to study the management of agency relationships with different alternative parties as the principal and the agent (see section 9.2).

It will be explained that the long-term survival of an independent firm depends to a very large extent on whether its supreme administrative body (typically, the *board*) is "firm-friendly" and protected against stakeholders.

This will be followed by an analysis of the regulation of corporate governance in Community law (section 9.3). The "firm-friendliness" of the board and the corporate governance tools available to shareholders who want to change the behaviour of the board from "firm-friendly" to "shareholder-friendly" or otherwise are either based on or influenced by laws.

The next step is to study the management of agency by legal means from the perspective of a *controlling* shareholder (section 9.4) and from the perspective of *minority* shareholders (section 9.5). After all, both may want to change the behaviour of the board and the firm's organisation. The corporate governance tools

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available to controlling and non-controlling shareholders are either based on or influenced by laws.

Finally, there will be a brief discussion of "*good corporate governance*" (section 9.6) and *outsourcing* (section 9.7) as corporate governance tools.

Many corporate governance questions such as monitoring and the regulation of risk management were already discussed in the context of risk management. The principal typically can manage agency relationships using generic legal tools and practices discussed earlier in this book.

9.2 Dealing with Different Agents: General Remarks

9.2.1 Agent Mix

Whether somebody can be regarded as somebody else's agent depends on who the principal is. If, in a legal study, any stakeholder can be chosen as principal depending on the perspective, principals can range from minority shareholders to the society at large and from the environment to the government.

The law protects different interests. Each of those different principals can therefore be protected by legal and other rules designed to influence the behaviour of the firm or the people belonging to its organisation.

As said above, the firm can be regarded as the most important principal in company law. This has influenced the duties of board members and managers and the distribution of power between shareholders and the board.

The firm can, to some extent, choose the relative weight of its agents. For example, the firm can choose to go public and be monitored by the market, or to remain private and be monitored by a controlling shareholder.[1]

A fundamental lesson of corporate finance is that the interests of the various claimants on a business's cash flow inevitably come into conflict. For example, the interests of fixed claimants conflict with the interests of equity claimants whenever the firm makes a decision about how to allocate capital.[2]

The extent to which the firm will take the interests of different claimants and stakeholder categories into account, and the choice of the relative weight of different categories of agent, belong to the most important strategic decisions. They should preferably be decided on at the highest management level by a body capable of protecting the long-term interests of the firm. In practice, they should not be left to short-term shareholders or creditors but can belong to the responsibilities of the statutory board.

There will thus be an *agent mix*. The contents of the agent mix and the relative weight of each agent category can vary over time. The existence of an agent mix should also influence the remuneration of the members of each agent category.

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[1] For a table of governance regimes, see Aglietta M, Rebérioux A, Corporate Governance Adrift. Edward Elgar, Cheltenham Northampton (2005) p 85.

[2] See Enriques L, Macey JR, Creditors Versus Capital Formation: The Case Against the European Legal Capital Rules, Cornell L R 86 (2001) p 1166.

For example, the agent mix can influence the amount of the CEO's remuneration package. If the existence of other agent categories is not taken into account, CEOs will be overcompensated for their services. The same can be said of the existence of other behaviour-changing tools and practices.

In the following, one can start with a non-firm perspective (with business as a whole or a particular industry as agents) and the perspective of another firm (with the firm as agent) and then move on to the perspective of the firm itself (with a long list of agents: society at large; shareholders as a class; individual shareholders; banks; customers and the public; managers as a class; individual managers; and the board).

9.2.2 Industries as Agents

From a *non-firm* perspective, such as the perspective of the government or a special interest, it is in some cases possible to regard business in general or a particular industry as the agent that should further public policy objectives. This is a politically controversial area, because there are different views on the division of duties between business and government.

Broad policy objectives. The regulation of business tends to focus on a number of broad policy objectives: the promotion of economic growth;[3] worker protection;[4] consumer protection;[5] and the protection of public welfare.[6] This is achieved by regulating the allocation of risk, income, and capital.

It is possible that the same legal rules further more than one objective or that the objectives of different legal rules conflict with each other. For example, the EC Treaty shows that European business is expected to be competitive and contribute to improving the production and distribution of goods and to promoting technical or economic progress, while allowing consumers a fair share of the resulting benefit.[7] In some countries, companies may have a duty to act for the benefit of employees, consumers, and the society as a whole.[8] Companies may also have a legal or social obligation to further diversity. Some believe that governments should adopt more rules in the area of social, environmental and industrial policy and make companies more "ethical" (corporate social responsibility, CSR).

The firm cannot change the legal and cultural environment in which it operates. It can only choose its business activities and where its operations are located. It can also consider whether it is worthwhile to operate in an unfriendly environment in the first place.

[3] Bagley CE, Winning Legally. Harv Bus S P, Boston (2005) p 28.
[4] *Ibid*, p 35.
[5] *Ibid*, p 37.
[6] *Ibid*, p 39.
[7] See Articles 2, 3 and 81 of the EC Treaty.
[8] See, in particular, § 76 of the German Aktiengesetz (AktG).

Community law. Business as a whole is regarded as an important agent under the EC Treaty. Substantive Community law is to a large extent concerned with economic matters and the regulation of business.

Community law assumes the existence of the market economy and seeks to promote the free exchange of goods, services and capital between the Member States in the material interests of their inhabitants.

Industries have been entrusted with the task of furthering public policy objectives through competition. Community law helps to make firms more effective by making them subject to competitive constraints. The EC Treaty generally: prohibits customs duties, quantitative restrictions and restrictions on the provision of services; prohibits restrictions on movements of capital; guarantees the right of establishment; and restricts the use of state aids and state monopolies.

9.2.3 The Firm as an Agent

From the perspective of another firm, a contract party, or the government, the firm is often regarded as the agent. As discussed in Chapter 6, there are generic ways to manage agency relationships. One can nevertheless highlight four typical ways to manage agency at this level.

Compliance requirements. First, the general public policy objectives can be complemented by strict statutory compliance requirements and a wide range of sanctions for non-compliance applied to the legal entity and/or the persons responsible (section 4.3.3).

Contract terms. Second, there is often a contractual relationship between the principal and the agent. Where the firm can be regarded as the agent, the principal is exposed to counterparty risk. The principal can then use legal tools designed to manage this form of risk (Volume II).

For example, this is regularly done in loan agreements. A loan agreement can set out how the funds can be used (rule-based strategy) and provide that the firm has a duty to act in good faith (standard-based strategy). The loan agreement can contain information covenants that act as an early warning system for the bank (trusteeship strategy). Some transactions may also be subject to the prior written consent of the bank (veto strategy). Failure to comply with all the terms of the loan agreement may lead to sanctions depending on the severity of the breach (punishment strategy). The loan may be transferable, and there may be termination events that lead to acceleration of all payments due under the contract (exit strategy).

Control. Third, the principal can obtain control of the firm. This is the most important corporate governance tool used by entrepreneurs, family owners, and private equity funds worldwide (for block-holding, see sections 9.2.6, 9.4, and 9.5).

Resources. Fourth, the principal can control the resources available to the firm. If the firm must do more with less, the firm and its managers and employees are forced to use the assets of the firm more efficiently and there will be less opportunities to expropriate surplus assets.

There are different ways for principals to control the resources available to the firm.

The firm is disciplined by *competition* from other firms.[9] The principal can subject the firm to more competitive pressures. (a) Where the firm is a supplier, the customer usually tries to ensure that there are alternative suppliers competing for the same deliveries (for the hold-up problem, see Volume II). (b) Firms can also make their own departments or divisions more effective by subjecting them to competition. For example, a big car company can spin off its parts-making subsidiaries. (c) Furthermore, this tool is used by state legislators and competition authorities. They can adopt rules that lower the barriers of entry to the market, change the structure of the market, and prohibit practices that restrict competition. (d) Obviously, too much competition from other firms can decrease the firm's profits. Being different can help the firm to avoid excessive competition from its rivals.

The principal can oblige the firm to make *regular payments*. (a) The choice between debt and equity investments is a typical example. A debt instrument legally obliges the firm to pay interest and repay the sum borrowed on specified dates (see Volume III). (b) Controlling shareholders may be able to force the firm to pay oversized transfer prices (this might be done in company groups) or fees for services rendered to the firm (this might be done by buy-out firms or other owners participating in the management and operations of the firm). Controlling shareholders can also decide on the capital structure of the firm and increase the ratio of debt to equity in the firm's balance sheet. (c) The usual way for state legislators to use this tool is to levy taxes and similar administrative duties.

The benefit of competition and regular payments is that it is at the discretion of the management to choose how to make the firm more effective.

In principle, the principal could control even *other resources* than funding. For example, the controlling shareholder can require the firm to achieve a certain level of productivity per employee, or the state legislator can reduce the firm's share of environmental resources. However, the quality of production or other activies of the firm may suffer if the amount of such resources is reduced without careful analysis.

9.2.4 Society at Large as an Agent

Turning now to the *firm as principal*, the firm can benefit from societal values and the general legal infrastructure. Laws, culture, social traditions, and fundamental values influence the behaviour of everybody in society. They also have an effect on agency relationships and stewardship.

For example, the rule of law is enforced differently depending on the jurisdiction. In some countries the governance of companies is regulated in one way, in other countries in a different way. NGOs and other interest groups are more im-

[9] See, for example, Fama EF, Agency Problems and the Theory of the Firm, J Pol Econ 88 (1980) p 289.

portant monitors of business in some countries than in others. Furthermore, in some societies stealing from the employer is socially less acceptable than in others, and in some societies loyalty to the employer is stronger than in others.

One can again say that the firm cannot change the legal and cultural environment in which it does business, but it can manage this risk by choosing the location for its operations.

Sometimes the firm may also choose whether to incorporate in one jurisdiction instead of another. In financial transactions, special purpose vehicles and similar legal entities that own assets tend to be established in countries that respect the rule of law and have a compliance culture.

9.2.5 Shareholders as a Class as Agents

As discussed above, shareholders can contribute to the long-term survival of the firm in many ways: investors who subscribe for new shares in the company are a source of equity capital; equity capital makes it easier for the firm to raise more senior debt capital; and shareholders can be providers of ancillary services.

Generally, shareholders provide various kinds of ancillary services (section 8.7.2). Even when shareholders do not provide new capital, the firm relies on shareholders as agents to: (a) monitor the long-term profitability of the firm; and (b) provide a market valuation for the company.

It was also discussed above (section 8.7.3) that the relative importance of shareholders as agents depends on: (a) the availability and cost of other sources of finance; (b) the availability and cost of risk capital (in other words, the efficiency of capital markets); (c) the existence of a market for control; (d) the transaction; (e) the concentration of share ownership; and (f) the provision of ancillary services.

There are many ways for the firm to influence how shareholders as a class can fulfil their function. The firm's key choices relate to questions of: share ownership structure; listing; and market for control.

Long-term profitability. Shareholders can become better monitors of sustainable long-term profitability if: they invest in the long term; their proximity to management is increased (this will give them better access to useful information); and they are given private benefits if monitoring results in increased long-term profitability (this will give them an incentive to monitor).

The company can achieve this, in particular, by changing its share ownership structure. Typically, the company can look for a controlling shareholder with a long-term interest in the sustainable growth and profitability of the firm (in particular an industrial or family shareholder) rather than short-term financial shareholders (whether controlling or not). Controlling blocks can be created through the allotment of shares and through share buybacks. Financial investors can be kept out, for example by: keeping the company private; restricting the right to purchase the company's shares; other takeover defences; and a market valuation that makes it unattractive for financial shareholders.

It is usual to try to increase shareholders' proximity to management by regulating the distribution of power in the company. For example, shareholders can have veto rights and appointment rights. However, although the existence of these rights may influence block-holding by providing an incentive to hold a certain minimum block of shares of votes in order to obtain control or veto rights, these rights alone are not likely to turn investors into long-term shareholders or give them an incentive to monitor the company.

Disclosure of information to shareholders or the public enables shareholders to monitor profitability better. However, like the distribution of power in the company, it is not a sufficient way to turn shareholders into long-term investors or give them an incentive to monitor long-term profitability.

Better market valuation. Shareholders can give the company a better market valuation if: there is an efficient market for the company's shares; shareholders are given useful information;[10] and the company adds emotional content to share ownership.

The market for the company's shares is more efficient if the shares have been admitted to trading on a regulated market, the company has dispersed ownership, there are no restrictions on the purchase of shares, there are no takeover defences, and there is a market for control.

Tradeoff. There can therefore be a tradeoff between those two objectives (long-term profitability v better market valuation). Shareholders are better monitors of the long-term profitability of the firm if the company is privately-owned and the company has controlling shareholders, but shareholders can give a higher market valuation if the company's shares have been admitted to trading on a regulated market and there are no controlling shareholders (in which case the firm is also more dependent on a higher market valuation).

There are some usual ways to achieve both objectives, at least to some extent.

First, very large listed companies with dispersed ownership can be controlled by a shareholder holding a relatively small block of shares (for block-holding, see below). If the block is small, it will neither reduce the liquidity of the remaining shares nor prevent the existence of a market for control.

Second, the company can use different classes of shares with a smaller class conferring multiple voting rights. Shares with multiple voting rights can confer control. The larger class of shares can provide a sufficient market valuation especially with the help of a stock exchange listing and dispersed ownership of that class.

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[10] See also Kuhnle H, Banzhaf J, Finanzkommunikation unter IFRS. Vahlen, München (2005) p 41, Abbildung 2–2. The authors show the following chain: (1) financial goals (reduction of funding costs, stabilisation of the price of securities, improving the availability of funding, protection against hostile takeovers, improvement of takeover powers) → effect (reduction of risks inherent in information, management of investor relationships, increasing the spread of securities, reduction of information asymmetries) → the high-level goal of financial communication (the optimisation of the price of securities) → the high-level goal of the firm. (2) In addition to financial goals, the firm has goals of communication policy (increase in trustworthiness and trust, increase in recognisability, better image).

For example, KONE Corporation, a lift and escalator company, has two classes of shares. Class A shares are not listed. Each class A share confers one vote, and they are controlled by members of the founding family. Class B shares are listed. Each block of 10 class B shares confers one vote. Class B shares are owned by a large number of investors.

Market for corporate control and share price. The existence of a market for corporate control or its absence can have a material influence on the valuation of shares.

In the absence of a market for corporate control, minority shareholders usually detemine the value of their shares on the basis of future revenues and income streams to shareholders.

If there is a market for corporate control, minority shareholders can determine the value of shares on the basis of what a potential buyer of control would be prepared to pay for their shares. A shareholder that obtains control of the company can pay more (a premium) because of private benefits of control. For example, a controlling financial shareholder able to decide on refinancing can pay more for the company's shares than a minority shareholder forced to rely on future dividends. An industrial shareholder that will not only be able to decide on refinancing but also to receive synergy benefits can also pay more compared with a minority shareholder.

The firm can therefore achieve a higher market valuation by ensuring that there is a market for corporate control. This requires: the lack of takeover defences; dispersed ownership or large shareholders willing to sell; and rules that enable minority shareholders to sell their shares at the same or higher price.

The downside of the existence of a market for corporate control is that the firm becomes more vulnerable to takeovers. In the worst case this can result in the death of the firm. The use of takeover defences and restrictions on takeovers can therefore be in the interests of the firm (see Volume III).

Unless the firm already has a controlling long-term shareholder, the firm may look for a market valuation that exceeds the value of its future revenues and income streams to existing shareholders and thus decreases the amount of private benefits of control. The use of structural takeover defences (Volume III) can increase the cost of obtaining control and thus reduce private benefits of control even more. The firm can further decrease the amount of private benefits of control by making refinancing more difficult. For example, the company can distribute surplus assets to shareholders by way of dividends or share buybacks. Share buybacks can decrease the amount of surplus assets, decrease the number of shareholders and outstanding shares, and increase the value of remaining shares, all of which are likely to increase the cost of takeovers, make refinancing more difficult, and reduce the amount of private benefits of control following a takeover.

Market for corporate control and managers. The existence of a market for corporate control is believed to "keep incumbent managers on their toes by threatening them with the prospect of takeover in case of poor managerial performance".[11]

[11] Tirole J, The Theory of Corporate Finance. Princeton U P, Princeton and Oxford (2006) p 429, citing Manne HG, Mergers and the market for corporate control, J Pol Econ 73 (1965) pp 110–120.

The market for corporate control can also be regarded as a corporate governance tool used by the firm itself, because the firm's board and managers can influence the firm's exposure to this market and its effect on share price.

High exposure to the market for corporate control combined with vulnerability to takeovers in the absence of effective takeover defences can nevertheless invite hostile takeover bids.

9.2.6 Individual Shareholders as Agents

Both controlling shareholders and other shareholders can act as agents. The role of individual shareholders as agents depends on many things: the size of their *holdings* in the company; their rights including both *formal rights* (rights based on legislation, the company's articles of association, other internal rule-making, and contracts) and *de facto rights*. The ways for a shareholder to increase those rights will be discussed in the context of controlling shareholders' corporate governance tools (section 9.4). Furthermore, *generic* legal tools and practices can be used to manage the agency relationship between the firm and a shareholder and make a shareholder act in a certain way.

Block-holding. The most important aspect on the above list is the size of the share block. Typically, an individual shareholder is an important agent for the firm, if the block held by that shareholder enables it to influence corporate decision-making (block-ownership will be discussed in sections 9.4 and 9.5 below).

The firm can influence its share ownership structure and regulate entry and exit (for exit, see Volume III). The firm can also regulate the powers of shareholders (decision management, decision control, and enforcement powers).

Question of time. While the founders of the company have relatively free hands to choose the company's share ownership structure, it is more difficult to manage it during the life of the company.

When the company is founded, its shares can be placed in the hands of safe long-term shareholders and their transferability can be restricted to some extent. The main rule is that it is legally very difficult to restrict the transferability of existing shares by unilateral action (for structural takeover defences and restrictions on exit, see section 9.4.2 and Volume III).

The choice between going public and remaining privately-owned influences the firm's chances to choose its shareholders. Shares issued by a listed company must usually be freely transferable and can therefore be bought by anybody. In a privately-owned company, the lack of a large market for shares makes it more difficult for existing shareholders to sell their shares and more difficult for buyers to find shares to buy.

The allotment of shares to friendly investors after the company has been founded is constrained by provisions of EU company law applying to public limited-liability companies. The Second Company Law Directive and the Directive on takeover bids provide for the equivalent treatment of all shareholders who are in the same position. The Second Directive also provides for the pre-emptive

rights of existing shareholders (right to subscribe for new shares issued by the company in proportion to existing shareholdings, see Volume III).

Quality of shareholders. The company has a legitimate interest in its share ownership structure, because the use by shareholders of their formal and de facto rights will influence the long-term survival prospects of the firm. Shareholders do not always share the interests of the firm.

There can be differences between the interests of the firm and those of its shareholders. (a) First, there are differences relating to the time perspective. The long-term interests of the firm are obviously long-term, but the interests of shareholders range from the extremely short-term interests of day-traders in listed companies to the long-term interests of family shareholders in some family firms. (b) Second, shareholders can obtain benefits indirectly (as residual claimants) and directly (private benefits). The benefits that a shareholder obtains directly do not have to be shared by other shareholders or the firm.

From the perspective of a shareholder, there can be a tradeoff between indirect and direct benefits. Direct benefits (private benefits) can be beneficial, neutral or harmful to the firm. If they are harmful to the firm, they may reduce indirect benefits.

A shareholder might extract direct benefits until the marginal direct benefits correspond to that shareholder's share of their marginal indirect costs. A shareholder will not be put off by harm sustained by the firm if the shareholder's direct private benefits outweigh the shareholder's indirect share of the harm.

The loss sustained by the firm can be larger than the shareholder's share of the loss, where: the shareholder owns only a small block of shares (in which case the indirect costs and benefits are likely to be smaller); the private benefits are not related to the actual business of the firm (in which case they are not constrained by the firm's business reasons); or the private benefits are not derived from the firm (in which case they are not constrained by the threat of bankruptcy).

The firm should not welcome shareholders who are looking for harmful private benefits.

On the other hand, the firm can benefit from shareholders whose direct benefits are aligned with the long-term business interests of the firm (for example, long-term manufacturing or commercial partnerships).

The quality of a controlling shareholder will influence the profitability of the firm, the price that minority shareholders will pay for shares, and the firm's funding costs. Minority shareholders regard the controlling shareholder as their agent.

For example, the efficiency of the controlling shareholder may be important in the case of mergers. Minority shareholders' confidence concerning the economics of a merger can be reinforced by the participation of a controlling shareholder who has a good track record and key players who are acquainted with the industry and its prospects.[12]

Generic legal tools and practices. Many of the ways to manage the agency relationship between the firm and particular shareholders will be discussed in the con-

[12] See Cheffins BR, Mergers and Corporate Ownership Structure: The United States and Germany at the Turn of the 20th Century, AJCL 51 (2003) p 491 on US experiences.

text of non-controlling minority shareholders' corporate governance tools as those shareholders try to make controlling shareholders act in a certain way.

Other important ways to manage the agency relationship between the firm and particular shareholders include: choosing shareholders by: managing their entry and exit (section 9.4.2 and Volume III); regulating the scope of agency by limiting shareholders' rights (section 9.5.5); managing the existence of qualified majorities or qualified minorities by choosing shareholders and regulating their rights (for block-holding, see sections 9.4.2 and 9.5.5); and the use of rules and standards telling shareholders what to do (duties). Although most of those questions will be discussed in later parts of this book, some general remarks can be made.

Whether the firm can choose shareholders by managing their entry and exit depends on many things: the transferability of shares (section 9.4.2 and Volume III); the existence of pre-emption rights (Volume III); the required qualifications of shareholders (statutory requirements in regulated businesses, articles of association); the existence of different classes of shares; and rules on involuntary transactions (rules on mandatory offers to buy, obligations to sell, and the withdrawal of shares).

Where the firm can control the transferability of shares, the firm can increase competition for firm-specific ancillary services (such as business partnerhips). Where there are no constraints on the transferability of shares, potential investors have weaker incentives to provide other than general ancillary services (such as the pricing of shares). The degree of transferability of shares can thus influence the profile of ancillary services provided by shareholders.

The scope of shareholders' *rights* depends on the business form and the governing law. Shareholders enjoy only limited rights in public limited-liability companies.[13] This can be contrasted with partnerships in which most things can be regulated by contracts. Most SMEs resemble partnerships even when they are incorporated companies.

Shareholders' *duties* range from statutory duties and duties under articles of association to contractual ones. Shareholders of a limited-liability company typically owe few statutory duties to the company after shares issued by the company have been paid up in full. There are nevertheless large differences depending on the business form and the governing law.

This can be illustrated by the lack of a general duty of care. The main rule is that shareholders do not owe any general duty of care, duty of loyalty, or fiduciary duties to the company or any other shareholders. Sometimes such duties may nevertheless exist. (a) Under German law, shareholders owe a general duty of loyalty towards the company and other shareholders (Treu und Glauben, § 242 BGB).[14] The duty of loyalty is combined with other statutory duties. (b) In the US, controlling shareholders may own fiduciary duties. For example, in Donahue v Rodd Electrotype Co. of New England, Inc., the court imposed a part-

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[13] See Bebchuk LA, The Case for Increasing Shareholder Power, Harv L R 118 (2005) pp 833–914; Mäntysaari P, Comparative Corporate Governance. Shareholders as a rule-maker. Springer, Berlin Heidelberg (2005).

[14] BGHZ 65, 15 (ITT).

nership-type heightened fiduciary duty on the controlling shareholder.[15] (c) In England, it is assumed that shareholders do not owe any general duty of care to the company. (d) These questions have been discussed in the context of incorporation in section 4.4.3.

9.2.7 Banks and Other Lenders as Agents

Apart from being contract parties, banks (and also other lenders such as providers of trade credit) act as the firm's agents in various ways. Banks are a source of debt capital. In addition, they provide ancillary services by assessing credit risk, pricing debt instruments, and signalling information to other banks and lenders.[16]

Banks as monitors of risk. Banks have the power to supply or withhold financing and to stipulate the terms on which it is to be made available. The availability of debt funding and the interest rate charged by banks depend on their assessment of the default risk, their chances of exit (liquidity of the loan instrument, maturity, acceleration, termination), their own costs, risks inherent in their own funding and other matters.

Lending by an informed party is a signal that the informed party is confident about the possibility of repayment. As "informed lending" can bring along less well-informed investors, the firm can reduce informational asymmetries if it borrows from investors who are perceived as well-informed and honest (because of reputation or otherwise).[17]

The terms on which banks make lending available signal the quality of the firm as borrower. For example, banks' refusal to lend signals very high risk. Where the firm does have access to bank lending, covenants required by one informed lender will signal to less informed lenders that even they should require such covenants, and the use of light covenants can encourage even less informed lenders to accept them.

Banks can also price traded debt instruments issued by the firm. For example, when the firm issues debt instruments, a bank that is perceived as well-informed and honest may be asked to cerfify their quality by acting as an underwriter. Higher risk can result in a lower valuation and make debt capital more expensive.

Capital adequacy rules. Banks have a growing role as monitors of risk because of new capital adequacy rules, in particular rules based on Basel II. There is interaction between credit risk management by banks and corporate risk management by firms. Corporate risk management influences credit risk, and credit risk influences the availability and cost of debt capital. These questions have already been discussed above (section 7.6).

Banks as monitors of management. Generally, banks can play an important role in the governance of companies. As the most important source of external funding,

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15 Donahue v Rodd Electrotype Co. of New England, 328 N.E.2d 505 (Mass. 1975).

16 See, for example, Ferran E, Principles of Corporate Finance Law. OUP, Oxford (2008) pp 342–343.

17 Tirole J, The Theory of Corporate Finance. Princeton U P, Princeton and Oxford (2006) p 250.

banks are more important monitors, for example, than investment and pension funds.

The firm can influence the role of banks as monitors by choosing its debt-to-equity ratio. The voluntary choice of a high debt-to-equity ratio means that management voluntarily commits to the constraining effect of debt covenants.[18] Furthermore, actions by the firm will influence the cost of debt, and the expected effect of transactions on its rating can act as a constraint.

For example, Lufthansa walked away from the acquisition of Alitalia in 2007, because Alitalia was in a need of a big and costly restructuring and an offer for Alitalia might have put its investment-grade credit rating at risk. An investment-grade credit rating gave Lufthansa access to much cheaper financing compared with most of its competitors.

In practice, managers will need to signal to banks that: the firm's business is sustainable; there is proper corporate risk management; the banks are taking an acceptable risk; and the banks are receiving a reasonable return. This will be made easier if there is a relationship of mutual trust. For this reason, the firm will also have to manage its reputation in relation to the banks (the management of reputation will be discussed in section 10.5.5).

Banks can act as monitors even in their capacity as providers of other advisory services or as friends to management. Where the relationship between the banks and their customers is very close, the monitoring role of the banks may sometimes be difficult to combine with their main role as lenders. There is a risk that the banks benefit from their proximity to management by charging too much for capital, pushing additional financial products and services, and abusing confidential information. On the other hand, informed lenders can also be able to provide financing on better terms.

Company law rules protecting creditors. Because of the important role of banks and other creditors as contract parties, providers of funding, and monitors, there are company law rules protecting them and mitigating their risks.

The legislative strategies can be divided into three groups depending on the jurisdiction: disclosure and transparency (the US and the UK approach); a legal capital regime consisting of restrictions on distributions to shareholders and the existence of different categories of assets in the balance sheet (the continental European approach); and the personal liability of controlling shareholders in a financial crisis or in the insolvency of the company (the UK and France).[19]

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[18] See, for example, Easterbrook FH, Fischel DR, The Economic Structure of Corporate Law. Harvard University Press, The United States of America (1991) p 176.

[19] Wiedemann H, Auf der Suche nach den Strukturen der Aktiengesellschaft: The Anatomy of Corporate Law, ZGR 2/2006 pp 248–249. See also Kraakman R, Davies PL, Hansmann H, Hertig G, Hopt KJ, Kanda H, Rock EB (eds), The Anatomy of Corporate Law. OUP, Oxford (2004) pp 83–84.

9.2.8 Customers and the Public as Agents

Competitive pressures can generally force the firm and its managers to become more efficient. The relative weight of customers as agents varies depending on the firm. Customers can act as customers or providers of ancillary services.

Just customers. Most customers will care only about the goods, the price, and competition. In this case, the firm can be more dependent on its customers if: the number of customers is small; or the firm relies on its product brand and the firm is generally identified as the firm behind its products.

Such constraints can also influence the choice of other corporate governance tools. For example, focused monitoring by a controlling shareholder may have no comparative advantage over market-based monitoring when competition in the product market is sufficiently intense. In high-technology industries, intense product market competition and rapid technological change can make it less necessary for the investors to pay for more focused monitoring.[20]

Strong customers. Depending on the firm, the behaviour of the firm's managers can thus be influenced by its customers' views. Where the firm relies on a small number of strong customers, it is wise to keep the customers informed about its plans, and many transactions will, in practice, require the customers' consent.

Branding and the customer outrage constraint. Branding plays a role, when the firm has no strong customer. For example, a large firm with a strong consumer brand can be forced to comply with societal values shared by many customers.

Branding plays a role even in the market for corporate control. The actions of an industrial firm selling branded consumer goods are constrained by the risk of customer outrage and the destruction of brand value.

Compared with local firms, especially local firms with a strong consumer brand, foreign private-equity firms may be able to achieve a higher return on the same assets, because it does not sell any branded goods to consumers. This can make it profitable for domestic firms to sell underperforming assets to private-equity firms.

In Germany, many domestic banks sold their troubled mortgage loan portfolios to Lone Star, a private-equity firm based in Dallas. Whereas German banks, which are based in Germany and have a German consumer brand to protect, are constrained by these factors, Loan Star is less constrained by what is regarded as socially acceptable business practice in Germany or under German consumer laws. Loan Star was therefore able to increase return on the same assets.[21] For example, a newspaper reported in 2005: "Germany's troubled real estate market, with high office vacancy rates and stagnant housing prices, has been a disaster for banks such as Munich-based HVB Group or Bankgesellschaft Berlin. But it has been a bonanza for private-equity firm Lone Star. German banks offloaded bad loans with a face

[20] Gilson RJ, Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy, Harv L R 119 (2006) p 1658, citing, for example, Roe MJ, Rents and Their Corporate Consequences, Stanf L R 53 (2001) p 1463.

[21] See Balzli B, Pauly C, Vollstrecker aus Texas, Der Spiegel 31/2006 pp 58–60.

value estimated at $13 billion to $16 billion [in 2004], and Lone Star was by far the biggest buyer, accounting for as much as two-thirds of the market."[22]

For the same reason, a private-equity firm can pay more for the target's shares. All other things being equal, a local industrial firm can therefore be out of the race earlier. The factors likely to increase the price difference include: the strong consumer brand of the local industrial firm; the existence of a business culture requiring a high level of corporate social responsibility as a social norm; and the absence of mandatory provisions of law supporting that social norm.

This price difference, which is likely to harm the long-term survival prospects of local firms and change societal values for the worse in the long term, can be reduced through effective mandatory laws that level the playing field for all investors.

Ancillary services. Many customers are not just customers but provide even ancillary services. In this case, the relative weight of customers as agents depends even on the nature of the ancillary services. For example, the firm can be more dependent on its customers if: customers own a large block of shares; or there is a business partnership.

9.2.9 Managers as a Class as Agents

General Remarks

Professional managers are the classic category of agents in corporate governance.[23] The firm can employ a large number of legal tools to manage this agency relationship. In addition to the generic legal strategies designed to address agency relationships (Chapter 6), it is typical to use various monitoring and risk management tools (section 7.4). In the following, "soft" and legally unregulated corporate governance tools will be discussed first. They will be followed by "harder" and more traditional legal tools. The use of the board as a corporate governance tool will be discussed in sections 9.2.11 and 9.4.3.

Stewardship

Large firms and complex organisations cannot be managed by individual managers acting alone. The management of a large firm requires the co-operation of a large number of managers. For this reason, individual managers have an incentive to do what their peers find right or acceptable.

Stewardship theory has identified methods that increase social incentives to act in the interests of the organisation.[24] Social incentives - and the use of the "collec-

[22] Lone Star Germany: Ravenous For Bad Debt. BusinessWeek Online, March 14, 2005.

[23] See Shleifer A, Vishny RW, A survey of corporate governance, J Finance 52 (1997) pp 737–783.

[24] Davis JH, Schoorman FD, Donaldson L, Toward a Stewardship Theory of Management, The Academy of Management Review, Vol 22, No 1 (January 1997) pp 20–47.

tive intelligence" of managers - can be enhanced by collegiate decision-making supported by monitoring procedures (section 7.4).

Even competition can be important. Just as the firm can be disciplined by competition from other firms, managers face both the discipline and opportunities provided by the markets for their services. There are markets for their services both within and outside of the firm.[25]

Internal standards, value management systems

Internal standards are one of many ways to change behaviour inside the firm (sections 6.2 and 6.7). A particular way to change the behaviour of managers as a class is the use of value management systems.

As said above, the ultimate goal of the firm is its long-term survival in a competitive environment. This requires profitability and efficiency. Managers can measure the profitability and efficiency of the business organisation in different ways, and managers can choose from a wide range of value management systems that can be used for the planning, controlling and monitoring of businesses.

Typical controlling parameters include: discounted cash flow (DCF); cash flow return on investment (CFROI); cash value added (CVA); and economic value added (EVA).[26]

Economic value added (EVA) belongs to the most popular value-based measures. EVA is the measure of whether the operating profit within a company is enough compared to the total costs of capital utilised. The theory of economic value added has traditionally suggested that every company's primary goal is to maximise the wealth of its shareholders. However, EVA is poor in periodising the returns of a single investment. EVA underestimates the return in the beginning and overestimates it at the end of the period. EVA is criticised to be a short-term performance measure, because ceasing investments increase short-term EVA.

Some financial performance measures like CFROI, CVA and DCF have modified depreciation schedules that even out the profitability during the investment period. However, this decreases the objectivity of these measures.

Cash value added (CVA) indicates the degree to which cash flows needed to cover the costs of equity and debt and of reproducing depletable assets have been generated. The CVA and gross cash flow (GCF) are profitability indicators for a single reporting period.

The profitability of the firm and its individual business entities can also be measured by cash flow return on investment (CFROI). This is the ratio of gross cash flow (GCF) to capital invested (CI).

According to the Balanced Scorecard concept, companies should use several different groups of measures (perspectives) in measuring performance. Kaplan and Norton say that the relative weight of each perspective should depend on the business field and situation of the company.

[25] Fama EF, Agency Problems and the Theory of the Firm, J Pol Econ 88 (1980) p 289.

[26] Mäkeläinen E, Economic Value Added as a management tool (1998).

The perspectives suggested by Kaplan and Norton are:[27] financial ("How should we appear to our shareholders?"); customer ("How should we appear to our customers?"); internal business process ("To satisfy our shareholders and customers, what business processes must we excel at?"); and learning and growth ("To achieve our vision, how will we sustain our ability to change and improve?")

Separation or Combination of Ownership and Decision Functions

The separation of residual risk bearing from decision functions (also called the separation of "ownership" and "control") is usually regarded as one of the fundamental causes of corporate governance problems.[28]

In this book, it is nevertheless assumed that the firm is the most important principal. Therefore, rather than being the cause of problems, the separation of share ownership and control or combining them can be used as a corporate governance tool.

It is in the long-term interests of the firm that important decisions are taken by the corporate bodies that can best represent the long-term interests of the firm (for the board, see section 9.2.11). These bodies should be adequately shielded against stakeholders and other parties that further their own short-term private interests rather than the long-term interests of the firm.

For example, the managers of German and Japanese car firms are typically protected against short-term shareholders. German and Japanese car firms are not only profitable but also leaders in technology, quality and design. The same cannot be said of English and US car manufacturers.[29].

Anyway, where an investor regards the separation of share ownership and decision functions as a problem, the investor can basically do two things. The firm can try to achieve the same two things in order to further its own interests.

First, the investor can obtain control through block-ownership (section 9.4.2). Where share ownership and decision functions are *not* separate, the firm can try to ensure that it has or will obtain a controlling shareholder that shares the long-term interests of the firm.

Second, where share ownership and decision functions *are* separate, the investor can try to mitigate the agency problems caused to the investor thereby. This is what the firm would be doing in any case, because the firm will have to manage its internal agency relationships as part of corporate risk management (section 7.4).

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27 Kaplan R, Norton D, Balanced Scorecard. Harv Bus S P, Boston (1996) p 9.

28 Fama EF, Jensen MC, Agency Problems and Residual Claims, J L Econ XXVI (2) (1983) pp 331–332.

29 Wüst C, Patient im Wachkoma, Der Spiegel 35/2007 p 123 (on the problems of Jaguar).

Separation of Control and Management

One of the usual ways to mitigate agency problems is to separate different steps in the decision process.

In broad terms, the decision process has four steps: initiation (generation of proposals for resource utilisation and structuring of contracts); ratification (choice of the decision initiatives to be implemented); implementation (execution of ratified decisions); and monitoring (measurement of the performance of decision agents and implementation of rewards).[30]

It is usual to separate management (initiation and implementation) and control (ratification and monitoring) of important decisions. Separation means that an individual agent does not exercise exclusive management and control rights over the same decisions.[31]

Although the participation of many people in the decision-making process can increase some costs, it can reduce the overall costs. First, it can increase the quality of decision-making. In complex organisations, specific knowlege relevant to different decisions is diffused among all levels of the organisation. The separation of management and control of important decisions can reduce costs by delegating the initiation and implementation of decisions to the agents with valuable relevant knowledge.[32] Second, it can reduce the risk and costs of abuse.

Devices for separating decision management and decision control include: (1) decision hierarchies in which the decision initiatives of lower level agents are passed on to higher level agents, first for ratification and then for monitoring; (2) one or more corporate bodies that ratify and monitor the organisation's most important decisions (for example, supervisory boards, management boards, one-tier boards, board committees, other committees, or shareholders in general meeting); (3) one or more corporate bodies that hire, fire, and compensate top-level decision managers; and (4) structures that encourage mutual monitoring among decision agents (for example, standard operation procedures, collegiate organs, and the joint liability of members of the collegiate organs).[33]

This can be done at all levels of the organisation.[34] For example, the firm's risk management mechanisms could separate management and control in the following ways: (a) The firm can adopt internal guidelines defining authority and responsibilities for each management and staff level. At the same time, the firm can define job functions for every position in order to clarify authority and responsibility. (b) Standard operation procedures can be adopted and published so that managers and employees can retrieve them for review at any time. The scope of delegation and responsibility for each management and staff level can be defined even more

[30] Fama EF, Jensen MC, Separation of Ownership and Control, J L Econ XXVI (2) (1983) p 303.
[31] *Ibid* p 304.
[32] *Ibid* p 308.
[33] See Fama EF, Jensen MC, Agency Problems and Residual Claims, J L Econ XXVI (2) (1983) pp 331–332.
[34] Fama EF, Jensen MC, Separation of Ownership and Control, J L Econ XXVI (2) (1983) p 304.

clearly in these documents. (c) Internal control guidelines can be used in order to ensure that all four steps in the decision process are not performed by only one person or only one corporate body. The firm should set up more than one control check point for each operation procedure in order to make sure that operation procedures are performed by more than one person or corporate body.

How the separation of control and management is done depends on the organisation. This can be illustrated by corporate bodies that consist of either one person or a committee.

Table 9.1 Control Bodies and Management Bodies

Control body	*Management body*	*Typical ways to organise decision powers*	*Importance of monitoring of control body (on a scale of 1–4)*	*Typical uses*
one person	one person	decrease the power of the control body; decrease the power of the management body	4, most important	below board level
one person	committee	decrease the power of the control body; increase the power of the management body (→ "2")	2, where the management body has much power and the control body has little power; 3, where the management body has little power and the control body has much power	CEO and internal executive committees
committee	one person	increase the power of the control body; decrease the power of the management body (→ "3")	2, where the management body has much power and the control body has little power; 3, where the management body has little power and the control body has much power	one-tier board and a powerful CEO
committee	committee	decrease the power of the control body; increase the power of the management body	1, least important	statutory two-tier board, statutory one-tier-board with a sub-board executive committee

It can be assumed that the actions of committee members are subject to monitoring by peers, whereas the actions of a lone person are not subject to such monitoring.

In any case, the separation of control and management requires the existence of two corporate bodies, the management body and the controlling body. There can be interaction between the organisation of these two bodies, the distribution of power, and the use of an external monitor: (a) If the management body is subject to effective monitoring in other ways, it can have more power and fewer decisions need to be ratified by the control body. (b) If the management body is not subject to effective monitoring in other ways, it should have less power and more decisions should be ratified by the control body. (c) The more power the control body has and the more decisions are ratified by it, the more important it becomes to monitor the control body effectively.

Monitoring

Monitoring is an important part of the decision process. There are a number of different legal tools employed in the monitoring of managers as a class.

First, it is usual to apply a mix of *monitoring tools*, but the relative weight of each monitoring tool depends on the jurisdiction and the agency relationship in question.

Typically, there are differences between continental Europe and the UK/ US. This can partly be explained by the more important role of debt funding and the more important role of employees in the governance of companies in continental Europe.

It is possible that different monitoring tools are available to different stakeholders and that different stakeholders prefer different monitoring tools. The stakeholders' choice of monitoring tools can also vary depending on the agent. For example, the monitoring tools can depend on whether the relevant agency relationship is minority shareholders v controlling shareholders, shareholders v professional managers, or tax authorities v management.

Second, there can be a large number of different *monitors*, some of which are external and others internal (mixed monitoring). Mixed monitoring is regarded as a good thing.[35] The main external monitors include: the capital market; banks; statutory auditors; private organisations; non-controlling shareholders; and the government. The main internal monitors include: controlling shareholders; different corporate bodies; members of collegiate organs; and employee representatives.

There are two basic models in Europe as regards the regulation of the monitoring of corporate governance in listed companies. The UK model is traditionally biased towards the use of disclosure and monitoring by the capital market. This can be contrasted with the German model which consists of the use of mixed monitoring by many different monitors (see below).[36]

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[35] Tirole J, The Theory of Corporate Finance. Princeton U P, Princeton and Oxford (2006) p 337.

[36] See Mäntysaari P, *op cit*, Chapter 6.

Third, monitoring would not be possible without *information*, and information can be produced in different ways (see Chapter 10). Community law provides for an extensive disclosure regime for companies (see also Volume III).

Fourth, managers can be monitored *internally*. When managers are monitored internally, a mix of mechanisms can be used.

Managers can be monitored by their *superiors and junior managers*. There is much internal monitoring of managers by managers themselves, because managers typically work as a team and each manager has a stake in the performance of other managers, in particular the managers above and below him. As a consequence, each manager undertakes some amount of monitoring in both directions.[37] Managers typically have reporting duties vis-à-vis known persons such as their superiors, they can be monitored by board members, and their actions can generally be made transparent within the company.

US Supreme Court Justice Louis Brandeis famously referred to the benefits of openness and transparency when he said that "sunlight is the best disinfectant".

Managers can also be monitored by their *peers*. Monitoring by peers can be enhanced by using boards and committees; it can further be enhanced if these boards and committees are corporate bodies that take formal decisions and if their members are collectively responsible for decisions.

For example, listed US companies typically have a powerful CEO – in the worst case an "imperial CEO"[38] - who is not subject to monitoring by his or her peers. Collective responsibility was nevertheless a technique used in the Sarbanes-Oxley Act after several corporate scandals. The CEO and chief financial officer (CFO) of an issuer now have important certification obligations. In addition, Section 404 of the Sarbanes-Oxley Act requires the management and the company's external auditor to appraise the internal controls over financial transactions and to report any weaknesses.

This can be contrasted with the German AG. The management board (Vorstand) of an AG is responsible for the top management of the company. The management board is a collegiate organ and its members are responsible for monitoring one another. By law, an AG cannot have a formal CEO and certainly not any "imperial CEO".

Furthermore, the prevailing principle in Europe is – in contrast to the US – the collective responsibility of board members for financial statements. For the sake of clarity, the European Commission proposed in October 2004 amendments to the Fourth and Seventh Company Law Directives that would confirm that board members of limited companies are collectively responsible to the company for the financial and other key information that they publish.

The effectiveness of internal monitoring systems may be enhanced through *organisational constraints and technical constraints*.[39] For example, the expropriation of

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[37] Fama EF, Agency Problems and the Theory of the Firm, J Pol Econ 88 (1980) pp 289 and 293.

[38] The Delaware Court of Chancery used this term in its decision in In re Walt Disney Co. Derivative Litigation, No. 15452 (Del. Ch. Aug. 9, 2005).

[39] See also Gilson RJ, Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy, Harv L R 119 (2006) p 1658.

company funds often requires a mechanism to move these funds. The use of company funds can therefore be made subject to sufficient organisational and technical constraints. In addition, major transactions or the company's transactions with its managers require contracts. The company can therefore regulate the right to represent it in its dealings with company outsiders and company insiders and make these constraints more effective through organisational measures (section 7.5; for counterparty corporate risk, see Volume II).

Internal monitoring is not always effective, as was shown by the fate of LTCM: "For all its attention to risk, Long-Term's management had a serious flaw. Unlike at banks, where independent risk managers watch over traders, Long-Term's partners monitored themselves. Though this enabled them to sidestep the rigidities of a big organization, there was no one to call the partners to account."[40]

Fifth, managers can be monitored *externally*. External monitoring is made easier by the duty to disclose financial information and statutory audit requirements (for disclosure obligations, see Chapter 10).

Legal Duties and Sanctions

There are even other traditional ways to manage the agency relationship between the firm and its managers. The existence of legal duties is one of them. The duties can range from general and open duties (standards) to very specific duties (rules). Both can be complemented by sanctions for breach of duty. One of the most basic standards is based on the duty of care.

Duty of care. In addition to a duty to act in the interests of the company, managers and board members typically have a duty of care. The duty of care can be based on law or contract. It is usual to distinguish between the duty of care and the duty of loyalty. In common law jurisdictions, it is also usual to distinguish between the duty of care and fiduciary duty.

In order to comply with their duty of care, managers and board members must act with the same degree of care a reasonably prudent person would use in similar circumstances. The required minimum standard of care is usually influenced by legal background rules, other external rule-making, the firm's internal rule-making, and contracts.

The required minimum standard of care varies depending on the jurisdiction. Typically, it ranges from a subjective (and lower) standard to an objective (and higher) standard. In some cases, board members are allowed to assume that other board members and officers of the company have complied with minimum requirements (indicating a lower standard), while in other cases they may have an active duty to monitor them (indicating a higher standard).

Obviously, the standards are likely to be lower and more subjective in countries with a laissez-fair approach to business (say, England), and higher and more ob-

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40 Lowenstein R, When Genius Failed. The Rise and Fall of Long-Term Capital Management. Fourth Estate, London (2001).

jective in countries with a large company law regime consisting of mandatory provisions of law (say, Germany).

If the legal default standards are regarded as too lax, companies can regulate the modalities of their board members' and managers' duty of care through contracts. Companies may also adopt internal guidelines that lay down a higher minimum standard.

As regards listed companies, the modalities of board members' and senior managers' duty of care are increasingly being regulated by the duty to comply with various corporate governance codes. Although corporate governance codes have usually not been adopted by the government,[41] they may nevertheless enjoy a semi-official status,[42] or their recommendations can be taken into account by the court when determining the required standard of care after the fact.

There is a trend of rising and more objective standards in modern company and securities markets law.[43] The trend is to increase board members' and senior managers' *obligations* in order to make them more accountable. Many of the new legal rules lay down *disclosure* obligations which in effect double as substantive rules.[44] This trend is complemented by the increasing *liability* of board members and/or senior managers for financial information and risk management systems (for the management of information, see Chapter 10; for risk management, see Chapter 7).

Duties and sanctions. The duty of care can be understood only in its legal context. The relevance of this duty thus depends on its contents, sanctions for its breach, and how vigorously these sanctions are enforced.

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[41] The German Corporate Governance Code is linked directly to action on the part of the state, which is unusual by international standards. It was adopted by a government commission on 26 February 2002, and is reviewed yearly by the government commission.

[42] Companies that are listed on the London Stock Exchange are required to comply with the Listing Rules approved by the UK Listing Authority. The Listing Rules contain a reference to the Combined Code of Corporate Governance. The City Code on Takeovers and Mergers (the City Code) and the Rules Governing Substantial Acquisitions of Shares (the SARs) apply to the acquisition of shares. Both the City Code and the SARs are administered by the Panel on Takeovers and Mergers. They have also been endorsed by the Financial Services Authority.

[43] For English law, see Re City Equitable Fire Insurance Co[1925] Ch 407; section 214(4) of the Insolvency Act 1986; Norman v Theodore Goddard [1992] BCC 14; [1992] BCLC 1028; Re D'Jan of London Ltd [1993] BCC 646; [1994] 1 BCLC 561; Bishopsgate Investment Management Ltd (in liq) v Maxwell [1993] BCLC 1282; Re Barings plc (No 5) [1999] 1 BCLC 433; section 234ZA(3) of the Companies Act 1985 [inserted by the Companies (Audit, Investigations And Community Enterprise) Act 2004]; section 418 of the Companies Act 2006. See also Mäntysaari P, Comparative Corporate Governance. Shareholders as a Rule-maker. Springer, Berlin Heidelberg (2005), section 4.6.7.

[44] See, for example, Easterbrook FH, Fischel DR, The Economic Structure of Corporate Law. Harv U P, The United States of America (1991) p 276: "... the SEC occasionally uses the rubric of disclosure to affect substance ..."

For example, Judge Frankfurter said in a US judgment[45] that “to say that a man is a fiduciary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respect has he failed to discharge these obligations? And what are the consequences of his deviation from duty?”

Managers, to some extent, will try to comply with their duties even without the threat of effective legal sanctions for their breach. There are several reasons for this: legal sanctions are only part of a mix of tools used in order to manage agency problems; managers receive private non-pecuniary benefits for doing a good job; and the existence of a standard of care evidenced by legal rules on civil or criminal liability can be effective as a social norm.

However, managers’ duties can be complemented by civil liability and/or criminal liability. Sometimes the liability of managers can be based on sector specific legislation such as environmental law or work safety law (see section 4.3.3).

Civil liability and the business judgment rule. Now, civil liability and criminal liability for breach of duty can be effective deterrents provided that these sanctions are sufficiently severe and the likelihood of their enforcement is sufficiently high. However, the civil liability of managers and board members has been limited in various ways.[46]

To begin with, there is a difference between managers and board members. In the legal sense, most managers are mere employees whose civil liability to their employer has typically been limited by mandatory laws in Europe, and an employer is liable for acts done by employees during their time at work.

The civil liability of board members is partly based on company law. Company laws often make it very difficult or impossible for shareholders to bring proceedings against negligent board members. Obviously, civil liability does not work as a deterrent unless it can be enforced.

Furthermore, board members can benefit from the business judgment rule.

For example, courts in the US usually defer to the directors’ business judgment when deciding whether a board of directors has satisfied its duty of care. As long as the directors have no personal interest in the decision at hand and inform themselves before acting, courts presume that they acted in good faith and in the honest belief that their decisions were in the best interests of the company. This presumption can be rebutted only by showing that the directors engaged in wilful misconduct, acted in bad faith, or were grossly negligent.[47]

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[45] SEC v. Chenery Corp., 318 U.S. 80, 85 (1943). See also Paefgen WP, Unternehmerische Entscheidungen und Rechtsbindung der Organe in der AG. Verlag Dr. Otto Schmidt, Köln (2002) p 11.

[46] Fleischer H, Haftungsfreistellung, Prozesskostenersatz und Versicherung für Vorstandsmitglieder, WM 2005 pp 909-920; Black BS, Cheffins BR, Klausner M, Outside directors and lawsuits: What are the real risks? McKinsey Quarterly (2004) Issue 4 pp 70–77; Black BS, Cheffins BR, Klausner M, Why directors’ damages may harm investors, Financial Times, 20 January 2005; A chink in the boardroom door, The Economist, December 2004.

[47] Bagley CE, Winning Legally. Harv Bus S P, Boston (2005) p 60.

Similar principles have been applied in Europe. The German Supreme Court (Bundesgerichtshof, BGH) in effect adopted the US business judgment rule in cases such as ARAG/Garmenbeck and Siemens/Nold.[48] The business judgment rule is now based on § 93(1) AktG.

In practice, the civil liability of managers and board members is less effective as a corporate governance tool where managers and board members are protected by indemnification and D&O insurance.

Criminal liability. The problems related to civil liability have made criminal liability look more attractive in the eyes of legislators.[49]

The criminal liability of managers and board members varies depending on the jurisdiction, and there is a difference between the US and the Member States of the EU.

In the US, indictments of managers are more common than in Europe, and it is more usual for corporate counsel to warn managers of this risk. During the last quarter century, the consistent trend in the law of white-collar crime has been to expand criminal liability.

First, there are new economic offences.[50] Second, their criminalisation has been accompanied by a parallel shift in enforcement. For example, the US Department of Justice has shifted the focus of its bank criminal prosecutions to the bank's own directors, officers, employees and customers.[51] Third, the Sarbanes-Oxley legislation and changes to the federal sentencing guidelines in 2001 and 2003 have meant that executives found guilty of large, economically-damaging frauds are likely to serve lengthy prison sentences.[52]

Unlike in the US, punishment is systematically mild in Europe. In principle, it is possible to find the same kinds of offences in the laws of European countries as well as in the US. In practice, however, prosecutions are rare in Europe and convictions even rarer. There is also a tradition of mildness in grading in Europe.

For example, the Napoleonic criminal code of 1810 established what are still three grades in French criminal law, subject to three different kinds of punishment: "contravention", "délit", and "crime". Neither of the first two was understood to rise fully to the level of crime. French law tends to regard white-collar offenses as délits or contraventions rather than crimes. German law has a long and similar tradition of treating economic offences as mere Ordnungswidrigkeiten, violations of good order.[53]

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[48] BGHZ 135, 244 (ARAG/Garmenbeck); BGHZ 136, 133 (Siemens/Nold). Paefgen WP, Unternehmerische Entscheidungen und Rechtsbindung der Organe in der AG. Verlag Dr. Otto Schmidt, Köln (2002) pp 1 and 27.

[49] See, for example, Well-dressed thieves. Why the threat of prison is necessary to deter cartels, The Economist, February 2008.

[50] Whitman JQ, Harsh Justice. Criminal Punishment and the Widening Divide between America and Europe. OUP, Oxford (2003) pp 43–44.

[51] *Ibid*, p 47.

[52] See, for example, Bosses behind bars, The Economist, June 2004; Justice for bosses. Do America's crooked executives really need to be jailed for so long? The Economist, June 2004.

[53] Whitman JQ, *op cit*, p 83.

9.2.10 Individual Managers as Agents

Agency problems relating to the behaviour of individual managers can be managed by applying the usual legal strategies already discussed above. The behaviour of individual managers will be influenced by the structure of the firm's governance system and corporate governance tools designed to influence the behaviour of the firm's managers as a class. In addition, there are legal tools designed to influence the behaviour of individual managers.

Choice of managers, appointments. The behaviour of individual managers can be influenced by means of an appointment strategy. Good performance may further the manager's career and poor performance may end it.

Appointments can be a relatively powerful corporate governance tool because most employees have invested plenty of human capital in their employer (the firm).[54] The appointment rights strategy is less effective in aligning the interests of the manager and the principal where: the principal cannot appoint and remove the manager; the manager will be sufficiently compensated on the termination of his employment; or the manager does not need the job any more in order to pursue his private interests. For example, if the manager has already made enough money, he may prefer to pursue his other interests.

According to these principles, the most senior managers should usually be appointed by a corporate body that furthers the interests of the firm. They should not be appointed by the shareholders. In a German AG, the most senior managers are appointed by the supervisory board which has a duty to act in the interests of the firm (Unternehmensinteresse).

Controlling shareholders have de facto powers to appoint and remove managers, but other shareholders or investors as a rule do not have similar powers. If the firm has invested in the shares of a corporation without being its controlling shareholder, the firm might thus not be able to change the corporation's management.

Rules and standards. The firm can use rules and standards. It is usual for a company to agree with its managers and board members on the terms of their employment or service contracts.

It would be more difficult for a shareholder or another investor to agree on personal terms with the board members or managers of a company in which it has invested. Such contracts would seldom be compatible with the duties owed to the company by its board members and managers.

[54] See, for example, Behind the brass plate, The Economist, April 2006: "Goldman operates as a strict hierarchy, with a fair number of its 24,000 employees aspiring to be chosen as one of the 1,200 managing directors, who in turn aspire to be among the 300 'participating' managing directors, in essence partners with a slice of the profits. The selection is not always fair, suffering from the usual politics and whatever other flaws that beset every company, but it is a potent managerial tool."

Compensation. Executive compensation packages typically consist of two or three components: salary, bonus, and stock-based incentives (stock, stock options).[55] For many reasons, rising executive pay is a longer-term trend.[56]

As said above, the mainstream view of corporate governance is based on two assumptions. On the one hand, it is assumed that managers should maximise shareholder value. On the other, it is believed that managers cannot be trusted and that managers are likely to behave opportunistically regardless of their contractual, legal or moral duties.[57]

In order to overcome this agency problem, the mainstream view and managers themselves recommend aligning managers' pecuniary incentives and shareholders' pecuniary interests.[58]

At the same time, it is assumed that even highly paid managers are motivated by increasing pay. Other corporate governance tools and practices designed to influence their behaviour will not always be taken into account when designing the compensation package.

Legal problems relating to rising executive pay. The arguments that have led to the trend of rising executive pay can be problematic from a legal perspective.

As said before, managers cannot have an obligation to maximise shareholder value under company law. As a rule, board members and senior managers usually owe their duties to the company. The agency relationship that should be managed by compensation packages is that of managers v the firm rather than that of managers v shareholders. Performance-based compensation should be calculated on the basis of how well they reach the firm's long-term goals (rather than the goals of shareholders or other stakeholders).

Aligning managers' interests with those of shareholders (the wrong principal) can explain why studies do not show any connection between stock option programmes and the long-term success of the firm (the right principal).

Furthermore, companies use a combination of different legal tools when managing agency relationships. As the compensation package is not the only way to influence the behaviour of managers, failure to take other corporate governance tools into account can lead to overcompensation.

Interests of shareholders. However, shareholders understandably regard themselves as the principal. In the conflict between principals, it can be in the interests of many managers to side with investors rather than the firm.

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[55] Tirole J, The Theory of Corporate Finance. Princeton U P, Princeton and Oxford (2006) p 21.

[56] One of them is abuse. See Bebchuk LA, Fried JM, Walker DI, Managerial Power and Rent Extraction in the Design of Executive Compensation, U Chic L R 69 (2002) pp 751–846. See also Fama EF, Jensen MC, Agency Problems and Residual Claims, J L Econ XXVI (2) (1983) pp 331–332; Lie E, On the Timing of CEO Stock Option Awards, Management Science 51 (2005) pp 802–812.

[57] Williamson OE, Markets and Hierarchies: Analysis and Antitrust Implications. The Free Press, New York (1975) p 26. See already Leo Tolstoi's War and Peace (1865–1869).

[58] See also Ghoshal S, Business Schools share the blame for Enron, Financial Times, 18 July 2003.

Short-term financial investors prefer a high return on their investment in the short term and are not affected by what will happen to the firm after they have sold their shares. Most shareholders in listed companies belong to this category. To combine the agency theory with the choice of shareholders as the principal is of course in the interests of short-term shareholders and also in the interests of managers. It enables both of them to argue that the alignment of the interests of managers with those of shareholders by monetary incentives such as share option programmes is legitimate and allegedly based on theory. It also gives short-term shareholders a means to make the company pay managers for putting short-term shareholders' interests first.

Private-equity firms can introduce share option programmes and other incentive programmes for similar reasons as other short-term financial investors. In addition, they enable the use of company funds to buy managers' support for refinancing and exit (see Volume III).

9.2.11 The Board as an Agent

It is characteristic of a legal entity to have a statutory body responsible for its administration. The board is a typical statutory body responsible for the basic management functions of the entity (for alternative bodies, see section 9.4.3). These functions relate to: compliance with fundamental legal requirements; fundamental decisions; as well as the general management of the entity or the monitoring of general management. From a legal perspective, an independent limited-liability company is controlled through its board.

Compliance with laws. A limited-liability company is a legal fiction (sections 4.4.3 and 4.4.4) which needs representatives and an organisation (section 8.2) in order to operate. It needs a body responsible for compliance with legal minimum requirements. Furthermore, it needs a body responsible for the company's internal decision-making, the representation of the company in its dealings with company outsiders, and compliance with statutory information duties (see section 10.7 and Volume III). The board can act as such a body.

Fundamental decisions. In addition, in order to reduce potential conflicts of interest and the risk of expropriation, certain high-level decisions should preferably belong to the responsibilities of a body designed to further the interests of the firm.

First, there are fundamental "first level" questions which must be answered because of the nature of legal entities (sections 8.2.2 and 8.2.3). To some extent, they have been regulated by laws. To a large extent, however, they must be regulated by the entity itself.

Second, such a body or bodies should be responsible for: the choice of corporate strategy; the allocation of value generated by the firm; the risk level of the firm; and the allocation of risk inherent in the firm's activities.

Third, such a body or bodies should also responsible for the centralised management of the firm or for the supervision of centralised management under it.

Typically, the board is the corporate body entrusted with the task of regulating such issues at the highest corporate level. Alternatively, it can act as the corporate body facilitating the internal decision-making of the entity.

The role of governing law. The board of a limited-liability company is partly a standardised legal way of combining those functions. The board usually has very large formal powers.

However, the actual responsibilities of the board vary depending on the governing law and the enterprise form of the entity.

The role of the board as an agent depends also on other factors. For example, company size can play a role. In micro companies - such as small GmbHs or small Ltds - the statutory board usually consists of owner-managers and has no clear monitoring function. In larger companies and companies with financial investors, the board typically acts as a monitor of management (sections 9.2.9 and 9.4.3).

Conflicting interests, firm-friendliness as an objective. The role of the board of course depends on the perspective. From the personal perspective of a short-term financial investor, the board act as his agent and should further his interests. From the perspective of a parent company, the board acts as the parent's agent and the parent has legal and de facto powers to ensure that the board is "parent-friendly". From the persperctive of the firm, the board acts as the firm's agent.

The choice of perspective and agency relationship will change views about: the preferred duties of board members; the management and monitoring role of the board; and board membership.

From the perspective of the firm, the values and preferences of the board as a whole are important because of the large formal powers of the board. The board should preferably further the interests of the firm and be "firm-friendly". A board which is biased towards furthering the interests of one or more stakeholder categories - too shareholder-friendly, lender-friendly, customer-friendly, worker-friendly, environment-friendly - can increase the firm's costs and risk.

Firm-friendliness rather than "independence". If one accepts this line of argument, the board as a whole should preferably be "firm-friendly". This is more likely to happen when the board is sufficiently independent from all stakeholder categories which do not act in a "firm-friendly" way.

In contrast, many stakeholders may try to change the behaviour of the board from "firm-friendly" and "stakeholder-independent" to "stakeholder-biased", i.e. biased towards favouring that stakeholder's own interests. In listed companies, short-term financial investors typically prefer board members who share their values and are biased towards favouring measures that increase share price in the short term. The firm's employees may prefer the board membership of employee representatives such as labour union activists. Many people can prefer a rule that requires a minimum quota for board members that are women. The list of other examples can be long.

In the Nordic countries, there is in effect a voluntary minimum quota for female board members in listed companies or large unlisted companies, because the lack of female board members would result in a media outcry and the threat of the adoption of laws that set out a mandatory quota. Since 2008, it has been compulsory for Norwegian public limited-

liability companies (allmennaksjeselskaper, ASA) to appoint a substantial number of women to their management boards.[59] Companies that fail to comply with the 40% female quota for board members can be threatened by closure. In Finland, both sexes should be represented in the board of a listed company according to the Corporate Governance Code of 2008.

Many of the firm's stakeholders also try to exclude or limit the board membership of people who can be expected to further the interests of competing stakeholders or the firm. For example, financial investors may prefer board members to be independent of management, short-term financial investors may prefer to limit the board membership of a previous or present CEO and the board membership of employee representatives, and male chauvinists can prefer to exclude the board membership of women regardless of merit.

Legal rules can reflect bias. The governing law and other external rules can reflect bias towards furthering the interests of the firm or the interests of a particular stakeholder category. While German company law applicable to large companies (AG) is biased towards being "firm-friendly", the regulation of listed companies has traditionally been "investor-friendly" in England. The Recommendation adopted by the European Commission to reinforce the role of independent directors on listed companies' boards[60] is, to a large extent, based on values imported from the London market.

According to the Aktiengesetz, all board members owe a duty to act in the interests of the company (Unternehmensinteresse). The two-tier board structure of AGs increases the independence of monitoring (decision control) from management (decision management).[61] German company law leads to mixed monitoring, and the corporate decision-making of large companies typically requires broad consensus. Because of structural measures, the personal "independence" of members of the two statutory boards is less important.

The Commission believes that board members should be independent, in particular from the firm and its management: "The presence of independent representatives on the board, capable of challenging the decisions of management, is widely considered as a means of protecting the interests of shareholders and other stakeholders ... In order to ensure that the management function will be submitted to an effective and sufficiently independent oversight function, the (supervisory) board should comprise a sufficient number of committed non-executive or supervisory directors, who, in addition to not performing management duties in the company or its group, are independent, i.e. free from any material conflict of interest."[62]

Integrity. Because of potentially powerful conflicts of interests between the firm and its stakeholders and stakeholders inter se, a high level of integrity should be required from members of the board. Structural measures can be employed to re-

[59] § 6–11a of Lov om allmennaksjeselskaper (allmennaksjeloven). For the Swedish proposal, see af Sandeberg C, Jämn könsfördelning i bolagsstyrelser, NTS 2006:3 pp 48–59.

[60] Commission Recommendation of 15 February 2005 on the role of non-executive or supervisory directors and on the committees of the (supervisory) board (2005/162/EC).

[61] See, for example, Mäntysaari P, *op cit*, Chapter 6.

[62] Recitals 8 and 9 of Commission Recommendation 2005/162/EC.

duce the required level of *personal* integrity of individual board members (the US/UK model) and increase the *organisational* integrity of the board as a corporate body (the German model; for fundamental organisational ways to manage risk, see section 7.4).

Firm-friendliness, appointments, culture. The degree of the board's firm-friendliness is particularly important because the board can change corporate culture and the firm's organisation.

If the board is firm-friendly, the appointment rights vested in the board will mean that the management of the company either is or will become firm-friendly in the long term. From the perspective of the firm, the board can be management-friendly, provided that the board and the management share the same values by being firm-friendly.

For example, if (1) the company has a two-tier board with a supervisory board that appoints the members of a management board, (2) the members of the supervisory board have a statutory duty to further the long-term interests of the firm, and (3) these duties are complemented by effective sanctions, the firm will benefit: the management board will - at least to some extent – be protected against stakeholders and will better be able to further the long-term interests of the firm.

On the other hand, if the company has a one-tier board whose members represent the values of short-term financial investors, the board is more likely to appoint senior executives sharinge the same values as the board.

Case: Stora Enso. The importance of the board's firm-friendliness and the adverse effects of a bias towards the interests of short-term financial investors can be illustrated by the case of Stora Enso, a Nordic paper, packaging and forest products company which was created through the merger of Stora Kopparbergs Bergslags Aktiebolag (an old Swedish company) and Enso (an old Finnish company). There is no shortage of other examples after the financial meltdown of 2007–2009.

Now, the paper industry is very energy intensive and dependent on the availability of large amounts of cheap wood. In 1999, Stora Enso's board redefined the strategic direction of the company. The board said that "Stora Enso's primary task is to secure shareholder value generation and profitability".[63] The company would therefore introduce a stock option programme and buy back its own shares. It would focus on three core businesses (publication papers, fine papers and packaging boards). It would sell a significant portion of its power assets.[64] In 2002 Stora Enso sold most of its forest land in Finland and in the US, and in 2004 its forest land in Sweden. In 2000, the company acquired Consolidated Papers, Inc. for €4.9 billion in order to gain access to the North American market. In addition to Nordic listings, Stora Enso's ADR's (American Depositary Receipts) were listed in the US.

After a few years, Stora Enso was a company in crisis because of rising costs of energy and wood and years of chronic losses in North America. After having overpaid for Consolidated Papers, Stora Enso divested its North American assets at a loss. In 2008, Stora Enso delisted its ADR's from the New York Stock Exchange. In 2008, its shares were

[63] Stora Enso, stock exchange release of 20 August 1999.

[64] The board said: "It is not necessary for Stora Enso to own all its power assets. The energy market and thus Stora Enso would benefit if the big international energy companies gained synergies by expanding their international network of assets. After divestment, Stora Enso's self-sufficiency in electrical power will be 40%, compared with 90% at present." Stock exchange release of 20 August 1999.

worth half of what they were worth in 1999 when the board disclosed the company's new shareholder-friendly strategy.

The firm's interests, other interests, division of power. The allocation of formal and real authority[65] is important for the long-term survival of the firm.

The firm can survive, although its shareholders, board members, and managers have different personal interests and personal objectives, provided that there is a clear distribution of power in the company.[66]

In the long run, however, the use of appointment rights (selection rights and removal rights) and other governance rights (such as the right to decide on incentives) is likely to mean that the preferences of those who will be appointed will match the preferences of those in whom the appointment rights are vested.

The board and senior executives will thus be more likely to act in the interests of the firm, if the real power in the firm (control) is vested in a body that shares those interests and is "firm-friendly". The allocation of real power is usually supported by the formal allocation of power under legal rules or articles of association.

The firm would benefit from formal rules that: (a) increase the independency of the body designed to further the interests of the firm from those furthering conflicting interests; (b) vest appointment rights in that body (for example, managers are typically not appointed by shareholders); and (c) provide that the body controlling the firm must act in the interests of the firm (for example, company laws typically provide that the duties of the statutory board are owed to the company).

How control is allocated to the body that shares or furthers the interests of the firm depends on the firm: its share ownership structure, separation of ownership and control, separation of decision management and decision control, and whether it has a centralised management under the statutory board or not.

Friendliness and objectives. The board can also have a supervisory and advisory role rather than the role of the supreme management body. However, the board cannot fulfil its role as adviser effectively in the interests of the firm, unless it is given useful information by the management. Useful information would lead to better advice.

The board is likely to receive more useful information, if it is perceived by management as management-friendly. On the other hand, the board cannot fulfil its role as monitor of management, if the board is too management-friendly in fact.[67] Perceived management-friendliness can be achieved by ensuring that the board and management share the same objectives such as the objective of furthering the long-term interests of the firm.

In addition, the board is the firm's main contact to shareholders. Shareholders prefer a board that is perceived as shareholder-friendly. Perceived shareholder-

[65] For the distinction between formal and real authority, see Aghion P, Tirole J, Formal and real authority in organizations, J Pol Econ, Vol 105, No 1 (February 1997) pp 1–29.

[66] Stewardship theory explains why people tend to further the interests of the organisation.

[67] Adams RB, Ferreira D, A Theory of Friendly Boards, J Fin 62 (2007) pp 217–250. See also Higgs D, Review of the role and effectiveness of non-executive directors (January 2003), 6.2–6.3.

friendliness can be achieved by ensuring that the board signals to shareholders that it shares their objectives. On the other hand, the board cannot fulfil its role in the interests of the firm, if it is too shareholder-friendly in fact. The board is thus tempted to say one thing (intention to take measures that increase shareholder value in the short-term) and do another (further the long-term interests of the firm).

Generally, management, the board, and controlling shareholders are more likely to influence each other where their interests are better aligned with those of the firm. In that case, their interaction is less constrained by company law rules, as the actions of the board members should always be aligned with the business judgment rule and other company law rules protecting the firm.

In practice, management, board members, and controlling shareholders are just as likely to influence each other where their interests are aligned in any other way. For example, where the interests of the management and members of the board are aligned with those of activist shareholders, there can be constant friction caused by the existence of mandatory provisions of company law protecting the firm.

9.3 Community Law

9.3.1 Introduction

The legal regulation of corporate governance typically focuses on a number of core questions caused by the nature of companies. As regards agency relationships, legal rules typically try to change the behaviour of the board, individual board members, and the most senior executives. Practically all corporate governance phenomena are based on or influenced by laws and can be understood only in the light of the governing law. The legal tools that the firm and its stakeholders can employ depend on the governing law.

Nature of regulation. The following things are characteristic of the regulation of corporate governance for limited-liability companies in the EU.

Although there is plenty of Community legislation in this area, there is no across the board harmonisation of corporate governance issues in EU company and securities markets law.

There is also a difference between company law and securities markets law as well as between listed companies (companies whose shares have been admitted to trading on a regulated market), public limited-liability companies, private limited-liability companies, and partnerships.

As regards traditional questions of company law, Community institutions have relied on a piece-meal approach and the harmonisation of a few important issues. Public limited-liability companies are governed by a mandatory legal capital regime.

The disclosure of financial information by public limited-liability companies is governed by similar rules in all Member States because of accounting directives and IFRS.

There is extensive harmonisation of securities markets laws in the EU, and listed companies tend to be subject to similar disclosure obligations in all Member States.

In the absence of across the board harmonisation of corporate governance issues, Member States' laws play the most important role. Different Member States have addressed agency relationships in different ways. Private limited-liability companies are typically governed by flexible rules and partnerships by very flexible rules.

In addition, there are common rules on the participation of employees. They can be regarded as constraints to governance rather than rules on corporate governance as such.[68]

Community law compared with US federal law. The limited regulation of the company law aspects of corporate governance and the extensive regulation of disclosure obligations means that there are similarities between the EU and US approaches to the regulation of corporate governance. However, there are two important differences.

There are radically different approaches to legal capital (see Volume III). In the EU, legal capital rules are core corporate governance rules that: allocate power between the statutory board and shareholders; require that many transactions must be decided on or authorised by shareholders; restrict the distribution of funds to shareholders; and, in some cases, allocate power between corporate bodies and creditors. In the US, shareholders' weak rights[69] are complemented by the absence of a similar legal capital regime, and there are less powerful constraints on the making of payments to shareholders.

The second difference is the regulation of labour relations.[70]

Contents. Four important methods to manage agency relationships through laws (and four risk management methods, see also Chapters 5 and 6) will be discussed below: (1) the separation of decision management and decision control; (2) monitoring by the board; (3) financial reporting and transparency; as well as (4) the alignment of interests through rewards.

They have been chosen because of their impact. All four are fundamental areas of corporate governance and apply to the firm's regular management processes. From the perspective of the firm, they should enable the board to act in a "firm-friendly" way. There is also a large amount of regulation at the Community level in these areas.

Related questions. Related questions will be discussed in other parts of this chapter. Section 9.4 will discuss the management of agency relationships from the perspective of controlling shareholders and section 9.5 from the perspective of

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[68] For this distinction, see Mäntysaari P, Comparative Corporate Governance. Shareholders as a Rule-maker. Springer, Berlin Heidelberg (2005), Chapter 2.

[69] See Bebchuk LA, The Case for Increasing Shareholder Power, Harv L R 118 (2005) pp 833–914.

[70] For a table on convergence and divergence of corporate governance in the US and the EU, see also Aglietta M, Rebérioux A, Corporate Governance Adrift. A Critique of Shareholder Value. The Saint-Gobain Centre for Economic Studies Series. Edward Elgar, Cheltenham Northampton (2005) p 72.

minority shareholders. The rights of shareholders will act as a constraint to the regular management of the firm and will enable shareholders to change the behaviour of the board towards "shareholder-friendliness".

Other ways to regulate corporate governance. There are many other ways to manage agency relationships in the context of corporate governance through laws. However, they can better be discussed in specialist books.

As regards company law, the Company Law Action Plan contains a fuller account of the regulation of corporate governance at the Community level and of the Commission's plans.[71]

Furthermore, prudential regulation and share ownership controls are typically used in regulated industries such as financial services. Share ownership controls are usually designed to allow supervisors to do three things: review the suitability of potentially dominant shareholders; prevent adverse influence on the conduct of the firm's business; and monitor conglomerates.[72] Typically, restrictions apply to qualifying holdings.[73] Prudential regulation and ownership control will not be discussed here.

Flexibility. The recognition of foreign companies (*Centros*) has increased flexibility.

For commercial and legal reasons, however, many firms still prefer to operate through local subsidiaries. Divergence in mandatory legal requirements can increase administrative costs for company groups.

In the future, the adoption of the SPE Regulation will make it easier for the vast majority of firms to incorporate companies governed by the same company law rules throughout the EU. The SPE will be a very flexible company form.

Because of increasing flexibility, it becomes more important to firms to rethink their management and control structures.

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[71] Communication from the Commission to the Council and the European Parliament - Modernising Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward, COM/2003/0284 final. See also Baums T, European Company Law Beyond the 2003 Action Plan, European Business Organisation Law Review 8 (2007) pp 143–160; Moloney N, Time to Take Stock on the Markets: The Financial Services Action Plan Concludes as the Company Law Action Plan Rolls Out, ICLQ 53 (2004) pp 999–1009.

[72] See, for example, Article 38(1) of Directive 2004/39/EC (MiFID): "Member States shall require the persons who are in a position to exercise, directly or indirectly, significant influence over the management of the regulated market to be suitable." See also Article 12(2) of Directive 2006/48/EC (Capital Requirements Directive) and Article 8 of Directive 2002/83/EC (Directive on life assurance).

[73] Article 4(1)(27) of Directive 2004/39/EC (MiFID). See also Article 1(1)(j) of Directive 2002/83/EC (Directive on life assurance) and Article 4(11) of Directive 2006/48/EC (Capital Requirements Directive). The regime was amended by Directive 2007/44/EC.

9.3.2 Separation of Decision Management and Control

General Remarks

The separation of decision management and decision control is one of the generic ways to manage agency relationships in the context of corporate risk management and corporate governance. The effect of Community law and Member States' laws on the separation of decision management and decision control depends on many things: the law governing the company; its company form (whether the company is a public limited-liability company or a private limited-liability company); and whether the shares of the company have been admitted to trading on a regulated market or the company is privately-owned.

European Company Forms

There are fundamental differences between the corporate governance models adopted by different Member States for limited-liability companies. This makes it difficult to harmonise core questions of corporate governance. For example, it would not be meaningful to harmonise all company law rules governing the activities of "boards".

The existence of a "board" is not a necessary condition for the existence of a functioning limited-liability company, and all companies do not have "boards".[74] Furthermore, the "board" of company X incorporated under the laws of country A is not the same thing as the "board" of company Y incorporated under the laws of country B, if the relevant functions of these two boards are not the same.[75]

It is therefore easier to approximate laws by common rules that regulate particular functions or transactions rather than "board" work as such. Alternatively, one can adopt rules facilitating the incorporation of new European company forms.

The SE Regulation (Statute of the European Company)[76] and the proposed SPE Regulation are examples of the latter. They address the question of management and control in different ways.

SE. The SE Regulation lays down the fundamental legal rules governing an SE. As the SE Regulation lays down only the most fundamental rules, an SE, to a large extent, is governed by the laws of the Member State in which it has been registered.[77]

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[74] In Germany, the vast majority of limited-liability companies are GmbHs which have one or more managing directors. § 6(1) GmbHG: "Die Gesellschaft muß einen oder mehrere Geschäftsführer haben." A supervisory board is optional. § 52(1) GmbHG.

[75] For differences between the German model and the British model see Mäntysaari P, Comparative Corporate Governance. Shareholders as a Rule-maker. Springer, Berlin Heidelberg (2005), Chapter 6.

[76] Regulation 2157/2001 (SE Regulation). See also Regulation 1435/2003 (SCE Regulation).

[77] Article 9(1) of Regulation 2157/2001 (SE Regulation).

According to the Regulation, "an SE shall comprise: (a) a general meeting of shareholders and (b) either a supervisory organ and a management organ (two-tier system) or an administrative organ (one-tier system) depending on the form adopted in the statutes".[78]

The choice between a two-tier system and a one-tier system has thus been left to the company.[79]

Where the company has chosen the two-tier system, the separation of decision management and decision control is relatively clear.

First, no member may serve on both the management board and the supervisory board at the same time.[80]

Second, the role of the supervisory organ is to "supervise" the work of the management organ, i.e. to check and monitor the management organ. The supervisory board may not itself exercise the power to "manage" the SE, i.e. to engage in management tasks or represent the company in transactions with third parties.[81]

Third, the management organ is responsible for "managing" the SE.[82] In addition, the management organ must report to the supervisory organ on a regular basis, pass information promptly on events likely to have an appreciable effect on the SE and respond to enquiries.[83]

The basic legislative technique used in the Regulation is (a) that the provisions of the Regulation set out some general rules which are directly applicable in the Member States and (b) that the modalities of different rights and obligations are based on the provisions of national laws.[84]

Where the company has chosen the one-tier system, the separation of decision management and decision control is not as clear. Under the single-tier structure, the SE is managed by an administrative organ instead of a supervisory organ and a management organ.[85]

There is room for a managing director or managing directors under both systems. According to the wording of Articles 39(1) and 43(1), a Member State "may provide that a managing director or managing directors shall be responsible for the current management under the same conditions as for public limited-liability companies". An SE can thus have one or more managing directors depending on the

[78] Article 38 of Regulation 2157/2001 (SE Regulation).

[79] Article 38(b), recital 14 of Regulation 2157/2001 (SE Regulation).

[80] Article 39(3) of Regulation 2157/2001 (SE Regulation).

[81] Article 40 of Regulation 2157/2001 (SE Regulation).

[82] Article 39(1) of Regulation 2157/2001 (SE Regulation).

[83] Article 41 of Regulation 2157/2001 (SE Regulation).

[84] Kübler F, Leitungsstrukturen der Aktiengesellschaft und die Umsetzung des SE-Statuts, ZHR 167 (2003) p 223: "Die VO gibt nur einen Rahmen vor, der durch die schon bestehenden Aktiengesetze der Mitgliedstaaten und durch die von ihnen zu schaffenden Rechtsvorschriften implementiert wird."

[85] Article 43 of Regulation 2157/2001 (SE Regulation).

implementation of the Regulation in the Member States. These managing directors should be board members.[86]

Under both systems, an SE must have a general meeting of shareholders.[87] The Regulation contains some provisions on the powers of the general meeting.[88] However, the legal nature of the general meeting has been left open in the Regulation.

The powers of the general meeting are generally governed by Member States' laws. In addition, the general meeting shall decide on matters for which it is given sole responsibility either by the Regulation[89] or the rules on employee involvement supplementing its provisions. For example, amendment of an SE's statutes require a decision by the general meeting.[90]

SE and co-determination. An SE is subject to a worker participation regime based on the before-after principle (see also Volume III).[91] In practice, changing to SE status allows firms to negotiate a cut in workers' representation.

SPE. Instead of harmonising the rules on management and control for private limited-liability companies, the proposed SPE Regulation would create a new and very flexible company form available in every Member State with as few variations as possible.

The proposal leaves the choice of the firm's management and supervision structure to the firm. There must be a management body which consists of at least one "director". The proposal contains a non-exclusive list of matters which must be decided on by a resolution of the shareholders.

Public Limited-liability Companies

The prevailing piece-meal approach and the approximation of specific matters in the area of company law have resulted in the adoption of some common rules for public limited-liability companies.

Important transactions. Shareholders in public or listed companies typically have veto rights according to the European legal capital regime (section 9.7.10 and Volume III).

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[86] Mäntysaari P, Comparative Corporate Governance. Shareholders as a Rule-maker. Springer, Berlin Heidelberg (2005), Chapter 3.

[87] Article 38 of Regulation 2157/2001 (SE Regulation).

[88] Article 52 of Regulation 2157/2001 (SE Regulation).

[89] See especially Article 8(4) (transfer of registered office); Article 23(1) (approval of the draft terms of merger); Article 32(6) (formation of a holding SE); Articles 37(5)–37(7) (conversion of an existing public limited-liability company into an SE, approval of the draft terms of conversion); Article 39(2) (appointment and removal of a member or members of the management organ); Article 40(2) (appointment of the members of the supervisory organ); 43(3) (appointment of the member or members of the administrative organ); Article 59 (amendment of an SE's statutes); Articles 66(4)–66(6) (conversion of an SE into a public limited-liability company, approval of the draft terms of conversion).

[90] Article 59(1) of Regulation 2157/2001 (SE Regulation).

[91] See, in particular, Articles 4 and 7 of Directive 2001/86/EC.

The Second Company Law Directive provides that any increase in the subscribed capital must be decided upon by the general meeting[92] and that the pre-emption rights of existing shareholders may not be restricted or withdrawn without the consent of the general meeting.[93] There are similar provisions on the reduction in subscribed capital.

The Second Directive is complemented by the Third Directive, which provides that a merger requires the approval of the general meeting of each of the merging companies,[94] the Sixth Directive, which contains a similar provision on the division of companies,[95] and the Directive on cross-border mergers of limited-liability companies.[96]

The Directive on takeover bids complements these directives by providing that the use of certain takeover defences requires the prior consent of the general meeting.[97]

Member States' laws. In the absence of common rules, different Member States may address the separation of decision management and decision control in different ways. There is a large variety of corporate governance models used by the Member States.

There can be plenty of *intra-state* variation as regards small *private* companies. The corporate governance models of private companies typically depend on the company's share ownership structure (entrepreneur – dispersed) and management structure (concentrated – dispersed) in addition to the applicable legal framework and cultural factors.

There can also be plenty of *inter-state* variation as regards corporate governance models used by large *listed* companies.

In addition, there is more intra-state variation in some countries than in others. Some countries have adopted relatively few mandatory rules on the governance structure of companies. Other countries have standardised the governance structure by mandatory rules.

This can be illustrated by the corporate governance models used by public limited-liability companies in Germany, a country whose laws restrict intra-state variation, and the UK, a country whose laws permit more intra-state variation.

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92 Article 25(1) of Directive 77/91/EEC (Second Company Law Directive).

93 Article 29(4) of Directive 77/91/EEC (Second Company Law Directive).

94 Article 7 of Directive 78/855/EEC (Third Company Law Directive).

95 Articles 5 and 6 of Directive 82/891/EEC (Sixth Company Law Directive).

96 Directive 2005/56/EC.

97 Article 9(2) of Directive 2004/25/EC (Directive on takeover bids).

Table 9.2 Corporate Governance Models for Public Limited-liability Companies

	Germany	*The UK*
Company forms:	Two main statutes (AktG, GmbHG) and two main company forms, one (AG) designed for public companies and the other (GnbH) for private companies.[98]	One main statute (Companies Act 2006) and one company form for all companies.
Regulation of the governance of public limited-liability companies:	Regulation predominantly in the field of company law.	Regulation predominantly in the field of securities markets law.
Characteristic principles of regulation:	Protection of shareholders, minority shareholders and creditors, regulation of management.	Protection of investors, regulation of disclosure.
Standardisation of board structure by legal rules:	Standardisation, mandatory two-tier board with a supervisory board (Aufsichtsrat) and a management board (Vorstand), mandatory employee co-determination regime (Mitbestimmung).	Discretion, board structure in accordance with articles of association, comply or explain principle under the Combined Code and the Listing Rules.
Regulation of the management body:	Statutory management body (Vorstand), mandatory rules on management.	Discretion, no statutory management body.
Separation of decision management and decision control:	Yes, mandatory law.	Discretion.
Shareholders' characteristic enforcement rights:	Individual shareholders' right to bring legal proceedings for breach of law or the articles of association.	Principle of majority rule.
Mixed monitoring:	More.	Less.
Importance of the independence of individual monitors:	Not important, independence of company organs more important, that independence safeguarded by legal rules and mixed monitoring.	Regarded as important.
Intra-board monitoring role of board committees:	No monitoring role, statutory two-tier board structure with mandatory separation of decision management and decision control.	Monitoring role regarded as important, committees create two-tier board structures within the statutory one-tier board.

[98] There are even other enterprise forms. For example, the AG & Co. KG is a limited partnership (KG) with an AG as the unlimited partner. This company form is typically used by large family firms. For partnerships, see Volume III.

9.3.3 Monitoring by the Board

Monitoring Mix

The company always uses a mix of monitoring tools. The relative weight of each monitoring tool depends on the jurisdiction, the company form, and the agency relationship in question (the firm v professional managers, minority shareholders v controlling shareholders, shareholders v professional managers).

Monitoring by the Board

The statutory board is the most important internal monitoring tool regulated by laws. However, at a very general level, there are at least two basic models in Europe as regards the monitoring mix.

Germany. The German model consists of the relatively balanced use of many monitoring tools and the internal self-enforcement of corporate governance rules. The governance structure plays an important role in this model.

The legal cornerstones of the German corporate governance model are: the existence of a company form especially designed for public limited-liability companies; the regulation of corporate governance by mandatory and relatively prescriptive provisions of law (Aktiengesetz); a statutory two-tier board structure with a management body (Vorstand) and a supervisory body (Aufsichtsrat); the fact that each body is a collegiate organ; shareholders' rights to contest resolutions of the general meeting; the existence of relatively concentrated ownership; close connections with the company's Hausbank (which acts as a source of funding and can be represented on the supervisory board); and employee representation on the supervisory board.

The mandatory provisions of the Aktiengesetz govern board structure, the distribution of powers between different organs, the duties of both the supervisory body (Aufsichtsrat), which monitors management and decides on some important matters, and the duties of the body that is responsible for the management of the company's business (Vorstand).

German company law is focused on the independence of the supervisory board from the management board, rather than the personal independence of individual supervisory board members. The independence of the supervisory board as whole from the management board is safeguarded by structural measures, i.e. by the separation of management and supervision, by the mandatory and prescriptive statutory provisions of the Aktiengesetz, and by monitoring tools that complement the use of a supervisory board.

The supervisory board is just one part of the mixed monitoring system. (a) Board members must in practice monitor each other, because both boards are by law collegiate organs. (b) Internal decision-making requires in effect broad consensus within each statutory board, and decision-making in important matters typically requires consensus between different organs of the company. (c) In addition, mandatory co-determination (Mitbestimmung) favours consensus with the representatives of the workforce. Representatives of the workforce can monitor

management not only under the co-determination regime, but also due to the right of many other statutory bodies to be informed or consulted. (d) The traditionally important role played by bank loans in the financing of German companies makes it often necessary to keep the Hausbank informed about important matters. (e) It is relatively easy for minority shareholders to contest resolutions of the general meeting that do not comply with the Aktiengesetz. This right is an important monitoring tool because both boards are statutory organs the activities of which are governed by many provisions of the Aktiengesetz and most acts made by the general meeting as a corporate body or by shareholders at the general meeting are based on information and proposals submitted by these two organs. (f) On top of these formal ways to monitor management, large shareholders enjoy some de facto powers regardless of the formal regulation of companies. (g) There is also monitoring by the capital market. The rules on the disclosure of financial information to the capital market as well as accounting and auditing requirements have largely been harmonised in the EU.

UK. The UK model is biased towards the use of disclosure and monitoring by the capital market. In addition, this model focuses on the integrity of each individual rather than the governance structure as a whole.

For this reason: there is one main company form for all companies (under the Companies Act 2006) rather than a tailor-made company form for listed companies; the 2006 Act contains relatively few rules on the management of a public limited company (but listed companies must comply with the Listing Rules and other securities markets legislation); the 2006 Act does not require the separation of monitoring from management; and the 2006 Act does not prevent two-tier (or three-tier) board structures within the nominally one-tier board.

It is nevertheless understood that the UK corporate governance model would not work without the use of some further corporate governance tools. The governance of listed companies is regulated not only by flexible and largely dispositive company law rules by also by securities market laws that are detailed and partly mandatory. The Listing Rules and the Combined Code contain many rules on governance matters that in Germany would be regulated in the Aktiengesetz. For example, the Combined Code provides for two-tier structures within the nominally one-tier board by requiring the use of committees and the appointment of (at least some) external non-executive directors; the use of committees and non-executive directors is also a step towards the separation of supervision and management.

This raises the question of the role of non-executive directors. Their role was studied in the Higgs review on non-executive directors: "An overemphasis on monitoring and control risks non-executive directors seeing themselves, and being seen, as an alien policing influence detached from the rest of the board. An overemphasis on strategy risks non-executive directors becoming too close to executive management, undermining shareholders' confidence in the effectiveness of board governance."[99]

[99] Higgs D, Review of the role and effectiveness of non-executive directors (January 2003), 6.2.

Community law. Community law contains few binding rules on monitoring by the board. It has not been possible to harmonise these rules because of fundamental differences between the national corporate governance models. Large differences remain as regards the structure of the statutory board, its functions, and the means to regulate these questions. Quite simply, "the board" can mean different things depending on the jurisdiction and company form.

Independent non-executive board members. Instead of binding rules, the Commission has adopted a non-binding Recommendation on the role of directors.[100] This Recommendation is based on UK corporate governance practices and favours the use of independent non-executive board members.

The Commission believes that independent non-executive board members have an important monitoring role: "The presence of independent representatives on the board, capable of challenging the decisions of management, is widely considered as a means of protecting the interests of shareholders and other stakeholders ... In order to ensure that the management function will be submitted to an effective and sufficiently independent oversight function, the (supervisory) board should comprise a sufficient number of committed non-executive or supervisory directors, who, in addition to not performing management duties in the company or its group, are independent, i.e. free from any material conflict of interest."[101]

In addition to independent non-executive board members, the Commission recommends the use of board committees as monitors: "The oversight role of non-executive or supervisory directors is commonly perceived as crucial in three areas, where the potential for conflict of interest of management is particularly high, especially when such matters are not a direct responsibility for shareholders: nomination of directors, remuneration of directors, and audit. It is therefore appropriate to foster the role of non-executive or supervisory directors in these areas and to encourage the creation within the (supervisory) board of nomination, remuneration and audit committees."[102]

Standards, Dynamic Provisions, Specific Duties

As discussed above (sections 8.3, 9.2.9, and 4.3.3), members of the company's administrative, management, or supervisory bodies typically have a duty to comply with certain *standards*. One of the most basic standards is the duty of care. Such standards are complemented by *dynamic* rules setting out how the standards can be complied with.

One of the most basic dynamic rules in this context is whose *interests* these people must further. For example, in order to comply with their general company law duty of care, they typically must try to further the interests of the *firm*. This duty is enforced by the *company* in its own name and on its own behalf.

Members of the company's administrative, management, or supervisory bodies have several duties to further *other interests* as well. Typically, such duties can be

[100] Recommendation 2005/162/EC.
[101] Recitals 8 and 9.
[102] Recital 9.

enforced by the party or parties to whom the duties are "owed" or whose interests the duties protect.[103]

Generally, members of the company's administrative, management, or supervisory bodies can have a large number of *specific duties* designed to further the firm's interests or other interests. Compliance with general standards typically requires compliance with these specific duties. This means that the rules setting out specific duties work as dynamic rules as well.

Community law. Such rules have not been harmonised at the level of Community law. There is piece-meal harmonisation of the duties of company representatives in many areas of law (for corporate risk management, see sections 7.6.6 and 7.6.7; for the information management regime for listed companies, see Volume III). However, the allocation of duties and their enforcement depend on the governing law. There is no room to discuss such questions here in detail.[104]

9.3.4 Financial Reporting and Transparency

Community law has influenced accounting and auditing requirements and the public disclosure of information to the capital market. In addition to the company form, the effect of Community law depends on whether the company's shares have been admitted to trading on a regulated market or whether the company is privately-owned.

The most important legal instruments adopted by Community institutions in this area include: the accounting directives[105] and regulations[106] as well as International Financial Reporting Standards; auditing requirements;[107] and the disclosure regime applicable to listed companies in general (see also Volume III). In addition, the Commission has adopted a recommendation on the role of independent directors.

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[103] See, for example, § 823(2) BGB ("Schutzgesetz").

[104] See, for example, Directive 2006/46/EC and Mäntysaari P, Comparative Corporate Governance. Shareholders as a Rule-maker. Springer, Berlin Heidelberg (2005), sections 4.6 and 5.6.

[105] In particular, Directive 78/660/EEC (Fourth Company Law Directive); Directive 83/349/EEC (Seventh Company Law Directive); and Directive 2003/51/EC.

[106] Regulation 1606/2002 (IAS Regulation); Regulation 1725/2003; and Regulation 707/2004 amending Regulation 1725/2003.

[107] In particular, Article 51 of Directive 78/660/EEC (Fourth Company Law Directive); Article 37 of Directive 83/349/EEC (Seventh Company Law Directive); and Directive 2006/43/EC (the new Eighth Company Law Directive, Directive on statutory audits).

Accounting

It is a central policy objective that securities can be traded on EU and international financial markets on the basis of a single set of financial reporting standards.[108] This has led to the harmonisation of financial reporting requirements.

Listed companies. Where a company has its securities admitted to trading on a regulated market in the European Economic Area (EEA), the International Accounting Standards (IAS) Regulation requires it to prepare consolidated accounts in accordance with IFRS.[109] The consolidation requirements in this system are set out in IAS 27.

Discretion of Member States. Member States have some discretion. They may permit or require listed companies to prepare their annual accounts and other companies to prepare their consolidated accounts and/or their annual accounts in conformity with IFRS.

The IAS Regulation thus allows Member States to require even other companies to apply IFRS. For example in Germany, the modernised financial reporting requirements (BilMoG) give an option to use IFRS provided that the company also prepares its annual accounts according to national requirements.[110]

All limited-liability companies. On the other hand, the Fourth and Seventh Company Law Directives have approximated the accounting requirements for all limited-liability companies in order to protect shareholders and third parties.

Whereas the Seventh Directive contains rules on consolidated accounts, Article 2 of the Fourth Directive lays down, for example, the following requirements: (1) "The annual accounts shall comprise the balance sheet, the profit and loss account and the notes on the accounts. These documents shall constitute a composite whole." (2) "They shall be drawn up clearly and in accordance with the provisions of this Directive." (3) "The annual accounts shall give a true and fair view of the company's assets, liabilities, financial position and profit or loss." (4) "Where the application of the provisions of this Directive would not be sufficient to give a true and fair view within the meaning of paragraph 3, additional information must be given." (5) "Where in exceptional cases the application of a provision of this Directive is incompatible with the obligation laid down in paragraph 3, that provision must be departed from in order to give a true and fair view within the meaning of paragraph 3. Any such departure must be disclosed in the notes on the accounts together with an explanation of the reasons for it and a statement of its effect on the assets, liabilities, financial position and profit or loss. The Member States may define the exceptional cases in question and lay down the relevant special rules." (6) "The Member States may authorise or require the disclosure in the annual accounts of other information as well as that which must be disclosed in accordance with this Directive."

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[108] EU Financial Reporting Strategy: the way forward, Communication from the Commission to the Council and the European Parliament COM (2000) 359 of 13 June 2000.

[109] Article 4 of Regulation 1606/2002 (IAS Regulation).

[110] § 264e HGB (as amended by the BilMoG). See Hommelhoff P, Modernisiertes HGB-Bilanzrecht im Wettbewerb der Regelungssysteme. Konzeptionelle Bemerkungen aus Anlass des RefE BilMoG, ZGR 2008 p 261: "Hinter dieser Option steht das Konzept der Parallelität von Informations- und Ausschüttungsrechnung, wobei freilich die HGB-Rechenwerk nicht auf ihre Ausschüttungsbemessumgsfunktion reduziert sind."

Two levels of financial information. In the short term, the result is two levels of comparability of financial information to be produced by companies: a first level of minimal comparability established by the Fourth and Seventh Company Law Directives, and a second level of enhanced comparability for financial statements of companies covered by the IAS Regulation.

As most companies are small and unlisted, the vast majority of companies still comply with national accounting requirements and the Fourth and Seventh Company Law Directives. In the long term, there will be a gradual alignment of national accounting requirements with IFRS.

Simplifying the rules. On the one hand, financial scandals tend to lead to increased disclosure requirements amd "more transparency". On the other, existing financial reporting requirements are regarded as too complex.

The Commission has published a plan to simplify company law, accounting, and auditing rules.[111] For example, the Commission intends to: simplify disclosure requirements for companies and for branches; and further reduce reporting and auditing requirements for small and medium-sized businesses.

The adoption of the German Accounting Law Modernisation Act (Bilanzrechtsmodernisierungsgesetz, BilMoG) was the largest reform of German accounting law since the adoption of the EU accounting directives by the Bilanzrichtliniengesetz (BiRiLiG) in 1985. On the one hand, the BilMoG meant a closer alignment of the HGB with IFRS. On the other, the reporting burden was reduced for "micro merchants". Sole proprietorships and partnerships are no longer obliged to comply with HGB bookkeeping and accounting requirements.[112]

In July 2008, the FRC launched a project to review the complexity and relevance of current company reporting requirements in the UK.

Auditing: General Requirements

Accounting requirements are complemented by auditing requirements. The central policy objective of EU auditing requirements is to ensure that investors and other interested parties can rely on the accuracy of audited accounts.[113] Furthermore, auditing can increase transparency and give the firm's board members and managers an incentive to comply with the laws governing the company and its business.

Auditing requirement. The Fourth and Seventh Company Law Directives (the Accounting Directives) require that the annual accounts and consolidated accounts be audited by one or more persons entitled to carry out such audits.

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[111] Communication from the Commission on a simplified business environment for companies in the areas of company law, accounting and auditing, 10 July 2007, COM(2007) 394.

[112] See Hommelhoff P, Modernisiertes HGB-Bilanzrecht im Wettbewerb der Regelungssysteme. Konzeptionelle Bemerkungen aus Anlass des RefE BilMoG, ZGR 2008 pp 250–274.

[113] Recital 9 of Directive 2006/43/EC (Directive on statutory audits).

As a rule, the requirement of audited accounts applies to all limited-liability companies.[114] However, Member States may relieve small companies from this audit obligation if they do not exceed the limits of two of the following criteria: balance sheet total (€4,400,000); net turnover (€8,800,000); and average number of employees during the financial year (50).[115]

Whether Member States want to exempt small companies from the audit obligation can depend on different views about its purpose. For example, where the audit obligation is only believed to provide information to shareholders, a company managed by its only shareholder will not need any mandatory audit obligation. However, where the audit obligation is designed to protect the firm by increasing monitoring and transparency, a mandatory audit obligation can be necessary whether or not the company has a controlling shareholder. In fact, the existence of a controlling shareholder can increase the risk of expropriation and non-compliance with certain provisions governing the company.

Directive on statutory audits - Eighth Company Law Directive. In the past, the conditions for the approval of persons responsible for carrying out the statutory audit were laid down in the old Eighth Company Law Directive.[116] However, neither the Accounting Directives nor the Eighth Directive said how a statutory audit should be conducted. The Commission therefore issued a Recommendation on quality assurance for the statutory auditor in the EU (In November 2000)[117] and a Recommendation on Statutory Auditors' Independence in the EU (in May 2002).[118] In 2006, the old directive was replaced by the Directive on statutory audits.[119] The new directive has a wider scope than the directive it replaces.

The Directive on statutory audits aims at high-level - though not full - harmonisation of statutory audit requirements. Its objectives are: "requiring the application of a single set of international auditing standards, the updating of the educational requirements, the definition of professional ethics and the technical implementation of the cooperation between competent authorities of Member States and between those authorities and the authorities of third countries".[120]

The Directive on statutory audits lays down minimum requirements. A Member State may impose more stringent requirements, unless otherwise provided for by the Directive.[121]

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[114] Article 51 of Directive 78/660/EEC (Fourth Company Law Directive); Article 37 of Directive 83/349/EEC (Seventh Company Law Directive); Directive 86/635/EEC on the annual accounts and consolidated accounts of banks and other financial institutions; Directive 91/674/EEC on the annual accounts and consolidated accounts of insurance undertakings.

[115] Articles 51(2), 11 and 12 of Directive 78/660/EEC (Fourth Company Law Directive).

[116] Directive 84/253/EEC on the approval of persons responsible for carrying out the statutory audits of accounting documents.

[117] Commission Recommendation 2002/590/EC.

[118] Commission Recommendation 2001/256/EC.

[119] Directive 2006/43/EC on statutory audit of annual accounts and consolidated accounts and amending Council Directives 78/660/EEC and 83/349/EEC.

[120] Recital 32.

[121] Recital 5.

In addition, the Directive on statutory audits can result in many levels of auditing rules in a Member State: auditing rules for limited-liability companies in general; less stringent rules for small companies depending on the Member State; more stringent rules for "public-interest entities"; and exceptions to these more stringent rules for non-listed "public-interest entities" depending on the Member State. Public-interest entities are usually listed companies, credit institutions or insurance undertakings, but even other companies can be regarded as public-interest entities depending on the Member State.[122]

Approval. If a Member State requires a statutory audit (as said above, small companies may be relieved from the audit obligation in some Member States), the statutory audit must be carried out only by statutory auditors or audit firms which are approved by the Member State requiring the statutory audit.[123]

This requirement is combined with the opening up of the audit market. First, the Directive on statutory audits removes nationality restrictions on ownership and management of audit firms. Although the majority of the voting rights and the majority of the members of the administrative or management body of the audit firm should still be in the hands of statutory auditors or audit firms, the Directive states clearly that these statutory auditors or audit firms may be approved in any Member State. This change allows for the creation of more fully integrated EU audit firms. Second, an aptitude test is prescribed for the approval of statutory auditors from other Member States.

Auditor independence. There are special rules on auditor independence. In 2002, the Commission published a non-binding Recommendation on statutory audit.[124] According to the Recommendation, a principles-based approach to statutory auditors' independence is preferable to one based on detailed rules.[125]

The basic principle of the Recommendation was that an auditor or an audit firm cannot carry out a statutory audit if there is a financial, business, employment or other relationship, including the provision of additional services, with the audited entity that might compromise the statutory auditor's or audit firm's independence.

This principle was also adopted in the Directive on statutory audits.[126]

As a rule, statutory auditors may not be appointed by the board of the audited entity. The Directive provides that the statutory auditor or audit firm must be appointed by the audited entity's general meeting.[127] However, Member States may nevertheless allow alternative systems or modalities for the appointment of the statutory auditor or audit firm, provided that such systems or modalities are designed to ensure the independence of the statutory auditor or audit firm from the executive members of the administrative body or from the managerial body of the

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[122] Article 2(13) of Directive 2006/43/EC (Directive on statutory audits).
[123] Article 3(1) of Directive 2006/43/EC (Directive on statutory audits).
[124] Statutory Auditors' Independence in the EU: A set of fundamental principles, 2002/590/EC, 16 May 2002.
[125] Recital 11 of Recommendation 2002/590/EC.
[126] Recital 11 of Directive 2006/43/EC (Directive on statutory audits) refers to the Recommendation of 16 May 2002.
[127] Article 37(1) of Directive 2006/43/EC (Directive on statutory audits).

audited entity.[128] For example, statutory auditors may be appointed by the supervisory board (Aufsichtsrat) of a German AG.

Member States must generally ensure that, when carrying out a statutory audit, the statutory auditor and/or the audit firm is independent of the audited entity and is not involved in its decision-making.[129] The statutory auditor or the audit firm may not carry out a statutory audit if there is a relationship[130] from which an objective, reasonable and informed third party would conclude that their independence is compromised.[131]

However, there is no general prohibition to provide non-audit services to audit clients.[132] Neither does the Directive on statutory audits contain a blacklist of banned services. The Directive follows the principles-based approach of the 2002 Recommendation because of the changing nature of markets.

The examples quoted in the Recommendation nevertheless continue to apply. For this reason, auditors should not provide non-audit services (such as bookkeeping or valuation services) which would almost always compromise the auditor's independence according to the Recommendation.

Furthermore, Member States must ensure that the owners or managers of the audit firm or an affiliated firm do not intervene in the execution of a statutory audit in any way which jeopardises the independence and objectivity of the statutory auditor who carries out the statutory audit on behalf of the audit firm.[133]

Fees. There is a special rule on audit fees. Member States must ensure that adequate rules are in place which provide that fees for statutory audits: are not influenced or determined by the provision of additional services to the audited entity; and cannot be based on any form of contingency.[134] The relationship between the statutory auditor or audit firm and the audited entity is made more transparent by the Fourth and Seventh Company Law Directives which require disclosure of the audit fee and the fee paid for non-audit services in the notes to the annual accounts and the consolidated accounts.

Member States must also ensure that a statutory auditor or audit firm documents in the audit working papers all significant threats to independence as well as the safeguards applied to mitigate those threats.[135]

There are restrictions on dismissal. Member States must ensure that statutory auditors or audit firms may be dismissed only on proper grounds. Divergence of

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[128] Article 37(2) of Directive 2006/43/EC (Directive on statutory audits).
[129] Article 22(1) of Directive 2006/43/EC (Directive on statutory audits).
[130] "... any direct or indirect financial, business, employment or other relationship - including the provision of additional non-audit services - between the statutory auditor, audit firm or network and the audited entity ..."
[131] Article 22(2) of Directive 2006/43/EC (Directive on statutory audits); recital 11 of Recommendation 2002/590/EC.
[132] Recital 12 of Directive 2006/43/EC (Directive on statutory audits).
[133] Article 24 of Directive 2006/43/EC (Directive on statutory audits).
[134] Article 25 of Directive 2006/43/EC (Directive on statutory audits).
[135] Article 22(3) of Directive 2006/43/EC (Directive on statutory audits).

opinions on accounting treatments or audit procedures does not constitute proper grounds for dismissal.[136]

On the other hand, there are rules on compulsory resignation. If statutory auditors or audit firms find themselves in a situation where the significance of the threats to their independence, even after application of safeguards to mitigate those threats, is too high, they should resign or abstain from the audit engagement.[137]

Professional ethics. In addition to special rules on auditor independence, the Directive on statutory audits requires compliance with professional ethics in general.

First, Member States must ensure that all statutory auditors and audit firms are subject to principles of professional ethics. These principles must cover at least: their "public-interest function"; their integrity and objectivity; and their professional competence and due care.[138] The "public-interest function" relates to "public-interest entities".[139]

Second, the Commission may adopt principles-based implementing measures on professional ethics as minimum standards.[140] When doing so, it will consider the principles contained in the IFAC's Code of Ethics.[141]

International auditing standards. The concept of international accounting standards is mirrored by the concept of international auditing standards.[142] Member States have previously applied different national auditing standards, but after the adoption of IAS, it would be consistent to have IAS financial statements audited according to the same international auditing standards. This would also be in the interests of large European companies, because the application of global standards throughout the EU could help to secure the recognition of EU audited financial statements in third country jurisdictions such as the US.

The Directive on statutory audits requires the use of international auditing standards, if the Commission decides to adopt them.[143] For example, the Commission may adopt a common standard audit report for annual or consolidated accounts which have been prepared in accordance with adopted IAS. For the audit of finan-

[136] Article 38(1) of Directive 2006/43/EC (Directive on statutory audits).

[137] See also recitals 11 and 12 of Directive 2006/43/EC (Directive on statutory audits).

[138] Article 21(1) of Directive 2006/43/EC (Directive on statutory audits).

[139] Article 2(13) of Directive 2006/43/EC (Directive on statutory audits).

[140] Article 22(4) of Directive 2006/43/EC (Directive on statutory audits).

[141] Recital 9 of Directive 2006/43/EC (Directive on statutory audits).

[142] Article 2 of Directive 2006/43/EC (Directive on statutory audits): "For the purpose of this Directive, the following definitions shall apply: ... 11. 'international auditing standards' means International Standards on Auditing (ISA) and related Statements and Standards, insofar as relevant to the statutory audit ..."

[143] Article 26(2) of Directive 2006/43/EC (Directive on statutory audits). Recital 14: "For the Commission to adopt an international auditing standard for application in the Community, it must be generally accepted internationally and have been developed with full participation of all interested parties following an open and transparent procedure, add to the credibility and quality of annual accounts and consolidated accounts and be conducive to the European public good."

cial statements in general, the audit report will at least have to comply with Article 51a of the Fourth Company Law Directive (78/660/EEC) on annual accounts and Article 36 of the Seventh Company law Directive (83/349/EEC) on consolidated accounts, which are largely based on the relevant international auditing standard (ISA 700).

After the adoption of international auditing standards, the same set of auditing standards will be applied throughout the EU.

In order to achieve a maximum degree of harmonisation,[144] the main rule is that it is prohibited to introduce additional audit procedures. However, there is some scope for the application of national auditing standards.

Member States may apply a national auditing standard as long as the Commission has not adopted an international auditing standard covering the same subject-matter.[145]

Member States may impose additional audit procedures "if these stem from specific national legal requirements relating to the scope of statutory audits".[146] As the scope of the audit may presently differ (today it sometimes includes elements which are felt to be particularly relevant in certain Member States, such as the audit of social, corporate governance or environmental matters) additional procedures may be introduced in order to ensure that those specific national requirements are complied with.

On the other hand, Member States may impose additional requirements relating to the statutory audits of annual and consolidated accounts only for a period expiring on 29 June 2010.[147]

Audit of consolidated accounts. The Directive on statutory audits contains a rule on statutory audits of consolidated accounts. As each group company usually has its own auditors, the division of responsibilities between these auditors is not always clear. The *Parmalat* scandal showed that it is unacceptable that group auditors should only be concerned with parts of the group's business when they are in fact responsible for the audit report concerning the group as a whole. For this reason, the Directive on statutory audits makes the group auditor responsible for the audit report.[148]

Quality assurance system and regular inspections. These rules are complemented by a compulsory quality assurance system. Regular inspections are regarded as a good means of achieving a consistently high quality in statutory audits. All statutory auditors and audit firms must be subject to a system of quality

[144] Recital 13 of Directive 2006/43/EC (Directive on statutory audits).

[145] Article 26(1) of Directive 2006/43/EC (Directive on statutory audits).

[146] Article 26(3) of Directive 2006/43/EC (Directive on statutory audits). Recital 13: "Any addition or carving out by Member States should add a high level of credibility to the annual accounts of companies and be conducive to the public good. The above implies that Member States may, for example, require an additional auditor's report to the supervisory board or prescribe other reporting and audit requirements based on national corporate governance rules."

[147] Article 26(4) of Directive 2006/43/EC (Directive on statutory audits).

[148] Recital 15 and Article 27 of Directive 2006/43/EC (Directive on statutory audits).

assurance. Each individual auditor is to be subject to a quality assurance review at least every six years.[149]

Factors that decrease the value of auditing. There are factors decreasing the value of auditing as a monitoring tool. (a) Financial statements can never be accurate in the sense that there is only one set of figures that correctly expresses the results of a company's operations and its financial status.[150] (b) Auditors are responsible for their work process rather than the result. They are not responsible for the accuracy of their statements about the audit company's accounts. (c) Auditors are not expected to notice everything. They do not prepare financial statements; they are expected to be independent of and separate from the management and supervisory boards of their clients.[151] (d) There are differences regarding the civil liability of the statutory auditor. The nature and scope of sanctions can have an impact on audit quality (see section 10.7.6).[152]

Fraud. Particular auditing rules can help to prevent fraud. Two examples can be mentioned.

According to Directive 95/26/EC,[153] auditors have a duty to *report* certain irregularities in the *financial sector*. Statutory auditors of a financial undertaking "shall have a duty to report promptly to the competent authorities any fact or decision concerning that undertaking of which he has become aware while carrying out that task which is liable to: - constitute a material breach of the laws, regulations or administrative provisions which lay down the conditions governing authorisation or which specifically govern pursuit of the activities of financial undertakings, or - affect the continuous functioning of the financial undertaking, or - lead to refusal to certify the accounts or to the expression of reservations ..."[154]

In addition, regulatory bodies in a number of Member States have issued auditing guidelines concerning the statutory auditor's *general* responsibility in relation to fraud, other irregularities, and errors. The guidelines recommend that if, during the course of the audit, the statutory auditor begins to *suspect* fraudulent activity, he has a responsibility to *investigate* until his suspicions are either allayed or confirmed.[155]

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[149] Article 29(1) and recital 17 of Directive 2006/43/EC (Directive on statutory audits).

[150] The role, the position and the liability of the statutory auditor within the European Union, paragraph 3.10.

[151] *Ibid*, paragraph 3.13.

[152] *Ibid*, paragraph 1.2.

[153] Directive 95/26/EC amending Directives 77/780/EEC and 89/646/EEC in the field of credit institutions, Directives 73/239/EEC and 92/49/EEC in the field of non-life insurance, Directives 79/267/EEC and 92/96/EEC in the field of life assurance, Directive 93/22/EEC in the field of investment firms and Directive 85/611/EEC in the field of undertakings for collective investment in transferable securities (Ucits), with a view to reinforcing prudential supervision .

[154] Article 5 of Directive 95/26/EC.

[155] *Ibid*, paragraphs 3.24–3.25.

Auditing: Public-interest Entities

There are more stringent rules for “public-interest entities”.[156] Member States may nevertheless exempt unlisted public-interest entities and their statutory auditor(s) or audit firm(s) from one or more of the more stringent requirements.[157] The more stringent requirements relate to audit committees, independency and rotation, transparency reports, and quality assurance.

Audit committee. First, each public-interest entity must have an audit committee. The Commission originally recommended the use of audit committees already in its Recommendation on the role of non-executive or supervisory directors.[158] The Parmalat scandal nevertheless showed the need for public-interest entities to have a body which monitors the financial reporting and audit process and that a non-binding Commission Recommendation was not sufficient.

There are exceptions to the audit committee requirement. (a) For listed companies regarded as small or medium-sized enterprises under the Prospectus Directive, Member States may permit the audit committee’s functions to be performed by the administrative or supervisory body as a whole, provided at least that when the chairman of such a body is an executive member, that person is not simultaneously the chairman of the audit committee.[159] (b) In addition, Member States may allow or decide that this requirement shall not apply to any public-interest entity that has a statutory body performing equivalent functions to an audit committee. In such a case the entity shall disclose which body carries out these functions and how it is composed.[160] (c) There are also certain other exceptions.[161]

When those exceptions do not apply, the Member State must determine whether audit committees are to be composed of non-executive members of the administrative body and/or members of the supervisory body of the audited entity and/or members appointed by the general meeting of shareholders of the audited entity. At least one member of the audit committee must be independent and have competence in accounting and/or auditing.[162]

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[156] Recital 23: “Since public-interest entities have a higher visibility and are economically more important, stricter requirements should apply in the case of a statutory audit of their annual or consolidated accounts.”

[157] Article 39 of Directive 2006/43/EC (Directive on statutory audits).

[158] Commission Recommendation of 15 February 2005 on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board.

[159] Article 41(1) of Directive 2006/43/EC (Directive on statutory audits): “... In public-interest entities which meet the criteria of Article 2(1), point (f) of Directive 2003/71/EC ...” Article 2(1)(f) of Directive 2003/71/EC (Prospectus Directive): “For the purposes of this Directive, the following definitions shall apply: ... (f) ‘small and medium-sized enterprises’ means companies, which, according to their last annual or consolidated accounts, meet at least two of the following three criteria: an average number of employees during the financial year of less than 250, a total balance sheet not exceeding EUR 43.000.000 and an annual net turnover not exceeding EUR 50.000.000 ...”

[160] Article 41(5) of Directive 2006/43/EC (Directive on statutory audits).

[161] Article 41(6) and recital 25 of Directive 2006/43/EC (Directive on statutory audits).

[162] Article 41(1) of Directive 2006/43/EC (Directive on statutory audits).

The exceptions show that audit committees are just one of alternative ways to manage agency problems by separating functions rather than a fundamental part of the corporate governance structure regardless of the jurisdiction and the nature of the firm.

In the US and UK, audit committees that consist of independent board members are regarded as necessary, because most listed companies have a one-tier board with no statutory separation of monitoring and control at board level. The audit committee will create a two-tier structure inside a one-tier board and have a supervisory role. In a German AG, the mandatory two-tier board structure and the statutory separation of monitoring and control functions makes audit committees less necessary and changes their function. In the past, audit committees have not had a supervisory role under the Aktiengesetz. Unlike in the US and UK, their sole purpose is to make board work more effective.

The Directive on statutory audits lays down the main duties of the audit committee. On the other hand, members of corporate bodies may have related duties under Member States' national provisions. Whether these duties are affected by the provisions of the Directive may depend on the governing law, because the duties of the audit committee under the Directive are "without prejudice to the responsibility of the members of the administrative, management or supervisory bodies, or of other members who are appointed by the general meeting of shareholders of the audited entity".[163] The audit committee may have additional duties under Member States' national laws.

The role of the audit committee under the Directive on statutory audits is influenced by experiences in the *Ahold* scandal. The Directive clarifies the role of the audit committee in relation to the internal control of the company. Following the Ahold case, the Directive specifically states that the audit committee of a public-interest entity must monitor the effectiveness of the company's internal control, internal audit (where applicable), and risk management systems.

The audit committee thus has a monitoring role under the Directive on statutory audits. On the other hand, the modalities[164] of "monitoring" have not been defined in this directive and must therefore be determined by the governing law. What is clear is that the statutory auditor or audit firm should in no way be subordinated to the committee.[165]

The audit committee must at least: (a) monitor the financial reporting process; (b) monitor the effectiveness of the company's internal control, internal audit where applicable, and risk management systems; (c) monitor the statutory audit of the annual and consolidated accounts; and (d) review and monitor the independence of the statutory auditor or audit firm, and in particular the provision of additional services to the audited entity.[166] (d) In addition, the audit committee is the body to which the statutory auditor or audit firm must report on key matters aris-

[163] Article 41(2) of Directive 2006/43/EC (Directive on statutory audits).

[164] The same technique has been used for example in the SE Regulation. See Mäntysaari P, Comparative Corporate Governance. Shareholders as a Rule-maker. Springer, Berlin Heidelberg (2005), Chapter 3.

[165] Recital 24 of Directive 2006/43/EC (Directive on statutory audits).

[166] Article 41(2) of Directive 2006/43/EC (Directive on statutory audits).

ing from the statutory audit, and in particular on material weaknesses in internal control in relation to the financial reporting process.[167]

The audit committee has one key initiation right. In a public-interest entity, the proposal of the administrative or supervisory body for the appointment of a statutory auditor or audit firm must be based on a recommendation made by the audit committee.[168]

There are again exceptions to these duties. Member States may allow or decide that the above duties shall not apply to any public-interest entity that has a statutory body performing equivalent functions to an audit committee. In such a case, the entity shall disclose which body carries out these functions and how it is composed.[169]

Independence and rotation. The second category of more stringent requirements relates to independence and rotation. (a) The Directive on statutory audits provides for the mandatory rotation of key audit partners within the audit firm but does not require the rotation of audit firms. Member States may, alternatively, require a change of the audit firm.[170] (b) In any case, Member States must at least ensure that the key audit partners responsible for carrying out a statutory audit rotate from the audit engagement within a maximum period of seven years from the date of appointment and are allowed to participate in the audit of the audited entity again after a period of at least two years.[171] (c) There is also an annual duty to confirm independence and disclose threats to independence to the audit committee.[172]

Transparency reports. Third, statutory auditors and audit firms that carry out statutory audits of public-interest entities must publish on their websites, within three months of the end of each financial year, annual transparency reports.[173]

Quality assurance review. Fourth, the quality assurance review must be carried out at least every three years for statutory auditors or audit firms that carry out statutory audits of public-interest entities.[174]

Other Forms of Disclosure to Capital Markets

Community law lays down a wide range of public disclosure obligations for companies whose shares have been admitted to trading on a regulated market. Some rules were necessary in order to establish internal capital markets. The gradual integration of capital markets increased the need for common rules and led to an ambitious programme of rules for the financial industry. The objective of the Financial Services Action Plan (FSAP) was to achieve an integrated capital market by 2005. The FSAP was complemented by a "disclosure and transparency

[167] Article 41(4) of Directive 2006/43/EC (Directive on statutory audits).
[168] Article 41(3) of Directive 2006/43/EC (Directive on statutory audits).
[169] Article 41(5) of Directive 2006/43/EC (Directive on statutory audits).
[170] Recital 26 of Directive 2006/43/EC (Directive on statutory audits).
[171] Article 42(2–3) of Directive 2006/43/EC (Directive on statutory audits).
[172] Article 42(1) of Directive 2006/43/EC (Directive on statutory audits).
[173] Article 40 of Directive 2006/43/EC (Directive on statutory audits).
[174] Article 43 of Directive 2006/43/EC (Directive on statutory audits).

agenda". Extensive rule-making was necessary in order to achieve a greater level of transparency.[175]

There is thus extensive harmonisation of disclosure requirements. The main disclosure obligations are based on: the Accounting Directives (the Fourth and Seventh Company Law Directives);[176] the IAS Regulation; the Directive on statutory audits;[177] the Directive on market abuse;[178] the Prospectus Directive;[179] the Transparency Directive;[180] the Directive on takeover bids;[181] and several company law directives (see below).

Periodic information. The purpose of the Accounting Directives is to improve the quality, comparability and transparency of the financial information provided by companies. EU company law contains rules on the publication of annual accounts (the Fourth Directive) and consolidated accounts (the Seventh Directive).[182] Current Community law requires only annual and semi-annual reports. There is no obligation to publish quarterly reports.

The Transparency Directive revised and replaced provisions of the Listing Directive.[183] The Transparency Directive is less demanding than the highest existing national standards on quarterly reporting. For example, quarterly reporting is required in England, and by the operator of the Frankfurt stock exchange.

The Transparency Directive provides for annual and half-yearly financial reports.[184] These reports are in effect mini-prospectuses. They must contain the audited (annual) or condensed (half-yearly) financial statements of the company, a management report, and statements. These statements are made by the "persons responsible within the issuer" to the effect that, to the best of their knowledge, the financial statements prepared in accordance with the applicable set of accounting standards give a true and fair view.

The Transparency Directive also lays down a minimum standard of liability for the breach of these rules.[185] Somebody – at least the issuer or its administrative, management or supervisory bodies – must be responsible for the information to be drawn up and to be made public in accordance with the provisions of the Directive. Somebody – either the issuer, its administrative, management or supervisory

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[175] See generally Mäntysaari P, *op cit*, Chapter 3; Moloney N, Time to Take Stock on the Markets: The Financial Services Action Plan Concludes as the Company Law Action Plan Rolls Out, ICLQ 53 (2004) pp 999–1009.

[176] See also Article 62 of the SE Regulation; Directive 2000/12/EC (credit institutions) and Directive 91/674/EEC (insurance undertakings).

[177] Directive 2006/43/EC (Directive on statutory audits).

[178] Article 6 of Directive 2003/6/EC (Directive on market abuse).

[179] Article 3 of Directive 2003/71/EC (Prospectus Directive).

[180] Directive 2004/109/EC (Transparency Directive).

[181] Directive 2004/25/EC (Directive on takeover bids).

[182] See also Article 62 of the SE Regulation; Directive 2000/12/EC (credit institutions) and Directive 91/674/EEC (insurance undertakings).

[183] Directive 2001/34/EC (Listing Directive).

[184] Articles 4, 5 and 6 of Directive 2004/109/EC (Transparency Directive).

[185] Article 7 of Directive 2004/109/EC (Transparency Directive). See also Article 24 .

bodies or "persons responsible within the issuer" – must also be liable for failure to do so. Member States are free to determine the extent of this liability.[186]

The Prospectus Directive requires issuers whose securities are admitted to trading on a regulated market to provide at least annually "a document that contains or refers to all information that they have published or made available to the public over the preceding 12 months in one or more Member States and in third countries in compliance with their obligations under Community and national laws and rules dealing with the regulation of securities, issuers of securities and securities markets". That obligation does not apply to issuers of non-equity securities whose denomination per unit amounts to at least €50,000.[187]

Remuneration packages. There are particular recommendations and rules on the transparency of the remuneration of board members and of auditors' fees (see section 9.3.5).

Ad-hoc disclosure. The most important rules on ad-hoc disclosure are contained in the Direective on market abuse and in the Transparency Directive. The Listing Directive contains further rules on ad-hoc disclosure.

The Directive on market abuse not only prohibits abuse but also requires issuers to publish information.[188] (a) There is an obligation to disclose inside information to the public.[189] Under some circumstances, disclosure of inside information may be delayed, provided that the delay would not be likely to mislead the public and the issuer is able to ensure the confidentiality of that information.[190] There is a rule on selective disclosure: "Member States shall require that, whenever an issuer, or a person acting on his behalf or for his account, discloses any inside information to any third party in the normal exercise of his employment, profession or duties … he must make complete and effective public disclosure of that information, simultaneously in the case of an intentional disclosure and promptly in the case of a non-intentional disclosure".[191] (b) Primary insiders[192] are prohibited from disclosing inside information to any other person unless such disclosure is made in the normal course of the exercise of his employment, profession or duties.[193] (c)

[186] Recital 10 of Directive 2004/109/EC (Transparency Directive).

[187] Article 10 of Directive 2003/71/EC (Prospectus Directive).

[188] See Articles 2, 3 and 6 of Directive 2003/6/EC (Directive on market abuse).

[189] Article 6(1) of Directive 2003/6/EC (Directive on market abuse). Article 1(1) provides that inside information "shall mean information of a precise nature which has not been made public, relating, directly or indirectly, to one or more issuers of financial instruments or to one or more financial instruments and which, if it were made public, would be likely to have a significant effect on the prices of those financial instruments or on the price of related derivative financial instruments ..."

[190] Article 6(2) of Directive 2003/6/EC (Directive on market abuse).

[191] Article 6(3) of Directive 2003/6/EC (Directive on market abuse).

[192] Articles 2(1) and 2(2) of Directive 2003/6/EC (Directive on market abuse). Article 2(1)(2): "The first subparagraph shall apply to any person who possesses that information: (a) by virtue of his membership of the administrative, management or supervisory bodies of the issuer; or (b) by virtue of his holding in the capital of the issuer; or (c) by virtue of his having access to the information through the exercise of his employment, profession or duties; or (d) by virtue of his criminal activities."

[193] Article 3(a) of Directive 2003/6/EC (Directive on market abuse).

They are also prohibited from recommending or inducing another person, on the basis of inside information, to acquire or dispose of financial instruments to which that information relates.[194] (d) Depending on the Member State, the same restrictions can also apply to secondary insiders, i.e to any person "who possesses inside information while that person knows, or ought to have known, that it is inside information".[195]

The Listing Directive contains regulations on the information that must be published in the listing particulars and on continuing obligations. Like the Directive on market abuse, the Listing Directive provides that "[t]he company must inform the public as soon as possible of any major new developments in its sphere of activity which are not public knowledge and which may, by virtue of their effect on its assets and liabilities or financial position or on the general course of its business, lead to substantial movements in the prices of its shares".[196]

The Transparency Directive provides that a person acquiring or disposing of shares so that its holding with a publicly traded company reaches, exceeds or falls below certain thresholds informs the company, which is in its turn responsible for disclosing this information to the public.[197]

The Transparency Directive also lays down a general obligation of the issuer to "ensure that all the facilities and information necessary to enable holders of shares to exercise their rights are available in the home Member State".[198] Like the Second Company Law Directive,[199] it also provides for the equal treatment of all holders of shares who are in the same position.[200]

Risk management and risk concentrations. The IFRS, the Transparency Directive and several international initiatives have increased the transparency of risk concentrations and the transparency of corporate risk management. These questions have been discussed above (Chapter 7).

Transactions. There are many transaction-related disclosure rules. Certain transactions require the consent of the general meeting under the company law directives. The Directive on takeover bids regulates disclosure in the context of voluntary or mandatory takeover bids.

Furthermore, the Prospectus Directive deals with initial disclosure requirements at the point of public offer of securities/its admission to trading on a regulated market.[201] The Listing Directive regulates the contents of the listing particulars.[202]

General meeting. In addition to particular rules on transaction-related disclosure, there is a general duty to disclose information before and at every general meeting. Directive 2007/36/EC, which applies to companies whose shares have

[194] Article 3(b) of Directive 2003/6/EC (Directive on market abuse).
[195] Article 4 of Directive 2003/6/EC (Directive on market abuse).
[196] Article 68(1) of Directive 2001/34/EC (Listing Directive).
[197] Article 9(1) of Directive 2004/109/EC (Transparency Directive).
[198] Article 13(2) of Directive 2004/109/EC (Transparency Directive).
[199] Article 42 of Directive 77/91/EEC (Second Company Law Directive).
[200] Article 17(1) of Directive 2004/109/EC (Transparency Directive).
[201] Article 3 of Directive 2003/71/EC (Prospectus Directive).
[202] Article 21(1) of Directive 2001/34/EC (Listing Directive).

been admitted to trading on a regulated market in the EU,[203] was designed to make it easier for shareholders to use their voting rights. It contains rules on the disclosure of information prior to the general meeting. Detailed information should be made available on the internet site of the company.[204]

9.3.5 The Alignment of Interests, Financial Rewards

General Remarks

Typical ways to align the interests of the agent with those of the principal include financial rewards and sanctions.

Financial rewards. While there are legal background rules on the disclosure of financial rewards and on sanctions for breach of duty, the main rule remains that the alignment of board members', professional managers', and auditors' interests with those of the principal through financial rewards is at the discretion of the company. The question of the structuring of rewards is largely unregulated by laws. However, there are exceptions. For example, the use of share-based incentives is governed by the European legal capital regime and particular rules.

Disclosure. Community law requires the disclosure of board members' remuneration (in companies whose shares have been admitted to trading on a regulated market) as well the remuneration of statutory auditors (generally).

Sanctions for breach of duty. Community law contains few general rules on sanctions applicable to board members, senior executives, or auditors. Where an obligation is based on Community law, some sanctions are nevertheless necessary. According to the case-law of the ECJ, "penalties for infringements of provisions of Community law must be effective, proportionate and dissuasive".[205]

According to Member States' national provisions, the main rule is that sanctions against board members, auditors and senior executives can be enforced by the company. Typically, provisions of company law restrict the enforcement rights of shareholders.

Board Members

Questions of board remuneration and sanctions for breach of directors' duties can better be discussed in specialist corporate governance books.[206] Some general remarks can nevertheless be made.

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[203] Directive 2007/36/EC on the exercise of certain rights of shareholders in listed companies.

[204] Article 5 of Directive 2007/36/EC.

[205] Case C-387/02 Berlusconi and others [2005] ECR I-3565, paragraph 36; Case 68/88 Commission v Greece [1989] ECR 2965, paragraphs 23 and 24. See also Article 51 of Directive 2004/39/EC (MiFID) and Article 25 of Directive 2003/71 (Prospectus Directive)

[206] For an introduction, see Mäntysaari P, *op cit*, Chapters 4 and 5.

Discretion. Questions of the form, structure, and level of remuneration depend on the governing law and the company. The approximation of such rules would be difficult because of large differences between the national corporate governance models. For example, corporate bodies that share the same name do not necessarily share the same legal or commercial functions in different Member States.

There are statutory "boards" consisting of non-executive members with a monitoring role, statutory "boards" consisting of executive directors with a management role, unregulated boards consisting of executives with a management role, and several kinds of combinations, depending on the governing law and the company.

Transparency. However, the Commission believes that shareholders in general meeting should monitor the remuneration of members of the statutory board (regardless of their actual function). In 2004, the Commission adopted a Recommendation on the remuneration of directors.[207] Member States were invited to implement the recommendation through legislation or best practice rules by 30 June 2006.[208]

The Recommendation focuses on four measures: disclosure of the remuneration policy (remuneration statement); shareholders' vote on the remuneration policy; disclosure of the remuneration of individual directors; and shareholder approval of share-based incentive schemes.[209]

According to the Recommendation, a remuneration statement that focuses on the company's policy on directors' remuneration should be submitted to the annual general meeting of shareholders for a vote.

The total remuneration and other benefits granted to individual directors over the relevant financial year should be disclosed in detail in the annual accounts or in the notes to the annual accounts or, where applicable, in the remuneration report.

In addition to the Recommendation, there are particular disclosure rules. Some of them are based on Community law.

There is a duty to disclose "golden parachutes" and "tin parachutes" under the Directive on takeover bids. If the company's shares are admitted to trading on a regulated market, the company must publish detailed information about "any agreements between the company and its board members or employees providing for compensation if they resign or are made redundant without valid reason or if their employment ceases because of a takeover bid".[210] The information must be

[207] Recommendation 2004/913/EC. See also recital 13 of Directive 2004/109/EC (Transparency Directive).

[208] In July 2007, the Commission published a report on the application of the recommendation. For German law, see the Disclosure of Board Compensation Act (Vorstandsvergütungsoffenlegungsgesetz, VorstOG).

[209] See also Article 29 of Directive 77/91/EEC (Second Company Law Directive).

[210] Article 10(1)(k) of Directive 2004/25/EC (Directive on takeover bids).

published in the company's annual report[211] and in an explanatory report presented by the board to the annual general meeting.[212]

Other particular disclosure rules are based on Member States' laws or the applicable corporate governance codes.

Remuneration policy. In April 2009, the Commission adopted two Recommendations on remuneration policies. The Recommendations cover listed companies[213] and undertakings in the financial services sector.[214] One can say that the Recommendations represent different corporate governance theories.

The scope of the Recommendation applicable to listed companies is limited to directors. It is based on the principle that directors' remuneration "should promote the long term sustainability of the company and ensure that remuneration is based on performance". In this context, performance seems to be understood as "long term value creation of the company". One of the purposes of the Recommendation is also to "strengthen the company's accountability towards its shareholders". This Recommendation is thus based on the shareholder primacy model. In reality, however, the interests of most shareholders are short-term, and the company cannot have any interests of its own (see section 8.2.5).

The Recommendation applicable to undertakings in the financial services sector is not limited to directors. In this case, remuneration policy "should aim at aligning the personal objectives of staff members with the long-term interests of the financial undertaking concerned". This Recommendation seems to be aligned with the theory represented in this book (section 8.2.6).

The Recommendation on remuneration policies in the financial services sector provides: "Member States should ensure that financial undertakings establish, implement and maintain a remuneration policy which is consistent with and promotes sound and effective risk management and which does not induce excessive risk taking." Furthermore, "[r]emuneration policy should be in line with the business strategy, objectives, values and long-term interests of the financial undertaking, such as sustainable growth prospects, and be consistent with the principles relating to the protection of clients and investors in the course of services provided."[215]

According to the Recommendation applicable to listed companies, the *remuneration committee* should periodically review the remuneration policy for executive or managing directors, and it should exercise independent judgment and integrity when exercising its functions. Furthermore, remuneration for non-executive or su-

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[211] Article 10(2) of Directive 2004/25/EC (Directive on takeover bids). See also Article 46 of Directive 78/660/EEC and Article 36 of Directive 83/349/EEC (the Fourth and Seventh Company Law Directives).

[212] Article 10(3) of Directive 2004/25/EC (Directive on takeover bids).

[213] Commission Recommendation complementing Recommendations 2004/913/EC and 2005/162/EC as regards the regime for the remuneration of directors of listed companies, C(2009) 3177.

[214] Commission Recommendation on remuneration policies in the financial services sector, C(2009) 3159.

[215] Points 3.1 and 3.2 of Recommendation C(2009) 3159.

pervisory directors should not include share options. This reflects European code practice.

Codes. Corporate governance codes typically contain recommendations on the remuneration of top executives and board members. Typically, the compensation package should include both fixed and variable elements.

However, there can be differences between national codes. For example, one can easily see that the Combined Code and the German Corporate Governance Code seek to align the interests of executive directors with the interests of different principals (the German Code: the firm; the Combined Code: shareholders).

According to the Combined Code, "the performance-related elements of remuneration should form a significant proportion of the total remuneration package of executive directors and should be designed to align their interests with those of *shareholders* and to give these directors *keen incentives to perform* at the highest levels".[216] Furthermore, "levels of remuneration should be *sufficient to attract*, retain and motivate directors of the quality required to run the company succesfully, but a company should avoid paying more than is necessary for this purpose".[217]

Unlike the laws of most countries, German law requires the remuneration package of each board member to be *reasonable*.[218] According to the German Code, the "variable compensation elements should include one-time and annually-payable components linked to the *business performance* as well as *long-term incentives* containing risk elements". Furthermore, "all compensation components must be *appropriate*, both individually and in total", and there is a cap on the amount of severance payments.[219]

According to the Combined Code, remuneration for non-executive directors should not include share options.[220] According to the mandatory provisions of German law, members of the supervisory board cannot be given share option rights.[221] However, they can receive fixed as well as performance-related compensation. Performance-related compensation should also contain components based on the *long-term performance of the enterprise*.[222]

Civil liability of board members. Managers and board members generally owe a duty of care and may owe fiduciary duties to the company. In practice, these duties are seldom enforced by courts. One the one hand, it is relatively easy to fire underperforming managers and board members. On the other, it can be difficult for shareholders or investors to sue (see sections 9.2.9 and 10.7.6).

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[216] Provision B.1.1 of the Combined Code.

[217] Main Principle B.1 of the Combined Code.

[218] §§ 87 and 113 AktG.

[219] Section 4.2.3 of the German Corporate Governance Code.

[220] Provision B.1.3 of the Combined Code.

[221] § 113(3) AktG.

[222] Section 5.4.3 of the German Corporate Governance Code.

Auditors

Questions of auditor independence, auditor remuneration, and sanctions for breach of auditors' duties have partly been regulated in Community law.

Auditor independence. In 2002, the Commission published a non-binding Recommendation on the statutory audit.[223] According to the Recommendation, a principles-based approach to statutory auditors' independence is preferable to one based on detailed rules.[224]

The basic principle of the Recommendation was that an auditor or an audit firm cannot carry out a statutory audit if there is a financial, business, employment or other relationship, including the provision of additional services, with the audited entity that might compromise the statutory auditor's or audit firm's independence. This principle was also adopted in the Directive on statutory audits (Eighth Company Law Directive).

Fees. There is a special rule on audit fees. Member States shall ensure that adequate rules are in place which provide that fees for statutory audits: are not influenced or determined by the provision of additional services to the audited entity; and cannot be based on any form of contingency.[225] The relationship between the statutory auditor or audit firm and the audited entity is made more transparent by the Fourth and Seventh Company Law Directives which require disclosure of the audit fee and the fee paid for non-audit services in the notes to the annual accounts and the consolidated accounts.

Penalties and civil liability. The Directive on statutory audits (the the Eighth Company Law Directive) requires three kinds of sanctions.[226] (a) There must be "effective systems of investigations and penalties to detect, correct and prevent inadequate execution of the statutory audit".[227] (b) Furthermore, the Directive requires "effective, proportionate and dissuasive penalties in respect of statutory auditors and audit firms", where statutory audits are not carried out in conformity with the provisions adopted in the implementation of the Directive. Penalties must include "the possibility of the withdrawal of approval". [228] (c) In addition, the measures taken and penalties imposed on statutory auditors and audit firms must be "appropriately disclosed to the public".

However, this is without prejudice to Member States' civil liability regimes. Whether statutory auditors and audit firms are responsible for carrying out their work with due care and liable for the financial damage caused by a lack of the care owed therefore depends on the governing law (see section 10.7.6).[229]

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[223] Commission Recommendation 2002/590/EC of 16 May 2002, Statutory Auditors' Independence in the EU: A set of fundamental principles.
[224] Recital 11 of Recommendation 2002/590/EC.
[225] Article 25 of Directive 2006/43/EC (Directive on statutory audits).
[226] Article 30 of Directive 2006/43/EC (Directive on statutory audits).
[227] Article 30(1) of Directive 2006/43/EC (Directive on statutory audits).
[228] Article 30(2) of Directive 2006/43/EC (Directive on statutory audits).
[229] See also recital 19.

In 2008, the Commission issued a Recommendation concerning the limitation of the civil liability of auditors.[230] It was accompanied by the publication of an impact assessment.[231]

According to the Recommendation, the civil liability of statutory auditors and of audit firms arising from a breach of their professional duties should be limited.[232]

The Recommendation introduced key principles to be followed by Member States when selecting a limitation method: the limitation of liability should not apply in the case of intentional breach of duty by the auditor or the audit firn; and any limitation of civil liability should not prevent injured parties from being fairly compensated.[233]

Furthermore, the Recommendation contains three examples of recommended methods for limiting liability.[234]

9.4 Controlling Shareholders' Corporate Governance Tools

9.4.1 Introduction

From the perspective of the firm, the controlling shareholder of the company and its board are its two most important agents.

Having a good controlling shareholder with a long-term interest in the sustainable growth and profitability of the firm can increase the firm's long-term survival chances.

On the other hand, a bad controlling shareholder can reduce the firm's survival chances. Controlling shareholders may have an opportunity to use the assets of the controlled firm for their own benefit (for private benefits, see also section 8.7.8) rather than for the benefit of the firm or minority shareholders.[235]

The controlling shareholder will need particular corporate governance tools in order to obtain control and to exercise it. As a controlling shareholder has both le-

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[230] Commission Recommendation 2008/473/EC concerning the limitation of the civil liability of statutory auditors and audit firms, C(2008) 2274, 5 June 2008. The Commission has also presented a report on "The role, the position and the liability of the statutory auditor within the European Union" (Article 31 of the Directive on statutory audits).

[231] Commission Staff Working Document, Accompanying document do the Commission Recommendation concerning the limitation of the civil liability of statutory auditors and audit firms. Impact Assessment, C(2008) 2274, SEC(2008) 1974, 5 June 2008.

[232] Article 2 of Recommendation 2008/473/EC.

[233] Articles 2–4 of Recommendation 2008/473/EC.

[234] See Article 5 and recital 6 of Recommendation 2008/473/EC.

[235] Generally, see Demsetz H, The Structure of Ownership and the Theory of the Firm, J L Econ 25 (1983) pp 375–390; Shleifer A, Vishny RW, A Survey of Corporate Governance, J Fin 52 (1997) pp 737–783.

gal powers and de facto powers, the legal governance system and the relational governance system tend to be interrelated.

Controlling shareholders can benefit from legal rules that protect holders of a certain block of shares or shareholders generally. Such rules increase their formal powers in their capacity as shareholders and give them de facto powers in their capacity as controlling shareholders. On the other hand, similar rules can also act as a constraint by protecting other shareholders or the firm.

The most important corporate governance tools used by the controlling shareholder include: block-holding; the participation of its own managers or family members in management and control; and control over the board.

There can be particular corporate governance tools depending on the governing law. An interesting example is the regulation of "connected undertakings" (verbundene Unternehmen) under the German Aktiengesetz.[236] Connected undertakings typically include: the parent and the subsidiary; two undertakings one of which controls the other; and companies that have concluded an "enterprise contract" (Unternehmensvertag).[237]

9.4.2 Block-holding as a Corporate Governance Tool

Introduction

Block-holding is an important corporate governance tool in all capitalist countries. Evidence on share ownership structures around the world suggests that the existence of one or more large blockholders is the rule rather than the exception.[238] Even in large US listed firms, institutional investors tend to own large blocks of shares.

Block-holding can give a controlling shareholder formal powers in the company, and the de facto powers of controlling shareholders enable them to tell managers what to do regardless of the formal regulation of corporate governance.

The minimum size of the block depends on many things, in particular on the law governing the company, its company form, the intended degree of control, and the structure of share ownership. The controlling shareholder can be the beneficial owner of all shares controlled by that shareholder. Sometimes the controlling shareholder benefits from shares owned by somebody else.[239] The existence of takeover defences can increase the minimum size of the block required for control.

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[236] § 15 AktG: "Verbundene Unternehmen sind rechtlich selbständige Unternehmen, die im Verhältnis zueinander in Mehrheitsbesitz stehende Unternehmen und mit Mehrheit beteiligte Unternehmen (§ 16), abhängige und herrschende Unternehmen (§ 17), Konzernunternehmen (§ 18), wechselseitig beteiligte Unternehmen (§ 19) oder Vertragsteile eines Unternehmensvertrags (§§ 291, 292) sind."

[237] See also Mäntysaari P, *op cit*, section 5.9.5 (Konzernrecht).

[238] La Porta R, Lopez-De-Silanes F, Shleifer A, Corporate Ownership Around the World, J Fin 54(2) (1999) pp 471–517.

[239] See Article 10 of Directive 2004/25/EC (Directive on takeover bids).

Reasons to Use Block-holding

Block-holding is used as a corporate governance tool for many reasons.[240] First, the basic way to control a company is by being its *sole shareholder*. Actions by the sole shareholder are not constrained by minority shareholders' rights.

In listed companies, obtaining full control may require the making of a public offer for shares (Volume III). Company laws often provide for sell-out rights and squeeze-out rights in the event that a threshold of 90%[241] or 95% is exceeded.

Start-ups and private companies. Second, block-holding is the rule and dispersed ownership the exception in start-ups and private companies in general. Most companies and company groups in the world are controlled by a family or a large shareholder.

In a study involving the ultimate ownership and control of 5,232 corporations in 13 Western European countries, firms were found typically to be widely held (36.93%) or family controlled (44.29%). Widely held firms are more important in the UK and Ireland, and family controlled firms in continental Europe. Whereas financial and large firms are more likely widely held, non-financial and small firms are more likely family-controlled. State control is important to larger firms in continental Europe.[242]

Groups, networks. Third, block-holding plays a very important role in the governance of corporate groups and networks.

Group structures with parent companies, subsidiaries and affiliated companies are the prevailing form of doing business for medium-sized and large firms.

Group structures are complemented by a wider network of business partners. Block-ownership can help to cement a business relationship.

Formal and de facto powers. Fourth, block-holding can generally provide a shareholder with important formal powers and de facto powers in the company. These powers form the basis of a controlling shareholder's private benefits of control.

Block-holding confers more power in jurisdictions that protect investors by vesting important rights in the holders of a certain block of shares. The holder of the block can either keep those rights or block the formal rights of shareholders whose holdings are too small.

Block-holding is an important corporate governance tool also in jurisdictions with a low level of investor protection. For example, Chinese companies are generally state companies run by political fiat or private firms controlled by entrepreneurs or family members.

Private benefits. Fifth, there is the question of private benefits of control.

Holding a controlling position imposes costs in illiquidity and lack of diversification on the controlling shareholder, in addition to the actual cost of monitoring.

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[240] See, for example, Becht M, Strong Blockholders, Weak Owners and the Need for European Mandatory Disclosure. ECGN, Executive Report (1997), Tables 1 and 2.

[241] Article 15 of Directive 2004/25/EC (Directive on takeover bids).

[242] Faccio M, Lang L, The Ultimate Ownership of Western European Corporations, J Fin Econ 65 (2002) pp 365–395.

Sometimes the controlling shareholder accepts these costs because of private benefits. A controlling shareholder can generally extract private benefits of control, i.e. benefits to the controlling shareholder not provided to minority shareholders.[243]

For example, an industrial shareholder can integrate the activities of the companies that it controls and organise their activities as intra-firm activities. This can give the controlling shareholder the benefits of intra-firm control. Compared with market transactions, these benefits include, for example, low-cost access to information, more efficient allocation of intra-firm resources, more precise own-performance evaluations, intra-firm incentive systems (use of employment, promotion, and remuneration processes), and low-cost intra-firm dispute resolution systems.[244]

A further result of the existence of private benefits is that an investor obtaining control can pay more for the company's shares. Typically, control enables financial investors to benefit from refinancing and industrial investors also from synergy effects. The larger the synergy effects, the more industrial investors can pay.

The private benefits of control can be pecuniary or non-pecuniary. For example, controlling a certain company may provide a favourable social and political position in the circumstances. The importance of block-holding to the investor can thus depend on cultural factors and the size of the market and not only on pecuniary benefits.[245]

Share ownership structure in the market. Sixth, the importance of block-holding can depend on the market.

It can depend on the prevailing share ownership structure. For example, the economy can be dominated by cross-shareholdings. Asian economies are a classic example of cross-holdings.

In Japan, cross-shareholdings by related companies were very important in the past.[246] The Japanese economy is still dominated by keiretsu (large groupings of inter-related companies) and the Korean economy by chaebol. The overseas Chinese operate through a maze of interlinked family companies. The same phenomenom can nevertheless be seen in other countries. Italy's most important commercial empires knit together strings of companies through cross-shareholdings.

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[243] Gilson RJ, Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy, Harv L R 119 (2006) pp 1651–1652.

[244] Williamson OE, The Vertical Integration of Production: Market Failure Considerations, Am Econ R 61(2), Papers and Proceedings of the Eighty-Third Annual Meeting of the American Economic Association (May 1971) pp 113–114.

[245] Gilson RJ, Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy, Harv L R 119 (2006) p 1663.

[246] Capitalism with Japanese characteristics, The Economist, October 2005: "In 1992, according to the Ministry of Economy, Trade and Industry, 46% of all listed equities were held as cross-shareholdings by related companies, and only 6% by foreign investors. In 2004, cross-shareholdings accounted for merely 24% of shares whereas foreign ownership had risen to 22% of the total."

The ease of creating or unwinding block-shareholdings depends on the market. It is easier to diversify investments in some markets than in others. This can depend on the size and efficiency of the market. Furthermore, there is interaction between past share ownership structures and the present legal infrastructure of the market, and between the earlier legal infrastructures and the present ownership structures (path dependency).[247]

For example, a high capital gains tax used to lock financial institutions into a web of cross-shareholdings in Germany in the past because any attempt to liquidate these blocks would have been punitively taxed.[248] This tax was eliminated as from 1 January 2002.[249] This was one of the factors making takeovers easier in the German market.

The importance of block-holding can also depend on cultural preferences and the preferences of investors. For example, where investors predominantly prefer to spread their risks by diversifying their investments and to remain passive, there is less competition between different shareholders. The size of the block is more important, if investors prefer to be active and use the management and supervision powers available to them.

This can be illustrated by the role of investment funds. (a) Passive investing by investment funds accounts for a big share of trading in the US. In addition to openly passive funds, there are actively managed funds that predominantly try to track the index.[250] (b) This can be contrasted with Germany. Investment funds are not as important in the German capital market as they are in the US. What is characteristic of the German economy is relatively concentrated ownership and block-holding by banks.

The global rule. Seventh, in most countries, block-holding is the rule even for listed companies. Block-holding belongs to the basic corporate governance tools almost anywhere in the world.

According to a study, more than half of listed companies in Italy and Germany had a single shareholder controlling more than 50% of the voting rights. In France and Germany, the vast majority of listed companies have a majority voting block or a blocking minority.[251] Banks play an important role as shareholders in many continental European countries such as Spain, Germany and Italy.[252] Even state ownership can be important. In France, Ger-

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[247] Generally, see Bebchuk LA, Roe MJ, A Theory of Path Dependency in Corporate Governance and Ownership, Stanf L R 52 (1999) pp 127-170.

[248] See Coffee JC, The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control, Yale L J 111 (2001) pp 15–16.

[249] The amended § 8b of the Corporate Tax Act (Unternehmenssteuergesetz) states that public companies' capital gains on the sale of shareholdings are generally tax-free.

[250] Bhattacharya U, Galpin N, Is Stock Picking Declining Around the World? See Passive aggression, The Economist, January 2006.

[251] Becht M, Röell A, Blockholdings in Europe: An International Comparison, European Economic Review (1999).

[252] ECB, Structural analysis of the EU banking sector, November 2003.

many and Italy, the government still holds approximately 10% of market capitalisation. State ownership is nevertheless decreasing as a consequence of privatisations.[253]

According to another study, 82.5% of German listed companies, 65.8% of Italian listed companies, and 64.2% of Swedish listed companies had a blocking shareholder minority of at least 25%. Moving the control level up to a majority lowers the percentage of listed companies with a control block to 64.2% in Germany, 56.1% in Italy, and 26.3% in Sweden.[254]

The US and the UK can be regarded as exceptions from the main rule. Whereas listed companies in most parts of the world typically have a single shareholder or group of shareholders with effective voting control, dispersed ownership of listed companies is the norm in these two countries.[255] In the US, few companies have shareholders with more than 5%.[256]

Industry. Eighth, a controlling shareholder structure may be superior in some industries and in some circumstances, and a dispersed share ownership structure may prove advantageous in others.[257]

For example, if the minimum efficient scale of production is very large, the company may need large amounts of capital and also a dispersed share ownership structure. The prevailing share ownership structures are highly concentrated in the most competitive sectors of German industry.[258]

Takeover defence. Ninth, block-holding is an effective takeover defence. Block-holding, concentrated share ownership structures, pyramid structures, and cross-shareholdings reduce the likelihood of the transfer of control.

Management of agency. Lastly, there can be agency reasons for block-holding. A controlling shareholder holds a large equity stake in the company and can therefore have the incentive either to monitor managers effectively or to manage the company itself. Because of their proximity to management, controlling shareholders can monitor managers better compared with the capital market.[259]

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[253] *Ibid*.

[254] Becht M, Reciprocity in Takeovers 11 (ECGI, Law Working Paper 14/2003, 2003) at p 19. Cited also in Gilson RJ, Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy, Harv L R 119 (2006) p 1646.

[255] Gilson RJ, *ibid*, pp 1642, 1645–1646.

[256] Becht M, Röell A, *op cit*, pp 1049-1056.

[257] Gilson RJ, *op cit*, p 1662.

[258] For example, BMW and Porsche are family-controlled. Volkswagen was controlled by the state of Lower Saxony before being taken over by Porsche. Daimler used to be controlled by Deutsche Bank. Audi (VW), Adam Opel (GM), and Ford Germany are subsidiaries.

[259] See, for example, Morck R, Strangeland D, Yeung B, Inherited wealth, corporate control, and economic growth: the Canadian disease. In Morck R (ed) Concentrated Corporate Ownership. U Chic P, Chicago (2000) (NBER Working Paper W6814).

Particular Remarks: "Bad Law" and "Good Law" Countries

One can distinguish between "good law" and "bad law" countries in this context. One can also distinguish between good and bad controlling shareholders (see also sections 8.7.1, 8.7.2, and 9.2.6).

Good law, good controlling shareholders. Financial investors have less need to monitor companies in countries with functionally "good law" (efficient controlling shareholder systems). "Good law" limits the pecuniary private benefits of control to amounts that are smaller than the increased productivity from more focused monitoring by controlling shareholders.

To accomplish this outcome, good law must specify substantive standards, require sufficient disclosure that those with the power to enforce the standards know of violations, and provide an effective enforcement process. Such a regime can be accomplished by formal legal rules or through private regulatory organisations, and through detailed legislation or by judicially developed principles of fiduciary duty.[260]

Bad law, bad controlling shareholders. In this context, "bad law" means that the legal system allows the cost of private benefit extraction to exceed the benefits of more focused monitoring by the controlling shareholder (inefficient controlling shareholder systems).

In countries with functionally "bad law", entrepreneurs retain control to protect themselves against private benefit extraction by someone who might subsequently assemble control if the existing controller gave it up.[261]

Laws and the legal system thus favour block-holding in countries with functionally "bad law". However, not all countries with a national pattern of concentrated share ownership belong to this category.[262]

Good or bad? In practice, there are some basic ways to identify countries with "bad law" and countries with "good law". First, countries where the rule of law is weak are always bad law regimes, because laws that do not exist or are not enforced cannot protect shareholders. Second, it is believed that the level of private benefit extraction is large in functionally bad law regimes. The level of private benefit extraction should be reflected in the difference in value between controlling and minority shares, because the value of controlling shares includes the net present value of expected private benefits of control.

For example, rule of law is probably stronger in Sweden and Finland than in Italy and Greece, and countries like Russia and China are bad law regimes (for the rule of law, see section 4.2 and Volume II). Italy can also be regarded as a bad law state on the basis of private benefit extraction, and Sweden as a good law state.[263]

[260] Gilson RJ, Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy, Harv L R 119 (2006) p 1646.

[261] *Ibid*, p 1654.

[262] *Ibid*, p 1652.

[263] *Ibid*, p 1655, citing Nenova T, The Value of Corporate Voting Rights and Control: A Cross-Country Analysis, J Fin Econ 68 (2003) pp 334–335, table 3; and Dyck A, Zingales L, Private Benefits of Control: An International Comparison, J Fin 59 (2004) p 551, table II.

The Minimum Size of the Controlling Block

As seen above, the minimum shareholding depends on many things, such as the purpose of the investment, the jurisdiction, whether the company is listed or privately-owned, the company's share ownership structure, the existence of takeover defences, the local business culture, the prevailing model of share ownership, and the investor's policy.

Company law. The minimum shareholding always depends on the provisions of the law governing the company. Shareholders' rights and duties vary depending on where the company is incorporated (see below).

The minimum shareholding can also depend on other legal factors. If the size of the block reaches, exceeds or falls below a certain threshold, negative or positive things can happen. For example, the validity of governmental permits can depend on the identity of the controlling shareholder.[264] Alternatively, negative implications may be caused by contractual provisions. The most typical clauses in this respect are change of control clauses and material adverse change clauses contained in many important financial and other contracts (see Volume II). The minimum size of the block can also depend on tax. For example, dividends paid by a subsidiary company to its parent company may be exempted from withholding tax, if the parent company holds at least a certain block of the shares in the subsidiary company.[265]

Shareholders' rights. The necessary minimum shareholding can depend on the provisions that protect minority shareholders and thus act as constraints on the exercise of majority shareholders' and managers' powers.[266]

The constraints can be based on the general principles of company law. For example, the German Aktiengesetz provides for the equal treatment of shareholders,[267] and shareholders owe a duty of loyalty towards the company and other shareholders (Treu und Glauben, § 242 BGB).[268] Depending on the objectives of the controlling shareholder, this and similar provisions can make it necessary to acquire all outstanding shares in order to reduce legal risk.

The constraints can also be based on provisions on the distribution of power in the company. The exercise of controlling shareholders' powers is constrained by company law rules vesting certain powers in minority shareholders.

Some provisions of company law create personal rights for shareholders. For example, the German Aktiengesetz gives each shareholder the right to bring proceedings against the company in the event that a resolution passed at a general meeting is void or voidable (see also section 9.5.5).[269]

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[264] See, for example, Directive 2004/39/EC (MiFID).
[265] According to Directive 2003/123/EC, the minimum shareholding is 10% from 1 January 2009.
[266] See Mäntysaari P, Comparative Corporate Governance. Shareholders as a Rule-maker. Springer, Berlin Heidelberg (2005).
[267] § 53a AktG.
[268] BGHZ 65, 15 (ITT).
[269] §§ 241–257 AktG.

The thresholds laid down by these provisions vary. In addition to the formal decision-making powers of the general meeting, shareholders can have a number of rights both individually and together with other shareholders.

This can again be illustrated by German law. (a) Each shareholder may: participate and express his opinion at a general meeting; vote at a general meeting;[270] request verbal information from the management board at a general meeting;[271] enforce this right;[272] contest the validity of resolutions of the general meeting;[273] nominate persons for election to the supervisory board; contest the validity of the composition of the supervisory board;[274] ask a court to appoint a member of the supervisory board;[275] and ask a court to determine the compensation payable under a profit transfer agreement.[276] (b) Shareholders holding 5% (one-twentieth) of the shares have further rights in the company. Typically, this group of shareholders may demand a general meeting and items to be put on the agenda. (c) Shareholders holding more than 25% (one-fourth) of the shares have a right of veto with regard to many important resolutions. In particular, resolutions relating to share capital often require a majority of at least 75% (three-fourths) of the shares represented and a simple majority of the votes cast at the general meeting. For the same reason, shareholders holding more than 25% (one-fourth) of the shares can block resolutions to amend the articles of association.

Some of the most important thresholds probably relate to: the distribution of profits (and the power to block or initiate the distribution of profits); the issuing and allotment of shares (and the power to block the issuing or allotment of shares); the amendment of articles (and the power to block it); and the squeeze-out of minority shareholders.

For example, takeover bids can be conditional upon the bidder ownership reaching a certain threshold after a succesful bid. This threshold is usually either the minimum shareholding required for the amendment of articles or the squeezing out of minority shareholders.[277] The Second Company Law Directive does not lay down any specific minimum shareholding required for the amendment of articles. However, it requires a minimum threshold of two-thirds for derogations from existing shareholders' pre-emption rights. The Directive on takeover bids provides for a squeeze-out right in some takeover bids; the threshold could then be "90% of the capital carrying voting rights and 90% of the voting rights in the offeree company".[278] There can be differences between the laws of Member States. For example, securities loans will not be taken into account in Germany when determining whether the 90% threshold has been exceeded.[279]

[270] § 134 AktG.
[271] § 131 AktG.
[272] §§ 131, 132(2) and 326 AktG.
[273] §§ 243 and 245 AktG as well as §§ 241 and 249 AktG.
[274] § 98(2)(3) AktG.
[275] § 104(1) AktG.
[276] § 304 AktG.
[277] See also recital 24 of Directive 2004/25/EC (Directive on takeover bids).
[278] Article 15 of Directive 2004/25/EC (Directive on takeover bids).
[279] Landgericht Landshut 01.02.2006 - 1HK O 766/05; Die Aktiengesellschaft, Heft 13–14/2006 p 513.

Structural devices in general. Block-holding is complemented by the use of various structural devices. These devices can reduce the minimum shareholding required for control.

There are many ways for shareholders to obtain a degree of control disproportionate to their equity ownership.[280] An external study commissioned by the Commission[281] identified 13 types of control-enhancing mechanisms (CEMs) in EU listed companies, ranging from pyramid structures and multiple voting rights to cross-holdings and shareholders' agreements.[282] According to the study, pyramid structures are the most important and widely available form of CEM in the EU (see also Volume III).

Some of these devices relate to shares. The capability of other shareholders to influence corporate policy can be reduced by the existence of: various classes of shares with differentiated voting rights (shares with limited or multiple voting rights); special control rights conferred on holders of a specific class of shares (for example, "golden shares") or on the board; pyramid structures or cross shareholdings; and general voting caps for shareholders (making takeovers more difficult).

Other devices relate to control. For example, the influence of other shareholders may be reduced: if the people controlling the company personally work for the company; by shareholder agreements (under which groups of shareholders act in concert); or by the control rights of board members relating to board appointments.

In wealthy economies, controlling shareholders typically have power over firms significantly in excess of their cash flow rights, primarily through the use of pyramids and participation in management.[283] Dual class shares and pyramids enhance the control of the largest shareholders, but overall there are significant discrepancies between ownership and control in only a few countries.[284]

Different classes of shares. As said above, the minimum shareholding can depend on the existence of different classes of shares (see also Volume III).

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[280] See, for example, the Report of the High Level Group of Company Law Experts on takeover bids.

[281] Report on the Proportionality Principle in the European Union, 18 May 2007. It was prepared by Institutional Shareholder Services, the European Corporate Governance Institute, and Shearman & Sterling LLP. See also Tricks of the trade, The Economist, June 2007.

[282] Multiple voting right shares; non-voting shares; non-voting preference shares; pyramid structures; priority shares; depository certificates; voting right ceilings; ownership ceilings; supermajority provisions; golden shares; partnerships limited by shares; cross-shareholdings; and shareholders' agreements. See also Becht M, Strong Blockholders, Weak Owners and the Need for European Mandatory Disclosure. ECGN, Executive Report (1997) pp 93–97. Becht identified 24 devices that separate "ownership" (capital investment) and voting power.

[283] La Porta R, Lopez-De-Silanes F, Shleifer A, Corporate Ownership Around the World, J Fin, vol 54(2) (1999) pp 471–517.

[284] Faccio M, Lang L, The Ultimate Ownership of Western European Corporations, J Fin Econ 65 (2002) pp 365–395.

It is to some extent possible to separate share ownership and voting rights, and long-term control can be enhanced by using multiple voting rights.

For example, the Swedish Wallenberg family controls Investor, a listed holding company that holds large stakes in large companies such as Ericsson (telecoms), SEB (banking), Atlas Copco (engineering), AstraZeneca (drugs), and ABB (engineering). Typically, the Wallenberg family[285] and Investor control companies with the help of multiple voting rights.

It is quite usual in Europe that control by a dominant shareholder results from structural devices that leverage voting rights above the level of equity investment. According to a study, 66.1% of listed Swedish companies, 51.2% of listed Swiss companies, 41.4% of listed Italian companies, and 17.6% of listed German companies issue dual classes of common stock, with one class having dramatically higher voting rights. Control is also frequently enhanced through the use of pyramids and multiple control chains.[286]

The Economist cited a study prepared for the Association of British Insurers (ABI) by Deminor Rating, a Belgian governance consultancy: "[O]nly two-thirds of the big European firms included in the FTSE Eurofirst 300 index operate a rule of one share, one vote. In the other third of firms, power tends to be concentrated in the hands of a minority of big shareholders who control a majority of the voting rights. Practice varies widely across Europe. A mere 14% of the firms in the sample from the Netherlands allow their owners one vote per share; 25% of the Swedish firms; and 31% of the French companies. Things are far more democratic in Germany (97%) and Britain (88%). One-fifth of the companies issue shares with multiple voting rights, giving additional votes to selected shareholders. One in ten firms imposes a ceiling on the number of votes that can be exercised by any one shareholder, irrespective of how many shares he owns."[287]

Restrictions on the use of multiple voting rights. There can be national restrictions on the issuing of shares with multiple voting rights. For example, a German AG may not issue shares with multiple voting rights[288] but may issue shares with no voting rights.[289] The myth of the "one share, one vote" rule will be discussed in section 9.5.6 below.

It is legally easier to decide on the issuing of such shares when the company is founded. They can be issued even later. However, such resolutions are constrained by existing shareholders' pre-emptive rights.[290]

The existence of several classes of shares can increase the complexity of corporate decision-making. In a public limited-liability company, some decisions may

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[285] Knut and Alice Wallenbergs Foundation.

[286] See Gilson RJ, Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy, Harv L R 119 (2006) pp 1646–1647.

[287] What shareholder democracy? Europe's unfair voting rights, The Economist, March 2005.

[288] § 12(2) AktG.

[289] § 12(1) AktG.

[290] Article 29(1) of Directive 77/91/EEC (Second Company Law Directive).

be subject to a separate vote for each class of shareholder whose rights are affected by the transaction.[291] This is likely to increase the minimum shareholding required for control.

In principle, the breakthrough rule could restrict the use of multiple voting rights under the Directive on takeover bids.

The contents of the breakthough rule are as follows: "Where, following a bid, the offeror holds 75% or more of the capital carrying voting rights ... multiple-vote securities shall carry only one vote each at the first general meeting of shareholders following closure of the bid, called by the offeror in order to amend the articles of association or to remove or appoint board members."[292] In addition: "Multiple-vote securities shall carry only one vote each at the general meeting of shareholders which decides on any defensive measures in accordance with Article 9."[293]

The breakthrough rule thus means that if a bidder secures 75% of the target's equity, then the extra votes of a high-voting class are ignored for such things as the election of board members. The effect of the rule is to limit the extent to which a controlling shareholder could use certain devices to lever its equity into control. A minimum of 25% of the equity value plus one share is necessary to command a majority of the vote.

In practice, however, the breakthrough rule will hardly ever apply (see Volume III).

Golden shares. The increased takeover activity caused by privatisations and the liberalisation of European capital markets under the provisions of the EC Treaty have prompted certain Member States to adopt specific measures to secure control of nationally important companies. The use of what is generally known as "golden shares" belongs to this category of measures designed to prevent foreign takeovers of national champions.

The purpose of "golden shares" is to give a shareholder or a third party the final say as regards certain kinds of corporate decisions or transactions. Golden shares are typically used in state-controlled companies.

In its judgments in the "golden shares" cases against Portugal, France and Belgium, the ECJ held that control rights constitute restrictions on movements of capital if they are effectively vested in the government.[294] In principle, the free movement of capital may be restricted only by national rules which fulfil the twofold criterion of being founded on overriding requirements of the general interest and being proportionate to the objective pursued.

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[291] See, for example, Articles 25(3), 31 and 38 of Directive 77/91/EEC (Second Company Law Directive); Article 7(2) of the Directive 78/855/EEC (Third Company Law Directive); Article 60 of Regulation 2157/2001 (SE Regulation).

[292] Article 11(4) of Directive 2004/25/EC (Directive on takeover bids).

[293] Article 11(3) of Directive 2004/25/EC (Directive on takeover bids).

[294] Case C-367/98 Commission v Portugal [2002] ECR I-4731, paragraph 38; Case C-483/99 Commission v France [2002] ECR I-4781, paragraph 37; and Case C-503/99 Commission v Belgium [2002] ECR I-4809, paragraph 38.

The same principles were applied in the *Volkswagen* case,[295] in *Commission v Netherlands* (see Volume III),[296] and in several other cases.

Pyramids. The minimum shareholding can also depend on the existence of pyramid structures, cross-shareholdings, or circular shareholdings.[297]

A pyramid structure enables the ultimate shareholder to exercise control over a company through a cascade of listed and/or unlisted holding companies. There may also be minority shareholders in every holding company in the chain. The more holding companies in the pyramid, the smaller economic investment the ultimate shareholder may have in a company controlled by the ultimate shareholder. Pyramid structures therefore achieve a disproportionality between ownership of risk-bearing capital and de facto control rights. They can therefore achieve the same result as multiple voting rights (for multiple voting rights, see above).[298]

Pyramid structures are not prohibited by EU company law. For example, pyramid structures are not covered by the breakthrough rule; the Directive on takeover bids only requires listed companies to publish information on "significant direct and indirect shareholdings (including indirect shareholdings through pyramid structures and cross-shareholdings)".[299]

Cross-shareholdings. Cross-shareholdings are legally more problematic than pyramid structures.

Cross-shareholdings are widely used in some countries. In Japan, the keiretsu is organised as a web of cross-shareholdings. In Germany, Italy and France, large companies have been protected against takeovers by cross-shareholdings in the past.

Cross-shareholdings have the effect of concentrating control rights in the hands of the statutory board or managers, because voting rights attached to shares owned by a company are generally used by board members or managers representing the company. Cross-shareholdings can also concentrate control rights in the hands of minority shareholders where minority shareholders control the board in their capacity as the ultimate owners of the company.

There is no general prohibition of cross-shareholdings in Community law. However, there is some piece-meal harmonisation. The Directive on takeover bids requires the disclosure of some cross-shareholdings.[300] What can make cross-shareholdings legally complicated is that cross-shareholdings have partly been regulated by the Second Company Law Directive and in EU competition law.

The Second Company Law Directive applies to public limited-liability companies.[301] If the laws of a Member State permit a public company to acquire its own shares, the company may do so only under certain circumstances (see Volume

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[295] Case C-112/05 Commission v Germany [2007] ECR I-8995.

[296] Joined Cases C-282/04 and C-283/04 Commission v Netherlands [2006] ECR I-9141.

[297] Generally, see Engsig Sørensen K, Regulering af cross-holding mellem selskaber i EU, NTS 2003:4 pp 494–518.

[298] Report of the High Level Group of Company Law Experts on takeover bids.

[299] Article 10(1)(c) of Directive 2004/25/EC (Directive on takeover bids).

[300] *Ibid*.

[301] Article 1(1) of Directive 77/91/EEC (Second Company Law Directive).

III).[302] For example, there can be: an optional 10% rule;[303] a mandatory rule based on net assets;[304] and a mandatory rule suspending the right to vote attaching to the company's own shares.[305]

As regards cross-shareholdings in particular, the Second Directive distinguishes between companies between which there is a control relationship and companies without a control relationship. Whereas cross-shareholdings between the former are subject to restrictions, those between the latter are not.

Because the proposed draft Ninth Directive on company groups has been dropped,[306] the Member States agreed to insert a new provision on controlled companies into the Second Directive.[307] The Second Directive now provides that: "The subscription, acquisition or holding of shares in a public limited-liability company by another company ... in which the public limited-liability company directly or indirectly holds a majority of the voting rights or on which it can directly or indirectly exercise a dominant influence shall be regarded as having been effected by the public limited-liability company itself".[308] These restrictions apply even where the controlled limited-liability company is a company founded outside the EU.[309]

This means that the (optional) 10% rule and the (mandatory) rule based on net assets will apply if a controlled limited-liability company (governed by the laws of any country) acquires shares in the public limited-liability company that controls it (and is governed by the laws of a Member State). There may be exceptions where the control is indirect.[310]

In the absence of a control relationship, cross-shareholdings are not restricted by EU company law.[311] They may nevertheless be restricted by EU competition law (see also Volume III).

Cross-shareholdings are constrained by Article 81 of the EC Treaty, which prohibits agreements and concerted practices restricting competition, and by Article 82 of the EC Treaty, which prohibits the abuse of a dominant position. Cross-

[302] Article 19 of Directive 77/91/EEC (Second Company Law Directive).
[303] Article 19(1) of Directive 77/91/EEC (Second Company Law Directive) (as amended by Directive 2006/68/EC which made the earlier rule optional for the Member States).
[304] *Ibid.*
[305] Article 22(1)(a) of Directive 77/91/EEC (Second Company Law Directive).
[306] Schwarz GC, Europäisches Gesellschaftsrecht. Nomos, Baden-Baden (2000) p 386. See also the principles proposed by Forum Europeaeum Konzernrecht, Konzernrecht für Europa, ZGR 1998 p 672.
[307] Directive 92/101/EEC.
[308] Article 24a(1)(a) of Directive 77/91/EEC (Second Company Law Directive).
[309] Article 24a(1)(b) of Directive 77/91/EEC (Second Company Law Directive).
[310] Article 24a(2) of Directive 77/91/EEC (Second Company Law Directive): "However, where the public limited-liability company holds a majority of the voting rights indirectly or can exercise a dominant influence indirectly, Member States need not apply paragraph 1 if they provide for the suspension of the voting rights attached to the shares in the public limited-liability company held by the other company."
[311] See Engsig Sørensen K, Regulering af cross-holding mellem selskaber i EU, NTS 2003:4 p 501.

shareholdings can also influence the application of the EC Merger Regulation which applies to concentrations with a Community dimension.[312]

In addition to EU company law and EU competition law, cross-shareholdings are naturally governed by the provisions of Member States' laws.[313]

Family-owned companies. In family-owned or family-controlled companies, the size of the block can depend on the participation of family members in ownership and management.

The participation of family members in ownership and management is likely to reduce the size of the block that the family needs in order to control the company. This can depend on family members' direct influence and the effect of family identity and family-firm identity on company culture.

The Maximum Size of the Block

Legal reasons not only influence the minimum size of the controlling block but can also affect the maximum size of the block. Some of the most typical constraints include the following.

Investment restrictions. There can be clear restrictions on inward direct investment, or certain areas may have been reserved for the state.

Thresholds. Sometimes the exceeding of a certain threshold would trigger an event which the firm or the investor would rather avoid. For example, the size of the block can effectively be limited by accounting rules (consolidation), mandatory bid obligations (under takeover law or the company's articles of association, see Volume III),[314] competition law (especially merger control, see Volume III), or the regulation of a certain area of business (regulatory approval may be required after the exceeding of a certain threshold). The negative impact can also be caused by takeover defences adopted by the target company.

Takeover defences. Some legal rules also make it irrelevant to increase the size of the holding. For example, the use of voting rights may be restricted by the company's articles of association. In some countries, the state has the last word or a "golden share" in important companies.

Disclosure of the Block

Community law generally requires large shareholdings in listed companies to be disclosed. This means, for example, that it is more difficult for potential bidders to

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[312] Article 1(1) and recital 21 of Regulation 139/2004 (EC Merger Regulation).

[313] See, for example, Engsig Sørensen K, Regulering af cross-holding mellem selskaber i EU, NTS 2003:4 pp 494–518; Jul Clausen N, Engsig Sørensen K, Disclosure of Major Shareholdings: A Comparative Analysis of Regulation in Europe, ICCLJ 4 (2002) pp 201–247.

[314] The law or the company's statutes can provide for a duty to make a bid for the remaining shares where the investor's shareholding exceeds a certain threshold. The threshold may vary depending on the country but is often set at 30% of the voting rights in the target company.

accumulate a large toehold in the target unnoticed in advance of the bid. This is also likely to increase the price that bidders must pay for shares (see Volume III).

Disclosure of material holdings. In the EU, the Transparency Directive requires the disclosure of the acquisition or disposal of major holdings in companies whose shares are admitted to trading on a regulated market.[315]

A shareholder must notify the issuer where the proportion of voting rights of the issuer held by the shareholder as a result of the acquisition or disposal reaches, exceeds or falls below the thresholds of 5%, 10%, 15%, 20%, 25%, 30%, 50% and 75%.[316] The issuer must, upon receipt of the notification, make public all the information contained in the notification.[317]

In the US, the Securities Exchange Act of 1934 imposes similar disclosure requirements on persons within ten days of the date that they acquire more than five per cent of the beneficial ownership of a public company (section 13(d)). The purpose of this section is "to provide information about any concentration of shareholdings", so that "even an investor making just a significant passive investment, one really made only for investment and not for the purpose of acquiring control, will have to deal with its requirements".[318] In addition, those persons must disclose their reasons for buying the shares and any plans or proposals they have with respect to the target (Item 4 of Schedule 13D).[319]

Disclosure of structures. The Directive on takeover bids[320] complements the Transparency Directive by requiring listed companies to disclose several legal instruments typically used by shareholders controlling the company jointly. The purpose of these rules is to make defensive structures and mechanisms more transparent.[321]

For example, Member States must ensure that listed companies publish detailed information on: "significant direct and indirect shareholdings (including indirect shareholdings through pyramid structures and cross-shareholdings ..." and "any agreements between shareholders which are known to the company and may result in restrictions on the transfer of securities and/or voting rights".[322]

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[315] Directive 2004/109/EC (Transparency Directive). The Transparency Directive repealed Directive 88/627/EEC on the information to be published when a major holding in a listed company is acquired or disposed of.

[316] Article 9(1) of Directive 2004/109/EC (Transparency Directive). According to Article 9(3), the company's home Member State need not apply: (a) the 30% threshold, where it applies a threshold of one-third; (b) the 75% threshold, where it applies a threshold of two-thirds. For German law, see § 21 WpHG ("Beteiligungspublizität") and § 25(1) WpHG.

[317] Article 12(6) of Directive 2004/109/EC (Transparency Directive).

[318] Gilson RJ, Black BS, The Law and Finance of Corporate Acquisitions, Second Edition. Westbury, New York (1995) p 898.

[319] Ferrarini G, Corporate Ownership and Control. Law Reform and the Contestability of Corporate Control. OECD, Company Law Refrom in OECD Countries. A Comparative Outlook of Current Trends. Stockholm, Sweden, 7–8 December 2000 (2000).

[320] Directive 2004/25/EC (Directive on takeover bids).

[321] See Recital 18.

[322] Article 10(1) of Directive 2004/25/EC (Directive on takeover bids).

Consolidation. The purpose of the Seventh Company Law Directive on consolidated accounts and IFRS is to prevent Enron-type situations from happening by requiring group accounts and making the use of off-balance sheet special purpose vehicles more difficult.

Family Participation as a Corporate Governance Tool

Family participation in ownership and management is a special case of block-ownership. In family-owned or family-controlled companies, powerful owners may have multiple roles: they may participate as family members, present owners and present managers, or as heirs and future owners and managers. The relationships between key stakeholders inter se are therefore long term, and share blocks controlled by the family tend to be illiquid.

Similar principles can be applied to the participation of the controlling shareholders' managers in the management of the controlled firm. In the following, it is nevertheless assumed that the company is family-owned.

Legal and relational governance mechanism. Like all companies, family-owned or family-controlled companies have a legal or formal corporate governance structure. Formal decision management and decision control is exercised by the statutory board.

Parallel to the legal governance structure, family members typically use a relational governance structure.[323] Moreover, strong social ties in family companies provide potential for social control. Relational governance mechanisms and legal governance mechanisms are complementary and not mutually exclusive.

The extent and quality of social interaction within the owner family influence the formation of mutual trust and a shared vision, which can improve the quality of decision-making.

The relational governance structure does not have to be institutionalised. On the other hand, positive social interaction within the owner family can be increased by establishing family institutions.

Effective monitoring. From the perspective of the family, family members can be effective monitors of management. They have advantages in monitoring and disciplining managers who are family members themselves, because family members have many dimensions of exchange with one another over a long period of time.[324] Family members can also have a relatively long-term perspective to the management of the firm.

The family is not the only party benefiting from such monitoring. The firm can benefit from: the family identity of the shareholders; the commitment of the fam-

[323] See Mustakallio MA, Contractual and Relational Governance in Family Firms: Effects on Strategic Decision-Making Quality and Firm Performance, HUT, Institute of Strategy and International Business, Doctoral Dissertations 2002/2. Helsinki University of Technology, Espoo (2002).

[324] Fama EF, Jensen MC, Separation of Ownership and Control, J L Econ XXVI (2) (1983) p 306.

ily to the firm; altruistic behaviour and trust between family members; and a corporate culture enhanced by family identity.

All this can reduce agency costs both for the family and the firm. Family control can therefore affect company performance positively.[325]

Perspective of the firm. From the perspective of the firm, there can therefore be a tradeoff between, first, the reduction of agency costs and, second, inefficiencies caused by the participation of family members in ownership and management.

The special challenges for family companies include the need to separate family relationships and company relationships (especially financial relationships and accounts), the informality of governance policies, and often the lack of formal internal controls.

Family ownership can also lead to risk aversion. If family members invest their monetary capital and human capital in just one company, they can be more risk averse and assign lower values to uncertain cash flows compared with shareholders who have diversified their holdings across many companies. This can restrict investment and penalise the company in the competition for survival in the long term.[326]

Challenges increase over time as the family grows and many family members become financial shareholders. Family members' management qualities may also change after the founder generation. The beneficial treatment of family members may make it more difficult for the company to hire good managers and keep them.

On the other hand, family ownership can bring benefits to the firm. It is often assumed that family firms can have special strengths such as a long-term view in decision-making, a desire to build a business for future generations, and the commitment of family management to their company. Firms can benefit from such "family-firm values".[327]

Furthermore, the conservative nature of family firms, their longer time horizons, and their lower appetite for gearing can make family firms less vulnerable in times of recession. This can also decrease the costs of debt finance (see Volume III).

In the long term, shares in companies where a family holds a large block of shares tend to outperform firms without any large family holdings.[328]

9.4.3 The Board as a Corporate Governance Tool

Introduction

Block-holding can in practice enable a shareholder to decide on the board structure and to appoint and remove board members. This is why the use of the board

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[325] See Anderson RC, Reeb DM, Founding family ownership and firm performance: Evidence from the S&P 500, J Fin 58 (2002) pp 1301–1328.

[326] Fama EF, Jensen MC, Separation of Ownership and Control, J L Econ XXVI (2) (1983) p 306.

[327] See Under the influence, The Economist, November 2001.

[328] See Feeling frugal, The Economist, March 2002.

as a corporate governance tool is discussed in the context of corporate governance tools available to the controlling shareholder. However, even the firm and non-controlling shareholders rely on the board as a corporate governance tool (section 9.2.11).

Why is there a board in the first place? The existence of a corporate body called the "board" is not a necessary condition for the existence of a legal entity. What is necessary is that there is: at least one person responsible for legal compliance in relation to the state; at least one person responsible for furthering the interests of the entity; at least one person responsible for the internal decision-making of the entity; at least one person authorised to represent the entity in its dealings with third parties; and a system to prevent self-dealing and to solve dead-lock situations.

As the First Company Law Directive puts it, there must be persons who either as a body constituted pursuant to law or as members of any such body are authorised to: represent the company in dealings with third parties and in legal proceedings; and take part in the administration, supervision or control of the company.[329]

In 2008, the Commission presented a proposal for a Regulation on a European Private Company (SPE, Societas Privata Europaea). According to the proposal, the SPE should have at least one director, but the existence of a board would not be mandatory. A German GmbH must have at least one managing director.[330] The existence of a board is not required, but the GmbH can have a supervisory board.[331]

A body consisting of more than one people is nevertheless practical for reasons of corporate risk management and the management of agency relationships (section 7.4). The existence of such a body can: improve the quality of corporate decision-making by enabling the participation of many people; increase the transparency of decision-making by facilitating monitoring by peers (other members of the same body); facilitate the separation of decision-management and decision-control; and reduce the number of self-dealing and dead-lock situations. Company laws worldwide normally require the use of a board or boards.[332]

Variation. On the other hand, even where many legal entities do have a board, there is plenty of variation.

Business forms can range from partnerships to foundations run on business lines, and from small privately-owned companies to large listed public companies. The roles of entrepreneurs, shareholders, and managers can vary depending on the actual enterprise form chosen for the firm.

A limited-liability company's share ownership and management structures tend to change over time. They can range from concentrated to dispersed. For example, dispersed share ownership can be replaced by the emergence of a controlling shareholder (in the most extreme case a listed company goes private after a suc-

[329] See Article 2(1) of Directive 68/151/EEC (First Company Law Directive).
[330] § 6(1) GmbHG.
[331] § 52 GmbHG.
[332] See also Kraakman R, Davies PL, Hansmann H, Hertig G, Hopt KJ, Kanda H, Rock EB (eds), The Anatomy of Corporate Law. OUP, Oxford (2004) p 11.

cessful bid to its shareholders). Share ownership and management structures do not necessarily change with the same pace or in the same direction.

Furthermore, share ownership and management can be in the hands of the same people or parties, or there can be various degrees of separation of ownership and management.

Berle and Means already identified in 1932 that ownership and control were separated in large US firms. It is nevertheless clear that most businesses are family businesses with no clear-cut separation between family interest and business interest, or between share ownership and management.

Factors influencing board structure. The share ownership structure, the management structure, and the degree of the separation of ownership and management should influence board structure where permitted by law.

The law governing the company is important in this context. For example, whereas board structure and board membership have largely been left to the discretion of shareholders and firms in countries like England, they have largely been standardised by mandatory provisions of law applicable to public limited-liability companies in countries like Germany.

These structures can change over time. In the following, this will be illustrated by some typical categories of companies:

- all companies with a corporate structure;
- small companies owned by an entrepreneur;
- small companies owned by commercial investors and an entrepreneur;
- small companies owned by commercial investors and an entrepreneur;
- medium-sized or large companies with a controlling shareholder;
- companies with dispersed share ownership and concentrated management;
- companies with dispersed share ownership and dispersed management; and
- companies with powerful external monitors.

Corporate Structure and the Division of Power

Corporate structure is likely to influence the management structure of the firm and the division of power between the board and management.

For example, where a large firm consists of just one limited-liability company with a unitary board, the firm's board and management will operate within the same legal entity. Operative management will have more say in the running of the firm as a whole, but even the board is likely to have more say in the operations of the whole firm.

In contrast, where a large firm consists of a holding company and several operating subsidiaries, the board of the holding company is more likely to focus on monitoring and control, formulating group strategy, and matters of group management. It will be easier to buy and sell the incorporated operations of the firm.

Operative managers are more likely to focus on the business of each subsidiary and have more discretion to run the subsidiaries.

Small Companies Owned by an Entrepreneur

The fundamental characteristics of the limited-liability company can make it attractive also to entrepreneurs founding start-ups. In the most basic case, the entrepreneur is the sole shareholder and manager of the startup company. Again, this will influence the use of the board as a corporate governance tool.

What the entrepreneur does not need. The entrepreneur does not need a board to monitor management (the entrepreneur is the management) or to disclose information to shareholders (there are no other shareholders). Neither does the entrepreneur need the board to give him advice (the entrepreneur can ask anybody for advice).[333] In addition, there is no incentive problem caused by the separation of share ownership and management.[334]

What the entrepreneur needs. For compliance reasons, the entrepreneur can need either a real board or a legal front. Both are ways to mitigate and transfer risk. In addition, using a legal front is a way to reduce transparency.

The transfer of risk can be constrained by mandatory provisions of law preventing the circumvention of board members' duties (for "shadow directors" and "faktische Geschäfsführung", see section 10.6.2 of Volume II).

A real board. If the entrepreneur chooses a real board, the entrepreneur needs: a board structure that fulfils legal requirements; friendly board members; and a sufficient legal framework for the work he does in the name of the company.

Not being a board member – or the sole board member – might confuse third parties about the real role of the entrepreneur, signal that the entrepreneur is not prepared to be legally responsible for the company's activities, increase the perceived risk of parties dealing with the company, and increase the company's costs. This speaks for the board membership of the entrepreneur.

At start up, many businesses rely heavily on family structures, close friendships and personal loyalties. Family and friends can be flexible, loyal, and inexpensive as board members.

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[333] See also Fama EF, Jensen MC, Separation of Ownership and Control, J L Econ XXVI (2) (1983) p 322: "When it is efficient to combine decision management and control functions in one or a few agents, it is efficient to control agency problems between residual claimants and decision makers by restricting residual claims to the decision makers. This proposition gets clear support from the proprietorships, small partnerships, and close corporations observed in small-scale production and service activities. These organizations are all characterized by concentrated decision systems and residual claims that are restricted to decision agents."

[334] Fama EF, Agency Problems and the Theory of the Firm, J Pol Econ 88 (1980) p 295: "When he is sole security holder, a manager consumes on the job, through shirking, perquisites, or incompetence, to the point where these yield marginal expected utility equal to that provided by an additional dollar of wealth usable for consumption or investment outside of the firm."

Legal front. Alternatively, the entrepreneur may prefer a "legal front" (see also section 8.2.4).

In many jurisdictions, board members are responsible for compliance with many legal and administrative requirements. The entrepreneur may therefore prefer: protection against non-compliance with legal or administrative requirements; professional board members ensuring that the company complies with legal and administrative requirements; and friendly board members who act according to his instructions.

Therefore, many entrepreneurs choose not to become board members in their own companies. Instead, the entrepreneur might choose board members who are both friendly and professional. This technique can also be used where the entrepreneur wants to keep the beneficial ownership of the company secret.

There are legal service providers acting as a legal front and taking care of the administration of the company.

The entrepreneur can achieve a legal front also by using a chain of different legal entities. In addition to the limited liability of shareholders, the entrepreneur can benefit from the separate legal personality of these entities enabling the entrepreneur to delegate business and management functions further down in the chain. Each legal entity will then have persons responsible for compliance with the legal and administrative requirements related to the activities of that entity.

The use of a legal front can be illustrated by the IKEA case. IKEA, the world's largest home-furnishing retailer, was founded by Ingvar Kamprad. IKEA was still perceived as a Swedish enterprise in 2006 when The Economist revealed that IKEA consisted of a web of legal entities in different countries.[335]

The parent for all IKEA companies - the operator of 262 of the 296 worldwide IKEA stores[336] - was Ingka Holding, a private Dutch-registered company. Ingka Holding, in turn, belonged to Stichting Ingka Foundation. This was a Dutch-registered, tax-exempt, non-profit-making legal entity, which had been given the shares of Mr Kamprad in 1982. Under its articles, Stichting Ingka Foundation channelled its funds to Stichting IKEA Foundation, another Dutch-registered foundation. Although Mr Kamprad had given up ownership of IKEA, the stichting meant that his control over the group was secure. A five-person executive committee, chaired by Mr Kamprad, ran the foundation. This committee appointed the boards of Ingka Holding, approved any changes to the company's statutes, and had pre-emption rights on new share issues. Mr Kamprad's wife and a Swiss lawyer had also been members of this committee, which took most of its decisions by simple majority.

The IKEA trademark and concept was owned by Inter IKEA Systems, another private Dutch company, but not part of the Ingka Holding group. Its parent company was Inter IKEA Holding, registered in Luxembourg. This, in turn, belonged to an identically named company in the Netherlands Antilles, run by a trust company in Curaçao. The beneficial owners remained hidden from view. Each IKEA store paid 3% of sales to IKEA Systems under a franchise agreement.

[335] Flat-pack accounting. Forget about the Gates Foundation. The world's biggest charity owns IKEA—and is devoted to interior design, The Economist, May 2006.

[336] IKEA Group corporate site, 17 March 2009.

Small Companies Owned by an Entrepreneur and Family

There are many kinds of family companies. Family companies could mean: companies that are wholly-owned and managed by the founders or their families (narrow definition); companies in which the founder's family at least has a controlling stake and a leading role in the senior management (broader definition); or companies in which the founder's family at least continues to have significant influence (broadest definition). There can be both private and public family companies, and both listed and unlisted family companies.

In any case, the first stage of the development of the family company is a company run by an entrepreneur and partly owned or managed by his family members whose interests are still the same as those of the entrepreneur.

Gradually, family members cease to share the same interests. While some of them have managerial roles in the company, some of them change into financial investors.

It is characteristic of family companies that family relationships (and family interest) and company relationships (and company interest) are not perfectly separated. Family members may have multiple roles in the business. In addition to the formal governance system, there may be a relational governance system based on social interaction within the owner family.

This makes it particularly challenging for the entrepreneur to use the board as a corporate governance tool in a family company.

First, family members are not always good board members from the perspective of the entrepreneur. Relatives that own shares in the company probably feel less dependent on the entrepreneur the more distant they are. They can also feel less dependent and be less friendly than paid executives. At the same time, they are usually not as competent to ensure compliance with legal and administrative requirements as professional managers and experts could be.

Second, like all shareholders, family members can be tempted to use their voting rights independently and contrary to the interests of the entrepreneur or the company.

Third, the roles of board meetings, family meetings and shareholders' meetings can become confused, making it necessary to delegate more power to professional managers.

The entrepreneur could deal with these problems in many ways.

First, the entrepreneur can try to separate family relationships and company relationships by making the company appoint external board members and keeping family members out of the board. The existence of board members who are not part of the family's relational governance system would have an impact on board work.

Second, the entrepreneur can try to channel the voice of family shareholders to bodies that are not directly connected with management or the supervision of management. These bodies can also be family meetings or communication mechanisms based on informal practices and conventions. However, it may become necessary to bring some clarity to these mechanisms by formalising them.

Third, the entrepreneur can try to concentrate dispersed family ownership into a holding company or a separate legal entity, the board of which the entrepreneur controls. This may become necessary over time when the number of family shareholders increases. The existence of a holding company can prevent family shareholders from selling shares in the subsidiary company to outsiders or from voting individually rather than as one voting bloc.

Small Companies Owned by External Investors and an Entrepreneur

External investors may be a source of funding and/or ancillary services (section 8.7.2). The existence of external investors wanting to further their own business interests changes the role of the board quite radically.

Protecting the minority and the firm. It is now necessary for the board to comply with legal rules that protect minority shareholders against expropriation by majority shareholders, and to disclose information to all shareholders.[337]

The entrepreneur has an incentive to profit from his position in the company by paying himself or consuming on the job more than the value of his work. For this reason, there must be a mechanism for agreeing the terms of his employment and remuneration package, for ensuring that this package is in line with the value of the entrepreneur's work, and for monitoring that the entrepreneur does not consume more on the job than is agreed in his contract.[338]

Structure. There can be tension between existing family structures and the need to adopt more formal governance structures.

It is in the interests of external investors to make management more structured, more professional, independent of the entrepreneur, and accountable. For this reason, it becomes necessary to separate family relationships and company relationships, family interest and business interest, as well as family funds and company funds.

The same can be said of the board. There should be a separation between business interest and family interest in the board, and decision-making through the board rather than through informal family channels. This can require the appointment of external non-executive board members or board members representing the interests of commercial investors.

This also requires the separation of decision management and decision control. For example, when venture capital is put into a small entrepreneurial organisation by outsiders, it is usual to put in place mechanisms for separating the management and control of important decisions.[339] Typically, the board will be used as a decision control mechanism. The board will not be an effective device for decision

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[337] See Kraakman R, Davies PL, Hansmann H, Hertig G, Hopt KJ, Kanda H, Rock EB (eds), The Anatomy of Corporate Law. OUP, Oxford (2004) pp 54–61.

[338] See Fama EF, Agency Problems and the Theory of the Firm, J Pol Econ 88 (1980) p 296.

[339] Fama EF, Jensen MC, Separation of Ownership and Control, J L Econ XXVI (2) (1983) p 306.

control, unless it is complemented by a mechanism limiting the decision discretion of individual top managers (section 7.4).

Exit of external investors. Where the benefits of having external investors are overweighed by the disadvantages related to minority rights, management structure and board composition, the entrepreneur may prefer to buy out the external investor's shares.

Whether minority shareholders can be forced to part with their shares depends on the applicable company law (for exit, see Volume III). In some cases, majority shareholders may force minority shareholders to sell their shares. For example, the Directive on takeover bids provides for a squeeze-out right and a sell-out right following a takeover bid;[340] the threshold for the use of such rights is usually at least 90% of the capital carrying voting rights and 90% of the voting rights.

Often a voluntary sale is the only way (for acquisitions, see Volume III).

This is what happened in the Bertelsmann case. Bertelsmann is a German media conglomerate controlled and owned by the Mohn family. In 2001, the Mohn family decided to exchange a 25% stake of the group's shares for 30% of RTL, a pan-European television group. After the exchange, the Mohn family controlled a 75% stake in Bertelsmann. 25% belonged to Groupe Bruxelles Lambert (GBL), a financial group controlled by Mr Frère, a Belgian businessman. At the time of exchange, the parties agreed that GBL would have a right to sell its 25% stake in Bertelsmann on the stock exchange. In January 2006, GBL announced that it was indeed planning to sell some, or all, of its 25% stake on the stock exchange. The Mohn family opposed a flotation, but the only way they could stop Mr Frère was by buying him out.[341] This case is also an example of the effect of company law on the value of shares. Bertelsmann agreed to pay GBL €4.5 billion to avoid a public listing of this block of shares. The price included also GBL's private benefits of controlling such a large minority block (the "blackmail value"), and the Mohn family's private benefits of keeping the company private.[342]

Medium-Sized or Large Companies with a Controlling Shareholder

The next stage in the development of the governance structure of the firm is the existence of both a controlling shareholder and professional management.

Entrepreneur v controlling shareholder. There is a difference between being an entrepreneur or a controlling shareholder. An entprepreneur participates intensively in the management of the company and obtains information as a member of the company's management. A controlling shareholder, by comparison, does not have to participate as intensively in management. Therefore, a controlling shareholder needs more information produced by corporate bodies and management. A controlling shareholder must also rely on corporate bodies and managers for compliance with laws and administrative requirements.

Composition of the board. As regards the composition of the board, the step from entrepreneur to controlling shareholder is nevertheless relatively small.

[340] Articles 15 and 16 of Directive 2004/25/EC (Directive on takeover bids). See also recital 24.

[341] A discreet dynamo, The Economist, April 2006.

[342] All in the family, The Economist, May 2006.

By definition, the controlling shareholder can decide who is to become a board member or member of the company's management. The controlling shareholder can therefore choose whether supervision and management should be separated at the board level or whether supervision and management should be in the same hands.

Company form. What can be more important is that medium-sized or large firms can require a different company form compared with small firms.

Private benefits. Control and focused monitoring can bring the controlling shareholder private benefits.[343] Company laws usually regard this as a problem and lay down mandatory rules that protect minority shareholders and creditors against expropriation by controlling shareholders. In countries with no mandatory separation of supervision and management at board level, listed companies often have a duty to address this problem by appointing non-executive board members.

Companies with Dispersed Ownership and Concentrated Management

The evolution of the share ownership structure from the existence of one large controlling shareholder to dispersed share ownership can have a big impact on the structure and composition of the board.

Interests of shareholders. In a legal sense, shareholders never own the firm; they own only shares which confer certain limited rights to their holder. If the company has dispersed ownership, it does not have owners in any meaningful sense.[344] Shareholders of companies with dispersed share ownership are likely to spread their wealth across many companies and so not be interested in directly controlling management of any individual company.[345]

Where dispersed ownership is combined with concentrated management,[346] the interests of shareholders are best served by the separation of decision management and decision control and by a board that monitors management (for other fundamental organisational measures used in the context of corporate risk management, see section 7.4).

There are four usual ways to achieve this. First, the separation of management and supervision can be based on mandatory provisions of law providing for a two-tier board structure with a supervisory body and a management body.

Well-known examples of this model include the SE (which can be founded in all Member States) and the German AG. For example, the SE Regulation provides that an SE may

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[343] Gilson RJ, Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy, Harv L R 119 (2006) p 1642.

[344] Fama EF, Agency Problems and the Theory of the Firm, J Pol Econ 88 (1980) p 289.

[345] *Ibid*, p 295.

[346] Concentrated management means that specific information valuable for important decisions affecting the company as a whole is concentrated in one or a few easily identifiable agents that are responsible for decision management (initiatiation and implementation).

choose either a two-tier system or a one-tier system.[347] The two-tier system of an SE consists of a supervisory organ and a management organ; no member may serve on both the management board and the supervisory board at the same time.[348]

Second, the unitary board can be complemented by a non-statutory executive body consisting of many members. In this case, the unitary board is the statutory board with broad company law powers, and its members owe a wide range of company law duties. In contrast, the main rule is that no company law powers are vested in the non-statutory executive body; moreover, its members owe no company law duties. There can be exceptions to this main rule depending on the governing law and the substantive area of law. For example, in some cases, legal duties are allocated functionally on the basis of the actual role of a person or persons acting on behalf of the company: some legal duties can be owed by "the person responsible" for a certain act or corporate function.

In Finland, many large listed companies have a statutory board of directors and a non-statutory management board chaired by a statutory CEO. Members of the statutory board share all the responsibilities of a body actually taking care of the administration of the company. In reality, however, the board acts as a monitoring body resembling the German Aufsichtsrat (or the optional supervisory board under Finnish company law). The company is managed by its management board and CEO. Apart from the statutory CEO, members of the statutory board have neither rights nor duties under company law. According to Finnish company law, the use of a supervisory board is optional. If companies used a supervisory board as a supervisory body and the board of directors as a management body, both monitoring and management would fall within the scope of company law. Unfortunately, practically no companies make use of this possibility.

Third, there can be a statutory board and a non-statutory management body that partly overlap. Typically, some managers can be members of both corporate bodies. But if top managers have control of the statutory board, there is a risk of collusion and expropriation of the company and shareholders. Therefore, executive board members can be complemented by external non-executive members.

The role of external non-executive board members is central in this board structure. The existence of external non-executive members generally increases the transparency of managers' actions, and external non-executive members can be used as professional "referees" whose task is to stimulate and oversee competition among the firm's top managers.[349]

Their existence makes it possible to create two-tier structures within the formally one-tier statutory board and thus to separate decision management and decision control.

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[347] Article 38.

[348] Article 39(3).

[349] Fama EF, Agency Problems and the Theory of the Firm, J Pol Econ 88 (1980) pp 293–294.

Such a structure is typically complemented by the use of board committees with a monitoring role. This is the model used by many listed UK companies complying with the Combined Code.[350]

According to the two-tier board model, board committees do not need to have any monitoring role. Instead, their purpose is to make board work more effective.

In 2004, the Commission published a Recommendation on the role of non-executive or supervisory directors and on supervisory board committees.[351] The Commission was of the opinion that "the primary purpose of the committees should be to increase the efficiency of the (supervisory) board by making sure that decisions are based on due consideration, and to help organise its work with a view to ensuring that the decisions it takes are free of material conflicts of interest".[352]

Where the chairman of the non-statutory management body is chairman of the board, the board structure will resemble a "propeller" with all important decisions controlled by the same manager or managers. Typically, such structures can be found in family firms controlled by an entrepreneur. From a risk management perspective, the use of such structures is not recommended for companies whose shares have been admitted to trading on a regulated.[353]

Fourth, there can be a statutory board and a powerful CEO. According to this model, the statutory board acts as a supervisory body and the CEO is responsible for the management of the company. It is usual to find a powerful CEO in US companies.[354]

Interests of the firm. From the perspective of the firm, the separation of decision management and decision control at the board level is part of corporate risk management and a fundamental way to manage agency relationships.

Companies with Dispersed Ownership and Dispersed Management

The previous ownership and management structure can be contrasted with dispersed ownership combined with dispersed (rather than concentrated) management below the board level. Dispersed management means here that specific information, valuable for important decisions affecting the company as a whole, is not concentrated in one or a few easily identifiable agents that are responsible for decision management (initiation and implementation). Where the company does not have concentrated management under its statutory board, the statutory board must be responsible for concentrated management. The statutory board must then play a bigger role not only in decision control but also in decision management.

[350] See, for example, Main Principle A.3 of the Combined Code.

[351] Commission Recommendation of 15 February 2005 on the role of non-executive or supervisory directors and on the committees of the (supervisory) board (2005/162/EC).

[352] Paragraph 6.1 of Recommendation 2005/162/EC.

[353] However, the Commision has not clearly advised against the practice of combining the roles of chairman and CEO. See paragraph 3.2 of Recommendation 2005/162/EC.

[354] See also paragraph 3.2 of Recommendation 2005/162/EC.

Example: corporate strategy. For example, it is usual for the statutory board to decide on corporate strategy. Where the company has concentrated management below the board level, it can be sufficient for the board to be responsible for decision control (ratification and monitoring). If the company has dispersed management below the board level, it may become necessary for the statutory board also to become involved in decision management (initiation and implementation) in this respect.

Board membership of managers. If dispersed ownership is combined with dispersed management under the statutory board, it is more important that at least some members of the statutory board are not only decision control experts but also decision management experts. In this case, typically some of its members are internal managers since they have valuable specific information about the organisation's activities.[355]

Choice between concentrated management and dispersed management below the board level. The choice between concentrated management and dispersed management below the board level is not static but may change over time. The management model may depend on the structure of the company's organisation, company culture, as well as the personality of its executives and board members, among other things.

Dispersed management can partly be caused by the use of separate legal entities with a holding company carrying on business through subsidiaries. In the absence of a sufficient number of executives in the holding company managing the group as a whole, the "management void" can be filled by the statutory board acting as a management body.

Dispersed management can also be caused by the delegation of decision functions to many expert boards below the statutory board, or by a company culture according to which different kinds of decisions are taken by different committees or other collective bodies.

Monitoring of monitors. On the other hand, the separation of decision management and decision control is one of the most fundamental principles of corporate risk management (section 7.4). If the board has large management functions in a company with dispersed share ownership, one must ask who monitors the monitors: *quis custodiet ipsos custodes*. (a) In a "self-enforcing" governance model, the separation of functions can help to mitigate this problem (section 8.3 and the German AG). The (supervisory) board should thus not have large management powers in the first place. (b) The "classic" model already identified by Plato in the Republic is to assume that members of the governing class (here: the board) are superior people monitoring themselves. (c) The "intermediary" model is used in the US and UK. Large management powers tend to be concentrated in the hands of a powerful CEO or a small group of other executives. These executives should not have a prominent supervisory role in the statutory board. Instead, they should be monitored by committees consisting of non-executive directors.[356]

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[355] Compare Fama EF, Jensen MC, Separation of Ownership and Control, J L Econ XXVI (2) (1983) p 314.

[356] See also Recommendation 2005/162/EC.

Companies with Powerful External Monitors Other than the Market

The position of the board changes again when managers are monitored by powerful external institutions other than the market. Many external institutions can in practice force managers to further certain special interests.

Non-state institutions. Important non-state institutions which can monitor the board range from the existence of an outside market for control[357] to labour unions,[358] NGOs, other political pressure groups, and political parties.

State institutions. State institutions are usually more powerful than non-state institutions, because they can adopt laws and administrative provisions enforceable by other state institutions. Practically all laws and administrative provisions can, under some circumstances, act as constraints on the governance of companies in a market economy, and some laws and administrative provisions regulate the governance of companies directly.[359] It has therefore been assumed that the political structure of society can influence the share ownership structure of companies.[360]

Pressures of any kind. Generally, powerful external pressures of any kind can influence the share ownership structure, management structure, and board structure of companies. For example, Roe has argued that there is a correlation between ownership concentration and "social democracy".[361]

Large companies bow to pressure groups by portraying an image acceptable to these groups, and the building of an image may require changes in the business the company is in and in its management structure. It may also require changes in its board structure.

Board structure can be influenced by the more or less forced membership of people that represent special interests. For example, the forced membership of employee representatives (like in the German supervisory board or Aufsichtsrat), female representatives, or politicians in the company's board is likely to correlate with the vesting of important powers in other corporate bodies. The CEO, the management board (Vorstand), non-statutory executive boards, or similar bodies will then exercise larger decision management powers and decision control powers.

Dealing with external monitors. There are ways to deal with powerful external monitors by making corporate bodies more powerful. This can be done by laws but also by internal corporate decisions.

Increasing the powers of shareholders. First, it is possible to make shareholders more powerful.

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[357] Fama EF, Agency Problems and the Theory of the Firm, J Pol Econ 88 (1980) p 294.

[358] See, for example, Fama EF, Agency Problems and the Theory of the Firm, J Pol Econ 88 (1980) p 294.

[359] For the distinction between governance and constraints to governance, see Mäntysaari P, Comparative Corporate Governance. Shareholders as a Rule-maker. Springer, Berlin Heidelberg (2005), Chapter 2.

[360] Roe MJ, Political Preconditions to Separating Ownership from Corporate Control, Stanf L R 53 (2000) pp 539–606.

[361] *Ibid*.

According to Roe, this has happened in "social democratic" countries like Germany and Sweden.[362] Whereas listed companies with dispersed shareholders dominate business in the US, companies with dispersed ownership would not survive in social democracies. Social democracy weakens the ties between managers and dispersed shareholders, because social democracies have powerful governments that play a large role in the economy, emphasise distributional considerations, and favour employees over capital-owners when the two conflict. For this reason, argues Roe, it is the family firm, or the listed firm with concentrated individual, financial, or corporate ownership, that dominates business in France, Germany, Italy, and Scandinavia.[363]

Problems caused by powerful social democratic governments are thus managed by ownership concentration. Controlling shareholders can manage the potential conflict between managers' goals and shareholders' goals.

Increasing the powers of the board. Second, it is possible to make the board more powerful and shield it from external pressure.

This could be a factor that partly helps to explain why there was no change in the dispersed ownership of UK listed companies during left-wing labour governments in the 20th century.

There was no need for companies to be protected against left-wing governments by concentrated ownership or by giving more power to boards, because boards and individual board members were already sufficiently protected against outside pressure, and the share ownership structure is path-dependent.

The main rule is that the board of an English company can exercise all management powers in the company, and courts have typically not wanted to interfere with management or board work. The powers of other than controlling shareholders have traditionally been very limited because of the principle of majority rule, the vesting of management powers in the board, and the principle that directors' duties are owed to the company and not to any particular shareholder.[364] Board members could be appointed either by the board or shareholders in general meeting, depending on the articles of association. Although the powers of the board were wide, board membership was not coupled with much risk in the past.

In addition, there were probably cultural reasons that protected board members against the government. England used to be a class society with board membership and senior jobs in the government to a large extent reserved for representatives of the same class with a similar background, education and interests.

Increasing the powers of management. Third, it is possible to make the top management body more powerful and shield it from external pressure. This can require the delegation of management matters to a sub-board corporate body.[365]

In Germany, this is achieved by: the statutory two-tier board structure; the mandatory rules on the distribution of power between the management board (Vorstand) and the supervisory board (Aufsichtsrat); the vesting of management power in the management board (Vor-

[362] *Ibid.*

[363] Coffee rejects Roe's theory. See Coffee JC, The Future as History: The Prospects for Global Convergence in Corporate Governance and its Implications, Northw U L R 93 (1999) pp 641-707.

[364] See, for example, Mäntysaari P, Comparative Corporate Governance. Shareholders as a Rule-maker. Springer, Berlin Heidelberg (2005), Chapter 5.

[365] *Ibid.*

stand); and the fact that both boards are collegiate organs. The management board is thus less likely to bow to external pressure, because its activities are regulated by provisions of law, and individual management board members are less likely to bow to external pressure separately, because important decisions must be decided on by the whole management board.

In England, it has become usual to delegate management matters to a sub-board executive body and use the statutory board of directors as a supervisory body taking care of decision control rather than decision management.

Monitors cancelling each other out. Fourth, it is possible that powerful external monitors cancel each other out. However, this can cause several problems.

What is not very problematic for the firm is that the powers of some external monitors can be cancelled out by the state. For example, the power of NGOs can in some cases be constrained by laws adopted by the government, and actions by the government can in some countries be constrained by the opposition and the media.

Sometimes board memberships and management jobs are distributed on the basis of what external organisation or interest each board member or manager represents. Such a system may in the worst case lead to dead-locks in decision-making, lack of direction, and warring factions in the company. In order to mitigate this risk, the company may decide to adopt and enforce a detailed legal framework. For example, the rules governing supervisory boards and co-determination in a German AG are usually prescriptive and mandatory.

Powerful external monitors can cancel each other out when the process of decision-making requires consensus. In the absence of a default legal framework for the mutual relations of different stakeholders, such a system would in practice require a strong cultural basis or contracts.

9.5 Minority Shareholders' Corporate Governance Tools

9.5.1 Introduction

Company laws require the board to act in the interests of the company. Acting in the interests of the company should mean furthering the interests of the firm (section 8.2.5). The board should therefore further the interests of the firm (section 9.2.11).

However, controlling shareholders and external pressure groups try to influence the company's actions. The most important corporate governance tools used by controlling shareholders include: block-holding; the participation of its own managers or family members in management and control; and control over the board. There can therefore be external pressure to further conflicting interests.

Even non-controlling minority shareholders will try to influence the company's actions. This can require changing the behaviour of the company's board, managers, and controlling shareholders.

Available tools. The usual corporate governance tools available to minority shareholders include the following: avoiding bad companies; information rights; equivalent treatment; different classes of shares (dual class shares); voting caps; exit rights; block-holding; and “good corporate governance”.

Position of minority shareholders. Basically, controlling shareholders can use the same tools. The position of minority shareholders is nevertheless different from that of controlling shareholders. This will influence the relative weight of the available tools.

When ownership is diffuse, many shareholders: do not have the means to monitor effectively; and do not have a sufficient information base to monitor effectively. As a result, many shareholders: lack incentives to monitor managers; and are free-riders.

For these reasons, the main corporate governance tools of minority shareholders are those that: enable them to exit the company; guarantee the equivalent treatment of all shareholders; enable them to block decisions; or force management and controlling shareholders to disclose relevant information to the public (for the disclosure regime under Community law, see section 10.7 and Volume III).

In some cases, minority shareholders can seek protection through contracts with the company and the controlling shareholder. For example, a venture capital firm will typically seek protection when it takes a minority shareholding (Volume III).

The position of minority shareholders changes when their shares are not freely transferable because of contractual (lock-up) or company law restrictions (company form, articles of association), or when there is no market for their shares (SMEs). This increases their incentives to monitor management and the demand for effective minority powers.

Controlling shareholders as agents. Obviously, the agency relationship between minority and controlling shareholders is influenced by the regulation of shareholders’ rights and duties.

The scope of shareholders’ *rights* will influence the *scope* of that agency relationship (for the scope of agency, see section 6.3). Shareholders’ rights show what shareholders and controlling shareholders legally can do. Limiting those rights to few things will limit the scope of the agency relationship as well.

For example, where shareholders’ rights have been limited by mandatory provisions of law separating share ownership and control, management is better protected against actions by controlling shareholders and can act more independently. From the perspective of minority shareholders, this will reduce the scope of the agency relationship between minority shareholders and controlling shareholders and increase the scope of the agency relationship between minority shareholders and management.

The *duties* of shareholders can influence the behaviour of controlling shareholders in relation to minority shareholders. The existence of shareholders’ duties is a way to regulate the *contents* of that agency relationship. The duties of shareholders depend on the governing law.

For example, shareholders of a German limited-liability company owes a general duty of loyalty to other shareholders (principle of Treu und Glauben, § 242 BGB). In the US, fiduciary duties to other shareholders can be triggered by control.[366] Under English law, the main rule is that a shareholder does not owe any general fiduciary duties to other shareholders.[367]

In addition to shareholders' duties, even *other duties* can act as a constraint. Where the company's board members and managers have strong incentives to comply with the company's or their own duties, controlling shareholders have less de facto power to force them to further conflicting interests.

The position of minority shareholders is stronger where the existence of rights and obligations is complemented by an effective *enforcement* mechanism.

9.5.2 Avoidance of Risk

An investor can avoid risk by refusing to become a minority shareholder in the first place. For example, risks inherent in agency can be too high for minority shareholders in: companies governed by "bad law" (section 9.4.2); companies not subject to sufficient external constraints (such as laws and product market competition); companies whose management is not subject to sufficient external constraints (such as laws or reputational constraints); or companies in which a controlling shareholder has access to a mechanism to move large amounts of funds (for example, transfer pricing in corporate groups).[368] Instead of avoiding risk, the investor can choose to invest in a company in which the risk of expropriation is lower.

9.5.3 Mitigation of Risk in Advance

If the investor does decide to become a minority shareholder, there are many general ways to mitigate risks inherent in the agency relationship between minority investors as principal and the controlling shareholder as agent.

Choice of legal framework, "good law". Minority investors can prefer to invest in companies governed by "good law" (see section 9.4.2 above; for legal risk, see section 4.2). Although investors cannot change the law as such, they can choose the legal framework by picking companies on the basis of the governing law and the company form.

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[366] For Delaware law, see Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1344 (Del. 1987).

[367] See Lower M, Good faith and the partly-owned subsidiary, JBL 2000 pp 238–239; Prentice D, The closely-held company and minority oppression, OJLS 3 (1983) p 417 at p 419; Mäntysaari P, Comparative Corporate Governance. Shareholders as a Rule-maker. Springer, Berlin Heidelberg (2005), Chapter 4.

[368] See Gilson RJ, Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy, Harv L R 119 (2006) pp 1657–1658.

The quality of the legal framwork is particularly important where the company has a controlling shareholder. If the legal framework is “bad law”, a minority shareholder might prefer to avoid the risk or look for a share block that enables the minority shareholder to obtain control himself.

It is characteristic of “good law” that it provides for the equal treatment of shares and shareholders in the same position and restricts the private pecuniary benefits of the controlling shareholder. However, it would not be in the interests of minority shareholders to choose a legal framework that deprives controlling shareholders completely of private pecuniary benefits of control, because this would give controlling shareholders and other shareholders less reason to monitor management. Minority shareholders might prefer a system with a controlling shareholder as long as the benefits from the reduction in managerial agency costs exceed the detriment of the controlling shareholder’s extraction of private benefits (sections 9.2.6 and 9.4.2).[369]

Choice of companies with an effective monitoring system. Investors can try to pick companies which are subject to effective external monitoring. For example, this can be intense product market competition, an efficient board structure, an efficient controlling shareholder system, efficient monitoring by the capital market, or efficient monitoring by the banks.

The relative importance of each monitoring tool depends on the market, the governing law, the company form, and other circumstances.

Generally, exposure to the market can add a new layer of monitoring. Banks have traditionally been important monitors of risk and management in continental Europe. “Good law” can be necessary to prevent the banks from abusing their proximity to management,, where the banks’ role exceeds that of lenders.[370] Companies often signal the presumed efficiency of their monitoring system by means of compliance with recommendations and codes.

Choice of an effective controlling shareholder. The quality of the controlling shareholder is important to the firm (see section 9.2.6). Investors can try to pick companies with efficient controlling shareholders.

By picking the companies they invest in, minority shareholders have the option of aligning their interests with those of the controlling shareholder.

For example, a long-term investor can pick a company controlled by an industrial shareholder or a family with a good track-record; the efficiency of controlling shareholders may therefore be important in the case of mergers.[371]

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[369] *Ibid*, p 1652.

[370] Schmidt RH, Tyrell M, Information Theory and the Role of Intermediaries in Corporate Governance, Working Paper Series: Finance and Accounting 142, Department of Finance, Johann Wolfgang Goethe-Universität Frankfurt am Main (2004).

[371] See Cheffins BR, Mergers and Corporate Ownership Structure: The United States and Germany at the Turn of the 20th Century, AJCL 51 (2003) p 491 on US experiences.

Some shareholders are notoriously bad. For example, long-term investments in state-controlled companies and companies controlled by labour unions are particularly risky.

For example, the collapse and sale of Allgemeine Hypothekenbank Rheinboden (AHBR) to Lone Star, a financial investor, in 2006 marked the end of union-owned business in Germany, and Volkswagen AG could be taken over by Porsche AG because of a very low valuation of VW shares after years of control by the State of Lower Saxony (Niedersachsen).

Delegation of control. Minority shareholders can delegate control to controlling shareholders in three main ways.

First, minority shareholders can buy shares in the same company as the controlling shareholder.

Second, minority shareholders can decide to invest in the controlling shareholder rather than the company that it controls. For example, minority shareholders may choose to buy shares either in Ericsson, a Swedish company controlled by Investor, or Investor, a Swedish company controlling Ericsson. Buying shares in Investor would nevertheless give rise to structural subordination (see Volume III).

Third, instead of becoming minority shareholders directly, investors can participate in collective investment schemes. In this case, ownership and control are perfectly separated, because investors pay somebody for investing their funds and for controlling the company in which they have invested.

One of the two most usual examples is private equity. Private-equity firms purchase other firms or take big stakes in them in order to reshape their businesses and to sell these holdings for a profit.

Private equity comes in two main forms: venture capital, which aims at helping young firms grow; and buy-out capital, which is used to improve established firms. Most private-equity firms raise funds as limited partnerships. The private-equity firm is the general partner that manages the fund and gets paid an annual fee (a percentage of the money in, or promised to, a fund) and later a large slice of any profits; outside investors (who often lock up their money for up to ten years) become limited partners who share only in the profits.[372] Private equity is largely unregulated. Hedge funds are a related industry.[373]

The other usual example is UCITS, i.e. undertakings for collective investment in transferable securities such as unit trusts and common funds.

Depending on the jurisdiction, UCITS can be constituted: under the law of contract (as common funds); under trust law (as trusts); or in corporate form (as investment companies). In Europe, the UCITS Directive[374] seeks to harmonise Member States' legislation on cer-

[372] See Survey. Private equity, The Economist, November 2004.

[373] Hedge funds use a broad array of techniques and instruments (such as short-selling or leverage) often not available to more traditional forms of collective investment schemes.

[374] Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (as amended).

tain categories of UCITS. The Directive applies to non-corporate forms of UCITS and UCITS in corporate form, provided that: they have as their sole object the collective investment of capital raised from the public in transferable securities and/or other liquid assets; they operate on the principle of risk-spreading; and the units are re-purchased or redeemed out of those undertakings' assets. The UCITS Directive requires both a fund manager and a depositary. The UCITS fund manager may be either a "management company" or a "self-managed investment company". As some Member States' legal frameworks are limited to common funds, their UCITS are without legal personality and depend on a designated external fund manager (a management company). Unlike common funds or unit trusts, corporate UCITS may bring together the fund and a fund management capacity into the same entity (a self-managed investment company).[375] Whereas private-equity firms are typically active owners in portfolio companies, UCITS management firms are passive owners in portfolio companies.

Contracts. The legal framework can also be based on contracts. Shareholders can regulate the governance of the company in shareholders' agreements. These contracts are generally used to govern the mutual relationship of shareholders, if ownership of shares in the company is not a mere financial investment. They are usual, for example, in family companies, joint-ventures, and venture capital.

Different classes of shares. Sometimes the company has different classes of shares. Different classes of shares can be used to cement control (see section 9.4.2 and Volume III), but they can also help to offset the lack of control. For example, different classes of shares can be used in venture capital in order reduce venture capital firms' risk and to make exit easier for them (see Volume III). One of the differences between shareholders' contracts and different classes of shares relates to enforceability. Whereas shareholders' contracts are binding on their parties but not necessarily on the company, rights attaching to different classes of shares are binding on the company that has issued these shares.

9.5.4 Equivalent Treatment

The equivalent treatment of holders of securities of the same class belongs to the general principles of European company and securities markets laws. It protects all shareholders but is particularly useful as a constraint on the private pecuniary benefits of controlling shareholders.

The principle of equivalent treatment belongs to the common foundations of the Member States' company laws.[376] EU company law has adopted a piece-meal approach to equivalent treatment.

In EU company law, the principle of equivalent treatment of shareholders is based on four directives. The Second Company Law Directive and the Transpar-

[375] Directive 2001/107/EC.

[376] See Goergen M, Martynova M, Renneboog L, Corporate Governance Convergence: Evidence from takeover regulation. ECGI - Law Working Paper 33/2005 (April 2005).

ency Directive generally require equal treatment.[377] According to the Directive on takeover bids, Member States must adopt the principle that "all holders of the securities of an offeree company of the same class must be afforded equivalent treatment" and that "other holders of securities must be protected" if a person acquires control of a company.[378] Directive 2007/36/EC applies to participation and the exercise of voting rights in the general meeting.[379]

The Second Directive ensures that the principle of equivalent treatment of shareholders covers at least capital transactions such as share buybacks[380] and the withdrawal or redemption of shares.[381] A further example of the equivalent treatment of shareholders is that a public limited-liability company "may not advance funds, nor make loans, nor provide security, with a view to the acquisition of its shares by a third party".[382]

9.5.5 Block-holding as a Corporate Governance Tool

Block-holding belongs to the most important corporate governance tools for minority shareholders. Apart from the right to buy shares, shareholders' exit rights, and the duty of the company to disclose information to the public, the active use of corporate governance tools typically requires a minimum block of votes or a minimum block of shares.

The size of the minimum block ranges from one share to all shares, depending on the right in question, the governing law, and the articles of association. A minority shareholder's rights to information, veto rights, enforcement rights, and other rights can thus depend on the size of the block that the minority shareholder holds alone or jointly with other shareholders.

Interests of the firm. Minority shareholder activism is neither good nor bad as such from the perspective of the firm. It depends on the objectives of minority shareholders.

The long-term survival of the firm can be supported by activist shareholders who have a very long investment perspective and whose interests thus are aligned with those of the firm.

In contrast, short-term financial shareholders can have an incentive to maximise their own short-term benefit at the expense of long-term shareholders and the firm.

For example, the shares of Deutsche Börse, the German company that operates the Frankfurt stock exchange, used to be owned by traditional German long-term institutions. However, Deutsche Börse went public in 2001. As a result, the shareholder base of the company

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[377] Article 42 of Directive 77/91/EEC (Second Company Law Directive). See also recitals 2 and 5. Article 17(1) of Directive 2004/109/EC (Transparency Directive). See also recitals 22, 23 and 25.

[378] Article 3(1)(a) of Directive 2004/25/EC (Directive on takeover bids).

[379] Article 4 of Directive 2007/36/EC.

[380] Article 19 of Directive 77/91/EEC (Second Company Law Directive).

[381] Articles 36–39 of Directive 77/91/EEC (Second Company Law Directive).

[382] Article 23(1) of Directive 77/91/EEC (Second Company Law Directive).

shifted from 68% German in 2001 to more than 90% foreign by 2005. In 2005, the two boards of Deutsche Börse decided to acquire London's rival exchange (LSE). The planned merger was nevertheless stopped by short-term rebel investors. The rebel investors were led by TCI, a well-known hedge fund.[383]

Private benefits. Usually, block-holding is not expected to bring private pecuniary benefits to non-controlling minority shareholders. Whereas an activist shareholder must bear at least some direct costs of monitoring and the use of voting rights, most benefits of monitoring and the use of voting rights will be shared by other shareholders. Either a large block held by the minority shareholder or large benefits shared by all shareholders are necessary to induce the minority shareholder to play an active role.[384]

In the EU, mandatory provisions of company and securities market law prohibit some of the typical sources of minority shareholders' private pecuniary benefits. For example, the principle of equal treatment of shareholders applies generally in public limited-liability companies whether they are privately-owned (and covered by the Second Company Law Directive) or listed. This principle applies to all transactions[385] including share buybacks, the redemption of shares, and the withdrawal of shares. For example, EU company law prevents the corporate acquisition strategy of greenmailing in public companies (see Volume III).

However, block-holding can bring private pecuniary benefits to minority shareholders under some circumstances.

First, block-holding can naturally bring pecuniary benefits shared by other shareholders.

Second, there can be a connection between the minority block-holding and the provision of ancillary services. For example, minority block-holding can bring some private pecuniary or non-pecuniary benefits in the form of business opportunities or board memberships.

From the perspective of the shareholder, minority block-holding can be driven by the ancillary services. Minority block-holding can signal long-term commitment to a business relationship and at the same time a lower level of counterparty risk and commercial risk.

From the perspective of the firm, it can be good business policy to cooperate with a minority shareholder because of such commercial reasons and the shareholder's legal and de facto powers.

A minority shareholder typically has no automatic right to send its own representatives to the board or claim a business relationship under company law or the company's articles of association.

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[383] A very unGerman coup, The Economist, May 2005; Seifert gets the blues, The Economist, May 2005; Battle of the bourses, The Economist, May 2006.

[384] For controlling shareholders see Gilson RJ, Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy, Harv L R 119 (2006) pp 1651–1652.

[385] Article 42 of Directive 77/91/EEC (Second Company Law Directive): "For the purposes of the implementation of this Directive, the laws of the Member States shall ensure equal treatment to all shareholders who are in the same position."

Third, depending on the jurisdiction, minority block-holding can also bring private pecuniary benefits to the block-holder in his capacity as shareholder when the other shareholders vote for the transaction benefiting the minority block-holder.

Fourth, there is a risk that minority block-holding will be abused.

For example, some decisions require the consent of all shareholders or all holders of shares belonging to a certain class, or 100% of votes cast by those shareholders. Any shareholder with a right to vote can block a decision that requires his personal consent.

Furthermore, corporate decision-making is to some extent constrained by mandatory provisions of company law. The existence of statutory constraints will often give somebody an opportunity to sue the company for breach of law. Some shareholders may have an incentive to abuse the right to sue if given the opportunity.

In Germany, minority shareholders in many cases have asked the company to reward them for not suing the company or for voting in a certain way.[386] When doing so, they often commit the crime of blackmail (Erpressung, Nötigung).[387] This problem was addressed by the UMAG which introduced a filtering mechanism. A court will filter shareholders' claims and authorise the proceedings (Klagezulassungsverfahren).[388]

Effectiveness. The effectiveness of minority block-holding as a corporate governance tool depends on the governing law, the articles of association, and the market for control.

Obviously, minority block-holding can be an effective corporate governance tool if the governing law or the articles of association vest useful rights in the block-holder.

The main rule is that minority block-holding will not work as an effective corporate governance tool, unless the shareholders generally enjoy relatively large powers under company law or the company's articles of association. For example, where a decision requires a large majority of votes, the holder of a block that confers the missing votes has a veto right. Where the decision requires a simple majority of shares or votes, the position of minority block-holders is weaker. Decisions that typically require a large majority of shares or votes include at least the amendment of the company's statutes (articles of association). Decisions that change an individual shareholder's rights typically require the personal consent of that individual shareholder.

Minority block-holding is a weak corporate governance tool where the powers of shareholders are generally weak or where the powers of controlling shareholders are not subject to effective constraints. For example, minority shareholders will not benefit from their voting rights where the matter belongs to the exclusive competence of the board.

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[386] See, for example, In der Hand der Piraten, Der Spiegel 29/2006 pp 75–77; Baums T, Die Anfechtung von Hauptversammlungsbeschlüssen, Universität Osnabrück, Institut für Handels- und Wirtschaftsrecht, Arbeitspapier 85 (2000).

[387] §§ 253(1) and § 240(1) StGB.

[388] According to the new § 148 AktG (UMAG).

Minority block-holding can be a stronger corporate governance tool regardless of the formal rights if there is a market for control of the firm and the sale of the block would enable the buyer to obtain control. In addition, the existence of minority shares can effectively prevent a controlling shareholder from obtaining unlimited control and force either the controlling shareholder or the company to purchase the minority shares in one way or another (purchase, share buyback, redemption).

This can be illustrated by the regulation of large listed companies in England and Germany.[389]

In England, a minority block confers few formal management and monitoring powers on its holder. However, more dispersed ownership and the market for control can make minority block-holding meaningful as a corporate governance tool.

In Germany, more concentrated ownership and the fact that companies typically have a controlling shareholder mean that the market for control is no reason to use block-holding as a corporate governance tool. On the other hand, holders of relatively small blocks of shares and to some extent even individual shareholders can have important monitoring powers enforced by the courts. Minority block-holding can therefore be a meaningful corporate governance tool because of shareholders' rights and the high level of shareholder protection under German company law.

Minority shareholders' rights. Shareholders' rights have been discussed in company law text books and comparative company law studies. It is sufficient to highlight some rights that are particularly relevant in the context of corporate governance. They include information rights, veto rights, initiation rights, appointment rights, and enforcement rights.

Information rights. There are various kinds of information rights and duties (section 10.6).

Information rights based on the company's or its representatives' duty to make general disclosures do not depend on the size of the block. Rules on the mandatory disclosure of information by companies have been harmonised to some extent by provisions of EU company law, securities markets law, and accounting directives (section 10.7 and Volume III).

Some information rights can depend on the size of the block and the governing law. For example, the right of minority shareholders to demand selective disclosure has not been harmonised.

For legal policy reasons, minority shareholders cannot have an unlimited right to demand selective disclosure or the disclosure of general information, because: shareholders usually owe no fiduciary duties to the company under company law and are thus free to use information disclosed to them; the principle of equal treatment can prevent some forms of selective disclosure; and rules on inside information restrict the disclosure of information in listed companies (under the Directive on market abuse).

[389] For a comparison, see Mäntysaari P, Comparative Corporate Governance. Shareholders as a Rule-maker. Springer, Berlin Heidelberg (2005), Chapter 6.

There can be differences between the Member States. For example, shareholders of German companies owe a duty of loyalty to the company and the other shareholders under the principle of "Treu und Glauben" (good faith) which is one of the key principles of German private law (§ 242 BGB). For this reason, shareholders of German companies can have slightly wider rights to demand the provision of information than shareholders in jurisdictions where no such duty of loyalty exists.

Decision rights: veto rights. In the EU, the most important formal powers of shareholders relate to share capital and structural change. The Second Company Law Directive is the basis of the European legal capital regime which protects the firm, shareholders, minority shareholders, and creditors. The Second Directive is complemented by the Third Directive, which provides that a merger requires the approval of the general meeting of each of the merging companies,[390] and the Sixth Directive, which contains a similar provision on the division of companies.[391]

Apart from the formal powers relating to share capital and structural change, shareholders have very limited formal powers to interfere with management.

What is important to minority block-holders is that shareholders generally decide on the amendment of the company's statutes (articles of association).[392]

In a German AG, the amendment of articles of association requires a majority of three-fourths (75%) of the registered capital of the company represented at the general meeting in addition to a majority of votes cast. In an English plc, the amendment of articles requires a majority of not less then three-fourths (75%) of such members as (being entitled to do so) vote. Less than 25% can therefore block the decision depending on how many shareholders attend the general meeting and actually vote.

Depending on the governing law, minority shareholders can even block transactions by challenging resolutions in the court or by injunction proceedings. This will typically require extensive statutory regulation of corporate actions and a high level of minority shareholder protection.

For example, it is probably easier for a minority shareholder to challenge the decisions of the general meeting in a German company than in an English company, because the governance of German companies is based to a larger extent on mandatory law (for enforcement rights, see below).

A shareholder holding 25% and one share can also block the application of the breakthrough rule under the Directive on takeover bids after a successful takeover bid.[393] However, few Member States have adopted the breakthrough rule.

Decision rights: initiation rights. Controlling shareholders exercise control through the board and can therefore ask the board to call a general meeting and

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[390] Article 7 of Directive 78/855/EEC (Third Company Law Directive).

[391] Articles 5 and 6 of Directive 82/891/EEC (Sixth Company Law Directive).

[392] See, for example, Articles 2 and 3 of Directive 77/91/EEC (Second Company Law Directive).

[393] Article 11(4) of Directive 2004/25/EC (Directive on takeover bids).

put things on the agenda. Minority block-holders do not enjoy similar de facto rights. Shareholders' formal rights to call a general meeting and put things on the agenda depend on the governing law. For example, shareholders of a German AG enjoy slightly larger rights than shareholders of an English plc in this respect.

Decision rights: appointment rights. One can distinguish between appointment rights (veto rights) and the right to nominate candidates (initiation rights).

Minority shareholders usually do not have any particular rights to appoint board members representing minority interests, and shareholders usually do not appoint the managers who actually run the company.

The right to nominate candidates to the (supervisory) board depends on the governing law.

In a German AG, the general meeting appoints supervisory board members who represent shareholders. The main rule is that candidates to the supervisory board are nominated by the supervisory board. On the other hand, any shareholder may nominate competing candidates, because it is easy for shareholders to put things on the agenda under German law.

In an English company, the power to appoint board members depends on the articles of association. Board members can be appointed by the board or the general meeting.[394] The board can usually fill casual vacancies. The Combined Code recommends that "[a]ll directors should be subject to election by shareholders at the first annual general meeting after their appointment, and to re-election thereafter at intervals of no more than three years". The right of shareholders to nominate candidates to the board is usually subject to restrictions.

It is interesting to note that the US Securities and Exchange Commission has proposed new rules that would require companies to include in their proxy materials security holder nominees for election as director.[395] These rather modest proposals have been criticised by the Business Roundtable. According to this lobbying group, such a change would substantially disrupt corporate affairs.[396] Critics of the proposed rules argue that shareholder access may lead to special interest directors, "balkanisation of the board", and adversarial relationships within the boardroom. However, Germany has had a very liberal system of shareholder proposals and nominations without any major problems.

Decision rights: the appointment and remuneration of auditors. The Directive on statutory audits provides that statutory auditors must be appointed by shareholders in general meeting.[397] Companies whose shares have been admitted to trading on a regulated market must have an audit committee, composed of "non-executive members of the administrative body" or "members of the supervisory body" with at least one "independent member with competence in accounting and/or auditing".[398] The proposal for the appointment of a statutory auditor or audit firm must be based on a selection made by the audit committee.[399]

[394] Article 17(1) of the Companies (Model Articles) Regulations 2008.

[395] Proposed Rule: Security Holder Director Nominations, SEC Release No. 34–48626.

[396] Detailed Comments of Business Roundtable on The "Proposed Election Contest Rules" of the US Securities and Exchange Commission.

[397] Article 35 of Directive 2006/43/EC (Directive on statutory audits)

[398] Article 39(1) of Directive 2006/43/EC (Directive on statutory audits)

[399] Article 43 of Directive 2006/43/EC (Directive on statutory audits)

Enforcement rights. Minority shareholders usually have few legal powers to enforce sanctions against defaulting board members or managers. In practice, managers and board members are hardly ever made personally liable for losses suffered by shareholders.[400]

Table 9.3 The Enforcement Taxonomy[401]

	Public	Private
Formal	Criminal penalties. Administrative sanctions.	Shareholder litigation. Derivative suits. Own interest suits (class actions)
Informal	Statement of public censure (for example, by the Take-over Panel).	Shareholder activism.

Minority shareholders enforcement rights nevertheless depend on the governing law. For example, shareholders of a German AG probably have slightly more efficient statutory remedies against breaches of law and breaches of articles of association compared with shareholders of an English public limited-liability company, although it is usually believed that the degree of shareholder protection is lower in Germany.[402]

It is difficult for shareholders to bring proceedings against defaulting managers under English company law. This is largely due to the doctrine that directors' duties are "owed" to the company and not to shareholders. The lack of duties "owed" to shareholders is coupled with the fact that many common law duties are indeterminate.[403]

Under German law, the mainly statutory duties of board members are more determinate. In the past, the main rule was that any shareholder could challenge decisions for alleged breach of law or statutes. In practice, this could prevent many capital transactions.

[400] Black BS, Cheffins BR, Klausner M, Outside directors and lawsuits: What are the real risks? McKinsey Quarterly (2004) Issue 4 pp 70–77. For the importance of the enforcement of rights, see also La Porta R, López-de-Silanes F, Shleifer A, Vishny RW, Investor Protection and Corporate Governance, J Fin Econ 58 (2000) pp 3–27.

[401] See Armour J, Enforcement Strategies in UK Corporate Governance: A Roadmap and Empirical Assessment (April 2008). ECGI - Law Working Paper 106/2008. Available at SSRN.

[402] Theissen E, Organized Equity markets. In: Krahnen JP, Schmidt RH (eds) The German Financial System (2004) p 142; La Porta R, López-de-Silanes F, Shleifer A, Vishny RW, Law and Finance, J Pol Econ 106 (1998) pp 1129, 1132 and 1139. See also van Aaken A, Shareholder Suits as a Technique of Internalization and Control of Management. A Functional and Comparative Analysis, RabelsZ 68 (2004) p 305.

[403] In the USA, indeterminate corporate law is coupled with better rights to sue. Compare Kamar E, Shareholder Litigation Under Indeterminate Corporate Law, U Chic L R 66 (1999) p 894.

The UMAG[404] which entered into force on 1 November 2005 made it easier for minority shareholders of a German AG to sue by making the company bear the costs of the proceedings.[405]

However, it became more difficult for shareholders to block important capital transactions.[406] A court will filter the claims by authorising the proceedings (Klagezulassungsverfahren).[407] There is also a special procedure for letting the company proceed with important capital transactions when the transaction is challenged in the courts (Freigabeverfahren).[408]

There is thus a fundamental difference between English law and German law in this respect. In Germany, even individual shareholders have a right to contest resolutions of the general meeting.[409] Since the resolutions are normally based on proposals submitted by one of the two statutory boards or both of them, a shareholder may at the same time indirectly contest acts done by the two statutory boards..[410]

Legal costs, class actions. The loser pays principle is the main rule in the Member States of the EU. The loser pays principle combined with the usual lack of indemnification in respect of legal costs is likely to deter minor shareholders from pursuing remedies.[411] Class actions do not belong to the legal tradition of the Member States of the EU.[412]

In Germany, the UMAG was intended to help cure the problem of legal costs. According to the UMAG, the company will bear the costs of proceedings authorised by the court. The Equity Investor Test Case Act (Kapitalanleger-Musterverfahrensgesetz, KapMuG) made it possible to bundle the claims of many investors.[413]

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[404] Das Gesetz zur Unternehmensintegrität und Modernisierung des Anfechtungsrechts.

[405] § 148(6) AktG.

[406] See, for example, Traichel C, Das Freigabeverfahren kann Unternehmen retten. Mißbrauchsmöglichkeiten durch Anfechtungskläger wurden verringert, FAZ, 16 August 2006 p 21.

[407] § 148 AktG. See in particular § 148(1) AktG: "Aktionäre, deren Anteile im Zeitpunkt der Antragstellung zusammen den einhundertsten Teil des Grundkapitals oder einen anteiligen Betrag von 100.000 Euro erreichen, können die Zulassung beantragen, im eigenen Namen die in § 147 Abs. 1 Satz 1 bezeichneten Ersatzansprüche der Gesellschaft geltend zu machen ..."

[408] § 246a AktG. See in particular § 246a AktG: " Wird gegen einen Hauptversammlungsbeschluss über eine Maßnahme der Kapitalbeschaffung, der Kapitalherabsetzung (§§ 182 bis 240) oder einen Unternehmensvertrag (§§ 291 bis 307) Klage erhoben, so kann das Prozessgericht auf Antrag der Gesellschaft durch Beschluss feststellen, dass die Erhebung der Klage der Eintragung nicht entgegensteht und Mängel des Hauptversammlungsbeschlusses die Wirkung der Eintragung unberührt lassen."

[409] See §§ 245 and 249 AktG.

[410] See also Ulmer P, Die Aktionärsklage als Instrument zur Kontrolle des Vorstands- und Aufsichtsratshandelns, ZHR 163 (1999) pp 323–326.

[411] Compare Ulmer P, ibid p 307 on US law. See also Easterbrook FH, Fischel DR, The Economic Structure of Corporate Law (1991) p 101: "… the method of compensating attorneys and assessing costs will have a large influence on the costs and benefits of derivative litigation."

[412] For a planned legislative reform in competition law cases, see White Paper on Damages Actions for Breach of the EC antitrust rules, COM(2008) 165, 2.4.2008.

[413] For a test case against Daimler AG, see Musterklage gegen Daimler kann beginnen, FAZ, 14 July 2006 p 21; BGH, judgment of 25 February 2008 – II ZB 9/07.

9.5.6 Different Classes of Shares

The principle of equivalent treatment does not prevent the use of different classes of shares. Depending on the circumstances, the firm, controlling shareholders, and minority shareholders may all benefit from the use of different classes of shares. Because of shared benefits, the issuing of different classes of shares can sometimes be based on contract.

Interests of the firm. The existence of different classes of shares can help the firm to reduce its funding costs. It can enable a more efficient use of subordination, the equity technique, and the mezzanine technique (see Volume III). Furthermore, the pre-emptive rights of shareholders to new shares can to some extent be circumvented in this way.[414]

The existence of shares with different voting rights enables the firm to manage its key agency relationships better. If the firm's control structure (with shareholders as providers of ancillary services, see section 9.2) can be separated from its funding structure (with shareholders as a source of equity capital, see Volume III), increased flexibility can help the firm to manage both in a more optimal way.

Benefits to the controlling shareholder. Typically, the controlling shareholder can use multiple voting rights to cement control (section 9.4.2).

Benefits to minority shareholders. However, the existence of different classes of shares can bring benefits even to minority shareholders.

First, the class of shares owned by minority shareholders can give them special rights. For example, a company which needs to raise new share capital may decide to offer shares with preferential dividend rights so as to encourage investment.

Second, the existence of different classes of shares can make it easier for minority shareholders to block certain transactions. Many capital transactions which require a decision by the general meeting are subject to a separate vote for each class of shareholder whose rights are affected by the transaction.

For example, the Second Company Law Directive provides that such a separate vote is required for: increases in the legal capital of the company;[415] reductions in the subscribed capital;[416] and redemptions of the subscribed capital or its reduction by the withdrawal of shares.[417]

Classes. In addition to ordinary shares, the most usual categories of shares include: shares with different voting rights; preference shares; redeemable shares; and convertible shares.

Depending on the jurisdiction and the company form, shares may differ as to the following rights: entitlement to a dividend, entitlement to a dividend in priority to holders of other share classes; voting rights; right to payment of capital on a reduction of capital; entitlement to priority in repayment of capital in a winding up; rights to payment of dividends missed whilst the company was a going concern;

[414] Articles 29(1) and 29(2) of Directive 77/91/EEC (Second Company Law Directive).

[415] Article 25(3) of Directive 77/91/EEC (Second Company Law Directive).

[416] Article 31 of Directive 77/91/EEC (Second Company Law Directive).

[417] Article 38 of Directive 77/91/EEC (Second Company Law Directive).

and rights to participate in a distribution of surplus assets after repayment of capital.

Ordinary shares. Ordinary shares are by far the most common type of share. Most companies have only one class of shares, and if they do, these shares are ordinary shares.

The rights attaching to ordinary shares can vary depending on the jurisdiction, the articles of association of the company, and other internal decisions of the company. However, if the company has issued two or more classes of shares, ordinary shares are typically closest to shares that would confer only statutory default rights on their holder.

For example, depending on the jurisdiction and the company, even ordinary shares may sometimes confer dividend rights which are different from the statutory default rights to dividend payments, and the company may also have a right or obligation to redeem them or buy them back from the shareholders.

Rights attached to ordinary shares are also subject to rules that apply to the company's shares generally, for example voting restrictions.

Shares with different voting rights. Shares with different voting rights can be used to increase the number of voting rights.As a rule, it is possible for companies to issue different classes of shares with different voting rights in the Member States (see section 9.4.2; for takeover defences, see Volume III).

For example, one class of shares held by a small select group of investors can be given ten votes per share while a second class that will be issued to the large majority of investors can be given one vote per share.

"One share, one vote" and "shareholder democracy". There is no "one share, one vote" rule in Community law.

In the Company Law Action Plan, the Commission considered that there was "a strong medium to long-term case for aiming to establish a real shareholder democracy in the EU" and that a study "evidenced that corporate governance codes tend to support the one share / one vote principle".

However, the "one share, one vote" rule is unlikely to be adopted, because it would not be necessary.[418] The absence of such a rule means that investors can benefit from a wider range of financial products. Investors are sufficiently protected by transparency and disclosure. They are free to pick the companies and securities they want and are not forced to buy bad shares. Firms can benefit from increased flexibility, and firms with a bad share ownership structure will be punished by the market.

"A real shareholder democracy" is a concept that lacks substance. Unlike cooperatives and non-profit associations with each member having exactly one vote (see Volume III), a limited-liability company is not designed to be "democratic" in its internal decision-making.

[418] Article 5 of the EC Treaty limits the competence of the Community.

The "one share, one vote" rule does not really exist in Europe, although there are some differences between the laws of Member States.

In some countries, company laws do not regulate the issue of differentiated voting shares at all. For example, there is no legal prohibition to issue multiple voting shares in England, but the London Stock Exchange has in practice discouraged such issues.[419]

The "one share, one vote" rule does not apply in most countries, because non-voting shares are usually allowed. Typically, they are allowed in the form of preference shares. The law generally restricts the issuing of non-voting shares to a maximum percentage of the equity (varying between 25% and 100%, with 50% in the majority of countries).[420]

The Nordic countries make large use of multiple voting rights. Interestingly, Nordic company laws have developed in opposite directions recently. In 2004, Sweden introduced a maximum ratio of 10:1 for the votes that can be attributed to multiple voting shares.[421] In 2006, Finland abolished the previous maximum ratio of 20:1 as unnecessary, because the company can issue shares with no voting rights (0:1 = 0:20 = 0:100 = 0).

Shares with multiple voting rights are prohibited in Germany and Italy as far as public companies are concerned, but this does not mean that all shares confer one vote. This can be illustrated by German law: (a) As regards public limited-liability companies (AG), the main rule is that each share carries one vote.[422] Multiple voting rights are not permitted. There may nevertheless be different classes of shares. An AG can issue both common shares (Stammaktien) and preferred shares (Vorzugsaktien). These shares can be issued either as bearer shares (Inhaberaktien) or registered shares (Namensaktien). Preferred shares may be non-voting. Only half of the registered share capital may be composed of preferred shares without voting rights.[423] (b) As regards private limited-liability companies (GmbH), the main rule is that each €50 of legal capital confers one vote.[424] Company law nevertheless provides for flexibility, and the parties may derogate from this rule in the articles of association.

The "one share, one vote" applies in the sense that even non-voting shares can usually vote on proposals on the changing of rights attached to those shares.

The existence of classes of shares with different voting rights seems to be compatible with the case-law of the ECJ. The ECJ has banned "golden shares",[425] but has not held that differences in rights conferred by shares would always restrict fundamental freedoms. For example, the ECJ has said that restrictions which arise as the result of the normal operation of company law do not constitute a restriction on the movement of capital.[426]

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[419] Goergen M, Martynova M, Renneboog L, Corporate Governance Convergence: Evidence from takeover regulation. ECGI - Law Working Paper 33/2005 (April 2005).

[420] *Ibid*. See also Ferrarini G, One Share - One Vote: A European Rule? ECGI - Law Working Paper 58/2006 (January 2006).

[421] Now: Aktiebolagslag (2005:551), 4 kap 5 §.

[422] § 12 AktG.

[423] § 139(2) AktG.

[424] § 47 GmbHG.

[425] Case C-483/99 Commission v France [2002] ECR I-4781, paragraph 37; and Case C-503/99 Commission v Belgium [2002] ECR I-4809, paragraph 38.

[426] See Case C-98/01 Commission v United Kingdom [2003] ECR I-4641.

In principle, the judgment of the ECJ in *Commission v Netherlands* could be used to support the view that the existence of classes of shares with different voting rights can amount to a restriction on the free movement of capital if it makes portfolio investments in the company's shares less attractive (see Volume III).[427]

In practice, however, the existence of shares with different voting rights and a larger variation of control structures enables each investor to pick securities according to its own particular preferences. Firms benefit from increased flexibility as it helps them to manage their control structure better and to reduce overall funding costs.

Many believe that the existence of multiple voting rights hampers European takeovers. But although multiple voting rights belong to traditional structural takeover defences in Europe, this is not enough to make multiple voting rights incompatible with the EC Treaty or to make common rules on "one share, one vote" necessary.

This is not really a problem for minority shareholders in listed companies. In listed companies, small investors are, as a rule, financial or retail investors who are basically interested in the value of their portfolios rather than the long-term development of any individual company's business. Small investors are interested in price changes rather than the level of the valuation of an individual company's shares as such. They are adequately protected by the freedom to pick the investments they like, the diversification of investments, issuers' disclosure obligations, the principle of equal treatment, and the right to sell their shares.

Furthermore, multiple voting rights have already been addressed by the breakthrough rule set out in the Directive on takeover bids. The Takeover Directive provides that multiple-vote securities carry only one vote and all restrictions on voting rights are overridden at the general meeting which decides on defensive measures during the bid. The same rule applies at the first general meeting following the bid, if the bidder has acquired 75% or more of capital carrying voting rights.[428] The High Level Group of Company Law Experts said in its report that the restrictions that should be overridden cover voting caps, multiple voting rights or double voting rights, provisions completely denying voting rights, and provisions conferring inappropriate voting rights to non-risk-bearing capital.[429]

The existence of multiple voting rights could be a problem if increased takeover activity were assumed to bring industrial policy benefits. Mergers and acquisitions could be necessary, for example, in branches with a rapid growth of the minimum efficient scale of production.[430] However, concentrations and the growth of firm size can decrease the level of competition.[431]

Preference shares. Depending on the governing law and the company, the company may issue preference shares. Preference shares can entitle their holder to preferential treatment as regards various types of distributions made to shareholders. For example, these shares can: rank ahead of ordinary shares in the event of

[427] Joined Cases C-282/04 and C-283/04 Commission v Netherlands [2006] ECR I-9141 paragraph 27.

[428] Article 11 of Directive 2004/25/EC (Directive on takeover bids).

[429] Report of the High Level Group of Company Law Experts on takeover bids.

[430] See Articles 2 and 3(1) of the EC Treaty.

[431] See Articles 3(1), 4(1) , and 81–82 of the EC Treaty.

liquidation of the company; or entitle their holder to a fixed dividend ahead of the company's ordinary shares (preferred dividends). They can also confer other rights on their holder.

Venture capital investment is often made by means of preference shares. (a) This enables the venture capital firm to ensure: that the company's assets will not be distributed to the original owners before the venture capital firm has got its agreed share; and that assets will not be paid back to other shareholders on the winding-up of the company before the venture capital firm has received its agreed share. (b) In addition, preference shares can be a means of ensuring that the venture capital firm can exercise important powers in the company even if it is not the holder of a share majority. For example, preference shares may give a right to appoint certain board members or to veto certain transactions. (c) A further reason to apply preference shares in venture capital investments is that they make it easier to raise capital from new groups of investors. New investment can be raised by adding new classes of preference shares.

Redeemable shares. Depending on the governing law and the company, shares may also be issued as redeemable at the option of the company or the shareholder or on a certain date. The redemption of the shares involves a repayment by the company to the shareholder of the capital subscribed for the shares, in return for which the shares are cancelled.

Whereas share buybacks are generally constrained by the principle of equal treatment of all holders of shares who are in the same position,[432] the use of redeemable shares can provide an alternative means to exit the company (as the holders of redeemable shares and other shareholders are not in the same position). This can make redeemable shares attractive, for example, in venture capital.

There can be many different kinds of redeemable shares. For example, redeemable shares can be zero-dividend preference shares with a fixed redemption date.

The Second Directive contains rules on the redemption or withdrawal of shares.[433] These rules will be discussed in Volume III. It suffices to point out that Article 39 lays down many of the basic rules on redeemable shares.

Convertible shares. Convertible shares are shares that can be converted into a different class of shares upon the occurrence of a certain event. Convertible shares are basically shares of one class combined with an option right.

For example, convertible shares can be used by a venture capital firm to give owner-managers an incentive to meet the agreed performance targets. They can also be a means to transfer power from owner-managers to the venture capital firm in the event that owner-managers fail to meet the targets. Convertible bonds can be used in the same way.

Where the company has issued two classes of shares, one traded on a stock exchange and the other untraded, the venture capital firm can prefer the untraded shares also to be convertible because this can help the venture capital firm to exit the company.

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[432] Article 42 of Directive 77/91/EEC (Second Company Law Directive) and Article 13(1) of Directive 2004/109/EC (Transparency Directive).

[433] Articles 35–40 of Directive 77/91/EEC (Second Company Law Directive).

9.5.7 Voting Caps

The effect of voting caps is to prevent any shareholder from obtaining control. If permitted under the national laws of Member States, voting caps can be designed to ensure a balanced share ownership structure or to function as a takeover defence in companies with dispersed ownership (see Volume III).

There are differences between the laws of Member States. For example, under German company law, voting restrictions including voting caps may only be adopted by privately-owned companies.[434]

Under Austrian law, the "one share, one vote" rule applies to all voting shares, but non-voting shares and voting caps are allowed (if provided in the articles). Other countries permitting voting caps include France, the Netherlands, Spain, the Nordic countries, and Switzerland.[435]

Voting caps are covered by the breakthrough rule under the Directive on takeover bids. They will thus not be applicable when the general meeting of shareholders decides on takeover defences during the bid, or at the first general meeting following the bid if the offeror holds 75% or more of the capital carrying voting rights.[436]

9.5.8 Exit Rights

Exit rights are the most important corporate governance tool for minority shareholders. They are particularly important in companies with a dispersed share ownership structure.

The exit of many shareholders can: signal the poor quality of the company's securities; reduce share price; reduce the availability of funding and increase its cost; and make the firm a more likely takeover target. Restrictions on exit can contribute to a lower share price (although there are exceptions, see Volume III for lock-ups).

There are three main forms of exit rights: the right to sell shares to any third party; the right to transfer shares to the company (the right to demand certain forms of distributions that involve the transfer of shares to the company); and the right to sell shares only to a certain party. In addition, there may be particular forms of exit (see Volume III). Exit rights are complemented by the principle of equivalent treatment of shareholders.

Right to sell. The sale of shares is the most common way to exit the company. The sale of shares in a limited-liability company is usually relatively easy, because

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[434] § 134(1) AktG and the KonTraG.

[435] See, for example, Weil Gotshal & Manges LLP, Comparative Study of Corporate Governance Codes Relevant to the European Union (January 2002); Faccio M, Lang L, The Ultimate Ownership of Western European Corporations, J Fin Econ 65 (2002) pp 365–395 at footnote 11.

[436] Article 11 of Directive 2004/25/EC (Directive on takeover bids).

the transferability of shares belongs to the core characteristics of this business form.[437]

In addition, the MiFID provides that regulated markets must have rules regarding the admission of financial instruments to trading. These rules must ensure that any financial instruments admitted to trading in a regulated market are freely negotiable.[438]

Constraints on the sale of shares. There can nevertheless be several legal constraints on the sale of shares even in companies with freely transferable shares.

Provisions of company law usually do not prevent the *sale* of shares as such. They may nevertheless provide constraints on the *purchase* of shares, which may influence the sale of shares indirectly.

Alternatively, the constraints can be based on contract, the company's articles of association, or the company's share ownership structure (for structural takeover defences and restrictions on the transferability of shares, see Volume III).

Other legal constraints can be found in various areas of law, for example in tax law or insider trading laws (for the market abuse regime, see Volume III).

Contract-based constraints. Contract-based constraints on the sale of shares are commonplace.

For example, shareholders' agreements often contain clauses on the terms of exit. Such terms are usual in privately-owned companies. In family companies, agreements on the terms of exit are important because of the need to ensure family control as the number of family shareholders increases over time.

Even other agreements can directly or indirectly prevent a shareholder from selling his shares. For example, important agreements such as major loan agreements often contain change of control clauses (see Volume II).

Share ownership structure. The sale of shares can also be constrained by the share ownership structure and the existence of control-enhancing mechanisms (see section 9.4.2).

For example, it is usual that family shareholders own shares in a wholly-owned holding company which owns a block of shares in a company controlled by the family. Combined with constraints on the sale or purchase of shares in the holding company, this will ensure that family control will not be affected although individual family shareholders sell their shares in the holding company.

The Directive on takeover bids makes such constraints more transparent in listed companies.[439]

Constraints on the purchase of shares. Like constraints on the sale of shares, constraints on the purchase of shares can be found in different areas of law.

However, it is legally easier to restrict the purchase of shares in private limited-liability companies than in public limited-liability companies. The purchase of

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[437] Kraakman R, Davies PL, Hansmann H, Hertig G, Hopt KJ, Kanda H, Rock EB (eds), The Anatomy of Corporate Law. OUP, Oxford (2004) pp 10–11.

[438] Articles 1(1) and 40(1) of Directive 2004/39/EC (MiFID). For the definition of transferable securities see Article 4(1).

[439] Article 10 of Directive 2004/25/EC (Directive on takeover bids).

shares admitted to trading on a regulated market in the EU is subject to least constraints.

There can be restrictions in the company's articles of association. The articles of association can make the purchase of shares subject to the company's consent or give existing shareholders veto or redemption rights. Where existing shareholders have such rights, it becomes easier for an existing shareholder to prevail in a takeover contest against an outside bidder.

Either the articles of association or securities markets laws can provide for a duty to make a bid for the remaining shares. Such duties can give an incentive for a bidder to ensure that the size of its block will not exceed a certain threshold. If permitted, such restrictions may take the form of anti-takeover devices or "poison-pills" (for takeover defences, see Volume III).

The Directive on takeover bids requires the disclosure of defensive structures and mechanisms in the company's annual report, and the board must present an explanatory report to the annual general meeting of shareholders on these matters.[440]

Article 10(1) provides that Member States must ensure that listed companies covered by the Takeover Directive "publish detailed information on the following: (a) the structure of their capital, including securities which are not admitted to trading on a regulated market in a Member State, where appropriate with an indication of the different classes of shares and, for each class of shares, the rights and obligations attaching to it and the percentage of total share capital that it represents; (b) any restrictions on the transfer of securities, such as limitations on the holding of securities or the need to obtain the approval of the company or other holders of securities, without prejudice to Article 46 of Directive 2001/34/EC; (c) significant direct and indirect shareholdings (including indirect shareholdings through pyramid structures and cross-shareholdings) within the meaning of Article 85 of Directive 2001/34/EC; (d) the holders of any securities with special control rights and a description of those rights; (e) the system of control of any employee share scheme where the control rights are not exercised directly by the employees; (f) any restrictions on voting rights, such as limitations of the voting rights of holders of a given percentage or number of votes, deadlines for exercising voting rights, or systems whereby, with the company's cooperation, the financial rights attaching to securities are separated from the holding of securities; (g) any agreements between shareholders which are known to the company and may result in restrictions on the transfer of securities and/or voting rights within the meaning of Directive 2001/34/EC; (h) the rules governing the appointment and replacement of board members and the amendment of the articles of association; (i) the powers of board members, and in particular the power to issue or buy back shares; (j) any significant agreements to which the company is a party and which take effect, alter or terminate upon a change of control of the company following a takeover bid, and the effects thereof, except where their nature is such that their disclosure would be seriously prejudicial to the company; this exception shall not apply where the company is specifically obliged to disclose such information on the basis of other legal requirements; (k) any agreements between the company and its board members or employees providing for compensation if they resign or are made redundant without valid reason or if their employment ceases because of a takeover bid."

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[440] Article 10 and recital 18 of Directive 2004/25/EC (Directive on takeover bids).

Sell-out right. In some cases, minority shareholders may force the majority shareholder to buy their shares. This right is often called the sell-out right.

The Takeover Directive provides for a sell-out right following a takeover bid.[441] The threshold for the use of this right is usually the bidder owning at least 90% of the capital carrying voting rights and 90% of the voting rights.

Whether shareholders have a similar general sell-out right other than following a takeover bid depends on the governing law.[442] The articles of association of some companies provide for similar sell-out rights as a takeover defence.

Section 13 of the articles of association of Nokia, a Finnish company, contains the following obligation to purchase shares: "A shareholder whose holding … of the total shares of the company equals or exceeds 33 1/3 per cent or 50 per cent … shall be obliged, at the request of other shareholders … to purchase their shares and securities which entitle to shares …"

Minority shareholders can have a sell-out right or similar rights also in formal mergers and divisions (see Volume III). Whether they do have such rights depends on the governing law.[443]

Takeover defences. The firm can benefit from takeover defences depending on the circumstances. The use of takeover defences will be discussed in Volume III.

On the other hand, takeover defences can influence minority shareholders' exit chances. There are good and bad takeover defences from the perspective of minority shareholders.

From the perspective of minority shareholders, *good* takeover defences do not prevent takeovers completely or hamper them in an unproportionate way but increase the value of minority shareholders' shares. The sell-out right and mandatory bid rules belong to this category.

It is characteristic of good takeover defences that they: enable minority shareholders to sell their shares at a price that reflects not only the income streams of the company before the takeover but also the pecuniary private benefits of control after the takeover; and enable minority shareholders to obtain the highest price paid to other shareholders or more.

From the perspective of minority shareholders, the best takeover defence might be a market valuation that is high enough to frustrate takeovers.

This might also be in the interests of the firm. The long-term survival of the firm would be hampered if the market price paid for control only reflected the income streams of minority shareholders and not the income streams of controlling shareholders. In particular, the price paid for control should not encourage unserious short-term financial shareholders that look for fast profits from the sale of assets to the detriment of the firm. On the other hand, it is in the interests of the firm that an industrial investor obtaining control can achieve private synergy benefits that make the firm more competitive.

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[441] Article 16 of Directive 2004/25/EC (Directive on takeover bids). See also recital 24.

[442] For German law, see § 327a AktG.

[443] Directive 78/855/EEC (Third Company Law Directive) does not provide for a general sell-out right in the context of mergers.

Takeover defences are *bad* from the perspective of minority shareholders if they: prevent takeovers completely; hamper them in an unproportionate way; or decrease the value of minority shareholders' shares otherwise. This may be the effect of many structural devices (see section 9.4.2).

9.6 "Good Corporate Governance" as a Tool

"Good corporate governance" means a combination of measures designed to lead to better corporate governance. What is regarded as "good" depends on the perspective, i.e. the choice of principal. For example, one cannot expect "good corporate governance" designed to maximise the benefits of short-term investors to maximise the firm's long-term survival chances.

Culture. It is usual to signal that "good corporate governance" is part of the firm's corporate culture. Corporate culture is an important tool in the context of corporate risk management and the management of agency relationships inside the firm. The ethical codes and other internal guidelines of the firm typically require "good corporate governance". However, apart from being an abstract ethical objective, there cannot be any concrete universal model for "good corporate governance".

Perspective of the firm. The different views on corporate governance will not be discussed here (see section 8.1). However, from the perspective of the firm, "good corporate governance" might mean six things according to the views represented in this book. One could say that "good corporate governance" consists of the following broad mix of measures:

- The firm has addressed the key questions that are characteristic of legal entities that have an organisation (see section 8.2).
- The legal entity has a board or a similar administrative or supervisory body committed to furthering the fundamental objectives of the firm (section 8.3). The fundamental objectives of the firm consist of its own long-term survival in a competitive environment.
- The firm has a policy of managing agency relationships between the firm as principal and its stakeholders as agents (section 8.5).
- The firm has a policy of allocating value and risk in accordance with the firm's own fundamental objectives (section 8.6).
- The firm has put in place an efficient corporate risk management regime (Chapter 7).
- The firm has put in place an effective information management regime (Chapter 10).

Path-dependency. The above principles can be easier to accept in the area of financial services because of the public policy objective of protecting customers and the financial system by making firms comply with prudential requirements de-

signed to ensure their long-term survival.[444] However, they do not reflect the mainstream view of "good corporate governance", because the mainstream view is based on a different principal-agency relationship with shareholders as "owners" and the only principal (section 8.1).

Views on what constitutes "good corporate governance" can therefore be path-dependent. This can be illustrated by views on what can be regarded as an efficient board.

Many institutional investors have tried to influence corporate behaviour by being vocal about their board structure preferences. Anglo-American institutional investors often prefer board structures that they are familiar with and the use of corporate governance instruments designed to solve problems caused by US or UK law.[445]

For example, the lack of a detailed statutory default framework for boards has made corporate governance codes and similar external rules necessary in these countries. Anglo-American institutional investors have therefore required the adoption of corporate governance codes even in countries with a tradition of regulating board composition and board work through mandatory legal rules.

Furthermore, the use of one-tier board systems in US and UK companies has made the perceived personal independency of each board member more important in these two countries. Institutional investors have therefore asked for independent board members even in countries with two-tier boards and a statutory separation of supervision and management,[446] although the whole point of adopting such structural measures is to make the control body as a whole independent from the management body.

And finally, the use of one-tier boards in the US and the UK has made it necessary to create two-tier structures within nominally one-tier boards. This has inspired institutional investors to demand board committees with a monitoring role even in countries with a statutory separation of supervision and management and no need for any particular committees with a monitoring role.[447]

There is often a conflict between investor demands influenced by legal background rules applicable to US and UK companies and proper ways to improve

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[444] Compare these measures with the "sound corporate governance principles" published by the Basel Committee. BIS, Basel Committee on Banking Supervision, Enhancing corporate governance for banking organisations (February 2006).

[445] See, for example, André TJ Jr, Cultural Hegemony: The Exportation of Anglo-Saxon Corporate Governance Ideologies to Germany, Tulane L R 73 (1998) 69–171.

[446] See, for example, section 5.4.2 of the German Corporate Governance Code: "To permit the Supervisory Board's independent advice and supervision of the Management Board, the Supervisory Board shall include what it considers an adequate number of independent members ..."

[447] The Commission recognised the continental European context in Commission Recommendation of 15 February 2005 on the role of non-executive or supervisory directors and on the committees of the (supervisory) board (2005/162/EC). See paragraph 6.1.

corporate governance in companies governed by the legal background rules of other countries and operating in a different business culture.[448]

The mainstream view, codes. The mainstream view is to focus on board membership and board work. For example, two partners at Wachtell, Lipton, Rosen & Katz, a US law firm, listed the following basic elements of "good corporate governance":[449]

- a board composed primarily of outside directors (both in the number of outside directors and in the role outside directors play in board deliberations);
- key committees (audit, compensation and nominating/governance) composed entirely of outside directors;
- the degree of independence of the outside directors (from the chief executive officer in particular and from management generally);
- the board's knowledge of the subject matter, as demonstrated by distribution of materials for review in advance of board meetings and questioning of management and advisers during the board meeting;
- full disclosure by management of facts and circumstances relevant to the board's complete understanding of the decision it is making;
- the frequency and length of board meetings; and
- the quality of the advice provided by legal and financial advisers.

This is what European corporate governance codes usually do. According to the Commission, forty or so corporate governance codes relevant to the EU have been adopted since the 1990s at the national or international level.[450] Moreover, corporate governance codes adopted in the Member States are surprisingly similar.[451]

As the Commission does not think that the development of a European code would offer significant added value, a European corporate governance code is not part of the Company Law Action Plan.[452]

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[448] A leader published in The Economist before the financial crisis of 2007–2009 gives a good idea of such unrealistic and ignorant demands. No time for consensus, The Economist, January 2005: "Yet there are a few simple things that can be done by the companies themselves. They could slash the size of supervisory boards; hive their real decision-making into smaller committees; and upgrade the quality and broaden the selection of board members. Better still, they could switch to the Anglo-Saxon system of a single board in which independent non-executive directors spar with executives. When set up properly, this system gets things done, and faster."

[449] Cole J Jr, Kirman I, Takeover Law and Practice. In: PLI, Doing Deals 2008: Understanding the Nuts & Bolts of Transactional Practice.New York City (2008) pp 66–67.

[450] In March 2002, the European Commission produced a comparative study on corporate governance codes in the EU.

[451] For the Combined Code and the German Corporate Governance Code, see section 7.6 above and, for example, Mäntysaari P, Comparative Corporate Governance. Shareholders as Rule-maker. Springer, Berlin Heidelberg (2005), Chapters 4 and 5.

[452] The speech of Charlie McCreevy, European Commissioner for Internal Market and Services, Corporate Governance in Europe, European Corporate Governance Forum, Brussels, 20 January 2005.

In 2005, the Commission adopted a Recommendation to reinforce the role of independent directors on the boards of listed companies. The Recommendation is largely based on UK/US practices.[453]

9.7 Outsourcing as a Corporate Governance Tool

At some point, it can become cheaper to pay for goods or services (and let the vendor of goods or provider of services organise production and its own governance function) than to produce them internally (and organise production and the related governance function internally).[454] Outsourcing can be introduced to transfer risk, management tasks, and compliance functions to the outsource provider. The firm is free to agree on its terms.

Control. On the other hand, outsourcing reduces the degree of control, because it is typically based on contracts between independent parties. Outsourcing means that operational or other risks are changed into counterparty risk.

This can be illustrated by the case of General Motors and Delphi, one of the world's largest automotive suppliers. Delphi is a spin-off of GM. It was incorporated in 1998 in contemplation of its separation from GM in 1999. After the separation, the share of sales to other customers than GM rose. In 2008, it was 69%. Although Delphi was no more controlled by GM and sales to GM were only 31% of Delphi's total sales, Delphi remained GM's most important supplier. The lack of control caused GM problems in 2008–2009, as it had to negotiate with Delphi's management and reluctant lenders on its own survival.[455]

Internal v outsourced production. There are fundamental legal differences between internal vertical integration and outsourced production.

From a legal perspective, internal production can bring many benefits. (a) One of them is legal *clarity*. As internal production is supported by a default legal framework governing ownership, management, and control, fewer things must be regulated by contracts. (b) The legal framework can also ensure *flexibility* in the legal sense. In principle, changes in internal production or the internal production system do not necessarily require changing the legal framework.

On the other hand, the internal production system can be *rigid* in the technical or commercial sense. The firm can increase the technical or commercial *flexibility* of its production system by introducing outsourcing. Increased flexibility can help to reduce costs.

Outsourcing can increase some legal problems. (a) One of them is the increased *complexity* of the legal framework. More inter-firm contracts are necessary in the absence of a default legal framework for outsourcing. (b) Furthermore, the legal

[453] Commission Recommendation of 15 February 2005 on the role of non-executive or supervisory directors and on the committees of the (supervisory) board (2005/162/EC). For a critique, see Mäntysaari P, Comparative Corporate Governance. Shareholders as Rule-maker. Springer, Berlin Heidelberg (2005), Chapter 6.

[454] Coase R, The Nature of the Firm, Economica, New Series, Vol 4, No 16 (November 1937) pp 386–405.

[455] See GM News Release of 23 April 2009 and Delphi's Press Release of 23 April 2009.

framework becomes more *rigid*, because changes in production can require changes in the contractual framework (see Volume II).

In addition, outsourcing can change the nature of *agency* problems and increase problems relating to *information*. (a) There can be higher monitoring costs since the company may need to establish stronger centralised controls for its outsource providers and other suppliers. (b) The company may need a mix of competing outsource providers in order to reduce counterparty and holdup risks and to create better incentives to perform (for counterparty risk and holdup, see Volume II). However, the existence of many suppliers and outsource providers can increase costs. (c) There is also a risk that changes in production take longer than expected because outsource providers cannot anticipate changes as early as the company's own managers and employees.

In March 2009, Siemens AG had 120,000 employees but 370,000 suppliers. In 2008, its procurement volume was €40 billion. In order to cut costs, Siemens decided to reduce the number of suppliers by 20% or 74,000.[456]

One of the factors increasing the cost of outsourcing is that the price of the outsourced products or services will reflect the risk-bearing function of the outsource provider if the outsource provider has such a function.

Table 9.4 Internal Production v Outsourced Production

	Internal production	*Outsourced production*
Flexibility of production	less flexible	more flexible
Cost of changes in production	Higher	lower
Cost of change from internal production to outsourced production (or from outsourced production to internal production)	lower	higher
Default legal framework	yes, specific	no, less specific
Contractual framework	less complex	more complex
Cost of drafting the legal framework	lower	higher
Cost of decision-making regarding change of production or change of production system	lower	higher
Cost of monitoring	lower	higher
Payment of risk premium	no transfer of risk	risk premium (price increase)

[456] Köhn R, Siemens trennt sich von 74 000 Lieferanten, FAZ, 31 March 2009 p 18; Siemens Press Release of 29 April 2009.

Contract v compliance duties. As regards the transfer of compliance duties, one should distinguish between (a) the contractual relationship between the company and the outsource provider and (b) other relationships.

Typically, neither the company nor the members of its supervisory, management, or administrative bodies can transfer their own duties to the outsource provider. For example, board members are responsible for compliance with their personal duties and liable for non-compliance even where the company has used an outsource provider. Furthermore, the representatives of the firm must exercise due skill, care and diligence when entering into, managing, or terminating any outsourcing arrangement.

Unlike most firms, investment firms governed by the MiFID may not freely outsource their functions or activities.[457] Investment firms may outsource critical or important operational functions or activities only on certain conditions. For example, the firm must "remain fully responsible for discharging all of its obligations" under the MiFID, and the outsourcing "must not result in the delegation by senior management of its responsibility".[458] Furthermore, the investment firm "must exercise due skill, care and diligence when entering into, managing or terminating any arrangement for the outsourcing to a service provider of critical or important operational functions or of any investment services or activities".[459]

Mitigation of risk. In addition to typical counterparty risk, outsourcing can give rise to various kinds of other risks. There can be particular legal and other risks depending on the field of activity and the area of law.

The particular legal risks can be illustrated by two examples. The first is financial services. The Basel Committee on Banking Supervision identified the following key risks of outsourcing in regulated financial services: strategic risk; reputation risk; compliance risk; operational risk; exit strategy risk; country risk; contractual risk; access risk; and concentration and systemic risk.[460] The second is public procurement. Public procurement and outsourcing by the public sector are governed by a complex legal framework based on Community law. The basic principles of the legislative regime that the public sector must comply with are transparency, non-discrimination, proportionality, and mutual recognition of documents.[461]

The firm can mitigate these general and particular risks internally by: drawing up comprehensive and clear outsourcing policies; establishing effective risk management programmes; and analysing the financial and infrastructure resources of the outsource provider. In addition, the firm can: negotiate appropriate outsourcing contracts; require contingency planning by the outsource provider; and require

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[457] Recital 19 of Directive 2006/73/EC complementing the MiFID; Article 5 of Directive 2004/39/EC (MiFID). Generally, see Moloney N, EC Securities Law. OUP, Oxford (2008) pp 483–486.

[458] Article 14(1) of Directive 2006/73/EC.

[459] Article 14(2) of Directive 2006/73/EC.

[460] BIS, Basel Committee on Banking Supervision, Outsourcing in Financial Services (February 2005).

[461] See Directives 2004/18/EC and 2004/17/EC (Utilities Directive).

strong corporate governance by the outsource provider.[462] The firm should consider several factors when applying these methods.

First, they should be applied according to the degree of materiality of the outsourced activity to the firm's business.

Second, the firm should consider any affiliation or other relationship between parties. While it is necessary to apply the outsourcing principles to affiliated entities, it may be appropriate to adopt them with some modification to account for the potential for differing degrees of risk with respect to intra-group outsourcing.

Third, where the firm is a regulated entity, the firm should consider whether the service provider is a regulated entity subject to independent supervision.

Fourth, appropriate due diligence should be used when selecting third-party outsource providers. The firm should "develop criteria that enable it to assess, prior to selection, the third-party service provider's capacity and ability to perform the outsourced activities effectively, reliably and to a high standard, together with any potential risk factors associated with using a particular service provider".[463]

Contract. In order to mitigate risk, outsourcing relationships should be governed by written contracts that clearly describe all material aspects of the outsourcing arrangement, including the rights, responsibilities and expectations of all parties.

For example, according to the Basel Committee on Banking Supervision, the key provisions of such a contract between a regulated entity and an outsource provider should include at least the following:[464]

- The contract should clearly define what activities are going to be outsourced, including appropriate service and performance levels. The service provider's ability to meet performance requirements in both quantitative and qualitative terms should be assessable in advance.
- The contract should neither prevent nor impede the regulated entity from meeting its respective regulatory obligations, nor the regulator from exercising its regulatory powers.
- The regulated entity must ensure it has the ability to access all books, records, and information relevant to the outsourced activity in the service provider.
- The contract should provide for the continuous monitoring and assessment by the regulated entity of the service provider so that any necessary corrective measures can be taken immediately.
- A termination clause and minimum periods to execute a termination provision, if deemed necessary, should be included. The latter would allow the outsourced services to be transferred to another third-party service provider or to be incorporated into the regulated entity. Such a clause should include provisions relating to insolvency or other material changes in the corporate form, and clear de-

[462] BIS, Basel Committee on Banking Supervision, Outsourcing in Financial Services (February 2005).
[463] See *ibid*.
[464] *Ibid*.

lineation of ownership of intellectual property following termination, including transfers of information back to the regulated entity and other duties that continue to have an effect after the termination of the contract.

- Material issues unique to the outsourcing arrangement should be meaningfully addressed. For example, where the service provider is located abroad, the contract should include choice-of-law provisions and agreement covenants and jurisdictional covenants that provide for adjudication of disputes between the parties under the laws of a specific jurisdiction.
- The contract should include, where appropriate, conditions of subcontracting by the third-party service provider for all or part of an outsourced activity. In appropriate cases it should require approval by the regulated entity of the use of subcontractors by the third-party service provider for all or part of a serviced activity or activity being delivered. More generally, the contract should provide the regulated entity with the ability to maintain a similar control over the risks when a service provider outsources to other third parties as in the original direct outsourcing arrangement.

10 Management of Information

10.1 Introduction

10.1.1 General Remarks

The purpose of the final chapter of the first volume of this book is to explain the role, regulation and management of information in corporate finance law. A distinction is made between the management of incoming and outgoing information. This chapter will also discuss the rather broad question of how Community law influences the management of information by firms.

Firms and other economic agents typically decide and act under uncertainty.[1] In modern economic theory, information can broadly be defined as any device that helps to reduce uncertainty. All decisions are based on information in one way or another.

Much of the law and practice of corporate finance is about the management of information in one way or another.[2] Well-known examples of the management of information by legal means include the strict disclosure regime applied to listed firms as well as the representations, warranties and covenants found in financial agreements. At a more general level, one can distinguish between two kinds of rules.

First, information about the legal framework will influence the behaviour of firms. Practically all legal rules can influence the behaviour of firms in a market economy in one way or another.

Second, there are also special legal rules, tools and practices addressing the problem of information by regulating a number of generic information rights and duties: the right to ask for information; the duty to ask for information; the right to disclose information; the duty to disclose information; the duty not to reveal in-

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1 For a historical survey, see Stiglitz JE, Information and the change in the paradigm of economics, Am Econ R 92 (2002) (3) pp 460–501.

2 Information management should not be confused with knowledge management. Knowledge management can be regarded as a particular form of information management. Characteristic of knowledge management as it is understood here is to maximise the ability of an organisation's people to: use existing business competence; maintain existing business competence; keep existing business competence secret; transfer existing business competence; create new business competence; protect this ability; and transfer this ability. For early works on knowledge management, see Karl-Erik Sveiby, Kunskapsledning (1990) and Ikujiro Nonaka, The Knowledge-Creating Company (1995).

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formation; the duty not to use information; the characteristics of information; the allocation of risk inherent in information; and similar questions.

Before discussing such legal rules, tools and practices, it is necessary to have a look at information economics and the nature of information.

10.1.2 Information and Information Economics

Before the 1960s, it was assumed in traditional microeconomic theory that economic agents were perfectly informed. Information had a relatively passive function.[3] In the 1960s, Stigler introduced the idea of an optimal search for information. The optimal search for information depends on the marginal costs and marginal benefits of additional information.[4] This led to modern information economics.

Modern information economics has developed theories about the consequences of imperfect information and information assymmetries. Theories such as optimal search, signalling and screening, adverse selection, moral hazard and principal-agent problems belong to the broad research programme in this field. In 2001, George Akerlof, Michael Spence and Joseph Stiglitz received the Nobel Prize for their analyses of markets with asymmetric information.

Problems for market economies. Basically, one can identify three classes of problems that information creates for market economies: (1) problems of inducing the socially optimal amount of investment in new, valuable information; (2) problems of inducing information revelation as a part of market transactions; and (3) problems that individuals and groups have in accurately and appropriately taking information into account in their decision-making.[5]

There is a connection between information and rational choice by individuals. The set of alternatives from which individuals choose depends on their knowledge about the actions they can choose and the pay-offs that follow from them. Their decisions can only be subjectively rational, because they can only choose the relatively best option within the limits of their subjective knowledge and information. The lack of or false information can lead to wrong decisions with negative wealth implications.[6]

Market for lemons according to Akerlof. Now, information is not like other goods. This can be illustrated with what Akerlof calls the market for lemons.[7]

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[3] Griffiths A, Contracting with Companies. Hart Publishing, Oxford and Portland, Oregon (2005) p 34.

[4] See Stigler GJ, The Economics of Information, J Pol Econ 69 (1961) pp 213–225.

[5] Ulen TS, Information in the Market Economy – Cognitive Errors and Legal Correctives. In: Grundmann S, Kerber W, Weatherill S (eds), Party Autonomy and the Role of Information in the Internal Market. Walter de Gruyter, Berlin New York (2001) p 98.

[6] See Kerber W, Vanberg V, Constitutional Aspects of Party Autonomy and Its Limits – The Perspective of Constitutional Economics. In: Grundmann S, Kerber W, Weatherill S (eds), *op cit*, p 65.

[7] Akerlof GA, The Market for Lemons: Quality Uncertainty and the Market Mechanism, Quarterly J Econ 84 (1970) pp 488–500.

According to Akerlof, there are good cars and bad cars ("lemons"). Buyers of new cars do not know in advance whether the car will be good or a lemon. Sellers of new cars have superior knowledge about the quality of cars. Buyers pay the same price for good cars and lemons, because buyers do not know the difference. Lemons drive out good cars, because it costs less to build lemons and they sell at the same price. The result is that good cars disappear and buyers are worse off.

Information as a commodity. In more general terms, the specific features of information as an economic good can lead to incentive problems in the production and use of information and to market failure in a market for information in general.[8]

First, a consumer of information searches for information until the marginal benefit of additional information is equal to the marginal costs of obtaining the additional information (Stigler).[9]

Second, information has nevertheless the characteristics of a public good meaning that ordinary markets are likely to do poorly. Public goods have two characteristics: non-rivalry in consumption or use; and non-excludability.

Non-rivalry means that the use of a given good by one agent does not reduce the possibility of others to use this good too. Non-rivalry does not only apply to the use of information but also to its transmission. Passing on information to others does not eliminate the information for the party which has transmitted the information.

Non-excludability refers to the effect that it may be difficult to prevent others from using a certain piece of information. For example, mobility of personnel among firms provides a way of spreading information, because an employee at one firm cannot help bringing some information acquired at that firm to another and legally imposed property rights can provide only a partial barrier (Arrow).[10] Non-excludability of information also results from the possibility of others to observe a certain behaviour – or economic effects which are caused by this behaviour – of someone who is assumed to be informed and to deduce the content of the information from the observed behaviour or its consequences.[11]

Third, information is rarely consumed and valued as such but rather used as an input into decisions about other goods. Therefore information cannot be evaluated independently of these other decisions.[12]

Fourth, as the use of the information in any productive way is bound to reveal it, at least in part (because of non-rivalry and non-excludability), information can to some extent be deduced from price.

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[8] Schmidt RH, Tyrell M, Information Theory and the Role of Intermediaries in Corporate Governance, Working Paper Series: Finance and Accounting 142, Department of Finance, Johann Wolfgang Goethe-Universität Frankfurt am Main (2004).

[9] Stigler GJ, The Economics of Information, J Pol Econ 69 (1961) pp 213–225 at p 216.

[10] Arrow KJ, Economic Welfare and the Allocation of Resources for Innovation. In: Nelson R (ed), The Rate and Direction of Inventive Activity: Economic and Social Factors. Princeton (1962) pp 609–625.

[11] Schmidt RH, Tyrell M, *op cit*.

[12] *Ibid*.

Hayek assumed that information used in economic decisions is integrated into prices and transmitted via prices.[13]

Grossman and Stiglitz wrote: (1) the more individuals who are informed, the more informative is the price system; (2) the higher the cost of information, the smaller will be the proportion of individuals who are informed; (3) the greater the magnitude of noise, the larger the proportion of informed individuals; (4) and when there is no noise, prices convey all information and there is no incentive to purchase information.[14]

Fifth, information is transmitted by various kinds of intermediaries. Information is added to by individual economic agents and intermediaries.

Sixth, different agents engaged in transactions with each other have different information sets, and agents on one side of the market can have much better information than those on the other side (theory of asymmetric information). The other agent can possess hidden information. For example, borrowers tend to know more than the lender about their own repayment prospects. The other agent can also take hidden action after contracting. For example, the lender does not always know what borrowers do with the money. Informational asymmetries can give rise to adverse selection on markets or the "market for lemons" (Akerlof).

Seventh, some goods are "search goods" or "experience goods" or "credence goods". One can determine the quality of "search goods" by searching and the quality of "experience goods" by experiencing them (Nelson).[15] "Credence goods" constitute a category for which the non-expert cannot verify the quality attributes of the goods (Darby and Karni).[16]

The problem of credence goods arises because it is sometimes difficult for consumers to discover how much of the good they actually need or the quality of the good they were supplied. They turn to sellers of the good who act as experts. This means that sellers not only provide the goods, but they also act as experts determining how much of the good the consumers actually need. With such credence goods, it is difficult for consumers to discover how much of the good they actually need or the quality of the good they were supplied. The asymmetry in information and the cost of verifying the expert's opinion is prohibitively high, and therefore creates the possibility of opportunistic behaviour on the part of the expert. For example, it is often impossible for the buyer to verify the expert's opinion in medi-

[13] Hayek FA, The Use of Knowledge in Society, Am Econ R 35 (1945) pp 519–530: "Fundamentally, in a system in which the knowledge of the relevant facts is dispersed among many people, prices can act to coördinate the separate actions of different people in the same way as subjective values help the individual to coördinate the parts of his plan."

[14] See Grossman SJ, Stiglitz JE, On the Impossibility of Informationally Efficient Markets, Am Econ R 70 (1980) pp 393–408 at pp 394–395.

[15] Nelson P, Information and Consumer Behaviour, J Pol Econ 78 (1970) pp 311–329.

[16] Darby MR, Karni E, Free Competition and the Optimal Amount of Fraud, J L Econ 16 (1973) pp 67–88.

cal, legal and financial advice services, as well as a wide variety of repair professions.[17]

10.1.3 Dealing with Information Problems

In the light of information economics, there are many ways for the firm (or economic agents in general) to deal with information problems. The firm can use these methods in the capacity of a party that uses information for its own decision-making purposes (see section 10.4 for incoming information). Other parties use the same methods for their own decision-making purposes. The firm can therefore take these methods into account when trying to influence the behaviour of others (see section 10.5 for outgoing information).

First, there is the concept of an optimally informed firm. The firm is optimally informed if the marginal benefits correspond to the marginal costs of information.[18] At some point it is no more relevant for the firm to gather and process more information.

If the costs of searching for and processing (evaluating and deliberating on) information were zero, and human information-processing capabilities were perfect, then an actor contemplating a decision would make a comprehensive search for relevant information, would process perfectly all the information he acquired, and would then make the best possible substantive decision.[19]

In reality, human rationality is normally bounded by limited information and limited information-processing.[20] (a) Searching for and processing information involves costs in the form of time, energy, and money. Most actors therefore choose some degree of rational ignorance. (b) Furthermore, human abilities to process information are constrained by limitations of computational ability, ability to calculate consequences, ability to organise and utilise memory, and the like.[21]

Second, to gather information, the firm implements a search strategy. Searching implies a general attitude of looking at potential valuable sources of information.

Third, in the case of asymmetric information, the firm may check to see whether information is true.[22] One can distinguish between two different aspects of asymmetric information: verifiable and nonverifiable information. The firm can

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[17] See, for example, Thambisetty S, Patents as Credence Goods, OJLS 27 (2007) pp 707–740.

[18] Stigler GJ, The Economics of Information, J Pol Econ 69 (1961) p 216.

[19] See Eisenberg MA, The Emergence of Dynamic Contract Law, Cal L Rev 88 (2000) pp 1743–1814 at p 1781.

[20] Simon HA, Administrative Behavior, Third Edition (1976) pp 79–109, cited *ibid*.

[21] March JG, Bounded Rationality, Ambiguity, and the Engineering of Choice, Bell J Econ 9 (1978) pp 587 and 590; Simon HA, Rational Decisionmaking in Business Organizations, Am Econ Rev 69 (1979) pp 493 and 502–503; March JG, Simon HA, Organizations, First Edition (1958) p 171. All cited in Eisenberg MA, supra.

[22] "Asymmetric information" is a situation in which one party knows more than the other party about some material aspect of a potential transaction and both parties know that one party has superior information to the other.

check to see if verifiable information is true, but not if nonverifiable information is true.[23]

Fourth, there is the possibility to screen information (Stiglitz).[24] Screening involves identifying and selecting the best within the set of possible information providers. In other words, the firm can choose whom to trust.[25] For example, the firm might want to use a reliable screening device or filter that would separate those potential counterparties that have desirable qualities from those who do not. This would be especially useful where the information is private and nonverifiable.[26]

Fifth, these activities are complemented by signalling activities by the producers of information (Spence). The firm implements a signalling activity to reveal knowledge to other economic agents. Signalling activity can be defined as the activity carried out by the firm aimed at voluntarily disclosing knowledge to less informed economic agents, to convince them of the firm's specific attributes (Spence).[27]

For example, contract terms form an important signal used by any contract party. (a) Manufacturers of goods can signal the credibility of their promises of good quality through the use of warranties, the reputation mechanism, and advertising.[28] (b) Generally, a party can use the terms that it offers to potential contract parties as a screening mechanism. Potential contract parties can signal their ability to comply with the terms by accepting them. This means that a party can use its own contract terms as a "self-selection" mechanism (Rothschild and Stiglitz).[29]

The distribution of dividends is another example of signalling activities. Managers and board members know more about the profitability of the company than shareholders do. A company often pays dividends, because dividends can act as a signal for favourable prospects. The market can interpret this as good news and

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[23] See Ulen TS, Information in the Market Economy – Cognitive Errors and Legal Correctives. In: Grundmann S, Kerber W, Weatherill S (eds), *op cit*, pp 98–129.

[24] Stiglitz JE, Information and the change in the paradigm of economics, Am Econ R 92 (2002) pp 460–501.

[25] For example, Hayek wrote that there are "different kinds of knowledge; those more likely to be at the disposal of particular individuals and those which we should with greater confidence expect to find in the possession of an authority made up of suitably chosen experts". Hayek FA, The Use of Knowledge in Society, Am Econ R 35 (1945) pp 519–530.

[26] See Ulen TS, Information in the Market Economy – Cognitive Errors and Legal Correctives. In: Grundmann S, Kerber W, Weatherill S (eds), *op cit*, pp 104–105.

[27] Spence M, Signaling in retrospect and the informational structure of markets, Am Econ R 92 (2002) (3) pp 434–459.

[28] According to Akerlof, the following "counteracting institutions" can help the firm to rise above "the market for lemons": guarantees and warranties; brand-name goods (which indicate quality and enable consumers to retaliate); chains; and licensing practices (which act as a certification mechanism and indicate the attainment of certain level of quality). Akerlof GA, The Market for Lemons: Quality Uncertainty and the Market Mechanism, Quarterly J Econ 84 (1970) pp 488–500.

[29] Rothschild M, Stiglitz JE, Equilibrium in Competitive Insurance Markets: An Essay on the Economics of Imperfect Information, Quarterly J Econ 90 (1976) pp 630–649.

therefore pay a higher price for the share. The market can pay a higher share price even if dividends are taxed more heavily than capital gains; the higher share price compensates shareholders for the extra tax they pay on dividends. Managers may thus prefer to incur the additional tax cost of dividends to signal high profitability.

Sixth, the firm can use information intermediaries that specialise in the gathering and processing of information. For example, when someone discloses information, another can check to see if the information is true.

Seventh, screening and signalling activities and the use of information intermediaries can be complemented by the use of (legal or other) strategies designed to reduce agency costs. The firm (the principal) would want the producer of information (the agent) to reveal useful information (for strategies to deal with agency problems, see Chapter 6). For example, there may be legal background rules or contract terms that set out a duty to disclose certain information in a certain way (the use of rules ex ante), and this duty may be complemented by the use of positive rewards ex post (for example, in the form of payments made to the producer of information for useful information) or negative rewards ex post (for example, the liability of the producer of information for false, misleading or incomplete information).

Eighth, the firm can design a system[30] that not only makes the producer of information reveal accurate or useful information but even enables the firm to reduce the cost of analysing its accuracy or usefulness.

For example, to give an example from wildlife, bird offspring beg for resources (food) by signalling need. Bird parents respond to more intense begging by allocating more food to the offspring. If bird offspring beg all the time, bird parents cannot rely on the signalling of need. To ensure the stability of the begging system, begging must be costly. If there is a cost, bird offspring are more likely to beg for food only when they need it. To reduce the cost of analysing the accuracy of signalling, bird parents can allocate food in two parts. The first part is allocated immediately without further analysis. The second part is allocated afterwards.[31]

Ninth, the firm can mitigate the risk of divergences from rational behaviour caused by cognitive errors.[32] Although the rational choice theory is the prevailing theory of decision-making in microeconomics, the behaviour of the parties is not always rational.[33] Behavioural economics has shown that there are systematic and

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[30] The 2007 Nobel Prize in economics was awarded to Leonid Hurwicz, Eric S Maskin and Roger B Myerson "for having laid the foundations of mechanism design theory".

[31] Nöldeke G, Samuelson L, How Costly is the Honest Signaling of Need? Journal of Theoretical Biology 197 (1999) pp 527–539.

[32] See Grundmann S, Kerber W, Weatherill S, Party Autonomy and the Role of Information in the Internal Market – an Overview. In Grundmann S, Kerber W, Weatherill S (eds), *op cit*, pp 15–16.

[33] Korobkin RB, Ulen TS, Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics. Cal L R 88(4) (2000) pp 1051–1144. See also Langevoort DC, Behavioral Theories of Judgment and Decision Making in Legal Scholarship: A Literature Review. Vanderbilt Law Review 51 (1998) pp 1499–1540.

predictable deviations from the rationality assumption. This can be illustrated by the following seven examples:

- Beliefs. People are more likely to accept information that confirms their beliefs, hopes and expectations. For example, when buying newspapers, people do not care about accuracy alone but also like to have their beliefs confirmed[34] (the "confirmatory" or "self-serving" bias[35]). One of the ways for the firm to mitigate problems caused by the tendency of managers to accept information confirming their beliefs is to ensure that decisions are made by a group of people whose members do not share the same beliefs (see the section on fundamental ways to organise risk management above).
- Undue confidence. Undue confidence is a related phenomenom. People have a tendency to believe that good things are more likely than average to happen to them and bad things are less likely than average to happen to them (the "overconfidence bias"[36]). For example, a counterparty's undue confidence in its ability to overcome obstacles could lead the firm's counterparty to mislead the firm. For this reason, the firm may require a third party who is potentially less likely to suffer from such a bias to analyse and verify information disclosed by the counterparty.[37]
- Herding. Managers are likely to mimic the choices made by others in the industry. Such herding may be individually rational (as a way of signalling that the manager acts according to the manager standard, as a way of mitigating liability risks, because of social benefits, and so forth) but lead to the accumulation of wrong choices.[38] For this reason, the firm may require a person who is potentially less likely to suffer from herding to analyse the usefulness of incoming information or to make the choice.
- Endowment effect, status quo bias. A person is likely to put a higher value on assets that he already owns compared with assets that he does not own (endowment effect).[39] This can make investors reluctant to sell investments they already hold (regardless of the cost of the asset, transaction costs, or emotional

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34 Mullainathan S, Shleifer A, The Market for News, Am Econ R 95 (2005) pp 1031–1053; Gentzkow MA, Jesse M Shapiro, What Drives Media Slant? Evidence from U.S. Daily Newspapers (2006). Available at SSRN.

35 See Ulen TS, Information in the Market Economy – Cognitive Errors and Legal Correctives. In: Grundmann S, Kerber W, Weatherill S (eds), *op cit*, p 119.

36 The belief that good things are more likely than average to happen to us and bad things are less likely than average to happen to us. See generally Jolls C, Behavioral Economics Analysis of Redistributive Legal Rules, Vand L R 51 (1998) p 1653; Ulen TS, Information in the Market Economy – Cognitive Errors and Legal Correctives. In: Grundmann S, Kerber W, Weatherill S (eds), *op cit*, p 117.

37 See Ulen TS, Information in the Market Economy – Cognitive Errors and Legal Correctives. In: Grundmann S, Kerber W, Weatherill S (eds), *op cit*, p 122.

38 See Tirole J, The Theory of Corporate Finance. Princeton U P, Princeton and Oxford (2006) p 310.

39 Thaler R, Toward a positive theory of consumer choice. J Econ Beh and Org 1 (1980) pp 39–60.

attachement). There is thus a status quo bias. The firm can try to mitigate this risk. For example, on the strategic level, the firm can create an exit culture supported by a group structure that makes it easier to divest assets and by internal guidelines. The private equity industry and GE are examples of businesses with strong exit cultures. In the absence of such a culture, the firm can also appoint managers from outside the firm and rotate people. For example, portfolio managers can be rotated in order to prevent them from becoming emotionally attached to their "own" assets - the downside of rotation can nevertheless be short-termism (see section 7.4).

- Anchoring. A person has a tendency to rely too heavily on one piece of information when making decisions even when that piece of information should not be relevant for the decision. This heuristic bias is clear when a person is asked to make estimations and valuations.[40] The firm can mitigate the risk caused by anchoring by questioning the relevance of the piece of information to which estimations and valuations are anchored.
- The influence of price on perceived quality. This leads us to the question of price. Price is a popular way to signal quality. According to The Economist, investors choose hedge fund managers in the following way: "Pay peanuts and you get monkeys. Most people assume the corollary must be true: pay handsome fees and you get superior people and an excellent standard of service."[41] The firm can mitigate the risk of falling for this hoax by using informed advisers that know the true quality of potential contract parties.
- Hindsight bias. In behavioural economics, the "hindsight bias" describes the tendency of people to overestimate the ex ante prediction that they had concerning the likelihood of an event's occurring after learning that it actually did occur. Events that have actually occurred seem, through the lens of hindsight, to have been almost inevitable.[42] In practice, the hindsight bias can often cause a party to use ex post sanctions that are triggered by the other party's fault. The firm can mitigate the risk that fault-based sanctions are used against it even in the absence of an actual fault by ensuring that the facts triggering the sanctions can be determined objectively (a certain amount, things expressed in numbers) rather than subjectively ("negligence", "fault", things expressed by open terms) or by diluting the sanctions otherwise (Volume II). Generally, the hindsight bias can increase the flexibility of law (Volume II).

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[40] Tversky A, Kahneman D, Judgment under uncertainty: Heuristics and biases, Science 185 (1974) pp 1124–1130.

[41] Mutiny about the bounty, The Economist, November 2006.

[42] Ulen TS, Information in the Market Economy – Cognitive Errors and Legal Correctives. In: Grundmann S, Kerber W, Weatherill S (eds), *op cit*, p 112. For a review of over 100 studies of the hindsight bias, see Christensen-Szalanski J, Willham C, The Hindsight Bias: A meta-Analysis, J Org Beh Hum Dec Proc 48 (1991) pp 147–168.

Tenth, all these activities are complemented by public solutions of information problems.[43] (a) The state, or non-state bodies such as stock exchanges or professional organisations (accounting, auditing, legal, and so forth), can decrease the cost of information in many ways and help the firm to be better informed. For example, the state, or non-state bodies, can help the private production and exchange of information by establishing mandatory disclosure rules and disclosure standards, and by preventing wrong (i.e. deceptive or misleading) information. (b) Rules that prevent deceptive and misleading information can be said to support free choice and the freedom of contract, because individuals can only choose the relatively best option within the limits of their subjective knowledge and information.[44] (c) These methods will at the same time make screening activities by the firm easier and less costly. They will also make it easier and less costly for producers of information to signal the quality of their information. For example, a potential contract party who has private, nonverifiable information that redounds to his credit would like to find a credible way to signal this to the firm;[45] accreditations, permits, and generally the existence of legal rules and standards that the party is expected to comply with can help him in doing so. (d) The state and non-state bodies can also act as information intermediaries. For example, information is often disclosed to the public by filing it with a public authority or register. (e) In addition, legal rules can help to overcome the "overconfidence bias" and the "confirmatory" or "self-serving" bias. For example, securities laws can require third parties such as auditors or lawyers who are potentially less likely to suffer from such biases to verify information that other parties provide to the marketplace.[46]

10.1.4 The Role of Legal Rules on Information

It is clear that legal rules can influence the gathering and processing of information in many ways. For example, practically all legal rules can influence the behaviour of firms in a market economy, and legal rules influence the information

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[43] See Grundmann S, Kerber W, Weatherill S, Party Autonomy and the Role of Information in the Internal Market – an Overview. In Grundmann S, Kerber W, Weatherill S (eds), *op cit*, p 15.

[44] Hayek FA, The Constitution of Liberty. U Chic P, Chicago (1960) pp 143–147. For "opportunistic behaviour", see Williamson OE, Markets and Hierarchies: Analysts and Antitrust Implications (1975) p 26; Williamson OE, The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting (1985) p 47.

[45] That people attempt to signal their desirability as a cooperative partner in business and social matters and that social norms develop as a leading method of signaling these characteristics is the theme of an important new work by Posner EA, Law and Social Norms (2000).

[46] See Langevoort DC, Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (and Cause Other Social Harms). In: Sunstein CS (editor), Behavioral Law and Economics. Cam U P, Cambridge (2000) pp 144–167; Ulen TS, Information in the Market Economy – Cognitive Errors and Legal Correctives. In: Grundmann S, Kerber W, Weatherill S (eds), *op cit*, p 122.

needs of firms.[47] In addition, there are legal rules that address the legal aspects of information.

The legal relevance of information. There must be legal rules on the legal relevance of information. For example, there must be legal rules on the attribution (section 10.4.9), communication (section 10.5.6), and interpretation of information (for the interpretation of law and contracts, see Volume II).

Particular legal rules on information management. There are also particular legal rules which address problems relating to information.

It is possible to regulate the duty to produce information, the quality of information, other modalities of production of information, and the allocation of risk inherent in information. For example, a contract party often has a duty of disclosure where knowledge of the relevant facts or knowledge of the relevancy of those facts lies only or mainly with that party.[48]

Legal rules can also help to correct for problems created by systematic errors in human decision-making.[49] For example, legal rules can require the separation of decision management and decision control to mitigate the risk caused by managers' overconfidence bias (section 9.3.2), and the verification of information that firms provide to the marketplace by third parties such as auditors and lawyers who are potentially less likely to suffer from overconfidence bias (section 10.7).

Nonverifiable information. There is a difference between verifiable information and private, nonverifiable information. There is relatively little that law can do to compel the disclosure of private, nonverifiable information. The law can nevertheless try.

Some provisions of law require firms or their managers to comply with requirements as to formal qualifications, experience and reputation. These requirements can be complemented by a prohibition to carry on certain activities without proof of compliance with these requirements and authorisation. Government authorities thus act as a screening device or filter separating those who have desirable qualities from those who do not, or at least government authorities try to give that impression in order to: signal that private information has been verified to the extent that it was verifiable; increase the expectations of customers for the quality of the products or services of the firm; increase the price that customers are willing to pay; and address the problem of the market for lemons. For example, statutory auditors can be required to be "independent" and "objective", and higher reli-

[47] See, for example, Kuhnle H, Banzhaf J, Finanzkommunikation unter IFRS. Grundlagen, Ziele und Gestaltung. Vahlen, München (2005) p 117: "Die Informationsbedürfnisse der einzelnen Mitglieder der Financial Community richten sich nach den jeweiligen vorherrschenden nationalen Usancen. Deutsche Eigenheiten wie Vorsichts- und Maßgeblichkeitsprinzip sowie ihr vorrangiger Zweck des Gläubigerschutzes und der Kapitalerhaltung konnten sich weder auf angloamerikanischen noch auf anderen internationalen Kapitalmärtkten durchsetzen."

[48] See also Coester-Waltjen D, Constitutional Aspects of Party Autonomy and Its Limits – The Perspective of Law. In: Grundmann S, Kerber W, Weatherill S (eds), *op cit*, pp 44–45.

[49] See Ulen TS, Information in the Market Economy – Cognitive Errors and Legal Correctives. In: Grundmann S, Kerber W, Weatherill S (eds), *op cit*, pp 111–112.

ance on audited financial information published by listed companies can increase the price paid for their securities.[50] The screening of information and authorisation requirements can be necessary because of reasons of public interest such as the protection of consumers or investors[51] or, for example in banking, the reduction of the risk of market collapse.[52]

On the other hand, the parties can also find methods of conveying nonverifiable information,[53] and the law can facilitate this process. For example, a customer may sometimes test products or services on a small scale or for a certain short period of time. A new employee can first be hired as a trainee for a trial period, or the delivery of a machine installed by the seller will only be accepted after the succesful completion of a testing programme. Those forms of testing can convey nonverifiable information provided that they say something about what will happen in the future. For example, whereas the specifications and future performance of a machine can be tested accurately in advance, the future reliability of the owners of a public investment scheme cannot, as is shown by many cases of pyramid schemes.

Amount of regulation. It is not the purpose of this book to discuss to what extent these issues should be regulated by the state. The predictions of rational choice theory often lead to the conclusion that, in the absence of externalities and high transaction costs, bargaining will achieve efficiency, and state intervention into private ordering is undesirable.[54] In any case, it is usual to find at least rules against fraud and deception (see below).[55] Fraud and deception are threats to the voluntariness of choice, and rules against them help to ensure that decisions are voluntary by protecting parties from being manipulated through intentionally wrong or distorted information.[56]

10.1.5 Corporate Finance Law, Information, the Firm

All financial decision-making by the firm is based on information. The better the firm is informed, the less there is uncertainty about cash flow and risk. The attainment of the firm's basic objectives business objectives (customer orientation,

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[50] See, for example, Directive 2006/43/EC (Directive on statutory audits).

[51] See, for example, recital 60, Article 6(1) and Article 40(3) of Directive 2002/83/EC concerning life assurance; Article 9(1) of Directive 2004/39/EC (MiFID).

[52] Article 6(1) of Directive 2000/12/EC relating to the taking up and pursuit of the business of credit institutions.

[53] See Ulen TS, Information in the Market Economy – Cognitive Errors and Legal Correctives. In: Grundmann S, Kerber W, Weatherill S (eds), *op cit*, pp 104–105.

[54] Ulen TS, Information in the Market Economy – Cognitive Errors and Legal Correctives. In: Grundmann S, Kerber W, Weatherill S (eds), *op cit*, p 116.

[55] For the rule against fraud in in the US, see, for example, Easterbrook FH, Fischel DR, The Economic Structure of Corporate Law. Harv U P, The USA (1991) p 283.

[56] Kerber W, Vanberg V, Constitutional Aspects of Party Autonomy and Its Limits – The Perspective of Constitutional Economics. In: Grundmann S, Kerber W, Weatherill S (eds), *op cit*, p 65.

profitability, lower costs) depends on the quality of the information. The management of information therefore belongs to the firm's basic legal objectives.

Better information does not necessarily mean more information, and more information does not necessarily lead to better decisions. Information is "better" when it is more *useful*.

Ulysses is a novel by James Joyce. In this book, Joyce describes what went on in Leopold Bloom's mind on 16 June 1904. The novel is extremely difficult to read, because Joyce discloses too much detailed information. Many people do not have the patience to finish it. Like Joyce's book, annual accounts are long and complex. Increasing the amount of disclosures does not always increase the usefulness of information and "transparency".

The firm must organise the production, distribution and use of information in some way. It is possible to distinguish between (a) information received by the firm (incoming information) and (b) information transmitted by it (outgoing information). The firm needs to gather, process and use information transmitted by others for its own decision-making purposes, but others also gather, process and use information for their own purposes. For example, one of the most important functions of shareholders is to provide a market valuation for the company (section 8.7.6). The firm can in theory increase its market valuation through better disclosure designed to reduce uncertainty about return and risk for investors. The firm will also need to protect its confidential information.

The law of corporate finance can help the firm to deal with uncertainty in many ways. It can help the firm to: secure the fair presentation of useful information for its own decision-making purposes; reduce uncertainty for investors, customers, contract parties and stakeholders; transfer this risk to somebody else and to keep part of this risk; protect its confidential information; benefit from information asymmetries; manage its reputation; and decrease risk by establishing legally relevant communication.

The management of information in the law of corporate finance is thus much more than what is generally known as data governance. At the same time, it provides legal tools for data governance.[57]

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[57] IBM has described its data governance system as follows: "IBM employs a cross-company control model to govern how information is used, promote the security and integrity of all data, and protect privacy on both the individual and the corporate level. Our data governance rules and policies are designed to comply with our contractual obligations and to protect our shareholders and our relationships with clients, vendors and third parties who process our information."

10.2 Information Management in Corporate Finance Law

10.2.1 Introduction

Information economics tells us that there are many ways to deal with information problems. What is open is how to combine information economics with the law of corporate finance.

There are two obvious questions: What legal lools and practices can the law of corporate finance provide the firm with? How can the firm choose the right legal tools to deal with different kinds of information problems?

It is again possible to distinguish between two kinds of information flows, information received by the firm (incoming information) and information transmitted by the firm (outgoing information). The firm both uses information for the purpose of financial decision-making and transmits information that will be used by others.

In both situations, the management of information is also a way to manage agency relationships. Agency problems can be mitigated through disclosure and transparency, because: disclosure of information to the agent can help the agent to fulfil the expectations of the principal; disclosure of information by the agent can help the principal to monitor the agent; and transparency is a way to facilitate disclosure and monitoring (for the management of agency relationships through information management, see Chapters 5 and 6).

The ways to manage information also depend on the location of the firm in the information delivery chain, and the location of its intermediaries and agents in the information delivery chain.

10.2.2 Information Delivery Chain

It is easier to understand how the firm can manage information problems by legal means if one first identifies the chain of intermediaries through which information is delivered from source to the spot in the firm that can be regarded as the end-user of information, and the different functions of the parties that belong to that information delivery chain.

Information delivery chain. Information can be produced anywhere, and it can originally be located anywhere. From the perspective of the firm, the firm cannot use information unless it is delivered to the spot in the firm where it is used on behalf of the firm. Information can be delivered in one way or another, and different parties can contribute to the delivery of information in one way or another.

Functions. Different parties can have different functions in the information delivery chain. Moreover, a party can have one or more functions simultaneously.

It is possible to distinguish four basic functions. A party can: be the target, produce information, transfer information, or be the end-user of information. One can also distinguish between the target and the topic.

The end-user of information is what Hayek calls the “man on the spot”.[58] The “spot” can be located in many places in the organisation, because the use of information is in practice highly decentralised. According to Hayek, “practically every individual has some advantage over all others because he possesses unique information of which beneficial use might be made, but of which use can be made only if the decisions depending on it are left to him or are made with his active coöperation.” Hayek continued: “But the ‘man on the spot’ cannot decide solely on the basis of his limited but intimate knowledge of the facts of his immediate surroundings. There still remains the problem of communicating to him such further information as he needs to fit his decisions into the whole pattern of changes of the larger economic system.” There must therefore be other parties in the information delivery chain.

If the party is the target, the information relates to that party. For example, if the firm wants to invest in, say, securities issued by Deutsche Bank AG, the end-user would need information about Deutsche Bank. Deutsche Bank would be the target. Those securities would be the topic. If the firm wants to buy a new machine instead, the firm would look for information about the manufacturer. The manufacturer would be the target. The machine would be the topic.

The party can also produce information. For example, Deutsche Bank - or rather, its organisation - can produce information about itself. Deutsche Bank can produce information either actively (by disclosing it) or passively (in the course its normal business). The producer of information does not have to be the target; even outsiders can thus produce information about Deutsche Bank.[59]

The fourth function is to transfer information further in the information delivery chain. For example, a firm that wants to invest in securities issued by Deutsche Bank may have received information concerning Deutsche Bank from a newspaper, a merchant bank, a law firm, or one of the firm’s own employees sending a clipping of a newspaper article to the person who has been instructed to analyse whether the investment would make any sense. From the perspective of the firm, all of these parties have transferred information. While some of them have also produced new information about Deutsche Bank, the function of others has been just to transfer it further.

Intermediaries. Information about the target reaches the end-user through many intermediaries. Some of these intermediaries can work for the firm in the broad sense, while others can work for the target. The firm and the target are typically legal entities or organisations that need real people to represent them. In addition to internal intermediaries representing legal entities or organisations belonging to the information delivery chain, there can be a large number of external intermediaries such as the media, investment banks, auditing firms, and law firms. Even these external intermediaries are represented by real people.

While some intermediaries simply transfer information, many intermediaries produce new forms of information by analysing information gathered by them or otherwise.

58 Hayek FA, The Use of Knowledge in Society, Am Econ R 35 (1945) pp 519–530.
59 I will not discuss the problem of automated machines producing information.

The location of these intermediaries in the information delivery chain varies. This affects their chances to analyse information, verify information and produce new information. Some of them are in a position to know or find out what is true about matters that are relevant in the circumstances (the topic). This may depend on their proximity to the topic inside the target's organisation, their access to information about the topic from outside, and their knowledge about the topic generally. Others can be closer to the firm and the end-user.

Quality of information. The firm can reduce risk inherent in information by analysing the information that it has gathered. The analysis can be made by intermediaries who analyse: the information needs of the firm; and the quality of the information.

The information needs of the firm can be determined in three main ways. They can be determined from an objective perspective. This can by done by determining either the information that firms belonging to the same category of firms typically need (deductive reasoning) or the information that the particular firm in fact needs (inductive reasoning).[60] They can also be determined from the subjective perspective of the firm by determining what information the firm has requested or what information the end-user of the information has requested.

The quality of information can be assessed in four main ways. It can be assessed objectively by determining whether the information is accurate as such (accuracy), typically useful for firms that belong to the same category of firms (generic usefulness), and useful for that particular firm (case-specific usefulness). It can also be assessed subjectively from the subjective perspective of the firm when the end-user of information determines whether the information is what the firm has requested (subjective usefulness).

Generally, the verification of information as to its accuracy requires proximity to the target and the topic (whoever verifies information should know something about what the information is about). The verification of information as to its case-specific usefulness requires proximity to the firm and the end-user (whoever determines whether the "man on the spot" has received enough information should know something about the firm and the end-user's information needs).

Quality of information and proximity. The verification of information is therefore connected with the question of proximity.

The quality of information can be assessed objectively on the basis of its accuracy and generic usefulness. There can also be objective standards regarding the information to be disclosed, the manner of disclosure, and the accuracy. Information can be verified as to its accuracy and generic usefulness by external intermediaries, because these forms of objective quality of information are basically not dependent on the personal preferences of the firm or of the end-user of the information.[61] Legal rules often regulate the objective quality of information.

The quality of information can also be assessed objectively on the basis of its case-specific usefulness or subjectively from the perspective of its end-user.

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[60] See, for example, Kuhnle H, Banzhaf J, Finanzkommunikation unter IFRS. Grundlagen, Ziele und Gestaltung. Vahlen, München (2005) p 26.

[61] See *ibid*, p 27.

This distinction is relevant for the firm, because different things can be necessary before the required levels of quality are achieved. For example, different requirements as to proximity can mean that information must be verified and information needs determined by many intermediaries.

Information becomes less reliable as to its accuracy, if the distance of the information producer from the topic and the target is increased. If one tries to see something from a great distance, the less one is likely to see.

On the other hand, information becomes less reliable as to its generic usefulness and case-specific usefulness, if the distance of the information producer from the firm is increased. The information producer is likely to know less about the firm and its information needs if there is great distance between the producer and the firm.

Requested quality depends on the subjective preferences of the end-user. The gap between objective usefulness and subjective or perceived usefulness can be narrowed if the end-user's knowledge of the matter is increased.[62] It is not sufficient for the firm to focus on the requested quality and subjective usefulness of incoming information. For example, it is usual for firms to work with a legal adviser that verifies the objective usefulness of legal information, because most managers do not have a legal background and managers often do not understand how law affects the risk/reward ratio of the firm. But as they do not know the right questions to ask, they cannot know when they have the right answers.[63]

To sum up: (a) the information producer's proximity to the topic and the target can increase the accuracy and generic usefulness of information received by the end-user; but (b) the case-specific usefulness and subjective usefulness of information received by the end-user can be increased by the information producer's proximity to the topic and the firm.

Number of end-users and the verification of the quality of information. The number of end-users influences how the quality of information can be verified. Where the number of end-users is small, information quality can be verified not only by using deductive reasoning but also by using inductive reasoning. Where the number of end-users is very large, it would either be very difficult or impossible to use inductive reasoning.[64]

For example, the public disclosure of financial information in the capital market is governed by very detailed legal rules. In the EU, these disclosure requirements are based on the typical information needs of professional investors and financial service providers such as banks and investment advisers (deductive reasoning). However, the rules governing the disclosure of information by an investment adviser to a customer contain a "know-your-customer" rule and the rule that the recommended investments must be "suitable" for the customer (inductive reasoning).[65]

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[62] *Ibid*, p 28.

[63] Bagley CE, Winning Legally. Harv Bus S P, Boston (2005) p 4.

[64] Kuhnle H, Banzhaf J, *op cit*, p 29.

[65] Article 19(5) of Directive 2004/39/EC (MiFID).

End-user, psychology, behaviour. The perceived quality of information will also depend on psychological and behavioural aspects.

10.2.3 Legal Tools and Practices: General Remarks

The legal infrastructure is not the only way to manage information. Communication can take many forms, and information can be managed in many ways. However, the other ways of managing information will be complemented by legal tools and practices. For example, technical and organisational "Chinese walls" (section 10.5.2) will typically be supported by a legal framework.

The management of information by the firm depends on the location of the firm in the information delivery chain and the information needs of the parties. For example, incoming information and outgoing information must be managed in two different ways. (a) The firm uses incoming information as a basis for its operations and decision-making. (b) Outgoing information is managed for other reasons. On the one hand, the firm must protect confidential information such as its know-how and trade secrets. On the other hand, the firm must influence the behaviour of others such as its customers, investors, business partners and other stakeholders. By disclosing information that those other parties find useful, the firm can reduce costs by reducing their perceived risk. (c) In both cases, the production and analysis of information comes at a cost. The firm might be prepared to pay for the production and analysis of information until it is "optimally informed" (and those costs are reasonably likely not to be in vain). In general, the firm invests in information gathering until the expected cost of further information gathering equals the expected marginal return from further information gathering).[66]

There are established tools and practices that can be used for such purposes.

10.3 Legal Tools and Practices: Investment in Information

10.3.1 General Remarks

The firm can reduce the risk inherent in investment in information production and analysis by: *screening* those situations; *controlling the flow* of information and ensuring that the firm achieves an advantage (for example vis-á-vis its contract parties or competitors); or ensuring that the firm receives *reimbursement* for the investment if the project fails to materialise or negotiations fail.

It is clear that the firm's compliance and risk management programmes should alert the firm to invest in the production and analysis of information when it is in the firm's interest to do so.

[66] Stigler GJ, The Economics of Information, The Economics of Information, J Pol Econ 69 (1961) pp 213–225.

In addition, measures to keep information confidential inside the firm and other measures that prevent others from using it can increase the rewards of investing in information (for keeping information secret, see section 10.5.2). The firm will also prefer to be able to use the information freely to its own benefit.

On the other hand, the firm should also filter situations where investment in the production and analysis of information would not be in the interests of the firm. For this purpose, various legal tools and practices have been designed.

10.3.2 Automation, Standardisation

Automation and standardisation require one-off costs. They can ensure that the necessary information will be available at a lower cost and without variation in later transactions.

The use of standard form contracts is an example of this form of information management (Volume II). For example, the use of standard form contracts can mitigate problems caused by the bounded rationality of the firm's own managers. Where the firm's managers typically price only certain circumstances in their decision-making, the firm can ensure that other circumstances and their effect on price have been addressed by the firm's standard terms and procedures.

10.3.3 Separate Decisions, Contracts

In separately negotiated contracts, the firm will take separate decisions on investment in information.

Choice of potential contract parties. The risk inherent in investment in information can be mitigated by screening for likely contract parties and increasing the likelihood of prospective contract parties reaching an agreement.

Usually, the firm can choose the parties it will do business with, the main rule being that the firm does not have a duty to contract.

Sometimes the expected rewards of the transaction are so low that the firm must have a cost-effective and standardised screening device to separate preferred contract parties from unwanted ones. For example, the credit rating and past payment behaviour of potential contract parties can signal their future behaviour in the sale of goods (for customer credit management, see Volume III). In mass transactions or standardised transactions, the use of standard terms can help the firm to find those contract parties that, by agreeing to the standard terms, want to signal that they are willing and capable of complying with their terms. Generally, contract terms offered by the firm can function as a "self-selection" mechanism.[67]

Sometimes the expected rewards are so high that the firm can invest more in the screening of its potential contract parties. For example, venture capital firms and private-equity firms do plenty of research before entering into negotiations.

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[67] Rothschild M, Stiglitz JE, Equilibrium in Competitive Insurance Markets: An Essay on the Economics of Imperfect Information, Quarterly J Econ 90 (1976) pp 630–649.

In many cases, "cheap talk" is used during the "courtship" phase. Courtship at the most fundamental level is a process by which parties acquire and communicate information to each other in an attempt to discern whether the deal is one which they both wish to make and, if so, on what terms. Courtship is costly, and each party has an incentive to incur those costs if and only if doing so will increase the chances of a profitable trade. For the negotiations to proceed, it may therefore be necessary for the parties to communicate with each other about the chances of agreement.[68]

Step-by-step approach. The step-by-step approach used in major transactions is an example of how parties invest in information when it seems optimal to do so. During the course of negotiations, the parties may gradually become morally bound to reach an agreement. Likewise, the firm will invest in information and information revelation on a step-by-step basis.

Agreement to negotiate in good faith. The first step could be an agreement to negotiate in good faith. This obligation would be a moral one and it would not necessarily be legally enforceable.

From a contract law perspective, an express agreement to negotiate lacks the necessary certainty. In addition, an obligation to negotiate "in good faith" would not prevent a party from threatening to withdraw if the party is not offered terms better than those on the table.[69]

Confidentiality, stand-still clause. On the other hand, the firm will not want to reveal information if it can be used against it. In a major transaction, the parties therefore agree on binding obligations of confidentiality and non-disclosure (NDA, see section 10.5.2).

In corporate takeovers, a stand-still clause is a particular term to negotiate in good faith. Before granting a potential buyer access to due diligence material, the target usually requires the potential buyer to commit to a stand-still provision that prohibits the potential buyer from making an unfriendly bid during a certain period of time and thus prevents the potential buyer from using the information against the target. The purpose of a stand-still clause is to create a binding obligation (see Volume III).

Lock-out agreement. The parties can agree not to negotiate with anyone else (a lock-out agreement). For example, a buyer of property would find a lock-out agreement desirable where the buyer is, without considerable expenditure, unable to assess what he is prepared to offer for the potential seller's property. The buyer may be unwilling to incur this expenditure unless the buyer is assured that the property will not be disposed of before the buyer is in a position to make an offer for it.

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[68] Johnston JS, Communication and Courtship: Cheap Talk Economics and the Law of Contract Formation, Virg L R 85 (1999) pp 388–389.

[69] Smith J, The Law of Contract. Fourth Edition. Sweet & Maxwell, London (2002) pp 47–48.

However, lock-out agreements cannot prevent the other party from negotiating forever. A term specifying the duration of the agreement is therefore essential.[70]

Letter of intent. The next step could be a letter of intent. The purpose of a letter of intent depends on the case (see Volume II). A letter of intent usually signals the common intent of the parties to reach an agreement without creating any legal obligation to actually become bound by the agreement. Letters of intent belong to the most usual ways of reducing the risk inherent in investment in information.

Signing and closing. The separation of signing and closing is characteristic of major contracts in corporate finance law (see Volumes II and III). Signing signals deeper commitment to the conclusion of the contract than a mere letter of intent.

A large part of information will be produced and revealed after signing. The substance of that information will be one of the usual conditions precedent to closing. For example, the parties often agree that a due diligence will be carried out after signing and that an acceptable due diligence report will be a condition precedent to closing.

Termination fees. Termination fees are particularly used in the context of mergers and acquisitions. Submitting an offer or negotiating a merger can be extremely costly. In the US, the general practice in negotiations of friendly takeovers is for the target company to provide the acquirer with a lockup agreement that compensates the acquirer should the deal not be consummated.

Agreements on termination fees or break-up fees provide that the target will pay the acquirer a fixed amount of money in the event that the deal fails. Typical termination fees are set between 1% and 5% of the target's value.[71]

10.4 Legal Tools and Practices: Incoming Information

10.4.1 Introduction

The firm needs information which is both accurate and useful. This creates an agency problem for the firm. Legal tools and practices help the firm to manage agency relationships, with the firm as principal and members of the information delivery chain as agents. At a general level, the firm can choose its intermediaries and address agency problems by the choice of legal background rules and by private contracting in order to complement the legal background rules.

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[70] See Smith J, The Law of Contract. Fourth Edition. Sweet & Maxwell, London (2002) pp 47–48. In the English case of Walford v Miles [1992] 2 AC 128 (House of Lords), it was said that a term limiting the duration of the agreement to a reasonable time could not be implied.

[71] See Grosskopf O, Medina B, A Revised Economic Theory of Disclosure Duties and Break-up Fees in Contract Law, Stanf J L Bus Fin 13 (2007) pp 166–167.

10.4.2 Transfer of Risk

The risk inherent in information cannot be avoided as such, because all decisions on return and risk are based on information. Information risk can nevertheless be managed otherwise. For example, the firm can to some extent try to transfer the risk inherent in information.

A party that discloses information - an intermediary or a third party - can warrant its accuracy or usefulness. Such a warrant can be combined with a legally enforceable promise to pay a certain amount of money to the firm if the information does not meet the agreed criteria.[72]

When the information risk is transferred, the risk does not disappear as such, but it can change into a manageable counterparty risk. To what extent it changes into a counterparty risk can depend on what criteria the information should meet and the obligations triggered by the information not meeting the promised criteria.

The risk can also change into other types of risk. For example, when acquiring a company, the firm may not have sufficiently reliable and useful information about the product liability of the target company. The firm might try to avoid this risk by separating the hazardous part of the target company's business from the company and acquiring the less hazardous parts. In this case, part of the risk inherent in information would change into a legal risk: "Is this sufficient to avoid product liability?" The firm may also have information about the risk, in which case the risk again changes its nature. For example, a firm in the process of acquiring a company may have information about a product's warranty but not of its cost. This risk will then become an operational and legal risk.

10.4.3 Intermediaries, Improving Information Quality

The quality of information depends largely on the quality of intermediaries. In order to mitigate risk inherent in incoming information, the firm can pick an intermediary that can produce accurate information or verify it. The firm can also pick an intermediary that can determine what information is useful for the firm, produce useful information, or verify information produced and delivered by others as to its usefulness.[73]

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[72] See Easterbrook FH, Fischel DR, The Economic Structure of Corporate Law. Harv U P, The USA (1991) p 282.

[73] Hayek wrote: "But the 'man on the spot' cannot decide solely on the basis of his limited but intimate knowledge of the facts of his immediate surroundings. There still remains the problem of communicating to him such further information as he needs to fit his decisions into the whole pattern of changes of the larger economic system. How much knowledge does he need to do so successfully? Which of the events which happen beyond the horizon of his immediate knowledge are of relevance to his immediate decision, and how much of them need he know?" Hayek FA, The Use of Knowledge in Society, Am Econ R 35 (1945) pp 519–530.

The quality of information produced by these intermediaries depends on many things. Some of them relate to the intermediary, while others relate to the user and the information itself.

Quality of information – the intermediary. The quality of information depends on the intermediary in many ways. (a) The quality of information depends on the proximity of the intermediary to the topic: the general knowledge, skill and experience that the intermediary has. (b) It depends on the access of the intermediary to information, and this can depend on the intermediary's proximity either to the target or the firm. (c) It depends on the diligence of the intermediary. (d) It also depends on the self-interest of the intermediary and other constraints to the production and delivery of useful information. Any intermediary can be biased in the right circumstances. For example, a board member who is expected to benefit from a planned takeover personally may not be the right person to decide whether information about the target company is useful for the firm or not. - The firm can manage those things by the choice of intermediaries and by internal management practices.

Typically, supervisory authorities are relatively reliable intermediaries of information about the application of legal rules falling within their competence. However, the interpretation of laws is always flexible, the supervisory authority can sometimes be biased for conflicting policy reasons or otherwise, and the court can interpret the same provisions of law in another way.[74]

Quality of information – information, the user. Other things that the quality of information produced by intermediaries depends on relate to information and the user. Information is useful to users if it has certain qualitative characteristics. One can learn from accounting standards that the four principal qualitative characteristics are understandability, relevance, reliability and comparability.[75]

An essential quality of the information is that it is readily *understandable* by the user.[76]

To be useful, information must be *relevant* to the decision-making of the user. Information has the quality of relevance when it influences the economic decisions of the user by helping him evaluate past, present or future events or conforming, or correcting, his past evaluations. The predictive and confirmatory roles of information are interrelated. For example, information about the current level and structure of asset holdings of a target firm has value to the user when he endevours to predict the ability of the target firm to take advantage of opportunities and its ability to react to adverse situations.[77]

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[74] In Germany, a model term based on § 14 BGB-InfoV was not in compliance with the BGB. The Federal Ministry of Justice (Bundesjustizministerium) was for a long time unwilling to change it. This resulted in a legal chaos. See Carsten Föhlisch, Internethändler erhalten mehr Rechtssicherheit, FAZ, 19 March 2008 p 21.

[75] IASB Framework for the Preparation and Presentation of Financial Statements (April 2001), paragraph 24.

[76] IASB Framework, paragraph 25.

[77] IASB Framework, paragraphs 26–27.

The relevance of information is affected by its *nature* and *materiality*. Information is material if its omission or misstatement could influence the economic decisions of the user taken on the basis of the available information. Materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have if it is to be useful.[78]

To be useful, information must also be *reliable*. Information has the quality of reliability when it is free from material error and can be depended upon by the user to faithfully represent that which it either purports to represent or could reasonably be expected to represent.[79]

To be reliable, information must comply with the principles of faithful representation, substance over form, neutrality, prudence and completeness.[80] Information should be a *faithful representation* of that which it purports to portray.[81] If information is to faithfully represent the things that it purports to represent, it is necessary that such things are accounted for and presented in accordance with their *substance* and economic reality and not merely their legal form; the substance of transactions or other events is not always consistent with that which is apparent from their legal or contrived form.[82] To be reliable, the information must be *neutral*, i.e. free from bias. Information is not neutral if, by the selection or presentation of information, it influences the making of a decision in order to achieve a predetermined result or outcome.[83] *Prudence* is the inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty.[84] To be reliable, the information must be *complete* within the bounds of materiality and cost. An omission can cause information to be false or misleading and thus unreliable and deficient in terms of relevance.[85]

More than one intermediary. Because the quality of information depends on many things, one intermediary may not be enough. For example, there could be two intermediaries each close to opposite ends of the information delivery chain.

This can be illustrated by the existence of sell-side financial analysts and buy-side financial analysts.[86] Whereas buy-side analysts are typically more proximate to investors who are end-users of their recommendations, sell-side analysts are more proximate to issuers.

Another example is legal opinions in international transactions. Legal opinions are then typically requested by the firm's own lawyer and rendered by another lawyer who comments on the law of his own country. Without its own lawyer's help, it would be difficult for the firm to ask the right questions and understand the

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78 IASB Framework, paragraphs 29–30.
79 IASB Framework, paragraph 31.
80 IASB Framework, paragraphs 31–38.
81 IASB Framework, paragraph 33.
82 IASB Framework, paragraph 35.
83 IASB Framework, paragraph 36.
84 IASB Framework, paragraph 37.
85 IASB Framework, paragraph 38.
86 See, for example, Kuhnle H, Banzhaf J, Finanzkommunikation unter IFRS. Grundlagen, Ziele und Gestaltung. Vahlen, München (2005) p 53–54.

opinion that it receives (subjective usefulness, proximity to the end-user). Without the foreign lawyer's help, the opinion would not be as reliable (generic usefulness, proximity to the topic).

A third example is the use of many different intermediaries in takeovers. Before a takeover, managers of the acquirer know what the acquirer is trying to achieve. However, they probably do not know as much about the internal affairs of the target. The acquirer must therefore turn to an intermediary who has knowledge about the target. On the other hand, an external adviser who has studied the target in detail cannot read the minds of the buyer's managers and does not know for sure what kind of information they need. That external adviser may therefore not be the right intermediary to decide on the case-specific usefulness information.

10.4.4 Creating Incentives

The firm should pick intermediaries that have sufficient incentives to produce accurate or useful information. The choice of intermediaries can be complemented by the choice of a legal framework that provides for sufficient incentives. This legal framework can be based on legal background rules or contract terms.

Dealing with agency problems. The incentives that align the interests of each intermediary with those of the firm are basically the same as the incentives used when managing agency relationships or contractual relationships in general (see Chapter 6 and Volume II). There are nevertheless some specific aspects relating to the management of incoming information.

Verification, monitoring by a third party. Monitoring by a knowledgeable third party whose interests are aligned with the firm can provide an incentive to produce accurate or objectively useful information.[87] For example, technical, financial or legal specialists such as the firm's lawyers can be present in negotiations with somebody dealing with the firm, and the analysis of corporate financial information by an independent auditor whose interests are not aligned with those of that company's managers might create an incentive for managers to disclose accurate or objectively useful information.

Disclosure rules. Sometimes there is a mandatory disclosure system supported by laws that control the time, place and manner of disclosure. A mandatory disclosure system can: bring more information to the market or prohibit disclosure in some circumstances;[88] increase the number of intermediaries that produce and deliver information; and make intermediaries and information producers more accountable for the quality of their information. However, the quality of information disclosed under the mandatory disclosure system depends on the quality of the system and the required quality of the information to be disclosed.

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[87] See Easterbrook FH, Fischel DR, The Economic Structure of Corporate Law. Harv U P, The USA (1991) p 289.

[88] See *ibid*, pp 286–287, 298–299.

Contracts. Incentives to produce accurate or useful information can be created by legal background rules or through contracts. The benefits of legal background rules or contracts for the firm are increased if:

- the intermediary is responsible for the accuracy of information or another result rather than the mere standard of his work process (see Volume II);
- the intermediary's work process must comply with high rather than low standards;
- the duties of the intermediary are owed to, or protect, the firm in particular rather than the market or a category of users in general;
- the duties are complemented by efficient sanctions for breach of duty;
- sanctions for breach of duty can be enforced by the firm at low cost;
- the firm does not have to prove the intermediary's fault;
- the elements of the liability claim (usually breach of duty, fault, damage and causation) are easy to prove, or there is a legal presumption that they are fulfilled, or the burden of proof is on the intermediary, or the liability of the intermediary is strict; and
- there is no express limitation of liability, and the liability of the intermediary is not limited by elements of the liability claim that are difficult to prove.

There are different legal background rules for different categories of contractual relationships. The reliability of information depends on such background rules, and background rules must be taken into account before the firm can choose contract terms that increase the reliability of information.

This can be illustrated by the liability of statutory auditors to third parties such as the audited company's investors, and with the sale of movable goods.

Example: statutory auditors. For several reasons, it can be difficult for a person to make a company's statutory auditors liable for breach of duty. For example, statutory auditors are responsible for their work process rather than the result, audit standards do not require statutory auditors to inspect everything, the aggrieved party may have to prove the existence of fault and other elements of the liability claim, the duties are not necessarily "owed" to the aggrieved party, and the civil liability of statutory auditors has been limited in various other ways (see section 10.7.6).

In order to create better legal incentives for the auditor to provide accurate and useful information, the firm should conclude a specific individually negotiated contract with the auditor (as opposed to a fictive contract or no contract) and regulate the quality of information and the sanctions for breach of duty privately. Such contracts can sometimes be found in acquisitions and large financial transactions.

Example: sale of goods. This can be contrasted with a contract for the purchase of movable goods. If the firm buys movable goods on the basis of information received from the seller's representatives, it could be sufficient for the firm to agree on the specifications of the goods. It is usually not necessary to agree on information as such. (a) The seller is responsible for a result: the delivery of goods that are of the agreed quality. (b) The standards applied by the seller do not decrease this

obligation but may influence the extent of liability for damage in some jurisdictions. (c) It is clear that the duties of the seller are owed to the buyer. (d) These duties are complemented by established sanctions for breach of duty. (e) These sanctions protect the seller. (f) Generally, the buyer does not have to prove the existence of fault. (g) However, the buyer must be able to prove breach of duty, damage, and causation. (h) There is no cap on the liability of the seller. The extent of liability may nevertheless depend on the nature of the breach and the extent of fault.

Incoming information policy. Finally, the firm can adopt its own incoming information policy, screen intermediaries and contract parties, and refuse to do business with parties that do not provide information fulfilling the required criteria. In some cases, there can also be a legal duty not to do business with customers that do not provide sufficient information.[89]

10.4.5 Screening of Potential Intermediaries

The firm can use legal tools as a screening device to make intermediaries signal that they produce accurate or useful information.

Ability and incentives. As explained above, the quality of information produced by these intermediaries depends on many things. The intermediary should generally have the general knowledge, skill and experience required for the work and incentives to do a good job. These questions have been discussed above.

Certification. A usual way to signal those qualities is to use a certification device. There are different kinds of certifications.

Some are legal requirements. This device has heavily been influenced by Community law. Community law requires certification in many industries ranging from auditing and financial services to dentistry. For example, in order to facilitate the free movement of professionals, Community institutions have adopted two parallel sets of rules for certain activities: one to coordinate the training required by the various Member States for taking up and pursuing the activity in question, and the other to govern the mutual recognition of the diplomas awarded at the conclusion of such training. The same principle has been applied in order to facilitate the freedom to provide services and freedom of establishment. Many activities require authorisation by the supervisory authority, but the authorisation will be recognised in the other Member States.

Warranties. The firm can use a warranty device. The firm can require producers of information or information intermediaries to give a warranty for the information that they produce. This warranty can be based on statutory rules and apply as an implied contract term, or it can be an express contract term. If the warranty is binding, easily enforceable, and complemented by effective sanctions for its breach, the intermediary has an incentive to give accurate information.

However, the warranty is weak if it only applies to the work process of the information producer or intermediary and not to the accuracy or usefulness of in-

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[89] See, for example, § 18 of the Kreditwesengesetz in German law.

formation as such. For example, lawyers, tax advisers, and doctors are unlikely to guarantee that what they say will actually happen. There is a distinction between liability for the result of work done by a party and liability for the work process of a party.[90] At best, many intermediaries only have a duty to comply with a due work process.

Compliance with standards. The existence of standards can increase the reliability of information.The firm can check whether the information producer has a duty to comply with high-level standards.

Standards can range from technical standards to mandatory disclosure rules. Some standards are legal rules laid down by the state. The fraud rule is an example of a standard based on law.

Other standards are voluntary codes based on industry self-regulation or contract. Contractual warranties are an example of contractual standards. The self-interest of a party to comply with different standards may vary because the incentives to comply with them and sanctions for their breach vary.[91]

Sometimes there are de facto behavioural standards based on warranties for information, warranties for the work process of information intermediaries, or mere commercial pressures.

Problem with standards. On the other hand, standards can also decrease the reliability of information.

For example, the work processes of a big auditing firm are highly standardised, because a high level of internal standardisation and compliance with those internal standards is a way to signal due care and mitigate liability risk. However, standardisation can also act as a cap. The existence of detailed internal standardisation that is perceived as mandatory means that auditors are less likely to exceed it.[92]

There are also de facto standards that can decrease the reliability of information, because information intermediaries can be inclined to do what other information intermediaries would do in the same situation. If the party is "an information intermediary in Rome", the party thus does "what Roman intermediaries do". Not doing so would make the intermediary stand out from the crowd and increase the risk of personal liability, loss of income, or other negative incentives. For example, professional analysts and investors contributed to inflated market values of internet companies during the dot-com bubble in the 1990s, and financial advisers contributed to investors' exposure to high risks in their share investments.

Verification by the firm. Some producers of information and information intermediaries permit the firm to verify information as to its accuracy.[93] Although their refusal to do so may help the firm to identify parties whom it might not want to

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[90] In German law, "Werkvertrag" (§ 631 BGB) and "Dienstvertag" (§ 611 BGB).

[91] See Easterbrook FH, Fischel DR, The Economic Structure of Corporate Law. Harv U P, The USA (1991) p 282.

[92] For German scandals like FlowTex (KPMG), Balsam (Price Waterhouse), Phoenix (Ernst & Young) and Sachsenring (Ernst & Young), see Wassermann A, Diletanttische Fälschung, Der Spiegel 44/2007 pp 112–114.

[93] See Easterbrook FH, Fischel DR, The Economic Structure of Corporate Law. Harv U P, The USA (1991) p 284.

trust, permission to verify information does not always say much about the quality of the information as such.

Only a limited amount of information can be verified at all. For example, the firm should separate statements of historical fact from statements that predict the future.[94] In addition, sometimes information about the target cannot be verified without the consent of the target. For example, the verification of information in the course of a takeover can require the carrying out of a due diligence in the target company and the target's consent.

Fraud rule not enough. The fraud rule is not enough as a screening device. There is usually a mandatory legal rule against fraud. If the fraud rule can be enforced effectively by others or by the firm at low cost, it decreases the likelihood of outright fraud.[95]

Even if enforced effectively, the fraud rule would not force information intermediaries to produce useful information, and the mere fact that information is not true does not necessarily amount to fraud. For example, the lack of accuracy can be caused by the ignorance or incompetence of the intermediary, in which case the fraud rule would not apply.[96] Sometimes the fraud rule does not apply as effectively to silence and passivity.[97]

10.4.6 Identifying Good Intermediaries

Intermediaries that can be asked to produce useful information or verify information as to its usefulness should fulfil certain additional criteria, because these intermediaries need information about the firm. These intermediaries can range from the firm's own managers and employees to external experts such as lawyers and tax advisers.

Generic usefulness. Where the intermediary verifies information as to its generic usefulness, the intermediary needs less detailed information about the firm. For example, experienced legal and tax advisers and similar technical experts can sometimes give sufficient opinions on narrowly defined questions although they have limited information about the firm.

Case-specific or subjective usefulness. On the other hand, where the intermediary verifies information as to its case-specific usefulness or subjective usefulness, the intermediary needs more detailed information about the firm. Usually, the firm's own managerial team has the best information about what information is necessary for the firm's financial decision-making. The managerial team has the best information about the subjective usefulness of information, i.e. whether the information is what the firm has requested. On the other hand, the firm may sometimes need external advisers to verify the case-specific usefulness of information.

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[94] See *ibid,* p 285.
[95] See *ibid,* p 283.
[96] See *ibid,* p 289.
[97] See *ibid,* p 284.

In both cases, at least the following two things should influence the choice of intermediary in addition to the things listed above.

Protection of confidential information. First, the firm's trade secrets should remain confidential. The firm would probably prefer not to disclose too much information to external intermediaries, because information disclosed to outsiders can later become available to its rivals or the public.

If it is necessary to use external intermediaries, they can signal their reliability by agreeing to sufficient fiduciary duties and a duty neither to reveal information nor use it other than for the purposes of the contract concluded with the firm. Some of these duties are based on law. For example, law firms typically owe fiduciary or similar duties and a duty of confidentiality to their clients in the Member States of the EU. These duties can also be based on contract. Non-disclosure agreements are very often used in large investment transactions or transactions involving the know-how and business secrets of the firm.

The firm can mitigate the risk of the intermediary abusing information about the firm by choosing an intermediary that has effectively separated these information services from other services that it supplies to the firm. Fiduciary duties and duties of confidentiality can be complemented by statutory or contractual obligations to operate Chinese walls.[98]

Whereas some of these intermediaries are external, most intermediaries that are asked to produce useful information, or verify information as to its usefulness, can be found inside the firm. For example, members of the statutory board usually owe fiduciary duties, duties of loyalty and related duties to the firm. These are imposed on board members by law and cannot easily be excluded by agreement. Sometimes senior executives owe related duties to their employer. If not, these persons can signal their reliability by agreeing to a non-disclosure agreement and to fiduciary or related duties.

Credence goods. Second, some of these intermediaries could be regarded as suppliers of credence goods.[99] For example, a limited-liability company will never be able to choose only those separate acts or transactions that are good for its business, because the choices are made by its organisation, in particular by its top management and suppliers of credence goods.

There are some ways for the firm to identify the intermediaries that can produce useful information or verify information as to its usefulness, even though such intermediaries are simultaneously time suppliers of credence goods. The firm can make sure that its intermediaries have the same one-off incentives to provide useful information regardless of the contents of their advice (a typical example being a flat fee for all services) and better long-term incentives if it later turns out that the advice was of good quality.[100] These methods have been applied, for example,

[98] Chinese walls are not always effective. See section 10.5.2 and The price of atonement, The Economist, November 2002.

[99] See generally Dulleck U, Kerschbamer R, On Doctors, Mechanics and Computer Specialists: The Economics of Credence Goods, March 2006.

[100] Analysis paralysis, The Economist, December 2005.

in investment research[101] and in investment advice. For example, an investment adviser can signal its independence from issuers by charging a flat and low monthly fee for its services and by transferring to its customers all fees that it has received from issuers. The investment adviser can try to signal that its long-term financial incentives have been aligned with the interests of its customers by using contract terms that give the investment adviser a share of profits that exceed a certain threshold during a certain period of time that is not too short.[102]

For credence goods, the firm can generally rely on a third party to provide truthful information to the firm about their quality. For example, third party certification is one way in which unobservable credence attributes can be transformed into observable search attributes.[103]

Example: takeover advice as a credence good. Takeovers provide a typical example of problems caused by many information producers and intermediaries being suppliers of credence goods. Mergers and acquisitions can be in the interests of both investment banks and those managers who push for them.

M&A is a way for investment banks to reap rich fees, because: both parties need advice (see Volume III);[104] both parties must comply with formalities and disclosure obligations; at least the acquiring company needs funding; and the target may need to enforce takeover defences.

Managers of the acquiring company may benefit from M&A because it gives them a chance to lead a larger firm, enhance their reputations, or be better paid. There can also be other reasons.[105]

Managers of the target may have concluded employment agreements that give them a right to golden parachute payments triggered by change of control. If the target is listed and its managers hold share options, managers can also take profits from the premium paid by the buyer straight away rather than having to wait for options to mature. IPOs can create similar problems.[106]

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[101] Unsettling, The Economist, May 2003.

[102] See, for example, Konfliktfreie Beratung vom Turnschuh-Banker, FAZ, 2 December 2006 p 23.

[103] See Auriol E, Schilizzi SGM, Quality Signaling Through Certification: Theory and Application to Agricultural Seed Markets' , Institut d'Économie Industrielle (IDEI), Toulouse, IDEI Working Papers 165 (2003).

[104] In England, the Takeover Code requires the offeree and, in some cases, the offeror to obtain independent advice in the context of public takeovers. Rule 3 of the Takeover Code.

[105] Learn as you churn. An acknowledged master at takeovers, The Economist, April 2006: "GE spends a lot of time looking for the reasons why deals fail. Unerasable from the corporate memory is the disaster of Kidder Peabody—a 1990's foray into the impermeable culture of investment banking. Jack Welch, the short, balding GE boss responsible for the deal, said later, 'I didn't know a diddly about it. I was on a roll. I thought I was six-foot-four with hair.' Acquirers can learn few more important lessons than managers' propensity to overestimate their own ability."

[106] The value of trust, The Economist, June 2002: "There is no doubt that Wall Street gave investors an unprecedented amount of bad advice; that those dispensing it often had an inkling that the firms they touted were probably overvalued; and that they had strong incentives to err on the bullish side."

In these situations, the information should preferably be verified as to its usefulness by a person whose incentives are the same, regardless of the content of her advice.

10.4.7 Identifying Bad Incentives

The firm cannot remedy the lack of sufficient incentives to produce accurate or useful information, unless it can identify intermediaries that lack those incentives. Generally, the firm should assess the self-interest of information intermediaries to disclose accurate and useful information to the firm.

Management. The firm can cure the lack of sufficient incentives to produce accurate or useful information: by choosing better incentives; by choosing a better intermediary; and/or through internalisation. Internalisation can be necessary, for example where it is not possible, except at great cost, for an outside intermediary to establish accurately what has happened after the fact.[107]

Examples. There are many examples of the lack of sufficient incentives and the existence of a moral hazard. They range from the lack of responsibility (sanctions) to incentives not to produce accurate or useful information.

Lack of responsibility. Sometimes the intermediary cannot be made responsible for information that it has produced. (a) Contractual limitations of liability can decrease the reliability of information.[108] These limitations can also take the form of restrictions on the enforcement of claims and include severe prescription rules,[109] restrictions on the actionability of claims, or restrictions on the right to sue. (b) It is possible that legal background rules protect only some categories of users but not all users, and legal background rules that, in principle, do protect the user category to which the firm belongs may, in practice, make it very difficult for the firm to enforce its rights (see above). (c) The lack of the rule of law has the same effect.

Standardisation of the form and content of disclosure. Rules on the disclosure of information to the public can result in the standardisation of the form and content of information disclosed to the firm. Compliance with disclosure rules can reduce information producers' risk but make information less useful,[110] if disclosure rules do not guarantee a high level of usefulness and the purpose of the form and

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[107] Williamson OE, The Vertical Integration of Production: Market Failure Considerations, Am Econ R 61(2), Papers and Proceedings of the Eighty-Third Annual Meeting of the American Economic Association (May 1971) pp 112–123: "The advantages of internalization reside in the facts that the firm's ex post access to the relevant data is superior, it attenuates the incentives to exploit uncertainty opportunistically, and the control machinery that the firm is able to activate is more selective ..."

[108] See Easterbrook FH, Fischel DR, The Economic Structure of Corporate Law. Harv U P, The USA (1991) p 308.

[109] See, for example, Bayerns Standortvorteil für Anlagebetrüger, FAZ, 9 August 2006 p 17.

[110] See Easterbrook FH, Fischel DR, The Economic Structure of Corporate Law. Harv U P, The USA (1991) p 308.

content of disclosure is compliance rather than fulfilling the users' information needs. Disclosure rules can lead to the disclosure of too much or irrelevant information, or the disclosure of more or less standardised blocks of text that provide no new or meaningful information.

For example, the purpose of the "safe harbour" provisions of the US Private Securities Litigation Reform Act of 1995 is to encourage companies listed in the US to identify important factors that could cause actual results and outcomes to differ materially from those contained in any forward-looking statement made by the company. It is nevertheless normal to disclose generic facts that add little new.

A US company in the food industry might identify the following factors which mostly belong to common knowledge: "Each of the company's segments is subject to intense competition, changes in consumer preferences, the effects of changing prices for its raw materials and local economic conditions. Their results are dependent upon their continued ability to promote brand equity successfully, to anticipate and respond to new consumer trends, to develop new products and markets, to broaden brand portfolios in order to compete effectively with lower priced products in a consolidating environment at the retail and manufacturing levels, and to improve productivity. The company's results are also dependent on its ability to consummate and successfully integrate acquisitions. In addition, the company is subject to the effects of foreign economies, currency movements and fluctuations in levels of customer inventories. The company's benefit expense is subject to the investment performance of pension plan assets, interest rates and cost increases for medical benefits offered to employees and retirees. The food industry continues to be subject to recalls if products become adulterated or misbranded, liability if product consumption causes injury, ingredient disclosure and labeling laws and regulations and the possibility that consumers could lose confidence in the safety and quality of certain food products. Developments in any of these areas could cause the company's results to differ materially from results that have been or may be projected by or on behalf of the company. The company cautions that the foregoing list of important factors is not exclusive."

Incentives not to produce accurate or useful information. The disclosure of accurate or useful information by an intermediary can be hampered if the intermediary has strong incentives not to do so.

For example, some intermediaries belong to a class of experts who not only provide a service but also tell the customer what service the customer needs. Customers take it on faith that the expert has given them what they need. The services of these experts are therefore known as "credence goods". The suppliers of credence goods have an incentive to give customers more than they need.

There can also be other conflicts of interest between the intermediary and the firm.

During the stockmarket bubble, equity analysts at many Wall Street investment banks were paid to tout new issues that their banks' corporate-finance departments were managing, and some investment bankers abused privileged information and misled clients on new-share sales (initial public offerings, or IPOs).

Bias. Different intermediaries can be biased in different ways, because each intermediary may have its own objectives and incentives. For example, lawyers are

typically more risk averse than managers are. Whereas managers have been trained to identify opportunities and to maximise the potential upside, lawyers are trained to focus on risk management, minimising the potential downside. [111]

10.4.8 Being Optimally Informed

In information economics, being optimally informed is connected to marginal cost and benefit. This definition can here be complemented by other interests of the end-user. To what extent the information user is optimally informed can be determined in the same way as the quality of information.

Like the usefulness of information, the possession of optimal information can be assessed in three ways, and there are at least three levels of being optimally informed: objective and generic; objective and case-specific (with the difference between these categories a continuum rather than strict); and subjective and perceived.

In addition, the circumstances under which the information user is optimally informed depend on the identity of the information user. For example, there can be a difference between when the firm is optimally informed and when its managers are optimally informed in their personal capacity. As regards the firm, being optimally informed is ultimately decided on by "the man on the spot" (section 10.2.2). On the other hand, "the man on the spot" needs to determine whether he is optimally informed as regards his own interests.

This can lead to an agency problem for the firm and influence the legal tools that the firm uses when determining when it is optimally informed.

Optimally informed firm. The firm should make sure that the information user whose being optimally informed is assessed is the firm rather than "the man on the spot" in his personal capacity. How to organise this is a question of operational risk management (section 7.3).

Determining the extent of optimal information requires a cost/benefit analysis. For example, potential contracting parties are not prepared to invest in feasibility studies and other information-generating activities to ensure that they have provided for every possible eventuality, because the number of eventualities is infinite.

It is always in the interests of the firm to focus on all reasonably likely eventualities that can put the survival of the firm at risk, and other reasonably likely eventualities that can cause the firm major harm.

The large number of similar transactions can multiply the effects of the eventuality where all transactions are affected by the same eventuality. For example, the death of one patient can force a pharmaceutical firm to withdraw a drug from the market, if the drug can kill many patients. In this case, the eventuality can cause the firm major harm.

On the other hand, sometimes the firm needs less information about individual transactions, because the risk relating to individual transactions is mitigated by the

[111] Bagley CE, Winning Legally. Harv Bus S P, Boston (2005) p 7.

large number of similar transactions. The impact of the eventuality is smaller if it affects only one transaction of many at a time. The insurance industry is based on this principle.

Sometimes the cost of information-generating activities would be too high or the benefits too small. For example, revealing the potential disruptive effect of some future eventuality can be beyond the state-of-the-art and available technology. Another example is the quality of sold goods that can be replaced at minimal cost. It can be cheaper for the seller to replace defective goods afterwards with new goods than invest in the inspection of goods.

Sometimes it is easier, cheaper and more equitable to adjust the parties' contractual relationship than to invest in information-generating activities. For example, extensive geological surveys can be carried out to identify possible oil reserves or the condition of land in a construction site. Yet, upon the commencement of drilling or construction, a contractor may discover dry wells or swamps beneath hard earth surfaces. From a cost/benefit analysis, it can be better to address this eventuality in the contract.[112]

Optimally informed managers. Many legal rules focus on the information that individual managers, board members or "people on the spot" have. For this reason, these members of the firm's organisation can have a bias to determine the level of being optimally informed from their own perspective rather than from the perspective of the firm. This risk is higher where those rules are effective in guiding their behaviour.

Management of agency problems. The difference between the optimally informed firm and optimally informed managers can increase agency costs. Agency costs are increased especially where compliance with the duties that managers owe personally requires less information than what the firm would need in order to be optimally informed.

This problem can be mitigated by aligning managers' duties with the information needs of the firm. For example, in takeovers, the boards of the participating companies may have a duty to obtain independent advice (see Volume III). In this case, the firm can mitigate risk by ensuring that the firm's status of being optimally informed is assessed from the perspective of the firm by an intermediary that is free from a similar bias.

Typically, in order to comply with their duty of care, board members should take into account whether the firm is optimally informed. This is because the modern duty of care lays down an objective standard.[113] When doing so, they

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[112] Sharma KM, From "Sanctity" to "Fairness": An Uneasy Transition in the Law of Contracts? NY L School J Int Comp L 18 (1999) pp 142–143.

[113] For example, Hoffmann LJ said in the English cases of Norman v Theodore Goddard (as Hoffmann J) and Re D'Jan of London Ltd that a director's duty of care could be defined as the conduct of "a reasonably diligent person having both (a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to the company, and (b) the general knowledge, skill and experience that that director has". Norman v Theodore Goddard [1992] BCC 14; [1992] BCLC 1028. Re D'Jan of London Ltd [1993] BCC 646; [1994] 1 BCLC 561.

should also take into account the quality of information intermediaries. This can be illustrated by two famous cases from the US, *Smith v. Van Gorkom*[114] and *Hanson Trust v. ML SCM Acquisition.*[115]

In *Smith v. Van Gorkom*, the Delaware Supreme Court held outside directors liable in damages for approving the sale of the corporation at a fifty per cent premium over the stock market price. Why was this? The duty of care requires fiduciaries to be informed. They may not blindly rely on what they are told by other managers or even by experts. In this case, board members had failed (1) to require an independent valuation of the corporation or, alternatively, a reliable post-signing "market-check"; (2) to obtain an adequate "no-shop" clause that enabled the board to consider higher bid offer and gave the board a reasonable basis to terminate the agreement; and (c) to employ a monitoring and decision-making process that was not controlled by the corporation's CEO. This amounted to gross negligence.[116]

In *Hanson Trust v. ML SCM Acquisition*, a Goldman Sachs partner told the directors of SCM that an option being given Merrill Lynch to buy two of SCM's divisions was priced at fair market value. The directors never asked why the two divisions – which they knew contributed two-thirds of SCM's total earnings – were being sold for less than one-half of the total purchase price for all of SCM. Had they asked, they would have learned that the Goldman partner had not actually calculated fair value and was talking off the cuff. The US Court of Appeals for the Second Circuit ruled that the directors were derelict in exercising their duty of care. Similarly, the SEC has cautioned directors that they cannot blindly accept assurances from company counsel that certain information may be excluded from a proxy stament or other SEC filing.[117]

10.4.9 Mitigating the Risk of Attribution of Information

All the above situations deal with the case that the firm wants to obtain useful information. Sometimes the firm does not want to become legally responsible for knowing something. At least the firm wants to control the information that is attributed to it (for the management of communication, see also section 10.5.6 below; for the representation of the firm, see section 7.5 above and Volume II).

Constructive knowledge. If the firm is legally deemed to have knowledge about a thing anyway, the firm should in fact try to have knowledge of that thing in order to mitigate legal risk.

There can be legal rules that set out what the firm is deemed to know. "Constructive knowledge" means a legal fiction that a person knows something. It is usually applied to information filed with a public register and disclosed to the public. It is also applied to law, because it is axiomatic that ignorance of law is no defence (ignorantia juris non excusat).

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[114] Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

[115] Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264 (2d Cir. 1986).

[116] Allen WT, Jacobs JB, Strine LE Jr, Realigning the Standard of Review of Director Due Care with Delaware Public Policy: A Critique of Van Gorkom and its Progeny as a Standard of Review Problem, Nw U L R 96 (2002) p 458.

[117] Bagley CE, Winning Legally. Harv Bus S P, Boston (2005) p 59.

Attribution. Generally, the problem of being deemed to know something is made worse because the firm has an organisation. The organisation of the firm consists of many people, each different in terms of knowledge, skills, experience, and legal status. Few of them are members of the company's statutory bodies. Most of them work below board level in different divisions of the firm and at different levels of hierarchy. Information in one spot of the firm (one person, one division, one level of hierarchy) is not necessarily available elsewhere in the firm (other persons, other divisions, other levels of hierarchy), but it may be attributed to other parts of the firm or the whole firm under the applicable laws depending on the circumstances. Information that the firm has can be in the possession of people who belong to the broader network of the firm (legal advisers, commercial agents, other network partners).

Unless the transaction is an automated mass transaction, a party is likely to deal with a firm through a person representing it. As information, skills and knowledge are not distributed evenly in the firm, one may ask what information, skills and knowledge are attributable to the firm when someone deals with it through one representative, a frontline contact person. Are the skills and knowledge of the firm determined on the basis of what skills and knowledge the firm has at the spot where someone deals with the firm, are they determined on the basis of the skills and knowledge of other people within the organisation of the firm, or objectively on the basis of the characteristics of the firm and the nature of its business?

Laws. States can address these questions in many ways. As explained above, there can be a legal fiction that the firm or its representatives know something. For example, the firm can be deemed to have constructive notice of a matter although its representatives do not have notice of it in fact.[118]

Alternatively, states can choose a strict liability regime according to which a legal entity is responsible for certain things regardless of the skills and knowledge of the person through whom the third party dealt with it. Strict liability regimes are typically based on mandatory law. A strict liability regime can take the form of a clear statutory obligation, an implied contract, or a duty of care combined with such a presumption of liability that can in practice seldom be rebutted by the firm.

This can be illustrated by the civil or criminal liability of a limited-liability company under English law. The relevant legal principles governing the circumstances in which a company can be held civilly or criminally liable for the acts of individuals and for their state of knowledge were explained by Lord Hoffmann in *Meridian Global Funds Management Asia Limited v Securities Commission*.[119] Those principles were applied in *Bank of India v Morris & Ors*[120] when interpreting section 213 of the Insolvency Act: "We would summarise our conclusions on the issue of attribution as follows. First, the proper approach to the

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[118] For legal problems, see, for example, Hoffmann LJ in El Ajou v Dollar Land Holdings Ltd [1994] BCC 143, [1993] EWCA Civ 4, [1994] 2 All ER 685; Infiniteland Ltd and another v Artisan Contracting Ltd and another [2005] EWCA Civ 758, [2006] 1 BCLC 632.

[119] Meridian Global Funds Management Asia Limited v Securities Commission [1995] 2 AC 500 (Privy Council).

[120] Bank of India v Morris & Ors [2005] EWCA Civ 693.

question of attribution in this case turns on the construction and purpose of section 213. Secondly, the severing of criminal and civil liability for fraudulent trading means that there is no question of any conclusion, in principle or on particular facts, as to civil liability affecting the basis on which criminal liability is assessed. Thirdly, the wording of, and policy behind, section 213 indicate that it would be inappropriate, in the case of a company, to limit attribution for its purposes to the board, or those specifically authorised by a resolution of the board ... Fourthly, it would be wrong, on the other hand, to attribute to a company the knowledge of any agent irrespective of the particular facts. To do so would risk obvious injustice to a company which had acted not only in good faith, but with scrupulous care; that would not accord with the purpose of section 213. Fifthly, it therefore must to some extent depend on the facts of each particular case whether an agent's knowledge should be attributed to the company for the purposes of section 213, where the circumstances are such that there would be no attribution on the application of the primary rules. We are of the view that it must typically depend on factors such as these. The agent's importance or seniority in the hierarchy of the company: the more senior he is, the easier it is to attribute. His significance and freedom to act in the context of the particular transaction: the more it is 'his' transaction, and the more he is effectively left to get on with it by the board, the easier it is to attribute. The degree to which the board is informed, and the extent to which it can be said that it was, in the broadest sense, put on inquiry: the greater the grounds for suspicion or even concern or questioning, the easier it is to attribute, if questions were not raised or answers were too easily accepted by the board."

Management of attribution. Part of the management of risk inherent in information is therefore to manage the attribution of information to the company.

First, if there is a legal fiction that the firm knows something, the firm should ensure that the people who need to have knowledge of the matter actually do so. The problem of attribution is not limited to the board but covers the whole organisation of the firm.

The firm should also introduce internal policies that address the risk of constructive notice. Constructive notice typically cannot be organised away. The firm should ensure that it has actual notice of matters that it is deemed to have constructive notice of.

Second, the firm typically manages the risk that the firm is deemed to know something in distinct areas such as competition law by using compliance programmes (see section 4.3.3). The introduction of compliance programmes that are effectively enforced can signal to outsiders, such as counterparties or the court, how information is allocated inside the firm. Compliance programmes are in practice always necessary where the firm is subject to a strict liability regime.

Third, as the attribution of information is caused by the fact that the firm has an organisation, the firm can mitigate this risk by changing the structure of its organisation. In this respect, the firm can use legally independent units. This can make it more difficult for the court to attribute information, skills and knowledge found in other subunits of the firm to the subunit that the third party dealt with.

Fourth, the firm can organise the work of people who belong to its organisation, control access to the information delivery chain, and signal it to outsiders. There is a risk that people who come into contact with the information delivery chain (either with members of the information delivery chain or with information flows) or have access to it are deemed to possess that information. The firm can mitigate

this risk by: introducing Chinese walls; limiting access to information only to those managers and employees that need that information; and keeping different activities physically in different premises (for keeping information secret, see section 10.5.2 below).

Fifth, the firm can channel external contacts that belong to a certain category always to the same spot in the organisation, a certain frontline contact person. This can decrease the involvement of unauthorised or unqualified representatives. The firm can achieve this, for example, by using internal guidelines, a hierarchy with exact job descriptions, an effective physical infrastructure, or a website. For example, a customer can easily be guided to pay at the cashier in a department store. In an industrial firm, a customer account manager can be assigned for each large customer.

Sixth, sometimes the firm can agree with its contract party how information is transferred between the parties and what procedure one party must follow if it wants information to be attributed to another party (section 10.5.6). This may be necessary, where the parties must co-operate for a certain period of time and many people from the firm's organisation may come into contract with the other party. In transactions between many parties, it is usual to appoint an agent who is authorised to receive information on behalf of the parties and distribute it to the other parties.

10.5 Legal Tools and Practices: Outgoing Information

10.5.1 Introduction

The control of outgoing information flows is an important part of the management of all firms. The firm produces and discloses information in many ways and in different contexts. It produces information not only actively but also passively in the course of its normal business. Compared with other economic agents, the firm typically possesses some superior information that it wants to use to its own benefit (Coase).

The firm has five main objectives regarding outgoing information: (1) keeping information secret; (2) benefiting from superior information; (3) increasing the perceived usefulness of information for others; (4) managing its reputation; and (5) establishing or restricting communication.

The legal background rules are complicated. (a) From a legal perspective, the firm can be represented by different intermediaries. Depending on the circumstances, each intermediary can have: a right to disclose information, a duty to disclose information, or a duty not to disclose information. These rights and duties can typically be based on different legal sources (for example, contract law, company law, securities markets law, or criminal law) depending on who the intermediary is and who the party to whom information is disclosed is. (b) Again depending on the circumstances, other parties than the firm may have: a right to ask for information, a right to have information disclosed to them, a duty to ask for infor-

mation, a duty not to ask for information, or a duty not to use information received. Even these rights and duties can typically be based on different legal sources depending on who that other party is and the circumstances. (c) For this reason, the analysis of the legal rules governing outgoing information always depends on the identity of two persons: the person by whom disclosure perhaps could be made and the person to whom disclosure perhaps could be made.

The firm can influence the legal framework governing outgoing information by: organising information flows (and choosing the parties that disclose or receive information); adopting internal guidelines (for example, a compliance programme for use in all countries where the firm does business); contracts (that set out the contractual framework for outgoing information flows in all countries where the firm does business); and adapting to the legal framework that best serves its interests where it cannot choose the legal framework as such.

The firm should of course manage the agency relationship between the firm as principal and its representatives as agents. For example, the firm should apply effective internal controls to ensure compliance with laws and its internal guidelines. The management of agency problems has already been discussed above.

The firm should also manage the agency relationship between the firm as agent and its stakeholders as principals. In order to reduce cost, the firm should increase the perceived usefulness of information received by its stakeholders.

10.5.2 Keeping Information Secret

Introduction

The firm needs to protect its know-how and other confidential information. As the firm can produce and be forced to disclose information in very many ways and in different contexts, the range of legal tools and practices that help the firm to keep information secret is very wide. The firm can keep information secret inside the firm and make its business partners keep information secret.

Bargaining power. Superior information and know-how can give the firm an advantage vis-à-vis competitors and increase the firm's bargaining power vis-à-vis contract parties. Bargaining power may be defined functionally by how the parties split the surplus from trade. On this definition, the larger a party's proportionate share of the surplus from trade, the greater the party's bargaining power. Private information can be a source of bargaining power.

For example, a buyer that has private information regarding the value of an asset can capture a larger share of the surplus from cooperation with the seller even where the seller has a strong market position.[121]

Revealing information could therefore impair the firm's competitive advantage and decrease its bargaining power. In addition, if the information is likely to be

[121] Johnston JS, Communication and Courtship: Cheap Talk Economics and the Law of Contract Formation, Virg L R 85 (1999) p 426.

revealed to competitors and potential contract parties anyway, the firm may not have a sufficient incentive to invest resources in its production and analysis in the first place.[122]

Excursion: contextual integrity. On the other hand, it is clear that the firm will not want complete secrecy. A philosophical theory called contextual integrity (Helen Nissenbaum)[123] helps to describe to what extent the firm will accept disclosure. According to the contextual integrity theory, people do not require complete privacy. They will share information with others as long as certain social norms are met.

Number of norms. There are numerous possible sources of contextual norms governing the duty not to disclose information: some of them are legal norms. It is impossible to list them all. In any case, there are some information norms in the context of corporate finance that are both well-known and quite specific.

Keeping Information Secret Inside the Firm

The most important decisions influencing how the firm can keep information secret inside the firm are: (1) incorporation; (2) the choice between being listed or privately-owned; and (3) the adoption of internal compliance programmes, disclosure policies, and trade secret programmes.

Incorporation. The firm can choose in what jurisdiction to establish a business entity and the form of that business entity.

The firm can choose from a pool of many different business forms. In a partnership, the lack of limited liability is coupled with the lack of extensive disclosure obligations. In a limited-liability company, the limited liability of shareholders is complemented by a duty to disclose more financial information and more information about the persons responsible for the management of the firm. Limited-liability companies can be private or public. Public companies are required to disclose more information.

Incorporation raises company law issues such as the duty to disclose financial information and the duty to disclose information to shareholders. Incorporation in a certain jurisdiction also makes the firm subject to other disclosure obligations, the application of which is not limited to companies. For example, a company incorporated in, say, Luxembourg, can be sued in Luxembourg,[124] and regulators in

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[122] See Grosskopf O, Medina B, A Revised Economic Theory of Disclosure Duties and Break-up Fees in Contract Law, Stanf J L Bus Fin 13 (2007) p 154.

[123] Nissenbaum H, Privacy as Contextual Integrity, Wash L R 79 (2004) pp 119–158.

[124] Article 2(1) of Regulation 44/2001 (Brussels I): "Subject to this Regulation, persons domiciled in a Member State shall, whatever their nationality, be sued in the courts of that Member State." Article 22: "The following courts shall have exclusive jurisdiction, regardless of domicile: ... 2. in proceedings which have as their object the validity of the constitution, the nullity or the dissolution of companies or other legal persons or associations of natural or legal persons, or of the validity of the decisions of their organs, the courts of the Member State in which the company, legal person or association has its seat. In order to determine that seat, the court shall apply its rules of private international law ..."

that country typically have jurisdiction over the company. In the EU, freedom of establishment and the principle of home country control have allocated supervisory powers to the authorities of the company's home Member State. For example, if a French bank opens a branch in London, prudential supervision will be conducted in France.

Company groups. The firm can influence the duty to disclose information by carrying on business through subsidiaries. The firm can allocate business activities and the related duties to disclose information between the parent company and one or more subsidiaries.

Whereas the parent often has a duty to disclose financial information relating to the whole group, many disclosure duties follow the legal entity that carries on the business activity in question. For example, the duty to disclose information to contract parties follows the allocation of business activities between the parent and its subsidiaries. The same can be said of the duty to disclose information to public authorities. For example, the firm may allocate the duty to obtain environmental permits for a certain part of its business and the related duty to disclose information to environmental authoritities by carrying on this part of its business through a subsidiary.

As a rule, the duty of the firm to disclose information is diluted by the use of a group structure. For example, shareholders might not have much of a chance to obtain detailed information about the business activities of a subsidiary of a subsidiary.

Offshore activities and special purpose vehicles. The powers of the court, supervisory authorities and other government entities are usually limited to their home state. As different business forms are subject to different disclosure obligations and different countries can regulate disclosure obligations in different ways, firms can hide information in jurisdictions which do not require certain business forms to disclose information.

Some firms and investors have abused this possibility. Enron used special purpose vehicles for improper purposes, such as concealing its debt. As jurisdictions with lax disclosure rules can at the same time be tax havens, some firms have used offshore accounts, trusts and shell companies in offshore financial centres to conceal taxable assets or income (unlawful tax evasion).

The use of offshore activities to conceal information is constrained by: the international cooperation of government authorities;[125] limitations to bank secrecy;[126] the prevention of money-laundering;[127] the extraterritorial effect of some countries' laws (some provisions of law can be applied anywhere and give national legislation extraterritorial effect over nationals no matter where the conduct takes place; some provisions of law can be applied to conduct that has an

[125] For example, Article 16(1) of Directive 2003/6/EC (Directive on market abuse).

[126] See, for example, Ortner J, Das Bankgeheimnis. Rechtsvergleich Österreich, Deutschland, Schweiz, Liechtenstein und Luxemburg. Österreichischer Volksbankenverlag, Wien (1995) pp 204–212. In England, the leading case is Tournier v National Provincial and Union Bank of England [1924] 1 KB 461 (Court of Appeal).

[127] For example, Articles 1(1), 6, 7 and 9(1) of Directive 2005/60/EC (Directive on the prevention of money laundering).

effect in the country no matter who is behind the conduct); and extradition treaties.[128]

The Economist reported[129] how American International Group (AIG) changed its organisation in order to manage risk in 2005: "... AIG has been undergoing an organisational metamorphosis that may have profound legal consequences. In the past two weeks Mr Greenberg has quit as both chief executive and chairman of AIG ... But Mr Greenberg remains in charge of three entities that collectively control the largest block of AIG shares. Of these, the most important is Starr International ... This is a private Panamanian firm that holds 12% of AIG's shares ... America's regulators clearly have jurisdiction over AIG, a company listed on the New York Stock Exchange, based in New York and incorporated in Delaware; but Starr International is outside their purview. By separating the leadership of the two companies, the most obvious way to extract information has been broken."

Choice of business form and duty to disclose financial information. The choice of business form influences, in particular, the duty to disclose financial information. The duty to disclose financial information, the form of disclosure, and the applicable accounting rules can also depend on the size of the firm.[130] There is no room to discuss accounting rules in detail in this book.

Remaining private or going private. Unlike privately-owned companies, companies whose securities have been admitted to trading on a regulated market are subject to a very extensive disclosure regime. Their disclosure obligations depend on where the securities are admitted to trading. Disclosure obligations can also be triggered by the marketing of securities to the public in a certain jurisdiction or the registration of the securities in a certain jurisdiction. Firms that prefer not to disclose financial information to the public (including their competitors, suppliers and customers) will therefore stay private.

This can be illustrated by the story of Google: "Google and its venture capital investors saw that the search engine was going to be a runaway financial success. The search engine generated $440 million in sales and $100 million in profits in 2002, although the world didn't know it, since Google was a private company ... [Brin, Page, and Schmidt] stayed absolutely silent about their financial numbers to prevent others, expecially Microsoft and Yahoo, from finding out how profitable their … business had become."[131]

As regards large firms, remaining private is more usual in continental Europe than in Britain or the US because of greater reliance on traditional bank loans as a source of funding in continental Europe (for going private transactions, see Volume III).

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[128] For example, Article 1 of the Council of Europe's European Convention on Extradition.

[129] Second round, The Economist, April 2005.

[130] For example, a large German undertaking must comply with stricter accounting rules under § 1 of the Publicity Act (Gesetz über die Rechnungslegung von bestimmten Unternehmen und Konzernen, "Publizitätsgesetz", "PublG"). For the contents of these stricter rules see § 5 and § 6 PublG.

[131] Vise DA, The Google Story (2005).

Going public and the marketing of securities to the public. The firm can choose where to have its securities listed and therefore also the applicable disclosure rules.

Whereas public disclosure rules have largely been harmonised in the EU, there can be differences between European rules and those applicable in the US. A listing in the US means that the firm must comply with US securities market laws including the Sarbanes-Oxley Act and SEC rule-making implementing its provisions.

It can be difficult and too expensive for European companies to comply with home country laws and US securities market laws simultaneously.

Special remarks: extraterritorial application. The firm should also try to make sure in other ways that it is not required to comply with foreign securities market laws. When issuing shares, the firm should ensure that it is not regarded as marketing its securities in a foreign jurisdiction or that the information that it discloses is not valid there. This is particularly important when the firm discloses information to the public on the internet in one jurisdiction in order to comply with its securities market laws but does not want to disclose the same information in another jurisdiction.

The firm can use two basic tools to prevent the application of foreign securities market laws, and the firm should use both of them at the same time.

First, the firm should apply a legal waiver. For example, if the firm wants to avoid the application of US securities laws, the firm can state in the waiver that: the information is not for release, publication or distribution in the US; the document does not constitute an offer of securities for sale in the US or to US persons; and the securities may not be offered or sold in the US.

Second, the firm should take technical precautions to ensure that the information does not reach unintended persons in fact. This can be done even where the firm discloses information on the internet. For example, a Finnish company can publish information intended to be disclosed only in Finland in the Finnish language which is not understood outside this country. The firm can also make it technically difficult to gain access to this information from a foreign country.

Compliance programmes of listed companies. A company whose shares have been admitted to trading on a regulated market should adopt a compliance programme because a stock exchange listing is combined with a large number of disclosure and other duties (see section 7.6.6 and Volume III). For example, a listed company must comply with strict rules on the equivalent treatment of shareholders, disclosure of financial and other information, the duties of the board, and inside information. A very strict information management regime applies for the offeror, the offeree, and their advisers in the context of public takeovers. These questions will be discussed in Volume III.

The legal requirements can be illustrated by insider trading rules. For legal reasons, listed firms must limit access to inside information and draw up insider lists. The Market Abuse Directive requires the disclosure of inside information[132] unless it is kept confidential and

[132] Article 6(1) of Directive 2003/6/EC (Directive on market abuse).

the non-disclosure is not likely to mislead the public.[133] The Market Abuse Directive requires permanent company-specific insider lists that are regularly updated,[134] and stock exhange rules can require project-specific insider lists. If inside information is disclosed to a third party, the firm must make a public disclosure of that information, unless the confidentiality of that information is guaranteed by non-disclosure agreements.[135]

Disclosure policies, choice of disclosure channels. One of the things that should be regulated by listed firms' compliance programmes is the choice of disclosure channels. Even unlisted firms can adopt internal guidelines and policies on the disclosure of information to outsiders.

The firm can choose the intermediaries by whom information produced by the firm will be disclosed. At the same time, the firm can prohibit the disclosure of the same information to persons who are not authorised to receive it, and by people who are not authorised to disclose it.

For example, a listed company can employ an investor relations manager who coordinates the disclosure of information to investors. The firm's top management has a personal incentive to ensure that disclosure is coordinated, as members of the board, the CEO, and/or the CFO can have a statutory or contractual duty to disclose information to investors.

Controlling information flows inside the firm. Policies on the disclosure of information to outsiders are complemented by policies on the disclosure of information inside the firm.

Now, the firm will have to disclose information internally as it needs an informed organisation in order to operate. On the other hand, the firm may also have a duty to keep information secret. This duty can be based on law. For example, financial insitutions and persons working for financial institutions can be bound by the obligation of professional secrecy. Community law also protects personal data.[136] In addition to law, the duty to keep information secret can be based on contracts with external parties.[137]

The firm can control information flows inside the firm by organisational measures and by regulating the duties of its employees.

The choice between a divisional structure and a matrix structure can play a role. The firm usually has a divisional structure, and different management functions are organised along divisional lines. Furthermore, the subunits of the firm can consist of subsidiaries, each with a separate legal personality. The management structure can also be linear. Whereas divisionalisation, the use of subsidiaries, and a linear management structure are likely to discourage information flows across divisional lines, the coordination of the firm's operations at different levels of the corporate hierarchy, through a matrix management system or otherwise, is designed to increase information flows across divisional lines.

[133] Article 6(2) of Directive 2003/6/EC (Directive on market abuse).
[134] Article 6(3) of Directive 2003/6/EC (Directive on market abuse); Article 5(5) of Directive 2004/72/EC.
[135] Article 6(3) of Directive 2003/6/EC (Directive on market abuse).
[136] For definitions, see Article 2 of Directive 95/46/EC.
[137] See, for example, Article 6(3) of Directive 2003/6/EC (Directive on market abuse).

The firm can prevent the disclosure of information within the firm by using Chinese walls. Sometimes there is a mandatory legal obligation to use Chinese walls.[138] Chinese walls, in this context, are institutional and procedural barriers put up to restrict the flow of information within a firm (or within an individual company or between companies within a group) in order to ensure that information entrusted in confidence to one department is not disclosed inadvertently or improperly to another department in the same firm. Chinese walls may be necessary especially where the firm at the same time owes duties (especially fiduciary duties) to parties who have conflicting interests.[139] Chinese walls do not always work.[140]

The central role of employees. The role of employees is central in information management since information is produced, kept confidential, and disclosed by employees. There is a constant turnover of employees. Employees work for the firm for some time but eventually change jobs or retire. People move from one firm to another quite legitimately, and they move with all the knowledge they have. As you cannot uninvent things, that knowledge is going to appear in their future work. The firm should therefore manage information both during the term of its employees' employment and after they have left the firm.

Unauthorised disclosure or abuse of confidential information such as trade secrets can be constrained by legal background rules. Employees can owe a general duty of care to their employer during the term of their employment, and unauthorised disclosure or abuse of trade secrets can sometimes be punishable as a criminal offence. However, legal background rules do not provide sufficient security.

Legal background rules are therefore complemented by contracts. (a) An employee who has access to confidential information such as trade secrets or inside information can thus be asked to sign a non-disclosure agreement (NDA). Such an agreement usually contains an express clause preventing the abuse of confidential information, and it continues to apply even after the employee has left the firm. (b) Non-disclosure agreements are complemented by non-competition clauses in employment contracts.

On the other hand, non-disclosure agreements and non-competition clauses can never prevent the spreading of information completely. (a) It might be possible to stop the transfer of information in written or electronic form, but it is not possible to prevent an employee from taking information in his head when he leaves the

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138 See, for example, Unsettling, The Economist, May 2003 (on measures designed to ensure the ingegrity of financial analysts).

139 See, for example, Bolkiah v KPMG [1998] UKHL 52; [1999] 2 AC 222; [1999] 1 All ER 517; [1999] 2 WLR 215.

140 The price of atonement, The Economist, November 2002: "... in 1998, Goldman Sachs ... played conflicting roles in the rescue of Long-Term Capital Management (LTCM), a huge hedge fund on the brink of collapse. It was part of a team sent in to investigate LTCM's balance sheet while, at the same time, it was secretly advising Warren Buffett on a possible purchase of the distressed hedge fund's portfolio. At the time there were also rumours that Goldman's traders were trading against LTCM's best interests in the bond and swaps markets. One firm; three highly conflicting activities. ... Goldman claimed they were separated by Chinese walls."

firm. (b) In addition, there are legal constraints on the use of non-competition obligations. Former employees cannot be prevented from competing with their former employee indefinitely. According to English law, the court will never uphold a covenant taken by an employer merely to protect himself from competition by a former employee. There must be some subject matter which an employer can legitimately protect by such a restrictive covenant.[141] But even in this case, protection cannot be legitimately claimed in respect of the skill, experience, know-how and general knowledge acquired by an employee as part of his job during his employment, even though that will equip him as a competitor of the employer or as a potential employee of a competitor. In Germany, the use of non-competition clauses is constrained by particular provisions of the Commercial Code[142] and by the provisions of the Civil Code applicable to standard form agreements (Volume II).[143] (c) This can be contrasted with the legal position in the US where an employer may be able to prevent a former employee from working for a competitor even in the absence of a covenant not to compete. According to the doctrine of inevitable disclosure, an employee should not work for a competitor of his former employer under circumstances where the employee inevitably will use or disclose the former employer's trade secrets in the course of his duties.[144]

As non-disclosure agreements and non-competition clauses do not guarantee sufficient protection in Europe, the firm should regulate the access of employees to information by internal practices, policies, and Chinese walls. This can prevent employees from taking information in their head when they move from firm to firm. A trade secret programme will therefore be necessary (for the contents of a trade secret programme, see below).

Employee involvement. Employee participation and involvement creates a further layer of disclosure rules. At a general level, the European Social Charter guarantees the right of employees to information and consultation.[145] There may be a duty to disclose information to employees or their representants under provisions of a Member State's national law[146] or provisions based on Community law.

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[141] In Stenhouse Limited v Phillips [1974] AC 391, Lord Wilberforce said at page 400 E: "The employer's claim for protection must be based upon the identification of some advantage or asset inherent in the business which can properly be regarded as, in a general sense, his property, and which it would be unjust to allow the employee to appropriate for his own purposes, even though he, the employee, may have contributed to its creation." See also Mummery LJ in FSS Travel and Leisure Systems v Johnson [1999] FSR 235 and Thomas v Farr plc and another [2007] EWCA Civ 118.

[142] §§ 74, 74a, 74b, and 74c HGB.

[143] See § 305 BGB.

[144] PepsiCo, Inc. v. Redmond, 54 F.3d 1262 (7th Cir. 1995).

[145] Articles 21 and 29 of the European Social Charter (as amended).

[146] Such as the German rules on mandatory co-determination under the Co-determination Acts: the Iron and Steel Co-determination Act of 1951 (Montan-Mitbestimmungsgesetz), the Works Constitution Act of 1952 (das Betriebsverfassungsgesetz 1952), the Works Constitution Act of 1972 (das Betriebsverfassungsgesetz 1972), the Co-determination Act of 1976 (Mitbestimmungsgesetz 1976) and the Works Constitution Act of 2001 (Reformgesetz zum Betriebsverfassungsgesetz 1972, BetrVReformG).

For example, there is legislation on employee involvement. Many multinational companies operating across Europe have set up European Works Councils as a result of the Directive on European Works Councils (94/45/EC). The purpose of the information and consultation Directive (2002/14/EC) adopted in 2002 is to establish a general framework setting out the minimum requirements for the right to information and consultation of employees in undertakings or establishments within the Community.

The SE Regulation is complemented by the Directive on employee involvement (2001/86/EC) which provides for alternative forms of co-determination to be applied in an SE. It is worth noting that the Directive requires "the allocation of seats within the administrative or supervisory body among the members representing the employees from the various Member States".[147]

Public takeovers of listed companies are covered the Directive on takeover bids which provides that the board of the offeree company must inform employees about the effect on the proposed takeover on jobs.[148]

Importance of trade secret programmes. For many legal reasons, it is important to adopt a trade secret programme. It can be necessary because of compliance duties and as protection against unauthorised disclosure by employees. There are even other legal reasons.

Laws generally protect the property rights of the firm, and they also protect the firm against unauthorised disclosure of its trade secrets and the use of those trade secrets by parties who obtained them in bad faith. However, trade secrets are not regarded as worthy of protection unless the firm has made an attempt to keep them confidential.[149] Without a trade secret programme, non-disclosure agreements and non-competition clauses would be less effective.

The laws of many countries protect confidential business information along the lines proposed by the Agreement on Trade Related Aspects of Intellectual Property Rights (TRIPS). According to TRIPS, information can be protected by laws if: (a) the information is secret (not generally known or readily accessible to persons that normally deal with that kind of information); (b) it has commercial value because it is secret; and (c) its owner has taken reasonable steps to keep it secret.[150]

Protection of trade secrets is a branch of unfair competition law both according to TRIPS[151] and in many jurisdictions.[152] Trade secrets can also be protected by labour laws which impose a duty of confidentiality upon an employee during the

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[147] According to the German Aktiengesetz applicable to the AG, only German employees are represented in the supervisory board.

[148] Article 9(5) of Directive 2004/25/EC (Directive on takeover bids). See also Article 14.

[149] See Francis Gurry's book Breach of Confidence (1984) cited in the English case of Cray Valley Ltd v Deltech Europe Limited [2003] EWHC 728 (Chancery).

[150] Article 39(2) of the TRIPS Agreement.

[151] Article 39(1) of the TRIPS Agreement: "In the course of ensuring effective protection against unfair competition as provided in Article 10bis of the Paris Convention (1967), Members shall protect undisclosed information in accordance with paragraph 2 and data submitted to governments or governmental agencies in accordance with paragraph 3."

[152] In Germany: § 17 UWG.

term of his employment. Depending on the jurisdiction, this duty can apply to the employee even after he has left the employer, if the employee had received the information in bad faith, or for a period of time determined in the contract (cooling off period).

However, trade secrets are not protected as confidential information unless they have been kept confidential. For example, the firm can signal to its employees what information is confidential and protected as its trade secrets. If the employer has not made any attempt to identify information as part of its trade secrets and keep it confidential, the information will be regarded as part of the employee's ordinary stock of acquired skill and experience which he is free to use for his own purposes after the termination of his employment.

The existence of effective security precautions for the protection of confidential information indicate that that the information was part of the employer's special trade secrets worthy of protection under the applicable laws.[153]

The US position is essentially the same. In 1939 the American Law Institute's (ALI) Restatement of the Laws of Torts dealt with the topic of trade secrets. One of the factors identified to be considered in deciding whether information is a protectable trade secret is: "(3) the extent of the measures taken by him to guard the secrecy of the information". The work of ALI led to a codification in the Uniform Trade Secrets Act 1979. The majority of States adopted it. Section 1(4) of the 1979 Act defines trade secret as: "information, including a formula, pattern, compilation, program device, method, technique or process that: (i) derives independent economic value, actual or potential, from not being generally known to, and not readily ascertainable by proper means by, other persons who can obtain economic value from its disclosure or use, and (ii) is the subject of efforts that are reasonable in the circumstances to maintain its secrecy".

Special Remarks on the Contents of a Trade Secret Programme

Trade secret programmes should address three specific functions: notification, identification, and security. In addition, the programme should be properly implemented, explained to employees, and maintained.[154]

Notification. Notification means that all parties having access to confidential information must be made aware of the trade secret programme. The firm should explain its trade secret policy to its employees and other parties that may receive confidential information.

In addition, the firm can require its employees to sign a non-disclosure agreement (NDA). Non-disclosure agreements often prohibit employees not only from revealing trade secrets, but also from utilising their specific human capital developed at the original place of employment in competitor firms during a cooling off period. However, an employee cannot be prevented from using the skill, experi-

[153] Mr Justice Jacob in the English case of Cray Valley Ltd v Deltech Europe Limited [2003] EWHC 728 (Chancery), citing Francis Gurry's book Breach of Confidence (1984). Gurry cited the following cases: Standex International Ltd v C B Blades [1976] FSR 114, 117–8 per Buckley LJ; New Zealand Needle Manufacturers Ltd v Taylor [1975] 2 NZLR 33, 36 per McMullin J.

[154] Bagley CE, Winning Legally. Harv Bus S P, Boston (2005) pp 133–137.

ence, know-how, and general knowledge acquired by an employee as part of his job during his employment, even though that will equip him as a competitor of the employer or as a potential employee of a competitor.

The firm should also require any consultant, vendor, joint venturer, or other party to whom a trade secret may be revealed to sign a confidentiality agreement that describes the protected information and limits the receiving party's rights to use it. Otherwise, the receiving party might unwittingly release trade secrets into the public domain. Sometimes an NDA may contain a "residuals" provision, which permits either party to use any information learned in the course of an engagement or discussions that is retained in the minds of the representatives of the nondisclosing party. Managers disclosing trade secrets should resist the inclusion of a residuals provision because if can create a large loophole in the legal framework.[155]

Identification. Like notification, identification is important for legal reasons. For example, restrictive covenants designed to prevent former employees from disclosing information and competing with their employer will not be enforced, unless it is possible to identify information, the use and dissemination of which is likely to harm the employer, and establish that the employer has limited its dissemination. There are alternative methods of identifying trade secrets.

These alternative methods, however, should be neither too wide nor too narrow. For example, "everything within the workplace" is too wide and vague and might not be recognised by the court. The methods should not be narrow, because information that has not been specified will not be protected. Typically, stamping documents "confidential" and posting signs in areas containing sensitive materials may leave plenty of information unprotected.

In order to avoid the risk of using too wide or too narrow methods, the firm can combine these two approaches by: using a limited number of catchall categories such as customer lists and sales data; and specifying as much information as possible as confidential.

Security. Security means that managers should take appropriate steps to ensure that trade secrets are not unintentionally disclosed to unauthorised parties.

The screening of applicants before hiring is important because the applicants may eventually leave the firm or disclose information even earlier. For example, an applicant or a new employee that reveals trade secrets belonging to his former employer signals that he is likely to reveal the firm's trade secrets when he leaves the firm; it is less risky to rely on the integrity of an individual who does not disclose any confidential information belonging to his former employers.

However, there are legal constraints on the screening of applicants before hiring as well as on the hiring and promotion criteria. In Community law, the constraints are based on the protection of privacy and the prohibition of discrimination.

Community law prohibits various forms of discrimination. The EC Treaty bans all discrimination on the basis of nationality (Article 12), lists the promotion of equality between men and women as one of its core tasks (Article 2), and enables

[155] *Ibid*, p 135.

Community institutions to take appropriate action to combat discrimination based on sex, racial or ethnic origin, religion or belief, disability, age or sexual orientation (Article 13). In 2000, two directives were adopted as a package of anti-discrimination measures. One of the directives implements the principle of equal treatment between persons irrespective of racial or ethnic origin.[156] The other bans discrimination in employment on the grounds mentioned in Article 13 of the EC Treaty (with the exception of sex).[157] Both directives give victims of discrimination access to justice[158] and a right to compensation[159] and shift the burden of proof to respondents.[160] National laws that implement EU anti-discrimination provisions increase the legal risk of employers.[161]

Furthermore, Community law protects privacy. Workplace privacy derives, in particular, from European treaty law[162] and the Data Protection Directive.[163] The Data Protection Directive applies to the processing of personal data. Processing is defined very broadly and includes even the collection of personal data.[164] The right to process (or collect) data is limited in many ways. For example, personal data may be collected only for specified, explicit, and legitimate purposes and may not be processed in any way that is inconsistent with those purposes ("finality principle"). Furthermore, the purpose of the processing itself must be legitimate ("legitimacy principle").[165] In practice, one of the effects of the legitimacy principle is that information may not be collected in the context of hiring if using it would be regarded as discrimination (see above) or a breach of labour laws.

The firm is basically free to erect organisational, physical and technical barriers that prevent employees from gaining access to confidential information. Moreover, the firm can permit access only on a need to know basis. Typically, only some employees are authorised to access the information, or access may require the consent of a superior officer. Further security measures include imposing password protections on access to information. The Data Protection Directive provides an example of technical and organisational security measures.[166]

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[156] Directive 2000/43/EC implementing the principle of equal treatment between persons irrespective of racial or ethnic origin.

[157] Directive 2000/78/EC establishing a general framework for equal treatment in employment and occupation.

[158] Article 9 of Directive 2000/78/EC.

[159] Article 17 of Directive 2000/78/EC.

[160] Article 10 of Directive 2000/78/EC.

[161] In Germany: das Allgemeine Gleichbehandlungsesetz. For practical problems for firms, see, for example, Die Stolpersteine der Gleichbehandlung. Unternehmen sollten ihre Arbeitsläufe und Strukturen genau überprüfen, FAZ, 4 August 2006 p 13.

[162] Article 8(1) of the ECHR; Article 7 of the Charter of Fundamental Rights of the European Union.

[163] Directive 95/46/EC. See also Article 29 Data Protection Working Party, Opinion 8/2001 on the processing of personal data in the employment context.

[164] Article 2(b) of Directive 95/46/EC.

[165] Article 7 of Directive 95/46/EC.

[166] Articles 16 and 17 of Directive 95/46/EC.

However, the screening of phone calls, e-mails and the use of the internet is constrained by employees' right to privacy.[167]

Exit interviews can be used to remind employees or contract parties of their duties to keep all trade secrets confidential.[168] However, the inspection of former employees' property, correspondence or computer files can again be constrained by privacy rights.

Special Remarks on Chinese Walls

Chinese walls can be used by all organisations. For example, Chinese walls are the favoured technique for managing the conflicts of interest which arise when financial services business is carried on by a large organisation. Chinese walls are used as a means of restricting the movement of information between different departments of the same organisation.[169]

Organisational arrangements. Chinese walls normally involve some combination of the following organisational arrangements: (a) the physical separation of the various departments in order to insulate them from each other (this often extends to such matters of detail as dining arrangements); (b) an educational programme, normally recurring, to emphasise the importance of not improperly or inadvertently divulging confidential information; (c) strict and carefully defined procedures for dealing with a situation where it is felt that the wall should be crossed and the maintaining of proper records where this occurs; (d) monitoring by compliance officers of the effectiveness of the wall; (e) disciplinary sanctions where there has been a breach of the wall.[170]

Legally effective Chinese walls. If Chinese walls are effective in the legal sense, they restrict the attribution of information to the person or department that represents the company in its dealings with a third party (for attribution, see section 10.5.6).

In the English case of *Bolkiah v KPMG*,[171] Lord Millett said that an effective Chinese wall needs to be an established part of the organisational structure of the firm and not created ad hoc. Chinese walls are more likely to restrict the movement of information between different departments of the same organisation if the departments work from different offices and there is little movement of personnel between them.

Example: the view of the FSA. In England, the Code of Market Conduct published by the Financial Services Authority recognises the effectiveness of some Chinese walls. The Code contemplates the existence of established organisational

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[167] See Article 5 of Directive 2002/58/EC (Directive on privacy and electronic communications).

[168] Bagley CE, Winning Legally. Harv Bus S P, Boston (2005) p 136.

[169] See, for example, The price of atonement, The Economist, November 2002.

[170] Lord Millett in Bolkiah v KPMG [1998] UKHL 52; [1999] 2 AC 222; [1999] 1 All ER 517; [1999] 2 WLR 215, citing the Law Commission's Consultation Paper 124 on Fiduciary Duties and Regulatory Rules (1992).

[171] Bolkiah v KPMG [1998] UKHL 52; [1999] 2 AC 222; [1999] 1 All ER 517; [1999] 2 WLR 215.

arrangements which preclude the passing of information in the possession of one part of the business to other parts of the business. There are similar provisions in the FSA Handbook, Conduct of Business.[172]

The Code of Market Conduct provides a safe harbour in respect of behaviour by a person in possession of relevant information which is not generally available, provided it does not influence his decision to engage in the behaviour. The "no influence" condition can be satisfied if the information is held behind an effective Chinese wall and the person engaging in the behaviour is on the other side of the Chinese wall.[173]

Chinese walls can also provide a safe harbour in respect of false or misleading information. There is a risk that an individual on the wrong side of the Chinese wall might unknowingly disseminate false or misleading information believing it to be accurate, unaware of contradictory information elsewhere in the organisation. There is no need for a safe harbour for individuals where knowledge is an element in the description of behaviour prohibited by laws and attributable to the individual. An organisation for which the individual works may, however, be in a different position. It might, depending on the facts, have the knowledge of the individuals behind the Chinese wall attributed to it. For that reason, the Code of Market Conduct published by the FSA has given organisations the benefit of a safe harbour where they have etablished and maintained effective Chinese walls.[174]

Not effective Chinese walls. Not all Chinese walls are effective in the legal sense. For example, Lord Millett indicated in the case of *Bolkiah v KPMG*[175] that Chinese walls are not effective if: they are created ad hoc; they are not an established part of the organisational structure of the firm; they are erected within a single department; the information barrier is placed between members, all of whom are drawn from the same department; the information barrier is placed between members of different departments who have been accustomed to work with each other; the number of personnel involved within one department is large; teams involved with projects that need to be kept separate have a rotating membership so that individuals may have joined from and returned to other projects.

Making Business Partners Keep Information Secret

The firm co-operates to various degrees with other firms as well as with its customers, suppliers and distributors. One can also idenfity various degrees of co-operation between competitors, ranging from strategic alliances such as joint ventures to informal co-operation such as verbal discussions. Depending on the de-

[172] See COB 2.4.4R (Control of information) and COB 2.4.6R (Attribution of knowledge).

[173] MAR 1.4.24C. Financial Services Authority, Code of Market Conduct. Feedback on CP 59 and CP 76 (April 2001), section 6.15.

[174] MAR 1.5.27C. Financial Services Authority, Code of Market Conduct. Feedback on CP 59 and CP 76 (April 2001), sections 7.6–7.7.

[175] Bolkiah v KPMG [1998] UKHL 52; [1999] 2 AC 222; [1999] 1 All ER 517; [1999] 2 WLR 215.

gree of co-operation, the business partners of the firm can receive information that the firm prefers to keep confidential. As these business partners can gain from utilising the information that they have received or reveal it to the firm's competitors or to the public, the firm must manage this agency problem.

Trade secret programmes. Basically, the firm can manage this agency problem by using the methods described above. The best way to protect confidential information is to keep it secret and to prevent access by physical and technical barriers. Since there are things that business partners do not need to know, the firm should keep in mind the following things.

Choice of business partners. The firm should of course manage this agency problem by choosing reliable business partners rather than partners that leak information or abuse it. The firm can prefer a business partner whose core business interests are aligned with those of the firm.

For example, a distributor that sells the goods of the firm, and may not sell the goods of other manufacturers, is more dependent on the success of the firm than a distributor that may manufacture and sell competing products.

Another example can be taken from manufacturing. A manufacturing partner that wants to start manufacturing competing products is less reliable than a manufacturing partner whose business is dependent on strict no-competition. For example, both Russia and China want to develop their commercial airliner industries. If Airbus builds an assembly plant in one of these countries and cooperates with local suppliers, it will be easier for that country to develop its own competing industry and the local suppliers to start manufacturing planes.

Organisation. Co-operation with other firms can be organised in different ways. The organisation form will influence the spreading of information. This can be illustrated with the following situations.

The firm cannot outsource business without giving the firm's contract party access to information about its internal processes. The firm should therefore decide what parts of its business it cannot outsource, choose a reliable contract party for business that it can outsource, regulate the access of its contract party to information, and complement the contractual framework with a non-disclosure agreement and non-competition clauses.

The firm can protect its business secrets and know-how by a hybrid model of outsourcing. The firm can also limit the use of valuable information to its home base and outsource only activities in areas of less sophisticated technology or design.

For example, the home factory of an international firm can produce high-tech components for use by plants in low-cost countries such as China and India.

A mobile telephone manufacturer can outsource the manufacturing and design of its phones to an "original design manufacturer" (ODM). Many ODMs manufacture phones at the same time for many competing customers. Without Chinese walls between different departments doing work for different customers and strict non-competition with customers, the ODMs would be out of business.

A joint venture in the form of a jointly owned company with its own organisation makes it easier for the firm to restrict the other party's access to information relating to other parts of the firm's business.

Non-Disclosure Agreements. The firm typically requires all business partners that may gain access to confidential information to sign a Non-Disclosure Agreement (NDA). There are one-way NDAs and two-way NDAs, depending on the flow of information.

Basically, a typical one-way NDA: names the owner of the information and the recipient of the information; defines the confidential information and the purpose of making the information available to the recipient; contains a general prohibition to use the information and an obligation to keep it secret; and contains an exclusive list of the only permitted ways to use the information or make it available to others.

The NDA generally contains a general catch-all obligation to keep the information secret.

In addition to the general catch-all obligation, the NDA typically contains two other components. (a) The NDA provides for a non-exclusive list of things that the recipient must do in order to keep the information secret. For example, these modalities of the recipient's obligations can contain: an obligation to keep records of how the information is used and by whom it is accessed; an obligation to require those persons to sign a NDA; an obligation to mark records of the information "Confidential"; and an obligation to mark records of the information with a reference to the owner of the information. (b) In addition to the non-exclusive list of things that the recipient must do in order to keep the information secret, the NDA can contain an exclusive list of things that the recipient may do with the information. Typically, the recipient may use the information only for the purpose mentioned in the NDA and the information may not be used for any other purpose. The NDA can also set out when the information is no more regarded as confidential. For example, the information can be in the public domain because of actions by third parties or the owner of the information.

Non-disclosure agreements can be complemented by other restrictive covenants. The sharing of confidential information can be facilitated by a covenant prohibiting the recipient from engaging in competition with the firm. Combinations of non-disclosure and non-compete clauses are usual in contractual relationships ranging from employment contracts to distribution contracts, intellectual property licences and joint ventures.

The use of restrictive covenants can nevertheless be constrained by competition laws. However, some non-compete clauses are permitted. For example, the Regulation on the application of Article 81(3) of the EC Treaty to categories of vertical agreements and concerted practices provides for an exemption that applies to vertical agreements.[176] This exemption covers certain categories of non-compete obligations.[177]

[176] Article 2 of Regulation 2790/1999.

[177] Article 5 of Regulation 2790/1999. See also Commission notice - Guidelines on Vertical Restraints, OJ C 291, 13.10.2000, p 1–44.

Confidential relationships. Some business relationships are confidential by law in the sense that the recipient must keep the information secret and may not reveal it to others, other than for the purpose of performing his duties to the owner of the information. If the confidentiality of the information is protected by effective legal rules and is not compromised for example by the recipient's conflicts of interest, confidential information can be deposited with that recipient.

For example, communications from a client to a lawyer and from a lawyer to a client can to some extent be protected by "lawyer-client privilege", "attorney-client privilege", "solicitor-client privilege" or similar privileges depending on the jurisdiction. In Community law, the existence and effect of these kinds of privileges was discussed by the ECJ in the case of *AM & S Europe Limited v Commission*.[178] The ECJ had to decide on the scope of the Commission's investigative powers in competition law proceedings. The ECJ said that Member States' national laws protect the confidentiality of written communications between the lawyer and client provided that, on the one hand, such communications are made for the purposes and in the interests of the client's rights of defence and, on the other, they emanate from independent lawyers (and not from employed lawyers like in-house lawyers). The ECJ was of the opinion that Community law incorporates such elements of that protection as are common to the laws of the Member States.[179] Although the standard of protection differs among the Member States, Community law thus contains a general principle of privileged correspondence between independent lawyers and their clients.[180]

Another form of confidential relationships is the banker-customer relationship. Typically, the banker may not disclose to any third party any information about the customer that has been obtained in the course of the bank's business with the customer. Under English law, this duty is based on an implied term in the contract between the banker and the customer (*Tournier v National Provincial*).[181] In Germany, this duty is based on two things: the General Contract Terms applied by all banks in the German market;[182] and the provision of the Abgabenordnung which restrict the disclosure of information to tax authorities.[183]

In both countries, bank secrecy is not without limitations. For example, it was held in the *Tournier* case that the duty of confidentiality does not prevent disclosure where: disclosure is under compulsion by law; there is a duty to the public to disclose; the interests of the bank require disclosure; or disclosure is made by the express or implied consent of the customer. There are a growing number of in-

[178] Case 155/79 AM & S Europe Limited v Commission of the European Communities [1982] ECR p 1575.

[179] See the principle in Article 288(2) of the EC Treaty.

[180] This principle influenced for example Directive 2005/60/EC on the prevention of money laundering and terrorist financing. See recital 20.

[181] Tournier v National Provincial and Union Bank of England [1924] 1 KB 461 (Court of Appeal).

[182] Die Allgemeinen Geschäftsbedingungen der Banken und Sparkassen (AGB/B).

[183] § 30a AO. See also BFH, judgment of 9 December 2008 -VII R 47/07 in which the tax authorities' monitoring powers were increased.

stances in which the "compulsion by law" qualification applies.[184] In Germany, bank secrecy is subject to several statutory duties of disclosure.[185] It is also qualified by the customer's consent, some of which are are fictive and developed by the courts.[186]

In the EU, personal data of individuals is protected by Directive 95/46/EC. The Directive protects natural persons[187] rather than firms.

The use of confidential business relationships to hide information is usually constrained by competing public policy objectives such as the prevention of crime and tax evasion. (a) According to the OECD Model Agreement on the exchange of information in tax matters, a contracting party has a duty to provide upon request information for certain purposes.[188] A number of bilateral agreements have been based on the model agreement. (b) In the EU, Directive 2005/60/EC makes it more difficult to use confidential business relationships for the purpose of money laundering and terrorist financing. Member States must ensure that money laundering and terrorist financing are prohibited.[189] The Directive applies not only to banks but also to independent legal professionals and other persons that can typically assist in money laundering.[190] The persons covered by the Directive have a duty to cooperate fully, for example by informing a national "financial intelligence unit" (FIU) of suspected money laundering or terrorist financing.[191]

10.5.3 Benefiting from Superior Information

The firm needs an information advantage in order to exist and the firm needs to use asymmetric information for its own benefit. It would be impossible to prohibit the use of superior information, but the law does restrict it under some circumstances. These restrictions depend on the nature of the transaction and the parties. Restrictions can take the form of clear prohibitions (such as fraud rules), substan-

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[184] See Blair W, England. In: Cranston R (ed) European Banking Law: The Banker-Customer Relationship. Lloyd's of London Press, London (1993) p 15.

[185] For example the following statutory disclosure duties. Duty to disclose information to BaFin and Deutsche Bundesbank (§§ 25a, 27, 44 KWG). Duty to disclose information in criminal proceedings (§§ 53, 161a StPO; see also § 46 Abs. 2 OWiG). Duty to disclose information to tax authorities (§§ 90, 92, 97 AO). Duty to disclose information in tax crime proceedings (§§ 370, 372, 385 Abs. 1 AO; see also § 208 AO and § 249 AO).

[186] For example, the SCHUFA clause is an implied term that permits the disclosure of account information and credit information to Schutzgemeinschaft für allgemeine Kreditsicherung, a credit information agency.

[187] Article 1(1) of Directive 95/46/EC.

[188] Article 5 of the OECD Model Agreement. Article 1: "… Such information shall include information that is foreseeably relevant to the determination, assessment and collection of [taxes covered by the Agreement], the recovery of and enforcement of tax claims, or the investigation or prosecution of tax matters …" See also Article 26 of the OECD Model Tax Convention on Income and on Capital.

[189] Article 1(1) of Directive 2005/60/EC.

[190] Article 2(1) of Directive 2005/60/EC.

[191] Article 22(1) of Directive 2005/60/EC.

tive rules, disclosure rules, and rules on the allocation of risk. Legal background rules can be complemented by contracts.

Main rule and constraints. The main rule is that the firm may use superior information for its own benefit. This is nevertheless subject to constraints that belong to three basic categories depending on the circumstances.

First, sometimes the duties of the firm are the same whether the firm uses information for its own benefit or not. (a) For example, some acts are prohibited. This can be illustrated with the General Product Safety Directive which categorically prohibits the placing of unsafe products on the market.[192] (b) Some acts lead to liability for loss or damage or personal injury regardless of fault. This can be illustrated with the Product Liability Directive which provides for strict liability or liability without fault of the producer in cases of damage caused by a defective product (see section 10.5.6).[193] (c) Sometimes the contents of the firm's contractual obligations are determined on the basis of information that the other party relied on or its expectations at the time of contracting (for interpretation of contracts, see Volume II). If the performance of the firm is not what it should have been under the terms or implied terms of the contract, failure by the firm to disclose material information can result in breach of contract. For example, the CISG contains default rules on the normal specifications of the goods.[194] Failure by the seller to tell the buyer that the goods do not comply with those specifications can result in the seller failing to perform his obligations under the contract.[195]

Second, sometimes the law prohibits the use of information rather than the act as such. For example, the prevention of fraud belongs to principles common to the laws of all Member States, and restrictions on internal market transactions can, under some circumstances, be justified by the need to prevent fraud.[196] Another example is market abuse. The Directive on market abuse prohibits the use of inside information[197] and market manipulation.[198] Furthermore, Member States have adopted unfair competition laws that prohibit many forms of unauthorised disclosure and use of trade secrets. As discussed above, the use of confidential information can also be prohibited by contract terms or implied contract terms.

Third, sometimes the law requires the firm to transfer information and close the information gap. Both Community law and Member States' laws contain a vast amount of publicity, disclosure and transparency rules in practically all areas of law.[199] Disclosure obligations can be based on legal rules or a contract between the parties. They can be illustrated with the following rules and areas of law.

In contract relationships, a party may owe a duty of care, fiduciary duties, a duty of loyalty, a duty to act in good faith, or similar duties to the other party. All these duties may require the disclosure of information.

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[192] Articles 3(1) and 6(1) of Directive 2001/95/EC.
[193] Article 1 of Directive 85/374/EEC.
[194] CISG Article 35.
[195] CISG Article 45.
[196] See, for example, Case C-275/92 Schindler [1994] ECR I-1039.
[197] Articles 2, 3 and 4 of Directive 2003/6/EC (Directive on market abuse).
[198] Article 5 of Directive 2003/6/EC (Directive on market abuse).
[199] See Merkt H, Unternehmenspublizität. Mohr Siebeck, Tübingen (2001) pp 6–21.

These duties can be general and apply to all transactions. For example, § 242 BGB lays down an obligation to act in good faith and to take the interests of the other party into account. This provision - Treu und Glauben - is one of the most fundamental principles of German private law.

They can also be limited to certain kinds of transactions. For example, in England, an insurance contract is regarded as a contract of utmost good faith meaning that both parties can have extensive disclosure obligations depending on the circumstances.

Typically, undertakings that sell goods or provide services to consumers are subject to disclosure obligations. This may be complemented by a "know-your-customer" rule or similar obligations that place the burden of finding out about the usefulness of information on the undertaking.

The disclosure obligations of issuers and providers of financial services have largely been harmonised in the EU.

Tort law does not require as extensive transfer of information to other parties. However, a person who can easily prevent serious damage from occurring can have an obligation to do so, or can be regarded to have contributed to the damage through negligence.

Sometimes there are considerations that justify non-disclosure. For example, there might not be any duty to disclose information to the extent that the disclosure would hamper the efficient conduct of the firm's important statutory duties. Disclosure might also be unfairly prejudicial to the firm in some cases.

The objectives of constraints. Such constraints exist for a reason. A firm that is in the possession of superior information may not use the information gap for the purpose of harming others when this is contrary to the policy objectives of the applicable laws.

In corporate practice, many prohibited ways to use superior information are therefore filtered by compliance programmes which address the main public policy objectives.

Legal sanctions. Failure to comply with those public policy objectives is discouraged by statutory legal sanctions. The nature of these sanctions can depend on: the extent of the information gap; the extent of knowledge of that information gap; proximity to the case; and proximity to the party that has inferior information.

First, fraudulent misrepresentation and deliberate concealment of material facts are sometimes regarded as criminal offences. At a more general level, the criminal law recognises numerous fault elements. They can include "intention", "recklessness", "maliciousness", "negligence", "knowledge", "belief" and "suspicion". Different offences have different fault elements. Most offences require that the offender must deliberately, as opposed to inadvertently, commit the proscribed conduct. For some offences, it suffices if the principal offender perpetrates the proscribed conduct while aware of a risk that he or she is doing so in those circumstances.[200]

[200] See for example, The Law Commission, Inchoate Liability for Assisting and Encouraging Crime (Report) [2006] EWLC 300(5) (04 July 2006) paragraph 5.113.

Second, the degree of knowledge influences contractual obligations. For example, unless the parties have agreed otherwise, a certain fact is not regarded as a breach of contract where the firm knew of the existence of that fact at the time of contracting. Another example is the question whether a disclaimer clause is enforceable where the party that uses the clause had prior knowledge of a fact that amounts to a breach of contract. Usually, a party may not restrict its liability for deliberate, reckless, or grossly negligent breaches of contract (see Volume II).

Third, if a party knows that a certain act would cause damage if committed by him, but commits that act all the same, his knowledge can be taken into account in three ways. (a) It can constitute a fault element such as "negligence", "recklessness" or "intention". The firm should note that contractual limitation of liability clauses typically do not exclude liability for damage caused by recklessness or a deliberate act. (b) It can be used to establish causation between the act and the damage. (c) It can also be taken into account when measuring the amount of damages payable by that party.

This can be illustrated by English law under which the extent of a person's fault and liability for breach of duty can influence the correct measure of damages for the breach.[201] The guilty party can be liable to compensate the injured party for losses caused by the breach, subject to rules of law excluding consequences which, because not reasonably foreseeable, are regarded as too remote.[202] On the other hand, a different test of causation can be applied in cases of fraud from those where the guilty party is liable for mere negligence, for example, negligent misrepresentation of material facts. Under English law, the guilty party is liable in fraud cases to compensate the injured party "for all the loss he has suffered ... for all the actual damages directly flowing from the fraudulent inducement".[203] In cases of negligence, however, the damages are restricted by a narrower definition of legal cause in addition to other things: "An injured claimant may be compensated only for loss which is held ... to have been effectively caused by the breach."[204]

Management of superior information. As the use of superior information is constrained by legal rules and in many cases serious sanctions for breach of those rules, the firm should in practice manage the use of superior information by addressing this question in its compliance programmes, trade secret programmes, and ethical codes.

If the firm is indeed in possession of superior information, it is easier for the firm to accept responsibility for the accuracy of information that it has disclosed to the other party. The firm should not accept responsibility for the usefulness of that

[201] For English law, see South Australia Asset Management Corporation v York Montague Ltd [1997] AC 191 (also referring to Banque Bruxelles S.A. v Eagle Star).

[202] Hadley v Baxendale (1854) 9 Ex. 341 (contract); The Wagon Mound [1961] AC 388 (tort).

[203] Per Lord Denning MR in Doyle v Olby Ltd [1969] 2 QB at 167. See also Smith New Court Securities Ltd v Scrimgeour Vickers Ltd [1997] AC 254.

[204] Lord Hoffmann in Banque Bruxelles Lambert SA v Eagle Star Insurance Co Ltd [1997] AC 191 (House of Lords), also known as South Australia Asset Management Corporation v York Montague Ltd.

information for the other party, unless the firm has superior information also in this respect.

As regards superior information possessed by another party, the firm can manage it by making that party responsible both for the (objective) accuracy of the information and for the (subjective) usefulness of information made available to the firm.

10.5.4 Increasing the Perceived Usefulness of Information

The firm can benefit, if information end-users that want to do business with the firm find the firm's outgoing information useful. Higher perceived usefulness of information means a higher level of certainty, a lower level of perceived risk, and perhaps a better price obtained by the firm. In order to comply with their own duty of care owed to the company or their employer, the representatives of the firm may even have a duty to disclose information and increase its usefulness. There are many ways for the firm to increase the perceived usefulness of outgoing information.

Usefulness. Generally, the usefulness of information in an investment context depends on the investment and the investor.[205]

The firm can manage the accuracy of information that it produces and discloses. In addition, the firm can manage the objective usefulness of that information, i.e. whether the information is of the kind that would satisfy the typical information needs of an end-user stakeholder belonging to a certain category of end-users. The firm does not need much information about the private preferences of individual end-users in this case. This makes the accuracy and objective usefulness of information important, especially when the firm discloses information to the public in capital markets, to a large number of end-users, or to analysts.

In contrast, the firm would need more information about individual end-users if it wanted to increase the subjective usefulness of information disclosed by it.

Signalling and perceived usefulness. It is not enough to increase the accuracy of information and its objective and subjective usefulness. The firm will not benefit from the increased usefulness of information unless it can signal the increase to the end-users of information (and thus avoid the market for lemons phenomenon).

There are two basic ways to achieve this. (a) The use of methods that typically increase the usefulness of information can also signal the increased usefulness of information and change its perceived usefulness. (b) In addition, the use of typical ways to decrease agency costs can increase the perceived reliability of information and its perceived usefulness.

[205] Kuhnle H, Banzhaf J, Finanzkommunikation unter IFRS. Grundlagen, Ziele und Gestaltung. Vahlen, München (2005) p 50: "Der Informationsbedarf einer Zielgruppe richtet sich nach dem Kenntnisstand der Anleger sowie dem Volumen und der geplanten Dauer des Investments."

Intermediaries perceived as reliable. One of the basic ways to increase the perceived usefulness of information is to let end-users receive it from intermediaries that are perceived as reliable.

The firm will often turn to external experts that are regarded as independent. This is often mandatory because of legal requirements. For example, company laws and securities markets laws often require the submission of reports by independent experts.

The firm can also turn to independent experts because of market practice. For example, fairness opinions are a means to convince investors or counterparties of the quality of valuation issues.

Even market participants and the general public can be used as information intermediaries.

This can be illustrated by the 2005 practices of rival search engines: "Google ranks ads based on two factors: the price a company is willing to pay and how frequently computer users click on the ad. Thus, even if a company outbids others on a particular keyword, if consumers are not clicking on the company's ad, it will move down to a less prominent spot. Yahoo, by contrast, guarantees that the highest bidders for a word will show up at the stop of the list of sponsored ads."[206] This also meant that Google increased the perceived usefulness of ads to consumers by using clicks by consumers as a mechanism to rank ads according to their relevance to a large number of consumers.

Transparency. Another basic way to increase the perceived usefulness of information is to increase access to information (transparency). Transparency will enable users and their intermediaries to gather information and process it at a lower cost. Transparency is increased by reducing the use of tools that are designed to keep information secret inside the firm (see section 10.5.2). For example, the firm can sometimes increase transparency for capital market investors by reducing the number of subsidiaries and affiliated companies and ensuring that its remaining subsidiaries and affiliated companies do not have minority shareholders.

Increased proximity to the end-user. The firm can increase its proximity to the end-user of information. The firm can either move closer to the end-user, or permit the end-user to move closer to the firm. It is easy to find many examples of the use of this tool.

Generally, relationship banking can increase the perceived usefulness of information for banks and reduce the need of debt covenants, and deal-based banking or transaction banking can increase the need to use debt covenants.

In Germany, it has been normal for firms to have a close relationship with a house bank (Hausbank).[207] Large German companies used to elect at least one supervisory member

[206] Vise DA, The Google Story (2005).

[207] For the concept of Hausbank, see Elsas R, Krahnen JP, Universal Banks and Relationships with Firms. In: Krahnen JP, Schmidt RH (eds) The German Financial System (2004) pp 211–212 and 227.

who represented the Hausbank.[208] The Hausbank system has helped to decrease information asymmetries and made it easier especially for small and mid-size firms to raise funding.

It is not part of English business culture to have a Hausbank. English banks have therefore more reason to regulate the governance of companies and the disclosure of information by financial contracts. This is one of the reasons that explain why debt covenants are more highly developed in the English market.[209]

The firm can increase proximity on a voluntary basis by founding and using customer or stakeholder "clubs" for this purpose. Furthermore, managers of listed companies seek proximity to large institutional investors in order to hear their views and to inform them of company affairs in a form understandable to them (roadshows, management of investor relations). Proximity can increase the subjective usefulness of information that the firm discloses to investors. For the same reason, large investors seek proximity to senior management.

It is nevertheless worth noting that selective disclosure is generally constrained by company and securities markets laws[210] and the regulation of inside information,[211] and may be constrained by the principle of equal treatment of shareholders.[212]

The use of similar tools is not limited to finance and corporate governance. For example, a supplier can agree to cooperate with its customer in the development of new products. Better access to the customer's trade secrets enables the supplier to take its customer's needs into account better.

Increased proximity to the topic. Where the information user relies on information provided by the firm or by other intermediaries, the firm can increase the perceived usefulness of that information by increasing proximity to the topic.

For example, let us assume that a good private old people's home in Germany can generate a good return on capital. However, there are always old people's homes that are badly run. Normal rating agencies cannot be expected to know much about such a specialised business. There is therefore a market for specialised rating agencies. In fact, neither banks nor private equity funds are prepared to invest in companies that manage old people's homes in Germany without a report by a specilialised rating agency.[213]

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[208] *Ibid*, p 201: "70 per cent of all sample firms have a bank representative as a member of the supervisory board, and in 41.6 per cent of all cases, bank representatives constitute more than 25 per cent of board members representing capital (i.e. excluding co-determination)." See also Hopt KJ, The German Two-Tier Board: Experience, Theories, Reforms. In: Hopt KJ, Kanda H, Roe MJ, Wymeersch E, Prigge S (eds), *op cit,* pp 242–243.

[209] For differences between German and UK corporate governance systems in general see Mäntysaari P, *op cit*, Chapter 6.

[210] Article 6 of Directive 2003/6/EC (Directive on market abuse).

[211] Articles 2 and 3 of Directive 2003/6/EC (Directive on market abuse).

[212] Article 42 of Directive 77/91/EEC (Second Company Law Directive); Article 13(1) of Directive 2004/109/EC (Transparency Directive).

[213] Anleger entdecken deutsche Pflegeheime, FAZ, 14 July 2006 p 41.

Another example is familiarity with a particular type of transaction. A party's familiarity with a particular type of transaction is an important determinant of both investigation and bargaining costs. The greater a party's familiarity with a particular type of transaction, the lower should be its cost of investigation and bargaining. For this reason, parties who are not themselves familiar with particular transactions, such as corporate mergers and acquisitions or complex executive employment agreements, employ lawyers and investment bankers who have the transactional expertise they lack. This is a way to reduce investigation and bargaining costs. The use of lawyers and investment bankers may also bring significant reductions in delay.[214]

Verification. Information can be verified in many ways. The firm can enable the end-user to verify information. The firm can permit an external intermediary instructed by the end-user to verify information, or instruct its own intermediary to verify it. Verification by external intermediaries can signal the accuracy of information.

For example, a certificate awarded by a well-known independent intermediary can signal that the information fulfils certain critieria. This can be necessary, for example, where it is practically impossible for the firm to signal the quality of its information otherwise.[215] Companies allow outsiders (auditors) to review books and records and to have these outsiders certify the accuracy of the company's representations.[216] A takeover target can permit a prospective buyer to inspect its books and documentation (for due diligence, see Volume III).

Analysis. The firm can add an analysis component to the information that it produces. Both the information needs of the end-user and the information can be analysed with a view to aligning them. This analysis can be done by the end-user, the firm, their employees and representatives, or an independent intermediary.

For example, insurance intermediaries that assist customers in choosing insurance policies and inform customers that they give their advice on the basis of a fair analysis have a legal duty based in the Directive on insurance mediation to: give that advice on the basis of an analysis of a sufficiently large number of insurance contracts available on the market;[217] and specify the demands and the needs of that customer.[218]

When an investment firm provides investment advice, it must comply with a "know-your-customer" rule based on the MiFID. It must "obtain the necessary information regarding the client's or potential client's knowledge and experience in the investment field relevant to the specific type of product or service, his financial situation and his investment objectives so as to enable the firm to recommend to the client or potential client the investment services and financial instruments

[214] Johnston JS, Communication and Courtship: Cheap Talk Economics and the Law of Contract Formation, Virg L R 85 (1999) pp 428–429.

[215] See, for example, Down in the woods, The Economist, March 2006 (on the certification of tropical timber).

[216] See Easterbrook FH, Fischel DR, The Economic Structure of Corporate Law. Harv U P, The USA (1991) p 282.

[217] Article 12(2) of Directive 2002/92/EC (Directive on insurance mediation).

[218] Article 12(3) of Directive 2002/92/EC (Directive on insurance mediation)

that are suitable for him".[219] A Level 2 Directive[220] defines more precisely the information which must be obtained from the client and the nature of the suitability assessment.[221]

Form. The firm can increase the perceived usefulness of information by disclosing information in a form that helps the end-user to understand and analyse it. This can again be illustrated by well-known examples from investment services and insurance.

When providing investment services to clients, an investment firm must give information that is "fair, clear and not misleading".[222] It must give "appropriate information" in a "comprehensible form" so that "the clients are reasonably able to understand the nature and risks of the investment service and of the specific type of financial instrument that is being offered and, consequently, to take investment decisions on an informed basis".[223]

There are similar rules in the insurance industry. All information provided by insurance intermediaries to customers must be communicated "in a clear and accurate manner, comprehensible to the customer".[224]

Delivery. The information will not reach the "man on the spot" that can be regarded as its end-user unless it is delivered to that spot. The information can be delivered there: actively (by the firm that delivers it there) or passively (by the end-user who searches for information); in one media or another (in a conference, in a brochure etc); as part of the products and services of the firm or otherwise; and to a group of end-users or to individual end-users.[225]

Management of agency problems. The firm can increase the perceived usefulness of information by signalling that its interests to produce information of certain quality are aligned with the end-user's needs to receive useful information.

For example, the firm can signal that is has an effective legal duty to comply with certain disclosure standards designed to ensure the production of useful information. Such disclosure standards can be based on statute, industry self-regulation, or contracts. The firm can sometimes choose the regulatory regime that governs its activities.

The firm can signal the alignment of interests even by other measures that normally reduce the principal's agency costs. These questions have been discussed in Chapter 6.

Disclosure to the public and usefulness. Legal rules that govern the disclosure of information to the public cannot guarantee the case-specific usefulness of information. If information is disclosed to a large number of potential end-users, the law can only require accuracy and generic usefulness. This form of objective use-

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[219] Article 19(4) of Directive 2004/39/EC (MiFID).

[220] Directive 2006/73/EC implementing Directive 2004/39/EC (MiFID).

[221] Articles 35–37 of Directive 2006/73/EC. See also recital 57.

[222] Article 19(2) of Directive 2004/39/EC (MiFID).

[223] Article 19(3) of Directive 2004/39/EC (MiFID).

[224] Article 13(1)(b) of Directive 2002/92/EC (Directive on insurance mediation).

[225] For different categories of end-users, see Kuhnle H, Banzhaf J, Finanzkommunikation unter IFRS. Grundlagen, Ziele und Gestaltung. Vahlen, München (2005) p 30.

fulness of information is determined on the basis of the information needs of a category of intermediaries or investors for the benefit of whom the disclosure rules have been designed. Case-specific usefulness must then be achieved in a different way.

For example, securities markets laws can require issuers to disclose accurate information. Some intermediaries may have a contractual duty to disclose information that fulfils certain typical information needs of a fictive category of users or investors (generic usefulness). This duty can be complemented by investment advisers' duty to recommend investments which are "suitable" for each customer (case-specific usefulness).[226] The purpose of these disclosure rules can be to increase the perceived usefulness of information and decrease perceived risk.

For this reason, legal rules on the disclosure of information to the public can be designed for the benefit of different categories of users each with different information needs.[227] Securities markets laws typically assume that information is disclosed to professional investors who use it in their own financial decision-making. Information is also disclosed to professional intermediaries who analyse it and provide new information to the marketplace. These professional intermediaries, who can also be called "multiplicators of market information",[228] include, in particular, the media, investment analysts and rating agencies. Information is also disclosed for the benefit of investment advisers who recommend suitable investments to investors. Securities markets laws can require that information disclosed by the issuer to the marketplace must comply with requirements as to its accuracy. The required generic usefulness of information varies depending on the category of users whose interests the legislator has chosen to protect. However, securities markets laws cannot require that information disclosed by an issuer or an intermediary complies with requirements as to its generic usefulness, unless the legal disclosure requirements are designed to protect a well-defined category of users (analysts, rating agencies, investment advisers). Investment services laws that protect retail investors can provide for case-specific usefulness of information provided that a particular investor turns to an intermediary for investment advice.

[226] Article 19(5) of Directive 2004/39/EC (MiFID): "Member States shall ensure that investment firms, when providing investment services other than those referred to in paragraph 4, ask the client or potential client to provide information regarding his knowledge and experience in the investment field relevant to the specific type of product or service offered or demanded so as to enable the investment firm to assess whether the investment service or product envisaged is appropriate for the client ..."

[227] See Kuhnle H, Banzhaf J, Finanzkommunikation unter IFRS. Grundlagen, Ziele und Gestaltung. Vahlen, München (2005) p 50.

[228] See *ibid*, pp 53–54.

Table 10.1 Typical Chains of Disclosure

Company →	→ Investors
Disclosure of information to the public, management of investor relations, marketing.	Financial decision-making.

Company →	The media →	→Investors
Disclosure of information to the public, management of investor relations, marketing.	Analysis and investment recommendations not based on contract.	Financial decision-making.

Company →	Analysts, rating agencies →	→ Investors
Disclosure of information to the public, management of investor relations, marketing.	Professional analysis and recommendations not based on contract with investors. Professional analysis and investment recommendations based on contract.	Financial decision-making

Company →	Analysts, rating agencies →	Investment advisers →	→ Investors
Disclosure of information to the public, management of investor relations, marketing.	Professional analysis and recommendations not based on contract.	Professional investment advice based on contract.	Financial decision-making.

Company →	Investment advisers →	→ Investors
Disclosure of information to the public, management of investor relations, marketing.	Professional investment advice based on contract.	Financial decision-making

10.5.5 Management of Reputation

The fourth of the five main objectives regarding outgoing information is the management of reputation. The firm needs to gain and retain the confidence and trust of its stakeholders (customers, suppliers, employees, shareholders, other providers of finance, and so forth). Reputation either increases or decreases: the attractiveness of the firm as a business partner; the attractiveness of the firm's products or services; the perceived accuracy and usefulness of information produced by the firm; and the perceived risk level of the firm and its securities. Reputation must be managed in the context of all kinds of activities.

In other words, a good reputation makes it easier to carry on business, and a bad reputation makes it more difficult. If the firm has a bad reputation, its sales are

likely to be lower and its costs higher. For example, a firm with a bad reputation is likely to become a less attractive business partner.[229]

The management of reputation is therefore important. Good reputation can be maintained by using several tools simultaneously.

For example, when Martin Lipton and other lawyers of Wachtell, Lipton, Rosen & Katz, a law firm, advised their clients in a famous memorandum to their clients[230] that companies need to do certain things in order to defend themselves against hedge funds, some of those things belonged to the management of reputation: "Consistently articulate the company's business and financial strategy in a way that is meaningful and understandable." "Carefully monitor analyst reports …" "Not allow the attackers to achieve the moral high ground by wrapping themselves in the cloak of good governance. Expose the attackers for what they are, self-seeking, short-term speculators looking for a quick profit at the expense of the company and its long-term value."

Consistency. The management of a good reputation requires maintaining a certain minimum level of consistency in the activities of the firm.

This can be illustrated by the development of US securities markets. As explained by *Brian Cheffins*,[231] corporate legislation did not afford extensive protection to minority shareholders in the US during the early decades of the 20th century. It was therefore standard practice for listed companies to establish a stable record of cash distributions and to avoid cutting dividends except under the direst of circumstances. In addition, firms that organised public offerings of shares on behalf of their clients normally wanted to protect their own good name, since being known as reliable could give them an edge over the competition in securing future business. They could do this, for example, by scrutinising a company's prospects prior to bringing it to the market. The NYSE also sought to build and protect its reputation by improving standards of corporate disclosure. In 1909, the NYSE imposed a requirement that listed companies distribute annual financial reports to their shareholders and from that point onwards carried out a strong campaign to improve the quantity and quality of disclosure.

The terms of trademark licences provide another example. Trademarks that have become distinctive of goods sharing a certain commercial origin can attract valuable goodwill. The owner of a trademark can grant trademark licences, for example, in the context of distribution or franchise agreements. Trademark licences usually contain provisions intended to provide the owner of the trademark with the means to ensure that the quality associated with the mark is maintained. Quality control clauses are so essential that trademark owners often would not be expected to grant a license at all without one. The importance of the maintenance of reputation by quality control clauses has been recognised in EU competition law. Necessary quality control clauses do not infringe Article 81 of the EC Treaty.[232]

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[229] In the Siemens case, adverse publicity caused by allegations of self-enrichment by employees, bribery and corruption endangered its planned joint venture with Nokia (Nokia Siemens Networks). Too little, too late? The Economist, December 2006.

[230] Be Prepared For Attacks By Hedge Funds, December 21, 2005.

[231] Cheffins BR, Law as Bedrock: The Foundations of an Economy Dominated by Widely Held Public Companies, OJLS 23 (2003) pp 10–11.

[232] Case 193/83 Windsurfing International v Commission [1986] ECR p 611, paragraph 86 (on patent licences); Commission notice.

On the contrary, such vertical restraints are believed to increase competition between manufacturers.[233]

Signalling. The above examples were also examples of signalling. The firm should signal consistency and other factors contributing to a good reputation to its stakeholders. In addition to the use of certification mechanisms, external standards, and trademarks, this can generally require the production of information that is perceived as accurate and useful. This question has already been discussed in the previous section.

Compliance programmes. The maintenance of a good reputation can make it necessary for the firm to adopt compliance programmes. The infringement of important laws and standards governing the firm's activities can signal that the firm has problems with its internal compliance culture and lacks sufficient internal controls. Compliance programmes are necessary even for reasons of corporate risk management.

Compliance with stakeholder or societal values. It is not enough for the firm to comply with minimum legal requirements and standards. The firm must usually signal to its stakeholders that it does what stakeholders expect from it, i.e. shares some core values with them.

The contents of those core values and their relative weight depends on the stakeholder category and the firm's business. (a) Firms that are in the supply chain for branded consumer goods or services are usually required to comply with societal values such as generally accepted notions of corporate social responsibility and business ethics. For example, a firm selling branded shoes to consumers will not want to be known as a firm that has its shoes made in a sweatshop. Such a firm will also have to ensure that its suppliers comply with the same ethical standards. If the firm fails to do so, the firm can eventually be punished by consumers. (b) On the other hand, a private equity fund selling nothing to consumers is less constrained by generally accepted notions of corporate social responsibility.

A usual method to ensure compliance with societal values and signal compliance to stakeholders is to adopt ethical guidelines and guidelines on corporate social responsibility and to disclose them to the public.

Corporate governance guidelines. It may be necessary for the firm to adopt a policy of "good corporate governance" (whatever it means, see section 9.6), introduce internal corporate governance guidelines, and comply with a generally acceptable corporate governance code. This is often a way to signal that the firm has adopted the values of one important stakeholder category: equity investors.

For example, the governance of a German public limited-liability company (Aktiengesellschaft, AG) is regulated by the mandatory provisions of the Aktiengesetz. There is hardly any room for any corporate governance code in Germany. A state commission nevertheless adopted a corporate governance code. The main purpose of the German Corporate Governance Code was to signal to foreign investors that German listed companies actually do adhere to generally acceptable corporate governance principles. Adopting the code was a gov-

[233] See, for example, Commission notice, Guidelines on Vertical Restraints (2000/C 291/01), paragraph 8.

ernment strategy to make German securities look more attractive without forcing German companies to change their behaviour much.[234]

Corporate risk management. The management of reputational risk belongs to corporate risk management. For example, the firm should monitor threats to reputation like it monitors any other serious risks.

Crisis management. In addition, the management of reputational risk is an important aspect of crisis management. The firm should adopt a crisis management plan and establish a crisis management team with power and authority that have clearly been defined in advance.

10.5.6 Establishing or Restricting Communication

Introduction

The last of the five main objectives regarding outgoing information is: (a) establishing communication with the intended recipients of information; (b) managing its contents; and (c) preventing communication with unwanted recipients of information. In other words: the mere production and transfer of information is useless unless the information causes a reaction in the intended recipient. Not only that, the firm would generally prefer the communication to have a certain legally relevant content. In many cases, the firm also needs to exclude some de facto recipients from the group of legally relevant recipients.

Establishing Communication

Communication can be determined in many ways.[235] For the purposes of this book, communication can be determined as one party making information available and another party reacting to that information. In this sense, communication: (1) does not exist to the extent that there is no reaction (for example, shouting in an empty desert causes air waves to vibrate but not much else); (2) is unilateral, if there is reaction to the information but the reaction does not cause a reaction in the original sender (lack of feedback like in mass communication); and (3) is bilateral, if there is reaction to the information and the reaction causes a reaction in the original sender (for example, a car computer communicating with the car engine, a stock exchange release causing a change in share price, and other forms of feedback). Social interaction increases unilateral and bilateral communication between people.

Real or fictive communication. In order for the information transfer to be legally meaningful, two things must happen.

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[234] See, generally, André TJ Jr, Cultural Hegemony: The Exportation of Anglo-Saxon Corporate Governance Ideologies to Germany, Tulane L R 73 (1998) 69–171.

[235] See Kuhnle H, Banzhaf J, Finanzkommunikation unter IFRS. Vahlen, München (2005) p 31, referring to Reichwald, Burkart, Staehle and Bruhn.

First, there must be either a real or a fictive reaction to the information by the intended recipient. There must in other words be either real or fictive communication. Real communication can be either unilateral or bilateral. Fictive communication is neither unilateral nor bilateral.

Second, the real or fictive reaction must be material enough in order to be regarded as actual notice or constructive notice.

In other words, the intended recipients should have knowledge of the information in the legal sense.

Creating evidence of real communication. The firm manages communication in order to ensure that the intended recipients are deemed to have knowledge of the information in the legal sense.

Management of communication is a mirror image of managing what information is attributable to the company and mitigating the risk that the firm itself is deemed to know something. This question was discussed in section 10.4.9 above. How the firm creates evidence of real communication can be illustrated by the following situations.

A person who signs a document which contains contractual terms is normally bound by the terms even though he has not read them and is ignorant of their precise legal effect.

The firm can also take other technical and legal measures that both force the recipient to react and create proof of that reaction. For example, the firm can ensure that the recipient cannot obtain access to a certain place, thing or information or use those things unless the recipient first physically confirms to have read and accepted certain information. One of the obvious examples of when this method is used is the mitigation of product liability.

In the EU, the Product Liability Directive provides for strict liability or liability without fault of the producer in cases of damage caused by a defective product.[236] A product is defective when it does not provide the safety which a person is entitled to expect, taking all circumstances into account, including: the presentation of the product; the use to which it could reasonably be expected that the product would be put; and the time when the product was put into circulation.[237] For this reason, manufacturers can to some extent mitigate their product liability by informing consumers of the characteristics and proper use of their products. In the US, product liability laws place a notoriously heavy burden on manufacturers. If a manufacturer receives information about its products being defective, the manufacturer must immediately decide what to do about it. The manufacturer can mitigate the danger by correcting the defect, warn the consumers, or do both (or do neither and risk liability). The consumers can take corrective action, if they have been warned by the manufacturer and given correct information about the defect.

A combination of technical and legal measures is often necessary when the firm conducts business over the internet and wants to use its own standard terms and conditions. Generally, the firm's standard contract terms will not become binding in its dealings with customers, unless the firm makes a reference to them, the firm

[236] Article 1 of Directive 85/374/EEC (Product Liability Directive).
[237] Article 6(1) of Directive 85/374/EEC (Product Liability Directive).

makes their contents available to the customer, the firm informs the customer of unusual clauses, and the customer accepts them. If the firm conducts business over the Internet, it is therefore not enough to merely state that the use of the website is subject to the firm's Terms and Conditions. The firm should also force its customers to scroll through the Terms and Conditions and give them the opportunity to decline to accept them. If customers wish to proceed they should be prompted to click an "I accept" button. In the EU, such "click-wrap" clauses are legally less problematic compared with "shrink-wrap".

The same technique can be used in other contexts. For example, it is often necessary to use this technique in order to avoid the extraterritorial application of foreign securities markets laws when information about securities is made public on an issuer's website.

In the US, the Securities Act of 1933 regulates the public offering and sale of securities by mandating public disclosures through the registration of securities. Congress used "interstate commerce" as the jurisdictional boundary for the application of the 1933 Act. The definition of "interstate commerce" covers not only "trade or commerce in securities ... among the several States", but also "between any foreign country and any State".[238] In 1990, the SEC adopted Regulation S in order to clarify the scope of the 1933 Act. Rule 903 contains a safe harbour exemption. First, the offer and the sale must be made in an "offshore transaction". The sale must not have been made to a person in the US, and the buyer must be outside the US when the order or the transaction takes places on the floor of a foreign securities exchange. Second, no directed selling efforts can be made in the US by the issuer of the security, the underwriter of the security, or any other distributor of the security. For this reason, many documents disclosed by issuers to the public contain a legal waiver according to which the document "does not constitute an offer of securities for sale in the United States" (for public offers, see Volume III).[239] In addition, a website which offers information to potential investors all over the world can refer potential investors based in certain countries to a local agent for the purposes of receiving information.

In capital markets, there are many examples of the use of technical measures and legal waivers that create evidence of a real reaction in securities markets.

The use of those technical measures and legal waivers can be illustrated by the publication on 18 January 2007 by Allianz SE, a German insurance company, of information about minority buyouts in major Allianz Group companies. The information was also published on the company's website. There was a headline at the portal. Readers who wanted to learn something about the matter could click on the headline. A legal disclaimer opened. The disclaimer first explained that the distribution of information contained in the text might in certain jurisdictions be restricted by law. The company then went on to say: "By activating the OK-button you confirm your agreement to the afore-mentioned restrictions. Further,

[238] 15. U.S.C. § 77b(a)(7)(2000).

[239] The document can contain, for example, the following clause: "The information contained herein is not for publication or distribution in or into the United States. This document does not constitute an offer of securities for sale in the United States or to or for the account or benefit of U.S. persons, nor may the securities be offered or sold in the United States absent registration or an exemption from registration as provided in the U.S. Securities Act of 1933, as amended, and the rules and regulations thereunder."

you confirm that you are not resident in the United States of America and that you are currently not physically present in the United States of America." The reader was not able to access the information without activating the OK-button.

This method can also be used when mere waivers are not enough and the firm must, for legal reasons, apply technical measures to screen its customers or people who get access to certain information. For example, if the firm wants to avoid the application of the mandatory consumer protection laws of the Member State in which a consumer has his habitual residence, the firm should not: pursue its commercial activities in that country; or direct commercial activities to that country.[240] If the firm does business over the internet, the firm should therefore ensure that its technology and web design make it possible to identify where each consumer lives and separate consumers on the basis of the governing law.

It is worth noting that such choice-of-law provisions protecting consumers do not apply to several securities transactions.[241]

These technical measures can be complemented by legal waivers. For example, the firm wants to be protected even where the firm has agreed to enter into a contract with a consumer who has lied about his habitual residence.

The Rome I Proposal contained a safeguard clause addressing this problem. According to the safeguard clause, the main rule on the law governing consumer contracts "… shall apply … unless the professional did not know where the consumer had his habitual residence and this ignorance was not attributable to his negligence".[242] However, the clause was later omitted from the Rome I Regulation.

Creating evidence of a fictive reaction. The firm can also take technical or legal measures that create a fictive reaction, because a party is presumed to have knowledge of certain facts under the applicable laws.

This can be illustrated by contract terms and the limitation of liability. Some contract terms, standard contract terms, and limitation of liability clauses can be *binding* even where the other party has never actually bothered to read them (see Volume II).

Beatson described this problem as follows: "Let us take the example of a railway ticket or cloakroom ticket, which the person receiving it puts into his pocket unread. Three general rules have been laid down by the terms contained in the ticket: (1) A person receiving the ticket who did not see or know there was any writing on the ticket will not be bound by the conditions. (2) A person who knows there was writing, and knows or believes that the writing contained conditions, is bound by the conditions. (3) A person who knows that there

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[240] Article 6(1) and recital 24 of Regulation 593/2008 (Rome I). See also Article 15(1)(c) of Regulation 44/2001 (Brussels I Regulation).

[241] Article 6(4)(d) and recital 29 of Regulation 593/2008 (Rome I).

[242] Proposal for a Regulation of the European Parliament and the Council on the law applicable to contractual obligations (Rome I), 2005/0261 (COD). See the last subparagraph of Article 5(2) of the Proposal.

was writing on the ticket, but does not know or believe that the writing contained conditions, will nevertheless be bound where the delivery of the ticket in such a manner that the writing on it could be seen is reasonable notice that the writing contained conditions. - It will quickly be seen that it is the third of these rules which is at once the most frequently to be applied and the most difficult in its application. It is sometimes known as the term of 'reasonable sufficiency of notice'."[243]

Furthermore, the firm often discloses information in order to influence the *interpretation* of the contract and to reduce its contractual liability. It is a general rule of contract law that a party who has actual or constructive (fictive) knowledge of a certain fact at the time of contracting cannot invoke that fact as a breach of contract.

On the other hand, sometimes the parties agree on a particular *procedure* for exchanging information, and they are presumed to have knowledge of information exchanged in the agreed way.

Another example of the same phenomenom is that the firm uses technical measures to inform the public of hazards in order to mitigate its own liability under *tort law*.

Managing the Legally Relevant Content of Information

It is not enough to manage communication as such. The firm should also manage the legally relevant content of information that it communicates. Information communicated to the recipient should in other words be attributable to the firm with the intended content. It should also be attributable to the recipient with intended content.

Real communication, a fictive reaction. The legal tools and practices used to create evidence of real communication or a fictive reaction also influence the legally relevant content of information (see above). In addition, as the contents of information communicated to the recipient will be interpreted, the firm will manage the content of information that it communicates by managing interpretation (for the management interpretation, see Volume II). There are also legal tools and practices that are characteristic of the management of the legally relevant content of information in corporate finance law (see below).

For example, a business acquisition contract often contains a material adverse change (MAC) clause as a condition precedent to closing or as a warranty. An acquirer who wants to ensure that it will not be deemed to have waived the right to invoke the MAC clause should therefore: avoid the making of statements according to which it is happy with the business it bought; and avoid the making of statements that can be understood to mean that it is unhappy with the deal for reasons other than those that trigger a MAC.[244]

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[243] Beatson J, Anson's Law of Contract, 27th Edition. OUP, Oxford (1998) p 162.

[244] See Schlößer D, Material Adverse Change-Klauseln in US-amerikanischen Unternehmenskaufverträgen, RIW 12/2006 p 896.

Interpretation, the common sense principles, context, legal rules. Interpretation happens every day, and firms manage the legally relevant content of information every day. For example, it goes without saying that the firm wants to increase the probability of its contracts being interpreted like it wants them to be interpreted.

Many of the methods used by the firm in contract law to manage interpretation can just as well be employed to manage the legally relevant content of information in general, because both cases are about giving the utterances, statements and behaviour of the parties a legally relevant meaning.

The starting point in the interpretation of the utterances and behaviour of a communicator is the everyday method of discovering the meaning of things said or done by the communicator. This method can be called "the common sense principles of interpretation".[245]

The meaning of things said or done cannot be ascertained separately from their context. The interpreter makes an assumption of rationality, an assumption that the communicator intends to communicate, an assumption that the communicator has optimally designed whatever is to be interpreted, and an assumption of normality (normality refers to the way things are normally done and contains normal beliefs, purposes, goals, ways of using language and so forth).[246]

The result of the process of interpretation is the discovery of the apparently intended meaning of the communicator.[247] For many reasons, there is a presumption in favour of the linguistic meaning, i.e. the meaning discovered by application of the linguistic code that is conventionally used in that particular community.[248]

On the other hand, legal rules will influence the interpretation of the legally relevant content of communication. When determining the legally relevant content of communication, legal rules form part of the context. As will be discussed in Volume II in more detail, managing that content requires special knowledge of law and legal terminology as well as the employment of legal techniques.

The legal techniques include: controlling the contents and flow of information; compliance with the interpretation techniques of the governing law; documentation and careful drafting; the use of sufficiently plain and clear language; the use of the language of the place where the information is to be interpreted; management of the problem of different linguistic versions (for example, choosing one linquistic version to be authoritative); adaptation of terms to the governing law; and, most importantly, ensuring that the communication is internally coherent.

Legal techniques characteristic of corporate finance. Some legal techniques are characteristic of the law of corporate finance in which the firm typically will try to limit its liability for the accuracy and usefulness of information. Whether the legal tools and practices used by the firm are legally effective often depends on mandatory provisions of law. For example, the firm cannot validly limit its liability for fraudulent misstatements.

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[245] Kramer A, Common Sense Principles of Contract Interpretation (and how we've been using them all along), OJLS 23(2) (2003) pp 173–196.
[246] *Ibid*, pp 176–177 and 181.
[247] *Ibid*, p 176.
[248] *Ibid*, pp 182–183.

Choice of topic. The firm may freely choose its topic, i.e. promise to make a statement only about a certain thing and refuse to say anything about anything else. The choice of the topic is a usual way to mitigate the firm's responsibility for the usefulness of information. The choice of the topic can cause a gap between the expectations of the recipients of information and the intentions of the firm as a source of information.

For example, credit-rating agencies that give opinions on debt instruments are careful to point out that their ratings measure credit risk, i.e. the odds of default on a debt instrument that is held to maturity. They do not measure market risk (whether the price of the asset will rise or fall until it reaches maturity) nor liquidity risk (whether the asset will remain easily tradeable). Because of an expectation gap before the subprime mortgage crisis, many investors wrongly assumed that all AAA-rated instruments would be equally liquid.[249] It became clear that investors willing to invest in a credit should understand both the credit and the rating; they should not invest in the rating.

The auditor-investor expectation gap provides a further example. This is the gap between the auditors' required standard of performance and the various public expectations of auditors' performance. Whereas many investors expect that an audit is an assurance of a company's financial health, an audit is in fact limited to the accuracy of a company's financial statements based on information that the company itself provides.

Choice of context. The firm may limit the context in which the information may be relied on.

For example, an offer document published by three Eurotunnel companies in 2007 contained a "Financial Analysis Report" by a bank. The report contained the following statement: "The analyses contained in this report … are reserved for the exclusive use of Eurotunnel and the Joint Board, solely within the framework of the [public exchange offer] and the implementation of the [safeguard plan adopted by the Paris commercial court on 15 January 2007]."

Choice of assumptions. A further way to dilute the legal relevance of information is by stating that it is only based on certain assumptions.

For example, a legal opinion provided by a law firm would be based on the assumption that the laws of a certain country apply. If the country is Switzerland, the opinion would contain the following waiver: "This legal opinion is expressed only with respect to the laws of Switzerland." The legal relevance of the information is diluted, if the law that governs contracts is not Swiss law, if one or more of the parties is a company incorporated outside Switzerland, if assets are not located in Switzerland, and so forth (for legal opinions, see section 4.3.4).

Another usual example is related to valuation. All valuations are based on assumptions. For example, the "Financial Analysis Report" provided by a bank to the three Eurotunnel companies (see above) was based on several assumptions: assumptions regarding Eurotunnel's business (market growth, change in market share and the prices charged by Eurotunnel); assumptions about Eurotunnel's future cash flow; the Capital Asset Pricing Model, the choice of a risk-free rate, the choice os a prospective market risk premium, the choice of a risk coefficient, and other things.

[249] On credit watch, The Economist, October 2007.

From a legal perspective, the choice of the assumptions is constrained by general constraints and specific constraints. (a) Generally, any provision of information can be constrained by the prohibition of fraud and liability for negligent misstatements. This applies also to the choice of assumptions. When a party provides information in the course of performance of its contractual obligations, the party may have a duty to show due care when making those assumptions. (b) Sometimes there are specific rules on the choice of assumptions. For example, when comparing different investment products, a financial adviser may have to comply with mandatory provisions of law or standards that set out in detail what assumptions a financial adviser may make.

Express limitations of liability, qualified terms. Other usual techniques range from express limitations of liability to the use of qualified terms such as "to the best of my knowledge".

The use of those two methods can be illustrated by the following "forward-looking statements" clause that might be found in an offer document relating to a share exchance offer or a takeover bid: "This document and the prospectus may contain forward-looking statements concerning the offeror and the target. Generally, the words 'will', 'may', 'should', 'continue', 'believes', 'expects', 'intends', 'anticipates', or similar expressions identify forward-looking statements. The forward-looking statements involve risks and uncertainties that could cause actual result to differ materially from those expressed in the forward-looking statements. Many of these risks and uncertainties relate to factors that are beyond the companies' abilities and therefore undue reliance should not be placed on such statements. The offeror and the offeree assume no obligation and do not intend to update these forward-looking statements, except as required pursuant to applicable law."[250]

Responsibility of the recipient. A further usual technique is to channel any responsibility for compliance with legal rules, any legal liability, or any responsibility for the accuracy or usefulness of information, to the recipient.

This technique can be illustrated by the following examples: (a) Business acquisition contract. "The vendor gives no warranty. The buyer has performed a due diligence inspection" (for such clauses, see Volume III). (b) Prospectus. "Persons in possession of this [document] or any other document relating to [shares] must make themselves aware of the potential restrictions imposed by local regulatory authorities and observe relevant regulations."[251]

Reliance on information analysed by others. In addition, the information intermediary can try to mitigate risk by: reducing its duty to analyse the accuracy and usefulness of information; acting mainly as an intermediary that just transfers infor-

[250] The text is roughly based on the offer document of Groupe Eurotunnel SA, Eurotunnel SA and Eurotunnel plc relating to the offer by Groupe Eurotunnel SA for the units comprising one share of Eurotunnel SA and one share of Eurotunnel plc. A French language version of the document was approved by the Autorité des marches financiers on 3 April 2007.

[251] The text is roughly based on the securities note of Groupe Eurotunnel SA and Eurotunnel plc relating to the issue of ordinary shares of groupe Eurotunnel SA and other securities. The document was approved by the Autorité des marches financiers on 4 April 2007.

mation without analysing it; and signalling to recipients that it only relies on information analysed by others. There are numerous examples of the use of this technique in corporate finance law.

For example, a legal opinion provided by a law firm to a bank could contain the following waiver: "As to any facts material to this opinion, we have, without further investigations, relied upon certificates of public officials or certificates, representations or opinions of officers and other representatives of the Borrower, and upon the representations of the Borrower contained in and given in connection with the Loan Agreement. In our examination we have assumed that all signatures are genuine, all documents submitted to us as copies conform with the originals and these originals are authentic."

From a legal perspective, the question is to what extent a person can comply with his duty of care and other legal duties and channel the responsibility for the accuracy and usefulness of information to others in this way. In many cases, the minimum requirement is that: the information intermediary had no actual knowledge of the information not meeting legal requirements; the information seemed to comply with legal requirements at first sight; and the information intermediary had shown due care when choosing the parties by whom the information was analysed.

The use of this method can be illustrated by reliance on information provided by expert advisers, reliance on information verified by auditors, and reliance on information provided by legal advisers.

Reliance on information provided by expert advisers. There are many examples of reliance on information provided by expert advisers.

According to the Second Company Law Directive, a report must be drawn up by one or more experts who are independent of the company before shares are issued for a consideration other than cash.[252] The Third Company Law Directive provides that one or more independent experts must examine the draft terms of merger and draw up a written report to the shareholders. In the report, the experts must, for example, state whether in their opinion the share exchange ratio is fair and reasonable.[253]

In both cases, the board would be guilty of breach of duty if it failed to submit the report to the general meeting. In addition, depending on the governing law, even a wrong valuation could trigger a breach of duty. Board members can therefore mitigate the risk of breach of duty by complying with the opinion of the independent experts.

Board members should not rely on an opinion if they know that it is not based on sufficient analysis. In the US case of *Smith v Van Gorkom*,[254] the Delaware Supreme Court decided that the board of directors of Trans Union Corporation, while acting in good faith, had nonetheless been grossly negligent in recommending a merger offer, in part, because the board had not made an "informed" decision.

[252] Article 27(1) of Directive 77/91/EEC (Second Company Law Directive).
[253] Articles 10(1) and 10(2) of Directive 78/855/EEC (Third Company Law Directive).
[254] Smith v Van Gorkom, 488 A.2d 858 (Del. 1985).

Both before and after *Smith v Van Gorkom*, there was not and is not a legal obligation that corporate boards obtain fairness opinions under Delaware law. However, there is widespread belief that a fairness opinion is required for protection under the business judgment rule and therefore is uniformly obtained by target firms' boards.[255] This can be contrasted with English law. In England, the City Code on Takeovers and Mergers (the Takeover Code) requires expert advice. For example, Rule 3.1 provides: "The board of the offeree company must obtain competent independent advice on any offer and the substance of such advice must be made known to its shareholders."[256] According to Rule 9.5, the value of a consideration other than cash must be determined by an independent valuation. Rule 29.1 further provides that, when a valuation of assets is given in connection with an offer, it should be supported by the opinion of a named independent valuer.

Reliance on information verified by auditors. Provisions of EU company and capital markets law often require information to be verified by a company's statutory auditors (see section 10.7.6). This gives other parties a chance to use statements made by statutory auditors as a basis for their own statements and in effect to mitigate risk of breach of duty of care.

This can be illustrated by a case where part of the responsibility of a "person responsible" was channelled to statutory auditors. In the 2007 registration document[257] relating to Groupe Eurotunnel SA and Eurotunnel Group UK plc, the "person responsible"[258] gave the following declaration: "I declare, having taken all reasonable care to ensure that such is the case, that the information contained in this Registration Document and its annexes relating to Eurotunnel, GET SA and EGP is, to the best of my knowledge, in accordance with the facts and contains no omission likely to affect its significance. I have been provided with a final report from the statutory auditors (lettre de fin de travaux) in which they indicated that they had performed the verification of the consistency of the information relating to the financial situation with the historical and forecast financial information and Pro Forma data contained in this Registration Document and its annexes and had read all of the Registration Document and its annexes. The final report contained the following observations …" The declaration then referred to several observations by the statutory auditors. In practice, it would have been hard to make the "person responsible" liable for any misstatements about the financial situation of Eurotunnel.

Reliance on information provided by legal advisers. As a rule, major financial contracts contain a clause according to which the closing of the contract (or the advancement of funds) is subject to the condition precedent that the firm receives acceptable legal opinions (for legal opinions, see section 4.3.4). Reliance on information provided by legal advisers is generally a usual way to mitigate the risk of breach of duty of care.

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[255] Bowers HM, Fairness Opinions and the Business Judgment Rule: an Empirical Investigation of Target Firms' Use of Fairness Opinions. Nw U L R 96 (2002) pp 570–571.
[256] See also Rules 3.2, 15 and 25.1 of the City Code.
[257] Article 5(3) of Directive 2003/71/EC (Prospectus Directive).
[258] Article 6(1) of Directive 2003/71/EC (Prospectus Directive).

Managing the Legally Relevant Recipients of Information

The firm will often have to limit the legally relevant recipients of information. For example, a listed company will need to avoid the extraterritorial application of foreign capital markets laws, a company issuing securities may prefer to avoid the application of prospectus rules, and a firm that sells its products by electronic means may want to avoid the application of foreign consumer laws.

Real communication, a fictive reaction. The legal tools and practices used to create evidence of real communication or a fictive reaction can again be used for this purpose (see above). The firm can thus use both legal waivers and technical measures in order to make sure that only a certain group of recipients will be legally relevant.

Choosing the relevant recipients of information. The choice of the relevant recipients of information depends on the context. It can also depend on many legal reasons. The most common situations are the following.

First, the firm may prefer to limit its liability. This is particularly important to financial and legal advisers and people who do similar consultancy work.

For example, a law firm that gives a legal opinion that will in practice be read by many could limit its liability by stating in the opinion that "the opinion is addressed to [a named client] and may not be relied on by any other party".

Second, the firm may try to avoid the application of legal requirements connected to the information being made available to certain recipients. Managing the legally relevant recipients of information is a way to adapt to provisions of mandatory law.

Legal practices used by firms for this purpose can be illustrated by the Securities Note (prospectus) published by Groupe Eurotunnel SA and Eurotunnel Group UK plc in 2007. The following things were mentioned in the Securities Note under the heading "Selling restrictions": (a) The publication of the Securities note may, in certain countries, be subject to specific regulations. (b) Persons in possession of the Securities Note must make themselves aware of the potential restrictions imposed by local regulatory authorities and observe relevant regulations. (c) The publication the Securities Note or any other document does not constitute an offer to sell or the solicitation of an offer to subscribe or to purchase securities in any country in which such an offer or solicitation would be illegal. (d) In particular, the Securities Note was adapted to US law by limiting the Securities Note's scope. (e) It was also stated in the Securities Note why it did not fall within the scope of the Prospectus Directive (see Volume III).

10.6 Analysis of Rights and Duties Relating to Disclosure

Before turning to the regulation of information related matters in Community law, it is useful to pay attention to the diversity of disclosure rights and duties.

There is a vast amount of rules that lay down rights and duties relating to disclosure of information. From a legal perspective, the firm can be represented by different intermediaries. Depending on the circumstances, each intermediary can have: a right to disclose information, a duty to disclose information, or a duty not

to disclose information. These rights and duties can typically be based on different legal rules (for example contract law, company law, securities markets law, criminal law) depending on who the intermediary is and who the party to whom information is disclosed. Again depending on the circumstances, other parties than the firm may have: a right to ask for information, a right to be disclosed information, a duty to ask for information, or a duty not to ask for information. Even these rights and duties can typically have different legal bases depending on who that other party is and the circumstances. In both cases, the existence of a duty of care or a similar duty or a contractual relationship always belong to the potential legal bases that might govern the rights and duties of the parties. There can also be other legal bases depending on the circumstances.

The rights and duties of each party can only be analysed separately, taking into account each legal base and each recipient of information (see for, example, section 10.7 below).

Table 10.2 Rights and Duties Relating to Information (a Framework). The duty of care is a potential legal basis in all cases. A contract is also a potential legal basis in all cases.

	Legal basis(1) Party A		Legal basis(1) Party B		Legal basis(2) Party A		Legal basis(2) Party B	
	To C	Or D	To C	Or D	To C	Or D	To C	Or D
Right to disclose info								
Duty to disclose info								
Duty not to disclose info								

	Legal basis(1) Party C		Legal basis(1) Party D		Legal basis(2) Party C		Legal basis(2) Party D	
	From A	Or B	From A	Or B	From A	Or B	From A	Or B
Right to ask for info								
Right to be disclosed info								
Duty to ask for info								
Duty not to ask for info								

10.7 Community Law

10.7.1 Introduction

Practically all legal rules can influence the behaviour of firms in a market economy and all decisions are based on information in one way or another. There is

therefore a vast amount of Community legislation affecting the management of information by firms indirectly. On the other hand, parts of Community law can influence the management of information by firms more directly. Morover, provisions of Community law regulate information rights and duties in different ways depending on the target, the intermediary, the user, the area of law, and other things.

This means that it is not possible to analyse all information-related legal aspects of Community law in a meaningful way. It suffices to highlight main policy choices, the regulation of certain intermediaries (gatekeepers), and the regulation of the quality of information. The information management regime for listed companies and information management in the context of takeovers of listed companies will be discussed in Volume III.

General information about investments. As discussed earlier, information is not like other economic goods. It is used as an input into decisions about other goods. The regulation of investment information therefore follows the regulation of the particular types of investment and depends on general policy objectives pursued in different areas of Community law. The effect of Community law on investment decisions will be discussed later in this book in the context of each particular transaction.

10.7.2 Main Policy Choices

General Remarks

The role of Community law has to a large extent been determined by four policy choices: the choice of the size of the information regulation regime at Community level; the choice between information rules and mandatory substantive rules; the choice to deal with agency problems at the level of Member States' laws or at the Community level; and the choice of the quality of information.

Information Rules v Substantive Rules

To begin with, there is a distinction between information (disclosure) rules and substantive rules, although this distinction is not always clear in practice.

Information rules and substantive rules. Disclosure rules are sometimes employed to affect other obligations or core obligations (the "substance"). For example, disclosure can discourage a party from dealing with a certain other party.

The use of this technique in Community law can be illustrated by a provision of the MiFID: "Where organisational or administrative arrangements made by the investment firm ... to manage conflicts of interest are not sufficient to ensure, with reasonable confidence, that risks of damage to client interests will be prevented, the investment firm shall clearly disclose the general nature and/or sources of conflicts of interest to the client before undertaking business on its behalf."[259] Another example can be found US securities market laws that

[259] Article 18(2) of Directive 2004/39/EC (MiFID).

may prohibit company insiders from trading unless they make disclosures that make trading pointless.[260]

One could also look at substantive rules regulating the core obligations of the parties the other way round. The existence of substantive rules regulating the behaviour of parties provides information about the expected behaviour of those parties. For example, if at least one board member must by law be an external non-executive director, you would be surprised to find a company with no external non-executive directors in that jurisdiction.

Domination of information rules. In any case, the EC Treaty generally gives supremacy to information rules over substantive mandatory law. The dominance of information rules is based on the fundamental freedoms and the principle of proportionality. The effect of this principle is partly to limit the amount of Member States' substantive mandatory rules, partly to throw doubt on the validity of existing substantive mandatory rules in cross-border situations.

Summary. To sum up, the firm can find many legal rules that set out the quality of information and the duty to disclose information. Some of them are based on legal instruments adopted by Community institutions. The firm can also find many legal rules that set out core obligations and modalities of fulfilling them (the "substance"). Those provisions are more likely to be found in Member States' laws than in legal instruments adopted by Community institutions.

Fundamental freedoms. The information model adopted in Community law was established by the judgment of the ECJ in the *Cassis de Dijon* case.[261] The Cassis de Dijon principle has been applied in numerous other cases. It is binding not only for Member States but also for the Community legislator.[262]

The case was about German law. It was at that time illegal to import French Cassis de Dijon to Germany. Whereas fruit liquors were required to have an alcoholic strength of at least 25% under German law, there was no such requirement in France. The ECJ held that the German requirement amounted to a breach of Community law, because the EC Treaty prohibits both quantitative restrictions on imports and all measures having equivalent effect.[263] The ECJ said that, in the absence of common rules, "obstacles to movement within the Community resulting from disparities between the national laws relating to the marketing of the products in question must be accepted in so far as those provisions may be recognised as being necessary in order to satisfy mandatory requirements relating in particular

[260] Easterbrook FH, Fischel DR, The Economic Structure of Corporate Law. Harv U P, The USA (1991) p 276.

[261] Case 120/78 Rewe-Zentral AG v Bundesmonopolverwaltung für Branntwein [1979] ECR 649 ("Cassis de Dijon").

[262] Joined Cases 80–81/77, Commissionaires Réunies and Fils de Henri Ramel [1978] ECR 927; see also Grundmann S, Kerber W, Weatherill S, Party Autonomy and the Role of Information in the Internal Market – an Overview. In Grundmann S, Kerber W, Weatherill S (eds), *op cit*, p 18.

[263] Article 29 of the EC Treaty. See also Article 30.

to the effectiveness of fiscal supervision, the protection of public health, the fairness of commercial transactions and the defence of the consumer”.[264]

The ruling of the ECJ in the Cassis de Dijon case influences the Community legislator’s choice between information rules and substantive rules. If a national legislator can attain its objective by prescribing information to be supplied to the person to be protected, the mere information rule has to be preferred to a mandatory substantive rule, because the latter would not be regarded as “necessary”.[265]

The information model has been applied in many areas of law. It has also been applied in company law in several cases dealing with the freedom of establishment. In the *Centros* case,[266] the ECJ held that the registration of Centros Ltd as a private limited company in England was sufficient to protect creditors and that Centros Ltd could not be required to comply with Danish company law including its minimum capital requirements. In *Inspire Art*,[267] the ECJ ruled that English disclosure requirements were sufficient to protect people dealing with an English limited-liability company and that the Netherlands could not require the English company to comply with further disclosure requirements under Dutch company law.

Secondary legislation and proportionality. Information rules can be found in legislative instruments adopted by Community institutions in various fields of Community law. Information rules dominate in EU contract law, in EU company and capital markets law, and in EU financial services law.

Various mechanisms are employed in order to enable the party less informed to take rational decisions. The techniques vary according to whether search goods, experience goods, or credence goods are involved.[268]

EU information rules typically protect consumers and non-professionals rather than parties that can look after themselves. However, many information rules protect even business undertakings.

This can be illustrated by product safety directives based on the principles of the so-called “new concept”. The directives require compliance with certain minimum standards and provide for a notification mechanism.[269] Many of the directives make CE marking mandatory. CE marking is a way to signal compliance.

The MiFID is an example of a directive which requires staggered levels of protection depending on the characteristics of the customer.[270]

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[264] Case 120/78 “Cassis de Dijon” [1979] ECR 649, paragraph 8.
[265] Grundmann S, Kerber W, Weatherill S, Party Autonomy and the Role of Information in the Internal Market – an Overview. In Grundmann S, Kerber W, Weatherill S (eds), *op cit*, pp 17–19 and 36.
[266] Case C-212/97 Centros [1999] ECR I-1459.
[267] Case C-167/01 Inspire Art [2003] ECR I-10155.
[268] Grundmann S, Kerber W, Weatherill S, *op cit*, p 36.
[269] See, for example, Directive 98/37/EC (machinery).
[270] Article 19 of Directive 2004/39/EC (MiFID).

Information rules have several advantages. The principle of proportionality speaks for information rules, because the EC Treaty provides that action by the Community shall not go beyond what is necessary to achieve the Treaty's objectives.[271] Information rules are supported by reasons of integration policy, because consensus can be reached more easily for information rules and disputes about mandatory substantive solutions can be avoided. In addition, party autonomy and market mechanisms can be maintained.[272]

Dealing with Agency Problems in General

In addition to the information model, it is necessary to study how Community law deals with agency problems relating to information. Community law leaves Member States plenty of discretion in this respect.

Lack of harmonisation. Again, the extent to which Community institutions can have power to adopt common rules to address agency problems depends on the principles of subsidiarity and proportionality.

Sometimes Community institutions adopt legal instruments that contain information rules. The harmonisation of information rules decreases the cost of being informed.

However, the principles of subsidiarity and proportionality in the EC Treaty make it more difficult to harmonise rules that allocate the responsibility to produce information, the incentives to produce high quality information, and the liability for failure to produce information that fulfils all requirements. Member States' laws should contain information rules required by Community law, but apart from that, each Member State may choose its own strategy to address agency problems.

This means that the firm should study Member States' laws before deciding how to manage agency problems. Member States' laws tell you how those agency problems have been dealt with by legal backgound rules. The existence of ,such rules makes some legal tools more useful than others depending on the context and the governing law.

Discretion of Member States. The case-law of the ECJ and secondary Community law contain many examples of the basic principle that agency problems have been addressed by Member States' laws rather than Community law.

The ECJ has repeatedly held that penalties for infringements of provisions of Community law must be effective, proportionate, and dissuasive.[273] In normal cases, the Member States are free to regulate sanctions for infringements according to that principle and the subsidiarity principle. If Community law laid down these sanctions, it would be necessary to ask whether such a provision of Community law complied with the principle of proportionality: Are the means which it

[271] Article 5 of the EC Treaty.

[272] Grundmann S, Kerber W, Weatherill S, *op cit*, p 36.

[273] Since Case 68/88 Commission v Greece [1989] ECR 2965, paragraphs 23 and 24. See, for example, joined Cases C-387/02, C-391/02 and C-403/02, Silvio Berlusconi and others [2005] ECR I-3565, paragraph 53.

employs suitable for the purpose of achieving the desired objective and are they necessary?[274]

Examples. It is therefore not surprising that both the allocation of the responsibility to comply with provisions of Community law and the sanctions for the breach of national provisions adopted under Community law have often been left to the discretion of the Member States.

For example, the First Company Law Directive, which approximates duties to disclose basic company information, provides that each Member State shall determine by whom the disclosure formalities are to be carried out,[275] and lay down appropriate sactions.[276] The Directive on takeover bids provides that the "Member States shall determine the sanctions to be imposed for infringement of the national measures adopted pursuant to [the Takeover Directive] and shall take all necessary steps to ensure that they are put into effect". In addition, the "sanctions thus provided for shall be effective, proportionate and dissuasive". [277] According to the Transparency Directive, "appropriate liability rules, as laid down by each Member State under its national law or regulations, should be applicable to the issuer, its administrative, management or supervisory bodies, or persons responsible within the issuer". The Directive makes clear that "Member States should remain free to determine the extent of the liability". As regards penalties, the Directive provides that "Member States shall ensure, in conformity with their national law, that at least the appropriate administrative measures may be taken or civil and/or administrative penalties imposed in respect of the persons responsible, where the provisions adopted in accordance with this Directive have not been complied with". Even in this case, "Member States shall ensure that those measures are effective, proportionate and dissuasive".[278]

The SE Regulation[279] provides a further example of the application of the principle that agency problems are addressed by Member States' laws rather than Community law. The SE Regulation contains a number of rules applicable to the governance of a European company (SE). For example, Article 38 lays down the basic management structure and organs of an SE. However, the Regulation contains detailed rules on relatively few issues. For example, the Regulation sets out the legal nature of an SE and how an SE can be set up. These rules are necessary since this company form is based on Community law, and it would not be possible to set up an SE under national company law only. In addition, the rules on the setting up of an SE address several legal problems relating to the cross-border restructuring of operations. The lack of detailed rules can be explained by the basic legislative technique used in the Regulation and great reliance on Member States' laws. The minimum use of uniform rules is based on the principle of subsidiarity (recital 29).[280] An SE founded in England is thus largely governed by English law, and an SE founded in Germany by German law. The basic legislative technique used in the Regulation is, first, that the provisions

[274] See, in particular, Case C-426/93 Germany v Council [1995] ECR I-3723, paragraph 42; and Case C-26/00 Netherlands v Commission [2005] ECR I-0000, paragraph 126.
[275] Article 5 of Directive 68/151/EEC (First Company Law Directive).
[276] Article 6 of Directive 68/151/EEC (First Company Law Directive).
[277] Article 17 of Directive 2004/25/EC (Directive on takeover bids).
[278] Article 28(1) and recital 17 of Directive 2004/109/EC (Transparency Directive).
[279] Regulation 2157/2001/EC on the Statute for a European company (SE).
[280] Recital 29 of Regulation 2157/2001 (SE Regulation). See also recital 9 and Teichmann C, Die Einführung der Europäischen Gesellschaft. Grundlagen der Ergänzung des europäischen Statuts durch den deutschen Gesetzgeber, ZGR 2002 pp 391–392.

of the Regulation set out some general rules which are directly applicable in the Member States and, second, that the modalities of different rights and obligations are based on the provisions of national laws.[281]

The effect of the Sarbanes-Oxley Act. The Sarbanes-Oxley Act adds a further layer to the regulation of agency relationships in the EU by expanding corporate governance and accounting requirements for SEC-registered non-US companies. A company incorporated in Europe must comply with the Sarbanes-Oxley Act if it wants to be in the US capital markets. The Sarbanes-Oxley Act has created problems for foreign companies listed in the US because it imposes new substantive requirements that may conflict with foreign companies' home country laws.[282] For this reason, the Sarbanes-Oxley Act has influenced new Community legislation in the field of corporate governance and the disclosure of information.[283]

The Size of the Regulatory Regime

The third policy choice is the size of the regulatory regime. The size of the regulatory regime depends on the general policy objectives of the EU. As regards the disclosure of *financial* information, the policy objectives of the EU include the creation of an internal market, the protection of the financial system, the protection of investors and shareholders, and a high level of protection for consumers and retail investors.

The question of regime size can be illustrated by the extensive disclosure regime applied to companies whose shares have been admitted to trading on a regulated market in a Member State (see also Volume III) or to public limited-liability companies (such as the SA, AG, plc) that are privately-owned. Most of this regime will not apply to private limited-liability companies (such as the SARL, GmbH, ltd).

There is also a large disclosure regime applicable to information intermediaries producing financial information. This regime will be discussed below.

Disclosure of periodic information. There are common rules on the publication of annual accounts (the Fourth Directive) and consolidated accounts (the Seventh Directive).[284] The Transparency Directive applies to listed companies and requires annual and half-yearly financial reports.[285] Financial reports must contain the

[281] Kübler F, Leitungsstrukturen der Aktiengesellschaft und die Umsetzung des SE-Statuts, ZHR 167 (2003) p 223: "Die VO gibt nur einen Rahmen vor, der durch die schon bestehenden Aktiengesetze der Mitgliedstaaten und durch die von ihnen zu schaffenden Rechtsvorschriften implementiert wird."

[282] See, for example, Ribstein LE, International Implications of Sarbanes-Oxley: Raising the Rent on U.S. Law, JCLS 3 (2003) p 306.

[283] See, for example, Communication from the Commission to the Council and the European Parliament of 27 September 2004 on preventing and combating corporate and financial malpractice, COM(2004) 611 final.

[284] See also Article 62 of Regulation 2157/2001 (SE Regulation); Directive 2000/12/EC (credit institutions); and Directive 91/674/EEC (insurance undertakings).

[285] Articles 4, 5 and 6 of Directive 2004/109/EC (Transparency Directive).

audited (annual) or condensed (half-yearly) financial statements of the company, a management report and statements. The First Directive provides for the compulsory disclosure by all limited-liability companies of the balance sheet and the profit and loss account for each financial year.[286]

Financial reporting standards. There are many sets of financial reporting standards in the EU. (a) Listed companies must use IFRS for their consolidated accounts under the International Accounting Standards (IAS) Regulation.[287] The IAS Regulation allows Member States to extend this requirement to the annual accounts of listed companies[288] and/or to the annual[289] and/or consolidated accounts of all companies.[290] (b) Other companies use the standards set out by the Fourth and Seventh Company Law Directives.[291] (c) These standards are complemented by Member States' national accounting requirements.[292] (d) In practice, a company may have to use US GAAP or the English version of IFRS in addition to IFRS as applied in its home country, if its securities are listed in the US. In 2007, the SEC decided to abolish the reconciliation to US GAAP for foreign companies using IFRS – but only for foreign companies using IFRS as published by the International Accounting Standards Board (IASB), i.e. the standard-setting body based in London. This increases the number of financial reporting standards. (e) There is also a proposal for IFRS for Non-publicly Accountable Entities (NPAEs).[293]

Ad-hoc disclosure. The most important rules on ad-hoc disclosure can be found in the Market Abuse Directive and the Transparency Directive. The Listing Directive contains further rules on ad-hoc disclosure.

The Market Abuse Directive not only prohibits abuse but also requires issuers to publish information.[294] (a) There is an obligation to disclose inside information to the public.[295] Under some circumstances, disclosure of inside information may be delayed, provided that the delay would not be likely to mislead the public and the issuer is able to ensure the confidentiality of that information.[296] There is a rule

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[286] Article 2(1) of Directive 68/151/EEC (First Company Law Directive).

[287] Article 4 of Regulation 1606/2002/EC (IAS Regulation). In Germany, § 315a(1) and § 315a(2) HGB.

[288] Article 5 of Regulation 1606/2002/EC (IAS Regulation). § 325(2a) and § 325(2b) HGB. See also § 264(1) HGB ("HGB-Abschluss").

[289] Article 5 of Regulation 1606/2002/EC (IAS Regulation). § 325(2a) and § 325(2b) HGB. See also § 242 and 264(1) HGB ("HGB-Abschluss").

[290] Article 5 of Regulation 1606/2002/EC (IAS Regulation). § 315a(3) HGB.

[291] Directive 78/660/EEC (Fourth Company Law Directive) and Directive 83/349/EEC (Seventh Company Law Directive).

[292] For example, § 242 HGB and § 264(1) HGB ("HGB-Abschluss").

[293] The first draft was issued in February 2007 ("International Financial Reporting Standards for Small and Medium-sized Entities", IFRS for SMEs). See, for example, Luttermann C, Rechnungslegung ist ein Rechtsakt, kein Marketing, FAZ, 26 February 2007 p 20. In May 2008, the name of the draft standard was changed to "IFRS for Private Entities".

[294] See Articles 2, 3 and 6 of Directive 2003/6/EC (Directive on market abuse).

[295] Article 6(1) of Directive 2003/6/EC (Directive on market abuse). For a definition of "inside information, see Article 1(1).

[296] Article 6(2) of Directive 2003/6/EC (Directive on market abuse).

on selective disclosure: “Member States shall require that, whenever an issuer, or a person acting on his behalf or for his account, discloses any inside information to any third party in the normal exercise of his employment, profession or duties … he must make complete and effective public disclosure of that information, simultaneously in the case of an intentional disclosure and promptly in the case of a non-intentional disclosure”.[297] (b) Primary insiders are prohibited from disclosing inside information to any other person unless such disclosure is made in the normal course of the exercise of his employment, profession or duties.[298] (c) They are also prohibited from recommending or inducing another person, on the basis of inside information, to acquire or dispose of financial instruments to which that information relates.[299]

The Listing Directive contains regulations on the information that must be published in the listing particulars and on continuing obligations. Like the Market Abuse Directive, the Listing Directive provides that “[t]he company must inform the public as soon as possible of any major new developments in its sphere of activity which are not public knowledge and which may, by virtue of their effect on its assets and liabilities or financial position or on the general course of its business, lead to substantial movements in the prices of its shares”.[300]

The Transparency Directive provides that a person acquiring or disposing of shares so that its holding with a publicly traded company reaches, exceeds or falls below certain thresholds informs the company, which is in its turn responsible for disclosing this information to the public.[301]

Transactions. Community law requires the disclosure of information in the context of important transactions. Some of those transactions fall within the scope of the Prospectus Directive. In addition, the Second and Third Company Law Directives, and other Company Law Directives lay down disclosure rules relating to capital transactions that must be approved by the general meeting. The Directive on takeover bids requires disclosure in the context of voluntary or mandatory takeover bids.

Prospectuses and listing particulars. The Prospectus Directive makes it easier and cheaper for companies to raise capital throughout the EU on the basis of approval from a regulatory authority (“home competent authority”) in one Member State. It reinforces protection for investors by guaranteeing that all prospectuses, wherever in the EU they are issued, provide them with the information they need to make investment decisions. A prospectus is a disclosure document, containing key financial and non-financial information, that a company makes available to potential investors when it is issuing securities (shares, bonds, derivative securities, etc.) to raise capital and/or when it wants its securities admitted to trading on exchanges. The Prospectus Directive only concerns initial disclosure require-

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297 Article 6(3) of Directive 2003/6/EC (Directive on market abuse).
298 Articles 2(1), 2(2) and 3(a) of Directive 2003/6/EC (Directive on market abuse).
299 Article 3(b) of Directive 2003/6/EC (Directive on market abuse).
300 Article 68(1) of Directive 2001/34/EC (Listing Directive).
301 Article 9(1) of Directive 2004/109/EC (Transparency Directive).

ments. Conditions for admission to listing are subject to the Listing Directive and national requirements.

According to the Prospectus Directive, “the prospectus shall contain all information which, according to the particular nature of the issuer and of the securities offered to the public or admitted to trading on a regulated market, is necessary to enable investors to make an informed assessment of the assets and liabilities, financial position, profit and losses, and prospects of the issuer and of any guarantor, and of the rights attaching to such securities. This information shall be presented in an easily analysable and comprehensible form.”[302] The prospectus shall also include a summary.

According to the Listing Directive, the “listing particulars shall contain the information which, according to the particular nature of the issuer and of the securities for the admission of which application is being made, is necessary to enable investors and their investment advisers to make an informed assessment of the assets and liabilities, financial position, profits and losses, and prospects of the issuer and of the rights attaching to such securities”.[303]

Public takeover bids. The Directive on takeover bids regulates the obligations of the board of the offeree company and the obligations of the offeror company in the context of public takeover bids. The main disclosure obligations of the board of the offeree company are the following:

- “[T]he holders of the securities of an offeree company must have sufficient time and information to enable them to reach a properly informed decision on the bid; where it advises the holders of securities, the board of the offeree company must give its views on the effects of implementation of the bid on employment, conditions of employment and the locations of the company’s places of business”.[304]
- “The board of the offeree company shall draw up and make public a document setting out its opinion of the bid and the reasons on which it is based, including its views on the effects of implementation of the bid on all the company’s interests and specifically employment, and on the offeror’s strategic plans for the offeree company and their likely repercussions on employment and the locations of the company’s places of business as set out in the offer document in accordance with Article 6(3)(i). The board of the offeree company shall at the same time communicate that opinion to the representatives of its employees or, where there are no such representatives, to the employees themselves. Where the board of the offeree company receives in good time a separate opinion from the representatives of its employees on the effects of the bid on employment, that opinion shall be appended to the document.”[305]

[302] Article 5(1) of Directive 2003/71/EC (Prospectus Directive).
[303] Article 21(1) of Directive 2001/34/EC (Listing Directive).
[304] Article 3(1)(b) of Directive 2004/25/EC (Directive on takeover bids).
[305] Article 9(5) of Directive 2004/25/EC (Directive on takeover bids).

- "During the period referred to in the second subparagraph, the board of the offeree company shall obtain the prior authorisation of the general meeting of shareholders given for this purpose before taking any action, other than seeking alternative bids, which may result in the frustration of the bid and in particular before issuing any shares which may result in a lasting impediment to the offeror's acquiring control of the offeree company ..."[306]

DCFR

The provisions of the Draft Common Frame of Reference (DCFR) on information and advice resemble the provisions of the MiFID applicable to retail customers.[307] However, their scope is much wider, and they are designed to lead to a very extensive contractual liability of the information provider. It is difficult to see how the possible adoption of such provisions would be necessary and proportional under Community law. (a) To begin with, the exchange of information and advice is part of all financial and commercial decision-making and all contracts. Depending on the jurisdiction, the exchange of information can also lead to fictive contracts. The provisions of the DCFR have an extremely wide scope, because they apply to all "contracts under which one party, the provider, undertakes to provide information or advice to another party, the client".[308] If adopted by the Community legislator, the provisions would make the voluntary exchange of goods, services, and information more difficult and open the floodgates for litigation. (b) There is a difference between disclosure to one contract party and disclosure to an unlimited number of recipients. In the latter case, the DCFR would require the collection of such preliminary data about the personal situation of recipients which cannot reasonably be collected.[309] (c) The DCFR contains an extremely broad causation presumption leading to very extensive liability of the information provider.[310] (d) Furthermore, while the provisions of the MiFID have a limited scope and set out staggered obligations depending on the customer category, the information duties based on the DCFR are not staggered.[311]

10.7.3 Regulation of the Quality of Financial Information

Introduction

The fourth policy choice is how to regulate the quality of information. As the regulation of the quality of information must depend on the number of addressees or users of the information (see below), this is also a question of choosing the addressees from a scale ranging from the public (everybody) to each individual ad-

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[306] Article 9(2) of Directive 2004/25/EC (Directive on takeover bids).
[307] DCFR IV.C.–7.
[308] DCFR IV.C.–7:101(1).
[309] DCFR IV.C.–7:102(2).
[310] DCFR IV.C.–7:109.
[311] See, for example, DCFR IV.C.–7:104.

dressee that belongs to a certain category of users of information, and a question of whether to protect a function (Funktionsschutz) or individuals (Individualschutz).[312] As different legal instruments adopted by Community institutions can have different objectives, they can protect different categories of users and require the disclosure of information with different levels of usefulness.

To sum up: The Community legislator must choose whether to require accuracy, generic usefulness, or case-specific usefulness, and there must be a choice between whether to regulate the disclosure of information to the public, to a certain category of addressees, or to each addressee individually.

The policy choices of the EU can be illustrated by the duty to disclose company information and the duty to disclose information about financial instruments.

Company Information

In Community law, rules on the disclosure of company information have typically been designed for the protection of the public or a very large number of investors. If information must be useful for the public or a very large number of investors, it is assumed to fulfil requirements as to generic usefulness where it is disclosed in compliance with the relevant rules on form and substance. It is basically irrelevant whether that information is useful in fact for individual users or a certain class of users.

Mere accuracy. EU company law contains a number of disclosure rules designed for the protection of the general public. In this case, the number of potential users of information is very large and potential users are not limited to any particular category of addressees. Therefore, the size of such a disclosure regime should be relatively small and information disclosed under the regime should typically be accurate. For example, the First Company Law Directive (Publicity Directive) provides for the compulsory disclosure of basic information about limited-liability companies.

Information that cannot be "accurate" - a true and fair view. Financial information cannot be "accurate" in the sense that there is only one set of figures that correctly expresses the result of a company's operations and its financial status.[313] In the EU, legal recognition that no set of financial statements can be uniquely "right" is embodied in the requirement that the annual and consolidated accounts should give a true and fair view. The true and fair requirement is an overriding principle in the Accounting Directives. It allows for the inevitably judgmental nature of many accounting figures.[314] The general requirement is complemented by many specific disclosure obligations in problem areas.

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[312] For the concepts of protection of function and protection of individuals see Brellochs M, Publizität und Haftung von Aktiengesellschaften im System des Europäischen Kapitalmarktrechts. Beck, München (2005) pp 14–15.

[313] The role, the position and the liability of the statutory auditor within the European Union, paragraph 3.10.

[314] *Ibid*, paragraph 3.11.

For example, it is particularly important in the context of structured finance (see Volume II) that there are particular rules on off-balance-sheet arrangements. Off-balance-sheet arrangements may expose a company to risks and benefits which are material for an assessment of the financial position of the company and, when the company belongs to a group, the financial position of the group as a whole.[315] Such off-balance-sheet arrangements could be any transactions or agreements which companies may have with entities, even unincorporated ones that are not included in the balance sheet. They may be associated with the creation or use of one or more Special Purpose Entities (SPEs) and offshore activities designed to address economic, legal, tax, accounting or other objectives. Examples of such arrangements include risk and benefit-sharing arrangements or obligations arising from a contract such as debt factoring, combined sale and repurchase agreements, consignment stock arrangements, take or pay arrangements, securitisation arranged through separate companies and unincorporated entities, pledged assets, operating leasing arrangements, outsourcing and the like.[316] Appropriate disclosure of the material risks and benefits of such arrangements that are not included in the balance sheet should be set out in the notes to the accounts or the consolidated accounts. Member States can exempt small companies from the requirements concerning off-balance-sheet arrangements.[317]

Generic usefulness - investors in listed securities. Several directives lay down disclosure obligations for issuers of securities admitted to trading on a regulated market. The purpose of these directives is to protect investors. However, the category of investors and their experience and general knowledge have not been defined in the directives. Their fictive information needs have been defined at least partly in the directives. Information that complies with the terms of the directives is assumed to fulfil requirements as to generic usefulness.

The Transparency Directive requires annual and half-yearly financial reports.[318] The disclosure of "accurate, comprehensive and timely information about security issuers" is assumed to allow an informed assessment of their business performance and assets.[319] However, the quality of information is not regulated by this directive.

Ad-hoc disclosure is regulated by the Market Abuse Directive, the Transparency Directive and the Listing Directive. The Market Abuse Directive requires issuers of financial instruments to disclose inside information to the public.[320] Inside information has been defined as "information of a precise nature which has not been made public, relating, directly or indirectly, to one or more issuers of financial instruments or to one or more financial instruments and which, if it were made public, would be likely to have a significant effect on the prices of those financial instruments or on the price of related derivative financial instruments". Disclosure of that kind of information fulfils the requirements as to generic usefulness.

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[315] Recital 8 of Directive 2006/46/EC.

[316] Recital 9 of Directive 2006/46/EC.

[317] Recital 11 of Directive 2006/46/EC.

[318] Articles 4, 5 and 6 of Directive 2004/109/EC (Transparency Directive). In Germany, § 40(1) BörsG. For modalities of interim reports, see §§ 55–62 BörsZulV.

[319] Recital 1 of Directive 2004/109/EC (Transparency Directive).

[320] Article 6(1) of Directive 2003/6/EC (Directive on market abuse). For German law, see § 15 WpHG.

The Listing Directive is based on similar principles. The Listing Directive contains regulations on the information that must be published in the listing particulars and on continuing obligations. Like the Market Abuse Directive, the Listing Directive provides that "[t]he company must inform the public as soon as possible of any major new developments in its sphere of activity which are not public knowledge and which may, by virtue of their effect on its assets and liabilities or financial position or on the general course of its business, lead to substantial movements in the prices of its shares".[321] In addition, the Listing Directive provides that "[t]he listing particulars shall contain the information which, according to the particular nature of the issuer and of the securities for the admission of which application is being made, is necessary to enable investors and their investment advisers to make an informed assessment of the assets and liabilities, financial position, profits and losses, and prospects of the issuer and of the rights attaching to such securities".[322]

Generic usefulness - shareholders. EU company law also contains disclosure rules designed for the protection of shareholders as a category of information users.

Disclosure is always necessary where a transaction must be decided on by shareholders in general meeting. The Second Company Law Directive (Capital Directive) contains special disclosure rules that apply where the company: buys back its own shares;[323] issues shares for a consideration other than in cash in the course of an increase in the subscribed capital;[324] or derogates from the preemptive rights of shareholders.[325] The Third Company Law Directive (Merger Directive)[326] provides for the disclosure of information to shareholders in the context of mergers of public limited-liability companies, the Sixth Company Law Directive[327] in the context of divisions of public limited-liability companies, the Cross-border Merger Directive[328] in the context of cross-border mergers, and the SE Regulation[329] in the context of the formation of an SE, the transfer of an SE's registered office or the conversion of an SE into a public limited-liability company.

However, as agency problems are generally dealt with by Member States' national laws rather than legal instruments adopted by Community institutions, those company law instruments do not lay down any specific minimum standard for the quality of information. For example, the wording of those instruments leaves open whether it is enough that the information that must be disclosed to shareholders in general meeting is accurate or whether it also must fulfil certain requirements as to its generic usefulness.

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[321] Article 68(1) of Directive 2001/34/EC (Listing Directive).
[322] Article 21(1) of Directive 2001/34/EC (Listing Directive).
[323] Article 19 of Directive 77/91/EEC (Second Company Law Directive).
[324] Article 27 of Directive 77/91/EEC (Second Company Law Directive).
[325] Article 29 of Directive 77/91/EEC (Second Company Law Directive).
[326] Directive 78/855/EEC (Third Company Law Directive).
[327] Directive 82/891/EEC (Sixth Company Law Directive).
[328] Directive 2005/56/EC (Directive on cross-border mergers).
[329] Regulation 2157/2001 (SE Regulation).

If the information must fulfil the typical information needs of shareholders as a class (which would be the better view in the light of the purpose of those instruments), it is open how the typical information needs of shareholders as a class should be defined. This can also be a question of interpretation of Community law.

One alternative could be to determine the general usefulness of information on the basis of broad principles.

For example, the generic usefulness of information disclosed to shareholders as a class could be determined on the basis of principles used in the Transparency Directive: the disclosure of accurate, comprehensive and timely information about the company allows an informed assessment of its business performance and assets and enhances investor protection.[330]

The benefits of a principles-based approach were mentioned in the Commission's recommendation on statutory auditors' independence: "A principles-based approach to statutory auditors' independence is preferable to one based on detailed rules because it creates a robust structure within which statutory auditors have to justify their actions. It also provides the audit profession and its regulators with the flexibility to react promptly and effectively to new developments in business and in the audit environment. At the same time, it avoids the highly legalistic and rigid approach to what is and is not permitted which can arise in a rules-based regime. A principles-based approach can cater for the almost infinite variations in individual circumstances that arise in practice and in the different legal environments throughout the EU. Consequently, a principles-based approach will better serve the needs of European capital markets, as well as those of SMEs."[331]

Another alternative could be to adopt legal instruments which lay down a legal fiction that the disclosure of specific facts mentioned in the instrument will guarantee the generic usefulness of information.

For example, Article 27 of the Second Company Law Directive requires the drawing up and disclosure of an experts' report where shares are issued for a consideration other than in cash in the course of an increase in the subscribed capital. According to Article 10(2), the experts' report shall contain "at least a description of each of the assets comprising the consideration as well as of the methods of valuation used and shall state whether the values arrived at by the application of these methods correspond at least to the number and nominal value or, where there is no nominal value, to the accountable par and, where appropriate, to the premium on the shares to be issued for them".

Those two methods will often be combined. For example, the Directive on takeover bids provides for a special form of disclosure to shareholders in the context

[330] Recital 1 of Directive 2004/109/EC (Transparency Directive). The same principle can be found also in recital 3 of Commission Recommendation 2004/913/EC of 14 December 2004 fostering an appropriate regime for the remuneration of directors of listed companies.

[331] Recital 11 of Commission Recommendation of 16 May 2002. Statutory Auditors' Independence in the EU: A Set of Fundamental Principles (2002/590/EC).

of public takeover bids. According to the principles of the Directive, "the holders of the securities of an offeree company must have sufficient time and information to enable them to reach a properly informed decision on the bid".[332] For this reason, an offeror is required to "draw up and make public in good time an offer document containing the information necessary to enable the holders of the offeree company's securities to reach a properly informed decision on the bid".[333] The Takeover Bid Directive sets out the minimum content of the offer document.[334] The board of the offeree company must "draw up and make public a document setting out its opinion of the bid and the reasons on which it is based".[335]

Generic usefulness - users of general purpose financial statements. As said above, there are many sets of financial reporting standards in the EU. There is one for listed companies (IFRS) and another for other companies (the Fourth and Seventh Company Law Directives). The standards are complemented by Member States' national accounting requirements. A company whose shares are listed in the US may in practice have to use either US GAAP or the English version of IFRS in addition to its local IFRS.

The contents of national accounting standards depend on the applicable legal framework. It is possible to distinguish between the model used in common law countries and the continental European model. (a) In common law countries, legal precedents set out relatively detailed rules, and legal rules are to a larger extent governed by case law with a lower level of abstraction. Continental European law is to a larger extent based on code law with a higher level of abstraction. Therefore, in common law countries, the government does not set accounting standards. Accounting standards are to a larger extent set by private institutions and are not based on detailed laws. In continental Europe, accounting rules are to a larger extent based on detailed laws. (b) This difference influences even the choice of addressees of general purpose financial statements. In continental European law, financial reporting requirements are for the protection of all stakeholders of the company, not just for the shareholders. Financial statements are part of the legal framework and combined with legal consequences. For example, they can be used as a basis for the distribution of funds to owners and taxation. The common law model is different. The main goal of general purpose financial statements is typically the presentation of information that is useful to potential capital investors in making rational financial decisions (decision usefulness).[336]

The US GAAP (Generally Accepted Accounting Principles use in the US) have played an important role in the development of the IFRS. The US GAAP is binding for companies that raise finance from capital markets. The US GAAP and the IFRS share the same objectives.

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[332] Article 3(1)(b) of Directive 2004/25/EC (Directive on takeover bids).
[333] Article 6(2) of Directive 2004/25/EC (Directive on takeover bids).
[334] Article 6(3) of Directive 2004/25/EC (Directive on takeover bids).
[335] Article 9(5) of Directive 2004/25/EC (Directive on takeover bids).
[336] Kuhnle H, Banzhaf J, Finanzkommunikation unter IFRS. Vahlen, München (2005) pp 101–102.

The IAS Regulation is thus based on the common law approach. According to IAS 1 (revised 1997), paragraph 2, "general purpose financial statements are those intended to meet the needs of users who are not in a position to demand reports tailored to meet their specific information needs". Paragraph 5 states the objective of general purpose financial statements. It is "to provide information about the financial position, performance and cash flows of an enterprise that is useful to a wide range of users in making economic decisions". According to paragraph 10, financial statements should "present fairly the financial position, financial performance and cash flows of an enterprise" and that the "appropriate application of International Ac-counting Standards, with additional disclosure when necessary, results, in virtually all circumstances, in financial statements that achieve a fair presentation".

Table 10.3 The Basic Principles of the US GAAP

Fair presentation	
Decision usefulness	
Relevance: Predictive value Timeliness Feedback value	Reliability: Representational faithfulness Verifiability Neutrality
Comparability and consistency	
Materiality	

Financial statements are prepared to meet the common needs of most users. The "users" referred to in IAS 1 (revised 1997) means a category of fictive users. According to the Framework adopted by the IASB in April 2001,[337] they include "present and potential investors, employees, lenders, suppliers and other trade creditors, customers, governments and their agencies and the public".[338] As the "users" of financial statements are fictive and not real, they are "assumed to have a reasonable knowledge of business and economic activities and accounting and willingness to study the information with reasonable diligence", and must therefore be professionals. This category of fictive users contains both users that can understand complex matters and those for whom complex matters are too difficult to understand.[339]

Also the information needs of this category of fictive users are a fiction. It is assumed that there are needs which are common to all users and that the provision of financial statements meeting the needs of providers of risk capital to the firm

337 IASB Framework for the Preparation and Presentation of Financial Statements (April 2001).

338 IASB Framework, paragraph 9.

339 IASB Framework, paragraph 25.

will also meet most of the needs of other users that financial statements can satisfy.[340]

The qualitative characteristics of financial reports can better be understood in this light. According to the Framework for the Preparation and Presentation of Financial Statements which states basic principles for IFRS, the required characteristics are:

- Relevance: Information has the quality of relevance when it influences the economic decisions of users by helping them evaluate past, present or future events or confirming, or correcting, their past evaluations.
- Reliability: Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent.
- Timeliness: In achieving a balance between relevance and reliability, the overriding consideration is how best to satisfy the economic decision-making needs of users.
- Faithful representation: To be reliable, information must represent faithfully the transactions and other events it either purports to represent or could reasonably be expected to represent.
- Substance over form: Transactions and other events should be accounted for and presented in accordance with their substance and economic reality and not merely their legal form.
- Neutrality: The information contained in financial reports must be neutral, i.e. free from bias.
- Prudence: Prudence is the inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty, so that assets or income are not overstated and liabilities or expenses are not understated.
- Completeness: To be reliable, the information in financial reports must be complete within the bounds of materiality and cost.
- Comparability: Users must be able to compare the financial reports of an entity through time in order to identify trends in its financial position and performance. Users must also be able to compare the financial reports of different entities in order to evaluate their relative financial position, financial performance and cash flows.

The Fourth and Seventh Company Law Directives neither set out the category of users nor define their information needs. There is a legal fiction of "true and fair view". In *Waltraud Tomberger v Gebrüder von der Wettern GmbH*, the ECJ said that compliance with the principle of the "true and fair view" is the primary objective of the Fourth Directive. However, the ECJ also said that the application of that principle must, as far as possible, be guided by other general principles con-

[340] IASB Framework, paragraph 10.

tained in the Directive.[341] "True and fair view" under the Fourth Directive is therefore qualified by other general principles. The potentially conflicting requirements under the Fourth Directive may influence the contents of Member States' national accounting rules.

Basically, the information needs of the firm depend on the context. IFRS/IAS and US GAAP are nevertheless generally regarded as more useful for (capital market) investors than typical continental European accounting standards such as the national rules set out in the German Handelsgesetzbuch (HGB).[342] There are many reasons for this: (a) Whereas the main objective of the former is decision usefulness, in particular relevance and reliability, the latter focus on the protection of creditors, the distribution of funds, and taxation.[343] (b) The former also require the disclosure of more information, for example a statement of cash flows and explanatory information in the notes. (c) IFRS/IAS and US GAAP permit fewer options than the HGB.[344] (d) In addition, the former are closer to the principles applied in internal accounting.[345] - This means that companies should basically be able to decrease perceived risk for investors by applying IFRS/IAS instead of national accounting standards, if they have a choice.[346]

Generic usefulness - investors and their investment advisers. Prospectus requirements provide a further example of how the required degree of usefulness depends on the parties that legal rules seek to protect.

Now, the prospectus must fulfil certain requirements as to form and content.

The Listing Directive provided that "[t]he listing particulars shall contain the information which, according to the particular nature of the issuer and of the securities for the admission of which application is being made, is necessary to enable investors and their investment advisers to make an informed assessment of the assets and liabilities, financial position, profits and losses, and prospects of the issuer and of the rights attaching to such securities".[347]

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[341] Case C-234/94 Waltraud Tomberger v Gebrüder von der Wettern GmbH [1996] ECR I-3133, paragraph 18. They include in particular those contained in Article 31(1)(c), (aa) and (bb), and (d). Article 31(1): "The Member States shall ensure that the items shown in the annual accounts are valued in accordance with the following general principles: … (c) valuation must be made on a prudent basis, and in particular: (aa) only profits made at the balance-sheet date may be included; (bb) account must be taken of all foreseeable liabilities and potential losses arising in the course of the financial year concerned or of a previous one, even if such liabilities or losses become apparent only between the date of the balance sheet and the date on which it is drawn up; ... (d) account must be taken of income and charges relating to the financial year, irrespective of the date of receipt or payment of such income or charges; …"

[342] See, for example, Hommelhoff P, Modernisiertes HGB-Bilanzrecht im Wettbewerb der Regelungssysteme. Konzeptionelle Bemerkungen aus Anlass des RefE BilMoG, ZGR 2008 p 270.

[343] Kuhnle H, Banzhaf J, Finanzkommunikation unter IFRS. Vahlen, München (2005) p 38; Hommelhoff P, *ibid*, pp 252–253.

[344] Kuhnle H, Banzhaf J, *op cit*, pp 118–119

[345] *Ibid*, pp 123–124.

[346] *Ibid*, p 124.

[347] Article 21(1) of Directive 2001/34/EC (Listing Directive).

According to the Prospectus Directive, the prospectus must contain "all information which, according to the particular nature of the issuer and of the securities offered to the public or admitted to trading on a regulated market, is necessary to enable investors to make an informed assessment of the assets and liabilities, financial position, profit and losses, and prospects of the issuer and of any guarantor, and of the rights attaching to such securities". In addition, this information must be presented "in an easily analysable and comprehensible form".[348]

The purpose of this disclosure requirement is to protect investors.[349] On the other hand, investors are in practice protected by a large number of very detailed provisions leading to a high degree of harmonisation of prospectus requirements. The exact contents of prospectuses have been defined in Commission Regulation 809/2004/EC implementing the Prospectus Directive. In practice, the harmonisation of the information contained in the prospectus provides equivalent and sufficient investor protection at the Community level.[350] Information published in compliance with the detailed provisions of the Prospectus Directive and implementing legislation is deemed to be sufficiently useful for investors and their advisers.

Information About Financial Instruments

The main objective of the regulation of the sale and marketing of all kinds of financial instruments in the EU is to achieve a common financial market by integrating national markets.

A level playing field for providers of financial instruments cannot be achieved unless financial instruments can easily be offered in all Member States. A further requirement is that investors should have reason to believe that intra-EU investments are not riskier than home country investments. Investors must therefore be protected in order to reduce their perceived risk. For these reasons, it is necessary to achieve the degree of harmonisation needed (a) to offer investors a high level of protection and (b) to allow firms to provide financial instruments throughout the Community.

On the other hand, too much protection can make it too difficult or costly to provide the same financial instruments and services in many Member States. This problem has been addressed in Community law by separating the protection of investors as a class and the protection of each individual investor. This would not be possible without the existence of financial intermediaries, and their importance was recognised by the ECJ in the case of *Alpine Investments*.[351]

The ways to regulate investment intermediaries can generally be divided into four categories: access regulation or authorisation controls, protective regulation,

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[348] Article 5(1) of Directive 2003/71/EC (Prospectus Directive).
[349] Recitals 16–21 of Directive 2003/71/EC (Prospectus Directive).
[350] See recital 20 of Directive 2003/71/EC (Prospectus Directive).
[351] Case C-384/93 Alpine Investments v Minister van Financiën [1995] ECR I-1141, paragraph 42.

prudential supervision, and compensation mechanisms.[352] However, there are four main ways to regulate the content and quality of information that must be disclosed to investors.

Information disclosed to the market. First, some directives require the providers of financial instruments to disclose information to the market or to a large number of investors. In this case, communication is basically one-way communication from providers of financial instruments to the general public, investors or potential investors. The providers of financial instruments can comply with their disclosure obligations by following relatively clear technical rules and without any knowledge of the information needs of individual investors/consumers. There is a legal fiction that information disclosed in accordance with those rules fulfils the requirements as to generic usefulness.

For example, the Prospectus Directive and the Life Assurance Directive work in this way. The purpose of the Prospectus Directive and its implementing measures is to ensure investor protection and market efficiency.[353] The Prospectus Directive and Commission Regulation (809/2004/EC) implementing it lay down the contents of prospectuses.[354] One of the purposes of the Life Assurance Directive is to ensure that consumers receive clear and accurate information on the essential characteristics of life insurance products.[355] The directive lays down a duty to disclose information before the conclusion of the contract.[356] Both the Prospectus Directive and the Life Assurance Directive make it easier for providers of financial instruments to market them in many Member States.

Information disclosed to individual investors by financial intermediaries. Second, there are directives that require intermediaries to disclose information to individual investors or consumers (customers). In this case, both the intermediary and the customer are typically present at the same time, and communication is two-way communication. The directives set out a work process that must by followed by the intermediary. Intermediaries can comply with their disclosure obligations by identifying the category to which the customer belongs, identifying the typical information needs of the customer, and providing information that typically fulfils the information needs of similar customers. The intermediaries cannot comply with their disclosure obligations without knowing each customer.

For example, the MiFID and the Directive on insurance mediation contain similar disclosure obligations that complement disclosure obligations belonging to the first category.

One of the objectives of the Directive on insurance mediation is to protect customers.[357] The Directive requires the disclosure of information before the conclusion of the insurance contract: "When an insurance intermediary informs the customer that he gives his advice on the basis of a fair analysis, he is obliged to give that advice on the basis of an analysis of a

[352] Moloney N, EC Securities Law. OUP, Oxford (2008) pp 343–344.
[353] Recital 10 of Directive 2003/71/EC (Prospectus Directive).
[354] Article 5(1) of Directive 2003/71/EC (Prospectus Directive).
[355] Recital 52 of Directive 2002/83/EC (Life Assurance Directive).
[356] Article 36(1) and Annex III(A) of Directive 2002/83/EC (Life Assurance Directive).
[357] For example, recitals 17–22 of Directive 2002/92/EC (Directive on insurance mediation).

sufficiently large number of insurance contracts available on the market, to enable him to make a recommendation, in accordance with professional criteria, regarding which insurance contract would be adequate to meet the customer's needs."[358] In addition, "the insurance intermediary shall at least specify, in particular on the basis of information provided by the customer, the demands and the needs of that customer as well as the underlying reasons for any advice given to the customer on a given insurance product".[359]

One of the objectives of the MiFID is to protect investors.[360] The MiFID sets out principles that investment firms must comply with when providing investment services to clients.[361]

The MiFID requires a suitability regime that consists of: a general know-your-customer rule; the assessment of suitability in the context of investment advice; and a general requirement to assess the appropriateness of products or services.[362] The nature of the client will influence the contents of these duties.[363]

In addition, all information addressed by the investment firm to clients or potential clients should be fair, clear and not misleading.[364] Investment firms must provide information about the service and the financial instrument so that clients or potential clients "are reasonably able to understand the nature and risks of the investment service and of the specific type of financial instrument that is being offered and, consequently, to take investment decisions on an informed basis". This information may be provided in a standardised format.[365]

As the intermediary - an insurance intermediary or investment firm - typically is in close contact with customers and is expected to be able to analyse the suitability of financial instruments for each customer, the providers of financial instruments have been freed of the similar duties.

Information disclosed to individual investors by providers of financial instruments. Third, where providers of financial instruments market them directly to consumers and there is two-way communication between the parties, providers of financial instruments are required to disclose more information than those providers of financial instruments that let professional intermediaries take care of direct customer contacts. However, as it should be possible to disclose the same information to a large number of users in many Member States, the required information can be disclosed in a standardised form and the firm can disclose it without much knowledge of individual users' preferences.

Directive 2002/65/EC that harmonises laws on the distance marketing of consumer financial services is a further example of how the two conflicting objectives - the creation of a single market with a level playing field for firms and a high level of consumer protection[366] - influence the disclosure obligations of firms. One of the aims the Directive is to "lay

[358] Article 12(2) of Directive 2002/92/EC (Directive on insurance mediation).
[359] Article 12(3) of Directive 2002/92/EC (Directive on insurance mediation).
[360] Recital 31 of Directive 2004/39/EC (MiFID).
[361] Article 19(1) of Directive 2004/39/EC (MiFID).
[362] Articles 19(1), 19(4) and 19(5) of Directive 2004/39/EC (MiFID).
[363] See also Article 19(10) of Directive 2004/39/EC (MiFID).
[364] Article 19(2) of Directive 2004/39/EC (MiFID).
[365] Article 19(3) of Directive 2004/39/EC (MiFID).
[366] Recitals 1–4 of Directive 2002/65/EC.

down the requirements needed to ensure that an appropriate level of information is provided to the consumer both before and after conclusion of the contract. The consumer should receive, before conclusion of the contract, the prior information needed so as to properly appraise the financial service offered to him and hence make a well-informed choice."[367] Suppliers of consumer financial services at a distance can basically comply with their disclosure obligations without knowledge of the preferences of individual customers other than the core commercial terms of the contract. Whereas the supplier has an obligation to disclose information that fulfils some general information needs of typical consumers, the consumer lets the supplier know whether he accepts the contract terms.[368]

Category of information user. Fourth, the disclosure obligations of providers of financial instruments depend on the category of users to which the user of information belongs. This can again be illustrated by the MiFID and other directives.

As discussed above, one of the objectives of the MiFID is to protect investors. Measures to protect investors must nevertheless be adapted to the particularities of each category of investors (retail, professional and counterparties).[369] The MiFID provides that the Commission must adopt implementing measures which take into account the retail or professional nature of the client or potential clients.[370] The purpose of this rule is to ensure a proportionate balance between investor protection and the disclosure obligations which apply to investment firms. Less stringent specific information requirements apply with respect to professional clients than apply to retail clients, because professional clients should be able to identify for themselves the information that is necessary for them to make an informed decision, and to ask the investment firm to provide that information.[371] Annex II of the MiFID distinguishes between professional clients, clients who may be treated as professionals on request, and retail clients.

Another example is the Directive on insurance mediation. Many of the usual disclosure obligations of insurance intermediaries do not apply when the insurance intermediary is a reinsurance intermediary or mediates in the insurance of large risks.[372]

In addition, many legal instruments adopted by Community institutions only apply to consumer services.

These four principal ways to regulate the content and quality of information that must be disclosed to investors are complemented by the public interest exception. National measures that form obstacles to the exercise of the four freedoms guaranteed by the EC Treaty infringe the provisions of the EC Treaty unless the restriction pursues a legitimate objective compatible with the Treaty and is justified by imperative reasons in the public interest.

[367] Recital 21 of Directive 2002/65/EC.

[368] See especially Article 3 (information to the consumer prior to the conclusion of the distance contract), Article 4 (additional information requirements), Article 5 (communication of the contractual terms and conditions and of the prior information) and Article 6 (right of withdrawal) of Directive 2002/65/EC.

[369] Recital 31 of Directive 2004/39/EC (MiFID).

[370] Article 19(10)(c) of Directive 2004/39/EC (MiFID).

[371] Recital 44 of Directive 2006/73/EC implementing Directive 2004/39/EC.

[372] Article 12(4) of Directive 2002/92/EC (Directive on insurance mediation).

10.7.4 Regulation of Intermediaries: General Remarks

When the firm is in the process of taking a decision, it should have information about the usefulness of incoming information on which its decision will be based. The reliability of information provided by information analysts is partly influenced by their legal incentives (for other factors influencing the reliability of information intermediaries, see section 10.4).

From the perspective of the firm, one can distinguish between external information analysts outside the target (such as credit-rating agencies, financial analysts, investment advisers, and banks in their capacity as lenders), external information analysts inside the target (i.e. the information target's own people such as members of the board and auditors), and internal information analysts (i.e. the firm's own people).

The nature of the relationship between the firm and the intermediary depends on which category the intermediary belongs to. Moreover, there are fundamental differencies depending on the category.

External information analysts outside the target. Investment firms and investment advisers provide information to their customers under a contract. The firm can become their customer and pay for information. As their duties are contract-based, the usefulness of the information that they provide can be increased through private contracting. Many of their duties are based on mandatory provisions of law.

When banks act in the capacity of providers of funding, they provide information about their customers to outsiders only indirectly. If the conclusions that the firm draws from a bank's behaviour are wrong, the firm typically cannot sue the bank unless the bank is guilty of serious wrongdoing (like fraud).

External information intermediaries inside the target. Information analysts inside the information target typically do not sell information about the target to outsiders in their personal capacity. On the contrary, they typically have duties of care, fiduciary duties, and a duty not to disclose the target's confidential information. The usefulness of information produced by those analysts must therefore depend on legal background rules. The firm cannot change them. On the other hand, the information target can agree to disclose information. In that case, the usefulness of information can be regulated through contracts (for example, see Volume III on due diligence in the context of acquisitions).

Internal information analysts inside the firm itself. Inside the firm, many people will act as information analysts. Board members typically owe duties to the company under company laws and managers to their employer under an employment contract. Some of the duties are based on laws. Further duties can be based on contracts. Even the internal rule-making of the firm plays a role.

Community law, regulation of gatekeepers. There is plenty of Community legislation in the area of financial services, capital markets and auditing. Community law governs the duties and liability of information intermediaries. Many of them

are regarded as market gatekeepers.[373] Gatekeepers are typically characterised as independent market actors who provide verification or certification services to investors.

Gatekeepers act as reputational intermediaries. Part of the Community legal regime therefore regulates their integrity. For example, the MiFID and implementing legislation require investment firms to manage conflicts of interest.[374]

Implications for the firm. Legal background rules may have been designed to increase the perceived quality of information produced by external information analysts. However, legal background rules are generally designed to protect a large category of users rather that an individual user (such as here the firm itself). The firm might not have any legal power to enforce those legal background rules if they are breached by the intermediary. The firm can increase the case-specific and subjective usefulness of information produced by external intermediaries by individually negotiated real contracts (as opposed to constructive or fictive contracts).

10.7.5 Information Analysts Outside the Target

Introduction

Many external intermediaries are in the business of analysing company information. The most important of them include credit-rating agencies, financial analysts and investment advisers. Even banks can signal the quality of borrowers.

Credit-rating Agencies

Credit-rating agencies play an important role in capital markets and in banking. Credit ratings influence credit terms and signal the quality of the firm's finances and business. For example, a company whose securities have been admitted to trading on a regulated market has a duty to disclose the lowering of its credit rating.[375] Credit-rating agencies therefore play a central role as gatekeepers in the debt markets.

The regulation of credit-rating agencies complements the prudential regulation of financial institutions. However, as the regulation of credit-rating agencies does not focus on the usefulness of credit ratings, the value of credit-rating agencies as a source of new information is limited.

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[373] For the role of market gatekeepers, see already Kraakman R, Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy, JLEO 2 (1986) pp 53–104. For the regulation of gatekeepers in Community law, see Moloney N, EC Securities Regulation, OUP, Oxford (2008), Chapter VIII. Generally, see Coffee JC, Gatekeepers. The Role of the Professions in Corporate Governance. OUP, Oxford (2006).

[374] Article 22 of Directive 2006/73/EC; Articles 13(3) and 18(1) of Directive 2004/39/EC (MiFID).

[375] Article 6(1) of Directive 2003/6/EC (Directive on market abuse).

Use of credit ratings. In capital markets, credit-rating agencies issue opinions on the creditworthiness of a particular issuer or financial instrument. In particular, they assess the likelihood that an issuer will *default* either on its financial obligations generally (issuer rating) or on a particular debt or fixed income security (instrument rating). What they do *not* assess is the *liquidity* of the issuer's securities, and they did not predict the turning of securities from liquid to illiquid after the drying up of the interbank market in 2008.

Ratings are usually requested and paid for by the issuers themselves. Sometimes credit-rating agencies issue unsolicited ratings. The laws of many countries now insist that certain types of investment products can only be sold, if the issuer can demonstrate a certain grade of creditworthiness reflected in a rating issued by a recognised credit-rating agency.[376]

Credit-rating agencies are also increasingly involved in the assessment of the risks associated with assets held by financial institutions which are subject to capital adequacy requirements (see sections 7.6 and 9.2.7).[377]

Quality. Credit-rating agencies have commercial incentives to produce information which is perceived as reliable: a credit rating is worthless if nobody believes it.

The quality of credit ratings depends on many things. First, it depends on the general quality of the credit-rating agency's work.

Second, it depends on the analysis of the available information. Obviously, credit-rating agencies should base their ratings on a diligent analysis of the available information. They should control the integrity of their information sources. They should do this continuously, and credit ratings should be updated when necessary.

Third, the quality of credit ratings depends on the integrity of the credit-rating agency. Credit-rating agencies should be independent and objective in their approach. This could be encouraged by transparency and by making credit-rating agencies disclose the way in which their ratings are arrived at. The position of credit-rating agencies should not be compromised by the relationships which they have with issuers or customers.[378]

There is nevertheless a risk that credit-rating agencies are biased if they are paid by companies whose loans or securities they rate. There is a potential conflict between the interests of users to receive reliable information, the interests of companies to obtain a favourable credit rating, and the interests of the credit-rating agency to find clients and get paid for its services.

In practice, past studies suggest credit ratings are of limited informational value to investors.[379] Moreover, third parties can hardly ever make credit-rating agencies responsible for inaccuracies (see below). The chances of the credit-rating agency's contract party are not much better. As a rule, contract parties can hardly ever make

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[376] Communication from the Commission on Credit Rating Agencies (2006/C 59/02) p 3.
[377] *Ibid.*
[378] *Ibid.*
[379] Partnoy F, The Paradox of Credit Ratings. In: Levitch RM, Majnoni G, Reinhart C (eds), The Role of Credit Reporting Systems in the International Economy. Kluwer (2002).

credit-rating agencies liable for breach of contract, because credit-rating agencies typically assume responsibility for their work process rather than for its result, and credit-rating agencies use extensive disclaimers. In addititon, the application of the available remedies can depend on the nature of the contract party: the issuer of securities, the borrower, or the bank.

Increased regulation. Legal instruments adopted by Community institutions can improve the quality of some credit ratings indirectly. Community law focuses on the integrity of credit-rating agencies rather than the details of their work process.

There are similar efforts to regulate credit-rating agencies in the US. Whereas the bill for the Credit Rating Agency Duopoly Relief Act of 2006 never became law, the Credit Rating Agency Reform Act of 2006 was passed. For example, the Act requires the SEC to establish clear guidelines for determining which credit-rating agencies qualify as "Nationally Recognized Statistical Rating Organizations (NRSROs).

Community law: general remarks. The duties of credit-rating agencies have only to some extent been regulated at the Community level. (a) A number of key legislative measures with major implications for credit-rating agencies have been adopted as part of the Commission's Financial Services Action Plan (FSAP). (b) On the other hand, Community law used to address only two specific aspects of credit rating under Directive 2003/125/EC[380] and the Capital Requirements Directive.[381] (c) In December 2004, the International Organisation of Securities Commissions (IOSCO) published a Code of Conduct Fundamentals for credit-rating agencies.[382] A revised version was published in May 2008. (d) In 2006, the Commission published a Communication on its regulatory approach towards credit-rating agencies.[383] Finally, a Proposal for a Regulation on Credit Rating Agencies was published in November 2008,[384] and approved in April 2009. There are some earlier legislative proposals relating to consumer credit.[385]

The IOSCO Code. The IOSCO Code is meant to be applied by rating agencies of all sizes and business models and in every jurisdiction. It has not been implemented into the national law of Member Sates. However, the IOSCO Code complements legal instruments adopted by Community institutions. The Commission expects credit-rating agencies to give full effect to the provisions of the IOSCO Code as long as these provisions are consistent with the EU Directives. Credit-rating agencies are thus expected to incorporate the IOSCO Code in their proce-

[380] See recital 10 of Directive 2003/125/EC implementing Directive 2003/6/EC (Directive on market abuse).
[381] See Annex VI Part 2 of Directive 2006/48/EC (Capital Requirements Directive).
[382] Code of Conduct Fundamentals for Credit Rating Agencies, The Technical Committee of the International Organization of Securities Commissions (December 2004).
[383] Communication from the Commission on Credit Rating Agencies (2006/C 59/02).
[384] Proposal for a Regulation of the European Parliament and of the Council on Credit Rating Agencies, COM(2008) 704 final, 12 November 2008.
[385] COM (2002) 443 final; COM (2004) 747 final.

dures, and the Code is expected to be applied by credit-rating agencies in all jurisdictions where they operate.[386]

The IOSCO Code works on a "comply-or-explain" basis. When credit-rating agencies choose not to incorporate all the provisions of the Code into their own internal Codes of Conduct, they must explain how their Code nevertheless gives effect to the provisions of the IOSCO Code. But this requirement is just a recommendation unless it has been implemented into national law.

Instruments adopted by Community institutions. Unlike the IOSCO Code, legislative instruments adopted by Community institutions are legally binding but apply only to credit-rating agencies operating within the EU.

There are three FSAP Directives relevant to credit-rating agencies: the Capital Requirements Directive; the Market Abuse Directive; and the MiFID.

External credit ratings that are mandatory. One of the effects of Basel II and the Capital Requirements Directive is to increase the monitoring and transparency of credit-rating agencies. Although this is not the main purpose of Basel II and the Capital Requirements Directive, it is necessary in order to make financial institutions comply with prudential regulations.

According to Basel II and the Capital Requirements Directive, financial institutions must choose between a standardised approach or an internal ratings-based approach. Basel II and the Capital Requirements Directive allow banks to use external credit assessments to determine the risk weight of certain credit and credit securitisation exposures as part of the standardised approach, provided the External Credit Assessment Institutions (ECAIs, mainly credit-rating agencies) that produce those assessments have been recognised as eligible for that purpose by the relevant national supervisor. ECAIs may be considered eligible for recognition if they meet the six criteria of: objectivity; independence; international access/transparency; disclosure; resources; and credibility.[387]

A recognition mechanism is therefore outlined in the Capital Requirements Directive.[388] The Capital Requirements Directive sets out a number of requirements which ECAIs should meet before the competent authority can grant them recognition. For example, their ratings must be objectively and independently assigned and reviewed on an ongoing basis, and their rating procedures must be sufficiently transparent. In addition, the competent authorities must assess whether individual credit assessments are recognised in the market as credible and reliable by the users of such credit assessments and accessible at equivalent terms to all interested parties.

However, the Capital Requirements Directive does not regulate the work process of credit-rating agencies in detail. Neither does the Capital Requirements Directive lay down general conduct of business rules for credit-rating agencies. Credit-rating agencies may choose not to become ECAIs under the Capital Requirements Directive.

[386] Communication from the Commission on Credit Rating Agencies, 2006/C 59/02, p 3.
[387] Part 2, Section II, Part B of the Basel II Accord.
[388] Annex VI, Part 2 of Directive 2006/48/EC.

Insider trading and market manipulation v fair presentation. The quality of credit ratings is also influenced by the Directive on market abuse. The provisions of the Market Abuse Directive and the legislation that complements it constitute a comprehensive legal framework for credit-rating agencies and also regulate the substance of credit ratings by covering conflicts of interest, the fair presentation of investment recommendations, and the access to inside information.

The Market Abuse Directive prohibits the abuse of inside information and the manipulation of markets in general. Furthermore, credit-rating agencies are, in particular, affected by certain specific rules on investment research, since the *production of research* can amount to market manipulation.

For example, one of the many forms of "market manipulation" defined in Article 2 consists of "(c) dissemination of information through the media, including the Internet, or by any other means, which gives, or is likely to give, false or misleading signals as to financial instruments, including the dissemination of rumours and false or misleading news, where the person who made the dissemination knew, or ought to have known, that the information was false or misleading ..."

Similar rules apply to journalists: "(c) ... In respect of journalists when they act in their professional capacity such dissemination of information is to be assessed ... taking into account the rules governing their profession, unless those persons derive, directly or indirectly, an advantage or profits from the dissemination of the information in question." Article 2 also contains typical examples of market manipulation such as "taking advantage of occasional or regular access to the traditional or electronic media by voicing an opinion about a financial instrument (or indirectly about its issuer) while having previously taken positions on that financial instrument and profiting subsequently from the impact of the opinions voiced on the price of that instrument, without having simultaneously disclosed that conflict of interest to the public in a proper and effective way."

Because the production of research can amount to market manipulation, the Directive on market abuse provides that: "Member States shall ensure that there is appropriate regulation in place to ensure that persons who produce or disseminate research concerning financial instruments or issuers of financial instruments and persons who produce or disseminate other information recommending or suggesting investment strategy, intended for distribution channels or for the public, take reasonable care to ensure that such information is fairly presented and disclose their interests or indicate conflicts of interest concerning the financial instruments to which that information relates ..."[389]

The Member States have plenty of discretion as regards the methods: "Member States should be able to choose the most appropriate way to regulate persons producing or disseminating research concerning financial instruments or issuers of financial instruments or persons producing or disseminating other information recommending or suggesting investment strategy, including appropriate mechanisms for self-regulation ..."[390].

[389] Article 6(5) of Directive 2003/6/EC (Directive on market abuse).
[390] Recital 22 of Directive 2003/6/EC (Directive on market abuse).

The Market Abuse Directive is complemented by Directive 2003/125/EC on *investment recommendations*.[391] This Directive addresses the fair presentation of investment recommendations and the disclosure of conflicts of interest.

For the purposes of Directive 2003/125/EC, credit ratings do not constitute a recommendation. They are regarded as opinions on the creditworthiness of a particular issuer or financial instrument. The Directive nevertheless provides that credit-rating agencies should consider adopting internal policies and procedures designed to ensure that credit ratings published by them are fairly presented. Credit-rating agencies must disclose any significant interests or conflicts of interest concerning the financial instruments or the issuers to which their credit ratings relate.[392] In addition, it follows from the Market Abuse Directive that publishing a credit rating can amount to the dissemination of false or misleading information and constitute market manipulation where the credit-rating agency knew, or ought to have known, that the credit rating was false or misleading.[393]

With respect to the legal treatment of credit-rating agencies' access to inside information,[394] the Market Abuse Directive prohibits any person possessing inside information from using that information by acquiring or disposing of financial instruments to which that information relates.[395] As a rule, an issuer must disclose inside information as soon as possible.[396] If an issuer decides to allow a credit-rating agency access to inside information, it should require the credit-rating agency and its people to undertake a duty of confidentiality. Failure to require a non-disclosure undertaking might trigger an obligation to disclose inside information.[397]

As a result, a credit-rating agency or an employee who has access to inside information of any sort is prohibited from any trading using inside information.[398] Moreover, it is not allowed to disclose this inside information to anyone else except in the normal course of employment, profession or duties.[399] In this respect, the Market Abuse Directive states that issuers, or persons acting on their behalf or for their account, draw up a list of persons working for them who have access to inside information.[400] This provision allows Member States to require credit-rating agencies to draw up lists of insiders. These lists must regularly be updated and transmitted to the competent authority whenever the latter requests it.

In addition to having access to inside information of the issuer, it is possible that a credit rating itself constitutes inside information, in particular when the

[391] Directive 2003/125/EC implementing Directive 2003/6/EC as regards the fair presentation of investment recommendations and the disclosure of conflicts of interest.

[392] See Article 1(8) and recital 10 of Directive 2003/125/EC.

[393] For the definition of "market manipulation", see Article 1(2) under c of Directive 2003/125/EC.

[394] For the definition, see Article 1(1) of Directive 2003/6/EC (Directive on market abuse).

[395] Article 2(1) of Directive 2003/6/EC (Directive on market abuse).

[396] Article 6(1) of Directive 2003/6/EC (Directive on market abuse).

[397] Article 6(3) of Directive 2003/6/EC (Directive on market abuse).

[398] Article 2(1) of Directive 2003/6/EC (Directive on market abuse).

[399] Article 3(a) of Directive 2003/6/EC (Directive on market abuse).

[400] Article 6(3), third subparagraph of Directive 2003/6/EC (Directive on market abuse).

credit-rating agency has access to non-public information of the issuer. This implies that using the unpublished rating for trading or disclosing this information to anyone else, except in the normal course of employment, profession or duties, is prohibited. However, a credit-rating agency communicating an imminent rating publication to the issuer on a confidential basis for the purpose of checking the accuracy of the information it is based on would be allowed.

Investment advice. The issuing of a credit rating will normally not result in the credit-rating agency providing "investment advice" within the meaning of Annex I to the MiFID. Therefore, the MiFID is not applicable to the rating process of credit-rating agencies unless the rating process involves the firm undertaking investment services and activities as defined in the MiFID.[401]

If a credit-rating agency also provides investment services and activities on a professional basis, it may need authorisation.[402] In that case, the provisions of the MiFID regarding conduct of business and organisational requirements will apply to the firm as well as its investment services and activities. For example, where a credit-rating agency provides investment services (such as investment advice) falling under the MiFID, the provisions on conflicts of interest will apply to protect the interest of those who receive these services. The provisions on conflicts of interest may require an appropriate degree of separation of investment services from the credit-rating process so that ancillary services may not interfere with the quality and objectivity of credit ratings.

Credit-rating agencies should therefore be aware of the precise limits of this activity in order to continue to operate outside the MiFID regulation.

Protection of personal data. The business of credit-rating agencies is constrained by the protection of personal data under the EU Data Protection Directive[403] and Member States' laws. There is also a 1981 Council of Europe Convention for the Protection of Individuals with Regard to Automatic Processing of Personal Data and a 1990 Council of Europe recommendation on the protection of personal data used for payment and other related operations. These questions will not be discussed here.

Regulation on Credit Rating Agencies. In November 2008, the Commission adopted a proposal for a Regulation on Credit Rating Agencies.[404] The proposal was part of a package of proposals to deal with the financial crisis. The proposal was accepted in April 2009.

One of the main rules requires certain financial institutions to use credit ratings issued by credit-rating agencies established in the Community and registered in accordance with the Regulation (Article 4). The competent authority of the home Member State will register the credit-rating agency if it complies with the conditions for the issuance of credit ratings set out in the Regulation (Article 12). In addition, the Regulation contains rules on, for example, independence, employees,

[401] Article 6(1) of Directive 2004/39/EC (MiFID).
[402] Article 5(1) of Directive 2004/39/EC (MiFID).
[403] Directive 95/46/EC.
[404] Proposal for a Regulation of the European Parliament and of the Council on Credit Rating Agencies, COM(2008) 704 final, 12 November 2008.

rating methodologies, disclosure and presentation of credit ratings, general and periodic disclosures, transparency, the public disclosure of fees, surveillance, and liability.

One of the effects of the Regulation on Credit Rating Agencies is that a credit-rating agency may not provide consultancy or *advisory* services to the rated entity or any related third party (Section A of Annex I). The main rule on rating *methodologies* is set out in Article 7(2) of the Regulation: "A credit rating agency shall ensure that the credit ratings it produces and disseminates are based on an analysis of all information available to it that is of relevance according to its rating methodologies. It shall adopt all necessary measyres so that the information it uses in assigning a credit rating is of sufficient quality and from reliable sources." Furthermore, it must disclose its methodologies, models, and key assumptions to the public (Article 7(1)). In the US, the Credit Rating Agency Reform Act of 2006 specifically prohibits the SEC from regulating an NRSRO's rating methodologies.

Excursion: Suing a Credit-rating Agency (or Any Other Third Party)

The business of credit-rating agencies has partly been regulated by specific legal rules. However, it is usually not the purpose of those rules to make credit-rating agencies themselves liable for damage caused by ratings that are of bad quality. In fact, third parties can hardly ever make credit-rating agencies responsible for inaccuracies unless they can prove breach of contract.[405]

US. In the US, it is generally difficult for investors to sue third parties for frauds committed by companies. For example, one may ask whether private investors can sue actors – whether accountants, lawyers, financial advisers, or other businesses – that allegedly participate in a scheme to violate Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5. In *Stoneridge Investment Partners v. Scientific-Atlanta*, the issue was whether the suppliers (Motorola and Scientific-Atlanta) could be sued by the investors of a company that committed securities fraud (Charter Communications, a cable company). The Supreme Court decided in 2008 that fraud claims are not allowed against third parties that did not directly mislead investors but were business partners with those who did. According to the Supreme Court, the investors had not relied on anything the suppliers had done to make their investment decisions.

Moreover, rating agencies are protected by law from the risks of "gatekeeper" liability faced by other financial intermediaries. Credit-rating agencies are immune from liability for misstatements in a registration statement under Section 11 of the Securities Act of 1933. Rating agencies generally face a low litigation risk, because they can, in practice, invoke both freedom of speech and extensive disclaimers.

Germany. In Germany, the Berlin court of appeals decided that rating agencies can be held liable for their ratings analogous to the liability of product-testing

[405] See also de Savornin Lohman HA, van 't Westeinde MG, Control and Liability of Credit-rating agencies under Netherlands Law, Electronic Journal of Comparative Law, vol. 11.1 (May 2007); Ebenroth CT, Daum T, Die rechtlichen Aspekte des Ratings von Emittenten und Emissionen, Wertpapier-Mitteilungen, Sonderbeilage 5/1992.

agencies.[406] Under German law, third parties have a cause of action mainly where the credit-rating agency has caused damage wilfully or through gross negligence.[407] Sometimes it can be held that there is a fictive contract between the credit-rating agency and the third party.[408] The mere disclosure of information will nevertheless not suffice.[409] The criteria establishing a fictive contract resemble those that can lead to liability under English law.[410]

England. In England, the leading case on misrepresentation and tort of negligence is *Hedley Byrne & Co Ltd v Heller & Partners Ltd.*[411] The Hedley Byrne v Heller principles were restated by the House of Lords in *Caparo Industries plc v Dickman.*[412] The position established in *Caparo* is that the law of England does not impose any general duty of care to avoid negligent misstatements or to avoid causing pure economic loss even if economic damage to the plaintiff is foreseeable. However, such a duty of care will arise if there is a special relationship between the parties.[413]

The prerequisites for liability are: (1) a statement which is inaccurate or failure to state a material fact which renders a statement misleading; (2) reliance on the material misstatement; (3) a sufficiently proximate relationship between the parties (proximity or a special relationship); (4) foreseeability of financial loss caused by the misleading statement; and (5) that it is just and reasonable to impose the liability.

Analogy. Similar principles are applied to other third parties that act as information analysts. For example, in Germany, a real estate broker has no duty to disclose specific information about the real estate to the buyer, unless the broker notices or should notice that the information is relevant for the buyer in her decision-making.[414] The broker has no duty to verify information provided by the seller, unless the broker has promised to the buyer to do so; the broker can in effect limit his liability for the accuracy of information provided by the seller by saying that he has not verified it.[415] The buyer should therefore instruct the broker to collect all relevant information and to verify it.

Regulation on Credit Rating Agencies. It is still open what effect the Regulation on Credit Rating Agencies will have on the civil liability of credit-rating agencies under Member States' laws. The regulation requires administrative sanctions such as the withdrawal of registration (Articles 17 and 21). In addition, Member States

[406] Kammergericht Berlin, Wertpapier-Mitteilungen 2006 p 1432. See Wiehe H, Jordans R, Roser E, Mezzanine Finance Structures under German Law, JIBLR 22(4) (2007) p 223.

[407] § 826 BGB. See Oellinger G, Die Haftung für Ratings. Eine Betrachtung nach österreichischem und deutschem Recht. Linde, Wien (2005) p 188.

[408] BGH, WM 1965, 287.

[409] § 676 BGB.

[410] See, for example, Oellinger G, Die Haftung für Ratings. Eine Betrachtung nach österreichischem und deutschem Recht. Linde, Wien (2005) p 192.

[411] Hedley Byrne & Co Ltd v Heller & Partners Ltd [1964] AC 465, [1963] 2 All ER 575.

[412] Lord Bridge in Caparo v Dickman [1990] 2 AC 605 at 621.

[413] White v Jones [1995] 2 AC 287.

[414] OLG Frankfurt am Main, judgment of 1 August 2005 (19 W 26/05).

[415] LG Landshut, judgment of 21 November 2000 (55 O 2555/00).

are required to adopt rules on penalties applicable to infringements of the provisions of the Regulation (Article 31): "Penalties shall, at least, cover cases of gross professional misconduct and lack of due diligence. The penalties provided for must be effective, proportionate and dissuasive."

Financial Analysts

Financial analysts can be important information intermediaries. There are different types of financial analysts. Buy-side analysts work for large institutional investment firms such as mutual funds, hedge funds or insurance companies. Their reports are mainly for their customers' internal use and paid for buy customers. Sell-side analysts are typically employed by broker-dealers and investment banks. Their recommendations and ratings are created to sell an investment and are typically offered free of charge to customers. The third category is independent analysts. Independent analysts provide objective ratings. Independent analysts are paid either by the companies they research (fee-based research) or by selling subscription-based reports.

Conflicts of interest. The accuracy of financial analysts' advice can be compromised by conflicts of interest, for example where the financial analyst works for an investment bank or a broker that is simultaneously trying to sell its other services. During the dot-com bubble, it turned out that many of the firms Wall Street analysts touted were overvalued and that many financial analysts working for investment banks had strong incentives to avoid "sell" recommendations.[416]

US law. The problems led to the regulation of the activities of financial analysts in the US. Section 501 of the Sarbanes-Oxley Act empowered the SEC to adopt rules "reasonably designed to address conflicts of interest that can arise when securities analysts recommend equity securities in research reports and public appearances". Section 501 in effect forced investment banks to adopt new operating procedures intended to separate the function of research (recommending shares) from investment banking (underwriting them). In February 2003, the SEC adopted Regulation Analyst Certification (Regulation AC),[417] which requires research analysts to certify the accuracy of the views they express in research reports and public appearances, and to disclose whether they have received any compensation related to the specific recommendations or views expressed in those reports and appearances. In April 2003, the SEC announced an agreement with ten of the largest investment banks (the Global Research Analyst Settlement).

Because of the new rules, analysts' pay should be determined by the quality of their stock-picking, investment banks should disclose the success of their research, and "spinning" (the provision of shares in initial public offerings to executives whose firms are potential clients) should not happen.[418] The rules also led to vol-

[416] Barbera BM, Lehavyb R, Truemanc B, Comparing the stock recommendation performance of investment banks and independent research firms, J Fin Econ 85 (2007) pp 490–517. See also The value of trust, The Economist, June 2002.

[417] Securities Exchange Act Release No. 47384 (February 20, 2003).

[418] Unsettling, The Economist, May 2003.

untary changes. For example, some investment banks spinned their research and retail-broking businesses into a separate entity.[419]

Community law. Community institutions have so far not harmonised the rules governing the activities of financial analysts. Community law nevertheless sets out a framework for the management and disclosure of conflicts addressed by the Sarbanes-Oxley Act. Like the work of credit-rating agencies, the work of investment analysts can be covered by the Directive on market abuse under some circumstances and, in some cases, by the MiFID. These situations have partly been discussed in the context of credit ratings (see above).

The MiFID. Financial analysis and research is included, as an ancillary investment service, in the MiFID.[420] Whereas firms combining research and analysis with other investment business are therefore subject to the MiFID, specialised and independent research firms/analysts remain outside its scope but subject to national supervisory regimes.[421]

The MiFID contains a provision that seeks to ensure that investment firms are organised so that client interests are not adversely affected by conflicts of interest between the brokerage and dealing business of the firm. Broker-dealers are required to identify, prevent or otherwise manage conflicts of interest so that they do not adversely affect investment client's interests (including those of retail customers).[422] Furthermore, the Commission must adopt implementing measures specifying the types of administrative and organisational arrangements that broker-dealers need to introduce.[423]

The Directive on market abuse. The provision of general investment recommendations/financial analysis is also subject to obligations imposed by the Directive on market abuse. The Market Abuse Directive establishes transparency standards requiring that persons who produce or disseminate information recommending or suggesting investment strategies to the public, or to distribution channels, disclose their interests or conflicts of interest and fairly present such information.[424] In practice, this provision applies in particular to research analysts, and to those financial journalists recommending investments to the public.[425]

[419] See, for example, Analysis paralysis, The Economist, December 2005.

[420] Section B, Ancillary services: "... (5) Investment research and financial analysis or other forms of general recommendation relating to transactions in financial instruments ..."

[421] See also Financial analysts: Best practices in an integrated European financial market. Recommendations from the Forum Group to the European Commission Services. 4 September 2003.

[422] Article 18 of Directive 2004/39/EC (MiFID).

[423] Article 18(3) of Directive 2004/39/EC (MiFID).

[424] Article 6(5) of Directive 2003/6/EC (Directive on market abuse).

[425] Financial analysts: Best practices in an integrated European financial market. Recommendations from the Forum Group to the European Commission Services. 4 September 2003.

Buy v hold v sell. In practice, however, financial analysts are typically less likely to give a “sale” recommendation than they could be expected to be.[426] Their behaviour can partly be explained by incentives. The issuer will often be happy with a “hold” recommendation but will not accept a “sell” recommendation. Financial analysts that are perceived as friendly will in practice have better access to the issuer’s management, and the financial incentives of many financial analysts depend directly or indirectly on access to management.[427]

Investment Advisers

The parties who provide investment advice can range from banks to independent professional advisers, insurance companies, and lawyers who provide investment advice in the course of their professional activity.

The information duties of investment advisers are typically based on mandatory provisions of law implementing the provisions of the MiFID, other mandatory or dispositive provisions of law, and the contract.

MiFID. Due to the increasing dependence of investors on personal recommendations, the provision of investment advice was included in the MiFID as an investment service requiring authorisation.[428] The MiFID does not apply to non-MiFID services,[429] but it applies even to banks when they provide investment services.[430]

The MiFID contains three approaches for information gathering on the sales process: “suitability” applies to investment advice and discretionary portfolio management;[431] “appropriateness” applies to all non-advised services;[432] and “execution only” forms an exception to the requirement for appropriateness in certain circumstances.[433]

As far as investment advice is concerned, the MiFID lays down a standard of objective usefulness. Investment advisers have a duty to act in the accordance with the best interests of the client,[434] a know-your-customer duty,[435] a duty to provide

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[426] Barbera BM, Lehavyb R, Truemanc B, Comparing the stock recommendation performance of investment banks and independent research firms, J Fin Econ 85 (2007) pp 490–517.

[427] Analysten meiden negative Beurteilungen, FAZ, 4 December 2007.

[428] Article 5(1) of Directive 2004/39/EC (MiFID). For optional exemptions, see Article 3.

[429] The MiFID contains an exemption, for example, for persons providing investment advice in the course of providing another professional activity not covered by the MiFID provided that the provision of such advice is not specifically remunerated. Article 2(1) of Directive 2004/39/EC (MiFID). For optional exemptions, see Article 3.

[430] Article 1(2) of Directive 2004/39/EC (MiFID).

[431] See Article 19(4) of Directive 2004/39/EC (MiFID).

[432] See Article 19(3) of Directive 2004/39/EC (MiFID).

[433] Article 19(6) of Directive 2004/39/EC (MiFID).

[434] Article 19(1) of Directive 2004/39/EC (MiFID).

[435] Article 19(4) of Directive 2004/39/EC (MiFID).

suitable advice,[436] and a duty to provide fair and clear information that is not misleading.[437]

Professional customers. According to the MiFID, measures to protect investors should be adapted to the particularities of each category of investor (retail, professional, and counterparties),[438] and the Commission must adopt implementing measures which take into account the retail or professional nature of the client or potential clients.[439]

Less stringent specific information requirements apply with respect to professional clients. Annex II of the MiFID distinguishes between professional clients, clients who may be treated as professionals on request, and retail clients. A professional client is "a client who possesses the experience, knowledge and expertise to make its own investment decisions and properly assess the risks that it incurs". For example, entities which are required to be authorised or regulated to operate in the financial markets are regarded as professional clients.

Member States' laws. The MiFID requires Member States to adopt "effective, proportionate and dissuasive" administrative measures or administrative sanctions against "the persons responsible" where the provisions adopted in the implementation of the MiFID Directive have not been complied with.[440]

As the relationship between the investment adviser and the customer is based on contract, the customer is protected even by contractual remedies (see Volume II).

For example, contractual remedies were applied in 2007–2008, when many German municipalities (including Hagen and Würzburg) sued banks after suffering huge losses under their swap contracts. The municipalities typically claimed the reimbursement of losses on grounds of "bad advice". In a test case, Landgericht Würzburg held Deutsche Bank liable for damage sustained by the municipality of Würzburg after Deutsche Bank failed to disclose all risks inherent in the Spread Ladder Swaps that it sold to the municipality.[441] In addition, the subprime mortgage crisis triggered plenty of lawsuits against a wide range of financial firms both in Europe and in the US.[442]

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[436] Article 19(4) of Directive 2004/39/EC (MiFID).

[437] Articles 19(2) and 19(3) of Directive 2004/39/EC (MiFID).

[438] Recital 31 of Directive 2004/39/EC (MiFID).

[439] Article 19(10)(c) of Directive 2004/39/EC (MiFID).

[440] Article 51(1) of Directive 2004/39/EC (MiFID).

[441] LG Würzburg, judgment ot 31 March 2008 (62 O 661/07). On 11 May 2009, OLG Bamberg nevertheless ruled that the Deutsche Bank did not breach its obligations to Würzburg. See also LG Frankfurt am Main AZ, judgment ot 16 December 2008 (2–19 O 99/08), in which the Frankfurt regional court held that Deutsche Bank did not adequately inform an industrial firm about risks related to an interest-rate swap ("spread ladder" swap).

[442] The finger of suspicion, The Economist, December 2007.

Banks

Banks are important providers and processors of information.[443] Banks can act as information intermediaries in many ways. Banks can provide information either in the capacity of a contract party or without any contractual obligation to do so.

Banks as providers of funding to third parties. Banks can influence the decision-making of the firm by providing funding to its contract parties or other third parties (for the firm's own funding, see section 9.2.7 and Volume III). The decision of a bank to extend a loan is often interpreted as a signal of the financial sustainability of the investment project and the borrower's business in general, because banks are assumed to have analysed the insolvency risk of the borrower before extending any credit. Furthermore, failure to raise bank finance signals to other parties that the investment project lacks a sound financial basis. For example, private equity investments, which are usually highly leveraged, would not be possible without the co-operation of banks.

On the other hand, the reliability of this information depends on the case. (a) Basically, a bank is not responsible for whatever the borrower's stakeholders or other parties understand its actions to signal. The lack of any contractual relationship between the bank and the borrower's stakeholders would make it very difficult for the latter to sue the bank when it turns out that they have misinterpreted the signal or got a wrong impression of the financial sustainability of the borrower's business. (b) Furthermore, the interests of the bank and the interests of other stakeholders are not necessarily aligned. The bank and other stakeholders can have conflicting interests, for example, where the bank is mainly interested in the repayment of loans while other stakeholders prefer the money to be used for other purposes. (c) Different banks can have different interests. Whereas some banks need to protect their long-term interests in the borrower, the interests of other banks can be short-term. (d) In addition, the access of banks to information about the borrower may vary. Whereas some banks are proximate to management and have access to reliable information about the financial health of the borrower, banks that are not as proximate to management may have to rely on what the borrower's managers tell them.

For example, a German company may have a "Hausbank" with long-term interests in the financial well-being of the company and access to reliable information about the borrower. On the other hand, a bank that extends loans that are used for the purpose of financing a highly leveraged takeover by a private equity fund may have short-term interests and may benefit from the transaction in the form of high fees. For a long-term investor, the acts of the "Hausbank" would provide a more reliable signal.

Community law contains only few rules influencing the reliability of information provided by banks in the capacity of providers of funding. The Basel II framework

[443] See, for example, Schmidt RH, Tyrell M, Information Theory and the Role of Intermediaries in Corporate Governance, Working Paper Series: Finance and Accounting 142, Department of Finance, Johann Wolfgang Goethe-Universität Frankfurt am Main (2004).

can nevertheless play a role. Under the Basel II framework implemented by the Capital Requirements Directive,[444] borrowers are punished or rewarded by banks on the basis of the banks' own or standardised assessment of the borrower's risk-level (see section 7.6.2).

Banks in their capacity as advisers. Banks provide many different types of services, and banks' customers can be other banks, other market counterparties, commercial customers, or private customers.

Central to the bank-customer relationship is the existence of a contract. Banks' contractual duties are determined by the governing law. Often, a standard-form contract will govern specific aspects of the bank-customer relationship.[445]

The regulation of this contractual relationship varies with the type of customer. Also in Community law the regulation of banks' duties varies with the type of customer and the subject matter.

For example, securities dealings are quite heavily regulated in the interest of investor protection. The MiFID lays down a know-your-customer rule and disclosure obligations for investment firms that provide investment advice.[446]

Community law especially seeks to protect consumers. For example, the purpose of the Consumer Credit Directive[447] is to ensure that consumers receive adequate information on the conditions and cost of credit and on their obligations, and one of the aims of the Distance Marketing Directive[448] is that the use of means of distance communications should not lead to an unwarranted restriction on the information provided to consumers.

The duties of banks when providing non-consumer services are regulated by many of the legal instruments discussed elsewhere in this context.

Providers of Fairness Opinions or Similar Independent Advice

Boards of the participating companies often obtain a fairness opinion or independent advice in the context of mergers and acquisitions. Fairness opinions and independent advice will be discussed in the context of mergers and acquisitions (Volume III).

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[444] Directives 2006/48/EC and 2006/49/EC (Capital Requirements Directive).

[445] See Cranston R, Principles of Banking Law. Second Edition. OUP, Oxford (2002) pp 129 and 133.

[446] Article 19 of Directive 2004/39/EC (MiFID).

[447] Directive 2008/48/EC on credit agreements for consumers and repealing Council Directive 87/102/EEC.

[448] Directive 2002/65/EC concerning the distance marketing of consumer financial services and amending Council Directive 90/619/EEC and Directives 97/7/EC and 98/27/EC.

10.7.6 Information Analysts Inside the Target

Introduction

Information analysts inside the target include, in particular, persons responsible for financial information and persons responsible for other information about the target company. Persons responsible for financial information can include board members or members of the target's other administrative, management and supervisory bodies. Auditors have an important function analysing financial information.

Management of risk: general remarks. As a rule, there is no contract between the firm as the information user and information analysts inside the target company, and the target's board members and managers owe their duties to the target company rather than information users.

Often the target itself owes duties to external users of information (the public, investors, a business acquisition contract, and so forth). In rare cases, the duties are owed by the target's board members or managers directly. For example, there are mandatory rules on the disclosure of financial information. The target is responsible for complying with mandatory disclosure rules, but even its board members, managers or other "persons responsible" (see below) can be legally responsible for compliance with some mandatory disclosure rules.

In rare cases, shareholders or third parties can have a personal right to sue board members or other persons responsible for breach of duties owed to them personally and not only to the company. Such rules can be found, for example, in Member States' national company and securities markets laws.

Management of risk under Member States' laws. Where information is produced and disclosed by information analysts inside the target, there is usually no contractual relationship between information analysts and third parties using the information. The firm can create an incentive for the target company to provide accurate and useful information through contracts. As the target company is responsible for the actions of its managers and employees by virtue of the company's primary rules of attribution together with the general principles of agency and vicarious liability, the target can internally create incentives to provide information that is accurate and useful for the firm as an external information user. On the other hand, where the target has an incentive to provide false or misleading information, even its managers and employees have an incentive to do so.

As explained above, there is a body of legal rules setting out a duty to disclose information and the minimum level of accuracy and objective usefulness of that information. For example, companies must disclose financial information in compliance with the applicable accounting standards, and listed companies must disclose information in order to comply with securities markets laws. Member States' laws often allocate these duties to the board and the functional equivalent to a CEO, and the work of auditors is regulated by laws and auditing standards.

Again, the main rule is that information analysts inside the target owe no duties to outsiders apart from the general prohibition of fraud and similar behaviour. In some cases third parties may nevertheless sue information analysts inside the tar-

get for breach of duty. Holders of a large block of shares can either cause the company to bring proceedings against members of its statutory administrative, management or supervisory bodies for breach of duty owed to the company, or sue them on behalf of the company. Shareholders or other third parties can have some limited rights to sue on their own behalf under company and securities markets laws. In practice, this is still the rare exception in Europe.[449] It is difficult for shareholders to bring proceedings against defaulting managers, and class actions are rare in Europe.

Community law. As regards information analysts inside the target, Community law usually does not determine the persons that would have a duty to provide accurate and useful information. Community law helps the firm to identify such persons only indirectly, because Member States' implementing laws should designate persons that have a duty to provide information fulfilling certain requirements as to its accuracy and objective usefulness. Also the incentives of those persons to comply with their obligations are determined by Member States' laws and may vary from country to country.

Therefore, the allocation of the duty to draw up and publish annual accounts and annual reports and the duty to disclose information to the capital market is determined by Member States' laws. The same can be said of the liability for the failure to disclose required information or for the disclosure of information that is not of the required quality.

However, Member States do not have complete discretion, since Member States' laws should designate the administrative, management and supervisory bodies that are responsible for financial information. The members of those corporate bodies that have a duty to draw up and publish annual accounts and annual reports must be collectively responsible for the information they publish and liable for breach of duty. The extent of their liability is determined by Member States' laws.

After the amendment of the Fourth and Seventh Company Law Directives, it is clear that all board members are collectively responsible for the financial statements and key non-financial information, and that all board members are held accountable for their actions and proper conduct of their responsibilities.

Members of Administrative, Management and Supervisory Bodies (Listed Companies)

Rules concerning the duty to disclose financial and other information about companies whose securities have been admitted to trading on a regulated market have partly been approximated by EU company and securities markets directives. The allocation of the responsibility to disclose information and the liability for breach of duty nevertheless depend on the context.

[449] See, for example, Mäntysaari P, Comparative Corporate Governance. Shareholders as a Rule-maker. Springer, Berlin Heidelberg (2005), Chapter 6.

Responsibility for periodic information under Community law. As discussed above, there are common rules on the publication of periodic information. There are also some common rules on the responsibility for the published information.

The First Directive provides for the compulsory disclosure by companies of the balance sheet and the profit and loss account for each financial year. Furthermore, the document containing the bal-ance sheet must give particulars of the persons who are required by law to certify it.[450]

The Transparency Directive partly clarifies the allocation of responsibility by rules on statements. Statements must be made by "persons responsible within the issuer" to the effect that, to the best of their knowledge, the financial statements prepared in accordance with the applicable set of accounting standards give a true and fair view.[451]

The Transparency Directive also lays down a minimum standard of liability for the breach of these rules.[452] Somebody – either the issuer, its administrative, management or supervisory bodies or "persons responsible within the issuer" – must be liable in the event of failure to do so.

The Transparency Directive does not idenfify the persons that are liable for infringements. Member States are free to determine those persons and the extent of their liability.[453] Originally, the Fourth and Seventh Directives did not contain similar provisions on the allocation of duties and liabilities relating to annual accounts. In contrast to the US, the prevailing principle in Europe is the collective responsibility of board members for financial statements. In the light of recent corporate scandals and the extraterritorial application of the Sarbanes-Oxley Act, it was deemed necessary to clarify the application of this principle and to extend it to key non-financial information.

Depending on the jurisdiction, the liability of the issuer to shareholders might not be compatible with a legal capital regime which restricts distributions to shareholders (for legal capital regimes, see Volume III).[454] The Transparency Directive does not limit the scope of restrictions on distributions to shareholders based on the Second Company Law Directive.[455]

After the amendment of the Fourth and Seventh Company Law Directives,[456] it is clear that all board members are collectively responsible for financial statements and key non-financial information and that all board members are held accountable for their actions and proper conduct of their responsibilities.

This is because members of the "administrative, management and supervisory bodies" of a company are, as a minimum requirement, collectively responsible for

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[450] Article 2(1)(f) of Directive 68/151/EEC (First Company Law Directive).
[451] Articles 4(2)(c) and Article 5(2)(c) of Directive 2004/109/EC (Transparency Directive).
[452] Article 7 of Directive 2004/109/EC (Transparency Directive). See also Article 24 .
[453] Recitals 10 and 17 of Directive 2004/109/EC (Transparency Directive).
[454] See Article 15(1)(d) of Directive 77/91/EEC (Second Company Law Directive).
[455] Article 15(1)(a–c) of Directive 77/91/EEC (Second Company Law Directive). See also Article 16.
[456] Article 5(1) of Directive 2006/46/EC (implementation by 5 September 2008).

drawing up and publishing annual accounts and annual reports.[457] The same approach applies to members of the administrative, management and supervisory bodies of undertakings drawing up consolidated accounts.[458] The identity of those bodies is determined by national law.

Corporate bodies act within the competences assigned to them by national law. In order to promote credible financial reporting processes across the EU, members of the company body that is responsible for the preparation of the company's financial reports thus have a duty to ensure that the financial information included in annual accounts and annual reports gives a true and fair view.[459]

In the event of breach of duty, the minimum requirement is that members of those bodies are liable to the company.[460]

Liability for drawing up and publishing annual accounts and consolidated accounts as well as annual reports and consolidated annual reports is based on national law. The minimum requirement is that penalties for infringements are "effective, proportionate and dissuasive".[461] Appropriate liability rules, as laid down by each Member State under its national law or regulations, should therefore be applicable to members of the administrative, management and supervisory bodies, but Member States remain free to determine the extent of the liability.[462]

The ECJ applied this requirement in joined cases *Silvio Berlusconi and others*[463] to the absence of any disclosure of annual accounts and also the case of the disclosure of annual accounts which have not been drawn up in accordance with the rules prescribed by the Fourth Company Law Directive in regard to the content of such accounts.[464]

Member States are permitted to go further and provide for direct responsibility towards shareholders or even other stakeholders. Furthermore, Member States must refrain from opting for a system of responsibility limited to individual board members, but the courts are permitted to impose penalties on an individual board member.[465]

Ad-hoc disclosure. The most important rules on ad-hoc disclosure can be found in the Directive on market abuse and the Transparency Directive. The Listing Directive contains further rules on ad-hoc disclosure.

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[457] Article 50b of Directive 78/660/EEC (Fourth Company Law Directive), inserted by Article 1(8) of Directive 2006/46/EC.

[458] Article 36a of Directive 83/349/EEC (Seventh Company Law Directive), inserted by Article 2(3) of Directive 2006/46/EC.

[459] Recital 4 of Directive 2006/46/EC; Article 36a of Directive 83/349/EEC, inserted by Article 2(3) of Directive 2006/46/EC.

[460] Article 50c of Directive 78/660/EEC, inserted by Article 1(8) of Directive 2006/46/EC; Article 36b of Directive 83/349/EEC, inserted by Article 2(3) of Directive 2006/46/EC.

[461] Article 60a of Directive 78/660/EEC, inserted by Article 1(10) of Directive 2006/46/EC. See already Article 6 of the First Directive (68/151/EEC).

[462] Recital 3 of Directive 2006/46/EC.

[463] Joined Cases C-387/02, C-391/02 and C-403/02, Silvio Berlusconi and others [2005] ECR p I-3565.

[464] Paragraph 56.

[465] Recital 2 of Directive 2006/46/EC.

Do these directives help an external user of information to identify persons that have a legal duty to provide accurate and useful information in the context of ad-hoc disclosure? Only indirectly. The directives require Member States to adopt rules that designate the categories of persons that are responsible for the disclosure of information. This duty to disclose information is complemented by sanctions based on Member States' national laws.

For example, the Directive on market abuse provides that: "Member States shall ensure, in conformity with their national law, that the appropriate administrative measures can be taken or administrative sanctions be imposed against the persons responsible where the provisions adopted in the implementation of this Directive have not been complied with. Member States shall ensure that these measures are effective, proportionate and dissuasive".[466] However, neither the persons responsible nor the sanctions have been defined in detail in the Market Abuse Directive.

Prospectuses and listing particulars. The Prospectus Directive requires the identification of "persons responsible" in the prospectus: "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. The persons responsible shall be clearly identified in the prospectus by their names and functions or, in the case of legal persons, their names and registered offices, as well as declarations by them that, to the best of their knowledge, the information contained in the prospectus is in accordance with the facts and that the prospectus makes no omission likely to affect its import."[467]

The identity of directors, senior management, advisers and auditors must therefore be disclosed in the prospectus. According to the Prospectus Directive, the purpose of this requirement is: "to identify the company representatives and other individuals involved in the company's offer or admission to trading; these are the persons responsible for drawing up the prospectus as required by Article 5 of the Directive and those responsible for auditing the financial statements".[468] A similar rule applies to the contents of the registration documents[469] and the contents of the securities note.[470]

According to the Listing Directive, the general duty to publish information "which, according to the particular nature of the issuer and of the securities for the admission of which application is being made, is necessary to enable investors and their investment advisers to make an informed assessment",[471] and "is incumbent upon the persons responsible for the listing particulars".[472]

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[466] Article 14(1) of Directive 2003/6/EC (Directive on market abuse).
[467] Article 6(1) of Directive 2003/71/EC (Prospectus Directive).
[468] Annex I of Directive 2003/71/EC (Prospectus Directive).
[469] Annex II of Directive 2003/71/EC (Prospectus Directive).
[470] Annex III of Directive 2003/71/EC (Prospectus Directive).
[471] Article 21(1) of Directive 2001/34/EC (Listing Directive).
[472] Article 21(2) of Directive 2001/34/EC (Listing Directive).

Prospectus liability. Member States must ensure that their laws, regulations and administrative provisions on civil liability apply to parties responsible for the information given in a prospectus.[473]

However, Member States must also ensure 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.

The summary contains several warnings, one of which is that: "civil liability attaches to those persons who have tabled the summary including any translation thereof, and applied for its notification, but only if the summary is misleading, inaccurate or inconsistent when read together with the other parts of the prospectus".[474]

The substance of prospectus liability has not been subject to detailed harmonisation in the EU and depends on the governing law. Approaches to civil liability vary considerably in terms of the basis for liability, the parties allowed to sue, the nature of the remedy, the valuation of loss, causation, evidence, and other things.[475]

This legal diversity increases legal risks for issuers. On the other hand, it can be difficult for investors to sue; in practice, prospectus liability suits remain relatively scarce in Europe. In addition to the above questions, this is caused by the loser pays principle and restrictions on class-actions.[476]

Takeovers. As said above, the Directive on takeover bids regulates the obligations of the board of the offeree company and the obligations of the offeror company in the context of public takeover bids. The sanctions to be imposed for infringement of the national measures adopted pursuant to these provisions are determined by the Member States. The sanctions must be "effective, proportionate and dissuasive".[477]

Important transactions. Shareholders in public limited-liability companies decide on many important transactions (see sections 8.7.10, 9.4.2 and 9.5.8 as well as Volume III). Typically, shareholders must then be given sufficient information by the board. The liability of board members is determined by Member States' na-

[473] Article 6(2) of Directive 2003/71/EC (Prospectus Directive).

[474] Article 5(2)(d) of Directive 2003/71/EC (Prospectus Directive).

[475] For a summary, see Kalss S, Recent developments in liability for nondisclosure of capital market information, Int R of Law and Econ 27 (2007) pp 70-95. For the problem of causation, see, for example, the Swiss case BGE 132 III 715. For the persons liable under German law, see § 44 BörsG, the proposed § 44a BörsG, and Zimmer D, Prospekthaftung von Experten? Kritik eines Gesetzentwurfs, WM 13/2005 pp 577-583. § 44a BörsG was part of the KapInHaG, which was dropped.

[476] See Mattil P, Desoutter V, Class action in Europe: comparative law and EC law considerations, BJIBFL 2008 pp 484–488; Moloney N, EC Securities Law. OUP, Oxford (2008) pp 164–165. For English law, see PR 1998, Pt 19, s III in conjunction with 58.6 A CPR and Ferran E, Principles of Corporate Finance Law. OUP, Oxford (2008) pp 444–464. For German law, see the Investor Test Case Act (KapMuG) and § 260 ZPO (bundling, objective Klagehäufung).

[477] Article 17 of Directive 2004/25/EC (Directive on takeover bids).

tional laws. However, where the disclosure obligations are based on Community law, the sanctions must again be "effective".

Statutory Auditors

Statutory audits are a *monitoring* mechanism designed to give members of the audited entity's administrative, management, and supervisory bodies an incentive to comply with their legal duties. Stakeholders can also use statutory audits as a *screening* mechanism, as statutory auditors have a duty to analyse information before companies disclose it to the public. Statutory audits can therefore *signal* the credibility of financial information.

For these reasons, statutory audits can benefit many parties: the information target, investors, creditors, employees, and other stakeholders.

There is an increasing amount of regulation in this area. In Community law, the credibility of statutory audit reports is increased and the agency costs of stakeholders are decreased in four main ways. First, statutory audits are carried out by *approved* persons who must satisfy the minimum conditions as to independence, integrity, professional competence, and experience. Second, approved auditors are *monitored* by public oversight bodies. Third, statutory audits must be carried out in accordance with auditing *standards*. Fourth, statutory auditors can be made *liable* for damage caused by breach of duty.

Duties. The Accounting Directives require annual accounts or consolidated accounts to be audited by one or more persons entitled to carry out such audits.[478] Member States may nevertheless relieve small companies from this obligation.

In the past, the Eighth Company Law Directive[479] dealt primarily with the approval of statutory auditors in Member States. As Community law left open how a statutory audit should be conducted, the Commission issued a Recommendation on quality assurance for the statutory auditor in the EU (November 2000)[480] and a Recommendation on Statutory Auditors' Independence in the EU (May 2002).[481]

In 2006, the Eighth Directive was repealed by the Directive on statutory audits,[482] which clarified the duties of statutory auditors and set out certain ethical principles to ensure their objectivity and independence.

The Directive on statutory audits (the new Eighth Company Law Directive) regulates: the introduction of an annual transparency report for audit firms; auditor rotation; audit quality reviews; the appointment of the statutory auditor or audit firm on the basis of a selection by the audit committee; and contacts between the statutory auditor and the audit committee.

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[478] Article 51 of Directive 78/660/EEC (Fourth Company Law Directive); Article 37 of Directive 83/349/EEC (Seventh Company Law Directive).

[479] Directive 84/253/EEC on the approval of persons responsible for carrying out the statutory audits of accounting documents.

[480] Commission Recommendation 2002/590/EC.

[481] Commission Recommendation 2001/256/EC.

[482] Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts, amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC.

According to the Directive on statutory audits, statutory auditors must comply with international auditing standards adopted by the Commission.[483] This is one of the cornerstones of the Directive. Companies whose shares have been admitted to trading on a regulated market have already moved to one set of accounting standards for their group accounts – the International Financial Reporting Standards (IFRS). The Directive on statutory audits creates a mechanism for the introduction of International Standards on Auditing in the EU.

In addition to the general rules on statutory auditors, several EU company law and securities markets directives contain particular rules on auditors'[484] or independent experts'[485] duties.

Auditor independence according to the Recommendation. According to the non-binding Commission Recommendation published in 2002,[486] a principles-based approach to statutory auditors' independence is preferable to one based on detailed rules.[487]

The basic principle of the Recommendation is that an auditor or an audit firm must not carry out a statutory audit if there is a financial, business, employment or other relationship, including the provision of additional services, with the audited entity that might compromise the statutory auditor's or audit firm's independence.

Auditor independence according to the Directive.This principle was also adopted in the Directive on statutory audits. It is complemented by a rule on audit fees (see section 9.3.4) and other particular requirements.

Whether statutory auditors may be appointed by the board depends on the structure of the statutory board. (a) The main rule is that statutory auditors or audit firms must be appointed by the general meeting of shareholders or members of the audited entity.[488] (b) However, Member States may allow alternative systems or modalities for the appointment of statutory auditors or audit firms, provided that those systems or modalities are designed to ensure the independence of the statutory auditor or audit firm from the executive members of the administrative body or from the managerial body of the audited entity.[489] For example, statutory auditors may be appointed by the supervisory board (Aufsichtsrat) of a German AG.

Member States must generally ensure that when carrying out a statutory audit, the statutory auditor and/or the audit firm is independent of the audited entity and is not involved in the decision-taking of the audited entity.[490] The statutory auditor

[483] Article 26(1) of Directive 2006/43/EC (Directive on statutory audits).
[484] For example Article 55 of Directive 2004/39/EC (MiFID).
[485] See, for example, Articles 10 and 27 of Directive 77/91/EEC (Second Company Law Directive).
[486] Commission Recommendation (2002/590/EC) of 16 May 2002, Statutory Auditors' Independence in the EU: A set of fundamental principles.
[487] Recital 11 of Recommendation 2002/590/EC.
[488] Article 37(1) of Directive 2006/43/EC (Directive on statutory audits).
[489] Article 37(2) of Directive 2006/43/EC (Directive on statutory audits).
[490] Article 22(1) of Directive 2006/43/EC (Directive on statutory audits).

or an audit firm may not carry out a statutory audit if there is a relationship[491] from which an objective, reasonable, and informed third party would conclude that the statutory auditor's or audit firm's independence is compromised.[492]

However, there is no general prohibition to provide non-audit services to audit clients.[493] Neither does the Directive on statutory audits contain a black list of banned services. Because of the changing nature of markets, the Directive follows the principles-based approach of the 2002 Recommendation. On the other hand, the examples quoted in the Recommendation continue to apply. For this reason, auditors should not provide non-audit services (such as bookkeeping or valuation services), if they would compromise the auditor's independence according to the Recommendation.

The owners or managers of the audit firm or an affiliated firm must not intervene in the execution of a statutory audit in any way which would jeopardise the independence and objectivity of the statutory auditor carrying out the statutory audit on behalf of the audit firm.[494]

Furthermore, a statutory auditor or audit firm must document in the audit working papers all significant threats to independence as well as the safeguards applied to mitigate those threats.[495]

There are restrictions on dismissal. Statutory auditors or audit firms may only be dismissed on proper grounds. According to the Directive, divergence of opinions on accounting treatments or audit procedures does not constitute proper grounds for dismissal.[496]

On the other hand, there are rules on compulsory resignation. If statutory auditors and audit firms find themselves in a situation where the significance of the threats to their independence, even after application of safeguards to mitigate those threats, is too high, they should resign or abstain from the audit engagement.

The conclusion that there is a relationship which compromises the auditor's independence may be different as regards the relationship between the auditor and the audited entity from that in respect of the relationship between the network and the audited entity.[497] It is nevertheless for the Member State rather than the statutory auditor or the audit firm to decide whether the statutory auditor or audit firm should resign or abstain from an audit engagement with regard to its audit clients.[498]

The regulation of statutory auditors' liability in Community law. Statutory auditors and audit firms are responsible for carrying out their work with due care and

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[491] "... any direct or indirect financial, business, employment or other relationship - including the provision of additional non-audit services - between the statutory auditor, audit firm or network and the audited entity ..."

[492] Article 22(2) of Directive 2006/43/EC (Directive on statutory audits). For example, see recital 11 of Recommendation 2002/590/EC.

[493] Recital 12 of Directive 2006/43/EC (Directive on statutory audits).

[494] Article 24 of Directive 2006/43/EC (Directive on statutory audits).

[495] Article 22(3) of Directive 2006/43/EC (Directive on statutory audits).

[496] Article 38(1) of Directive 2006/43/EC (Directive on statutory audits).

[497] Recital 11 of Directive 2006/43/EC (Directive on statutory audits).

[498] Recital 12 of Directive 2006/43/EC (Directive on statutory audits).

thus should be liable for the financial damage caused by a lack of the care owed.[499] However, their civil liability has not been harmonised by directives.[500]

The trend. There is an increasing trend for litigation against auditors. Because of insurance protection, auditors and audit firms may belong to the few parties having the financial means to reimburse for losses sustained by an audited entity's stakeholders when the entity collapses.

On the other hand, the availability and cost of professional indemnity insurance cover may depend on the extent of auditors' and audit firms' liability.[501] The lack of available commercial insurance would increase the risk of claims that threaten the existence of audit firms. It is therefore usual to limit statutory auditors' liability to the audit clients' stakeholders.

Commission Recommendation on civil liability. In 2008, the Commission issued a Recommendation concerning the limitation of the civil liability of auditors.[502] It was accompanied by the publication of an impact assessment.[503]

According to the Recommendation, the civil liability of statutory auditors and of audit firms arising from a breach of their professional duties should be limited.[504]

The Recommendation introduces key principles to be followed by Member States when they select a limitation method: the limitation of liability should not apply in the case of intentional breach of duty by the auditor or the audit firn; and any limitation of civil liability should not prevent injured parties from being fairly compensated.[505]

Furthermore, the Recommendation contains three examples of recommended methods for limiting liability: caps (instead of unlimited liability); proportional liability (instead of joint and several liability); and limitation of liability agreements.[506]

Civil liability under Member States' laws. The civil liability of statutory auditors in the EU was analysed in a study carried out on behalf of the Commission and published in 2001.[507]

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[499] Recital 19 of Directive 2006/43/EC (Directive on statutory audits).
[500] See Articles 30(2) and 31 of Directive 2006/43/EC (Directive on statutory audits).
[501] See, for example, Revenge of the nerds, The Economist, May 2003.
[502] Commission Recommendation 2008/473/EC concerning the limitation of the civil liability of statutory auditors and audit firms, C(2008) 2274, 5 June 2008.
[503] Commission Staff Working Document, Accompanying document do the Commission Recommendation concerning the limitation of the civil liability of statutory auditors and audit firms. Impact Assessment, C(2008) 2274, SEC(2008) 1974, 5 June 2008.
[504] Article 2 of Recommendation 2008/473/EC.
[505] Articles 2–4 of Recommendation 2008/473/EC.
[506] See Article 5 and recital 6 of Recommendation 2008/473/EC.
[507] A study on systems of civil liability of statutary auditors in the context of a Single Market for auditing services in the European Union (15 January 2001). See also the Commission's Green Paper on the role, the position and the liability of the statutory auditor within the European Union (1996).

Depending on the country, the liability of statutory auditors can be based on the general rules of civil liability, particular statutory provisions applicable to statutory auditors, or a combination of both.

There are differences regarding the amount and nature of damages that can be recovered, the statute of limitations, and even the extent of the auditor's duty of care. Many of these differences are connected to a distinction between contract and tort.

Germany. In Germany, statutory auditors' contractual liability to the audit client is based on the specific statutory provisions for statutory auditors contained in § 323 HGB.[508] There is a liability cap under § 323 HGB. Contractual liability to the audit client is limited to €1 million per examination in unlisted companies[509] to €4 million in listed companies.[510] According to the wording of § 323 HGB, neither cap applies to loss or damage caused by wilful acts or gross negligence. Liability under § 323 HGB can neither be waived nor limited.[511]

Statutory auditors' liability in tort is based on the general provisions contained in the BGB and requires a wilful breach of duty or recklessness (vorsätzliches Fehlverhalten, Leichtfertigkeit).[512]

Some of the statutory provisions applicable to auditors' liability can also be found in the professional rules contained in the Wirtschaftsprüferordnung (Act on the Profession of Auditors).

England. In England, the Companies Act 2006 provides that provisions protecting auditors from liability are generally void.[513] Certain "liability limitation agreements" are nevertheless permitted.[514]

In contrast, third parties can only rarely be entitled to compensation for loss caused by misstatements. Under English law, auditors' civil liability to third parties is governed by general common law rules on misrepresentation. The two most important cases are *Hedley Byrne v Heller* and *Caparo Industries v Dickman*.[515] These cases were discussed in section 10.7.5.

Furthermore, there are limitations on who can sue auditors. The audit client may bring an action against its statutory auditor for breach of contract, but the company's management hardly ever has reason to do so. There are differences concerning the rights of shareholders and third parties to bring proceedings. The main rule is that it is legally difficult for them to sue.[516]

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[508] § 323(1) HGB, third sentence.

[509] § 323(1) HGB, second sentence.

[510] § 323(2) HGB, second sentence.

[511] § 323(4) HGB.

[512] § 823 BGB, § 826 BGB, § 831 BGB.

[513] Section 532 of the Companies Act 2006.

[514] Section 534 of the Companies Act 2006.

[515] Hedley Byrne & Co v Heller & Partners [1964] AC 465 (House of Lords); Caparo Industries v Dickman [1990] 2 AC 605 (House of Lords). See also South Australia Asset Management Corporation v York Montague Ltd [1997] AC 191 (Banque Bruxelles Lambert SA v Eagle Star Insurance Co Ltd [1996] UKHL 10) and Man Nutzfahrzeuge AG and another v Freightliner Ltd and another [2007] EWCA Civ 910.

[516] See A study on systems of civil liability of statutory auditors in the context of a Single Market for auditing services in the European Union (15 January 2001) p 21.

The duties of statutory auditors may or may not be owed to the audit client. This question was discussed in the 2001 study:[517] “An important difference concerns the standing of third parties to bring liability actions against the statutory auditor. In a majority of Member States (Belgium, Denmark, Finland, France, Greece, Italy, Luxembourg, Portugal and Sweden), the statutory audit is considered to be not only in the interest of the company, but also in that of the public. As a result, any third party may recover damages from the statutory auditor upon proving the elements of the liability claim, usually fault, damages and causation. However, in Common Law countries (Ireland and the United Kingdom) as well as Spain, the third party must prove that the statutory auditor owes him a duty of care. The statutory auditor will owe a duty of care to a person other than the audited company only if he assumes responsibility to that person for ensuring the substantial accuracy of the accounts with regard to the facts of the particular case. This entails that the auditor knew or should have known that the claimant would rely upon his work and/or that the auditor knew or should have known that the claimant would rely upon his work and/or his report for a particular purpose. A similar reasoning applies in Austria and Germany with the concept of implied contracts and of contracts having protecting effects to third parties.”

10.7.7 Information Analysts Inside the Firm

It goes without saying that most information analysts are the firm’s own people. The firm’s internal information analysts range from board members and managers to employees and other people that belong to its organisation.

The responsibility of managers and board members for the quality of information is generally governed by the applicable Member States’ laws. The quality of information that the information target’s board members or managers are responsible for is influenced by: the question to whom they primarily owe their duties; the dual role of board members as advisers as well as monitors of management;[518] and the multiple roles of managers who not only act as advisers and monitors but also initiate business ideas, assess the feasibility of ideas, make business plans, execute business plans, and try to achieve the planned benefits and synergies.

Managers and board members generally owe a duty of care and may owe fiduciary duties to the company. For example, board members have a duty to make informed decisions. This duty is typically qualified by the business judgment rule. Those duties are only enforced by courts in exceptional cases, because underperforming managers and board members can usually be ousted from the company. These general duties have not been harmonised by EU company law directives.

Employees typically owe a duty of care to their employer. Underperforming employees typically face social rather than legal sanctions. The threshold of liability for loss or damage sustained by their employer is quite high, and mandatory labour laws can make it difficult to fire employees.

[517] A study on systems of civil liability of statutory auditors in the context of a Single Market for auditing services in the European Union (15 January 2001) pp 6–7.

[518] Adams RB, Ferreira D, A Theory of Friendly Boards, J Fin 62 (2007) pp 217–250.

10.7.8 Regulation of Outgoing Information Otherwise

General Remarks

As discussed above, Community law and Member States' laws address the rights and duties relating to disclosure of information in many different ways. The rights and duties of each intermediary can only be analysed separately, taking into account each legal base and each recipient of information (see section 10.6). There is no room for it here. It suffices to highlight certain rules that are particularly interesting in the context of corporate finance. Volume III contains a fuller analysis in the context of acquisitions and due diligence.

Duty of Care, Contract

The duty of care (or a similar duty) and contractual duties always belong to the potential legal bases that might govern the rights and duties of the intermediary that discloses information and the rights and duties of the party that receives information. For example, members of the information target's statutory bodies such as board members generally owe a duty of care and may owe fiduciary duties to the information target. These duties also act as a constraint to the disclosure of information to outsiders and as an incentive to disclose information.

The information target may have a contractual duty to disclose information or to keep it confidential. These duties can be taken into account when interpreting the duty of care of its board members and managers. Sometimes their duty of care requires compliance with the contractual obligations of the company, sometimes not. Depending on the circumstances, the duty of care of company representatives can also require them to breach contractual obligations.

Right to Disclose Information

Sometimes information analysts inside the information target have a right to disclose information provided that certain conditions are met.

Duty of care. It may be in the interests of the company to disclose information to the public or selectively. For example, the board of a company and its managers are expected to disclose information in the course of merger negotiations (see Volume III).

Selective disclosure of inside information. Selective disclosure of information is often necessary. Especially in listed companies, the selective disclosure of inside information may be contrary to the principle of equivalent treatment of shareholders.[519] There are therefore constraints to selective disclosure.

Primary insiders[520] are not prohibited from disclosing inside information to other persons, where such disclosure is made in the normal course of the exercise

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[519] For example § 53a AktG: "Aktionäre sind unter gleichen Voraussetzungen gleich zu behandeln." For Community law, see section 9.5.4 above.

[520] Article 2(1)(2) of Directive 2003/6/EC (Directive on market abuse).

of his employment, profession or duties.[521] Selective disclosure of information by listed companies is sometimes constrained by the duty to make the same information public. For example, the Market Abuse Directive requires issuers to disclose inside information to the public, if the same information is disclosed to a third party, unless that third party owes a duty of confidentiality.[522]

The technical modalities of disclosure of inside information can act as constraints to selective disclosure. For example, it can be difficult to answer the questions of shareholders at a general meeting by disclosing inside information, if the information cannot be disclosed in the required manner.[523] In a German Aktiengesellschaft, a shareholder may demand the disclosure of information at the general meeting, where the same information has been selectively disclosed to another shareholder outside the general meeting.[524] In any case, the disclosure of inside information at the general meeting always requires simultaneous compliance with rules on the disclosure of inside information.[525]

Non-disclosure agreement. The right to disclose confidential information is often constrained by the general duty of care. It is often unwise to disclose confidential information unless the recipient owes a duty of confidentiality under a non-disclosure agreement or otherwise.

Duty Not to Disclose Information

The general duty of care is complemented by a large number of norms that prohibit or restrict the disclosure of information (see section 10.6). This can be highlighed by two cases of norms.

Insider dealing. Unlike the general duty of care and fiduciary duties of directors, rules on inside information have largely been approximated by the Directive on market abuse.

As said above, primary insiders[526] are prohibited from disclosing inside information to any other person unless such disclosure is made in the normal course of the exercise of his employment, profession or duties.[527] They are also prohibited from recommending or inducing another person, on the basis of inside information, to acquire or dispose of financial instruments to which that information relates.[528]

Directives implementing the Market Abuse Directive require the establishment of insider lists.[529] Member States must ensure that lists of insiders include all persons covered by Article 6(3) of the Market Abuse Directive who "have access to inside information relating, directly or indirectly, to the issuer, whether on a regu-

[521] Article 3(a) of Directive 2003/6/EC (Directive on market abuse).
[522] Article 6(3) of Directive 2003/6/EC (Directive on market abuse).
[523] See Article 6(10) of Directive 2003/6/EC (Directive on market abuse).
[524] § 131(4) AktG.
[525] Especially § 15(2) and § 15(3) WpHG.
[526] Articles 2(1) and 2(2) of Directive 2003/6/EC (Directive on market abuse).
[527] Article 3(a) of Directive 2003/6/EC (Directive on market abuse).
[528] Article 3(b) of Directive 2003/6/EC (Directive on market abuse).
[529] See recital 6 of Directive 2004/72/EC.

lar or occasional basis."[530] The persons required to draw up lists of insiders must take the necessary measures to ensure that any person on such a list that has access to inside information acknowledges the legal and regulatory duties entailed and is aware of the sanctions attaching to the misuse or improper circulation of such information.[531] Stock exchange rules typically require the use of transaction-specific insider lists.

Competition law. Competition law restricts contacts between competitors. Article 81 of the EC Treaty prohibits agreements and concerted practices between firms that distort competition within the Single Market.

For example, Article 81 of the EC Treaty strictly prohibits any direct or indirect contact between competitors, the object or effect whereof is either to influence the conduct on the market of an actual or potential competitors or to disclose the course of conduct which they themselves have decided to adopt or contemplate adopting on the market.[532] Article 81 can thus be infringed by: discussions on prices; exchanges of commercially important information; exchanges of confidential information on markets and/or undertakings; the conclusion, implementation and monitoring of price agreements; the participation in meetings and other contacts to facilitate infringement; and so forth.

The prohibition of concerted practices may even restrict the exchange of information in the course of pre-acquisition due diligence, if the parties are competitors (see Volume III).[533]

Duty to Increase the Usefulness of Information

As described above, Community law contains a large number of instruments designed to increase the usefulness of outgoing information disclosed by companies whose securities have been admitted to trading on a regulated market. Big steps in particular included the Financial Services Action Plan (FSAP) and the "disclosure and transparency agenda" that complemented it.

Right to Ask for Information

Freedom of speech usually permits people to say what is on their minds, but whether laws support the right to actually get an answer is another matter.

For example, individual shareholders have only a limited right to request information and get an answer, and this right may be constrained by several modalities. In this respect, there are differences between Member States' laws.

Under English company law, directors do not have any general obligation to address the requests of all shareholders for information and clarification at the

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[530] Article 5(1) of Directive 2004/72/EC.
[531] Article 5(5) of Directive 2004/72/EC.
[532] Cases 40/73, etc., Suiker Unie v Commission [1975] ECR p 1663, paragraphs 173–174.
[533] For US law, see Omnicare, Inc. v. UnitedHealth Group, Inc., No. 06 Civ. 06235 (N.D. Ill. Jan. 16, 2009).

general meeting, and they do not have any general obligation to answer the questions of individual shareholders.

Shareholders have more effective rights in a German AG. A shareholder has a subjective right to request verbal information from the management board regarding any item on the agenda (Auskunftsrecht). This right covers all information regarding the company, and in the parent company all information regarding the group, without which it would not be possible to assess the agenda of the meeting.[534] The management board has a duty to disclose the information provided, for example, that disclosure would not be detrimental to the company or to an affiliated undertaking.[535]

The right to request information and get an answer depends on the company form. In a German GmbH, the main rule[536] is that shareholders have a right to request information and that the managing directors (Geschäftsführer) of the company have a duty to disclose it to them[537] apart from in cases of abuse.[538]

[534] § 131(1) AktG.
[535] § 131(3) AktG.
[536] § 51a(3) GmbHG.
[537] § 51a(1) GmbHG.
[538] § 51a(2) GmbHG.

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