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THE BOARD STRUCTURE AS A SIGNIFICANT ELEMENT OF CORPORATE GOVERNANCE

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Abstract. *Corporate governance systems play a central role in economic performance because they provide mechanisms affecting the returns on suppliers' investment of external finance to firms. The task of modernizing company law and enhancing the quality of corporate governance poses itself in all industrial countries. It is estimated that within the European Union, the contents of up to 80 per cent of all legislation in the field of business law is determined by the legislation in Brussels. This article provides a critical overview of the corporate governance legislations. It suggests the measures for making a better decision regarding the structure of the board and a way of efficient decision-making. In order to facilitate the communication between shareholders, the legislator should intend to create a shareholders' forum. This forum could be suitable for coordinating the exercise of voting rights, for exchanging information and for uniting in the exercise of their rights independent of their whereabouts. The conclusions are based on the comparison of some EU legislation, and also on EU and US jurisdictions.*

Keywords: *shareholder, board structure, corporate governance*

1. INTRODUCTION

Corporate governance is an excellent area in which the "soft law" approach can be applied. The harmonization in this area would jeopardize the strength of the diversity of the national systems. During the last decade, the corporate governance debate has spread to almost all European countries. The main result of this activity is the adoption of codes that are broadly parallel in their scopes and recommendations. Generally speaking, the focus is on the role of the board of directors, financial reporting, and the role of the auditors and the function of the general meeting.

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2. CORPORATE GOVERNANCE DEFINITION

Corporate governance is a part of a well functioning market-based system. Also, it is a mix of internal company rules, soft law codes and statutory legislation. But, what does the corporate governance exactly mean? We cannot find universal definition of corporate governance. One of the basis definitions of this term is OECD's definition, which determines it as "the internal means by which corporations are operated and controlled".[1] The UK was the pioneer in corporate governance reform. The debate in this country resulted in the Cadbury Code (1992), as the listing rule for the London Stock Exchange. UK's influence spread to the France, Netherlands, and other European countries (for example, Germany was one of the last in following this trend and adopted its own corporate code in 2002). The HLG Report II is one of the most important acts in the filed of corporate governance. It was issued in November 2002 and recommended measures for the improvement of internal mechanisms of corporate governance regimes in the EU. The Report's recommendations are based on the concept of "shareholder democracy", which includes, especially, shareholders' rights and minority protection, and also the role of non-executive directors, duties of the board, and audit practices. HLG Report also announces 17 legislative and 7 non-legislative measures in the area of corporate governance. The final result should be a code for European corporate governance based on the following items:

- The structure of corporations,
- Corporate governance disclosure requirements,
- An integral legal framework to facilitate efficient shareholder communication and decision-making,
- Increased disclosure of group structure relations, and
- Enhanced disclosure of institutional investors and their investment and, in particular, voting policies.

One of the core features of the corporate governance is investor ownership; it means that shareholders have a significant right of control over their companies. The second characteristic is delegated management, which implies that shareholders generally exercise this control indirectly, by participating in the selection of directors, for example. Regarding the company forms, there is a different aspect between continental European corporate laws and UK company law. The first one generally distinguishes 'open' corporate forms with freely transferable shares, and 'closed' forms, in which transferability is restricted. On the other hand, UK company law uses the term 'closely held' to define corporations whose shares do not trade freely, and term 'publicly held' for corporations that adopt the open corporate form.

One of the most important aspects of corporate law is the shareholders' position. At first sight it could be concluded that the rules in this field are based on different strategies: the appointment rights strategy, decision rights, trusteeship, incentives, constraints, and affiliation rights strategies. The appointment strategy is the dominant way of protecting the shareholders' interests. The focus is on the structure and power of the board, and the voting of shareholders in the open companies. The other strategies are particularly based on management-shareholder agency problem.

[1] OECD Principles of Corporate Governance (OECD 1999) preface

3. SYSTEMS OF THE BOARD

HLG Report II highlights the equivalent (but not equal) opportunities and facilities in shareholders' participation, information and communication rights across the EU to allow enhanced decision-making. It is completely clear that the power of influence over the company should be conferred upon the shareholders. The shareholders have a double role: they act on their own behalf, but also on behalf of their stakeholders. The HLG Report II especially pays attention to situations when shareholders prefer to sell out shares rather than monitor and influence corporate performance. This is known as "rational apathy". (Lanno, Khachaturyan, 2004, p. 46) The vote regime is very important for that shareholders' right and, connected with their position, the percentage of companies under majority control on one hand, and blocking minority on the other. The HGL Report II makes specific recommendations about shareholders' rights to ask questions, to table resolutions, to vote in absentia and to participate in general meeting by means of electronic communications. Not right but shareholders' obligation is their responsibility to institutional investors. Institutional investors have a key role in the corporate governance of companies in which they invest. This is a reason why shareholders have to respect investors and their relationship with beneficiaries.

According to the HGL Report, board systems could be one-tier or two-tier. It means that companies have a choice between these two systems. Structure and composition of the board reflect legal and institutional legacies. The HGL Report confirms that controlling the shareholder structure mitigates the problems of executive monitoring in the EU. But, the same activity creates the problems, agency problems, between minority shareholders and controlling shareholders, but also problems between the minority shareholders and managers. The point of voting regime is the one-share/one vote. This way of voting is associated by HLG and European Commission as the shareholder democracy method. But, no one has clear proposals and goals of this regime, particularly for listed companies in EU.

In some papers the comparison between corporate boards and governing structures in political contexts could be found. (Birds, Boyle, 2004, p. 451) Political structures often offer a bicameral system, but corporate boards in almost all jurisdictions involve electoral majority (without a separately elected executive). But, the law might have different approach and allows the minority shareholders to be protected through a bicameral board structure (one board elected on a one-share/one-vote basis, and the other elected on a one-shareholder/one-vote basis, for example). This situation based on bicameral structure is very rare. The main reason for this is serious risk of deadlock and that the interest of minority shareholders can be protected applying the other rights, or maybe it is better to say by the other strategies. The distribution of voting rights affects the value of the firm even under qualifying conditions. The one-share/one-vote rule is not in any case optimal. Especially, this concept could be politically marketable, but on the other hand, its economic foundations are very questionable. Regarding the takeovers HGL Report endorses the principle of proportionality between the risk-bearing capital and decision- making (not one-to-one match).

Generally speaking, corporate structures in the EU, particularly in open companies, are characterized by different policy measures about the number and internal bodies' structure. The first question is which kind of board structure is required: one-tier or two-

tier. The second question could be the way of decision-making in the company's board. France is one of major jurisdictions that permit a two-tier board structures for open companies. Actually, this country similarly provides the option to choose a one or two-tier board. German Aktiengesellschaft that is required under the Aktiengesetz to have a two-tier board, and a Netherlands company that, except for companies with statutory two-tier status, offers both possibilities: a one-tier board of management that does not distinguish between executives and non-executives, and two-tier board with clearly distinguishable tasks – management and supervision. Many Netherlands companies, particularly Euronext companies, are not required to have a two-tier board, but almost all have chosen to have one. Netherlands law provides that the applicable default rule for large corporations will be the revised structuurecht model[2]. An exception is made for international holdings, subsidiaries, and joint ventures. International holdings are corporations controlling a group of companies of which more then 50% of its employees are employed outside the Netherlands. They are exempted as foreign holding companies. The goal is to prevent the board structure of internationals from being dominated by Dutch employee representatives. In subsidiaries and joint venture corporations there is a company's supervisory board, which has to oversee in governance matters[3]. As in the Netherlands law, Germany law also restricts the power of shareholders to elect the directors of large corporations in order to ensure the representation of laborers' interests in the boardroom. In both cases the two boards are organized vertically rather than horizontally. There is an elected supervisory board. On the other hand, managing board has members who are the principal managers of the firm. Thus, the two boards are in a semi-hierarchical relationship. This does not mean that the management board is powerless in two-tier systems. In the German law on joint stock companies the general aim of strengthening shareholders' rights can be seen, but on the other hand there is the aim of restricting possibilities for abuse. It focuses on two points: the responsibility of members of the companies' organs (management and supervisory board), as well as on the action for avoidance against resolutions of the general meeting of shareholders.

A strong and balanced board is the key for good corporate governance. The board should closely monitor managerial strategies in an effort to bridge the gap between uninformed shareholders and fully informed managers. It has already been mentioned that HLG Report recognizes two different board systems. The HLG offers companies a choice between these systems. Indeed, this moves a wider 'issuer choice' regime in the EU. (Lanno, Khachaturyan, 2004, p. 48) Shareholder structures, specially controlling shareholders, mitigate the problems of executive monitoring in the EU. A set of agency problems, which exists between minority shareholders and controlling shareholders on one hand and the minority owners and managers on the other, should be highlighted. These relationships include the role of non-executive directors and their monitoring in the areas of executive nomination and auditing, for example. Because of that role, non-executive directors should be independent in the majority.

The Statute (Art. 43-45) defines the rules governing one-tier boards. Regarding SE (it means European Company), this form of company is completely free to elect its own

[2] The Role of Employees in the European Company, art. 3:2 (5) and 4:3 (B)
[3] Netherlands Civil Code, arts. 2:153-155, 162-164 and 2:263-265, 272-274

board structure. SE will have one-tier board structure if it proves only to be of interest to a cross-border combination of equal partners into an SE holding corporation of a group of companies[4]. The Statute only provides a minimum number of rules on one-tier boards, defined as an 'administrative organ' manage the SE. The OECD sets out principles on Board decision-making in more detail as well as the 'key function' to be performed by the Board. Member States may provide that one or more managing directors will be responsible for the *day-to-day management* under the same conditions as those applying to their national public corporations. The number of directors should be defined by the SE's internal acts. According to Directive on Employee Involvement, the Board could consist of a least three members, including the employees. But, the experience of applying it is different in practice and often gives unexpected results. Following these facts, particular major corporate failures as Maxwell, the UK Cadbury Committee strongly recommended: a) a redefinition of basic duties of the Board particularly with respect to audit and business controls; b) a clear distinction between independent non-executive directors and executive directors in the composition of UK Boards; and c) the assignment of key function of the Board to be executive by committees composed of independent non-executive directors.

A Statute defines a two-tier board structure in a case when Member States do not regulate for a one-tier board system for their public corporations. This case is known for Germany and the Netherlands laws. Both laws restrict the power of shareholders to elect the directors of large corporations in order to ensure the representation of labor's interests in the boardroom[5]. (Kraakman, Davies, and others, 2004, p. 36) The Netherlands presents a more extreme example. Dutch law currently establishes a so-called previously mentioned, 'structure regime'. Under this regime, shareholders of medium to large companies do not elect their directors at all. In 2001 the Dutch Government (the Social and Economic Committee, exactly) recommended the replacement of the structure regime with a board elected two-thirds by shareholders and one-third by employees. The same body also recommended that the shareholders meeting retain the power to dismiss the entire board.

Those jurisdictions, German and the Netherlands, require a two-tiered board, which include tendencies to undermine board responsiveness to shareholder interests rather than to enhance it. But the reason for this result has to do with the composition of these boards, not with their structure. (Kraakman, Davies, and others, 2004, p. 35).

4. STRUCTURE OF THE BOARD

It seems paradoxical that the HLG recognizes the problems of controlling structures, and at the same time mandates a solution for non-controlling structures[6]. Controlling

[4] Under French law the societe anonyme (SA) is governed by the one-tier conseil administration, unless the charter provides that it shall be governed by the two-tier directoire et conseil de surveillance; Art. L.225-57 Code de commerce

[5] For example, the corporation law in some important jurisdictions (UK and Delaware) would appear to allow corporate directors to be selected by non-shareholders if the charter so required

[6] Jurisdictions make differences in the decision-making characteristics of the board. The main differences are between EU and US systems, in particular regarding the nature of agency problems of controlling shareholders in the EU and dispersed shareholder structures in the US

shareholders through promoting their own interests do the same for minority. According to Gilson&Gordon, controlling shareholders can unilaterally and disproportionally benefit from their holdings in three ways: through operating, selling control and freeze-outs. (Gilson, Gordon, 2003, p. 228) Also there are numerous suggestions about the size and structure of the board. "Best practice" is one of the basic facts. The question could be what size of the board is the best (are the small boards better or not); or, committee structure of the board, the frequency of board meeting, and the ratio of insiders to independent directors (is a majority of independent directors good or not).

Obviously, there is a significant difference between EU and US jurisdictions. Comparisons of German and UK (and US) corporate governance are typically focused on the role of German banks as holders of equity stakes in large firms. Large German firms take several different legal forms. Two types of firms can issue shares: AG – a stock corporation, and the KGaA – a partnership partly limited by shares. AG and KGaA can be listed on a stock market, but many of them are unlisted. Both forms are required to have a supervisory board, consisting of both shareholder and employee representatives. The two-tier board system provides a structure in which the decision whether a claim of the company against a member of either the management board or the supervisory board can be taken by a disinterested body. The supervisory board has the legal right to appoint and dismiss the management board. The structure of supervisory board depends on number of employees, and on a size of company. In companies of over 2000 employees, for example, there are equal numbers of shareholders and employee representatives (mandatory board-level participation for employees). On the other hand, in smaller companies there are twice as many representatives of shareholders. General meeting is a body by which the shareholder representatives on the supervisory board are elected. They are elected by a simple majority vote of shareholder representatives. The supervisory board decides regarding claims against members of the management board. Also, the management board has decision-making power in respect of claims against members of the supervisory board[7]. On the other hand, shareholders are in certain circumstances entitled to initiative but not to control the assertion of claims against members of the administrative organs[8]. The 'German model' of corporate governance with its concentrated shareholdings and strong presence of banks has been advocated as a model for both developing countries and countries in transition process. German banks are, perhaps, one of the best examples of board structure. These institutions are able to influence corporate governance through their positions on the supervisory boards of large companies. The banks act in this case as shareholder representatives. For example, in 22 of 25 listed companies, supervisory board is chaired by a banker, and also in some unlisted companies the same situation could be found. Bank supervisory board representation is also concentrated among the listed companies, and what is interesting, in the hands of the three big banks. Obviously, the banks are not in a position to dominate supervisory boards numerically. Measures of bank con-

[7] Art. 112 and 78 I Aktiengesetz

[8] According to German law, 147 I and III Aktiengesetz, a majority of shareholders and a minority of shareholders holding at least 10% of the nominal share capital can at a shareholders' meeting request the assertion of claims against members of the management or the supervisory boards; or, a minority holding at least 5% of the nominal share capital or the pro rata amount of 500000euros can initiate the assertion of claims against such members

trol of equity voting rights should explain two different dependent variables. The first one is the proportion of total supervisory board seats held by bank representatives. The second measure depends on institution whether the chairman of the supervisory board is a banker or not.

According to German law general meeting is a more popular company's body than management board. This is the reason why a lot of decisions are made by vote at the shareholders' general meeting, rather than by the management board. Decisions such as increases or decreases in equity capital, changes in the company's statutes, mergers, and similar, usually need a 75% majority. It means, on the other hand, that a shareholder with 25% of the voting equity or over this percentage can block these decisions. This relation (majority-minority vote) is characteristic of German company law.

One-tier board is a usual form for companies in UK. The number (minimum and maximum) of members of boards is often defined by articles. Actually, there is no legal qualification regarding being a member of company's board. Company Act (1985) requires that every company must have a director or directors. Under section 294 of mentioned Act it is provided that a person who has attained the age of seventy cannot be appointed director of a public company or a private company that is a subsidiary of a public company. It means that a person appointed or proposed to be appointed a director of such a company at the time when he has reached 70 must give notice of his age to the company. The Company Act does not require that a director be a shareholder, but article may do it. As it was said about the board structure, in a similar way the articles define that a number of directors shall form a quorum. A quorum could be prescribed. If it is not, a majority of the board is required to attend, unless quorum can be established by the practice of the board. The board, according to British rules, has a dual function, to lead and to control the company. The Cadbury Committee defined the distinction between executive and non-executive directors, as a part of the corporate governance, at least for listed companies. This act recommended that at least 1/3 of the board should be non-executive directors, most of whom should be independent[9]. However, in large companies in UK, the central management of company is in the hands of the board. The modern law introduced the Combined Code on the composition of the board. This act, as a part of soft law, is focused on the role of the independent non-executive directors.

5. REGULATION OF CORPORATE GOVERNANCE IN EU

Corporate governance systems play a central role in economic performance because they provide mechanisms affecting the returns on investment by suppliers of external finance to firms. In the beginning of the new century the regulation in the field of corporate law has received very important rules: Council regulation on the Statute for a European Company, and the Directive on Involvement of Employees. European Company is known as Societas Europaea (SE). This form has an international status and it will be governed by supporting corporate law of the Member State in which the SE has its 'registered office and has a real and continuous link a Member's economy'. The Statute allows individual

[9] In report 2003 it was highlighted that at least ½ of the board should be non-executive directors and ½ should all be independent

firms to adopt either a one-tier or a two-tier board structure to govern the jurisdiction of corporation. The Fourteenth recital of the Statute's preamble states: "An SE must be efficiently managed and properly supervised. It must be borne in mind that there are at present in the Community two different systems for the administration of public limited-liability companies. Although an SE should be allowed to choose between the two systems, the respective responsibilities of those responsible for management and those responsible for supervision should be clearly defined"[10]. After adopting the Statute, Member States may now choose from a menu of options regarding the level of involvement granted to its corporate officers at the board level. Organizations have to be properly governed according to their objectives, whether private businesses, non-profit organizations, public utilities, or even agencies of the government. The High Level Group of Company Law Experts, in its Report on a Modern Regulatory Framework for Company Law in Europe, recommended that the European Commission refrain from introducing a full harmonization or a European Corporate Governance Code. Most Member States have already had such codes and some have recently been revised (UK Combined Code on Corporate Governance, the German Corporate Governance Code, the Netherlands Corporate Governance Code, for example). Corporate governance systems differ significantly. The German system has attracted considerable interest because it is thought to address corporate governance problems more effectively than the Anglo-American system. For example, in large firms in UK and US, ownership and control are usually separated: owners are diffuse and numerous shareholders, but control is exerted by managers.

Generally speaking, the 'ideal' model of corporate governance recommended for all forms of companies is far away. Successful management understands directors qualified for this function and one of the possible ways of setting the board. At the same time, it is important to say that directors may be unfit (the reason is, certainly, their disqualification). For example, in 2001-2002 1,761 directors of insolvent companies were disqualified for unfitness. But, the problem also could be the effectiveness in deterring improper conduct and promoting good standards of practice in corporate governance. (Hicks, 2001, p. 433) For some other author, disqualification of directors has become one of the most significant parts of company law. (Walters, 2002, p. 531-538) Regarding the EU meanings about the board and its fit or unfit members, the HGL is focused on the merits of introducing a disqualification sanction for non-compliance with disclosure requirements.

EU adopted the Action Plan on "Modernizing Company Law and Enhancing Corporate Governance in the EU". The Action Plan has a deep influence on current company law and reforms in this area in the Members States. Germany is going to make a special act on corporate integrity and on modernizing the right of avoidance and the corporate governance code, which is not an imperative law. Generally, the focus should be on responsibility of members of companies' bodies, particular, management and supervisory boards. These persons have to exercise the due diligence of a prudent and conscientious person in charge of a business and insofar bear the burden of proof. According to German law, they are liable already in the case of ordinary negligence[11]. But, in spite the best international standards applied as a base of legal base, experience and practice cases show

[10] Article 23 and 38(b) of Statute preamble
[11] AktG, art. 93 para. 1(1), 116

that rightful claims asserted by action in court are very seldom. Actually, the facts could be defined as following: enabling minority shareholders to effectively put claims through, introducing a special judicial admission procedure in order to prevent abusive legal action, statutory determination of requirements for indemnity against liability for entrepreneurial decision making, in order to protect business initiative.

In order to promote the previous goals German legislator defines a set of interesting new provisions. In future, the principle of internal liability shall be retained. It means that under the existing law the members of management and of supervisory board are not directly liable to the shareholders, nor will a system of liability to shareholders be introduced by new legal solutions. Obviously, only the company and not the individual shareholder may receive compensation for damages (action pro socio).

Shareholders may sue managers or directors only when their share, individually or combined with those of other shareholders, reaches certain threshold values. These values will be dramatically lowered in future legal proposals[12].

6. CONCLUSION

Company law should have an important role in promoting economic integration. European Company Statute was adopted in 2001. The Action Plan on "Modernizing Company Law and Enhancing Corporate Governance in the EU" which contains not less than 24 measures can be taken into account. The task of modernizing company law and enhancing the quality of corporate governance poses itself in all industrial countries. In order to facilitate communication between shareholders, German legislator intends to create a shareholders' forum. Creation of a shareholders' forum could enable shareholders as well as associations of shareholders to exchange information. Also, it should enable uniting these persons in the exercise of their rights independently from their whereabouts. The shareholders' forum is suitable for coordinating the exercise of voting rights. In addition, the shareholders will be able to fulfill a quorum; it means to operate with more strength. In aforementioned new company's body the shareholders and company will not be allowed to plead their case in the forum itself but publish only the request. All measures should provide preventing of abuse. The highlighting idea is to put up filters through which only those applications that have a realistic chance of success pass. For example, the action for damages could be admitted if the shareholders who bring the action have acquired the shares before obtaining knowledge of the breach of duty.

Obviously, a feature often claimed to distinguish the German from the Anglo-American system of corporate governance is the absence of hostile changes in ownership in the former and their presence in the latter. In both systems, the main role of board should be better minority shareholders protection, particularly when the new controlling shareholder is another company. Banks play an important role in assisting companies to make hostile acquisitions of ownership stakes. The standard view of banks in the German corporate governance system is that of their close connections to companies, through control of equity voting rights and supervisory board representation.

[12] At the moment, according to German law, the shareholders are not allowed, in the case dealt with here, to sue a company manager director in their own name. Because of that, it is necessary to appoint a special representative. The new act defines the shareholders will at least be entitled to act in their own name

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STRUKTURA UPRAVNOG ODBORA KAO ZNAČAJAN ELEMENT KORPORATIVNOG UPRAVLJANJA

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Sistem korporativnog upravljanja igra centralnu ulogu u ekonomskim performansama jer obezbedjuje mehanizme čiji je jedan od zadataka vraćanje investicija kompanijama od njihovih eksternih finansijera. Zadatak modernizovanja kompanijskog prava i unapredjenje kvaliteta korporativnog upravljanja je prisutan u svim industrijskim zemljama. Procena je da unutar Evropske unije više od 80% od celokupne legislativne u okviru oblasti poslovnog prava je oderedjeno pravilima uspostavljenim u Briselu. Ovaj članak treba da pruži kritički osvrt legislative o korporativnom upravljanju. U tom cilju se predlažu mere u cilju donošenja boljih odluka u pogledu strukture upravnog odbora i način efikasnijeg odlučivanja. Kako bi komunikacija izmedju akcionara bila olakšana, zakonodavac treba da omogući kreiranje akcionarskog foruma. Ovaj forum bi mogao da predstavlja pogodan način izražavanja prava glasa akcionara, kao i razmene informacija. Osnovu zaključaka predstavlja komparacija pojedinih evropskih zakonodavstava, kao i evropskih i američkih zakonodavnih rešenja.

Ključne reči: *akcionar, struktura odbora, korporativno upravljanje.*