EU CORPORATE GOVERNANCE, RECENT TRENDS AND DEVELOPMENTS, RELATED TO BOARD COMPOSITION AND CONFLICT OF INTERESTS

Abstract
A modern and efficient corporate governance framework for European undertakings, investors and employees must be adapted to the needs of today’s society and to the changing economic environment. High performing, effective boards are needed to challenge executive management. This means that boards need independent non-executive members with diverse views, skills and appropriate professional experience. Such members must also be willing to invest sufficient time in the work of the board.

The article addresses the following subjects which are at the heart of good corporate governance:
Comply or explain approach: The ‘comply or explain’ principle is an important tool for the application of the corporate governance rules in the EU. Most corporate governance is soft law and guidelines are included in voluntary national codes of conduct. In principle, member countries decide upon what type of legal instrument to use, in the respective field: mandatory or ‘comply or explain’.

Board of directors, structure and composition: There is no uniform approach as regard structure of corporate governance. As generally known, there are two basic concepts of the public limited (joint stock) companies' corporate governance structures: one and two tier system. In EU, different board structures coexist. Depending on the country, listed companies may put in place either a ‘single board’ system (also called ‘monistic’ or ‘unitary board’ system), a two-tier (or ‘dual board’) system or some form of mixed system.

Non-executive or supervisory directors: The administrative, managerial and supervisory bodies should include an appropriate balance of executive (managing) and non-executive (supervisory) directors such that no individual or small group of individuals can dominate decision-making on the part of these bodies. A sufficient number of independent non-executive or supervisory directors should be elected to the (supervisory) board of companies to ensure that any material conflict of interest involving directors will be properly dealt with.

Independent directors: A director should be considered to be independent only if he is free of any business, family or other relationship, with the company, its controlling shareholder or the management of either, that creates a conflict of interest such as to impair his judgement. Duties are assured (Annex II, which identifies a number of situations reflecting the relationships or circumstances usually recognised as likely to generate material conflict of interest). Boards should be organised in such a way that a sufficient number of independent non-executive or supervisory directors play an effective role in key areas where the potential for conflict of interest is particularly high.

Board committees: Nomination, remuneration and audit committees should be created. The nomination, remuneration and audit committees should make recommendations aimed at preparing the decisions to be taken by the (supervisory) board itself. The primary purpose of the committees should be to increase the efficiency of the (supervisory) board by making sure that decisions are based on due consideration, and to help organise its work with a view to ensuring that the decisions it takes are free of material conflicts of interest.

Keywords
Non-executive or supervisory director, Board committees, Independent directors, Qualifications and commitment of directors, Evaluation, transparency and communication of the (supervisory) board

1 University of Ljubljana, Slovenia, e-mail: Rado.Bohinc@fdv.uni-lj.si
1. Introduction

The ‘Europe 2020’ Communication\(^2\) calls for improvement of the business environment in Europe. An effective corporate governance framework is of key importance to society, as well-run companies are likely to be more competitive and more sustainable in the long term (\(2102\) COMMUNICATION Action Plan: European company law).

Corporate governance and company law are essential to ensure that companies are well-governed and sustainable in the long term and therefore have an important role to play in the long-term financing of the economy\(^3\).

Good corporate governance is first and foremost the responsibility of the company concerned. Rules at European and national level are in place to ensure that certain standards are respected. These include legislation and soft law, namely national corporate governance codes\(^4\).

EU Company law is lagging behind the developments in the EU and world economy. In any discussion on the future of EU company law, the financial and economic crisis that has challenged the business environment over the last years must be taken into account. It is obvious that weaknesses and malfunctions in EU company law have attributed to the crisis.

The last comprehensive analysis of European Company Law is the Plan on Modernising Company Law and Enhancing Corporate Governance in the European Union and the subsequent consultation on future priorities for this Action Plan carried out in 2005 and 2006 (\(2102\) COMMUNICATION Action Plan: European company law).


Moreover, the Commission adopted two Recommendations regarding the role of independent non-executive directors and remuneration (Commission Recommendations 2005/162/EC and 2004/913/EC).

Besides, the Second Company Law Directive on formation of public limited liability companies and the maintenance and alteration of their capital\(^8\) and the Third and Sixth Company Law Directive on mergers and divisions have been simplified (Directives 2007/63/EC and 2009/109/EC amending Directives 78/855/EEC and 82/891/EEC).

A number of legal solutions concerning the functioning of financial markets including those regulating the issues of directors’ disqualification and of the conflicts of interest arising between shareholders and managers, and those between shareholders and creditors, turned out to be weak, and therefore inappropriate and obsolete.

Harmonization can provide common rules and standards or it can remove obstacles. The choice of legal instrument ranges from directly binding regulations to directives requiring national implementation (Commission, 2011b).

Mere recommendations are not sufficient any more in fields like conflict of interest and directors’ disqualification. Frankly speaking, there are some binding regulations (directives), which have been implemented into national legislations, especially in the field of financial market regulation, but this does not correspond with the emerging needs, caused by the circumstances of the crisis and nor does it aim to overcome them.5

Harmonization in the field of conflict of interest and directors’ boards composition would make cross-border business operations in the EU market more transparent and contribute to sufficient safeguards against abuse, and prevent people engaged in abuse in one member state from continuing to carry on their abuse in another member state.

2. Comply or explain’ approach

2.1. Comply or explain approach

The ‘comply or explain’ principle is an important tool for the application of the corporate governance rules in the EU. Most corporate governance is soft law and guidelines are included in voluntary national codes of conduct. In principle, member countries decide upon what type of legal instrument to use, in the respective field: mandatory or ‘comply or explain’.

The “comply or explain” approach allows listed companies to depart from a particular recommendation of the applicable national corporate governance code, provided that they explain the reasons for doing so. In this way, it offers companies an important degree of flexibility to adapt their corporate governance to their specific situation, yet encourages them to follow corporate governance best practices.

Also corporate governance codes in the EU are applied on a ‘comply or explain’ basis. This approach allows companies to depart from particular recommendations of the applicable code, provided they explain the reasons for doing so.

2.2. Mandatory corporate governance reporting

EU directive (Directive 2013/34/EU on the annual financial statements) requires companies to include a corporate governance statement in their management report if their transferable securities are admitted to trading on a regulated market of any Member State (see also Directive 2004/39 on markets in financial instruments);

According to the ‘comply or explain’ principle (Article 20 of Directive 2013/34/EU) companies that depart from the relevant corporate governance code are required to explain in their corporate governance statement which parts of the code they depart from and the reasons for doing so.

2.3. Shortcomings in the way of the ‘comply or explain’

In many Member States there is insufficient monitoring of the application of the codes. The informative quality of explanations published by companies departing from the corporate governance code’s recommendation is - in the majority of the cases - not satisfactory. The quality of the corporate governance reports produced by listed companies has been subject to criticism. The explanations provided by companies are often insufficient. They either simply state that they had departed from a recommendation without any further explanation, or provide only a general or limited explanation (Study on Monitoring).

There are shortcomings in the way the ‘comply or explain’ principle is applied. Companies often do not provide appropriate explanations when they depart from corporate governance codes. There is too much of flexibility in the implementation of the ‘comply or explain’ approach. This makes it more difficult for investors to take informed investment decisions; they are in favour of better quality explanations (2011 Green Paper)

2.4. Directive, rather than recommendations

Companies should provide better explanations for departing from codes’ recommendations. In some Member States discussions have been initiated or guidelines issued on the quality of explanations (2102 COMMUNICATION Action Plan: European company law).

However in order to maintain the key role of codes of conduct in ensuring good corporate governance and their legitimacy, more decisive action at EU level is needed. However the existing recommendation (2014 Recommendation on ‘comply or explain’ reporting) is not sufficient in order to implement EU guidance, across the EU. A directive, based on national best practices, legally binding for listed companies, investors and national monitoring bodies would be needed to improve the quality of disclosures and ensure better transparency.
National binding rules for companies, following the directive, should provide guidance on how they followed the relevant corporate governance codes on the topics of most importance for shareholders, in order to improve transparency and quality of corporate governance reporting and on how listed companies should explain their departures from the recommendations of the relevant corporate governance codes.

To what extent and how apply the ‘comply or explain’ approach (governance code recommendations) as opposed to compulsory regulation should depend on the corporate governance tradition and the level of business ethic in a respective country. Universal patterns and recipes for each country, regardless its corporate history and tradition, is wrong approach.

3. Board of directors

3.1. No uniform approach as regard structure of corporate governance

As generally known, there are two basic concepts of the public limited (joint stock) companies' corporate governance structures: one and two tier system. As concerns the legal regulation of the governance structures there is the approach of compulsory one tier system (like USA, UK and the followers) or compulsory two tier system (Germany, Austria and the followers). In addition, there are countries which leave shareholders to decide upon introduction on one or two tier system, according to Articles of Incorporation as France, Finland or for example Slovenia. There are also countries with different types of two tier system, with different competences and legal position of the Supervisory body, which range from more or less classical supervisory board, to supervisory or other monitoring and auditing bodies with limited competences. In addition there are legislations, with conditional and/or limited one or two tier system of corporate governance.

On a unitary board, one way to ensure this is that the roles of chairman and chief executive are separate; in the case of unitary and dual boards, one option may be that the chief executive does not immediately become the chairman of the (supervisory) board.

In EU, different board structures coexist. Depending on the country, listed companies may put in place either a ‘single board’ system (also called ‘monistic’ or ‘unitary board’ system), a two-tier (or ‘dual board’) system or some form of mixed system. These board structures are often deeply rooted in the country’s overall economic governance system.

3.2. Other stakeholders’ participation

It is important to underline that different governance systems have very little to do with the participation of other but capital stakeholders in in governance and appropriation in the profit of a corporation. All the different systems of corporate governance follow the same concept, the concept of one share one vote. The differences are not related to diversified
stakeholders' participation in governing and supervising bodies (like labour) but rather to different organization of managerial and supervisory functions.

Yet there are systems, that permit more influence to employee representatives in management or supervisory board, however that should be considered as mere correction of dominant capital based corporate governance rather than corporate governance reform in the terms of changing the relationship between labour and capital.

### 3.3. Board composition

The composition of the board has to suit the company’s business. Non-executive board members should be selected on the basis of a broad set of criteria, i.e. merit, professional qualifications, experience, the personal qualities of the candidate, independence and diversity (professional, international and gender). Diversity in the members’ profiles and backgrounds gives the board a range of values, views and sets of competencies. It can lead to a wider pool of resources and expertise. Different leadership experiences, national or regional backgrounds or gender can provide effective means to tackle ‘group-think’ and generate new ideas. More diversity leads to more discussion, more monitoring and more challenges in the boardroom (2011 Green paper).

Diversity of competences and views among the board’s members is very important. It facilitates understanding of the business organization and affairs and thus enables the board to challenge the management’s decisions objectively and constructively. In contrast, insufficient diversity could lead to a so-called group-think process, translating into less debate, fewer ideas and challenges in the boardroom and potentially less effective oversight of the management board or executive directors. Increased transparency as regards board diversity policy (including gender balance among non-executive directors) could make companies reflect more on the issue (2011 GREEN PAPER Anex 2).

In order to encourage companies to enhance board diversity and give greater consideration to non-financial risks, disclosure requirements with regard to their board diversity policy was strengthened through amendment of the accounting Directive.

### 4. Conflicts of interest

#### 4.1. Independent directors on the board

Independent representatives on the board, capable of challenging the decisions of management, is widely considered as a means of protecting the interests of shareholders and other stakeholders. In companies with a dispersed ownership, the primary concern is how to make managers accountable to weak shareholders. In companies with controlling shareholders, the focus is more on how to make sure that the company will be run in a way that sufficiently takes into account the interests of minority shareholders. Ensuring adequate protection for third parties is relevant in both cases (2003 Action Plan ‘Modernising Company Law).
A sufficient number of independent non-executive or supervisory directors should be elected to the (supervisory) board of companies to ensure that any material conflict of interest involving directors will be properly dealt with.

**4.2. Profile of independent non-executive or supervisory directors (for listed companies)**

A director should be considered to be independent only if he is free of any business, family or other relationship, with the company, its controlling shareholder or the management of either, that creates a conflict of interest such as to impair his judgement. Duties is assured, which identifies a number of situations reflecting the relationships or circumstances usually recognised as likely to generate material conflict of interest).

There is no definition and legal regulation of “independence” in the context of directors, in any of the laws analysed. The independency of directors is not a legal obligation to be taken into consideration for the composition of corporate boards.

On the other hand, there are explanations in different codes and EU recommendations on this. However, the respective recommendation leaves it to the member countries to decide whether to implement the recommendation in the company legislation or to use the principle to explain or comply with the corporate governance codes. Unfortunately, the great majority of EU member countries decided for the latter, the consequence of which is poor implementation of legal remedies for solving conflicts of interest in European corporate legislation.

**4.3. Criteria for independency**

Criteria for independency, which should be, for listed companies, tailored to the national context, should be based on due consideration of at least the following situations (Anex II to Recommendation 2005/162 on the role of non-executive or supervisory directors):

(a) not to be an executive or managing director of the company or an associated company, and not having been in such a position for the previous five years;

(b) not to be an employee of the company or an associated company, and not having been in such a position for the previous three years, except when the non-executive or supervisory director does not belong to senior management and has been elected to the (supervisory) board in the context of a system of workers’ representation recognised by law and providing for adequate protection against abusive dismissal and other forms of unfair treatment;

(c) not to receive, or have received, significant additional remuneration from the company or an associated company apart from a fee received as non-executive or supervisory director. Such additional remuneration covers in particular any participation in a share option or any other performance-related pay scheme; it does not cover the receipt of fixed amounts of compensation under a retirement plan (including deferred compensation) for prior service
with the company (provided that such compensation is not contingent in any way on continued service);

(d) not to be or to represent in any way the controlling shareholder(s) (control being determined by reference to the cases mentioned in Article 1(1) of Council Directive 83/349/EEC (1));

(e) not to have, or have had within the last year, a significant business relationship with the company or an associated company, either directly or as a partner, shareholder, director or senior employee of a body having such a relationship. Business relationships include the situation of a significant supplier of goods or services (including financial, legal, advisory or consulting services), of a significant customer, and of organisations that receive significant contributions from the company or its group;

(f) not to be, or have been within the last three years, partner or employee of the present or former external auditor of the company or an associated company;

(g) not to be executive or managing director in another company in which an executive or managing director of the company is non-executive or supervisory director, and not to have other significant links with executive directors of the company through involvement in other companies or bodies;

(h) not to have served on the (supervisory) board as a non-executive or supervisory director for more than three terms (or, alternatively, more than 12 years where national law provides for normal terms of a very small length);

(i) not to be a close family member of an executive or managing director, or of persons in the situations referred to in points (a) to (h);

4.4. Requirements for disclosure

In the majority of the EU countries, directors must make full disclosure of all the relevant facts referring to the contract concluded on his own behalf in the field of companies business activities. However, only in some legislation is it a legally binding provision rather than a recommendation of the code. Declaring interest in an existing transaction or an arrangement under UK Law requires a director to declare any interest (direct or indirect) that he or she has in any transaction or arrangement entered into by the company.

There are four types of transaction requiring the approval of members in the Companies Act 2006: long-term service contracts, substantial property transactions, loans, quasi-loans and credit transactions and payments for the loss of office.

According to French law, the annual report gives details of the total remuneration and benefits of all kinds paid to each executive during the financial year from the company and controlled companies. The annual report also includes a list of all the posts and functions that each of those executives occupied in any company during the financial year. Contracts
in which French directors are interested must be approved by the board, notified to the auditors and submitted to the general meeting.

According to the Slovenian Code, all legal transactions between the company and a member of the management board, as well as transactions between the company and persons or companies related to the member in whom he is personally involved are recommended (rather than legally defined as mandatory) to be concluded by observing the code of good practices and be publicly disclosed.

4.5. Non-executive or supervisory directors

Effective oversight of the executive directors or the management board by the non-executive directors or supervisory boards leads to successful governance of the company. Boards need non-executive (or supervisory board) members with diverse views, skills and appropriate professional experience. Board members must also be willing to invest sufficient time in the work of the board. (2011 GREEN PAPER Anex 2).

The administrative, managerial and supervisory bodies should include in total an appropriate balance of executive/managing and non-executive/supervisory directors such that no individual or small group of individuals can dominate decision-making on the part of these bodies. On a unitary board, one way to ensure this is that the roles of chairman and chief executive are separate; in the case of unitary and dual boards, one option may be that the chief executive does not immediately become the chairman of the (supervisory) board. (Recommendation 2005/162 on the role of non-executive or supervisory directors).

The EU position (Recommendation 2005/162 on the role of non-executive or supervisory directors) as to the role of non-executive or supervisory directors is, that in key areas where executive directors clearly have conflicts of interest (i.e. remuneration of directors, and supervision of the audit of the company’s accounts), decisions in listed companies should be made exclusively by non-executive or supervisory directors who are in the majority independent.

Non-executive or supervisory directors are recruited by companies for a variety of purposes. Of particular importance is their role in overseeing executive or managing directors and dealing with situations involving conflicts of interests.

Boards should be organised in such a way that a sufficient number of independent non-executive or supervisory directors play an effective role in key areas where the potential for conflict of interest is particularly high.

4.6. Role of the committee’s vis-à-vis the (supervisory) board

The nomination, remuneration and audit committees should make recommendations aimed at preparing the decisions to be taken by the (supervisory) board itself. The primary purpose of the committees should be to increase the efficiency of the (supervisory) board by making
sure that decisions are based on due consideration, and to help organise its work with a view to ensuring that the decisions it takes are free of material conflicts of interest.

4.7. Qualifications and commitment

The (supervisory) board should ensure that it is composed of members who, as a whole, have the required diversity of knowledge, judgement and experience to complete their tasks properly. The members of the audit committee, should, collectively, have a recent and relevant background in and experience of finance and accounting for listed companies appropriate to the company’s activities.

Each director should devote to his duties the necessary time and attention, and should undertake to limit the number of his other professional commitments (in particular any directorships held in other companies) to such an extent that the proper performance of his duties is assured.

5. Some conclusions

The company laws in EU member countries in the field of structure and composition of the board of directors’ and conflicts of interest and is not harmonized; there are separate and very diverse national pieces of legislation in this regard. Rules on diversity in composition and on independent directors and also on conflicts of interest at the EU level are mainly recommendations, rather than binding legal rules, which leave it to the member countries to decide either to implement the recommended concepts by legislation or merely in corporate governance codes (comply and explain).

Unfortunately, the voluntary principle “explain or comply” in corporate governance codes has been widely applied, as opposed to legislative implementation in EU member countries, which appears not to be the most appropriate and effective method of regulation, especially not in the times of world economic and financial crisis.

There are substantial and important differences in the legal regulation of board’s members’ position and conflicts of directors’ interests between the EU countries. Bearing in mind that the world economic and financial crisis was to an important extent caused by inefficient corporate governance regulation, especially in financial services, a substantial harmonization of the EU regulation in the field of board director’s diversity and independence, directors’ disqualification and conflict of interest would be welcome.

The financial crisis has highlighted how important it is for legislators to react to the changing business environment and to react in due time with efficient legal tools. Further harmonization of company law, not in general but in particular fields of company law (like board director’s diversity and independence, directors’ disqualification and conflict of interest) is more than needed. Due to the financial roots of the economic crisis, this is especially true for financial service companies and listed companies, dealing with a broader public in a very sensitive financial field.
6. Literature

1. Directive 2013/34/EU of the European Parliament and of the Council of 26 June 2013 on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings; (Directive 2013/34/EU on the annual financial statements);
7. COMMISSION RECOMMENDATION 2005/162/EC of 15 February 2005 on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board (Text with EEA relevance) (Recommendation 2005/162 on the role of non-executive or supervisory directors);
8. Annex II to COMMISSION RECOMMENDATION 2005/162/EC of 15 February 2005 on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board (Text with EEA relevance) (Annex II to Recommendation 2005/162 on the role of non-executive or supervisory directors);
9. GREEN PAPER, Anex 2, The EU corporate governance framework (Text with EEA relevance) (2011 GREEN PAPER Anex 2);
10. Study on Monitoring and Enforcement Practices in Corporate Governance in the Member States, (Study on Monitoring);
16. NL Erhardt, JD Werbel...Board of director diversity and firm financial performance Corporate governance: An ..., 2003 - Wiley Online Library