Minimizing the Expectation Gap Through An Independent Board Of Directors

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To my parents for their unwavering support throughout my education.

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ABSTRACT

The traditional model of corporate governance is comprised of three main players: the board of directors, the management, and the shareholders who own of the corporation. This model has received a wave of criticism. The two most important complaints were that the directors had little to do with the day-to-day business of the corporation, and in their decision making the interests of the shareholders were not being taken into account. This situation has led to the creation of what has been called the "expectation gap" which is defined as the gap which exists between the shareholder's expectation, and the performance and actions of the board of directors.

To reduce this gap, the corporate governance actors have called for an increase in the independence of the board. Among the panoply of changes suggested to improve the representation of the interest of the shareholders as a whole, many have proposed that the number of independent directors be increased, that specialised committees be established, and that the functions of the CEO/Chairman functions be separated. These proposals are incorporated in reports which contain recommendations for the legislature and corporations in general, and listed companies in particular. The most important ones are the American Institute Principles of Corporate Governance ("the ALI Principles"), the Report of the Committee on the Financial Aspects of Corporate Governance in the United Kingdom ("the Cadbury Report"), the Report of the Toronto Stock Exchange Committee on Corporate Governance in Canada ("the Dey Report"), and the French *Rapport sur le Conseil d'Administration des Sociétés Cotées* ("the Viénot Report").

The purpose of this study is to give advisors to the French government a comparative understanding of the way that corporate governance in general, and in particular, the way the issue of the independence of the board has been dealt within the United States, the United Kingdom, and Canada. We evaluate all of these proposals, noting which ones have been applied in France, and we recommend which ones should be considered by the French Government.

RESUMÉ

Le modèle traditionnel de gouvernement des entreprises comprend trois principaux acteurs: le conseil d'administration, la direction générale et les actionnaires qui sont propriétaires de la société à travers la détention du capital. Ce modèle a fait l'objet de nombreuses critiques. Il a été reproché aux administrateurs de ne pas s'intéresser à la conduite journalière de la société et de ne prendre que faiblement en considération l'intérêt de ses actionnaires. Les critiques ont été à l'origine de la création de l'"expectation gap" qui a été défini comme l'écart entre l'attente des actionnaires et l'action et la performance du conseil d'administration.

Pour réduire cet écart, les participants au débat sur le gouvernement des entreprises ont appelé à un accroissement de l'indépendance du conseil d'administration. Parmi les remèdes suggérés tendant à une meilleure représentation de l'intérêt des actionnaires, beaucoup ont proposé d'accroître le nombre d'administrateurs indépendants, de créer des comités spécialisés et de séparer les fonctions de président du conseil et de directeur général. Ces propositions ont été incorporées dans des rapports qui contiennent des recommandations destinées au pouvoir législatif et aux sociétés anonymes, en particulier celles faisant appel public à l'épargne. Parmi ces rapports, les plus importants sont le *American Institute Principals of Corporate Governance* ("the ALI Principles"), le *Report of the Committee on the Financial Aspects of Corporate Governance in the United Kingdom* ("the Cadbury Report"), le *Report of the Toronto Stock Exchange Committee on Corporate Governance in Canada* ("the Dey Report"), et en France le Rapport sur le Conseil d'Administration des Sociétés Cotées ("le Rapport Viénot").

Cette étude, destinées aux conseillers du gouvernement français, a pour objectif de décrire de manière comparée le débat sur le gouvernement des entreprises, et plus particulièrement comment la question de l'indépendance du conseil d'administration a été abordée aux Etats-Unis, au Royaume-Uni et au Canada. Seront ensuite évaluées les différentes recommandations faites dans les principaux rapports tout en notant leur application en France, avant que soient mises en avant celles qui doivent encore être développées.

TABLE OF CONTENTS

INTRODUCTION: THE CORPORATE GOVERNANCE DEBATE AND THE INDEPENDENT BOARD

"La *corporate governance* n'est rien d'autre qu'une étape vers le capitalisme de marché. C'est sans doute pourquoi il suscite tant d'appréhensions et tant de troubles; il est le symptôme d'une évolution profonde des relations au sein de l'entreprise, entre l'entreprise et ses actionnaires, ses dirigeants et ses salariés. Un changement de culture est en jeu."

(**Hervé Juvin**, 1996)

In 1985, corporate governance was undoubtedly a "hot" issue in the United States as well as in the United Kingdom. Since then, not only has it remained such in those two countries, but the governance wave has also reached other shores, those of Canada in the past five years, and France in the past three years. In these countries, and particularly in France, the corporate governance debate continues to grow in importance. For example, in France a committee constituted by the *Conseil National du Patronat Français* (CNPF) and the *Association Française des Entreprises Privées* (AFEP) in 1995 released a report on boards of directors of publicly traded companies.[1] While this first step towards the revision of the French corporate governance system was made by private entities, more recently the Prime Minister, Alain Juppé, asked senator Philippe Marini to recommend reforms to the French 1966 Company Law.[2] His report was made public in September 1996, and deals with corporate governance issues such as the establishment of specialized

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[1] *Rapport sur le Conseil d'Administration des Sociétées Côtées* (Paris: CNPF-AFEP Editions Techniques Professionnelles, Juillet 1995) (Chairman: Marc Viénot) [hereinafter **Viénot Report**]. This report was drafted by a committee constituted by the *Conseil National du Patronat Français* and by the *Association Française des Entreprise Privées*, chaired by Marc Viénot, the Président Directeur Général of the Société Générale. It was released in July 1995

[2] **A. Leparmentier**, "Le droit français des sociétés doit s'adapter aux réalités économiques" *Le Monde* (18 April 1996). The Sénateur Marini (RPR, Oise) was charged to reform the *Loi n° 56-537 du 24 juillet 1966 sur les sociétés commerciales* [hereinafter 1966 Company Law] on January 17, 1996. He was scheduled to report his work to the Prime Minister mid-July 1996.

committees of the board — e.g., the audit, compensation, and nominating committees — and limitations on interlocking directorships.[3]

In this introductory chapter, we describe the corporate governance debate in general (**I**). We then draw a framework for our study, and give reasons for focusing our discussion on the independence of the board of directors (**II**).

I. THE TRADITIONAL MODEL OF CORPORATE GOVERNANCE

A. The Players

There are three main players in the corporate governance debate: the board of directors, management, and shareholders, or owners, of the corporation. Under the traditional model of corporate governance, each of these players has a different role, roughly summarized in **Table 1**. There are other players in the corporate governance debate: the public at large, employees, the corporation's customers and its creditors. We encounter these other players during our study, but we focus on the three main ones.

B. The Corporate Governance Debate

The traditional model of corporate governance has received a wave of criticism. There were two main complaints about directors and the board as a whole. First, directors had little to do with the day-to-day business of the corporation. As a consequence, the board could not play its role of monitoring the management, and therefore the executives were operating the corporation. Scholars from Berle and Means[4] on have elaborated on this owner/manager-principal/agent split. Among them, Margaret Blair writes that:

> "Although numerous individuals, from financial investors to suppliers, to employees, may contribute resources to and have a stake in the success of a given corporation, the broad policies, strategic plans, and day-to-day decisions in large publicly traded corporations are largely controlled by professional managers."[5]

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[3] **B. Fillion-Dufouleur**, "La modernisation du droit des sociétés commerciales" (1996) D. 1996 p. 287. Senator Marini made public his report during a press conference at the Senate on September 10, 1996.

[4] **A. Berle & G. Means**, The *Modern Corporation and Private Property* (New York, MacMillan, 1932). According to them, the shareholders own the corporation; therefore, the corporation should be managed in their interests.

[5] **M. Blair**, *Ownership and Control: Rethinking Corporate Governance for the Twenty-First Century* (Washington, D.C: The Brookings Institution, 1995). The classic work dealing with the debate duty to

THE PLAYERS IN THE TRADITIONAL MODEL OF CORPORATE GOVERNANCE	
1. **The Board**[6]	**The responsibilities of the board include setting the company's strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship.**
2. **The Management**	**The management and especially top executive officers act as agents of the corporate board and execute the board's decisions.**
3. **The Shareholders**	**They are the owners of the corporation, but they are generally limited to electing directors, and voting on major corporate matters such as mergers, and amendments to corporate bylaws. Their primary interest is in the return on their investment.**

Table 1

The second complaint was that directors were taking little account of the shareholders' interests in their decision making. They have been criticized for protecting themselves in take-over situations and of responding to bids in ways that were in the interests of the shareholders as a whole.[7] In this context, one premise of the corporate governance debate is that corporations in general, and publicly traded ones in particular, can and should be made more responsive to their shareholders.[8] The reality is different. The result is called the "expectation gap", which we will define as the gap that exists between shareholders' expectations, and the board of directors' actions and performance. We analyze this gap in **Chapter I**.

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shareholders only, or duty to shareholders and stakeholders including the public is **A. Berle & G. Means**, *supra* note 4.

[6] *Report of the Committee on the Financial Aspects of Corporate Governance* (London: Gee and Corporation. Ltd. 1992) (Chairman: Sir A. Cadbury) [hereinafter **Cadbury Report**] 2.5.

[7] Their own financial interests in the corporation (e.g., in the form of stock options) has been said to have a negative effect on the independence of their judgement.

[8] S. **Friedman**, "Corporate Governance and the Board of Directors", in **A. Cohen & R. Loeb, eds**, *Corporate Governance* (New York: Practising Law Institute, 1979) 245 at 255.

II. THE NEW CORPORATE GOVERNANCE MODEL

A. Framework of Our Study

1. The Subject

According to Blair:

> "The phrase corporate governance is often applied narrowly. to questions about the structure and functioning of boards of directors or the rights and prerogatives of shareholders in boardroom decision making."[9]

In *Ownership and Control - Rethinking Corporate Governance for the Twenty-First Century*. Blair has decided to include in the concept of corporate governance not only corporation law and boardroom practices. but also some aspects of corporate finance. securities and bankruptcy law. laws governing the behavior of financial institutions. labor relations practices. contract law and theory. property rights. compensation systems. and internal information and control systems.[10]

Our study does not attempt to cover all of these subjects. and despite Blair's criticism on the narrowing of the phrase "corporate governance". we will deal primarily with the functioning of the board and the influence of shareholders. especially institutional investors. in boardroom decision making. More precisely. we will focus on the issue of the independence of the board. To reduce the expectation gap. there have been many proposals. made primarily by institutional investors. The majority of them revolve around the concept of the independence of the board: a careful selection of directors (**Chapter III**). the presence of a majority of independent directors (**Chapters IV**). the establishment of specialized committees composed of independent directors (**Chapter V**). and the separation of the functions of Chief Executive Officer (CEO) and Chairman of the board (**Chapter VI**). There are several other proposals which we include but are briefly discussed — lead director concept. public director. dual board model (**Chapter VII**).[11] The fundamental premise behind all theses proposals is that independent directors bring

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[9] **Blair**. *supra*. note 5 at 3.
[10] **Blair**. *supra*. note 5 at 3-4.
[11] There are other propositions which are oriented towards a more dependent board: special-interest director. institutional investors and employee representatives. We will discuss them in **Chapter VIII**.

objectivity to the board's decision making. Independent directors have less or no personal interest in the company. Therefore, they are more likely to govern the corporation taking into consideration the interests of the shareholders, thus reducing the expectation gap. This central theme is underlined by our title *Minimizing the Expectation Gap With An Independent Board of Directors*.

2. The Jurisdiction

We apply to France our observations, while the model jurisdiction is the United States. This choice has been made for one reason with two facets: France is at the edge of taking firm action to improve corporate governance, or "*le gouvernement des entreprises*", while the United States has been the first to consider the issue and deal with it: it is also the jurisdiction where there has been the most legal writing on the subject.[12] The United Kingdom and Canada provide other examples from jurisdictions which are dealing with the corporate governance debate.

3. The Audience

The purpose of this study is to give advisors to the French government a comparative understanding of the way corporate governance in general, and the issue of the independence of the board in particular has been dealt with in three major countries: the United States, the United Kingdom, and Canada. We describe some of the recommendations and legal developments that have been made in these countries. In our last chapter, we evaluate all these proposals, noting which ones have been applied in France, recommending which ones should be considered, explaining why they are advisable and how they might be implemented (**Chapter VIII**).

B. The Sources

Our study focuses on two major sources of information: the reports on corporate governance, and diverse literature. A general criticism is that much of the writing on the subject is descriptive, narrative, and although useful in some way, deals insufficiently with the legal application of the proposals made.

[12] See below II.C.

1. The Reports

We consider four main reports: the American Law Institute (ALI) Principles of Corporate Governance,[13] the Report of the Committee on the Financial Aspects of Corporate Governance in the United Kingdom,[14] the Report of the Toronto Stock Exchange Committee on Corporate Governance in Canada,[15] and the French report released by the CNPF and the AFEP.[16] We will briefly review the history of these reports, their main characters, and their implementation in **Chapter II**. There will be a more detailed description throughout the study, of the recommendations found in the reports. The **Annex** contains extracts of the reports.

2. The Literature

The USA dominates the literature on corporate governance in general, and on the independence of the board in particular. If the immense amount of US legal writing is not entirely practical, it must be taken into consideration. UK and Canadian literature is scarce. The French have just recently begun to tackle the subject. The **Bibliography** lists the books, reviews, and articles that we used.

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[13] **The American Law Institute**, *Principles of Corporate Governance: Analysis and Recommen-dations* (St. Paul, Minn.: American Law Institute Publishers, 1994) [hereinafter **ALI Principles**].

[14] See *supra* note 4.

[15] **The Toronto Stock Exchange Commission on Corporate Governance in Canada**, *Where Were the Directors? - Guidelines for Improved Corporate Governance in Canada* (Chairman: Peter Dey) [hereinafter **Dey Report**].

[16] **Viénot Report**, *supra*, note 1.

CHAPTER I: THE EXPECTATION GAP

"L'"expectation gap" est une expression sans équivalent en français qui décrit à la fois la désillusion, crise de confiance et malentendu profond entre le public et le monde des entreprises."

(**Jacques Manardo**, 1994)

INTRODUCTION

Under corporate law, shareholders own the company in which they hold stock. Sometimes they feel that the management and the board of directors should always make decisions respecting their interest. But as we will see later, if the shareholders' interest is the primary concern of the executives of the corporation, there are other interests that need to be taken into account, such as those of employees and customers.[17] It can therefore be easily understood that shareholders sometimes feel that there is not always a link between corporate decisions and their interests. This gap is referred to as the "expectation gap". We define this term as the gap which exists between shareholders' expectations, and the board of directors' actions and performance.[18] This definition is purposely narrowed down because our study focuses on the relationship between the board and the shareholders. There are other "expectation gaps" that lie between managers and stakeholders in general — the other players of the corporate governance debate[19] — or the gap between managers and shareholders and stakeholders. They will not be part of our study, but these gaps are present.

The expectation gap thus defined has been the focus of much of the corporate governance debate. Proposals that have been made, especially those dealing with a greater independence of the board, are explicitly or implicitly oriented toward its reduction. In the first part of this chapter we will try to analyze what are the origins of the expectation gap.

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[17] See Chapter III at III.B.
[18] This expression is often used by accountants or auditors with a similar meaning.
[19] See Table 1 at 2.

and how it was formed (**I**). The participants in the corporate governance debate have focused much of their attention on how to reduce this gap. Because of their large investments in their portfolio companies (**II**), institutional investors have triggered the activist movement that seeks to reduce the expectation gap. Institutional shareholders often claim that they have the right to express their concern about matters that can affect corporate performance, and at the same time their share value (**III**). In this chapter, we will try to be as comparative as possible, even though most of the literature deals with the United States.

I. THE EXPECTATION GAP

A. Origins of the Expectation Gap

Different factors have contributed to the formation of the expectation gap.[20] The trend towards stock market globalization, and the technological revolution have made transactions more complex and less and less tangible. The opening of new markets, and their overall democratization have created a new wave of shareholders with different expectations. Recent media coverage of scandals involving directors has lead to important pressure put on the management of listed corporations. The sheer size of investments in public companies and their influence on people's lives has focused attention on expectation and satisfaction.

B. The Formation of the Gap

The expectation gap is the result of two opposite phenomena: corporate performance, and shareholders' expectations. It is believed that the gap can be reduced by reforming corporate governance.

[20] **J. Manardo**, "Corporate Governance et Auditeur", in "La Corporate Governance-Actionnaires, administrateurs, dirigeants: objectifs, pouvoirs et responsabilités" (Les Echos Conférences, 16 October 1994) 31 at 31.

1. Corporate Performance

The debate about whether corporate performance can be improved by reforming the ways corporations are controlled and managed touches fundamental questions such as whose interests corporations should serve and what their functions are.

a) Whose Interests Should Corporations Serve?

Traditionally, directors felt that they held the corporation in trust for the shareholders. This view, which Blair calls the "financial model",[21] goes back to the theory of the "separation of ownership from control" of Adolph Berle and Gardiner Means.[22] Following this theory, the shareholders own the corporation, and society is best served if corporations are solely run for shareholders. Therefore, the corporation should be managed in their interests. From this theory, we can conclude that the board, in its decision making, should only take into consideration the interests of the shareholders.

Today, directors find themselves assailed by demands for accountability to employees, creditors, government policies over wages rates and prices, customers (for safety of products and for defective products), environmentalists, the communities where they are located, and the national interest.. Some argue that society as a whole may not be best served if corporations are run solely for shareholders, that what is optimal for shareholders often is not optimal for the rest of the society, and that other goals might sometimes be as or more important than maximizing shareholder value. The boards that have responded positively to these demands have found it impossible to only take into account the interests of the shareholders. They have also taken into account other interests that might not have been in accordance to the shareholders' interests, thus creating the expectation gap.

b) The Functions of Corporations

According to Kenneth Midgley, the main objective of a corporation is to meet the demands of consumers as efficiently as possible.[23] To achieve this goal, production must

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[21] **Blair**, *supra*, note 5 at 12.
[22] See *supra* note 4 at 71.
[23] **K. Midgley**, "To Whom Should the Board be Accountable...and for What?", in **K. Midgley, ed.** (London: The Macmillan Press Ltd., 1982) 61 at 66.

be directed towards areas where there is unsatisfied demand, and costs must remain as low as possible. A company that does not pursue this end will not survive. This point is arguable. Some others say that the maximization of share value or return is the main objective of the corporation. In any event, a corporation has to be competitive, and pursue a policy of profit maximization. This calls for decisions that are not in accordance primarily with the interests of the shareholders, at least in the short-term. If the corporation lacks competitiveness its market shares will be priced lower than more successful firms, and several consequences might result from this situation. First, it will be harder for the company to raise share and loan capital. Secondly, directors might not only suffer a fall in their wealth via the loss in the value of their holdings in the corporation, but they might also be subjected to pressure to leave the board. A group of private shareholders, sometimes using the proxy voting machinery, can put pressure on the board of directors. However, because of the increasing complexity of public listed corporations, individual shareholders feel that they have little ability to influence the destiny of these corporations.[24] Therefore, the pressure is most likely put on the board by institutional shareholders, who sometimes, such as in the United States, hold half or more of the equity shares.[25] Finally, if the share price falls sufficiently, the corporation might become attractive to predatory outsiders who may make a bid to take-over the corporation. The most likely reaction is that management, in particular the CEO, and inefficient directors, will be replaced.

We can see that directors are under a lot a pressure when dealing with the future of a corporation. Not only do they have to be aware of the fact that they can be replaced — either through a proxy vote or by the arrival of a new board in case of a take-over — but also they need to continuously balance the expectations of different stakeholders. Most important of all are the shareholders' expectations.

[24] **B. Barker**, "The Relationship Between Public Companies and their Shareholders", in **Midgley**, *supra*, note 23, 85 at 86.
[25] See below II.B.

2. Shareholders' Expectations

Shareholders' expectations are diverse. but as a general rule. the majority of them are solely looking for the maximization of their investment. Small shareholders are mainly interested in dividends and in capital appreciation. and they have neither the time nor the inclination to participate in corporate governance. Large institutional investors however. represent a different case. If their main expectation remains the maximization of their investment. they are often actively involved in the corporate governance debate. especially in issues involving directors' independence.[26] Because of their important participation in the share capital of listed companies. they are more likely to be listened to than private shareholders.

II. THE IMPORTANCE OF INSTITUTIONAL INVESTORS AND THEIR CRITICISM

A. The Lack of Influence of Private Shareholders

Although shareholders do not run the corporation directly. they can have a strong influence on the way it is managed on a daily basis because they elect the board of directors. Traditionally. this was a mere facade of shareholders power when the usual practice was for the existing board. possibly the chairman alone. to propose the new board members. It was this aspect which earned the board. in each of the four countries studied. the description of a self-perpetuating oligarchy. This is not to suggest that chairmen of executive-director management committees should not have appointed tried and efficient men and women of their own choice. but rather that representatives of shareholders should be selected more genuinely. [27] Under these circumstances. some have argued that shareholders do not have enough control or influence over management. and that companies too often get away with lacklustre performance. while executives enjoy

[26] For example. large investors often claim that boards of directors of their portfolio companies should be more independent. so that their interests be more represented.
[27] Midgley. *supra* note 23 at 71.

generous remuneration and lavish perks. Adam Smith had anticipated that corporations would exhibit this sort of problem:

> "The directors of such companies, however, being the 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."[28]

Today, individual shareholders still have very little influence over the board. The majority of them are only interested in economic results, rather than in corporate operations and the governance debate. Also, because individual shareholders are so numerous and scattered, their views are diluted, even in the context of a proxy solicitation.[29] The concrete result of all this is the low percentage of participation of individual shareholders in annual general meetings (AGM). This is true in the four jurisdictions studied. In France, for example, AGMs are often pejoratively referred to as "*un cirque*", "*un auditorium pour langue de bois*", or "*une chambre d'enregistrement*". Also, in spite of the considerable detail which appears in annual reports, there appears to be a constant demand for more information. If small shareowners remain almost a non-existent source of protest, large institutional investors represent a different case.

B. The Importance of Institutional Investors

1. United States

In the United States, institutional investors own a majority of all publicly traded US stock.[30] A 1989 *Business Week* survey found that 29.6% of the 1,000 largest US companies had more than 60% of their stock owned by financial institutions. The extreme example of an institutionally held firm is Capital Cities/ABC, where 88% of all

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[28] **A. Smith**, *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776) (London: Methuen and Co. Ltd., 1922) 233.

[29] **The Business Roundtable**, "The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation", in **Cohen & Loeb**, *supra* note 8, 283 at 297.

[30] **M. Siconolfi**, "Individual Investors' Holdings of US Stocks Fall Below 50% of Total Market for the First Time" *Wall Street Journal* (13 November 1992) C1 (citing data collected by the Securities Industry Association).

outstanding stock is held by financial institutions.[31] The Columbia Institutional Investor Project estimates that institutional investor asset holdings had reached $5.8 to 6.0 trillion by 1990, up from $107 billion in 1950. The 1990 figure represents approximately 18.7% of total US financial assets, and 45% of total US equities. Over the period from 1981 through 1988, assets under management by institutional investors grew at a compounded annual rate of 13.9%.

The major US institutional investors are banks and other depository institutions (they hold collectively about $5.3 trillion in financial assets, or 12.4 per cent of all financial assets in the United States), insurance companies (they hold collectively about $2.5. trillion in assets, or 5.8 per cent of all financial assets in the United States), mutual funds and investment companies, and pension funds.[32] Among these pension funds are public employee pension funds such as the California Public Employees Retirement System (CalPERS),[33] which has been and still is one of the leading activist institutional investors. The largest private pension fund is TIAA-CREF (Teachers Insurance and Annuity Association - College Retirement Equity Fund). It administers retirement savings for teachers and college professors, and manages $125 billion. It is also very active in the corporate governance debate.

2. Canada and France

As in the United States, it is estimated that over 50 per cent (50-60 per cent) of the shares of widely held companies traded in Canada are held by institutional investors. In France, foreign investors, and especially US and UK institutional investors control approximately 30 per cent of the *Bourse de Paris*.[34] Also, much like in Germany, the big French institutional players are banks, or listed companies that have a mutual participation in each other — known as "*participation croisée*" or "*croisement des participations*".

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[31] **C. Brancato**, "The Pivotal Role of Institutional Investors in Capital Markets: A Summary of Economic Research at the Columbia Institutional Investor Project" (manuscript, on file with The Geo. Wash. L. Rev., 1990) [unpublished] 19 tbl. 5.

[32] **Blair**, *supra*, note 5 at 147-165.

[33] CalPERS is the largest publicly-funded retirement system in the United States with assets valued at approximately $83 billion.

[34] **J-J. Caussain & B. Richard**, "Corporate Governance et Droit Français: Convergence ou Opposition?" *Les Echos* (17 Janvier 1995).

Mutual participation in the capital often comes with mutual participation on the board of directors — also known as interlocking directorships.[35] The main reason for this capital structure is that there are no pension or mutual funds that hold stocks of listed companies. This is seen by many as a major flaw especially because it is combined with a decline of the attractiveness of the French stock market for foreign investors.[36] One of its consequences is that it leads to a lack of institutional activism.[37] This is likely to change with the recent law introducing in France the concept of pension funds.

C. Short-Termism and Myopia

1. Short-Termism of Institutional Investors

Institutional investors are the subject of much controversy in the corporate governance debate. According to Margaret Blair, corporations underperform because of the short-termism of shareholders who prefer short-run gains to larger, but deferred payouts.[38] Portfolio managers are rewarded for their performance in the short term (often quarterly). They are sometimes accused of pursuing faddish investment strategies, and of buying and selling their stock much too quickly based on relatively insignificant news. This point explains some of the volatility of stock prices, and some of the short-term pressure on corporate management.[39] Instead of being too responsive to the short-term pressures coming from shareholders, management should encourage long-term

[35] See below III.A.
[36] See e.g., **Viénot Report**, *supra* note 1 at II.4:

> "La faiblesse relative du capitalisme français est à l'origine d'une multiplication des participations croisées.
> L'indispensable création des fonds de pension, une incitation de l'épargne française à s'orienter plus vers la détention d'actions ainsi que l'afflux des capitaux étrangers, devraient, en favorisant le développement des fonds propres, réduire naturellement ces croisements de capitaux.
> Le croisement des participations apparait ainsi comme un état transitoire du capitalisme français, dont la résorption aussi rapide que possible est au demeurant très souhaitable."

[37] See below III.A.
[38] **Blair**, *supra*, note 5 at 12.
[39] **Blair**, *supra*, note 5 at 47.

shareholding, which would enable corporations to invest more in research and development and/or engage themselves in costly market expansion strategies.

2. The "Myopia" of Directors

Although the appropriate goal for managers and directors should be to maximize long-term value for shareholders, often the financial markets push them in a different direction in practice. This attitude is often referred to as the "myopia argument". For example, two Harvard Business School scholars in 1980, argued that American management suffered from "competitive myopia". They blamed this myopia on several features of what they called the "new management orthodoxy", including a tendency for managers to rely too heavily on "short-term financial measurements like return on investment for evaluating performance."[40]

III. THE NEW APPROACH TAKEN BY INSTITUTIONAL INVESTORS

According to Professors Gilson and Kraakman:

> "Institutional Investors first entered the world of corporate governance in response to efforts by portfolio companies to insulate themselves from the market for corporate control."[41]

Institutional investors, because of their large share holding, represent a force strong enough to serve as an adequate check on the power of management. US institutional investors in particular have been active not only in criticizing the way their underperforming portfolio companies operate , but also in requesting changes especially in the functioning of the board. This activism has been combined with a switch from a short-term to a long-term approach. In this section, we mainly describe the US situation not only because the US literature is preponderant, but also because the largest and most active institutional investors are American.

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[40] **R. Hayes & W. Abernathy**, "Managing Our Way to Economic Decline" (1980) 58 Harv. Bus. Rev. 67 at 70.

[41] **R. Gilson & R. Kraakman**, "Reinventing the Outside Director: an Agenda for Institutional Investors" (1991) 43 Stan. L. Rev. 863 at 868.

A. Institutional Activism

Barry Barker, Secretary and Chief Executive of the UK Institute of Chartered Secretaries and Administrators, wrote that:

> "[The private shareholder] is unlikely to be able to contribute very much by way of knowledge of how to run a large manufacturing enterprise, even if he had the means of enforcing his advice on the corporation whose shares he owns. This applies even to the financial institutions, who are the first to declare their ignorance of how industry can best be run. Their principle aim and purpose is to provide the best possible return for the employees whose pension funds they administer. They too are open to the accusation that they, as shareholders, do little to promote improved profits and are disinclined to maintain their investment at all, if it looks like turning sour."[42]

This statement made in the United Kingdom in 1978-79, would not apply today in any of the four jurisdictions studied. Since the mid-80's, there has been a 180° shift in terms of the influence of institutional investors. Institutional shareholders have changed their attitude from passive to active/aggressive, towards their portfolio companies, and especially to those which underperform. The reaction has primarily come from US investors, and has spread out to the other countries that are part of our study.

Comparative Survey. Even though institutional investors play an increasing role in each of the countries studied, there are still discrepancies due to certain factors.

The United States. The early signs of institutional activism were observed in the take-over context. Today, a few financial institutions, especially large pension funds such as CalPERS, are more and more active in influencing corporate behavior of their portfolio companies. CalPERS, for example, spent over $500,000 a year between 1987-1992 on its corporate governance activism.[43] In fact, they are playing a monitoring role that was originally envisioned for individual shareholders, a role that most shareholders still play in small closely held companies, but that has been neglected in large, publicly traded corporations.

The United Kingdom. In a survey on Corporate Governance, *The Economist* reported that "British institutions are unlikely to rival CalPERS for activism. Mostly they

[42] See *supra* note 23 at 87.
[43] "Corporate Governance" *The Economist* (29 January 1994) 3 at 16.

prefer to act quietly behind the scenes."[44] But *The Economist* also remarked that British institutional investors had become more and more outspoken in recent years, as exemplified by Postel, a $30 billion fund for postal and telecom workers.[45] We must not forget one of the major players in the UK institutional activism: the Institutional Shareholders' Committee (ISC). The ISC is an entity comprised of institutional investors.[46] On April 18 1991, it released a declaration which contains recommendations on the composition and operation of boards of directors.[47]

France. In France, the corporate governance debate is not only new, but the scheme is different. Because of the nature of institutional shareholding and of the interlocking directorship structure,[48] there has been so far little activism. Let us take an example of two listed companies that are also institutional investors. Company A holds stock in company B and vice versa, and the *Président-Directeur Général* (PDG)[49] of A is a

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[44] *Ibid.* at 17.
[45] *Ibid. The Economist* does not describe Postel's activism.
[46] **M. Draper**, "What Price Independent Directors?" (1991) 88 Law Society's Gazette 31, available on Lexis-Nexis:

> "The ISC is of growing importance to the development of a more coherent voice on the part of institutional investors. It was founded in the early 1970s at the behest of the Bank of England and had an important role to play during the recession created by the first oil crisis of 1973. It was prominent also during the early 1980s when British industry went through a further period of enforced restructuring brought about by the recession then.
> During the mid-1980s, the ISC became less active. Its previous primary function, to intervene in the case of problem companies, had becaome less relevant as the UK economy recovered and the stock market entered a prolonged bull phase. The ISC's recent renaissance reflects a need for investors to have an industry-wide vehicle to represent their interests.
> The ISC membership now comprises the Association of British Insurers, the Association of Investment Trust Companies, the British Merchant Banking and Securities Houses Association, the National Association of Pension Funds aand the Unit Trust Association. Together, these bodies represent institutions which own or control some 60% of all the shares listed on the London Stock Exchange."

[47] **The Institutional Shareholders' Committee**, *The Role and Duties of Directors — A Statement of Best Practice* (London: ISC, 1991). See Chapter IV I.B.2 for a further analysis of the ISC recommendations. The ISC has also published *The Role and Responsabilities of Institutional Shareholders in the UK* (December 1991).
[48] See above II.B.2.
[49] The first of the two systems which is used by French companies comprises a PDG and a board of directors (*conseil d'administration*). The PDG holds the two functions of Chief Executive Officer and of Chairman of the board. This system is largely preferred to the second one which comprises a management committee (*directoire*), and a supervisory board (*conseil de sureveillance*).

director in B: reciprocally, the PDG of company B is a director in company A. In this case, there is little doubt that company A will not, as a major shareholder, exercise pressure on company B to change the functioning of the board for example. The reciprocity in shareholding prevents virtually any conflict between the two companies, for the simple reason that A needs B for its capital as much as B needs A. If A decides to withdraw its ownership of B shares, B might withdraw from A. In this game, both A and B would be the losers. The mutual shareholding system links the two companies, and has been criticized for that reason.[50]

The Diligence of Portfolio Managers. An important issue raised by institutional investors is whether investment manager nominees of institutional investors (who are not personally investors in their own right) will be as diligent in putting pressure on the boards as would individual shareholders. It seems fair to say that they are in most cases more diligent than private shareowners, who lack information and competence. These large investors are trying to be as attractive as possible to the public by having the highest rate of return, thus enticing more people to invest in their funds. Their aim is to maximize investment in their portfolio companies as much as possible, and will not hesitate to pressure the board of poorly performing corporations.

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[50] It has been said that interlocking directorship prevents the independence of judgement that is necessary for the objectivity of the board decision making. The **Viénot Report** (*supra* note 1) divides the problem of interlocking directorship in two. First, it recommends that the number of directorhips allowed be reduced:

> "... le conseil [d'administration] doit particulièrement veiller à ce que leur nombre excessif ou les fonctions particulières qui leur sont éventuellement dévolues, par exemple au sein de comités, ne puissent faire craindre une perte d'indépendance préjudiciable à l'exercice de leur mission ou au fonctionnement collégial du conseil." (Introduction)

Secondly, it recommends that a board of directors avoid appointing as a member of the compensation committee a director of a company in which it also has a director in the same committee:

> "De même le Comité recommende-t-il que le conseil d'une société A évite de nommer au sein de son comité de rémunération comme de son comité d'audit des administrateurs venant d'une société B lorsque au comité analogue de la société B siège déjà un administrateur venant de la société A." (II.4.)

B. From a Short-Term to a Long-Term Investment Approach

Relationship Investing. Some have argued that institutional investors should engage in "relationship investing". According to Blair, it is most often described as:

> "a situation in which the investing institution is responsibly engaged in overseeing the management of the company, rather than remaining detached or passive, and is committed to the company for the long term."[51]

One of the main consequences of relationship investing is that both the investor and the portfolio company get to know each other. On the one hand, the investor will be patient and support some decisions of the board that are based on the long-term needs of the company. On the other hand for example, the board of the portfolio company will keep the investor well informed of the corporate internal and external environment. For example, CalPERS can be a leading example of a long-term investor. Its annual portfolio turnover rate is approximately ten per cent, and its average stock holding period is between six and ten years.[52]

Reactions. This new "long-term attitude" of institutional investors has caused some reaction among the participants in the corporate governance debate. For example, Jeremy Bacon, a long-time surveyor for The Conference Board,[53] wrote:

> "Why don't institutional investors simply sell their holdings in companies that are poor performers, rather than make the efforts to twist the arms of the board and of management to get improvement?"[54]

The answer to this question is not simple and goes beyond our present study. However, we can briefly say that if institutional investors withdraw their participation from poor performing companies every time an agreement can not be reached on a corporate governance issue, they would not have the same positive effect on the poor performers. Instead of implementing new corporate governance standards, due to pressure from institutional shareholders, they might look for other investors willing to provide the capital.

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[51] See *supra*, note 5 at 172.
[52] **California Public Employees' Retirement System**, "Why Corporate Governance?" (1989), p. 4.
[53] The Conference Board is a US business informational and consultative organisation that has regularly published surveys revealing the attitudes of corporate officers on the problems of governance. There is also the Conference Board of Canada, and the Conference Board Europe.
[54] **J. Bacon**, *Corporate Boards and Corporate Governance* (New York: The Conference Board, 1993) 30.

In the short-term, the word will spread among institutional shareholders that these companies do not intend to improve their corporate governance standards. And sooner or later, these companies will see their attractiveness decline. Another answer to this question can be found in interviews with representatives of major funds commissioned by The Conference Board. According to them, it is disruptive to the investment technique know as "indexing" to trade securities of poor performing companies that are part of the indexed portion of a portfolio (that portion is over 85 per cent in the case of CalPERS). When the option of selling is not practical, efforts can be aimed at improving a company's performance. For CalPERS, it means that it is soon likely to experience even lower turnover because the proportion of its equity portfolio that is passively managed through indexing is expected to increase.

C. The Goal Sought by the Activist Institutional Shareholders

The goal sought by these institutional investors is to improve bottom-line results of poor performers in their portfolios. They want boards of directors to be more effective in representing the interests of shareholders in general and of their own in particular. To achieve this end they believe that they have to put pressure on the board, and according to Professors Gilson and Kraakman, "they have correctly focused on the boardroom."[55] Large US shareholders have elaborated numerous kinds of suggestions and proposals. These propositions — some of which are enumerated below (**Table 2**) — ask for changes in the boards' membership and structure, and are often oriented towards independence. In the United Kingdom, the Institutional Shareholders' Committee's 1991 declaration contains recommendations on the composition and operation of boards of directors.[56] It is interesting to consider the ISC statement, as well as the CalPERS propositions, in the context of the short-termism debate discussed earlier:[57]

> "Arguably the greater willingness of institutions to set out criteria of good management represents the terms on which they are prepared to remain as long-term investors. On the other hand, the enunciation of these criteria could make existing managers feel increasingly

[55] See *supra* note 41 at 873.
[56] See *supra* note 47.
[57] See above III.B.

nervous of direct intervention by institutional investors, possibly through the agency of the non-executive directors."[58]

PROPOSITIONS MADE BY ACTIVIST INSTITUTIONAL INVESTORS TO BOARDS OF DIRECTORS[59]

General Propositions	Propositions Seeking the Independence of the Board
- stating their intention to use votes, including withholding them, so as to influence the outcome of the election of the board.	- changing the board's membership so that independent directors are in the majority.
- objecting to a particular plan or strategy of the board that they believe would have a negative affect on the company's worth or performance.	- establishing audit, compensation, and nomination committees, composed solely or mainly of independent directors.
- requesting a voice in the criteria to be used in nominating directors.	- separating the function of outside director chief executive officer or chairman of the board and CEO.
- requesting to be informed of the criteria the board will use to find a successor to the chief executive officer.	- nominating an independent director as a "lead director" to act as a counterbalance to the CEO, when the functions of chairman and CEO are combined.
- requesting that that the board meet directly with investor representatives to discuss issues or proposed actions.	

Table 2

[58] See *supra* note 52. For a definition of the term "non-executive directors", see Chapter IV I.B.2.
[59] Bacon, *supra* note 54 at 29-30.

It is clear that propositions such as the ones made by CalPERS or the ISC may have been also made by Canadian, and French institutional shareholders, but we have been unable to find sources of information on this matter.

D. Institutional Investors Corporate Actions

1. The Targeted Companies or the "Hit List"

Activist shareholders do not try to persuade every company in their portfolio to implement these changes. They focus primarily on poor performers, unless the particular issue is important and touches a important number of portfolio companies (e.g. the implementation of a committee). There are several criteria used to choose target companies, but the one most often referred to is financial performance. Sometimes a major holder might apply pressure on the board of a company for reasons other than financial ones. For example, it might want to influence the board to accept an offer of sale for the company on terms considered unsatisfactory. Compensation might also be an issue. What results from the selection of the target companies is a "hit list" that usually contains about ten to twelve firms. These targeted firms only represent a small proportion of the total portfolio of the fund, that can have over 1,000 listed companies. To illustrate this point, we take the example of the CalPERS, which released its list of top ten target companies that will be the focus of their corporate governance activism in the 1996 proxy season.[60] Dr. William Christ, President of the CalPERS Board of Administration, stated that:

> "The time has come to publicly identify the companies that have failed to make the financial grade, compared to their industry peers. These companies will receive close scrutiny and be the subject of intense efforts on our part to enhance performance for the benefit of our beneficiaries and all shareholders."[61]

The document continues with the enumeration of the target companies. Some of these companies had already been on the "hit list" the previous year. The companies rank among the poorest long-term relative performers in the pension fund's domestic portfolio of more

[60] "CalPERS Announces Top Ten Target Companies", http://bankrupt.com/news.960206.html.
[61] *Ibid.*

than 1.500 companies. Many of this year's companies are outside the Fortune 200 family. because. says Dr. Christ:

> "Now that we've been successful with Fortune 200 underperformers. we're moving further down the Corporate America food chain — to the mid-size. less-than-household name companies. Smaller companies should take heed from Corporate America's giants who have turned their companies around through measures suggested by active investors. They can no longer use the industry downturn as an excuse for their underperformance."[62]

2. The Strategy

The strategy used by US activist major holders is to communicate with each of the company's board of directors. The funds express concerns and/or try to obtain information. They ask for a meeting to discuss issues of performance and shareholder value. Sometimes. they meet with a company's independent directors. when no one from management is present. Often. institutional investors act in concert on some issues. which creates an extra pressure on targeted firms. To return to our example. during the 1996 proxy season. CalPERS will focus on eight issues that address components of board structure and performance of the targeted companies (**Table 3**).

3. Velvet Glove Versus Iron Fist

Recently. the activism of investment funds seeking changes in portfolio companies has put more emphasis on negotiating. rather than in confrontational relationship. However. the "velvet glove" is often removed when negotiations are not productive (and the funds are no less active in pursuing their goals). For example. if the targeted companies fail to cooperate with them. CalPERS is prepared to take more aggressive actions. such as engage in 'Just Vote No' campaigns or utilize extensive proxy solicitations to support its proposals.[63]

4. The Effectiveness of this Activism

Are the proposals of the institutional investors listened to by the target company? Annual fund reports and public statements by representatives indicate that meetings. and the pressure of removing the "velvet glove". have been effective in persuading companies

[62] *Ibid.*
[63] Richard H. Koppes. Deputy Executive Officer and General Counsel of CalPERS. *ibid.*

CALPERS' EIGHT ISSUES ADDRESSED TO ITS TARGET COMPANIES

1. A requirement that the position of Chairperson of the Board be separated from the position of Chief Executive Officer, so that the Board is truly empowered to hold the CEO accountable.

2. Assurance that an independent director is the "lead" outside director to act as a counterbalance to the CEO — where the Chair and the CEO positions are combined.

3. A requirement that the majority of the Board be comprised of outside directors and that all key committees — such as audit, compensation and nominations committees — be comprised entirely of independent directors.

4. Elimination of staggered board terms, thereby making it easier for shareholders to effect board changes.

5. A linking of Board member performance with pay, including making a portion of the directors' fees be in the form of company stock.

6. Improved Board oversight of executive compensation.

7. Adoption of a formal method for strategic oversight, such as a strategic or business audit.

8. Examination of Board member expertise, time spent, backgrounds and perspectives to ensure a well-balanced board comprised of individuals with a diversity of backgrounds and interests, while protecting against the "too many board appointments" syndrome, which spreads a member.

Table 3

to agree to suggested changes.[64] To return to CalPERS, a Wilshire Associates study of the "CalPERS effect" on corporate governance examined the performance of 53 companies

[64] **Bacon**, *supra* note 54 at 31. Bacon does not indicate what changes have been made among the boards of targeted companies, but they certainly are oriented towards a close following of CalPERS eight issues (See **Table 3**).

targeted by the System over a five year period (1987-1992).[65] Over this period, CalPERS spent over $500,000 a year on its corporate governance activism.[66] Results indicated that while the stock of these companies trailed the Standard & Poor's 500 Index by 75.2 percent in the five year period before CalPERS acted, the same stock prices outperformed the index by 54.4 percent in the following five years, adding approximately $150 million annually in excess. According to *The Economist*, "these early results should be treated with caution."[67] Also, it is difficult to compare these results with others from the UK, Canada or France, because similar studies do not seem to exist.

E. Negative Reactions to the Activism of Institutional Investors

In the latest survey of The Conference Board, CEOs and other executives surveyed pointed out a few negative aspects of the activism of major holders (such as mandated practices) do not make sense because:

1. Every company is different;
2. Money managers lack the experience of running a business and are unqualified to judge what is best for companies in their portfolios;
3. Funds have no real accountability for the outcome of actions they are urging their target companies; and
4. Funds are overly concerned with short-term results.[68]

CONCLUSION

Institutional investors are now major players in the corporate governance debate. Directors and managers of their portfolio companies are required to listen to them and to meet if possible their expectations, otherwise they might see their major shareholders withhold their votes or ask for a change of CEO or in the board's composition. The main

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[65] See *supra* note 44. For further details on the study, see **S. Nesbitt**, "Long Term Rewards from Corporate Governance" (Wilshire Associates, November 1993).
[66] See *supra* note 52.
[67] *Ibid.*
[68] **Bacon**, *supra* note 54 at 31.

comment that can be drawn from our research is that US institutional shareholders dominate the debate. They are the most active, not only in the United States, but also in France where they have an important participation in the listed companies on the *Bourse de Paris*. French listed companies have so far remained out of the influence of institutional investors. But things are about to change. First, the Viénot Report has materialized the corporate debate, and has brought some interesting proposals. Some of them, such as the reduction of interlocking directorship, are likely to be formalized in to law. Others should be developed.[69] Secondly, US investors, who are the major foreign investors in France, and are responsible for "*la pluie et le beau temps*" on the French stock market, are now starting to require from French companies what they have required from US listed companies, mainly a more independent board of director.

[69] See below Chapter VIII.

CHAPTER II: THE REPORTS AND THEIR IMPLEMENTATION

"The country's economy depends on the drive and efficiency of its companies. Thus the effectiveness with which their boards discharge their responsibilities determines Britain's competitive position. They must be free to drive their company forward, but exercise that freedom within a framework of effective accountability. This is the essence of any system of good corporate governance."

(**Cadbury Committee**, 1992)

INTRODUCTION

To reduce the expectation gap, CEOs, directors, bankers, and scholars among others, have debated on corporate governance issues. They have focused mainly on the composition of the board of directors, its role and the role of the other constituencies of the corporation. The result of these debates is incorporated in reports which contain recommendations for the legislature and corporations in general, and listed companies in particular. Our study deals with four major reports (the Reports): the American Institute Principles of Corporate Governance (the ALI Principles),[70] the Report of the Committee on the Financial Aspects of Corporate Governance in the United Kingdom (the Cadbury Report),[71] the Report of the Toronto Stock Exchange Committee on Corporate Governance in Canada (the Dey Report),[72] and the French *Rapport sur le Conseil d'Administration des Sociétés Côtées* (the Viénot Report).[73] The corporate governance debate has caught the attention of many other jurisdictions, and there are numerous other governmental or private reports such as the South African King Report on Corporate Governance,[74] or the Himler

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70 **ALI Principles**, *supra* note 10.
71 **Cadbury Report**, *supra* note 6.
72 **Dey Report**, *supra* note 15.
73 **Viénot Report**, *supra* note 1.
74 See http://www.southernlife.co.za/sla/pubs/slbn9506.htm:

Report in Australia.[75] In this chapter, we briefly review the reasons for the selection of the four reports (**I**), then analyze their history and main characters (**II**). Finally, we discuss their application (**III**).

I. THE REASON FOR THE SELECTION OF THE REPORTS

We focus on the United States, the United Kingdom, Canada, and France, for several reasons. First, each of these countries is at a different stage in the corporate governance debate. The United States has been debating corporate governance issues in general and the independence of the board in particular for quite a long time. It is the jurisdiction which contains the largest number of reports on corporate governance, such as the General Motors' Board Guidelines on Significant Corporate Governance Issues,[76] the

> "The King Report, released in November 1994, contains a series of recommendations designed to achieve the highest standards of corporate governance in South Africa. The principles of accountability to organisational stakeholders and transparency of decisions are very much in the limelight in the new democratic South Africa - particularly in light of local and international corporate failures. Along these lines, a code of corporate practices and conduct has been published for the attention of the corporate community. The following five areas of corporate governance were investigated and commented upon:
>
> 1. The responsibilities of executive and non-executive directors and the importance of information to stakeholders.
> 2. The auditing function and the need for objectivity and independence.
> 3. The communication to shareholders, employees, customers, government bodies and other stakeholders.
> 4. The need for all stakeholders to adhere to the highest ethical standards and for established guidelines to exist.
> 5. The need for compliance by all interested parties of the recommendations."

Other jurisdictions are studying corporate governance. For example, the Amsterdam Stock Exchange has set a Corporate Governance Commission (see http://www.businessmonitor.co.uk/docs/proc/25hb/corpmod.html).

[75] According to **B. Tricker**, "Corporate Governance — a subject whose time has come", *Corporate Governance* — An International Review, October 1995, 187:

> "The Himler Report argued that, although protection of shareholders was important, the vital task of the board was not conformance but performance — achieving better returns than average in the industry".

[76] See http://www.cipe.org/e18/gm.html.

Chrysler Corporate Governance Report.[77] or the New York Stock Exchange (NYSE) which aks for corporate governance requirements to be eligible for listing.[78] The most important work has been done by the American Law Institute. The first tentative draft of the ALI Principles dates from 1982.[79] but there has been intense amount of literature previous to then[80]. It is only in the early 90's that the United Kingdom. and then Canada have focused public debate on this issue. France only joined the public debate in 1994 with the initiative of the *Commission des Opérations de Bourse* (COB). the French stock market regulator.[81] It is therefore useful to analyze propositions made in the United States. the United Kingdom. and more recently Canada. to see if they can be partly. fully. or not applied. in

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[77] See http://www.investor-rel.com/chrysler/proxy/proxy-html/appenda.html.

[78] See http://www.nyse.com/public/about/market/domproc2.html:

> "Aside from the NYSE quantitative standards. other factors are taken into consideration when determining eligibility for listing. The New York Stock Exchange requires that domestic listed companies meet certain criteria with respect to outside directors. audit committee composition. voting rights and related party transactions. The following is a summary of these policies:
>
> Outside Directors:
> New York Stock Exchange corporations must have a minimum of two outside directors. For those corporations which do not have outside directors at the time their eligibility for listing has been approved. the NYSE will normally require one outside director to be appointed prior to listing. and a second within one year after listing.
> As a guideline. an outside director is a director who is not an employee. officer or former officer of the corporation or a subsidiary or division thereof. or a relative of a principal executive officer. or who is not an individual member of an organization acting as an advisor. consultant. legal counsel. etc.. receiving compensation on a continuing basis from the corporation in addition to director's fees. The NYSE encourages discussion with an Exchange representative to clarify any uncertainty with regard to qualification of outside directors.
>
> Audit Committee:
> Each domestic corporation seeking to list on the New York Stock Exchange must have an Audit Committee comprised solely of directors independent of management and free from any relationship that would interfere with the exercise of independent judgment as a committee member..."

[79] **The American Law Institute**. *Principles of Corporate Governance and Structure: Restatement and Recommendations* (Philadephia. Pa: The American Law Institute. 1982).

[80] See *e.g.*. **J. Bacon**. *Corporate Directorship Practices: Membership and committees of the Board* (New York: The Conference Board. 1973); **The Business Roundtable**. *supra* note 29. 283 at 307.

[81] The COB organised one of the first public meeting on the issues of corporate governance. See **M-N. Dompé & A. Dorison**. "Les pouvoirs dans l'entreprise" (Entretiens de la C.O.B. 4ème table ronde. 17 Novembre 1994) [unpublished]. See also Les Echos Conférence. *supra* note 20.

France. Secondly, it is interesting to compare what has been done in three major common law countries, and see if the solutions found there could be transposed to a civil law country.[82]

II. THE REPORTS: HISTORY AND MAIN CHARACTERS

A. ALI Principles

The American Law Institute long work in the corporate governance field began after the Airlie House Conference of 1975, sponsored by the Section of Corporation, Banking and Business Law of the American Bar Association. The Conference persuaded Herbert Wechsler, director of the ALI at that time, that there were important problems in the field of corporate structure and governance that the Institute could address.[83] Since then, the ALI has released several drafts,[84] and in May 1992 released the *Principles of Corporate Governance* "as adopted and promulgated by The American Law Institute."[85] The *Principles* cover most of the corporate governance issues that will be addressed in this study.

B. Cadbury Report

Since 1973 with the creation of the ISC by the Bank of England[86] and the establishment of PRONED (Promotion of Non-Executive Directors) in 1982,[87] there has been much debate in the United Kingdom regarding corporate governance. More recently, public concern over the collapse of companies like Maxwell Communications and BCCI,

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[82] See Chapter VIII.
[83] See *supra* note 79 at vii.
[84] The latest draft was released in 1992. See **The American Law Institute**, *Principles of Corporate Governance: Analysis and Recommendations* (Proposed Final Draft) (Philadephia, Pa: The Executive Office, The American Law Institute, 1992).
[85] See *supra* note 13.
[86] See *supra* note 47.
[87] PRONED is an organisation which helps companies to find non-executive directors. The following documents were published by PRONED: *Code of Recommended Practice of Non-Executive Director* (April 1987); *A Practical Guide for Non-Executive Directors* (revised edition February 1991); *Research into the Role of the Non-Executive Director* (sponsored jointly with the London Stock Exchange, published July 1992); *10th Annual Review* (September 1992).

the activities by some directors (which may have caused or initiated such collapses), and the controversy over directors' salaries, has led to the establishment of the Committee on the Financial Aspects of Corporate Governance (the Cadbury Committee), chaired by Sir Adrian Cadbury.[88] The Committee was set up in May 1991 by the Financial Reporting Council, the London Stock Exchange, and the accountancy profession.[89] The stated objective of the Committee was to "review those aspects of corporate governance specifically related to financial reporting and accountability."[90] However, the Committee intended also to "contribute positively to the promotion of good corporate governance as a whole."[91] This is the reason why we have decided to include it in our study. The Committee concluded that the recommendations in the final report "will involve a sharper sense of accountability and responsibility all round." The Cadbury Committee made its report in December 1992, offering guidelines to large companies as to how they should conduct their affairs. At the core of that report is a Code of Best Practice suggesting specific procedures for companies to follow[92] Although these procedures are not mandatory, the London Stock Exchange requires every listed company to include a statement in its annual report and accounts (for accounting periods ending after 30 June

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[88] **Cadbury Report**, *supra* note 6 in Preface. See also **C. Drew**, "The Director's Duties — An Examination of Directors' Fiduciary Duties Following the Issue of the Cadbury Code and the DTI's Forthcoming Review" (1995) 92 Law Society's Gazette 16.

[89] **Cadbury Report**, *supra* note 6 at 2.1.

[90] *Ibid.* at 11.

[91] *Ibid.* See also *supra* note 61: the Committee adopted as its terms of reference:

> "To consider the following issues in relation to financial reporting and accountability and to make recommendations on good practice:
> (a) the responsibilities of executive and non-executive directors for reviewing and reporting on performance to shareholders and other financially interested parties; and the frequency, clarity and form in which information should be provided;
> (b) the case for audit committees on the board, including their composition and role;
> (c) the principal responsibilities of auditors and the extent and value of the audit;
> (d) the links between shareholders, boards, and auditors;
> (e) any other relevant matters."

[92] See **Cadbury Report**, *supra* note 6 at 1.3:

> "At the heart of the Committee's recommendations is a Code of Best Practice designed to achieve the necessary high standards of corporate behaviour."

1993) confirming that it is complying with the Code, or giving details of and reasons for any areas of non-compliance.[93]

The Cadbury Report is not the only UK report we could have studied. There is also the declaration issued by the Institutional Shareholders' Committee (ISC).[94] However, the Cadbury Report was released after the ISC declaration, and encompasses more corporate governance issues that are relevant to our study.

C. Dey Report

Prompted in part by the failure of a few major Canadian corporations, and especially trust companies,[95] the Toronto Stock Exchange (TSE) established the Committee on Corporate Governance in Canada in 1993. The Committee was chaired by Peter Dey, a former Chairman of the Ontario Securities Commission (OSC). The Committee members included chief executives from large Canadian public companies and institutional investors, as well as senior representatives of the legal, accounting, financial and academic communities.[96] The Committee's mandate was to conduct a comprehensive study of corporate governance and to make recommendations that would improve the manner in which Canadian corporations are governed. The Committee received 80 written submissions and held public meetings across Canada receiving 37 oral submissions. A draft report outlining a number of guidelines for effective corporate governance was released on May 16, 1994. Roundtable discussions were held across Canada in June 1994. More than 150 submissions were made on the draft. A final report was presented to the TSE in December 1994. In early 1995, the TSE adopted the recommendations of the report. The recommendations range from the responsibilities, the composition, and the size of the board of directors and its committees, to the compensation of directors. As of June 30, 1995, all the companies listed on the TSE are required to provide their shareholders

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[93] See http://www.ernsty.co.uk/ernsty/ifc/ifc1.htm and http://www.ernsty.co.uk/ernsty/ifc/ifc2.htm=Background.
[94] See *supra* note 47.
[95] Such as Royal Trust and Central Guaranty Trust.
[96] **D. Drinkwater & R. Nathan** (Osler, Hoskin & Harcourt), "New Corporate Governance Disclosure Standards of Canadian Stock Exchanges Become Effective", at http://www.osler.com/Resources/BoardSum_2.html.

with disclosure of their corporate governance practices with reference to the Guidelines of the Dey Report. Similar guidelines and reporting requirements have been recently adopted by the Montreal Exchange (ME).[97]

D. The French Reports

1. Viénot Report

Two French employers unions, the *Conseil National du Patronat Français* (CNPF) and the Association Française des Entreprises Privées (AFEP) requested Mr. Marc Viénot, the Chairman of the *Société Générale*, to preside over a committee composed of 14 chairmen of some of the most prestigious French companies.[98] The mission of the committee was to examine the composition, powers and functioning of the board of directors of listed companies.[99] The committee has started to consider how to adapt the 1966 Company Law[100] to the market expectations and listed corporations.[101] A Report, the Viénot Report, was made public at the Paris Europlace Congress on July 10, 1995. The Viénot Report does not pretend to be the French equivalent of the Cadbury report; it merely comprises a list of recommendations which will permit a "soft" adaptation of the boards of French listed companies to improved principles of corporate governance. Also,

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[97] *Ibid.* On July 10, 1995, the ME advised listed companies that it had approved a similar requirement of disclosure of corporate governance practices for ME companies "in order to provide uniformity" with the TSE standards. The ME corporate governance guidelines and disclosure requirements are virtually identical to their TSE counterparts.

[98] **Clifford Chance, Paris**, in http://www.businessmonitor.co.uk

[99] **Viénot Report**, *supra* note 1, Introduction:

> "Le Conseil National du Patronat Français (CNPF) et l'Association Française des Entreprises privées (AFEP) ont confié à un Comité spécialement constitué pour ce faire le soin d'examiner les principaux problèmes relatifs à la composition, aux attributions et aux modes de fonctionnement des conseils d'administration des sociétés cotées."

[100] See *supra* note 2.

[101] **Viénot Report**, *supra* note 1, Introduction:

> "Plus fondamentalement, le Comité s'est interrogé sur l'adaptation aux attentes du marché et aux besoins des entreprises des dispositions de la Loi du 24 juillet 1966 relatives aux conseils d'administration ainsi que sur les principes qui doivent constamment inspirer tant les conseils eux-mêmes que chacun des administrateurs des sociétées cotées."

as opposed to the Cadbury Report which was the result of an eighteen month collaboration among executives of listed companies, the Viénot Report was drafted in a few months without much consultation.[102] We will discuss throughout our study the recommendations of the Viénot committee, and in our last chapter, what still remains to be done to improve corporate governance in France.[103]

2. Marini Report

In his mission statement to Senator Philippe Marini, the Prime Minister felt it to be useful that:

> "be identified those matters requiring the intervention of the legislator which would appear, over time, to be justified in the three areas of proper structural functioning, shareholder information and the duties and responsibilities of directors and managers."[104]

In chapter III of this mission statement, entitled "To promote a better balance of power and responsibilities within companies", it has been officially recognized that:

> "Our company law reveals a double imbalance:
> - on the one hand, it insures the supremacy of operational roles over supervisory roles;
> - on the other hand, it prefers external controls (e.g. judicial review) over the internal controls exercised by shareholders and auditors.
> The result of which can be a situation where a corporate manager can be accountable to no one other than a judge implementing criminal law".[105]

Senator Marini made his report public in September 1996.[106] Regarding corporate governance, the Marini Report is in favor of a *laisser-faire* attitude. With the exception of the limitation of interlocking directorships the Marini Report does not go as far as the Viénot Report which remains the key document on corporate governance.

III. APPLICATION OF THE REPORTS' RECOMMENDATIONS

The proposals made in the aforementioned reports are non-mandatory guidelines which are not legally binding. The dilemma between voluntary versus mandatory

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102 Option Finance (1995).
103 See below at Chapter VIII.
104 **B. Richard**, "The reform of company law as a means of fighting organizational leadenness", *MTF-L'AGEFI*, October 1996, 57 at 58.
105 *Ibid.*
106 See Introduction and *supra* note 3.

guidelines is not particular to the corporate governance debate. The reason behind implementing non-mandatory recommendations is summed up by the Cadbury Report:

> "We believe that our approach, based on compliance with a voluntary code coupled with disclosure, will prove more effective than a statutory code. It is directed at establishing best practice, at encouraging pressure from shareholders to hasten its widespread adoption, and at allowing some flexibility in implementation. We recognize, however, that if companies do not back our recommendations, it is probable that legislation and external regulation will be sought to deal with some of the underlying problems which the report identifies. Statutory measures would impose a minimum standard and there would be a greater risk of boards complying with the letter, rather with the spirit, of their requirements."[107]

Despite their proclaimed non-binding nature, voluntary guidelines or codes are often associated with laws for two main reasons:

1. A set of standards developed, issued and endorsed by governments is, by virtue of authorship, associated with legal authority;
2. Current voluntary standards can become the forerunner of later mandatory regulations.

In the corporate governance debate, the second reason is especially pertinent. The recommendations made by the reports serve as "benchmarks" for legislators.[108] The first reason is also apt if we replace "endorsed by governments" by "endorsed by stock market regulators". The ALI Principles are closely linked to the views of the New York Stock Exchange. The Cadbury Report and Code of Best Practice have been commissioned and endorsed by the London Stock Exchange, and the Dey Report by the Toronto Stock Exchange (TSE). In France, the corporate governance debate was accelerated by the *Commission des Opérations de Bourse*. Companies that do not comply with the recommendations will have to explain their reasons for any area of non-compliance. For example, as of June 30, 1995, all corporations with stocks listed on the TSE are required to report on their governance structures *vis-à-vis* the guidelines as part of their annual reporting to shareholders. Compliance with the TSE guidelines is not a requirement, but

[107] **Cadbury Report**, *supra* note 6 at 1.10.
[108] See for example the proposed reduction of interlocking directorships in the Marini Reprot, which was a problem pinpointed by the Viénot Report.

companies are expected to explain how their boards address each of the issues raised in the guidelines.[109]

CONCLUSION

The reports are at the core of the corporate governance debate. In the following chapters of our study, we try to compare as much as possible the recommendations that they contain. Regarding France, we will determine in **Chapter VIII** what remains to be done to ameliorate the Viénot Report, and what modifications should the French legislator make in the 1966 Company Law.

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[109] See *supra* note 96.

CHAPTER III: THE INDEPENDENT BOARD OF DIRECTORS

> "The board of directors is located at two critical corporate interfaces — the interface between the owners of the enterprise and its management, and the interface between the corporation and the larger society. The directors are stewards — stewards of the owners' interest in the enterprise and stewards also of the owners' legal and ethical obligation to other groups affected by corporate activity."
>
> (**The Business Roundtable**, 1979)

INTRODUCTION

In the late 1970's and early 1980s, boards of directors received considerable criticism. Critics mainly complained that boards of directors are not independent from management and that members of the board were rubber stamps, hand-picked by the CEO, and therefore suomissive to him. They also complained that directors did not spend enough time on board work to be effective, that they were poorly informed on committee matters and therefore poorly prepared for board discussions, and that boards were too homogeneous because directors were all cast from the same mold and would not "rock the boat".[110] The past fifteen years have seen a dramatic change in the way boards of directors are organized and operated. It is now accepted that boards must be active, must add value to the corporation, and be effective contributors to corporate competitiveness, and must be more responsible to its shareholders and stakeholders.[111] As a consequence, in recent years there have been major increases, at least in practice, in the duties, powers, and responsibilities of many corporate boards.

In this chapter, we first attempt to describe what is meant by the expression "independent board" (**I**). We then describe the selection process of board members (**II**).

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[110] **The Business Roundable**, *supra* note 23 at 294.

[111] **J. Longair**, *Choosing the Board of Directors for the '90s* (Ottawa: The Conference Board of Canada, 1992) 3.

Directors are not anymore hand-picked by the CEO, but are selected by a nominating committee independent of management. Finally, we briefly analyze the functions of the board relevant to our study (**III**). We review the compensation of the members of the board in the chapter on specialized committees, before the description of the compensation committee.

I. THE INDEPENDENT BOARD

The corporate governance debate has focused mainly on the independence of the board. It is believed that an independent board is objective in its decision making, and takes into consideration the expectations of the shareholders as a whole. The independence of the board is a two-sided problem: first is the independence of the board as a collective entity, and second is the independence of its members taken individually — chairman, and directors. In this chapter, we only examine the first side of the problem. We develop the second side throughout the following chapters: the independent director, the independent chairman.

A. Independence from Management

A board is said to be "independent" when it maintains its separation from management. This theme, which is central to the Cadbury, Dey, and Viénot Reports is the key to effective corporate governance. We take the Dey Report as an example. It explicitly recommends that:

> "Every board of directors should have in place appropriate structures and procedures to ensure that the board can function independently from management."[112]

Alternative structures include: a chairman of the board who is not part of management (chairman of the board who is not also the CEO)[113], or the appointment of an outside director, know as the "lead director", who is responsible for administering the board's

[112] **Dey Report**, *supra* note 15 at Guideline 12.
[113] See Chapter VI III.

relationship with management.[114] Appropriate systems include regular board meetings that management does not attend, or the assigning to a committee of the board of the responsibility for administering the board's relationship with management.[115] Sixty per cent of respondent companies of the latest Conference Board of Canada study indicated that they had some type of structure or system to ensure the independence of the board.[116] Of these companies 82 per cent have a chairman who is an outside person or have a policy in place that requires that the chairman of the board not be a member of management. In general, a greater percentage of large companies[117] have such a system in place. This can be explained by the fact that large companies receive more pressure from institutional investors, or the market in general, than smaller companies, to fulfill the requirements of the reports.

B. Internal and External Interaction

A good interaction between members of the board and between the board and management is a sign of strength. Within the board, there must be free and open discussion. To achieve this, the board must be comprised of well informed independent directors, and be chaired by a strong chairman who should encourage the debate. A strong chief executive officer seeks the best judgment of his independent directors to maximize the soundness of board decisions.

The relationship between the independent board and the chief executive officer (CEO)[118] should be challenging yet supportive and positive. The key objectives of the interaction between the board and the CEO is communication, collaboration, and mutual confidence. On the one hand, the board should stimulate management to perform at the peak of its capacity, and on the other hand the management, and especially the CEO,

[114] **Dey Report**, *supra* note 15 at Guideline 12. See below for a description of the "lead director" concept.
[115] *Ibid.*
[116] **C. Conner**, *Canadian Directorship Practices: A New Era in Corporate Governance* (Ottawa: The Conference Board of Canada, 1995) 14.
[117] Conner defines a large company as a company with assets exceeding $1,750 million.
[118] See Chapter V I.A for a description of the role and function of the CEO.

should ensure that board members not act only as rubber stamps. The CEO needs all the supporting wisdom, experience and judgment his board can provide.

II. COMPOSITION OF THE BOARD

Who should serve on the board, and what mechanisms should be used to make the choice? The question of board composition has received increased attention, mainly because the burden placed on boards is bigger, and the skills required to be a director have increased.[119] Also, we can view the composition of the board as the first pillar of the corporate governance debate. Without appropriate selection of board members, the committees can not properly function, and the interaction between the CEO/Chairman of the board (when one person combines the two functions) and the directors can not be productive. Also, if there is no prudent balance between inside and outside directors, the board can not be objective in its decision making.

A. The Selection of Directors: Generalities

There is no single magical formula to select a new director. But there is a general rule that should guide in selecting candidates: the contribution of the board depends on its collective strengths, and not on the character and personalities of the directors taken individually.[120] To follow this rule, the board must include people qualified to deal with various issues faced by the company, and the membership must be well balanced, in terms of occupation, experience, age, gender, race, geographical representation, etc. Both the target populations of potential directors, and the methods used to reach them are evolving. If there is no "one best way" to select a new director, changes in the selection process of directors should be introduced. The process is often formalized by the creation of a nominating committee specialized in this activity. This should not interfere with the fact that the formal decision of whether or not a director is appointed rests with the

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[119] **J. Worthy & R. Neuschel**, *Emerging Issues in Corporate Governance* (Northwestern University, J. L. Kellogg School of Management, 1983) 23.
[120] **The Business Roundtable**, *supra* note 29 at 307.

shareholders; but in practice, the board's recommendation has already been made, and the shareholders are asked to confirm it.[121] However, shareholders are perfectly capable of proposing their own candidates or of defeating a particular set of directors (though this is rare) as has happened in proxy fights.

B. The Nominating Committee

In many companies, the executive committee is in charge of nominating responsibilities, but larger companies usually have a nominating committee. The purpose of the nominating committee is to find and recommend to the board candidates for membership on the board consistent with the needs of the board and the corporation. We believe that the nominating committee is one of the three most important committees with the audit and compensation committees.[122]

1. The Creation of a Nominating Committee

a) The United States and Canada

In 1972, only 8 per cent of the US companies surveyed by The Conference Board indicated that they had a nominating committee composed solely of outside directors. In the 1993 survey, this figure had risen to 64 per cent.[123] The ALI, like the other reports studied, favors the creation of a nominating committee (**Table 4**). By contrast, The Conference Board of Canada's recent survey in 1995 on Canadian Directorship Practices showed that 52 per cent of respondents have a formal process in place to identify, recruit, nominate, and appoint new directors, but that only 32 per cent of the companies surveyed had a nominating committee.[124] This figure compares with the 1990 and 1991 surveys where only 12 to 15 per cent of the responding firms had such a committee.[125] From the

[121] **J. Longair**, *supra* note 111 at 9.
[122] We understand that most would also rank the executive committee high.
[123] **Bacon**, *supra* note 54 at 15.
[124] **Conner**, *supra* note 116 at 8. Of the 106 companies indicating that they had a formal process for the nomination of new directors, 42 per cent involved the full board in the process, 50 per cent involved the chair or CEO, and 73 per cent involved a committee. When asked if inside directors were involved in the nominating process, 70 percent of the companies responding to the question indicated yes. See **Chart I** at Chapter V II.
[125] **Longair**, *supra* note 111.

1995 study, there appears to be a greater percentage of large companies[126] having such a process — partly for the same reasons mentioned earlier for the presence of a structure ensuring the independence of the board.[127]

THE ESTABLISHMENT AND COMPOSITION OF A NOMINATING COMMITTEE

ALI Principles (§3A.04(a))	**"Every publicly held corporation, ..., should establish a nominating committee composed exclusively of directors who are not officers or employees of the corporation, including at least a majority of members who have no significant relationship[128] with the corporation's senior executives."**
Cadbury Report (4.30)	**"A nomination committee should have a majority of non-executive directors on it and be chaired either by the chairman or a non-executive director."**
Dey Report (Guideline 4)	**"The board of directors of every corporation should appoint a [nominating] committee of directors composed exclusively of outside, i.e. non management, directors, a majority of whom are unrelated directors." with the responsibility for proposing to the full board new nominees to the board and for assessing directors on an ongoing business."**
Viénot Report (II.5)	**All boards should set up special committees for the selection of directors and corporate officers. The committee should be composed of three to five members, including the *Président-Directeur Général*, and at least one *administrateur indépendant* (independent director).**

Table 4

[126] See definition *supra* note 117.
[127] See above I.A.
[128] See *infra* note 141.

According to John Longair, the discrepancy between the United States and Canada is due to the difference in corporate structures in the two countries.[129] While in the United States most companies are widely held, in Canada less than a quarter of corporations fall into that category. In closely held corporations, the nominating committee is not as useful because of the individual owners' greater control over the corporations. If this argument is valid, it is necessary to point out two other reasons that might explain the discrepancy between the two countries. First, it is most likely that the Canadian figures underestimate the number of companies with a nominating committee responsible for the nomination of new directors: companies may use a different name for this committee, or may transfer its responsibilities to another committee such as the executive committee. Secondly, the corporate governance debate in general, and the questions regarding boards' committees, such as the nominating committee, have emerged later on the Canadian scene than in the United States where they originated. Therefore, Canadians corporations have more recently followed the US example regarding the establishment of nominating committees.

b) France

Pursuant to Article 90 al. 2 of the *Décret* implementing the 1966 Company Law,[130] the *conseil d'administration* can create committees to advise the board on questions submitted by the *conseil* itself or its president. It can therefore establish a nominating committee. The *conseil* determines its composition, and its functions.[131] It also determines the compensation of its members.[132] The committee remains under the board's responsibility and only has consultative powers.[133] The *Décret* is very broad, and leaves enormous powers to the board, who can create other committees under the same powers.[134]

[129] **Longair**, *supra* note 111.
[130] Décret n° 67-236, March 23 1967 [hereinafter 1967 Décret].
[131] 1967 Décret at Article 90 al. 2:

> "[Le conseil d'administration] peut décider de la création de comités chargés d'étudier les questions que lui-même ou son président soumet, pour acis, à leur examen. Il fixe la composition et les attributions des comités qui exercent leur activité sous sa responsibilité."

[132] 1967 Décret at Article 94.
[133] 1967 Décret at Article 90 al.2.
[134] See Chapter V.

If the boards of directors can freely establish a nominating committee, a study conducted by Vuchot-Ward-Howell in 1994 pointed out that only a very low percentage (less than 10 per cent) of French publicly traded corporations have a *comité de sélection* or *comité de nomination des administrateurs* (nominating committee)[135]. Three times out of four, the president of the board is responsible for proposing board candidates.[136] Also, the survey reveals that the formalization of the selection process is not favored by half of the respondents.[137]. Nevertheless, the 1995 Viénot Report stresses the importance of the nominating committee, and recommends that each board establishes one.[138] For the Viénot committee, a good balance in the composition of the board can only be obtained if the candidates are chosen objectively through a formal process. This first step towards a more objective selection of a board's candidates must be firmly supported.[139]

2. Composition of the Nominating Committee

Typically, the nominating committee is constituted by a large majority, or solely of outside directors. All the reports agree on this point — except the Viénot Report which cautiously recommends the presence of at least one independent director (see above **Table 4**). The CEO is sometimes part of the committee. We discuss later the influence of the CEO on the selection process.[140]

a) United States and Canada

Nominating committees in the United States are mostly composed solely of independent directors. The ALI is more precise and recommends that nominating committees for large publicly held firms exclude corporate officers, and include at least a majority of members "who have no significant relationship with the corporation's senior

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135 **Vuchot-Ward-Howell**, "Enquête sur le Système Français de Corporate Governance" in Les Echos Conférences, *supra* note 20, 9 at 20 (speaker B. Richard). Of the 341 respondents (out of 2500 CEOs, and directors surveyed), 7 % indicated that a *comité de nomination des administrateurs* had been established in their company, 80 % indicated that they had not, and 13 % did not answer.
136 *Ibid.* at 24.
137 *Ibid.* Fourty-nine per cent of the respondents are opposed to a formal selection process, while 43 per cent are in favour of such process.
138 **Viénot Report**, *supra* note 1 at II.5.
139 See Chapter VIII.
140 See below II.C.3.

executives." This term is broadly defined by the ALI, [141] and can be assimilated with the term independent directors.[142] In Canada, according to the 1995 *Canadian Directorship Practices*, of the 32 per cent of the companies surveyed that have a nominating committee, 87 per cent are composed of a majority of outside directors, but only 48 per cent are composed exclusively of outside directors. [143] Seventy-one per cent of the companies with a nominating committee indicated that the CEO is not a member of the committee. The percentage of large companies[144] with a committee is greater than small and medium-sized companies. One of the reason for this difference is that the larger the company, the more complex its organization and functioning, and the more care required to select directors capable of dealings with complex matters. When dealing with a small-sized company, directors are often chosen among close colleagues of the CEO, for example his relatives or people who have had a long business relationship with him.

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[141] See **ALI Principles**, *supra* note 10 at § 1.34:

> "... a director has a 'significant relationship' with the senior executives of a corporation if, as of the end of the corporation's last fiscal year:
>
> (1) The director is employed by the corporation, or was employed within the *two* preceding years;
> (2) The director is a member of the immediate family of an individual who (A) is employed by the corporation as an officer, or (B) was employed by the corporation as a senior executive within the *two* preceding years;
> (3) The director has made to or received from the corporation during either of its *two* preceding years, commercial payments which exceeded *$200,000*, or the director owns or has power to vote an equity interest in a business organisation to which the corporation made, or from which the corporation received, during either of its *two* preceding years, commercial payments that, when multiplied by the director's percentage equity interest in the organisation, exceeded *$200,000*;
> (4) The director is a principal manager of a business organization to which the corporation made, or from which the corporation received, during either of the organization's *two* preceding years, commercial payments that exceeded *five percent* of the organization's consolidated gross revenues for that year, or *$200,000*, whichever is more; or
> (5) The director is affiliated in a professional capacity with a law firm that was the primary legal adviser to the corporation with respect to general corporate or securities law matters, or with an investment banking firm that was retained by the corporation in an advisory capacity or acted as a managing underwriter in an issue of the corporation's securities, within the *two* preceding years, ..."

[142] See Chapter IV.
[143] **Conner**, *supra* note 116 at 9-10.
[144] See definition *supra* note 117.

b) France

The Viénot Report recommends that the nominating committee be composed of three to five members. The Report does not preclude the committee being composed of a majority or solely of independent directors: it merely requests that at least one of the committee members be an independent director. It is interesting to notice that the Report specifically includes the PDG[145] among the members of the nominating committee. This can be seen as positive and negative. On the one hand, this recommendation might be understood as a return to the past, when directors were hand-picked by the PDG. On the other hand, it could be interpreted as a way to make sure that the selected candidates receive the approval of the PDG, and that they share with him similar views on the future of the corporation.[146] We believe that the members of the Viénot Committee had this second view in mind when writing the recommendation.

3. Role of the Nominating Committee

The main function of the nominating committee is to select directors. Sometimes, it is also given other responsibilities.

a) Selection of Directors

Selection of Directors as Individuals. What kind of people are sought as directors? What qualities must they possess? The members of the nominating committee should elaborate a set of criteria for choosing directors, identify the candidates, and recommend selected candidates to the board — it is important to bear in mind that the board is solely responsible for the final decision (**Table 5**). A director may be chosen according to the following criteria: availability in terms of time, background, knowledge in particular fields, age, freedom from conflicts of interest, freedom from legal disqualification, geographic proximity, regional representation, willingness to learn. Another criterion used to select an outside director is his or her independence from management.[147] It appears from the different studies on the selection of directors that the most important qualities sought in board candidates are still sound business judgment, and

[145] See definition *supra* note 49.
[146] See below II.A.3.
[147] See Chapter IV I.

the ability to work with other members of the board. We see later what differs in the selection of independent directors.[148]

THE ROLE OF THE NOMINATING COMMITTEE	
ALI Principles (§3A.04(b))	**"The nominating committee should: (1) Recommend to the board the candidates for all directorships to be filled by the shareholders or the board. (2) Consider, in making its recommendations, candidates for directorships proposed by the chief executive officer and, within the bounds of practicability, by any other senior executive or any director or shareholder. (3) Recommend to the board directors to fill the seats on board committees."**
Cadbury Report (4.30)	**"[The nominating committee has] the responsibility of proposing to the board, in the first instance, any new appointments, whether of executive or of non-executive directors."**
Dey Report (Guideline 4)	**"[The nominating committee has] the responsibility for proposing to the full board new nominees to the board and for assessing directors on an ongoing business."**
Viénot Report (II.5)	**[The nominating committee's] task would be to assess, and propose candidates to the board taking in consideration, for example, the number of independent directors, the interest of specific stakeholders, etc.**

Table 5

Availability. One of the first matters in the selection of board candidates is the amount of time required in the function and their availability and willingness to commit to the task. Directors need to be more and more available as the number of board and committee meetings and preparation time for them increase. Worthy and Neuschel, in

[148] See Chapter IV II.A.

1984, noted that among the boards they interviewed for their study, there was consensus that:

> "The time commitment required from today's board member is fifty to one hundred percent greater than it was ten to fifteen years ago".[149]

Even though this statement is over ten years old, time commitment has remained a major criterion in today's selection process.

Knowledge, Experience and Age. The new recruits should be sufficiently experienced and diligent. This issue is so obvious that it is sometimes not even mentioned in the reports, e.g. the Dey Report. In France for example, the first criterion of selection seems to be knowledge in particular fields.[150] Regarding the age, the dilemma is whether to choose younger or older people to serve as directors.[151] On the one hand, young people (40 to 60 years old) are likely to be more flexible and more amenable to new ideas, and to serve on the board for a reasonably long period of time. On the other hand, older people (between 60 and 70 years old)[152] are likely to be more experienced and prudent in their decision making. The key to this dilemma is that the board should be well balanced and comprise both younger and older directors.[153]

No conflict of interest. Choosing experienced candidates who are not in a conflict of interest is sometimes difficult, given the ownership structure which often features interlocking board memberships.[154] In France for example, pursuant to Article 92 of the 1966 Company Law, the maximum of directorships that one can undertake is 8.[155] The members of the Viénot committee, by specifying that interlocking directorship should not

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[149] **Worthy & Neuschel**, *supra* note 119 at 38.
[150] **Vuchot-Ward-Howell**, *supra* note 135 at 22. The criterion which follows the knowledge in particular fields is the independence of judgement.
[151] **S. Morgan**, "The Role of the Outside Director from the Inside Director", in **Cohen & Loeb**, *supra* note 8, 259 at 279.
[152] The retirement age is often 70 years old. In France, for example, the number of directors over 70 years old must not exceed one-third of the board (1966 Company Law, art. L 80-1).
[153] The board should also be conscious of the succession of its retiring members. One of the criticism expressed by the French market actors, and dealt by the Viénot Report (*supra* note 1 at II.5) is that French board of directors lack fast responsiveness when facing the vacancy of its members.
[154] See above II.B. and III.A.
[155] 1966 Company Law, at art. 92:

be excessive[156] implicitly pointed out that the 1966 Company Law has set too high a limit, and should be reduced. For the members of the Viénot committee, a director should not accept more than five directorships when he is already Chairman of the board or CEO of a corporation.[157] This recommendation does not concern directors who are neither Chairmen nor CEOs, and has therefore less force. The expected Rapport Marini should also deal with this question, and may adopt a different position. Another remedy to avoid any conflict of interest is to select independent directors who, by definition, have no personal interest in the corporation.[158]

Geographical representation. An example relevant to Canada is the strong awareness of the need for regional representation on almost any board of corporations doing business across the country.

Independence of judgment. This criterion applies mainly to the selection of independent directors, but it should also be taken into consideration even for the selection of inside directors.[159]

These different criteria are used in all four countries we study. We describe briefly the Canadian example. In the most recent Canadian Directorship Practices, conducted by

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> "Une personne physique ne peut appartenir simultanément à plus de huit conseils d'administration de sociétés anonymes ayant leur siège social en France métropolitaine."

This rule is applicable to the classic SA with a board of directors and a president general manager. For the "new" SA composed of a directorate and a supervisory board, article 127 of the 1966 Company Law indicates that no one can be a member of more than two directorates. For a more detailed description of the two forms of SA, see Chapter VIII.

156 **Viénot Report**, *supra* note 1 at II.4:

> "... lorsque le conseil [d'administration] examine l'équilibre optimal de sa composition, il doit particulièrement veiller à ce que le nombre des mandats réciproques ne soit pas excessif en son sein."

157 **Viénot Report**, *supra* note 1 at III.4:

> "L'administrateur doit consacrer à ses fonctions le temps et l'attention nécessaires. Lorsqu'il exerce des fonctions de président ou de directeur général, il ne devrait en principe pas accepter d'exercer plus de cinq mandats d'administrateur dans des sociétés cotées françaises ou étrangères extérieures à son groupe."

158 See Chapter IV.
159 See Chapter IV at II.A.

The Conference Board of Canada in 1995, companies surveyed were asked to provide information on the criteria used in the selection and nomination of new board members.[160] The most frequently used criteria are specific skills that complement the board, financial knowledge and experience in the industry. Other criteria mentioned include family members, relations with parent company, government experience, geographical or regional representation, and integrity.

Choosing Directors Bearing in Mind that the Board is a Collective Entity. If the selection of directors as individuals is important, it is important to bear in mind that the board does not function as a mere addition of individuals.[161] Therefore, when selecting board members, two other criteria come into play underlined in Longair's commentary:

> "A company must acquire directors who not only bring individual talents and experience to the boardroom, but who also fit the other needs of the board and are able to work well with the other directors."[162]

Also, the board must have a balanced membership — various backgrounds, ages, genders, geographical representations, and so on. The members of a good board should reflect the needs of the corporation and be closely linked to the corporate mission and markets. They should have different qualifications so that as a whole the board can deal and respond to various issues faced by the corporation. This becomes extremely important, for example, in the context of a hostile take-over bid: the members of the board must act as a team to respond quickly and wisely to the bid. Members of the board who do not get along with each other, and who are inexperienced will diminish the board's capacity to deal effectively with this matter.

b) Other Responsibilities of the Nominating Committee

Recently, boards of directors have been the focus of much attention. They have been criticized for granting excessive executive compensation, and for their lack of responsiveness to shareholders' expectations. The members of the TSE Committee were aware of this when they pointed out that:

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[160] Conner, *supra* note 116 at 10.
[161] See *infra* III.D.
[162] Longair, *supra* note 111 at 4.

"Good governance requires the board to have in place a mechanism for assessing its own effectiveness as a board and for assessing the contribution of individual directors."[163]

To justify a mechanism to assess the board's effectiveness, the TSE Committee cites a survey done by the Business Council on National Issues (BCNI), which states that while 90 per cent of CEOs support the idea of a board assessment process, virtually no board has a formal process in place. The solution proposed by Dey is that:

"Every board should implement a process, to be carried out by the nominating committee or other appropriate committee, for assessing the effectiveness of the board as a whole, the committees of the board and for assessing the contribution of each individual directors."[164]

This task is likely to be difficult to fulfill. In a submission to the TSE Corporate Governance Committee, Matthew Barrett of the Bank of Montreal stated "individual director assessment is an intellectually elegant concept, but politically impractical."[165] The key concern is to ensure that there is an appropriate separation between the nominating or recruitment process and management. The TSE committee points out that a director who is "beholden" to management or the CEO would have difficulty acting independently and in the best interest of the corporation, particularly in assessing the performance of management.[166]

In the United States, some corporations have established a corporate governance committee with similar functions as the ones recommended by the Dey committee for nominating committees. In France, the Viénot Report does not specifically recommend the creation of a special structure among the board of the directors to assess its effectiveness. However, the members of the Viénot Committee were aware of the importance of this "self-assessment."[167]

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[163] **Dey Report**, *supra* note 15 at 28.
[164] *Ibid.* at Guideline 5.
[165] See **McCarthy Tétrault**, *Disclosure of Corporate Governance Systems - A New Challenge for TSE Companies*, http://www.mccarthy.ca/mt-cordi.html, at 4.
[166] **Dey Report**, *supra* note 15 at Guideline 4.
[167] **Viénot Report**, *supra* note 1 at Introduction:

"Le Comité estime en conséquence que chaque conseil a la double obligation d'examiner périodiquement sa composition, son organisation et son fonctionnement et de faire part aux actionnaires des positions ou dispositions qu'il a alors prises."

4. Conclusion: Effect of the Nominating Committee

According to the US Securities and Exchange Commission (SEC):

> "The existence of a nominating committee ... may help assure or increase the accountability of a board of directors to its shareholders and potentially to the public.... This committee can be the single most effective force in improving corporate governance because of its impact over time on the composition of the board and, accordingly, the succession of management."[168]

In a 1989 survey of The Conference Board, 34 US companies gave their assessment of the impact that their nominating committee have had.[169] More than two-thirds said that this committee has had either a "definite" or, less often, a "major" effect on improving the director recruitment process as a whole. Slightly more than half said that the committee had similar positive effects in the mix of experience and talents represented on their boards. Half said that the work of this committee in director selection has had either a definite or major effect on improving the board's potential for exercising independent judgment. We are not aware of similar surveys in the other jurisdictions studied, but the results would probably be alike. In this context, the establishment of nominating committees must be strongly encouraged, especially in France where only a few companies have such a structure for selecting board candidates.[170] The formalization of the nomination process would bring objectivity and certainty in the selection of the candidates that are still missing in some French companies.[171]

See also at II.1:

> "Le Comité estime [que] chaque conseil doit s'interroger sur l'équilibre souhaitable de sa composition ou de celle des comités qu'il constitue en son sein, en prenant des dispositions propres à assurer les actionnaires et le marché que ses missions sont accomplies avec l'indépendance et l'objectivité nécessaires."

[168] **Securities and Exchange Commission**, "Statements on Corporate Governance", in **Cohen & Loeb**, *supra* note 8, 63 at 91.
[169] **J. Bacon**, *Membership and Organization of Corporate Boards* (New York: The Conference Board, 1990).
[170] See **Viénot Report**, *supra* note 1 at II.5.
[171] See Chapter VIII.

B. Size of the Board: Is Smaller Better?

There have been numerous studies that have reported that boards of directors are too big, and that, as a consequence, companies — especially large ones — have great difficulty taking action. It seems impossible to establish the optimum size for the board; the size is related to the business environment of the firm or to its strategy.[172] In the four countries we study, there seems to be an average of 7 to 12 board members. For example, in the United Kingdom, the average board has between 7 and 8 directors.[173] In Canada, the figure rises to 11 directors.[174] Is a smaller board better? It is difficult to answer this question. On the one hand, a small board is more cohesive and might seem more efficient when there is a need to deal quickly with an issue, e.g. a take-over bid. But on the other hand, it seems that in terms of independence of judgment, the board might be better off with a larger number of directors. The more directors there are on the board, the more chances there are that the stakeholders' interests will be taken into account — if directors have been carefully selected by the nominating committee to represent the interests of the stakeholders.[175] In France, where the 1966 Company Law allows boards of directors to have between 3 and 24 members,[176] there is still much debate on the reduction of the number of board members. Recently, the Viénot Report implicitly pointed out that the nomination of independent directors should not impede the effective participation of each board members.[177] This is a key issue that we develop later.[178]

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[172] **Longair**, *supra* note 111 at 5.
[173] **M. Peel & E. O'Donnell**, "Board Structure, Corporate Performance and Auditor Independence" (1995) 3 Corporate Governance 207 at 208. The exact figure is 7.58 directors.
[174] **N. Carlyle**, Canadian *Directorship Practices: Compensation of Boards of Directors* (Ottawa: The Conference Board of Canada, 1995) 5. More precisely, manufacturing companies have an average of 10 directors, while non-manufacturing firms have 12 directors.
[175] See below III.B.
[176] 1966 Company Law, *supra* note 2, modified by the *Loi n° 94-126 du 11 février 1994*, at art. 89.
[177] **Viénot Report**, *supra* note 1 at II.1:

> "Sans accroître excessivement le nombre de ses membres, au risque de compromettre la participation effective de chacun aux délibérations, le conseil doit s'interroger notamment sur l'opportunité de la nomination d'un ou plusieurs administrateurs indépendants et sur le nombre de mandats réciproques."

[178] See Chapter VIII

C. The Influence of the Chief Executive Officer/Chairman

1. The CEO/Chairman Who is not a Member of the Nominating Committee

a) Generalities

Despite the common but not universally accepted practice of splitting the two positions in order to ensure an independent and objective board, chairmen of boards are often also CEOs.[179] They remain a major factor in the make-up of the board, whether it is the board's size, its committee structure, or the choice of its individual members. The CEO is responsible for managing the company, and therefore determines where the firm is going and how it will get there. In order to meet the goals set by the CEO, new board recruits must be chosen accordingly to his or her vision. The appointment of a new director would not make sense without the approval of the chief executive officer. Even when substantial stockholders in the corporation are members of the nominating committee, the nominating committee is unlikely to go directly against the CEO's wishes that he or she opposes a proposed candidate.

b) The United States and Canada

The United States. In the United States, the CEO is often in a dominant position over board selection. However, in 1989, Lorsch noted that this dominance by the CEO was giving way to a more consultative process, one in which the CEO nonetheless retained important input. He commented:

> "Even today, many CEOs are a major influence in the selection of directors, and many still refer to the board as 'my directors', but the trend is moving away from such CEO dominance, mainly because of the emergence of the nominating committee."[180]

Indeed, the nominating committee is now found in a majority of US companies (64 per cent in 1993[181]). This growth in nominating committees, however, has not lacked support from CEOs. They point out that the difficulty of finding qualified directors, especially people who do not have schedule or time conflicts, can be attenuated by a nominating committee.[182] CEOs also recognize the "political correctness" of a nominating committee

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[179] See Chapter V II.
[180] **Lorsch & MacIver** (1989).
[181] **Bacon**, *supra* note 54 at 11.
[182] *Ibid.*

and might wish to avoid opposing the idea.[183] Chief executives interviewed for the 1993 Conference Board report indicated they are not concerned by the fact that a nominating committee reduces their control over director selection.[184] Rather, CEOs seemed comfortable with less control over the selection process, and some found a change necessary. The reasons are various. Most CEOs said that their personal network no longer suffices: the source of potential candidates must be expanded. As Bacon points out:

> "Several spoke of having excellent board members whom they did not know, even by reputation, prior to their being recommended by the nominating committee."[185]

Also, there are two obstacles that explain why CEOs are not reluctant to losing control over the selection process. First, it has become harder to find qualified candidates who are able to commit the time it takes to be a diligent director today. Secondly, schedule conflicts prevent many a would-be directors from attending meetings.

In the future, CEOs are likely to lose even more control over the selection process if the ALI recommendations are closely followed. The ALI Principles weaken the impact of the CEO on the nomination process by recommending that nominating committees be composed exclusively of directors "who are not officers."[186]

Canada. The functions of CEO and Chairman are still often combined, but when they are separate, current literature and interviews with Canadian board members show that the CEO is still the most influential individual in the selection of directors.[187]

c) France

In France, the majority of the *Sociétés Anonymes* (SAs)[188] follow the monist model where the Président Directeur Général (PDG) holds by nature both the functions of CEO and Chairman of the board.[189] In this context, the separation of the two functions is not seen as a panacea.[190] To those who criticize the combination of the two functions the

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183 *Ibid.*
184 *Ibid.* at 15.
185 ***Ibid.*** at 15.
186 **ALI Principles**, *supra* note 10 at §3A.04.
187 **Longair**, *supra* note 111 at 8.
188 A *Société Anonyme* can be assimilated to a corporation.
189 See Chapter VII I.
190 **Viénot Report**, *supra* note 1 at I.4:

Viénot Report replies that this system was put in place because of the failure of the separate functions structure before the second World War.[191] We discuss later what our opinion on the issue is, and what reforms we recommend to the French legislator.[192]

2. The CEO/Chairman Who Is a Member of the Nominating Committee

When the CEO/Chairman is also a member of the nominating committee, his or her influence on the selection process becomes evident. While courtesy demands solicitation of the support of existing board members for the current choice, the CEO is often said to dominate the selection process. There is a trend towards the presence of the CEO/Chairman within the nominating committee. The Cadbury Report recommends that the nomination committee be chaired either by the chairman of the board or a non-executive director.[193] In Canada, the CEO is often a member of the nominating committee. In 1992, 29 per cent of the companies surveyed by The Conference Board of Canada indicated that the CEO was a member of the nominating committee.[194] In France, there is no data available on the composition of the nominating committee because of its novelty. However, the Viénot Report recommends that the PDG be a member of the nominating committee.[195]

On the one hand, the presence of the CEO/Chairman on the nominating committee may seem awkward. It could be interpreted as a loss for the board in terms of independence over the selection of board members. On the other hand, the presence of the CEO/Chairman guarantees the sharing of views concerning the future of the corporation between the new recruits, the board and the CEO/Chairman. This argument prevails, and

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"[Le Comité] considère pour sa part que si en France la plupart des sociétés cotées, comme d'ailleurs la plupart des sociétés anonymes, sont dotées d'un conseil d'administration, c'est que le plus souvent une très stricte séparation des fonctions ne paraît pas s'imposer et qu'elle ne constitue pas, dans la plupart des cas, la condition nécessaire d'une bonne direction général ou d'un contrôle efficace de la gestion."

[191] *Ibid.*
[192] See Chapter VII III.
[193] **Cadbury Report**, *supra* note 6 at 4.30.
[194] **Conner**, *supra* note 116 at 10.
[195] **Viénot Report**, *supra* note 1 at II.5.

this is why we favor the presence of the CEO/Chairman among the members of the nominating committee.

D. The Influence of Institutional Investors on the Selection of the Directors

Institutional investors, which hold in the United States the majority of the shares in publicly traded firms, now play a role in the selection of outside directors of their portfolio companies. For example, Lockheed agreed to allow institutional investors to influence the selection of three board members as a means of gaining their support in the 1990 proxy fight initiated by Harold Simmons. Similarly, to win support in its proxy fight with Carl Icahn, Texaco's management agreed to select one board member from a list provided by CalPERS. The result was the addition of the President of New York University to the Texaco board.[196] A different motive for attempting to influence the identity of outside directors was reflected in the efforts of institutional investors to cause Exxon to name an environmentalist to its board following the Exxon Valdez oil spill.[197]

British and Canadian institutional investors are now beginning to follow suit. Canadian fund managers, for example, who face the requirement in the regulation of their own fund to invest in Canadian equities, now want a bigger say in how their portfolio companies are run.[198] It is not possible to describe accurately what the situation in France is not only because of the structure of the institutional investment is different,[199] but also because we have been unable to find any data related to the influence of institutional investors on the selection of the directors.

E. Other Recommendations Related to the Selection of Directors

The Dey Report also includes other recommendations related to the process for constituting the board, such as the creation of an orientation and education program for new recruits to the board,[200] and examination of the size of the board with a view to

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196 **J. Flanigan**, "Texaco Stressed the "Share" in Shareholder", L.A. Times, Jan. 25, 1989, at D1, col.1.

197 See **M. Wald** "Exxon Head Seeks Environmentalist to Serve on Board; Pension Fund Pressure", N.Y. Times, May 12, 1989, at A1, col.4.

198 **Longair**, *supra* note 111 at 10.

199 See Chapter I at III.A. and II.B.2.

200 **Dey Report**, *supra* note 15 at Guideline 6.

determining the impact of the number upon effectiveness. The Viénot Report, in its *Charte de l'administrateur*, is also concerned about the information given to board candidates before accepting a directorship.[201]

F. Conclusion: Who Should Be on the Board?

The selection of new members of the board is of utmost importance. The four jurisdictions studied are all aware of this. If the selection process is not always formalized into law, the reports all agree on the necessity to implement a structure capable of recruiting efficiently board members. Typically, a board will comprise inside and outside/independent directors[202] who come from different industries, and who can bring their insights to board meetings based on their various experiences.[203] Sometimes, the board will also have people with experience in the public sector, and academics. The idea behind the diversity of members is that the more varied the board is, the more adequate its collective decisions will be. Also, as Anderson and Anthony stated in *The New Corporate Directors - Insights for Board Members and Executive*:

> "A board with diverse membership will also have an extensive network of contacts throughout industry, government, and the professions, that can be useful to the company in many ways."[204]

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[201] **Viénot Report**, *supra* note 1 at III.4:

> "... le Comité estime que tout administrateur d'une société cotée doit se considérer tenu aux obligations suivantes:
>
> - Avant d'accepter ses fonctions, l'administrateur doit s'assurer qu'il a prisconnaissance des obligations générales ou particulières de sa charge. Il doit notamment prendre connaissance des textes légaux ou réglementaires, des statuts, de la présente charte et des compléments que chaque conseil[d'administration] peut lui avoir apporté ainsi que, le cas échéant, des règles de fonctionnement interne dont ce conseil s'est doté.
> - ..."

[202] In this section, we purposely did not distinguish between inside and outside/independent directors. We review later in Chapter IV I.B. the pros and cons for the selection of either of them and discuss why we believe that a numerical balance must be found between them.

[203] **C. Anderson & N. Anthony**, *The New Corporate Directors - Insights for Board Members and Executives* (New York: John Wiley & Sons Inc., 1986) 89.

[204] **Anderson & Anthony**, *supra* note 203 at 89.

Also, in some cases, a limited number of directors elected by the employees of the corporation can be members of the board.[205] This board composition formalizes the necessity to go beyond simply representing the interest of the shareholders.[206]

III. FUNCTIONS OF THE BOARD

We limit ourselves to the basic functions of the board, focusing on the responsibilities that are relevant to its independence.

A. The Separation of Ownership and Control

The issue of corporate governance at large, and the issue of the role and functions of the board of directors in particular, is grounded in the separation of ownership and control often called "the Berle and Means hypothesis", because it was first examined in the 1930's in the United States, by Adolf Berle and Gardiner Means.[207] The board of directors governs the corporation. It conducts its affairs so that the corporation becomes an efficient, effective and profitable operation. It selects strong and competent management, advises, and counsels it to do its best.[208] The board has the power to hire and fire the chief executive officer and other top-level members of the management team. It is responsible for monitoring the company's accounts and approving its strategic plans and all of its other important decisions and actions. It has to serve primarily shareholders' interests , but should also serve the other constituencies of the corporation such as employees, customers, suppliers, labor unions.

B. Duty to Different Interest Groups

Generalities. As Sir Arthur Knight stated:

> "Though first and foremost, the duty of the board of directors is to the company, and not to any particular group, the board must treat with a whole range of interest groups."[209]

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[205] See below III.B. for the example of France.
[206] See below III.B.
[207] **Berle and Means, *supra*** note 4 at 71.
[208] **J. Louden**, *The Director - A Professional's Guide to Effective Board Work* (New York: AMACON, 1982) 73.
[209] **Sir A. Knight**, "The Aims and Objectives of Corporate Boards", in **Midgley**, *supra* note 23, 3 at 6.

These interest groups include customers of the corporation, governments (if the industry is one which depends on government support in any major way), those who provide the funds, employees who are not managers, managers. It is difficult for boards of directors to be directly responsible to various different bodies. In any conflict, there must be an overriding responsibility. Corporate law has identified this responsibility as being to the shareholders whose money is invested in this company — the interests of the shareholders as a whole generally being taken to be that of the company. Directors are required to ensure that their interests be a paramount. For example, the Viénot Report states that the board represents shareholders as a whole, not individual interests.[210]

It is based on this overriding responsibility to shareholders that institutional shareholders — because of their strong voting power — have been active in demanding various changes to the board. They feel that the board is not sufficiently representing their interests. They often criticized the board for being self-centered, and the directors are being accused of taking care more of their personal interests rather than of the interest of the corporation as a whole and of its shareholders. Other stakeholders have demanded that the board take into account their interests. Among these people are employees of the firm. Even though their interests come after those of shareholders, it is difficult to deny that that the rights of employees should not be given some recognition in corporate law.

Employee Representatives on French Board of Directors. In France, there are three levels of employee representation on boards of directors. First, members of the *comité d'entreprise*[211] must be invited to attend board meetings.[212] They must receive the same documents as those sent to the board members before meetings. If they do not vote, they express their concerns to the board about its actions, and the board must reply.

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[210] **Viénot Report**, *supra* note 1 at II.1:

> "... quelles que soient sa composition et l'origine de ses membres, le conseil d'administration représente collectivemenr l'ensemble des actionnaires; il n'est pas un agrégat disparate de représentants d'intérêts contradictoires...."

[211] The *comité d'entreprise* can be roughly described as a labour-management committee.
[212] *Code du Travail*, art. L. 432-6.

Secondly, the 1966 Company Law permits the board to allow employee representatives become directors.[213] These employee representatives have a deliberate voice, and have the same rights and duties as the other board members. This situation appears to bother an important proportion (46 per cent) of the other board members.[214] However, the legislator keeps supporting the participation of employee representatives. For example, the 1994 Privatization Law encourages corporations whose stock is at least 5 per cent owned by employees to nominate one or two employees who will be voting directors.[215] One of the remarks expressed by the Viénot committee on the employee representatives is that when there are employee representatives on the board, there is no reason for the presence of members of the *comité d'entreprise*. The Viénot Report implicitly suggests that *comité d'entreprise* not be represented on the board when there are directors elected by the employees among the members of the board. [216] We disagree with the views of the Committee on this point, because the main advantage of the representatives of the *comité d'entreprise* is that they are in equal numbers of members of management (*cadre*) and of labor (*non-cadre*). On the contrary, the 1966 Company Law allows that representatives of labor be in a greater number than representatives of management.[217] The strict parity

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[213] 1966 Company Law (*supra* note 85), modified by the *Ordonnance n° 86-1135 du 21 octobre* 1981 [hereinafter 1986 Ordonnance], at art. 97-1:

> "Il peut être stipulé dans les statuts que le conseil d'administration comprend, ..., des administrateurs élus soit par le personnel de la société, soit par le personnel des la société et celui des filiales directes ou indirectes dont le siège social est fixé sur le territoire français. Le nombre de ces administrateurs ne peut être supérieur à quatre ou, dans les sociétés dont les actions sont admises à la cote officielle d'une bourse de valeurs, cinq, ni excéder le tiers du nombre des autres administrateurs."

[214] **Vuchot-Ward-Howell**, *supra* note 135 at 25. Of the 387 respondents, 46% consider that representatives of the *comité d'entreprise* hinder the good functionning of the board, while 31% agree that they are useful in terms of informing the board, and 23% that they are a necessary counter-power.

[215] Loi n° 94-640 of 25 July 1994.

[216] **Viénot Report**, *supra* note 1 at I.3.

[217] 1966 Company Law (*supra* note 85), modified by the 1966 Ordonnance (*supra* note 181), at article 97-1:

> "Lorsque le nombre des administrateurs élus par les salariés est égal ou supérieur à deux, les ingénieurs, cadres et assimilés ont un siège au moins."

between *cadres* and *non-cadres* on the *comité* is one of the reasons that make the *comité d'entreprise* such a powerful body in the corporation. It plays an active role

. It should also be active at the board level. This is why, even though they do not vote, representatives of the *comité d'entreprise* should participate in board meetings.

C. The Board's Overall Responsibility

Giving a clear and well defined content to the board's overall responsibility is a difficult task. In the four jurisdictions we study, it is accepted that if the corporation is "managed" by the board or "managed under the direction of" the board, this does not mean that the board conducts day-to-day operations. It means that the board is the ultimate corporate authority which takes final decisions — apart from matters that require shareholder approval.

It is difficult to describe board functions because these functions often vary from enterprise to enterprise, and in the case of a particular enterprise, from time to time. In any case, the board also has specific responsibilities which are straightforward and well-understood, such as adoption of by-laws, calling special meetings of shareholders, declaration of dividends, proposing amendments of the articles of incorporation, prior review of matters such as mergers which require shareholder approval, and compliance with the law. The board also have functions that can be described along the following lines: selection and succession of managers (including the CEO) and directors, corporate actions and decisions with potential for major economic impact, corporate social responsibility.. We describe briefly each of these responsibilities.

Selection and Succession of Managers and Directors. One of the principal board functions is the selection of the chief executive officer and his principal management associates. Choosing a CEO is a critical task. There is constant interaction between the CEO and the board. The members of the board and the CEO must therefore get along with each other. It is also the board's duty to decide whether the CEO should also be the Chairman of the board or whether the two functions should remain independent. The board is also responsible for selecting directors. The first part of the selection process (defining selection criteria, scanning the candidates) is now often delegated to a nominating committee.[218] The committee proposes candidates to the full board which makes final decisions. A corollary function of the board is to replace directors and managers, including chief executive officers, who have not met their responsibility — whether responsibility for business performance or responsibility for lawful and ethical behavior. Shareholders in general, and institutional investors in particular, have focused their attention on this two-sided responsibility. They want boards of directors to take their interests into consideration. To meet this objective, they pressure the boards of their portfolio companies to select candidates who correspond to their own criteria.[219] Also, their pressure has helped to oust the bosses of poorly-performing firms as shown by recent US examples of IBM, Westinghouse and Kodak.

Corporate Actions and Decisions with Potential for Major Economic Impact. Although the board cannot effectively conduct day-to-day operations, the board does have a major interest in, and a major accountability for, the financial performance of the enterprise. This clearly requires a continuing check on financial results and prospects, including profit and loss, cash flow and debt by major business segments. But the board's responsibility extends far beyond this monitoring role. The focus should be on a system assuring prior board consideration of any major commitment of corporate resources over a period of time. Normally these corporate resource allocation decisions will be embodied in corporate "strategic plans" and board consideration of such plans should be an integral part of the strategic planning process.

Corporate Social Responsibility. Another major responsibility of the board is the consideration of significant social impacts of corporate activities and the consideration of views of substantial groups (other than shareholders) significantly affected by such activity. The board's responsibility is to manage the enterprise in a way which is in the interest of the owners. However, the interest of shareholders cannot be conceived solely in terms of short-range profit maximization. The owners have an interest in balancing short-

[218] See *supra*.
[219] See *supra* I.A.4.

range and long-term profitability, in considering the political and social viability of the enterprise over time and in adjusting to the global environment in which it operates. Moreover, shareowners and directors alike have an interest in assuring that entities with which they are identified behave ethically and as good citizens. It is the board's duty to consider the overall impact of the activities of the corporation on (1) the society of which it is a part, and on (2) the interests and views of groups other than those immediately identified with the corporation. This obligation arises out of the responsibility to act primarily in the interest of the shareholders, particularly their long-term interest.

D. The Board Functions as a Collective Entity

We saw earlier that the composition of the board must reflect the fact that the board is more than a collection of individuals.[220] In terms of its responsibilities, the board functions as a collective entity. Other than in very small corporations or in corporations where the top management has a real proprietary interest, the board does not make decisions by itself. The power and responsibility to manage the affairs of the corporation are vested in the board as a collective entity, in which no individual member has specific powers over the company. The board as a whole is responsible to act to safeguard and enhance the value of the shareholder's investment. This is the theory; in practice, the only time the board actually manages is in time of crisis, either when the CEO is unable to manage or when there is no CEO.

E. The Functions of the Board According to the Reports

In this section, we will only analyze the Dey and the Viénot Report. The views of the other Reports on the functions of the board are briefly summarized in **Table 6** below.

The Dey Report. The Dey Report, in its first set of guidelines, describes what are, in the opinion of the TSE committee, the principal responsibilities of the board of directors. The Report recommends that responsibility for the improvement of corporate governance be assumed by the board. In fact, each of the board's areas of responsibility is likely to be

[220] See *supra* I.A.1.c) ii).

initiated and implemented by the CEO (except the monitoring of the CEO), and his or her team, and only monitored by the board.[221] Therefore, the duty of the board is to ensure that the appropriate system is in place rather than to carry out itself the five activities listed below in **Table 6** (the Report characterizes the role of the board using the term "stewardship"). As part of the disclosure approach to corporate governance, the Report also recommends that the board of directors be required to:

> "disclose on an annual basis whether the board has a majority of unrelated directors, and in circumstances where a corporation has a significant shareholder, whether the board is constituted with the appropriate number of directors which are not related to either the corporation nor the significant shareholder."[222]

In case the corporation has a significant shareholder, the corporation must satisfy the requirement to fairly reflect the investment of minority shareholders in the corporation.

The Viénot Report. In the view of the Viénot, the *conseil d'administration* has four main responsibilities described in **Table 6**.[223] The Report notices that as opposed to the Anglo-Saxon tradition where the board of directors seeks to maximize the overall share value, in France the *conseil d'administration* focuses on the *intérêt social* of the corporation. The *intérêt social* of the corporation can be defined as the utmost interest of the corporation, understood as a autonomous person, separate from the interests other consistencies surrounding it (shareholders, employees, creditors, ...), but at the same

[221] **McCarthy Tétrault**, *supra* note 165.
[222] **Dey Report**, *supra* note 15 at Guideline 3.
[223] **Viénot Report**, *supra* note 1 at Introduction:

> "... le conseil [d'administration] remplit selon le Comité une quadruple mission: il définit la stratégie de l'entreprise, désigne les mandataires sociaux chargés de gérer celle-ci dans le cadre de cette stratégie, contrôle la gestion et veille à la qualité de l'information fournie aux actionnaires ainsi qu'aux marchés à travers les comptes ou à l'occasion d'opérations très importantes."

THE ROLE OF THE BOARD OF DIRECTORS

ALI Principles (§3.02)	The board of directors of a publicly held corporation should perform the following functions: (1) Select, regularly evaluate, fix the compensation of, and, where appropriate, replace the principal senior executives; (2) Oversee the conduct of the corporation's business to evaluate whether the business is being properly manage; (3) Review and, where appropriate, approve the corporation's financial objectives and major corporate plans and actions; (4) Review and, when appropriate, approve major changes in. and determinations of other major questions of choice respecting, the appropriate auditing and accounting principles and practices to be used in the preparation of the corporation's financial statements."
Dey Report (1st Guideline)	The Report specifically includes within the board's mandate the following matters: (i) adoption of a strategic planning process; (ii) the identification of the principal risks of the corporation's business and ensuring the implementation of appropriate systems to manage these risks; (iii) succession planning, including appointing, training and monitoring senior management; (iv) a communications policy for the corporation; (v) the integrity of the corporation's internal control and management information systems.
Viénot Report (Introduction)	The board of directors has four main responsibilities: - it defines the company's strategy; - it designates the officers; - it controls the management; - it makes sure that the information contained in financial statements, or given to shareholders and markets when there is an important operation, is accurate.

Table 6

time in accordance with them.[224] Any action taken by the board must be motivated by the sole interest of the corporation. The concept of the *intérêt social* makes the decisions of the board primarily oriented towards the interest of the corporation itself.The interests shareholders, and of the rest of the stakeholders come after. This leads to saying that the French corporation does not follow the Berle and Means hypothesis in which the corporation should be managed in the interests of the shareholders.[225] Does this mean that the French expectation gap has in fact two facets? We believe that this is the case. The first gap lies between the board's decision making and shareholders' expectation — the "traditional" expectation gap —[226] while the other one lies between the board's decision making and the *intérêt social*.

CONCLUSION

At the beginning of this chapter, the Berle and Means conception of the role of the corporation was clear in our mind: the corporation must serve the interests of the shareholders. If they are not properly taken into consideration, the board is held responsible for lack of objectivity. The remedy is simple: a careful selection of directors, experienced and independent in their judgment — which leads to the selection of more and more directors who have no personal or conflicting interest in the corporation (outside/independent directors).[227] At the end of this chapter, we come to the conclusion that in France, the problem is more complex, and that the Berle and Means hypothesis is

[224] *Ibid.* at I.1:

> "L'intérêt social peut ainsi se définir comme l'intérêt supérieur de la personne morale elle-même, c'est-à-dire de l'entreprise considérée comme un agent économique autonome, poursuivant des fins propres, distinctes notamment de celles de ses actionnaires, de ses salariés, de ces créanciers dont le fisc, de ses fournisseurs et de ses clients, mais qui correspondent à leur intérêt commun, qui est d'assurer la prospérité et la continuité de l'entreprise."

[225] See Chapter I.B.1.a).
[226] See Chapter I in the Introduction.
[227] See Chapter IV.

only partly applicable.[228] This calls for more explanations. We describe later if the proposals made to reduce the "traditional" expectation gap can also be applied to the second gap.[229]

[228] This could also be the case in the other jurisdictions studied, but we can not expand the scope of our research to these other countries.
[229] See Chapter VIII.

CHAPTER IV: THE INDEPENDENT DIRECTOR

"In the corporate governance debate, all arguments ultimately converge on the role of board of directors in general, and on the role of outside directors in particular."

(**Ronald Gilson and Reinier Kraakman**, 1991)

"Previously little more than a spear-carrier in the drama of corporate governance, the non-executive has now moved center-stage and is hogging the spotlight to the evident embarrassment of some other members of the cast."

(**Stephen Williams**, 1994)

INTRODUCTION

During the past twenty to twenty five years, there has been an unprecedented ferment in ideas about the process of management of corporations and the role of the board of directors. The ideas range from concepts of how to improve the corporation's ability to maximize long-range profits and/or to comply with the law to provocative proposals for structuring the board of directors of the largest corporations so that broader social concerns will be given more consideration and hopefully acted upon. Many of these ideas tend to focus upon "outside directors", and especially "independent" ones. The ideas nearly always envision much more active outside directors and postulate that "outside directors" will deal with management at arm's length.[230]

In this chapter, we first we isolate the differences between outside and independent directors before comparing the countries studied (**I**). Then, we review the pros and cons of the selection of outside/independent directors as opposed to inside directors, we deal with the selection process of independent directors, and finally, we describe what the role of the independent director is and compare it to what it was (**II**).

[230] **Cohen and Loeb**, *supra* note 8 at 265.

I. DEFINITIONS

A. Difference Between an Outside Director and an Independent Director

A 1978 study, sponsored by Deloitte, Haskins and Sells, Chartered Accountants, which sought to explore the reality of both non-executive directors and audit committees, in the context of British and North American boardrooms, pointed an ambiguity in the definition of the non-executive director: to be non-executive does not necessarily imply independence.[231]

1. Inside and Outside Directors

The distinction between inside and outsiders is clear. Typically, an outside director is not an employee, a former employee, a former executives, or a former managers of the corporation, and has no relationship with any of those people (see **Table 7**). Inside directors will be those who do not fall in this category. Used in this sense, an outside director is not necessarily an independent director. For example, the corporation's lawyers or investment bankers would usually be considered outside directors. According to Professor André Tunc, both the terms inside and outside directors are now abandoned and replaced for example by executive and non-executive directors.[232] Inside director because it sounds like insiders understood pejoratively as someone who takes advantage of corporate information. Outside director because it evokes the idea of a director who has nothing to do with the corporation. Despite Tunc's remark, we keep for practical purposes the traditional dichotomy between inside and outside directors.

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[231] **B. Tricker**, "The Independent Director", in **Midgley**, *supra* note 23 at 27-28.

[232] **A. Tunc**, "Le Gouvernement des SA- Le Mouvement de Réforme aux Etats-Unis et au Royaume-Uni" (1994) R.I.D.C. 59 at 61:

> "D'où la distinction traditionnelle des *inside directors*, qui occupent une double situation, et des *outside directors*, qui se bornent à siéger au conseil. Cette terminologie est aujourd'hui abandonnée: "*inside directors*" évoquait fâcheusement les *insiders*: les initiés abusant de leur information, alors que les "*outsider directors*" paraissaient afficher qu'ils se désintéressaient de la société! On préfère donc aujourd'hui parler des *management directors* ou *executive directors*, et des *non-management* ou *non-executive directors*."

2. Independent Directors

What Does Independent Mean? According to Blair:

> "Although nearly all reformers agree that boards should include more outside directors. they disagree bout whether those directors should also be independent and whether they should also be independent and whether they should or should not represent specific consistencies."[233]

There are many different views and uncertainties with respect to the criteria of independence. The only certainty is that being independent is something more than being only an outsider. Roughly. the term independent director is defined as an outsider who has no other affiliation or link to the company. other than as shareholder and board member.[234] More precisely the criteria of independence ranges from the requirement of having no direct financial interest in. or not being "interested" in. a transaction or being a party to it. to a potentially broad injunction against any affiliation (including family) that in the opinion of the board or an objective bystander would interfere with the exercise of independent judgment. A director who does not meet this criterion will not be *stricto sensu* considered independent (See **Table 7**). To return to our previous example. if the corporation's lawyers or investment bankers are outsiders. their dealings with the corporation negate their independence. i.e. their capacity to make judgment free of any personal interest. Therefore. executives of banks that supply significant credit. lawyers. and others such as suppliers or union representatives can not be independent directors. We see later that the criteria employed to select independent directors are somewhat open to criticism[235].

B. Comparative Survey of the Terms Employed

In the four countries we study. different terms are used: "outside director". "independent director". "*administrateur indépendant*". "non-management director". "non-executive director". "non-employee director". "unrelated director". director free of any

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[233] **Blair**. *supra* note 5 at 81.
[234] *Ibid.* at 81.
[235] See below II.B.1.

THE "NON-INDEPENDENT" DIRECTOR
A director will not generally be considered independent if he or she: 1. is an executive or an employee of the corporation; 2. is an employee or owner of a firm that is one of the corporation's or its affiliate's paid advisers or consultants; 3. is employed by a significant customer or supplier; 4. has a personal services contract with the corporation or one of its affiliates; 5. is a relative of an executive of the corporation or one of its affiliates; 6. is part of an interlocking directorate in which the CEO or other executive officer of the corporation serves on the board of another corporation that employs the director; 7. is employed by a foundation or university that receives significant grants or endowments from the corporation or one of its affiliates.

Table 7

significant relationship with the corporation's senior executives, etc. Behind all of these terms is one identical concept: the concept of the directors' independence.

1. United States

In the United States, a clear dichotomy exists between inside and outside directors. However, the ALI Principles introduce other concepts such as the director "free of any significant relationship" with the corporation's senior executives. This terminology is also used by the SEC.[236] The American Law Institute defines what the test of non-significant relationship is.[237] The commentator explains the *rationale* behind this notion is. and that the test is objective.[238] According to the ALI commentator. a major shareholder or a creditor of the corporation are not in significant relationship with the executives of the corporation because they do not "inhibit the ability of a director to review objectively either management's performance or matters in which management has an interest."[239] This terminology introduces confusion: according to the Institute. there are inside and outside directors. and directors who are no in a "significant relationship" with the senior executives of the corporation. A directors who is in a "significant relationship" can be an insider (defined as above)[240] — an example is a director who is employed by the

[236] **ALI Principles.** *supra* note 10. 36 (comment of § 1.34): the commentator refers to SEC Reg. S-K. Item 404.

[237] **ALI Principles.** *supra* note 10 at § 1.34 (b):

> "A director shall not be deemed to have a significant relationship with the senior executives under § 1.34 (a)(3)-(5) if. on the basis of countervailling or other special circumstances. it could not reasonably be believed that the jugment of a person in the director's position would be affected by the relationship under § 1.34 (a)(3)-(5) in a manner adverse to the corporation."

[238] **ALI Principles.** *supra* note 10 at 36-38:

> "b. It has long been common to emphasize a distinction between "inside" and "outside" directors. without clarifying the precise meaning of those terms. Section 1.34 recognizes a further distinction. often critical. between directors who have a significant economic or professional relationship with the senior executives. and directors who do not. The only application of § 1.34 lie in provisions ... involving the composition of the board and overview committees of publicly held corporations [§ 1.31]. whose functions include reviewing the performance of the executives and matters in which the executives have an interest. Accordingly. the tests of § 1.34 are based on relationships that may be expected to inhibit the objectivity of such review. not simply on relationships with the corporation. So. for example. § 1.34 does not encompass major shareholders or creditors. as such. because neither owning shares nor extending credit in themselves inhibit a director's ability to review objectively either management's performance or matters which management has an interest. Indeed. individuals with shareholder or creditor relationships to the corporation have a special interest in such scrutiny.
>
> ...
>
> [§ 1.34 (b) puts in place] an objective test based on an evaluation of the manner in which the judgment of a reasonable person in the director's position would be affected. not a subjective test based on an evaluation of how the particular director would be affected."

[239] *Ibid.*

[240] See above I.A.1.

corporation.[241] A director who is not in a "significant relationship" is more than an outside director as defined above.[242] For example, a director who is affiliated "in a professional capacity with a law firm that was the primary legal adviser to the corporation with respect to general corporate or securities law matters"[243] could be assimilated to an outside director, but to be free of any significant relationship, he or she also must also "not reasonably be believed that the judgment of a person in the director's position would be affected by the relationship."[244] If a director who has no "significant relationship" with the corporation's executives is not an insider, and is more than an outsider, can he or she be assimilated to an independent director? Not really, but the reason behind this answer can only be demonstrated through an example. A director who is affiliated in a professional capacity with a law firm that was the primary legal adviser to the corporation with respect to general corporate or securities law matters can, according to § 1.34 (b) of the ALI Principles be free of any significant relationship with the senior executives if he or she passes the objective test of the reasonable man. Such a director is not *stricto sensu* an independent director, because he or she has an interest, at least indirect, in the corporation. We can not provide further analysis on this subject because of a space requirement, but the term "significant relationship" would certainly need further explanation. To conclude, the notion introduced by the ALI lies between the notion of outside and independent director.

2. The United Kingdom

The Cadbury Report. In the United Kingdom, the distinction lies between the executive director, and the non-executive director. The former has management responsibilities and is a full-time employee, while the later is not involved in day-to-day management and is not an employee. The Cadbury Report introduces another distinction among the non-executive directors. Pursuant to recommendation 2.1 of the Code of Best Practice:

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241 For example, see **ALI Principles**, *supra* note 10, at § 1.34 (a)(1).

242 See above I.A.1.

243 **ALI Principles**, *supra* note 10, at § 1.34 (a)(5) (see *supra* note 118).

244 *Ibid.* at 38 (comment of § 1.34).

"The majority of [non-executive directors] should be independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgment, apart from their fees and shareholdings."[245]

According to the Code, there are two categories of non-executive directors: those who are independent of management and "free from any business or other relationship", and those who are not. Some scholars who follow closely the corporate governance debate do not see that distinction.[246] The first category of independent directors corresponds to our definition of independent director, and is close to the notion of *administrateur indépendant* discussed below.[247] Regarding the second, it is difficult to clearly circumscribe it. Are they independent of management? Yes, because otherwise they would not be different from executive directors. Are they just less independent than the first type of non-executive directors, and are sometimes involved in day-to-day management? The Cadbury Report does not bring any answer to this question, and the difference between the two categories in terms of role is also not clear.[248]

The Declaration of the Institutional Shareholders' Committee. Even though the Cadbury Report is the leading corporate governance document in the United Kingdom, it is interesting to discuss also the recommendations made by the Institutional Shareholders' Committee (ISC).[249] The 1991 ISC declaration defines independence very strictly as being absolute freedom from any kind of bias, involvement or partiality.[250] The ISC regards advisers such as bankers and solicitors as unlikely to be adequate substitutes for the truly independent non-executive director. Also, there is a greater chance of ensuring the independence of each non executive director if:[251]

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[245] **Cadbury Report**, *supra* note 6, at Code of Best Practice 2.2. See also Chapter II B, and *supra* note 87.
[246] See e.g., **A. Tunc**, *supra* note 232 at 70:

> " Le Code [Code of Best Practice] consacre ensuite quatre articles aux *non-executive directors*. ... Ils doivent être indépendants du *management* et détachés de toute relation, familiale ou autre, qui gênerait leur indépendance de jugement."

[247] See below I.B.4.
[248] See below II.C.2.
[249] See *supra* note 42.
[250] **M. Draper**, *supra* note 46.
[251] **A. Tunc**, "Supprimer ou renforcer le conseil d'administration des sociétés anonymes" (1991) 5 R.D.A.I. 669 at 674-676.

1. He or she has not been employed by the company in recent years:

2. He or she is not a personal adviser to the company, either personally or by belonging to a firm which acts as an adviser to the company:

3. He or she is not a supplier or a client of any importance to the company.

Furthermore, non-executive directors should not normally be offered participation in share option schemes, performance-related or other incentivised remuneration or even pension schemes.[252] Finally, non-executive directors should hold other directorships in the same industry only with the approval of the board.[253]

3. Canada

The Unrelated Director. The Dey committee goes beyond the traditional dichotomy between inside and outside directors, and argues that every board of directors should have a majority of unrelated directors. The issue of the "unrelated director" is one of the most controversial in the TSE guidelines.[254] An unrelated director is not completely assimilated to an outside director:

> "The board of directors of every corporation should appoint a [nominating] committee of directors composed exclusively of outside, i.e. non management, directors, a majority of whom are unrelated directors. ...."[255]

The notion is defined by the Report as:

> "a director who is free from any interest and any business or other relationship which could, or could reasonably be perceived to, materially interfere with the director's ability to act with a view to the best interests of the corporation, other than interests and relationships arising from shareholding."[256]

The Report cites providers of legal or financial services to a company, or an officer of one of the company's lenders as examples of persons who generally would be regarded as related directors. In the 1995 *Canadian Directorship Practices - A New Era in Corporate Governance*, of the companies surveyed, 82 per cent conform with the unrelated director

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[252] **M. Draper**, *supra* note 46.
[253] *Ibid.*
[254] **Conner**, *supra* note 116 at 5.
[255] **Dey Report**, *supra* note 15 at Guideline 4.
[256] *Ibid.* at Guideline 2.

requirement of the Dey Report.[257] There is little difference between manufacturing and non-manufacturing companies; however, a greater percentage of large companies[258] conform than small or medium-sized companies.[259]

Differences Between Unrelated and Outside Directors. What are the differences between the notions of outside and unrelated director? The first is that a director who is an employee or representative of a firm that provides a service to the company, such as a banker, lawyer or accountant, is an outside director but may be considered related, according to the TSE definition. The concerns of the TSE committee regarding these related directors is the potential for a conflict of interest to arise from the connection that will inevitably exist between management and any company providing services to management. The second and more controversial difference deals with the relationship between a director and a significant shareholder. The TSE Committee defines a significant shareholder as "a shareholder with the ability to exercise a majority of the votes for the election of the board of directors."[260] This definition is controversial because often, effective control is exercised with less than 50% of the voting shares. A potential consequence of this definition is that many corporations which are effectively controlled by a particular shareholder, but in which this shareholder has less than 50% of the votes, will not follow the Guideline which prescribes that:

> "In addition to a majority of unrelated directors, the board should include a number of directors who do not have interests or relationships with either the corporation or the significant shareholder, and which fairly reflect the investment in the corporation by shareholders other than the significant shareholder."[261]

In the first draft of the guidelines, the qualification regarding the interests and relationships arising from shareholding was not included in the definition of a related director. Therefore, significant shareholders and other directors related to the significant shareholder were considered related directors. Some have argued that including directors with relations

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257 **Conner**, *supra* note 116 at 5-6.
258 See *supra* note 98.
259 See explanation of the difference between large companies and smaller ones in Chapter III I.A.
260 **Dey Report**, *supra* note 15 at Guideline 2.
261 *Ibid.*

to the significant shareholder would take away the fundamental right of the shareholder to make appointments to the board. While the rights of minority investors must be considered, it was pointed out that many investors seek out such companies because there is a key shareholder controlling the operations of the company. The definition of related director was amended in the final report to allow for proportional representation of significant shareholders. In such cases, which include subsidiaries and all companies where one shareholder has the "ability to exercise a majority of the votes for the election of the board of directors", the guidelines provide that the proportion of completely unrelated directors should approximate the percentage of shares held by minority of independent shareholders.[262] The amendment to the first draft and incorporated in the final report must be appraised. Minority shareholders must have their interests taken into account. But by nominating unrelated directors who represent proportionally minority shareholders, the Dey Report may have gone further than expected.

Differences Between Unrelated and Independent Directors. At first, one might have thought that the notion of unrelated director could be assimilated to the notion of independent director. The unrelated director is:

> "free from any interest and any business or other relationship which could ... materially interfere with the director's ability to act with a view to the best interests of the corporation, other than interests and relationships arising from shareholding."[263]

Isn't it what an independent director is? The problem lies with the fact that one of the role of an unrelated director envisioned by the Dey Committee is the protection of minority shareholders against a significant shareholder. A director who in his or her judgment favors one group of shareholders can not be said to be independent. Such an unrelated director is in fact related to minority shareholders. The notion of unrelated director introduced by Dey tends therefore towards a more dependent board in general.[264] More precisely, according to the Reports, unrelated directors should be present within board's

[262] **Dey Report**, *supra* note 15 at Guideline 3.
[263] *Ibid.* at Guideline 2.
[264] See Chapter VII II.

committees.[265] The Dey Report is on that point very different from the Viénot Report.[266] It fails to fully introduce the concept of the independent director.

4. France

"Administrateur Indépendant". The Viénot Report defines the "*administrateur indépendant*" (independent director) as a director who has no direct or indirect relationship with the corporation (or any corporations in the case of a group), and who therefore can be said to be participating objectively to the board's work.[267] The Report then lists who cannot be an independent director. According to the Viénot committee, the Président Directeur Général (PDG)[268] as well as important shareholders, or people in relationship with a commercial or financial partners of the corporation, cannot be independent directors.[269] The list given by the Report is very broad. This can be related to the fact that the Viénot Committee as a restricted vision of what an independent director should be. As opposed to the Dey Report which allows unrelated directors to represent the interests of minority shareholders and does not develop the concept of independent director,[270] the Viénot Committee foresees conflicts of interests between the represented parties on the board. The Committee would rather see all the shareholders represented equally by independent directors (*administrateurs indépendants*) strictly speaking.[271]

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[265] **Dey Report**, *supra* note 15 at Guideline 4 and 9.

[266] See below I.B.4.

[267] **Viénot Report**, *supra* note 1 at II. 2:

> "L'administrateur indépendant peut, en effet, en s'inspirant des standards anglo-saxons, être défini comme une personne qui est dénuée de tout lien direct ou indirect avec la société ou les sociétés de son groupe et qui peut ainsi être réputée participer en toute objectivité aux travaux du conseil."

[268] See *supra* note 49.

[269] **Viénot Report**, *supra* note 1 at II.3:

> "[L'administrateur indépendant] doit ainsi n'être ni salarié, ni président du ou directeur général de la société ou d'une société de son groupe ni ne l'être plus depuis une période suffisante qui est d'au moins trois ans; n'être pas un actionnaire important de la société ou d'une société de son groupe ni être lié de quelque manière que ce soit à un partenaire significatif et habituel, commercial ou financier, de la société ou des sociétés de son groupe."

[270] See above II.B.3.

[271] **Viénot Report**, *supra* note 1 at II.3:

C. Conclusion: Terminology Used

There are a lot of confusion regarding the definition and the scope of the concepts introduced at the beginning of Section B. An outside director is not automatically independent. a director free of "significant relationship" with the senior executives of a corporation lies between the notion of outside and independent director. and similarly an unrelated director is more than an outside director but less than an independent director. In fact. it seems that the Cadbury Report and the Viénot Report are the closest to the conception of what. in our point of view. a independent director should be. For the Viénot Report. it certainly has to do with the fact that the members of the Viénot Committee have had the time to carefully analyze the notions introduced by the other Reports. so that they could give the notion of independence its full meaning.[272] Another reason is that notion of *administrateur indépendant* is inspired by the Cadbury Report.[273]

In our study. we use the term "outsiders" to include both outside directors and independent directors. while the term "outside directors" is limited to those who are not also officers. managers. or employees of the enterprise. We use independent director to include only outside directors who have no direct or indirect relationship with the corporation (neither a substantial stock interest in the corporation nor material business dealings with the corporation).

> "Faut-il. comme le suggèrent certains. multiplier au sein du conseil les représentants de telle ou telle catégorie d'intérêts spécifiques?
> Le Comité considère qu'il n'est pas souhaitable d'aller dans cette voie parceque le conseil risqueraient d'être le champ clos d'affrontements d'intérêts particuliers au lieu de représenter collectivement l'ensemble des actionnaires et parceque la présence d'administrateur indépendants est un gage suffisant de ce que tous les intérêts susceptibles d'être pris en compte l'auront été."

272 The Viénot Report was released after the ALI Principles. the Cadbury and the Dey Reports. See Chapter II at II.

273 **Viénot Report**. *supra* note 1 at II 2:

> "L'administrateur indépendant peut. en effet. en s'inspirant des standards anglo-saxons. être défini comme ...."

II. THE OUTSIDE/INDEPENDENT DIRECTOR

A. Insiders Versus Outsiders

1. Issue and Facts

The Issue. The main issue is whether or not the board should be dominated by members who are not managers. On one hand, not letting managers participate in board's meetings could lead to a lack of expertise in determining the best interests' of the corporation regarding its specific business environment, and making adequate decisions. On the other hand, reducing or eliminating managers' representation permits the board not only to better assess and exercise effective control over the internal functioning of the company, but also to make decisions that are not determined by the managers' own interests in the company's assets.

Facts. Over 90 per cent of US boards have a majority of outside directors, almost 80 per cent of Canadian directors are outside directors, and UK boards are comprised of an average of 30 per cent of non-executive directors.[274] In France where the notion of *administrateur indépendant* is new, there has not yet been a major study which clearly describe the number or ratio of independent directors on French boards. In any case, the increasing presence of outside/independent directors on the boards of corporations of the four jurisdictions studied leads to the questioning of the pros and cons of outside/ independent directors as opposed to inside directors.

2. Pros and Cons of Inside and Outside Directors

Insiders and outsiders each bring valuable though varied contributions to the board. Because their contributions are different they cannot be measured by the same criteria.

a) Insiders

Pros.[275] While the concept of the outside board is generally accepted, there are many excellent companies which have a majority of insiders on their board. Their proponents point out that having a majority of outsiders does not necessarily assure a good

[274] See below II.B.2.
[275] **Worthy and Neuschel**, *supra* note 119 at 36.

board.[276] They believe that the advantage of having experienced company executives making board decisions is more important than having a majority of outsiders on the board who usually have limited knowledge of the company's business. The insider can perform valuable functions.[277] He is often criticized because he typically does not argue with his chief executive officer at the board meeting. One may hope they have had any arguments before the board meeting, and as result have shaped what is to be presented in the board room. The insider's role is not to disagree and argue with the chief executive officer at a board meeting. However, the insider can, when necessary, offer a different point of view. He can be "his own management" without demonstrating an overt willingness to "take on" his boss at a board meeting. Major, open disagreements among members of management before their assembled directors is hardly desirable. In summary, effective insiders complement, strengthen, and supplement outsiders. And of course the reverse can, and should, be true. **Table 8** sums up the inside director's functions.

Cons. For some CEOs interviewed by The Conference Board in 1993, the disadvantages of having inside directors outweigh the advantages. While company executives are knowledgeable about what is going on in the company, a number of CEOs interviewed point out that the board gets the benefit of insider knowledge through presentations made by executives at board meetings. Moreover, although a board seat is status symbol, a sign that an executive has "arrived", and therefore a way of rewarding successful performance, it is difficult at best for an executive director to take issue with the CEO at a board meeting or to bring an objective point of view to discussions of company affairs.

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[276] **Anderson & Anthony**, *supra* note 203 at 88.
[277] See below C, and Table 10.

INSIDE DIRECTOR'S FUNCTIONS

1. **Providing additional windows on the company to ensure that outside directors are getting a balanced understanding of the company and its performance;**
2. **Increasing the board's credibility with inside management; for example, an all-outside board could have great difficulty establishing rapport with the internal managers of the company;**
3. **Adding their informed judgments on important strategic issues or policy matters;**
4. **Providing key members of senior management with a trial experience and exposure for possible succession (merely attending board meetings as a guest is much less effective as a test).**

Table 8

b) Outsiders

Pros. For his part, the outsider can bring fresh ideas and an independence of thinking to board deliberations. He can challenge management and ask the hard questions, whether out of unfamiliarity or because he is not beholden to the CEO. He can often bring skills and experience that complement and provide a counseling service to senior management. And of course, there are pressures from government, the public, academia, and others for more outsiders on boards. While many chairmen maintain they would seek an independent outside board of their own choice, the fact remains that public demands and expectations have been a key impetus behind the growing presence of outsiders on boards. Recognizing the inevitability of more outside directors, many chairmen/CEO have taken the initiative to get the maximum good from them.

The grounds that are typically given for the use of outside directors are enumerated in **Table 9**. We describe later in greater details these functions.[278] It is clear that an independent director *stricto sensu* — non-executive director "free from any business or other relationship which could materially interfere with the exercise of their independent judgment" in the UK or a French *administrateur indépendant* — [279] is likely to better exercise some of the functions described below than a mere outside director.

OUTSIDE DIRECTOR'S FUNCTIONS
To give access to relevant external information;
1. To provide an independent appraisal and check on management;
2. To strengthen the board;
3. To give new perspectives on the company direction;
4. To provide status.

Table 9

Cons. While the outside director is widely accepted as the wave of the future, there is, in many corporations, lingering resistance. There is still genuine concern by many that an outsider has trouble understanding operations of exceptional complexity.[280] Also, outsiders are often said to lack the inside knowledge of the company of the inside directors.[281]

c) Conclusion

There are both pros and cons to the presence of inside and outside/independent directors on the board. To the lack of independence of inside directors echoes the lack of

[278] See below C.
[279] See above I.B.2 & 4.
[280] **Worthy and Neuschel**, *supra* note 119 at 34.
[281] See e.g., **Cadbury Report**, *supra* note 6 at 4.14.

knowledge of the corporation for outside directors. These can both be reduced by selecting independent directors through a careful selection program.[282] If there are to be inside directors on the board, there must remain a balance between them and outsiders.

2. The Importance of Balance Between Inside and Outside Directors

Increasingly, corporate leaders are recognizing the importance of achieving balance on their boards. This calls for an effective combination of directors with varying backgrounds and skills, and an appropriate mix of insiders and outsiders. One thing is clear: the inside versus outside director issue cannot be reduced to simple numbers. No single balancing formula can apply to all boards: balance must be tailored to the unique needs of the individual corporation. The requirements may vary by industry, by the particular history of any company and its level of sophistication, by the role the board plays in the affairs of the corporation, and by numerous other factors.[283] Ultimately, the answer should be sought on a corporation-by-corporation basis. The problem is that the law needs to set layouts. There is general (though not total) agreement that the board should have a majority of outside board members; both the facts and the recommendations of the different reports studied tend to follow the same idea.[284] Even strong advocates of an insider board generally agree that there should be at least a core of outside directors present.

B. Selection and Number of Independent Directors on the Board

1. Criteria of Selection and Orientation Program

a) Two fundamental criteria

The main question is whether independent directors should be selected using the same criteria used for choosing inside directors.[285] Much like the inside director, the independent director may be chosen in accordance to criteria such as availability in terms of time, background, knowledge in particular fields, age, willingness to learn. However,

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[282] See below II.B.1.
[283] **Worthy and Neuschel**, *supra* note 119 at 32.
[284] See below II.B.2.
[285] See Chapter III , II. A.1.c)i).

two elements are predominant: freedom from conflicts of interest, and independence of judgment. If the former is easily understandable, the latter is harder to approach because of its subjectivity.

b) The Independence of Judgment

The independence of judgment is not a quality that can be acquired, but a state of mind. It is inconceivable that a director could have an independent judgment one day and not the next. Furthermore, it is impossible to determine if one candidate will be able to have an independent judgment on the different matters discussed at board's meetings. Two reasons can be advanced: first, the subjects discussed at board's meetings are so various that one cannot predict that a potential candidate will be able to bring an independent point of view on all the different matters. Secondly, no selection process can assure that a candidate will remain impartial. Of course, the solution is not to have a *test the vérité*, but rather that directors be trusted in their choice to accept the independent directorship. This calls for an orientation program where potential candidates can receive sufficient information on the corporation that is offering them a directorship.

Orientation Program. The call for an orientation program is not new. It has been proposed in 1976 by Leech and Mundheim.[286] An orientation program would enable selected candidates to receive an intimate knowledge of the corporation, to balance the pros and cons of the offered directorship, and therefore to decide whether to accept or not the position. The difficulty lies in the selection of the information given to the candidates. This information must be detailed but at the same time the company should not easily give away strategic material. Leech and Mundheim suggested that candidates be allowed to:[287]

- Acquire information about the board of directors: the organization of the board, the expected duties of board members, the established procedures for carrying our board responsibilities;

- Acquire and review information regarding key operating management: biographies (resumes), compensation including recent history incentives, how earned and how paid, summary of terms of employment contract;

[286] **Leech & Mundheim** (1976).
[287] *Ibid.* at 1812-1813.

- Acquire and review information on company structure and history:

- Acquire and review reports and manuals describing the business and its problems. facilities information (take a tour if possible):

- Acquire and review documents relating to financial status:

- Visit with top management. with outside independent auditor alone. with outside counsel alone to get a feel for the major legal problems facing the company.

More recently. the Viénot Report. in its *Charte de l'Administrateur*. states that each director of a publicly traded corporation must consider that he/she is obliged. before accepting the directorship. to make sure to have a full knowledge of his/her general and special obligations. The potential director must review corporate legal texts. the statutes of the corporation. and the rule of the functioning of any specific structure set by the board.[288] The Dey Report also recommends that every corporation should provide an orientation and education program for new recruits to the board.[289]

2. Number of Independent Directors on the Board

Independent directors have been present on US. UK. Canadian and even French boards before the publication of the reports studied.[290] The ALI Principles. the Cadbury and Dey Reports have confirmed this ongoing custom. and have tried to specify not only the proportion of independent directors on the board but also their functions.[291] In the case of France. the Viénot Report is the first "official" document that acknowledges the necessity to have independent directors on the board.

a) Before the Reports

United States. Most US boards in the companies surveyed by The Conference Board in 1993 have a majority of outside directors: 94 per cent of manufacturers: 94 per cent of financial companies: and 93 per cent of non-financial service companies. The largest companies (except for financial firms) have the highest proportion of outside

[288] **Viénot Report.** *supra* note 1. at III.4 (see *supra* note 170).
[289] **Dey Report.** *supra* note 15 at Guideline 6.
[290] See above I.A.2.
[291] For the role of independent directors. see below III.

directors. Also, more than 60 per cent of all companies have only one inside board member (the CEO, according to 28 per cent of respondents) or only two insiders (34 per cent).[292]

US law does not contain any provision for the composition of the board: however, independent directors are present in important numbers.[293] One of the reason behind the popularity of independent directors is that some of the most prestigious US stock exchanges have required their present on the board of publicly traded companies. For example, the New York Stock Exchange as well as the NASDAQ require that listed companies have a minimum of two directors independent of management.[294]

The United Kingdom. A 1992 study of the structure and characteristics of the board of 132 UK companies showed that the average company board comprised 7.58 directors of which 2.79 were non-executive directors — the average ratio of non-executive directors to total directors was 36.2 per cent.[295]

Canada. The Canadian Business Corporation Act (CBCA) does not mention the independent director in the CBCA. However, at the end of 1994, at the time when the Dey Report was released, the vast majority of directors (79 per cent) were outside directors.[296] The study also revealed that the number and percentage of outside directors increases with the size of the corporation. The number of outside directors varied, on average, from 6 for small firms to 12 for large firms. The survey also pointed out the fact that Canadian-owned companies averaged 10 outside directors, while foreign-owned companies averaged only 6 outside directors on their boards.

France. There is no reference to the concept of independent director in any legal text. However, it is highly probable that some French companies had independent directors on their boards.

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[292] **Bacon**, *supra* note 54 at 10.
[293] See *supra* **I.A.2**.
[294] See *supra* note 78.
[295] **Peel & O'Donnell**, *supra* note 173 at 208-209.
[296] **Carlyle**, *supra* note 174 at 3.

Conclusion. Before the publication of the Reports, outside/independent directors were present on US, UK, and Canadian boards of directors. In France, the lack of data makes it difficult to ascertain the existence of independent directors.

b) The Reports' Recommendations[297]

The American Law Institute's Recommendation. The ALI recommends that a board must be composed of at least three outside directors, and of a majority of directors "free of any significant relationship" with the corporation's senior executives when the corporation is publicly held.[298]

The Cadbury Report. The *Code of Best Practice* is in favor of a "sufficient caliber and number" of non-executive directors.[299] This sentence is open to interpretation; it seems fair to say that non-executive directors would be in a "sufficient number" if they constitute the majority of the board. The Cadbury committee also emphasizes on the importance of non-executive directors in a large section of the Report.[300] It makes the distinction between non-executive directors that are independent of the company (independent directors) and those who are not.[301] According to the Cadbury committee, the majority of non-executives directors should also be independent directors.[302] Even if we combine this proposition with the fact that non-executive directors should be in a "sufficient number", it is difficult to say what should be the proportion of independent directors within the board. One of the only certainties is that a board constituted with a majority of independent directors would be in accordance with the Report.

The Dey Report. The TSE Committee believes that the board of directors of every corporation should be constituted with a majority of individuals who qualify as "unrelated" directors. The TSE Committee defines an unrelated director as:

> "a director who is free from any interest and any business or other relationship which could, or could reasonably be perceived to, materially interfere with the director's ability to act with a view to the best interests of

297 See below **Table 10**.
298 **ALI Principles**, *supra* note 10 at §3A.1. See Chapter Definitions, II.A.
299 **Code of Best Practice** (1994, 1.3).
300 **Cadbury Report**, *supra* note 6 at 4.10- 4.17.
301 **Cadbury Report**, *supra* note 6 at 4.12.
302 **Cadbury Report**, *supra* note 6 at 4.12.

the corporation, other than interests and relationships arising from shareholding."[303]

In the 1994 draft of the Dey Report, the TSE Committee had recommended that a majority of directors be independent both of management and any party, such as a dominant shareholder, which is in a position to exert influence upon management. This Guideline was controversial: it had the effect of eliminating the ability of significant shareholders ("shareholder[s] with the ability to exercise a majority of the votes for the election of the board of directors"[304]), to control the boards of their investees. It was excluded in the final version of the Report.

THE PRESENCE OF INDEPENDENT DIRECTORS ON THE BOARD

ALI Principles (§3A.01)	**A majority of the board of directors of every large publicly held corporation should be directors "free of any significant relationship" with the corporation's senior executives, and that the boards of other public corporations include at least three outside directors.**
Cadbury Report (Code 1.3)	**"The board should include non-executive directors of sufficient caliber and number for their views to carry significant weight in the board's decisions."**
Dey Report (Guideline 2)	**The board of directors of every corporation should be constituted with a majority of individuals who qualify as "unrelated" directors**
Viénot Report (II. 2)	**The boards of all listed companies should have at least two independent directors.**

Table 10

303 Dey Report, *supra* note 15 at Guideline 2.
304 *Ibid.*

Where a corporation has a "significant shareholder", the Guidelines recommend that:

> "in addition to a majority of unrelated directors, the board should include a number of directors who do not have interests or relationships with either the corporation or the significant shareholder, and which fairly reflect the investment in the corporation by shareholders other than the significant shareholder."[305]

The final Report, as opposed to the draft report, does not automatically consider a director who has a relationship with a significant shareholder as related.

The Viénot Report. The Committee chaired by Marc Viénot is in favor of the presence of independent directors among the board, partly because the institutionalization of the independent director will respond to the Stock Market's expectations. It recommends that the boards of all listed companies should have at least two independent directors.[306] We discuss in Chapter VIII whether this number is sufficient to make the board independent.

c) What has Occurred since the Publication of these Reports, and What can Still be Expected?

Globally, the report recommendations concerning independent directors have been closely followed by the companies. For example in Canada, two recent studies have demonstrated that the vast majority of Canadian boards are now composed primarily of outside directors.[307] In France, the Cegos report on French corporate governance has shown similar results.[308] One of the factors that has permitted better implementation of independent directors is that the Reports' recommendations have been endorsed by the stock exchanges.[309] These market regulators have required the companies to explain the

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305 *Ibid.*

306 **Viénot Report**, *supra* note 1 at II. 2.

307 The first study has been conducted by KPMG which surveyed the corporate governance disclosures of TSE 300 companies in their 1995 annual reports and information circulars. The second study has been conducted by Spencer Stuart, a leader in board director recruiting, which mailed a questionnaire to CEOs and corporate governance secretaries of 150 leading Canadian companies representing diverse segments within Canadian business community, and collected data from information/proxy circulars on 100 major Canadian companies. According to the Spencer Stuart survey, 75 per cent of Canadian board directors are "unrelated" as defined in the Dey Report, while this figure rises to 85 for the KPMG survey.

308 See Chapter VII at II.C.

309 See Chapter II at III.

reason for their non-compliance with the guidelines. Also, institutional investors have continued there quest for better corporate governance.

But the next step is yet to be made: the incorporation of the Reports' recommendations into binding legal texts. On this point, France seems to have done first a step in that direction with Senator Marini's recommendations.[310]

C. The Duties of the Independent Director

Because they cannot be expected to concern themselves with the day-to-day problems of the corporation, independent directors have a special contribution to make to the debate about long-term issues. Because they are informed and involved but at the same time detached and dispassionate, they can contribute valuably in different views to boardroom discussions. Not being dependent on the corporation for their livelihoods, independent directors can sometimes have a greater freedom of expression of view and of action.

1. The Older View of the Duties of Independent Directors[311]

Until about twenty five years ago, the perceived role of the independent director did not differ much, except in the intensity of time spent on the task, from that of the inside director. Independent directors were though to have special values — a window to the outside world, a fresh viewpoint, special expertise or experience as would be the case, for example, with an investment banker or a lawyer — but they were not generally expected to devote much time to the position, and this was most often reflected in their pay.

The role of the independent director was not that of a detailed monitor of management. It was not be generally believed that an independent director should adopt an arm's length attitude in reviewing management and its recommendations to the board of directors. Morgan Shipman gives two main reasons to explain this: not only it is difficult to deal at arm's length on complicated technical, marketing, and financial matters without the expenditure of considerable time and study, but more importantly were perceptions that

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[310] See in Chapter VIII Senator Marini's proposed amendments to the 1966 Company Law.
[311] Morgan, "The Role of the Outside Director Distinguished from the Inside Director", *supra* note 151.

there were common goals and responsibilities, that solidarity on the board was crucial, that arm's length discussion, debate, and that probing are inimical to solidarity.

2. The Present Duties of the Independent Director

We saw earlier the grounds that are typically given for the use of independent directors.[312] The only report that clearly defines what the duties of the independent director should be is the Cadbury Report.[313] The first is reviewing the performance of the board and of executives: the second is taking the lead where potential conflicts of interest arise. While the latter is straightforward, the former duty needs further explanations. The justification for relying on independent directors as a monitoring mechanism is easily understandable: because such directors are "independent" they can act as shareholder surrogates to assure that the company is run in the long-term best interests of its owners. This analysis has not provided an analytically satisfying answer to the question of who will monitor the monitors. Two inadequate answers have been given: the managerialist explanation for why outside directors can be trusted to monitor effectively rests on noblesse oblige. Some academic economists have proposed quite a different reason for trusting outside directors to monitor management faithfully: the market will punish them if they fail.[314] Neither of these explanations for why independent directors would discharge their functions effectively is very persuasive. Good character and financial independence from management may be necessary conditions for effective monitoring, but they are hardly sufficient. First, even financially independent directors depend on management for their tenure as directors. Second, most independent directors share management's ideological disposition toward the single issue most central to their monitoring responsibilities: how intensely independent directors should monitor management. Third, independent directors are not socially independent. As Victor Brudney stated:

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[312] See **Table 9**.

[313] **Cadbury Report**, *supra* note 6 at 4.4 to 4.6.

[314] See e.g., **E. Farma**, *Agency Problems and the Theory of the Firm*, 88 J. Pol. Econ. 288 at 294:

> "In a state of advanced evolution of the external markets that buttress the corporate firm, the outside directors are in the turn disciplined by the market for their services which prices them according to their performance as referees."

"No definition of independence yet offered precludes an independent director from being a social friend of, or a member of the same clubs, associations, or charitable efforts as the persons whose performance he is asked to assess."[315]

CONCLUSION

There is a lot of terminological confusion among the participants of the corporate governance debate. Even if they sound alike, the terms outside directors, independent directors, unrelated directors, and directors who are "free of any significant relationship" with the corporation's senior executives do not encompass the same notions. The most common confusion lies between the terms outside and independent directors. An outside director is not always independent. In the four jurisdictions studied, only the United Kingdom and France have envisioned the presence of strictly independent directors among boards of directors.

The presence of outside/independent directors on boards of directors is increasing. The question that naturally arises is to what extent should they be on the board. In Canada, 79 per cent of the directors are outside directors.[316] In the United States, 60 per cent of the boards

We can not close this chapter without approaching an important paradox in the definition of independent director. To be a director, one needs to hold stock of the company. How can a director be "independent" and have a totally objective judgment when he or she has a financial interest in the corporation? It is clear that holding stock of a company does not make you an insider. But holding stocks, stock options or any other indirect financial interest in a corporation makes a director an interested party, an insider in the pejorative sense. The Viénot Report states that the important shareholders can not be independent directors.[317] This is not enough. We strongly believe that this

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[315] **V. Brudney**, "The Independent Director — Heavenly City or Potemkin Village?" (1982) 95 Harv. L. Rev. 597, 613.
[316] **Carlyle**, *supra* note 174 at 3.
[317] **Viénot Report**, *supra* note 1 at II.3 (see *supra* note 252 for the text of the recommendation).

recommendation should be extended to any shareholders. We discuss this issue in **Chapter VIII**.

CHAPTER V: SPECIALISED COMMITTEES

INTRODUCTION

Another proposed reform to increase the independence of the board is the establishment of committees within the board which perform specific functions. It is believed that this process shifts power in these areas away from the CEO and management toward the committee members, and enhances the oversight function of the board.[318] Committee members are most of the time chosen so that they are independent from management. For that reason, specialized committees are seen as a mean to increase the independence of the board's judgment. In this chapter, we first describe what the general structure of a board committee is, and how members of a committee are compensated (**I**). Then, we review the functioning of each of the committees , with a greater attention given to two of the three most discussed committees in the Reports, the audit and the compensation committees (**II**).[319]

I. GENERAL COMMENTS

A. Committee Structure

The structure of board committees is almost identical in the four countries studied study (see **Table 11**). Typically, a committee is composed of a small number of people, who are in majority or solely independent directors. Most of the time, there is also a committee chairman who is almost always an independent director. Board committees may also include individuals who are not *stricto sensu*

[318] **Blair**, *supra* note 5 at 82.
[319] The last of the three major committes, the nominating committee, has been analysed in Chapter III.

STRUCTURE OF BOARD COMMITTEES	
ALI Principles (§3A.02, §3A.04 and §3A.05)	The ALI Principles recommend that the audit committee in small publicly held corporations (§3A.02), and that the nominating (§3A.04) and compensation committees (§3A.05) of large publicly held corporations be composed exclusively of directors who are neither employed by the corporation nor were so employed by the corporation within the two preceding years, including at least a majority of members who have no "significant relationship" with the corporation's senior executives.
Cadbury Report (4.30, 4.35, 4.42)	The nomination committee should have a majority of non-executive directors on it and be chaired either by the chairman or a non-executive director (4.30). Membership of the audit committee should be confined to the non-executive directors of the company, and a majority of them should be independent (4.35). The remuneration committee should consist wholly or mainly of non-executive directors (4.42).
Dey Report (Guideline 9)	With the exception of the executive, audit and nominating committees, the TSE guidelines do not advocate a particular set of committees. However, in the interest of maintaining independence, the guidelines recommend that committees should generally be composed of outside directors, with a majority being unrelated directors. The exception is in the case of an executive or similar committee where one or more inside directors may be necessary.
Viénot Report (III.3)	The Viénot Report recommends that each board sets up at least a nominating, a compensation, and an audit committee. The audit committee must be composed of at least three directors who are not executives or employees of the firm, of whom at least one must be independent.

Table 11

members of the committees. These individuals, such as external auditors or legal consultants provide special expertise. For instance, the Cadbury Report states that:

> "Membership of an audit committee is a demanding task requiring commitment, training and skill. The directors concerned need to have sufficient understanding of the issues to be dealt

with by the committee to take an active part in its proceedings. This is why the committee should. .... be able to invite outsiders with relevant experience to attend meetings."[320]

B. Compensation for Service on Board Committees

Directors who belong to specialized committees are compensated for committee service. Inside and outside/independent directors are differently compensated. While the former are rarely compensated for committee service. the latter are often compensated. As an example. we discuss the compensation for committee service of Canadian directors. The 1995 *Canadian Directorship Practices* reveals that 84 per cent of responding companies compensate their outside directors for committee service in addition to any compensation made for regular board service. while only 6 per cent of inside directors were compensated.[321] While per-meeting compensation varied from $2.364 to $5.105 for outside directors (respectively for the ethics committee and the executive committee). the most common payment for inside directors was a per-meeting fee of $500.[322]

C. Observations

Three observations can be made of the use and operation of board committees.[323] First. is the issue of the rotation of committee members and chairmen. On the one hand. there should be enough rotation so that no director will become uncomfortable about being shifted. On the other hand. playing musical chairs every year or two probably serves no useful function. Second. is the recognition that committees emanate from the board: they are not independent of it. The function of board committees is to facilitate the work of the full board. The different specialized committees collect data. identify and define problems. and develop recommendations for consideration by the full board. However. sometimes the full board may empower them to decide and carry out specific tasks. Finally. although the full board can delegate certain functions to its committees. this delegation does not relieve individual board members of their ultimate responsibility.[324]

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[320] Cadbury Report. *supra* note 6 at 4.37.
[321] Carlyle. *supra* note 174 at 12-15.
[322] *Ibid.* .
[323] Worthy and Neuschel. *supra* note 119 at 56.
[324] In the United States for example. the Federal Court. in its 1967 BarChris case. emphasised that:

II. THE DIFFERENT TYPES OF COMMITTEES AND THEIR EFFECT ON CORPORATE GOVERNANCE

Of the many kinds of board committees that have been established (see **Chart 1** for Canadian Committees). three stand out as being especially important from the perspective of corporate governance issues: the nominating. audit. and compensation committees. Most companies have these three committees. These three types of committees are the most discussed in the Reports. are believed to be essential for each company. listed or non-listed.

A. Audit Committee

The audit committee is an emanation of the board which deals specifically with financial reporting and controls. Auditing has become more and more complex. and companies need the help of auditing firms with appropriate experience.

1. The United States

Before the ALI Principles. The audit committee is the most commonly found committee. In 1972. only 45 per cent of the companies responding to a survey conducted by The Conference Board had an audit committee. In 1983. that figure reached 97 per cent. where it has remained since.[325] The fact that almost all publicly traded companies have an audit committee is partly due to the fact that since 1978. the New York Stock Exchange has required such committees and with a majority of outside directors for listed

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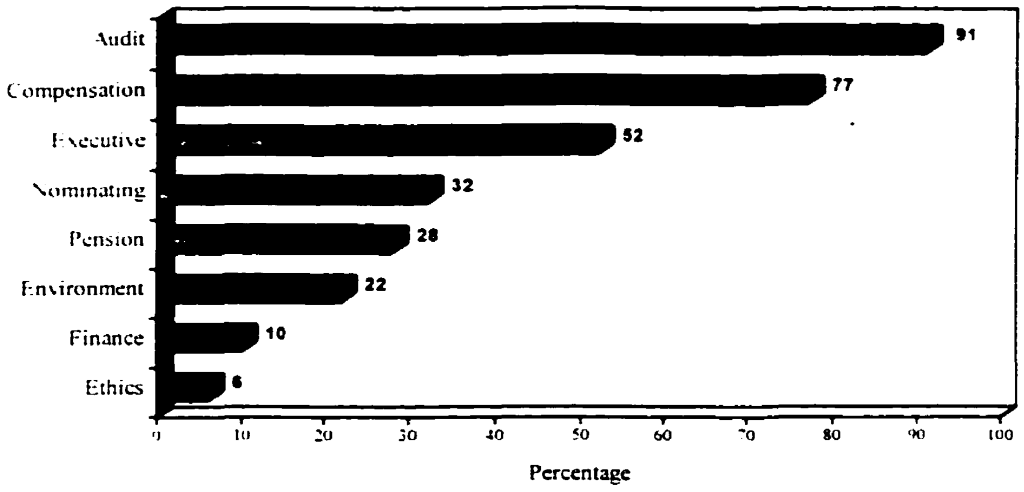
"Section 11 [of the Securities act of 1933] imposes liability in the first instance upon a director. no matter how new he is.... He is presumed to know his responsibility when he became a director. He can escape liability only by using that reasonable care to investigate the facts which a prudent man would employ in the management of his own property."

[325] Bacon. *supra* note 54 at 13.

PREVALENCE OF CANADIAN COMMITTEES BY TYPES[326]



Source: The Conference Board of Canada

Chart 1

companies.[327] The principal responsibilities of the audit committee are the following:[328]

- To ensure that the published financial statements are not misleading;
- To ensure that internal controls are adequate;
- To follow up on allegations of material, financial, ethical and legal irregularities; and
- To recommend the selection of the external auditor.

These responsibilities are quite similar in the other jurisdictions, and for that reason, we do not come back to them. To conduct audits, the audit committee relies on two audit groups: one internal, and the other external. The first entity is the firm's internal audit staff, composed of employees who report to a senior officer, often the

[326] **Carlyle**, *supra* note 174 at 13.
[327] **Blair**, *supra*, note 5 at 82.
[328] **Anderson & Anthony**, *supra* note 203 at 141.

CEO or chief financial officer. The other is the outside auditor, who is a certified public accountant that all listed corporation are required to engage and that most other corporations do engage in order to satisfy the requirements of banks and other lenders.[329]

The ALI Principles. The ALI recommends that every large publicly held corporation should have an audit committee consisting of at least three members, and composed exclusively of directors who are neither employed by the corporation nor were so employed by the corporation within the two preceding years, including at least a majority of members who have no "significant relationship" with the corporation's senior executives.[330]

2. Canada

Before the Dey Report. Pursuant to Section 171 (1) of the Canadian Business Corporations Act (CBCA), a corporation whose shares are publicly traded:[331]

> "must have an audit committee composed not less than three directors of the corporation, a majority of whom are not officers or employees of the corporation or any of its affiliates."

Section 171 (1) of the CBCA also states that any other corporation may have such committee.

The Dey Report. The Dey Report states that while it is management's responsibility to design and implement an effective system of internal control, it is the audit committee's responsibility to ensure that management has done so.[332] While Guideline 9 recommends that "committees should generally be composed of outside directors", Guideline 13 recommends that audit committees be composed only of outside directors.[333] This is the real novelty of the Dey Report s opposed to the CBCA. A survey realized in 1995 after the released of the Dey Report indicated that 91 per cent of

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[329] **Anderson & Anthony**, *supra* note 203 at 141-142.
[330] **ALI Principles**, *supra* note 13 at § 3A.05.
[331] More precisely, a corporation "any of the issued securities of which are or were part of a distribution to the public and remain outstanding and are held by more than one person." (CBCA Section 102 (2))
[332] **Dey Report**, *supra* note 15 at Guideline 13.
[333] *Ibid.*

responding companies had an audit committee.[334] Of those 91 per cent. 96 per cent had a majority of outside directors on the committee. and 75 per cent indicated that their audit committee consisted exclusively of outside directors. The survey also noted that the percentage of large firms having an audit committee was greater than small and medium-sized firms. The survey does not include a commentary for this aspect because it is obvious: auditing the operations of a large and diversified company is a complex. and therefore the need for a specialized body dealing with it is greater. The audit committee is therefore not only considered the most prevalent committee in Canadian companies[335] but is also the most independent one. and should be even more independent if the Dey Report is followed by more Canadian companies.

3. France

Before the Viénot Report. Articles 90 al. 2 of the 1967 *Décret* allows the *conseil d'administration* to create an audit committee. and to determine its composition. its functions. and the compensation of its members.[336] The committee remains under the board's responsibility and only has consultative powers.[337] Before the Viénot Report. only a few *Sociétés Anonymes*[338] — 16 per cent — has established and audit committee.[339]

The Viénot Report. The Viénot Report recommends that all board establishes an audit committee (*comité des comptes* or *comité d'audit*) with the function of overseeing the stability and the effectiveness of the auditing methods. and the quality of financial information.[340] The audit committee should also examine if any important operations have

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334 **Conner**. *supra* note 116 at 8.
335 See **Chart I** *supra*.
336 See above Chapter III II.A.1.b)..
337 1967 Décret at Article 90 al.2.
338 See *supra* note 158.
339 **Vuchot-Ward-Howell**. *supra* note 135. Of the respondents. 16 % indicated that their company had established a *comité d'audit*. 74 % indicated that they had not. and 10 % did not answer.
340 Viénot **Report**. *supra* note 1 at III.3:

> "Aussi le Comité recommende-t-il que chaque conseil se dote d'un comité ayant pour tâche essentielle de s'assurer de la pertinence et de la permanence des méthodes comptables adoptées pour l'établissement des comptes consolidés et sociaux de l'entreprise et de vérifier que les procédures internes de collecte et de contrôle des informations garantissent celles-ci."

resulted in a conflict of interest.[341] The members of the committee should meet, without the presence of management, with those who participate in the accounting process, such as the chief financial officer, the chief of internal auditing, or the *commissaires aux comptes*. The audit committee should be composed of at least three directors, who are neither officers nor employees of the firm, with at least one of them being an independent director.[342] We believe that the audit committee is not only the most important board committee, but also the committee that should be the most independent. If a good step towards an independent audit committee, the Viénot Report does not go as far the Dey Report which recommends that the committee be composed solely of outside directors.[343] We describe in **Chapter VIII** what is our point of view on this matter.[344]

4. Effect on Corporate Governance

The chief internal auditor has a reporting relationship with the members of the audit committee. Most importantly, the committee establishes an independent working relationship with the outside auditors with whom they meet from time to time without management being present. Furthermore, different Conference Board's studies come to the conclusion that the audit committee has a positive aspect on the quality and reliability of corporate financial reporting and on the quality of corporate internal auditing procedures. For example, a 1988 report by The Conference found that the majority of chief executives and chief financial officers surveyed said that the audit committee had improved not only the procedures but also the effectiveness of internal auditing in their firms, as well as the board's effectiveness in fulfilling its responsibilities.[345] Also, about half said the committee had improved financial reporting. We were unable to find such a survey

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341 **Viénot Report**, *supra* note 1 at III.3:

> "Il est également souhaitable qu'à l'occasion de l'examen des comptes le comité se penche sur les opérations importantes à l'occasion desquelles aurait pu se produire un conflit d'intérêt...."

342 **Viénot Report**, *supra* note 1 at III.3.
343 **Dey Report**, *supra* note 15 at Guideline 13
344 See Chapter VIII.
345 **Bacon**, *supra* note 54 at 13.

realized in the other countries studied. However, we can presume that the establishment of an audit committee must also have positive effects in the other jurisdictions.

B. Compensation Committee

Excessive directors and top executives' compensation has been one of the determining factors in the pressure for more independent board. One result has been the establishment of compensation committees composed mainly or solely of independent directors.

1. Directors and Executives' Compensation

a) Criticism of Executive Compensation and Dilemma

Criticism. It is often said that directors are overpaid for what they do and underpaid for what they should do. In the recent years, there have been a few cases of excessive executive compensation which have attracted the attention of the public. This is true in the four countries studied. Most of the time, the outcry was triggered by angry institutional investors, or major shareholders, alleging both excessive executive compensation compared to corporate performance and inadequate auditing of their portfolio companies. Boards of directors were held responsible for not standing up to greedy managers and of over rewarding managers.[346] The result was often the ouster of CEOs. Another result was also the creation of corporate governance study groups such as the Cadbury or the Viénot committees. Institutional investors now often place pressure on the boards by saying that they are ready to withhold their votes at re-election if their directorship proposals are not acknowledged.

Dilemma. Directors and executives' compensation leads to a dilemma: how can directors be fairly compensated? On the one hand, they have to be compensated on a competitive basis: the greater the corporate performance, the greater the compensation. There is also another aspect: the exchange made between an individual of his time and

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[346] *Ibid.*

freedom for money and other considerations.[347] On the other hand, their compensation must not be excessive, so that they could never be exposed to criticism.

b) The Reality of Directors and Executives' Compensation

Chief Executive Officer's Compensation. Arthur Earle, who has conducted a study on the compensation of Canadian CEOs, concluded that:

> "there is little link between Chief Executive cash compensation and corporate profitability... for the very simple reason that cash compensation is seldom determined with that objective in mind."[348]

This statement can be illustrated by many examples of CEOs who see their compensation increase over the years despite a decrease in corporate performance. In some cases, activist shareholders, especially institutional investors, have forced many CEOs to accept salaries more closely linked to their performance. Earle concludes that cash compensation is a means to retain the services of the executive concerned, or to attract him or her when the company is looking for a new executive.[349] A more pessimistic view of the lack of linkage between CEO compensation and corporate performance is expressed by Warner Woodworth:

> "The bottom line of all this is that chief executives of too many corporations are not managing plants, equipment and people. They aren't representing the stockholder's interest. They seem interested and skilled in primarily on thing — managing their personal portfolios."[350]

Woodworth refers to the fact that executives are often paid using a share option schemes. This has become one of the most common way executives and directors are paid. This is also one of the factors that have led to the establishment of a compensation committee on many boards of directors. Share option schemes are a means by which executives are encouraged to better perform. The more successful the company is, the greater the return for the executives. However, sometimes executives may act in consideration of their personal short-term profit rather than the corporation's long-term profit. The expectation

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[347] **A. Earle**, *Compensation for Chief Executive Officers - A Test of Corporate Governance* (National Centre for Management Research and Development, University of Western Ontario, 1990) 7.
[348] ***Ibid.*** at 15.
[349] *Ibid.*
[350] **W. Woodworth** (1987) 25.

gap reappears.[351] For example, in case of a take-over bid, executives are often said to protect their own financial interest — by requesting their staying in the merged committee — whatever the consequences for the corporation are. Even if this is an excessive view of the reality, one can not deny the fact that this is sometimes true.

Inside Directors' Compensation. Inside directors are generally not compensated for regular board service, and for committee service when they are members of a committee. Also, they are generally not entitled to supplementary benefits such as liability insurance, travel insurance or retirement plan. For example, the 1995 *Canadian Directorship Practices* revealed that only 17 per cent of the responding companies with inside directors compensated them for regular board service.[352] The figure regarding compensation for committee service is even lower: 6 per cent of the responding companies with inside directors on committee compensated them for serving on committees.[353] It is not the purpose of our study to develop in details, and give a precise view of what the average compensation in the four countries studied is. Despite this, it is interesting to note that compensation to directors seems to increase with the size of the company, as represented by total assets.

2. Creation, Popularity, and Structure of the Compensation Committee

a) Creation of the Compensation Committee

Generalities. To avoid any criticism of excessive compensation, boards of directors have enlarged in their annual reports the disclosure of directors and executives' compensation. Another way to avoid criticism has been the establishment of a compensation committee. If in theory the board of directors determines the compensation for the CEO and the other principal corporate officers, in practice, many boards now delegate this function to a compensation committee. The creation of a nominating committee is a fairly new trend, but it must be noted that the functions of the compensation committee had always been dealt with in some less formal way by the board, e.g. by *ad hoc* committees, by consultation between a dominant shareholders and the CEO, or by a

[351] See Chapter I.
[352] Carlyle, *supra* note 174 at 8.
[353] Carlyle, *supra* note 174 at 14.

special session of the board.[354] According to Warner Woodworth, there are a three main reasons that have motivated companies to formalize a specialized committee for the process of reviewing the compensation of directors and executives.[355] First is that compensation committees have become a trend. Because more and more companies show such a committee in their annual reports, it seemed imprudent for boards to resist this trend: not having such a committee might be perceived as a resistance by top executives to examine their compensation. Secondly, sometimes the establishment of a compensation committee has followed a constitutional crisis, where for example directors were unhappy with the CEO or with the performance of the corporation. Finally and most importantly, the presence of a compensation committee establishes greater independence and objectivity in fixing compensation, and allows better board monitoring of the compensation and performance relationship.

United States. There is another reason, specific to the United States, triggering the increasing number of compensation committees. The compensation committee has become a necessity for publicly traded companies: since late 1992, the SEC has required firms to have compensation committees. Firms must also include in their annual reports a declaration by the compensation committee justifying the compensation packages awarded to CEOs.[356] The US Congress has reinforced this requirement in the summer of 1993 when it eliminated the corporate tax deduction for executive compensation packages that exceed $1 million a year, unless those packages tie compensation tightly to performance and meet certain other requirements.[357]

United Kingdom. The Cadbury Report states that:

> "Executive directors' pay should be subject to the recommendations of a remuneration committee made up wholly or mainly of non-executive."[358]

[354] **Earle**, *supra* note 347 at 18.
[355] *Ibid.* at 18-19.
[356] **Blair**, *supra*, note 5 at 82.
[357] The rules apply to the CEO and the next four top executives. See **J. Lublin**, "Firms Forfeit Tax Break to Pay Top Brass $1 Million-Plus" *Wall Street Journal* (April 21, 1994) B1.
[358] **Cadbury Report**, *supra* note 6, at Code of Best Practice 3.3.

France. The concept of a compensation committee is new in France, and does not appear in the 1966 Company Law. However, Article 90 al. 2 of the 1967 *Décret* permits the *conseil d'administration* to establish such a committee.[359] By contrast to the audit committee, the compensation committee has only appeared recently in France. Partly because of excessive executive compensation that has engendered public outcry, and to follow the US and UK examples, compensation committees have been established in some of the largest French multinationals. The Viénot Report favors this trend. It recommends that all boards should set up a compensation committee (*comité des rémunérations*) with the function of proposing to the full board directors and officers' compensation.[360] The Report also recommends that a director of B should not be a member of the nominating committee of A if there are also members of A in the nominating committee of B.

b) The Popularity of the Compensation Committee

The compensation committee has become one of the most popular board committees. In the United States, 91 per cent of the surveyed firms by The Conference Board in 1993 had such a committee to approve and oversee executive pay plans (in the 1972 survey, only 69 per cent had such a committee).[361] In Canada, The Conference Board of Canada found that the compensation committee was present in 77 per cent of their respondents.[362] In France, specialized committees are rare, with the exception of the compensation committee (*comité des rémunérations*). The *comité des rémunérations* is found in a third of French publicly traded companies.[363]

c) Structure of the Compensation Committee

The committee makes its recommendations to the full board for review and approval. A compensation committees is typically composed with a majority of or entirely of independent directors. The four reports studied all agree on this principle.

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[359] See *supra* **II.B.3.** and note 20.
[360] **Viénot Report**, *supra* note 1 at III.3.
[361] **Bacon**, *supra* note 54 at 14.
[362] **Carlyle**, *supra* note 174 at 13 Chart 6.
[363] See *supra* note 114 at 20.

Furthermore, in the United States, one of the requirements, besides the link between corporate performance and executive compensation package, stipulated in the 1993 US Congress bill discussed earlier is that the compensation package be determined by a compensation committee be composed exclusively of outside directors.[364] Often, outside consultants and experts are hired by the committee. These outsiders do not participate in the voting.

3. Functions of the Compensation Committee

The compensation committee recommends to the full board the compensation arrangement for the CEO. This is the most important compensation decision the board makes, because the compensation of the other senior executives are related to the CEO's.[365] The CEO's compensation should motivate the CEO to do what is expected of him, and therefore must be related to his performance. The CEO compensation may take such forms as stock option plans, performance share plans, or base salary plus annual discretionary bonuses. The compensation committees must interpret, with the help of an outside expert if necessary, the fairness, the equity, and the likely results of these complex compensation plan proposals, which in any case must be oriented toward meeting the company's goals for corporate governance. The compensation committee also recommends to the full board the compensation of the other principal officers, and the compensation arrangements for the board itself. Obviously, this is a delicate matter, since the board is disbursing company funds to itself.[366]

4. Effect on Corporate Governance

Directors' compensation is one of the most controversial topic during annual general meetings, and is closely followed by the media. The members of the compensation committee play a delicate role. They have to find a balance between commitment to board membership and compensation.[367] A committee composed of independent directors should

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[364] See *supra* note 35.
[365] **Anderson & Anthony**, *supra* note 203 at 111.
[366] *Ibid.* at 123.
[367] According to the **Dey Report**, supra note 15 at Guideline 8:

provide the grounds for a more objective judgment as to the fairness of the compensation, shifting the burden of proof upon the person attacking the fairness of the compensation.[368] One of the key to more objectivity is full transparency of their decision making (i.e., in annual reports). However, a paradox remains: should the members of the compensation committee be responsible for determining their own compensation?

C. Other Important Board Committees

1. Executive Committee

The executive committee is one of the most important committees of US, UK, and Canadian boards. It is also one of the most commonly found. In Canada for example, over 50 per cent of respondent companies of the 1995 Canadian Directorships Practices, indicated that they have an executive committee.[369] Eighty-one per cent of those companies indicating that they have such a committee also reported that the committee is composed of a majority of outside directors. Despite its importance, the Reports tend not to mention it. It is perhaps due, as the Dey Report notes, to the trend towards its abandonment as a decision making body of the board. The Dey Report supports this trend.

2. Shareholder Advisory Committee[370]

A shareholder advisory committee is a committee which represents the largest shareholders of a company, that is typically institutional investors. The committee is in contact with the management: on one hand, it receives reports from the management, while on the other hand, it informs the management of shareholders' concerns and grievances. One of the advantages of such a shareholder advisory committee, as Professors Gilson and Kraakman stated, is that such a committee "might be able to resolve problems at an early stage, before they become serious enough to invite a take-over." However, their following

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> "The board of directors should review the adequacy and form of the compensation of directors and ensure the compensation realistically reflects the responsibilities and risk involved in being an effective director."

[368] **P. Devesa**, "Les administrateurs indépendants", RDAI/IBLJ, n°5, 1994.
[369] **Conner**, *supra* note 116 at 7.
[370] **Gilson & Kraakman**, *supra* note 41 at 872-873.

argument is that the shareholder advisory committee "is likely to prove an effective tool form reform." They conclude by saying that:

> "The advisory committee strategy correctly identifies the problem — institutional investors do need a tool for continuously monitoring management — but fails to offer a serious solution. It neglects the one existing instrument that *might* be able to compensate for the shortcomings of the market for control: the board of directors itself."

The institution of a shareholder advisory committee has been advocated by CalPERS. and adopted. for example. by Lockheed's management to win institutional votes in its 1990 proxy contest with Harold Simmons. Is the shareholder advisory committee only a US phenomenon? We are not aware of the existence of such a committee in the other jurisdictions studied. Should there be a shareholder advisory committee in the other jurisdictions? It depends on the degree of institutional investors board's implication the jurisdiction is ready to allow. Institutional investors' representation has pros and cons that must be balanced.[371] The shareholder advisory committee seems to be a good compromise between the non-representation of institutional investors and the nomination of professional directors. At the present moment. the advisory committee is mainly a US phenomenon.

3. A Committee of Independent Directors

In a few US firms surveyed by The Conference Board in 1993. a forum for independent directors had been formalized.[372] The rationale behind the establishment of a committee of independent directors is that outsiders are not generally a cohesive group. Traditionally. direct communications between them have been unplanned. and have occurred at board meeting dinners or in other situations that present the opportunity. Creating a forum where all the independent directors can deliberate without management — outside directors can also deliberate without management in the audit. compensation and nomination committee. but in this case. only a few directors at the time can meet together and they focus only matters that are the responsibility of that particular committee — makes the outside directors a cohesive and effective group. that can deal with problems

[371] See Chapter VII II.
[372] **Bacon**. *supra* note 54 at 16.

effectively at their early stage. We are not aware of the existence of a committee of independent directors in the other jurisdictions studied. Is this due to its lack of utility? If on the one hand such a committee assures that independent directors meet separately, on the other hand, informal meetings or lunch reunions between independent directors seem sufficient to get to know each other better, and to reduce the gaps that exist between their opinions. Also, a committee of independent directors seems useless in a board composed entirely (or mainly) of independent directors. In this situation, the establishment of a committee composed of inside directors may provide the necessary balance.

D. Less Important Board Committees

There are a number of other committees which, though now used less frequently, have the potential of greatly increasing the capacity of the board. Among these lesser-used committees are:[373]

- The planning committee reviews strategies, acquisitions, divestitures, new ventures, and the like.

- The social responsibility committee monitors the organization's activities in fulfillment of its responsibilities to society.

- The contributions committee establishes contribution policies and approves charitable and other contributions.

- *Ad hoc* committees deal with temporary issues or projects.

- Advisory committees help the organization in specialized areas, such as technology or international affairs.

CONCLUSION

The establishment of specialized committees must be approved. It enhances the oversight functions of the board, and increases its independence when the committees are solely composed of independent directors. CEOs and inside directors should not view

373 E. Mattar & M. Ball, eds, *Handbook for Corporate Directors* (McGraw-Hill Book Company, 1985) 6.11.

these committees as a negative counter-power. They keep their say before any decision is taken because the board must ratify all committees' propositions. The establishment of specialized committees must be developed. At present, despite the fact that by-laws of large companies mention them, too often specialized committees appear to be only *ad hoc* committees. They are often created to remedy to a lack of transparency in the nomination of new board members or to compensation fights. This is not sufficient. Corporate law needs to be amended to promote the establishment of board committees. The French government seems to have made a step in that direction with the expected Marini Report. The other countries studied should follow suit.

CHAPTER VI: THE INDEPENDENT CHAIRMAN

INTRODUCTION

Support for separating the position of chairman of the board from that of chief executive has re-emerged as a major issue. Advocates of a separate chairman believe this structure strengthens the board's independence and provides the board with its own leadership. Chief executives, however, defend combining the titles as practical and question whether a permanent, separate board chairman position is viable except in particular circumstances. Precedent for separating the functions (except in other countries) is too rare to shed much light on the debate.

I THE CHIEF EXECUTIVE OFFICER AND THE CHAIRMAN

A. The Chief Executive Officer

There is a wide interaction between the CEO and the board of directors. As a consequence, the CEO plays the key role in determining the board's effectiveness.[374] The board is likely to be productive if the CEO considers the board as significant to the corporation's governance and policy-making processes. On the other hand, the board will probably be ineffective if the CEO considers it as a nuisance. At the extreme, it is possible that the CEO's opinion and operating style will discourage the independent board from acting. This is why boards of directors tend to select CEOs who have their full confidence. Boards will also look for CEOs who have demonstrated qualities of leadership that can make an organization work effectively together.

[374] **Anderson & Anthony**, *supra* note 203 at 47.

B. The Chairman of the Board

The title of chairman is sometimes largely honorary — recognition of being a company founder or long-serving officer and director. Under the circumstances, the chairman might simply open and close the board meetings, leaving the actual conduct of the meetings to the president and CEO. Other chairmen are partially active, representing the company's interests, for example, to the government or to its industry. In some instances, the chairman is a full-time executive who shares top management duties with the president-CEO. Finally, there are chairmen who concentrate their activities solely on governance issues, avoiding involvement in executive management, which is the territory of the president-CEO.

II THE COMBINED CHAIRMAN-CEO ROLE

A. The Clear Preference for a Combined Chairman-CEO Role

1. Examples: the United States and France

The United States. A 1993 Conference Board study revealed that 94 per cent of the responding companies reported having a person who holds the title of chairman of the board.[375] The most noticeable figure is that among those companies, the chairman was also the chief executive officer in 76 per cent. This finding seems to reflect a consistent pattern in US board rooms, and according to Jeremy Bacon, "it follows that most CEOs expect to hold both positions when they assume leadership of a company."[376]

France. In France, the quasi-totality of publicly traded corporations opt for the *moniste* structure where the Président-Directeur Général (PDG) holds both the role of the Chairman of the board and of the CEO in the United States, the UK or Canada.

2. The Reason of the Combination of the Two Functions

The main reason for the combination of the positions of chairman and CEO is that this provides a single focal point for company leadership. There is never any question over

375 Bacon, *supra* note 54 at 11.
376 *Ibid.*

who the boss is or who is responsible. This is an important issue. There are unfortunate examples of chairmen-CEOs who relinquish their role and title of CEO to a president and then forget they are no longer running the show. This is guaranteed to produce chaos both within the organization and in relationships with the board.

In such a situation, the board needs to exercise caution in establishing an arrangement in which the roles of chairman and CEO are separated. There must be a clear understanding of respective responsibilities, and these must be carefully observed. Moreover, there must be unusually good "chemistry" between the two individuals. If the relationship is competitive or if there are ego problems, a division of responsibility is not likely to work.

B. Interaction Between the Chairman-CEO and the Board of Directors

The chairman-CEO holds the key to determining the board's effectiveness. The way he views the role of the board and his relationship with the board members determines in large measure how well the board functions. A host of other activities under his control — including the way he organizes and conducts meetings, and the information he chooses to provide to board members — can also influence the effectiveness of the board.

1. Trust

An effective board begins with a constructive relationship and mutual trust between the CEO and outside board members. The board must believe beyond any doubt that the CEO is completely trustworthy, that he provides the board with every bit of information it wants and needs, accurately and promptly, and that nothing is being or ever would be withheld. Any suspicion on the part of the board that the CEO is "playing games", is being less that forthright in providing information, or is slanting it to support a preconceived position, is destructive of the absolute trust essential to this relationship. The other side of the coin is that the CEO must be convinced that he has the board's support. He should not be in a position to suspect, for example that board members are meeting privately to question his actions, or that they are plotting to make a change.

2. Relationship Problems

A common criticism of some boards of directors is that they are passive, slow to change the CEO, and act merely as rubber stamps. Unfortunately, this is an accurate characterization of some boards. Even if there is a good, constructive relationship between the board and the CEO, it is sometimes difficult to get sensitive issues out in the open. Individual directors may be uncomfortable about the course the corporation is taking , but they may also be reluctant to make their concerns known. Moreover, CEOs, who usually are strong, confident people, may be highly sensitive to what they interpret as criticism. Accordingly, they may either avoid discussion of controversial issues or, when they do discuss them, they may give the impression that their position is obviously the right one, and that further discussion is not welcome.

The good CEO creates an environment that encourages debate and discussion within the board. He is a good listener. Likewise, the effective directors will manage his relations with the CEO so he can raise controversial matters with the minimum likelihood of offending the CEO. The essence of an effective board is active, candid interaction among all participants. It is the responsibility of both the CEO and the directors to develop an atmosphere which encourages wide and frank participation. Many corporate boards have some distance to go to achieve this objective.

III THE INDEPENDENT CHAIRMAN

While it is common for the CEO to be the chair, the wisdom of this is questionable.[377] The role of the chair is so important that serving successfully as CEO as well can be very difficult. Holding both titles may border on conflict of interest, for it deprives the directors of an independent agent to continually monitor corporate performance. On the other hand, the need to have an orderly progression of top management can outweigh the disadvantages. A progression that is often successful is

[377] **Mattar & Ball**, *supra* note 373 at 4.5.

from president and chief operating officer. to president and CEO. and eventually to chair and CEO. Then a new president and chief operating officer is brought on.

Of course. most large corporations need both a chair and a president. When the chair is CEO. all line and day-to-day operations usually report to the president and chief operating officer. In these cases. the chair oversees support services. such as finance. human resources. corporate secretary. and planning.

A. Independence from Management

Sixty per cent of respondent companies of the latest Conference Board of Canada study indicated that they had some type of structure or system in place. either formally or informally. to ensure the independence of the board. Eighty-two per cent of these companies have a chairman of the board who is an outside person or has a policy in place that requires that the chairman of the board not be a member of management. In general. a lower percentage of manufacturing companies indicated that they have a process for board independence. and a greater percentage of large companies have a system in place.

B. The Separation of the CEO/Chairman Functions

1. The Call for a Separate Chairman Position

Some commentators have suggested that the chairman of the board should not be the CEO. Proponents who are calling for the use of a separate board chairman position want a permanent structural change. not a transitional arrangement or a structure imposed only on poorly managed firms. The basic premise of this proposal is that the ability of a board to function independently is comprised when the CEO is board chairman. By establishing a separate chairman position. the board's effectiveness as an agent for improving corporate governance will be enhanced in three ways:

1. The board's chief responsibility to look after shareholder interests will be clarified;
2. The board's role as overseer and monitor of management will also be clarified. and its hand in dealing with management will be strengthened: and

3. The board will be better organized and more effective by virtue of having its own leadership.

2. Issues Raised by the Proposal

Whatever its appeal in theory, the proposal for a separate board chairman raises several issues as to its implementation.

What Should the Role of a Separate Chairman Be? Recent proponents of establishing this position have concentrated on the overall desired results rather than on defining details of what the independent chairman might actually do. Those general goals are:

1. To restore the full potential of outside directors to function as independent monitors of management a potential that is arguably weakened when the CEO runs the board, and

2. To define for boards a clear leadership structure that will enhance their effectiveness as a group.

Judging by what some companies have done in the past in setting up a permanent non-executive board chairman position, the job can take a form that may not necessarily give total emphasis to corporate governance goals. The chairman's duties may reflect the interests or special strengths of the incumbent, or the needs of the company at a particular time. Nevertheless, the board of directors is invariably a major focus on the independent chairman position. The job usually includes the three elements (see **Table 12**).

The following, taken from the bylaws of corporation surveyed in 1993 by The Conference Board, is a fairly typical description of the role of a board chairman who is not also CEO:

> "The chairman of the board shall preside, when present, at all meetings of the board of directors and shall have such other powers and duties as may be conferred upon or assigned to the chairman by the board of directors."[378]

[378] **Bacon**, *supra* note 41.

THE ROLE OF THE INDEPENDENT CHAIRMAN	
Organization	The chairman plans and schedules meetings of the board and its committees and presides at those meetings as well as at the annual meeting of shareholders;
Leadership	The chairman is the designated leader of the board and its chief spokesperson in its dealings with management;
Coordination	The chairman works with the chief executive on such matters as establishing meeting agendas and, in general, is expected to maintain a healthy working relationship with the CEO. But it is not a reporting relationship and the chairman is not the "boss"; the CEO's responsibility is to the board as a group.

Table 12

It is doubtful that the position described in such brief and in general terms envisions a strong and independent board leader like the chairman currently being proposed for corporate governance purposes. However, a few cooperators do have a non-CEO chairman who is expected to play that kind of role to some extent.

Who Might Serve in this Position? To date, the original incumbent has tended to be an existing chairman-chief executive who has decided to divide those functions and continue as chairman only. But interviews reveal a difference of opinion as to whether a former CEO should serve as outside chairman.[379] Some believe that experience as CEO is an advantage; a thorough understanding of the organization would improve the chairman's ability to work with the president-CEO and to focus the board's efforts.

Others, however, are against having an ex-CEO in such an influential position because it could inhibit the new chief's ability to put his own stamp on the company. Some also fear

[379] *Ibid.*

that people within the organization might have doubts about where the real power lies in some kinds of decisions in which the board is involved.

Where the former CEO is ruled out as a candidate, the most likely alternative is someone chosen by the outside directors from among themselves. Perhaps the overriding criterion is whether the chairman can work in harmony with the CEO. In many interviews, it was stressed that if the independent chairman and the CEO should be incompatible, the arrangement would do more harm than good.

How has this Form of Organization Worked Where it has Been Tried? The fact that about one-quarter of the US chairmen represented in the survey, conducted in 1993 by The Conference Board are not the CEOs of their firms suggests that the idea of a separate board chairman is not a novelty. However, this structure usually means that a retiring CEO has relinquished that title to his successor but is keeping the chairman title during the transition period until he actually retires. Recently, activist shareholders of a few troubled firms have pressured the incumbent CEO to relinquish that role and accept a new, diminished one as chairman only, but to date these are unique situations, and too few to amount to a trend.

Most experience in the United States with separating the chairman and chief executive functions goes back only two decades or so. The major firms publicized as having opted for this structure over this period include Armco Steel (now ARMCO Inc.), Becton Dickinson and Company, Connecticut General Insurance (since merged into Cigna Corporation), and Dow Chemical Company. None of these pioneer efforts has survived as permanent practice. In one of these cases, a merger was the reason; in another, the person elected as chairman found the assignment unrewarding; in the remaining two companies, the structure was viable only during the tenure of the CEOs who instigated it.

Proponents of separating the chairman and CEO functions point to the successful use of this structure in Europe, especially in the United Kingdom, as proof of its practicality. (It is required by law in some European countries; it is not a requirement for UK firms but many corporations in that country have traditionally appointed a non-executive chairman.) Skeptics argue that legal and cultural differences in the United States are less favorable to the concept of an independent chairman. Some US CEOs also questioned in interviews whether the system works all that well, citing as evidence problems observed at subsidiary companies or comments from foreign executives serving on their boards.

What are the arguments against it? It is not very surprising that CEOs in the United States, accustomed as they are to wearing the double mantle of chairman and chief executive, are largely negative toward the idea of separating those jobs. Some acknowledge not wishing to weaken their authority, but a greater number voice their objection in terms of reducing the efficiency of decision making. They raise other issues as well:

1. It would lead to confusion among managers as to where the decision-making authority lies for some kind of matters;

2. It would in effect create a new layer of management requiring additional information and reporting burdens;

3. The chairman's post would amount to a "super director" position that might be an affront to other outside board members; and

4. Defining a job for the chairman that is meaningful without overlapping in the chief executive's role would be difficult?

However, some CEOs, even those who have reservations about the concept, don't write off the idea entirely. Some concede that it might make sense in some situations (such ad in companies in need of stronger board involvement to cope with problems). And a few said that if their own board decided to adopt this structure they would probably not argue strenuously against it.

The Relationship between the CEO and the Independent Chairman. The general experience of the Roundtable members has been that the board functions well where the CEO also serves as chairman and where there is no sharp organizational line drawn between the board and operating management.[380] It would be a mistake to suppose that the board can perform its mission apart from the CEO or in adversary relationship with

[380] **Cohen & Loeb**, *supra* note 8 at 312.

him. It is not only that the CEO is the principal operating agent of the board in directing the affairs of the corporation. The CEO is also a director and the bridge between the board and the whole operating organization, both line and staff. The board decision process must be characterized by independence, but this principle is entirely compatible with the proposition that the board-CEO relationship must be open and mutually supportive.

Moreover, the chief executive is the agent and collaboration of the board as public spokesman not only for his own enterprise but also for the larger corporate community in defending the essential elements of the private enterprise system and in promoting the political conditions essential for its effective operation. This is a challenging and important dimension of the chief executive's overall responsibilities

Should the Establishment of an Independent Board Chairman be Mandated? CEOs interviewed by The Conference Board reject the suggestion that companies be required to separate the chief executive and board chairman functions as a matter of course.[381] Many stated emphatically that, at best, this arrangement might work for some companies but that it would not be right for most and hence should not be required. Institutional investors have recently imposed this structure on several major companies that have run into serious trouble. However, these moves were evidently more geared to removing the CEO in order to position the new leadership than toward separating the chairman and CEO jobs as a structural ideal. It is too early to say how well these enforced transitions will work out and to what extent institutional investors will pursue this remedy for ineffective management in the future.

The Reports. See **Table 13**.

CONCLUSION

It is necessary to keep in mind that the quasi-totality of the literature concerning the separation of the functions of Chairman and CEO comes from the United States. It appears that there are pros and cons to the separation of the functions of Chairman and CEO, and

[381] **Bacon**, *supra* note 54.

that in some cases, the separation is not necessary. In France, the Viénot Report has expressed its disapproval of the separation of the two functions.[382] Despite this point of view, we believe that the French government should not abandoned the idea of the separation.[383]

THE INDEPENDENT CHAIRMAN OF THE BOARD	
Cadbury Report (4.17)	**"Given the importance and particular nature of the chairman's role, it should in principle be separate from that of the chief executive. If the two roles are combined in one person, it represents a considerable concentration of power."**
Dey Report (Guideline 12)	**"Every board of directors should have in place appropriate structures and procedures to ensure that the board can function independently of management. An appropriate structure would be to (i) appoint a chair of the board who is not a member of management with responsibility to ensure the board discharges its responsibilities."**
Viénot Report (I.4)	**Choice between *conseil d'administration* and *président*, and *directoire* and *conseil de surveillance*.**

Table 13

[382] Viénot Report, *supra* note 1 at I.4.
[383] See Chapter VIII in Conclusion.

CHAPTER VII: OTHER PROPOSITIONS

INTRODUCTION

So far, we have discussed the more important proposals to minimize the expectation gap: the presence of more outside/independent directors on the board, the establishment of specialized committees composed of independent directors, and the separation of the function of CEO and Chairman of the board. They all have the same objective: a greater independence of the board. There have been other important propositions. Some of these propositions, such as the lead director concept, are also oriented towards a more independent board of directors (**I**). Others, such as the special-interest director concept, do not lead towards a more independent board, but rather towards a more "dependent" board (**II**). Space permits only a brief description of these propositions. In the next chapter, we consider their application in France.

I. PROPOSITIONS TOWARDS A MORE INDEPENDENT BOARD

A. The Lead Director Concept

United States. In January 1994, the General Motors Board of Directors reviewed its processes and issued the "Guidelines on Significant Corporate Governance Issues" (revised in August 1995) to ensure that its responsibilities to shareholders are carried out effectively.[384] These guidelines introduced the concept of the non-executive lead director:

> "The Board adopted a policy that it have a director selected by the outside directors who will assume the responsibility of chairing the regularly scheduled meetings of outside directors or other responsibilities which the outside directors as a whole might designate from time to time.
> Currently, this role is filled by the non-executive Chairman of the Board. Should the Company be organized in such a way that the Chairman is an employee of the Company, another director would be selected for this responsibility."

[384] See the General Motors' internet site.

Cadbury Report. The Cadbury Report implicitly introduces the lead director concept:

> "If the chairman is also the chief executive, board members should look to a senior non-executive director, who might be the deputy chairman, as the person to whom they should address any concerns about the combined office of chairman/chief executive and its consequences for the effectiveness of the board."[385]

Dey Report. The Dey Report explicitly brings forth the lead director concept. To ensure that the board can function independently of management, the Dey Report recommends to separate the appoint a chairman who is not a member of management, or to "adopt alternate means such as assigning this responsibility to a committee of the board or to a director, sometimes referred to as the "lead director"."[386]

France. The lead director concept does not yet exist in France. Such concept comes after the basic ones (independent director, specialized committees) that French companies are beginning to consider. However, the nomination of a lead (independent) director may be applicable in France where the separation of the functions of Chairman and CEO is not envisioned by the Viénot Report.[387]

B. Applying the Dual Board Model

Germany. Dual, or two-tier, boards, required by German law, are formal ways of separating non-management boards from management ones by essentially setting up two separate boards. The supervisory or outside board has superior legal powers over the managing board, including the power to replace it. The Germans believe that, in order to have a truly independent assessment of management, the supervisory board should be wholly comprised of outsiders, except for the CEO. The management board has the independent power to make the company's policies and plans, while the supervisory board concentrates on monitoring management's function and replacing top management.

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385 **Cadbury Report**, *supra* note 6 at 4.5.
386 **Dey Report**, *supra* note 15.
387 See *supra* note 386.

France. This model also exists in France with the second form of *Société Anonyme* composed of a *directoire* (management board) and a *conseil de surveillance* (supervisory board).[388] We consider later the pros and cons of this dual board structure.

United States. In the US, boards are already rapidly becoming more like supervisory boards, while top management constitutes something like a de facto management board. Although US law does not require two separate boards, the reality of the situation is not too far from the dual boards of Germany.

C. Public Directors

One proposed reform is to install public-interest directors. In 1971, Robert Townsend, the successful Avis Rent-A-Car executive, advocated that boards of large corporations each have one public director whose job was to represent the community at large. He proposed giving such directors an annual operating budget of $1 million. Other reformers have proposed public directors who would serve as corporate consciences and oversee the firm's compliance with laws and social responsibilities.

Holding some directors specially responsible for safeguarding the public interest on the board poses some problems. The notion that some board members should owe their loyalty to the public would mark a fundamental departure from the basic success of the company and its shareholders. It raises the questions of whether conflicting loyalties in the boardroom would invite continued policy confusion and stalemate, and whether factionalism would be preferable to excessive clubbiness, as proponents of public directors assert. For all these reasons, we do not favor the presence of public directors on the board.

II. PROPOSITIONS TOWARDS A MORE "DEPENDENT" BOARD

The second set of proposals leads to a more dependent board. These could lead to conflicts detrimental to the functioning of the board. In such a board, the decisions are not

[388] See below **Chapter IX**.

made in consideration of the interests of the stakeholders as a whole. but rather in consideration of the interests of each stakeholder taken individually.

A. Special-Interest Directors

The proposals for special-interest directors were originally made to broaden the perspectives of corporate boards. which seldom included members of minority groups. women. or individuals deeply concerned with the environment or product safety. Many corporations have added women and members of minority groups to their boards. But some critics say this is not enough. It is also necessary. they urge. to impose a special responsibility on each member of the board for changing the company's policies.

Consumer advocate Ralph Nader has proposed that boards have about nine directors. each of whom would have oversight responsibilities for one of the following: employee welfare. consumer protection. environmental protection and community relations. shareholder rights. compliance with the law. profits and financial integrity. purchasing and marketing. management efficiency. and planning and research. While this proposal is perhaps the natural outcome of charges that corporate boards are not sufficiently representative of society. it has not gained substantial support. Individual directors responsible to particular claimant groups would introduce into the board a divisive and adversary atmosphere which would obstruct the effective performance of the enterprise. It is one thing to believe that intelligent managers and boards should carefully consider the corporation's impact on society: it is another to turn the board into a parliamentary body representing all factions of society. In fact. all members of the board. not only a chosen director. have a responsibility to investigate violations of law or ethical lapses that are likely to harm society and the company. Therefore, special-interest directors should not be necessary.

B. Institutional Investors Representation on the Board

As a result of the enormous holdings of institutional investors, several legal scholars have proposed that institutional shareholders or representatives of institutional investors should be represented on the corporate board.[389]

Pros. Such representatives, or, more appropriately named, institutional directors, will be less influenced by corporate executives, will react more quickly to declining corporate performance, will expeditiously attempt to replace a weak chief executive officer, and will swiftly question executive compensation. Already, several major United States corporations such as Lockheed and Cleveland-Cliffs have agreed to permit institutional directors to serve on their corporate boards.

Cons. Even though institutions do hold a majority of the equity in large publicly held corporations, institutional shareholders or their representatives may not be the most effective monitors of management decisions and corporate activity. First, institutional investors are merely managers of large sums of money and it is unclear how well institutions can monitor corporate performance. As Professor Bernard Black has stated: "[t]o date, the institutions haven't done much monitoring. Their people aren't trained to do it, and might not do it well."[390] Second, as institutions grow in dominance through their shareholdings, they may concentrate their power to the detriment of the corporation. For example, institutions could potentially "embrace [market] fads en masse" or even deny capital to the corporations for new ideas.[391] Such concentrated institutional power could be highly dangerous. Third, if institutional shareholders are able to extensively review a corporation's financial data or oversee major decisions, the institutions could trade shares based on the non-public information they possess. Fourth, institutional shareholders are far from homogenous and typically only public pension funds such as the California Public Employees Retirement System (CalPERS) have been active in corporate governance.

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[389] See e.g. **Gilson & Kraakman**, *supra* note 41; **J. Coffee**, "Liquidity Versus Control: The Institutional Investor as Corporate Monitor" (1991) 91 Colum. L. Rev. 1277.
[390] **B. Black**, "Agents Watching Agents: The Promise of Institutional Investors in Corporate Governance" 39 U.C.L.A. Rev. 852.
[391] *Ibid.* at 866.

CalPERS has been prominently involved in challenging management decisions, offering proposals to restructure the composition of corporate boards, and fighting for increased shareholder voice. Yet, the majority of institutional groups have never demonstrated interest in taking an active role on the board. Fifth, institutional investors, when faced with the choice between exercising control over corporate management or maintaining liquidity, have traditionally preferred liquidity to control. Professor John Coffee asserts that some institutional shareholders such as mutual funds, banks, and insurance companies prefer to have liquidity, rather than control, chiefly "because their shareholders, depositors, or policyholders can withdraw their funds on short notice."[392] Because of the need for liquidity, this group of institutional investors is most unlikely to oppose corporate management and would be unable to effectively monitor the corporation. Thus, the use of institutional investors as corporate monitors, although sound in theory, is highly problematic in practice.

CONCLUSION

If the proposals oriented towards more independence should gain favor, the others must be carefully looked out by the governments. There have been many other proposals such as the nomination of employee representatives.[393] The most extreme proposition has been elaborated by Professors Gilson and Kraakman. They have recommended the election of professional directors by institutional investors.[394] According to them, nominating independent directors is not sufficient, because they lack an incentive to act as ongoing monitors of management performance. They also lack the time to monitor because they are either CEOs themselves or hold equally demanding full-time positions. A core of professional directors, in the view of Professors Gilson and Kraakman, can command the motivation, information, and influence to serve as effective monitors on

[392] **Coffee**, *supra* note 389 at 1318.
[393] For example, French Company Law allows employee reprensation on the board (see Chapter VIII at IA.3).
[394] See e.g., **Gilson & Kraakman**, *supra* note 41.

behalf of institutional shareholders. This proposition revolutionizes the whole structure of the board. The professional directors would be nominated by institutional investors; thus minority shareholders would not have a say in the choice. We believe that directors should represent the whole shareholding population. For that reason, we are strongly opposed to Professors Gilson and Kraakman. However, the idea of professional directors elected by all the shareholders could be developed. For example, these directors could be organized through a clearinghouse.

CHAPTER VIII: APPLICATIONS IN FRANCE

"French company law has always hesitated between the contractual approach, inspired by Anglo-Saxon law, and the institutional approach characteristic of Germanic law. It is the latter which essentially underlies the company law of 24 July 1966. Today, the demands of internationalization appear to require a rethinking of this model in order to introduce more contractual freedom. Such an approach appears all the more necessary as one has to ask whether the interests of the company, supposed to transcend shareholder's interests, have not become a new alibi for enlightened despotism."

(Senator Marini, 1996)

INTRODUCTION

The corporate governance debate reached France two or three years ago. Not only has the publication of the Cadbury Report led to an increase in interest in corporate governance issues but so has the pressure of foreign investors on the French market. There have been a lot of conferences and seminars organized by the *Commission des Opérations de Bourse* (COB),[395] the Senate,[396] audit and executive search firms such as Deloitte-Touche-Tohmatsu or Vuchot-Ward-Howell. But the Viénot Report was the first major document on corporate governance. First, it is necessary to point out the main specificity of the French corporation, that is its dual structure, and to describe briefly how each of these structures operate (**I**). Then, summing up the propositions made by the Viénot Report, we analyze the present status of the corporate governance debate in France (**II**), and finally, we draw a set of recommendations addressed to the French legislator (**III**).

395 See *supra* note 81.

396 Conference organized by the association Droit et Démocratie: "Démocratie et Transparence dans le Gouvernement d'Entreprise", January 23, 1997.

I. THE FRENCH CORPORATION

The French corporation — the *société anonyme* (SA) — can take two different structures. The "classic" SA is managed by an administrative board whose members must be shareholders. The board designates an individual to act as president who manages the company, potentially with one or two general managers (**A**). The "new" SA is managed by a committee called the *directoire*, composed of individuals who need not be shareholders and who are named and supervised by a supervisory board of shareholders (*conseil de surveillance*) (**B**). The dual system is not popular in France even though it offers the most guarantees for independence of the board: less than two per cent of French companies have adopted the dual structure.[397]

A. The Classic SA

1. Directors

Individually, the directors have no supervisory powers; they must act as a group when exercising the powers accorded by law or in the articles. Nevertheless, they have individual rights to certain information regarding the corporation.

2. Officers

In the classic SA, the corporation is usually managed on a day-to-day basis by the president of the administrative board, called a president-general-manager (PDG: *président-directeur-général*). The PDG can be assisted by one or more general managers. He is selected from among the directors by the board itself, and has two main functions. As president of the board, he normally presides over board and shareholders' meetings and is responsible for properly calling the meetings, notifying required parties, etc. In addition, the PDG supervises and manages the corporation on behalf of the board and represents the corporation *vis-à-vis* third parties. The PDG can perform any act within the corporate purpose not exclusively reserved for the board or the shareholders or prohibited by the board or the articles.

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[397] J-J Caussain, "Le droit français face à la corporate governance", in Les Echos Conférences, *supra* note 20, at 48. The author gives a more precise figure of 1.62%.

3. Employee Representatives on SA Administrative Board

Two members of an SA's labor-management committee must be invited to attend board meetings. Independent of this obligation, two additional legal bases for employee participation in an SA's management could operate. The Ordinance of 21 October 1986 amended the 1966 Company Law to permit SAs to change their articles to allow elected employee representatives to sit and have a deliberate voice on their administrative and supervisory boards. The employee representatives have the same rights and duties as other board members. In addition, Law 94-640 of July 25 1994 encourages SAs whose stock is at least five per cent owned by employees to nominate one or two employees to the board and that they be voting administrators.

B. The New SA

The new SA is comprised of a directorate (*directoire*) which manages the SA, and a supervisory board (*conseil de surveillance*) that controls the directorate. Management and ownership are separate in the new form, whereas the two functions are joined in the classic form. Most of the rules which apply to the classic SA also apply to the new SA.

1. Directorate

Members of the directorate need not be shareholders, but they must be physical persons. A member of the supervisory board cannot serve simultaneously as a member of the directorate. One of the most interesting aspects of the new SA is that a member of the directorate may have an independent employment contract with the SA. An employee can be named to the directorate, or a member of the directorate can become an employee. The employment function must be distinct from the duties normally assigned to a member of the directorate. No one can, at the same time, be a member of more than two directorates of SAs established in France. The supervisory board selects the member of the directorate and names one of them president.

The law does not indicate how a directorate must function, leaving this to be established in the articles. Two restraints are applicable: first, the members of the directorate owe the same duty of discretion regarding information of a confidential nature as administrators. Second, voting agreements are only valid on condition that members' voting powers are not too limited. The directorate is vested with the power to perform any act in the name of the corporation consistent with its purpose. In general, the directorate should act as a group.

2. Supervisory Board

The role of the supervisory board is to supervise the directorate's management of the corporation. For this purpose, supervisors have a right to examine any necessary corporate records. However, the board cannot intervene in the management of the corporation. The members of the supervisory board are not normally responsible for managerial decisions, whereas an administrative board in an SA remains responsible for the SA's management. This difference aside, the two boards act in essentially the same way.

II. CORPORATE GOVERNANCE IN FRANCE: MUCH ADO ABOUT NOTHING?

A. The Reports

1. Viénot Report

The Viénot Report: a Modernizing Yet Timid Step Forward. As opposed to the Cadbury Report, which was the result of an eighteen-month collaboration among executives of listed companies, the Viénot Report was drafted in a few months without much consultation.[398] It has come under some criticism,[399] yet this Report is beneficial for a few reasons. First, it has a pedagogical interest: it identifies key issues in the corporate governance debate in France. If the work done in the United States, Canada, and the

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[398] Option Finance (1995).

[399] See e.g., Option Finance, December 18, 1995. *Option Finance*, a French weekly financial magazine, published on December 18, 1995, a special issue entitled "1995, Une Année de Finance - Le Bilan". The article in June 1995, entitled "Corporate Governance: Beaucoup de Bruit Pour Rien", related the principal recommendations of the Viénot Report. The author concluded that despite the Viénot Report there remains a lot to do in order to make corporate governance a reality in France:

> "Il reste donc beaucoup à faire pour que le gouvernement d'entreprise ne reste pas en France qu'un voeu pieux."

United Kingdom must be analyzed, there cannot be a mere application of these principles in France. Second, it points out the main changes that need to occur to bring France to the same level of corporate governance as its partners. That is mainly:

- the concept of independence of the board; and
- the creation of specialized committees.

Thus, through a series of technical measures, listed below, a board of directors must become a true decision making body and not, as is often the case, a recording body:

- a need to review cross directorships;
- effective limits on the number of directorships held;
- creation of independent directors and the notion of the accountability of the board to the shareholders;
- creation of audit, compensation and nominating committees;
- adoption of proper working methods and respect for the board's right to be informed and in control;
- adoption of a director's charter.

Furthermore, it carries a series of strong messages. It incites all boards to consider regularly their make up and *modus operandi* in order to evaluate the quality of their efforts in respect of their given missions.

Nonetheless, reading this report leaves a taste of the unachieved as it does not consider — or does so without serious debate — a series of fundamental questions:

- to give priority to the company's interests over those of the shareholder is not without consequences. One of the principal causes of the non-functioning of the board is the imperfect representation of shareholder interests due to the mediocre functioning of annual general meetings.
- to recognize the director's duty to obtain information without being prepared to touch on the legal ambiguity of the director's total lack of individual authority is nonsensical.

- to close the door on all legislative evolution on these matters is to accept that one remains in a system which can produce the best of both worlds: best when the PDG is conscious of his or her obligations *vis-à-vis* the board, and worst when he or she controls power with neither distribution nor safety measures.
- to recommend the creation of compensation committees without questioning the masquerade performed by those whose only objective is to avoid the publication of officers and director's salaries (a practice questioned by the *Cour de cassation* on July 4, 1995) is to consider only half of the issue.
- to plan no detailed implementation measures for its recommendations is to condemn the Viénot Report to the peril of being simply an alibi and not a vector of change (as opposed to its British equivalent which clearly defined implementation measures for its recommendations).

2. Marini Report

The main characteristic of the Marini Report is its *laisser-faire* attitude towards corporate governance issues. Some have objected that Senator Marini excludes the idea of imposing the presence of independent directors on the board. According to him, this matter lies in the hands of market actors and not the legislator.[400]

As for concepts, the Marini report embarks on at least one clearly innovative path which reveals a preference for a return to the basis of the contract. By affirming that jurisprudence has gone too far in considering a company as an institution carrying an *intérêt social* distinct from that of its members one can hope that contrary to the Viénot Report the primacy of shareholder interests will at least be restored. As a consequence, managers will be held to their mandates.[401]

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[400] "Il s'agit d'une question dont la solution relève essentiellement du comportement des acteurs et non de dispositions législatives". *MTF-L'AGEFI, supra* note 104 at 30.

[401] It is necessary to bear in mind that the more this concept is removed from the sole basis of shareholders' interests towards the common good, the more managers responsible for multiple interests dispose of greater freedom of maneuver and can distance themselves from shareholder control.

The most significant recommendations of the Marini Report are:

- the right (not the obligation) to disassociate in company articles the roles of the Chairman and the Chief Executive;
- the limit on the number of directorships;
- the statutory recognition of director's committees should give them greater weight;

Nonetheless, one regrets that the Marini Report is silent on certain questions which appear essential to proper corporate governance. Nothing is said about:

- the necessary disclosure of the individual compensation of directors and officers;
- the potential liability assumed by a non-executive Chairman or a director sitting on certain committees.

In conclusion, the Marini Report turned out to be very disappointing — at least in the corporate governance matter. Over all, it merely reproduced the recommendations contained in the Viénot Report. The law in progress should not go beyond Marini's recommendations.

B. The Corporate Governance Debate and its French Specificities

The Debate. A number of scandals involving major companies have shaken public opinion and put corporate government in the public spotlight. The chairman of Alcatel, the telecom giant, was questioned for deliberate over-billing of France Telecom,[402] and using corporate funds to finance political parties. After colossal losses for several years running, the Crédit Lyonnais had to ask the government to come to its rescue for the first time in 1994.[403] These examples which show the failure of the corporate and political elite are both indicative of a lack of clear delineation of responsibilities within French companies.

The pressure for reform is picking up momentum. Shareholders, even minority shareholders, are joining together to defend their rights in board matters. Organizations like the *Association de défense des actionnaires minoritaires*, under Colette Neuville, are

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[402] According to *Le Monde* of June 26th 1994, the over-billing is estimated to be FF 500 millions.
[403] According to *Libération* of March 14th 1997, the government aid to Crédit Lyonnais reaches FF 130 to 150 billions!!

working together to promote directors' responsibilities, transparency, more equitable treatment of shareholders, and even seats on boards.

The French corporate governance debate involves a number of institutional and individual participants of a high stature, the national government being the most important among them. For example, deficit reduction is high on the public agenda, and the government appears committed to private pension plans. The ultimate objective is to provide some relief to the present social welfare system. By creating a system of funded retirements, personal savings invested in the market would be used by privatized companies whose equities would be held in pension fund portfolios. In addition, privatized companies are more likely to pay attention to profit and performance.

Prior to privatization, banks which held shares of major corporations in France were one more vehicle the national government used in managing the economy. And the same banks, namely Crédit Lyonnais, Banque Nationale de Paris (BNP), Société Générale, Paribas, Crédit Agricole and Banque de Suez will continue to play a major role in the restructuring of the French system. Furthermore, insurance companies such as Assurance Générale de France (AGF) and Union d'Assurance de Paris (UAP), the Stock Exchange, and market organizations such as the *Comission des Opérations de Bourse* (COB), *SBF-Bourse de Paris*, and *Conseil des Bourses des Valeurs*, are likely to play active roles in the debate on corporate governance. All of these players are at the top of all the major industrial and financial institutions with cross holdings in several corporations.

There are several ways to ensure that all the institutions which have shareholders who are based in France remain stable. Up until recently a number of major institutional investors were controlled by the national government, which used its holdings to influence most industries. This practice tends to be winding down due to the privatization of a large number of corporations. However, the national government has reserved a share capital in companies that are to be privatized for groups of shareholders who form a stable shareholder core holding stakes of at least 10 per cent for an eighteen-month minimum. This policy also seems to be easing up because core shareholders are no longer going to be required to hold their shares for such an extended period.

French corporations can also change or restrict voting rights by amending their bylaws. They can grant double voting rights to long-standing shareholders in order to provide for a stable shareholder base. In addition, shareholders have to disclose any changes of shareholdings to France's watchdog, COB, when they surpass or fall beneath threshold levels of 5, 10, 20, 33.3, and 66.6 per cent.

The "Exception à la Française". No one can disagree with the fact that:

> "Concepts of corporate governance are not directly transferable from the English-speaking world to France, where power is exercised differently."[404]

Moving from corporate governance to actually governing companies involves more than translation from one language into another. There are major cultural differences between France and the English-speaking world. For some, specific mentalities and entrepreneurial practices, more than actual regulations and legal structures, are at the root of the French difference.

The first difference is that the French system is based on a tradition of strong centralization. In the "classic" SA, if officially it is the board that elects the chairman, in practice, it is the chairman who selects directors, by submitting a list of nominees to the shareholders for their approval.[405] Therefore, all executive power is vested in the chairman. This stems from a long tradition of a strong centralized authority, but it has also given chairmen an excessive amount of influence over corporate policy. Although French law is sensitive to the presence of internal directors on corporate boards limiting their number to one-third of the total,[406] the way a company is run depends mainly on the personalities of its directors and its chairman.

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[404] MTF-L'AGEFI, *supra* note 104 at 68.

[405] Shareholders can reject the chairman's list and nominate different individuals. However, this rarely happens, not only because the support of the chairman and other board membres is very important, but also because the names of the other board candidates must be on the *ordre du jour* (the *ordre du jour* limits the debates and the voting at the annual general meeting).

[406] 1966 Company Law, Article 93 §3:

> "Le nombre des administrateurs liés à la société par un contrat de travail ne peut dépasser le tiers des administrateurs en fonctions:"

At a time when directors continue to be heavily influenced by France's tradition of centralization, the country is going through a period of transition toward a more market-oriented economy. The privatization process goes hand in hand with the need to increase the capitalization of the French market. Raising capital through issues of equity is fairly under-developed in France due to the low level of market capitalization and massive government intervention. This tradition is all the more entrenched since smaller family run companies prefer to raise capital by issuing a debt rather than equity in order to retain control with the family. Even large corporations often prefer bond issues or major cross holdings among friendly companies to public issues of equity. With capital markets under-developed, liquidity is also very limited. However, equity issues should become more common, because capital markets are growing under privatization, and the government is trying to create a shareholder culture as well.

In the United States, the UK and Canada, the board's role is to increase share value. But in France, boards promote the business interests of corporations as separate objectives. In fact, the *intérêt social* is distinct from the interests of shareholders, employees, creditors, tax authorities, suppliers and customers.

There also seems to be a great deal of flexibility in the French system of governing corporations. Under French law, boards can organize responsibilities according to the specific needs of companies. Another important factor that makes the corporate governance debate in France different than in the other countries studied is the substantial presence of foreign institutional investors, and their active role.[407] These investors such as CalPERS have to adapt their objectives to the prevailing conditions in each country. Different goals are set for the different targeted countries, through in-depth analyses of the political, economic, and financial environment in each country. According to Richard Kopes, former vice-president of CalPERS:

[407] Foreign investors own approximately 30 per cent of the value of stocks on the Paris stock market. See *supra* note 34. The largest shareholders of some of France's most important companies are now US or UK investment funds. For example, Pechiney's two largest shareholders are the US investment fund Templeton and Henderson Management from the UK.

"CalPERS' goal is to understand and to take into account local practices in the exercise of corporate governance. Naturally, a chapter is dedicated to France, where the fund recognizes that implementation of its policy will require "tact and diplomacy"."[408]

C. Corporate Governance in France Today

The Déminor Survey. The UK, France, Germany, Belgium, Holland: this is the ranking of the five major European financial centers on the issue of corporate governance. This ranking was established by Déminor, a company specialized in corporate governance issues, based mainly on recent annual reports and the bylaws of 140 companies listed on the leading European stock exchange indices.[409]

Déminor considered five criteria:

- the attention paid to the rights and duties of shareholders;
- observance of any practices discriminating against minority shareholders;
- the quality and accessibility of information made available to institutional shareholders and small investors;
- the independence and efficiency of the decision-making bodies;
- the independence and efficiency of any existing advisory committees to the board of directors.

The first stage survey was at the country level. The study revealed certain general trends in the five countries examined. For instance, European shareholders are often poorly informed as to how the board of directors operates, or how share buy-backs are carried out or even on mergers which are contested by minority shareholders. According to Déminor, there are other results which are country-specific. For instance, manager's pay is only truly made public in the UK. Elsewhere, this information is parsimonious and incomplete, except in the case of certain French companies. Hence, most of the time, shareholders are only given a consolidated figure that provides the total payments made to

[408] R. Kopes, "Origine et développement de la "Corporate Governance"", Colloque Droit et Démocratie, *supra* note 396.

[409] DAX in Germany, FT-30 in Great Britain, CAC 40 in France, AEX in the Netherlands and BEL-20 in Belgium.

the management team. Furthermore, only the UK and France seem to go in for creating committees within the board of directors. On the contrary, the other countries appear much more reserved on the issues. Lastly, the rule of "one share, one vote", is only followed in the UK, Belgium and Germany. On the other hand, Dutch companies almost consistently maintain considerable distinctions between the right to ownership and control to the company.

The second part of the Déminor study highlights those companies in Europe which hold the principles of corporate governance the highest. In the UK, they are GEC, Glaxo-Welcom-Hanson, Marks & Spencer, Boots. The French companies Air Liquide, Crédit commercial de France (CCF), l'Oréal, Lyonnaise, and Rhône-Poulenc stand out clearly on the issue of corporate governance. By comparing each company's score with its financial performance, Déminor showed that a correlation would only be possible for the UK. This would seem to imply that the relationship between corporate governance and financial performance is not immediate, but could arise beyond a certain maturity threshold. This intuition would seem to be corroborated by the behavior of US pension funds which make corporate governance a key factor for their investment in European firms.

In its survey, Déminor confirms the relevance of Senator Marini's report. The survey judges its proposals to be "excellent", and specifies that "their adoption by the parliament should enhance Paris' credibility as a key financial capital in the eyes of international investors." Hence, they are likely to encourage companies to better inform their shareholders, to simplify participation in meetings, particularly by making use of proxy votes, to reduce anti-takeover measures and to adopt a code of good conduct for financial restructuring, whether it involves mergers, takeovers, or issues to do with threshold-crossing and share buy-backs.

In conclusion, the Déminor study has revealed that France, compared to its European partners, is far from being left behind in the corporate governance race.

Application of the Viénot Report. According to the Cegos report on French corporate governance,[410] boards are increasingly organized in specialized committees. Audit committees are growing the most rapidly. Of the companies responding to the survey, 51 per cent reported having an audit committee in 1995, compared with only 33 per cent in 1994. The rise was even more significant between 1995 and 1996: at the end of 1996, a quick survey realised by AFEP, the French association of private companies, revealed that 86 per cent of boards of directors had an audit committee.[411] However, contrary to the recommendations of the Viénot Report, 28 per cent of committees include at least one member of the *technostructure*, or of France's governing elite. Sixty-eight per cent of corporations reported having compensation committees, compared with only 62 per cent in 1994. One third included a representative of the *technostructure*. Twenty-seven per cent of corporate boards included a nominating committee, compared with only 15 per cent in 1994. Usually, one representative of the *technostructure* is on the committee. Thirty per cent of corporations reported having other types of specialized committees, including strategic development, ethics, and shareholder relations committees.

So all in all, 80 per cent of corporations have one or more specialized committee. Thirty-six per cent pay directors additional fees for service on committees.

The Cegos study also reveals that there are more and more independent directors within the meaning of the Viénot Report (directors who are neither large shareholders — a category that is not precisely defined in the report — nor customers or suppliers, nor present of former employees, nor internal executives). With an average of thirteen directors, usually elected to five-year terms, 86 per cent of the boards had at least one independent director in 1995, compared with only 74 per cent the previous year. However, independent directors are still in a minority on most boards. The average was five, but 66 per cent of companies responding reported fewer than five.

The rise of independent directors goes hand in hand with the increasing presence of another category of director (who is not at all independent, at least in the meaning of the

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[410] The questionnaire in reference to the recommendations of the Viénot and Cadbury Reports (February 1996).

[411] See MTF-L'AGEFI, *supra* note 104 at 38.

Viénot Report) namely directors who are part of the *technostructure*. They were present on 72 per cent of board in 1995, compared with only 67 per cent in 1994 among corporations responding to the survey.[412] Only 28 per cent of French companies operating as a SA reported a corporate officer other than the CEO on the board. Seventy-four per cent of companies reported having directors with both executive responsibilities and responsibilities for representing outside interest. They averaged six per board, although there were no more than three cross directorships on average. Twenty-two percent of companies have bylaws calling for a certain number of directors to be designated by employees rather than by shareholders.

Conclusion. Both the Déminor and the Cegos surveys have revealed that France is on its way for better corporate governance. It is also important to mention the recent creation of the *Observatoire du gouvernement d'entreprise* on May 22, replaced a few months later by the *Centre d'Etudes du Gouvernement d'Entreprise*.[413] This body's principal mission is to promote and coordinate corporate governance for French listed companies. With this new entity, France could become a member of the International Corporate Governance Network (ICGN), a new organization which has the objective to link the world's corporate governance actors.[414]

III. REFORM RECOMMENDATIONS

Our recommendations are primarily directed to the French legislator. They could also be of interest to other jurisdictions such as those that have been the focus of our study. Before describing the recommendations, it is necessary to deal with one of the major

[412] *Ibid* at 39. The AFEP study revealed that 90 per cent of boards of directors include independent directors.
[413] The *Centre d'Etudes du Gouvernement d'Entreprise* was instituted by the *SBF-Bourse de Paris* and the *CNPF*.
[414] See MTF-L'AGEFI, *supra* note 104 at 65. The ICGN was created on March 29, 1995 in Washington with the objective to faciliating the exchange of ideas and information on corporate governance, the exercise of shareholder rights and the protection of minority shareholder interests. The main reasons of ICGN's creation is that of the geographic diversification of assets undertaken by major institutional investors and the change in approach on matters of corporate governance by these same institutions. The ICGN is looking to establish a code of good conduct for corporate governance which would be actively promoted amongst the members' home countries. Membership in the ICGN is open to all representatives of national organisations of individual or institutional shareholders.

questions that arises when dealing with any new set of norms: should these norms be mandatory?

It is important to bear in mind that the guidelines and principles of the ALI. Cadbury. Dey. and Viénot reports are not binding.[415]

We disagree with Sir Adrian Cadbury who favors a voluntary approach. He believes that a non-binding code coupled with disclosure is more effective than a statutory code.[416] According to him it is only if companies do not apply the Report recommendations that legislation should be sought to impose minimum standards.[417] Senator Marini follows the same view. as do others.[418]

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[415] See Chapter II at II.

[416] **Cadbury Report**. *supra* note 6 at 1.10:

> "We believe that our approach. based on compliance with a voluntary code coupled with disclosure. will prove more effective than a statutory code. It is directed at establishing best practice. at encouraging pressure from shareholders to hasten its widespread adoption. and at allowing some flexibility in implementation. We recognize. however. that if companies do not back our recommendations. it is probable that legislation and external regulation will be sought to deal with some of the underlying problems which the report identifies. Statutory measures would impose a minimum standard and there would be a greater risk of boards complying with the letter. rather with the spirit. of their requirements."

[417] *Ibid.*

[418] **H. Juvin**. "Du *corporate governance* aux stratégies d'actionnariat". *MTF-L'AGEFI. supra* note 104 at 32. According to him:

> "Le rôle central attribué au contrat privé dans le futur projet de loi sur les sociétés devra être observé avec attention et espoir: car il s'agit bien de remettre le train de la loi sur ses rails. en reconnaissant la force des contrats privés. et en acceptant que la liberté des parties contractantes mesure l'étendue de leur responsabilité."

See also the interviews during the conference "Gouvernement d'entreprise". organised by l'Agefi. November 6. 1995. reported in MTF-L'AGEFI. *supra* note 104 at 39.

- André Lévy Lang of Paribas:

> "Such as it is. the Viénot Report is a relatively exemplary exercise in corporate self-regulation. To me. it is important that we demonstrate our ability to rule ourselves. to apply those operating rules that generally suffice to improve the system without having to legislate further. In France. we are too used to over-legislating."

- Marc Viénot of Société Générale:

> "The Report deliberately took a flexible approach.

We believe that non-binding recommendations are inappropriate for France. First, French corporate governance actors have been aware of the debate and the recommendations that have been made in other countries. For that reason, they cannot propose to set lower standards for French listed companies. That would inevitably lead to inhibit foreign investors to invest on the French capital markets.

Some have reacted against this *laisser-faire* attitude. For example, the London Stock Exchange has required that every listed company include a statement in its annual

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> The COB approved this approach and the report's chief implications. Reactions to the initiatives that French companies have already taken from the large UK and US institutional investors and shareholder associations show that this is the right approach.
>
> There would not seem to me to be any need for intervention by the lawmakers (except to improve the way board meetings are run by allowing them to use all modern forms of simultaneous, interactive communication to carry out meetings).
>
> For his part, Senator Marini has come up with plenty of other interesting proposals on the general topic of corporate governance, but I am afraid that they may create even more onerous formalities to be followed. For instance, I am against the idea of the board giving delegation to certain committees which would then, even without decision-making power, be able to present their conclusions to the general meeting."

- Jean Peyrelevade of Crédit Lyonnais (who is the leading "collector" of board membership with 9 directorships):

> "Many things have changed, and may yet change under the pressure of shareholders, especially foreign shareholders, and maybe also under the pressure of the courts. Will these changes become so widespread that the recommendations of the Viénot Report will be implemented everywhere? I do not think so.
>
> First, the heads of the large listed companies are divided over this point: a strong minority is still opposed to the very principle of corporate governance and of the kinds of committees that a number of us have tried to institute. Second, I do not think that we have the British knack of generalizing recommendations and of rendering them compulsory. This goes against French practice, in which the sanction has to be of a regulatory or legislative nature".

- Pierre Richard of Crédit Local de France:

> "The Viénot Report has been more useful in showing things up than in setting off a pro-corporate governance movement, the reason being that it already started in the larger French companies. Instead, it provides a very useful guide to companies which were lagging behind. To tell the truth, the changes in mindset occurred very rapidly. The "French exception" has ceased to exist: people don't dare to mention 'French-style capitalism" for fear of scaring off international investors! As for weakness, I would mention the reciprocal shareholdings and the way directors are swapped between companies, which limits the control that managers have. That is on of the last peculiarities of the French system, which must be corrected before long and should eventually disappear."

report and accounts confirming that it is complying with the Code, or giving details of and reasons for any areas of non-compliance.[419] Such explanations would be detrimental to the companies, and would put them in a feeble competitive position. This approach is the first step towards a better compliance with the recommendations. But a similar approach by the COB would not be sufficient to homogenize corporate governance in France. It is important for that reason to keep the pressure on the national government so that it translates the "soft" law of these recommendations into legally binding obligations for listed companies.

A. Necessity to Favor The New SA Form

The dual system offers the most guarantees for independence of the board. However, it is still not popular in France. Less than two per cent of French companies have adopted the dual structure.[420]

Pros. First, while in the classic form the administrative board is not limited to merely supervising the PDG's actions but theoretically at least, participates in the classic SA's management, the new SA form distinctly separates these two functions. This reflects more accurately the reality of the operation of an SA: the administrative board often fulfills only a supervisory role. Second, unlike administrators and the PDG who must all be shareholders the members of the directorate need not own any shares. Therefore, professional managers can be appointed without their holding a sufficient number of shares to attend shareholders' meeting or needing to hold "guarantee" shares. Thirdly, the shareholders' control over the members of the directorate is not necessarily less effective than in the classic form since their representatives on the supervisory board choose the directorate members and decide which of them will represent the corporation. Furthermore, the articles can make certain managerial acts subject to prior board approval. Finally, the supervisors' exposure to civil and criminal liability is significantly less than that of administrators, because they are not responsible for managing the corporation. In

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[419] See Chapter II at II. B.
[420] Caussain, *supra* note 397.

practice. the responsibility connected with being an administrator could deter a person with a limited amount of time to devote to the corporation's business from accepting a position on the board.

Cons. The new SA is not a panacea. In practice. there is a risk that a supervisory board could become a "rubber stamp" and the directorate itself could become a sort of administrative board. More particularly. the fact that the president is not involved in selecting the other members of the directorate and. specifically. the general managers. could damage the directorate's ability to act coherently. Finally. the fact that a supervisor cannot serve in any other salaried position in the enterprise could prevent a small corporation from using the new form when all shareholders are employees.

B. Modifications to the 1966 Company Law

We believe that the 1966 Company Law should be amended to incorporate certain elements to increase the independence of the board: the presence of independent directors on the board. the creation of specialized committees. the reduction of interlocking directorships. and the separation of the functions of Chairman and Chief Executive Officer. We focus only on the regulations of the classic SA. because they concern most of the corporations.

1. The "Administrateurs Indépendants" and the "Président du Conseil"

Recommending the participation of outside directors on the board raises a few questions. The main one is whether it would be useful. On that matter. France does not differ from its US. UK. and Canadian partners: independent directors are indispensable on boards to bring better objectivity. Another issue is their degree of independence. Should they be outside directors or *stricto sensu* independent directors? The Viénot Report is in favor of the latter.[421] and so are we. The more independent the board. the better the impartiality of the debate. and the representation of the interests of the shareholders.

Another problem concerns the question of the number of independent directors on the board. Should there be a fixed number. a minimum number. or a proportion of independent directors? We saw earlier the pros and cons of both inside and

[421] See e.g. the definition of the *administrateur indépendant. supra* note 267.

outside/independent directors. The choice of the balance should lie in the hands of the members of the board. This explains why in our proposed amendment of Article 89 alinéa 1 of the 1966 Company Law we employ the terms "en nombre suffisant". If they consider it necessary to have the views of an insider then the *président du conseil* should be chosen from outside the board. If not, he or she could be chosen within the members of the board

At present, Article 89 alinéa 1 of the 1966 Company Law reads:

> Article 89 La société anonyme est administrée par un conseil d'administration composé de trois membres au moins. Les status fixent le nombre maximum des membres du conseil, qui ne peut dépasser vingt-quatre.

We propose the following amendment:

> Article 89 La société anonyme est administrée par un conseil d'administration composé de trois membres au moins. Le nombre de membres du conseil ne peut être inférieur à trois. Les statuts fixent le nombre maximum des membres du conseil, qui ne peut dépasser vingt-quatre. Le conseil doit comprendre des administrateurs indépendants en nombre suffisant pour assurer son bon fonctionnement dans l'intérêt social de l'entreprise.

This new Article 89 is purposely imprecise: "nombre suffisant", "bon fonctionnement". We believe that it is important to set a minimum standard rather than imposing a percentage of independent directors (e.g., 1/3, or 2/3). Every board and every company are different. It is the role of the *jurisprudence* to bring more accuracy. This amendment also points out the purpose for the presence of independent directors: better board performance in the interest of the corporation as a whole, that is its *intérêt social.*[422]

Another article must be amended. Article 110 alinéa 1 reads:

> Article 110 Le conseil d'administration élit parmi ses membres un président qui est, à peine de nullité de la nomination, une personne physique. Il détermine sa rémunération.

[422] See Chapter III III.E. for a definition of the *intérêt social.*

We propose that Article 110 be amended as follows:

Article 110 Le conseil d'administration. sur proposition du comité de sélection. élit un président parmi ses membres ou non. qui est. à peine de nullité de la nomination. une personne physique. Il détermine sa rémunération après avis du comité des rémunérations.[423]

2. Specialized Committees

Pursuant to Article 90 of the 1967 Décret implementing the 1966 Company Law. the board is allowed to create committees which study questions posed by the board or the chairman. These *ad hoc* committees do not have specific functions. and are solely advisory. Many listed corporations have already gone beyond the creation of *ad hoc* committees and have established formally (or not) specialized committees. However. the creation of such committees would not be seen as an incentive for foreign investors unless it is harmonized. Therefore. it is necessary to introduce the concept of specialized committees in the 1966 Company Law itself. We propose the creation of a new article. Its drafting is inspired by Article 90 of the 1967 Décret. and by the Viénot Report could be as follows:

<u>Chapitre IV. Section III. Sous-section III: Dispositions communes</u>

Article 150-1 Le conseil doit se doter au moins d'un comité de sélection. d'un comité d'audit. et d'un comité des rémunérations. Le conseil peut également décider la création d'autres comités chargés d'étudier les questions que lui-même ou son président soumet à leurs examens.
Les membres composant ces comités spécialisés sont choisis parmi les membres du conseil. et doivent être. en nombre suffisant. des administrateurs indépendants. Le président du conseil peut siéger dans un ou plusieurs comités spécialisés.

The number of independent directors on a specialized committee is purposely imprecise for the reasons stated above for the proposed amendment to Article 89. This general amendment is not sufficient. and it is also necessary to amend specific articles to include

[423] See below III.B.2. for the *comité de sélection* and the *comité des rémunérations.*

the different specialized committees. The proposed modifications will not need much explanation.

a) Comité de Sélection

The first directors are elected by the shareholders at the first general meeting (*assemblée générale constitutive*).[424] The board is responsible for the following nominations of directors, but the general meeting must ratify this choice.[425] We propose to amend Article 90 and Article 110 of the 1966 Company Law. The proposed new Article 110 has been described above.[426] Pursuant to Article 90 of the 1966 Company Law:

> Article 90 Les administrateurs sont nommés par l'assemblée générale constitutive ou par l'assemblée ordinaire.

We propose this new draft:

> Article 90 Les administrateurs sont nommés par l'assemblée générale constitutive, ou par l'assemblée ordinaire sur proposition du comité de sélection.

The *comité de sélection* composed of inside and outside directors proposes a list of board candidates to the general meeting. At the general meeting, shareholders can propose other board candidates with respect to the rule of the *ordre du jour*.[427] Therefore, the creation of a *comité de sélection* only affects the nomination of board candidates not their actual election.[428] The final decision (i.e., the actual election) remains in the hands of the shareholders as a whole.

b) Comité d'Audit

We have seen earlier that the audit committee is the key committee in US, UK, and Canadian companies, not only by its popularity but also by its important functions.[429] In France, the board is responsible for approving the published financial statements (Company Law Articles 157 and 340). The establishment of an audit committee is highly

[424] 1966 Company Law, Article 90.
[425] 1966 Company Law, Article 94.
[426] See above VIII.B.1.
[427] See *supra* note 405.
[428] This explains why we prefer the terms "comité de sélection" rather than "comité de nomination".
[429] See Chapter V at II.A.

recommended by the Viénot Report which gives it the function of overseeing the stability and effectiveness of auditing methods, and the quality of financial information. As for the amendments, we only deal with Article 157 which states that:

> Article 157 L'assemblée générale ordinaire est réunie au moins une fois par an, dans les six mois de la clotûre de l'exercice, sous réserve de prolongation de ce délai par décision de justice. Après lecture de son rapport, le conseil d'administration ou le directoire, selon le cas, présente à l'assemblée les comptes annuels et, le cas échéant, les comptes consolidés.

We propose the following amendment:

> Article 157 L'assemblé générale ordinaire est réunie au moins une fois par an, dans les six mois de la clôture de l'exercice, sous réserve de prolongation de ce délai par décision de justice.
> Le conseil d'administration ou le directoire, selon le cas, doit requérir l'avis du comité d'audit sur l'approbation des comptes annuels.
> Après lecture de son rapport, le conseil d'administration ou le directoire, selon le cas, présente à l'assemblée les comptes annuels et, le cas échéant, les comptes consolidés.

The Viénot Report does not go as far as the Dey Report which recommends that the audit committee be composed solely of outsiders. We believe that insiders are necessary to better assess auditing methods and the effectiveness of financial information. The "nombre suffisant" of outsiders of Article 150-1 seems compatible with this view, keeping in mind that the jurisprudence will reduce this uncertainty.

c) Comité des Rémunérations

Excessive directors and top executives' compensation has also been in France one of the determining factors in the pressure for more independent board, and the establishment of compensation committees. The *comité des rémunérations* should play an active role in determining the compensation of the members of the board. Its functions should not be different than what has been described earlier.[430] It is necessary to amend the 1966 Company Law. Article 108 of the 1966 Company Law reads:

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[430] See Chapter V at II.B.3.

Article 108 L'assemblée générale peut allouer aux administrateurs en rémunération de leur activité, à titre de jetons de présence, une somme fixe annuelle que cette assemblée détermine sans être liée par des dispositions statutaires ou des décisions antérieures.

We propose this new version:

Article 108 L'assemblée générale, après avis du comité des rémunérations, peut allouer aux administrateurs en rémunération de leur activité, à titre de jetons de présence, une somme fixe annuelle que cette assemblée détermine sans être liée par des dispositions statutaires ou des décisions antérieures.

The *comité des rémunérations* should also be consulted for the compensation of the *président du conseil*. Article 110 of the 1966 Company Law should be amended as described above to accomplish this.[431] It is important to point out that the one committee that should be fully independent is the compensation committee.[432] The "nombre suffisant" of independent directors proposed in the new Article 150-1 could be raised to a figure close to 2/3 of independent directors or could even call for full independence. Article 108 should then be comprised of a second paragraph such as:

Article 108 Le comité des rémunérations doit comprendre deux tiers d'administrateurs indépendants.

or

Article 108 Le comité des rémunérations doit être composé exclusivement d'administrateurs indépendants.

Once again, we favor a *laisser-faire* attitude in this legally binding context at this juncture of comparative law reform in France. The terms "en nombre suffisant" should be defined as appropriate to each company in its particular circumstances. There may be different standards for the different committees on a company-to-company basis.

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[431] See above VIII.B.1

[432] This is the case in some US, UK, and Canadian corporations. See Chapter V at II.

3. The Reduction of the Number of Directorships

Pursuant to Article 92 of the 1966 Company Law, the maximum of directorships that one can undertake is 8.[433] The Viénot Report lowers this number: it recommends the limitation five directorships in the sole case of a director who is also Chairman or CEO.[434] It is difficult to say whether this reduction is sufficient. Some companies, such as Air Liquide, have decided not to allow any interlocking directorship for the members of its board.[435] This situation is extreme. However, this is the goal that must be sought.

4. The Separation of the Functions of *Président du Conseil* and *Directeur Général.*

Another important theme is the separation of functions between the *Président du Conseil* and the *Directeur Général.* However, the Viénot Report seems strongly opposed to it.[436] the Marini Report does not deal with it. Very few corporations are incorporated under the new SA form which separates well the two functions. This is due to the fact that the new SA form does not only come with a separate management and supervisory board, but also with other mechanisms wrongly believed to be more complex. In this context, the classic SA combined with a separation of the functions of CEO and Chairman appears to be a fair compromise between no separation at all and the new SA form. Therefore, the government should not put aside this issue even though senator Marini does not deal with it in his report.

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433 1966 Company Law, at art. 92:

> "Une personne physique ne peut appartenir simultanément à plus de huit conseils d'administration de sociétés anonymes ayant leur siège social en France métropolitaine."

This rule is applicable to the classic SA with a board of directors and a president general manager. For the "new" SA composed of a directorate and a supervisory board, article 127 of the 1966 Company Law indicates that no one can be a member of more than two directorates. For a more detailed description of the two forms of SA, see Chapter VIII.

434 See *supra* note 155.

435 Interview with Mr. Delvos, Responsable du Service aux Actionnaires d'Air Liquide.

436 **Viénot Report**, *supra* note 1 at I.4.

CONCLUSION

We have focused our recommendations on the independent director. the establishment of specialized committees. and the reduction of the number of directorships. and the separation of the functions of *Président du Conseil* and *Directeur Général*. These four themes appear to be the most important ones. not only in the Viénot Report but also in the other debates involving the corporate governance actors. We believe in changes by stages. We suggest that the 1966 Company Law be amended. and that there be a revision every 5 years to implement new changes. such as the as the nomination of a lead director.[437]

There are still a lot of obstacles to overcome to bring better corporate governance to French boards. The biggest challenge in France may well be the perception that US . UK and Canadian models are being imposed on French business. France is certainly going to want to keep its own identity. Institutional investors will have to take this identity into account. Nevertheless. the ultimate goal is to attract more and more investors in the French capital market. France can not expect to set lower standards than any of the another countries already submerged by the corporate governance wave. The fastest way to attain an homogenous minimum standard is to legislate. and we therefore consider the Marini propositions too weak. There are also other obstacles of importance such as the ability of the national government and corporations to restrict voting rights. or grant double rights.

Another obstacles lies in the limitations to the concept of independent directors. The concept of independent director. in the sense of the Viénot Report. is almost inapplicable in the case of companies whose equity capital is concentrated in the hands of the managers or a family. This is notably the case of Promodès (54 per cent of the voting rights belong to the Halley family). or Eridania Béghin-Say (50.3 per cent of the capital belongs to Montedisone). Likewise. Carrefour's board is predominantly made up of the owners (the Fournier and Defforey families). These directors. if they cannot be considered independent in the terms of the Viénot Report. are nonetheless particularly demanding since they are directly and financially implicated in the success or failure of the company.

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[437] See Chapter VII.

Along these lines, at Pernod-Ricard the make-up of the board itself is considered "ideal for defending shareholder interests", since 40 per cent of the equity capital is held by the founding families and the staff (with another 20 per cent in the hands of shareholders regarded as "faithful"). Schneider also contests the idea of the independent director since "a director does not have to be independent *per se*, but should represent the interests of shareholders." The prevailing view at Air Liquide is that the heart of the matter is respect for the shareholder, which can be expressed in other ways than those put forward by the Viénot Report.[438] At Air Liquide, for the last twenty years, the shareholders meetings have been held on a regular basis in areas remote from Paris.

These obstacles could easily be surpassed with better information and clarification of the concepts of corporate governance (for instance by the *Centre d'Etudes du Gouvernement d'Entreprise*).

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[438] See *supra* note 435.

CONCLUSION

> "For the time being, we cannot establish a cause and effect relationship between corporate governance and corporate performance. As long as we do not show that relationship exists... the principles of corporate governance in the best cases will be the object of polite attention or perhaps more often the object of generalized scepticism."
>
> **(Jean-Claude Delorme, 1994)**

Does corporate governance matter?[439] Our study has demonstrated that companies with good board governance practices (i.e., independent directors, specialised committees, ...) have a shareholder-value focus, and that institutional investors care about good governance. There are key variables that influence the importance certain investors place on good performance. Investors with low turnover ratios in their portfolios value governance most. They hold stocks longer and believe good governance will help improve performance in the long term. The stock of a well-governed company may be worth more simply because governance is such a hot topic these days.

Just how much is good corporate governance worth? There are three main reasons why investors will pay a premium for good governance: a company with good governance will perform better over time, leading to a higher stock price. Also, good governance is a means of reducing risk, because it decreases the likelihood of "bad things" happening to a company. Finally, when "bad things" do happen, well-governed companies are more likely to rebound more quickly.

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[439] **J. Gillies & D. Morra**, "Does Corporate Governance Matter?" (1997) Bus. Quat. Spring 1997, 71.

When is good governance important? It is the most important during crises, or when CEOs might be tempted to spend too freely unless constrained by a strong board (for example, in a declining industry with high cash flows). By contrast, governance is least important in highly competitive industries, where market pressures keep CEOs on their toes more effectively than any board ever could.

If for some the recent increase in attention to governance remains fade, we consider that believing in the value of corporate governance should no longer be a question of faith. Some investors will pay a significant premium for good governance. And though it is more important in some circumstances than in others, and more important to managers of some types of funds than others, it remains clear that good board governance can serve as a tool for attracting certain types of investors, as well as influencing what they will pay for stock. This should motivate the French government for improving corporate governance in France. Before then, companies can take actions to improve their own practices. A good first step would be for senior executives, investors and board members to learn how to talk together about substantive governance issues in a productive way. We believe that a much broader consensus exists on board issues between management and investors than has typically been portrayed, and that there are likely to be opportunities for much productive discussion.

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INDEX OF TABLES AND CHARTS

INDEX OF TABLES

INDEX OF CHARTS