On the Role of Monitoring near Financial Distress – an Economic and Legal Analysis

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On the Role of Monitoring near Financial Distress – an Economic and Legal Analysis

Over de rol van 'monitoring' bij financiële nood –
een economische en juridische analyse

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PREFACE

Inspiration by Academia forms the basis of any PhD trajectory. Passionate lecturers are the primary asset of a university. The RUG professors and lecturers (ca. 1975) Meijer, Lokin, Brahn, Brunner and J. Wiarda made me a civil lawyer to the bone. Researchers like professors H.J. Scheltema and Kuipers and research with Groenveld and professor Degenkamp showed me the fun an academic career had to offer. The outstanding and challenging lectures of professor Pen opened a completely new world, that of economics. The actual studying of it, although eye-opening, would never impress as much as Pen's teachings.

Jacqueline and I declined an academic career at the time. It was Den Uyl's era, the challenge was to find the right model and the right parameters to create a better society where all people would have equal rights and be happy. We wanted to contribute to that, first in Zeeuws-Vlaanderen, then in Islamabad, later on in Numansdorp. The thought of writing a thesis arose in abstract form – maybe I should make an appointment with Pen – or more specifically when I worked in labour law and questioned the legal, economic and ethic basis of the 'dissolution compensation'. Finally and by sheer coincidence, Auke de Bos and Han Donker offered me the opportunity to return to Academia – although incomparable with Groningen's then Turftorenstraat-quarters – to work on a thesis on a part-time basis. The subject which I owe to Han Donker really has the importance for society I always – perhaps incorrectly – thought a thesis should have.

Before you lies a book on the role of monitoring near financial distress. I have seen a lot of bankruptcies. During the thesis process I have become convinced that every entrepreneur would be better off by discussing every now and then with an independent challenger his strategy, corporate policy, and even himself. Maybe we would all be. It is maintenance, just like going to the dentist twice a year. This does not imply that every company should have a supervisory board with independent non-executives, a qualified auditor or at least several directors. Hiring counsel on a regular basis, for example one of Rotterdam's highly-qualified management school alumni, discussing with industry advisors or bank experts, reading books or articles might help as well. An open mind to challenge and change – that is the precondition for success.

I would like to make acknowledgements to Auke de Bos, who offered me this opportunity and guided me patiently and with confidence through the process. His critical remarks triggered me continuously to make the most of it. To Vino Timmerman who, although joining the process at a late stage, arranged time to discuss the manuscript intensively. His valuable contributions improved the manuscript considerably. To professors Blommaert, Mertens and Assink for finding time to study, discuss and approve this thesis. To my colleagues for occasional advice and patience. To Hans Quak for providing search and other useful assistance and convincing me that my first research on bankrupt foundations was worth publishing – my first academic publication in EUR service. To Jan Adriaanse for the many discussions we had and for opening the failure process and informal reorganization field to me. To Gijs Santen who protected me from at least one serious statistical error and helped me out on a lot of statistical issues – of course the blame is mine if an error occurs. To Elwin Frank and Joline Santen for coaching me when I was stuck in the process. To Jacqueline Santen–Reestman, my 'co–promovenda' to whom I owe a lot of content, from common sense to statistics. And finally, at a personal level, to my parents, my family and my friends, and especially to Jacqueline, Gijs, Nina, Joline and Hans, who supported me throughout with gestures, attention and their company. I owe you all!

When reading this thesis, or glancing through it, I hope the reader will experience the joy which I felt during my research and the writing process. I welcome your comments, remarks or questions at bernard@santenonline.nl.

Leiden, 22 December 2010

Bernard Santen

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LIST OF ABBREVIATIONS

i.a.	*inter alia (among other things)*
aant.	note (*aantekening*)
AFM	Netherlands Authority for the Financial Markets (*Autoriteit Financiële Markten*)
AG	Dutch advocate general (*Advocaat-Generaal*)
AG	German public limited company (*Aktiengesellschaft*)
AGM	annual general meeting
AktG	German Company Law (*Aktiengesetz*)
ALI	American Law Institute
Amvb	Dutch order in council (*Algemene maatregel van bestuur*)
ANBI	Dutch public service organization (*Algemeen Nut Beogende Instelling*)
AO	German General Tax Code (*Abgabeordnung*)
APR	absolute priority rule
art.	Section (*artikel*)
Awb	Dutch General Administrative Law Act (*Algemene Wet Bestuursrecht*)
BaFin	German Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*)
BERR	UK Department of Business, Enterprise and Regulatory Reform (former DTI)
BetrVG	German Works Council Act (*Betriebsverfassungsgesetz*)
BGB	German Civil Code (*Bürgerliches Gesetzbuch)*
BGH	German Supreme Court (*Bundesgerichtshof*)
BIK	Dutch Company Industrial Classification (*Bedrijfs Industrie Klassificatie*)
BIS	UK Department for Business, Innovation and Skills (formerly known as BERR, DTI)
BJR	Business Judgement Rule
BOD	Board of Directors (UK, USA)
Buba	Deutsche Bundesbank (informal)
BV	Dutch private limited company (*besloten vennootschap met beperkte aansprakelijkheid*)
BW	Dutch Civil Code (*Burgerlijk Wetboek*)
CA	UK Companies Act 2006
CA 2004	UK Companies (Audit, Investigations and Community Enterprise) Act 2004
CAO	Dutch collective agreement (*Collectieve ArbeidsOvereenkomst*)
CBS	Statistics Netherlands (*Centraal Bureau voor de Statistiek*)
CCBSA	UK Co-operative and Community Benefit Societies and Credit Unions Act 2010
CDDA	UK Company Directors Disqualification Act 1986
CEO	Chief Executive Officer
CFO	Chief Financial Officer
CIC	Community Interested Company (UK)
CIO	Charitable Incorporated Organisation (UK)
comm.	commentary
COSO	Committee of Sponsoring Organizations of the Treadway commission
CPA	Certified Public Auditor
CPB	Netherlands Bureau for Economic Policy Analysis (*Centraal Planbureau*)
CV	Dutch limited partnership (*commanditaire vennootschap*)
CVA	UK company voluntary arrangement
DC	Dutch corporate governance code 2008
DNB	Dutch central bank (*De Nederlandsche Bank*)
DR	UK Directors' Report
DrittelbG	German Law on Workers Participation for one-third in the supervisory board (*Drittelbeteiligungsgesetz*)
DRR	UK Directors' Remuneration Report
DTI	UK Department of Trade and Industry (later known as BERR, presently as BIS)
D&O	Directors and Officers liability insurance
e.g.	*exempli gratia* (for example)
EB	executive board (*bestuur, directie*)
ED	executive director (*bestuurder, directeur*)

EEA	European Economic Area
EFS	European Foundation Statute
eG	German co–operative (*eingetragene Genossenschaft*)
EGM	extraordinary general meeting
SstG	German Income Tax Act (*Einkommensteuergesetz*)
et al.	*et aliis* (and others)
etc.	*et cetera* (and more)
EU	European Union
EUR	Erasmus University Rotterdam
eV	German association (*eingetragener Verein*)
EWC	European Works Council
FIPSA	UK Friendly and Industrial and Provident Societies Act 1968
FMStG	German Financial Markets Stabilization Act 2008 (*Finanzmarktstabilisierungsgesetz*)
fn.	footnote
FRC	UK Financial Reporting Council
FRRP	UK Financial Reporting Review Panel
FSA	UK Financial Services Authority
FSMA	UK Financial Services and Markets Act 2000
Fw	Dutch Bankruptcy Act (*Faillissementswet*)
GC	German corporate governance code 2008 (as amended on 26 May 2010)
GDP	Gross Domestic Product
GenG	German co–operative law (*Genossenschaftsgesetz*)
GM	General Meeting of Shareholders (the organ)
GmbH	German private company (*Gesellschaft mit beschränkter Haftung*)
GmbhG	German private company law (*Gesetz betreffend die Gesellschaften mit beschränkter Haftung*)
HGB	German Commercial law (*Handelsgesetzbuch*)
HMRC	UK *Her Majesty's Revenue & Customs*
HR	Dutch Supreme Court (*Hoge Raad*)
Hrgw	Dutch Commercial Registers Act (*Handelsregisterwet*)
i.e.	*id est* (that is to say)
IA	UK Insolvency Act 1986
ICER 2004	UK *Information and Consultation of Employees Regulations 2004*
ICP	Information and Consultation Procedure
ICTA	UK Income and Corporation Taxes Act 1988
InsO	German Insolvency law (*Insolvenz Ordnung*)
INSOL	International Association of Restructuring, Insolvency & Bankruptcy Professionals
IPO	initial public offering (of shares)
IPS	UK Industrial and Provident Society
IPSA	UK Industrial and Provident Societies Act 1965
ISIC	UN International Standard Industrial Classification of All Economic Activities
Iw	Dutch Collection of State Taxes Act (*Invorderingswet*)
jo	*juncto* (in conjunction with)
JAR	Dutch journal on case law relating to labour law (*Jurisprudentie Arbeidsrecht*)
JOR	Dutch journal on case law relating to business law (*Jurisprudentie Ondernemingsrecht*)
KStG	German Corporation Tax (*Körperschaftsteuergesetz*)
Ktr	Dutch Subdistrict Court (*Kantongerecht*)
KvK	Dutch Chamber of Commerce (*Kamer van Koophandel*)
LR	Listing Rules (UK)
LTIP	Long Term Incentive Plan
MDA	Multiple Discriminant Analysis
MitbestG	German law on co–determination by employees (*Mitbestimmungsgesetz*)
MoMiG	German Act to Modernise the Law Governing Private Limited Companies and to Combat Abuses (*Gesetz zur Modernisierung des GmbH–Rechts und zur Bekämpfung von Missbräuchen*)
NACE	EU industry classification (*Nomenclature statistique des activités économiques dans la Communauté Européene*)
NED	non–executive director (*commissaris*)

NJ	Dutch Law Reports (*Nederlandse Jurisprudentie*)
NPM	new public management
no.	number
NV	Dutch public limited company (*naamloze vennootschap*)
NVB	Netherlands Bankers' Association (*Nederlandse Vereniging van Banken)*
OK	Enterprise Division of the Amsterdam Court of Appeal (*Ondernemingskamer*)
OM	Dutch Public Prosecution Service (*Openbaar Ministerie*)
OOB	Dutch public interest entity (*Organisatie van openbaar belang*)
OR	Dutch works council (*Ondernemingsraad*)
OVR	Dutch incorporated public partnership (*openbare vennootschap met rechtspersoonlijkheid*)
p.	page
par.	paragraph (Dutch: lid)
PDV	predistressed value of a firm
PIDA	UK Public Interest Disclosure Act 1998
RA	Dutch certified auditor (*registeraccountant*)
Rb	Dutch district court (*Rechtbank*)
RBS	Royal Bank of Scotland Plc
RO	Dutch Judiciary (Organization) Act (*Wet op de Rechterlijke Organisatie*)
ROC	Receiver–Operating Characteristic
RVR	Dutch Council for the Judiciary (*Raad voor de Rechtspraak*)
r.o.	Dutch: legal ground (*rechtsoverweging*)
s	Section (Dutch: *artikel*)
SB	supervisory board (*Raad van Commissarissen*)
SBI 2008	Dutch standard industrial classification (*Standaard Bedrijfsindeling 2008*)
SCE	Societas Cooperativa Europaea
SE	Societas Europaea
SEC	USA Securities and Exchange Commission
SER	Dutch Social and Economic Council (*Sociaal–Economische Raad*)
SI	UK Statutory Instrument
SIC	Standard Industrial Classification
SIR	UK Summary Information Returns (to Charity Commission)
SME	Small and Medium–sized Enterprise
SOx	Sarbanes–Oxley Act 2002
SPE	Societas Privata Europaea
Sr	Dutch Criminal Code (Wetboek van Strafrecht)
TC	UK Takeover Code
TCE	Transaction Costs Economics
UK	United Kingdom
UKC	The UK Corporate Governance Code 2010
UMAG	German Company–integrity and Modernization of Litigation Act *Gesetz zur Unternehmensintegrität und Modernisierung des Anfechtungsrechts*
UmwG	German law on the change of corporate form (*Umwandlungsgesetz*)
UN	United Nations
USA	United States of America (US, adjective)
VOF	Dutch general partnership (*vennootschap onder firma*)
VpB	Dutch Corporation Tax Act (*Wet op de Vennootschapsbelasting*)
WBP	Dutch Personal Data Protection Act (*Wet Bescherming Persoonsgegevens*)
WED	Dutch Economic Offences Act (*Wet op de Economische Delicten*)
Wft	Dutch Financial Supervision Act (*Wet op het financieel toezicht*)
WMZ	former Dutch Disclosure of Major Holdings in Listed Companies Act (*Wet Melding Zeggenschap*)
WOR	Dutch Works Councils Act (*Wet op de Ondernemingsraden*)
WpÜG	German Securities Acquisition and Take–over Act (*Wertpapiererwerbs– und Übernahmegesetz*)
Wta	Dutch Audit Firms (Supervision) Act (*Wet toezicht accountantsorganisaties*)
Wtfv	Dutch Financial Reporting (Supervision) Act (*Wet toezicht financiële verslaggeving*)
WW	Dutch Unemployment Insurance Act (*Werkloosheidswet*)

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Delaware Court of Chancery (Delaware)

Chapter

1

The why, what and how of this thesis

I am drowning here, and you are describing the water.
(Jack Nicholson in: As Good as It Gets)

1.1 INTRODUCTION: WHY?

When things turn out wrong for a company, the people involved usually have some idea why. With hindsight scholars, judges, journalists, trade union representatives, share–holders or bankers may conclude that an acquisition was too big, an investment too risky, reorganization too late, or that the management was not capable of doing its job. Bad faith might play a role. Administrators[1] often detect fraud or serious negligence. In large bankruptcies like Enron, WorldCom, Parmalat or Lehman Brothers, billions of US dollars were at stake. Such cases are rare. Mostly the amounts are much smaller, but there are definitely many of such small bankruptcies. Severe losses may be suffered by trade creditors, banks, bondholders, the tax authorities and social securities agencies. More important than the amount of money involved might be the damage inflicted on human beings as a consequence of bankruptcy (Argenti, 1976). Due to unemployment, pension loss or commercial losses, the future prospects of employees, pensioners, small service providers and product suppliers may be seriously damaged. Thus, human beings as well as society will win by decreasing the incidence of bankruptcy.

This thesis focuses on companies near financial distress. 'Companies' means private–sector legal persons, with either a profit or a nonprofit object[2]. 'Financial distress' is the subject of chapter 2. Its most widely–known form is bankruptcy. Specifically, this study analyses economic and legal mechanisms in situations of near financial distress. These prove to be of a rather *ex post* nature. In chapter 5 the study develops an approach with an *ex ante* character.

This chapter sets out the relevance of the subject and defines the research question and method. The macro economic impact of bankruptcy is the topic of 1.2, whilst 1.3 presents a micro economic analysis. The legal impact of bankruptcy is the subject of 1.4. These analyses show the relevance of this thesis. Section 1.5 defines the research question, 1.6 is about the applied methodology and 1.7 describes the outline of this thesis. The significance of this thesis will be discussed in 1.8.

1.2 MACRO–ECONOMIC IMPACT OF BANKRUPTCY

1.2.1 Bankruptcy costs and recovery rates in the Netherlands

This section analyses the financial impact of bankruptcy on creditors and on the national economy based on previous research and on an analysis of CBS figures (Centraal Bureau voor de Statistiek; Statistics Netherlands).

Table 1.1: survey of concluded bankruptcies of legal persons in the Netherlands 1992–2008 (mln euros)

year	number of concluded legal person bankruptcies	total assets	of which (3) to secured creditors	net assets (3)-(4)	total debt	total dividend paid	calculated recovery rate in % (3)/(4)+(6)	overall recovery rate (CBS) in %
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
1992	1,576	248.5	157.8	90.6	947.3	90.6	22.5	4.5
1994	2,403	226.7	121.9	104.8	1,129.0	104.8	18.1	5.0
1996	2,576	230.8	121.0	109.9	1,100.3	109.9	18.9	4.1
1998	2,584	246.5	86.1	160.4	1,296.9	160.4	17.8	7.1
2000	2,173	242.7	109.5	133.2	1,097.0	132.9	20.1	5.2
2002	2,188	167.1	68.2	98.9	974.5	98.3	16.0	4.5
2004	3,334	254.0	63.2	190.8	1,802.7	188.0	13.6	5.4
sub-average	2,405	230.9	104.0	126.9	1,192.5	126.4	17.8	5.2
2006	4,972	758.3	115.7	642.5	3,331.3	641.8	22.0	14.9
2008	4,023	423.8	70.2	353.6	3,530.0	353.5	11.8	5.7
average	2,870	310.9	101.5	209.4	1,689.9	208.9	17.4	7.5

Source: CBS StatLine[5]

Couwenberg and de Jong (2008) report for a sample of 137 Dutch companies with either at least 10 employees or at least €227,000 debt, an average recovery rate of 37.2% (median[3]: 32.6%), whilst the direct costs of the proceedings are 16.0% (median 11.2%) of the total realized asset value (p. 124). This means that the average creditor has to write down 62.8% of his debt. The results are even worse if *all* concluded bankruptcies of legal persons in a given year are taken into account[4].

Table 1.1 shows for the Netherlands that on average 17.4% of the total debt in a bankruptcy is recovered (column 8). This recovery rate, calculated as in Couwenberg and de Jong (2008: 114) by dividing all of the assets of the estate by all of the debt, is a very rough estimate. In fact, on average almost 33% of the asset value liquidated by the administrator is directly distributed to the secured creditors (column 4; CBS, 2008: 9). This distribution diminishes the numerator as well as the denominator in the recovery rate calculation, thus leaving less in percentage terms for other creditors. The estate handling costs which are part of the 'total debt' column 6 have the same effect, because they are of a preferential nature by law. CBS calculates the overall recovery rate as net assets after deduction of estate handling costs paid, divided by total debt less estate handling costs (CBS, 2008: 11, 16). On average this figure is between 5.2% (average 1992–2004) and 7.5% (average 1992–2008) (column 9). Table 1.1 presents a sub-average after 2004 because the figures of an unknown concluded bankruptcy in 2006 severely influence the average of assets and dividend paid. Especially the overall recovery rate (CBS) in column 9 shows an all time high of 14.9%. It should be noted here that the CBS figures do not contain the (unknown) amount recovered by mortgage and pledge holders by sale under execution

Table 1.2: composition of the total debt of concluded bankruptcies of legal persons in the Netherlands 1992–2008 (in percentages)

		debt categories (in percentage of total debt)			overall recovery rates by debt category		
year	total debt in mln euros	estate handling	taxes and social security	other debt	estate handling	taxes + social security	other debt
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
1992	947.3	6.5	23.1	70.4	83.3	10.5	2.5
1994	1,129.0	5.8	24.2	70.0	79.1	11.9	2.6
1996	1,100.3	7.7	30.3	62.0	80.2	8.3	2.1
1998	1,296.9	7.3	19.4	73.3	79.4	11.6	5.9
2000	1,097.0	9.2	20.3	70.6	80.6	16.2	2.0
2002	974.5	7.9	25.4	66.7	75.1	10.8	2.1
2004	1,802.7	7.5	23.2	69.3	71.7	7.7	4.7
sub-average	1,192.5	7.4	23.5	69.0	77.8	10.5	3.4
2006	3,331.3	7.5	22.8	69.7	73.0	9.6	16.7
2008	3,530.0	6.1	21.5	72.4	76.0	6.8	5.4
average	1,689.9	7.1	22.9	70.0	76.4	9.5	6.8

Source: CBS StatLine

without recourse to the estate, as provided by law[6] (CBS, 2008: 9). The overall recovery rate (CBS) in column 9 therefore underestimates total recovery (Boot and Ligterink, 2000: 26 table 10).

Table 1.2 analyses the total debt of concluded bankruptcies as mentioned in column 6 of table 1.1 in detail. Three debt categories are discerned: *estate handling* related debt with highest preference according to s 182 Fw[7]; *taxes and social security* with high preference according to s 21 Iw; and *other debt* with low preference or without any preference. Estate handling costs are on average 7.1% of the total debt. These are the costs the administrator incurs. On average 76.4% of these costs are recovered and €30 million is written off annually. Apparently the estate is often too small to cover even all estate-related costs. Taxes and social security premiums form 22.9% of the total debt. Despite the high preferential nature of this debt, on average a mere 9.5% of the tax and social security debt is recovered, which implies that on average over €350 million had to be written off annually between 1992 and 2008. Other debt, on average over €1.2 billion/year, shows a recovery rate of 6.8% (an increase on the 2004 average of over 3% points). This means that, every year, ordinary creditors write off well over €1.1 billion on average. The amounts increase fast, however. In a favourable year such as 2006, the recovery rate for the other debt category amounted to 16.7%. Still, almost €2 billion had to be written off, and in 2008 even €2.4 billion. Thus the category ‘other debt’, mainly trade creditors, seems to bear most of the bankruptcy losses. In effect, and depending on the actual tax regulation, part of this burden is shifted to the State.

Table 1.3: the impact on the Dutch economy of concluded bankruptcies of legal persons in the Netherlands, 1992–2008, (mln euros)

			total dividend paid					
year	GDP	total debt	in mln euros	% to estate	% to taxes +social security	% to other debt	remaining debt (3)-(4)	remaining debt as % of GDP (t=-2) (5)/(2)
(1)	(2)	(3)	(4)				(5)	(6)
1990	243,561							
1992	266,472	947.3	90.6	56.3	25.3	18.4	856.7	0.35
1994	287,517	1,129.0	104.8	49.4	31.1	19.5	1,024.2	0.38
1996	319,755	1,100.3	109.9	62.0	25.1	12.9	990.4	0.34
1998	362,464	1,296.9	160.4	46.6	18.3	35.2	1,136.5	0.36
2000	417,960	1,097.0	132.9	61.0	27.2	11.8	964.1	0.27
2002	465,214	974.5	98.3	58.9	27.1	14.0	876.2	0.21
2004	491,184	1,802.7	188.0	51.9	17.1	31.0	1,614.7	0.35
sub-average	337,563°	1,192.5	126.4	54.5	23.4	22.1	1,066.1	0.32
2006	534,324	3,331.3	641.8	28.3	11.4	60.3	2,689.5	0.55
2008	595,900	3,530.0	353.5	46.1	14.5	39.3	3,176.5	0.59
average	376,495°	1,689.9	208.9	44.0	17.6	38.4	1,481.0	0.39

Source: CBS StatLine
° in calculating the average the last year has been omitted due to the time lag assumed in column 6 (see text).

The macro–economic impact of bankruptcy losses is evident by relating those figures to the GDP (Gross Domestic Product), as shown in table 1.3. Because the actual loss was incurred some years before the conclusion of the bankruptcy, the losses are (arbitrarily) related to the GDP two years before. The impact on the economy is clear: on average at least 0.39% of GDP is annually lost due to bankruptcies. To put this in perspective: the debt to be written off amounting to €1.5 billion/year is 3.3 times the annual costs of the Erasmus University Rotterdam[8]. This figure probably underestimates[9] the true macro–economic losses. Not all creditors give notice to the administrator of the debts payable (CBS, 2008: 9), while the administrator might not be able to trace all of the debts due to an incomplete administration. Banks, moreover, do not always give notice of the remaining debt after liquidation of the secured goods and receivables, knowing that there is little or nothing left to be distributed. Unemployment benefits are only bankruptcy–related debt up to the notice term[10], and not all employees will have found a new job by then. Termination of the activities of one company could cause lay–offs in other companies. On the other hand, efficiency gains due to better allocation of production factors cannot be excluded. These are hard to calculate.

To conclude, the average overall recovery rate in Dutch bankruptcies of legal persons is as low as 7.5% (with an outlier in 2006 of 14.9%). The resulting macro–economic loss due to bankruptcies in the Netherlands averages at least 0.39% of the GDP annually and showed a tendency towards 0.55–0.59% between 2006 and 2008. The next section is about international research on bankruptcy costs and recovery rates.

1.2.2 Data on bankruptcy costs and recovery rates in other countries

Studies on the efficiency of bankruptcy systems in other countries focus on recovery rates and bankruptcy cost. The *recovery rates* are, as Boot and Ligterink (2000: 28) and Couwenberg (2001: 268) mention, difficult to compare[11]. Table 1.4 presents the results of some studies in other countries on recovery rates after default. Note that default, which means non–compliance with financial obligations, is a broader concept than bankruptcy. Altman, Resti and Sironi (2001), Branch (2002) and Couwenberg and de Jong (2008) refer to numerous other studies and results. Leaving aside the Bris et al. (2006: 1288, 1263) results, which rely on assumptions regarding direct asset seizures in Chapter 7 of Title 11 of the US Code (Bankruptcy Code) that may be too low, the bottom average recovery

Table 1.4: summary of some international studies on recovery rates after default

author	subject	recovery rate
Franks and Torous (1994)	37 US Chapter 11 reorganizations	average 50.9% of face value; secured 80%, bank debt 86%, senior debt 47%, junior debt 29%
Carty, Lieberman and Fons (1995)	750 defaulted US bonds issues (1970-1994), over $ 60 billion in face value	average 37.61% of par value; senior secured 53%, senior unsecured 45%, senior subordinated 36%, subordinated 29%.
Altman and Kishore (1996)	696 defaulted US bonds issues (1978-1995)	average 41.7% of par value; senior secured 58%, senior unsecured 48%; senior subordinated 34%, subordinated 31%
Carty (1998)	200 bank loans in the bankruptcy of 119 large public borrowers, US Chapter 11 (1986-1997)	secured 87%, unsecured 79% (of which prepack Chapter 11: secured 93%; unsecured 100%)
Gupton (2000)	121 Loss Given Defaults (LGD) for 181 bank loans US (1989-2000)	senior secured 69%; senior unsecured 52% (single loan 63%, multiple loan 37%)
Thorburn (2000)	263 small-firm bankruptcies in Sweden	average 35%; secured 69%, priority 27%, unsecured 2%
Franks and Sussman (2005)	542 small or medium size UK companies in default or deemed in distress by banker's assessment	74%-77% of the main bank loan
Bris, Welch and Zu (2006)	61 US Chapter 7 and 225 Chapter 11 cases	27.4% (median 6%) for Chapter 7, 69.4% (median 79%) for Chapter 11
Davydenko and Franks (2008)	2,280 defaulted firms according to Basel II criteria, in France, BRD and UK	informal formal bankruptcy UK 78% 69% (bank) France 83% 47% (bank) BRD 76% 59% (bank)

rate reported is 37.61% for the United States of America (USA) in the Carty et al. (1995) study and 35% for Europe in the Swedish study of Thorburn (2000). With 53% – 58% the defaulted US bonds show a lower recovery rate for secured creditors than other debt categories, which increase from 69%. Bank debt recovery also amounts to 69% or more, with the exception of France and Germany (BRD) in the case of formal reorganizations, which will be discussed in chapter 2. The reported results are reasonably in line with those of Couwenberg and de Jong (2008: 115) for the Netherlands, who report an average recovery rate of 37.2% (median 32.6%) and a bank recovery rate of 80.0% (median 99.5%).

It should be noted that these results rely on samples and may suffer from a sample bias[12]. The Dutch overall recovery rates as reported in table 1.1 are based on *all* concluded bankruptcies of legal persons in a given year. Boot and Ligterink (2000: 29, 31) concluded from the difference between the reported CBS figure of 7.5% and the international recovery rates that the Dutch bankruptcy system is inefficient. However, the Djankov, Hart, McLiesh and Shleifer (2006) study shows that the Netherlands has a remarkably efficient bankruptcy system: it is ranked first of *all* liquidation–based bankruptcy systems they studied. Another explanation of the difference in recovery rates might be that smaller companies recover less (Bris et al. 2006) and that, while most of the empirical studies focus on bonds or bank loans, there is a bias in all samples towards relatively larger companies. Logically, the recovery rates will decline if *all* bankrupt entities are taken into consideration, as in table 1.1.

As for the *costs of bankruptcy*, Branch (2002: 42), distinguishes:

- real bankruptcy costs borne *by the firm ex ante* and *ex post* as there are:
    - professional fees (lawyers, accountants, investment bankers, appraisers, auctioneers, actuaries),
    - internal staff resources.
- real bankruptcy costs borne directly *by the firm's interest holders:*
    - professional fees (for assessment of legal position, to follow court proceedings, to negotiate disputes),
    - internal staff resources (the owner of an interest must take and therefore prepare for certain decisions, e.g. should a reorganization plan be voted for or against? Should the interest holder take a position in court?),
    - reduced marketability (the now–distressed assets are less suitable for the original investor than they were when they were non–distressed instruments. Thus higher transaction costs are involved to sell it off including a discount on the original asset).
- losses for the distressed firm that may be *offset by gains* of other entities:
    - market share loss (business goes from the distressed firm to another),

  - o short run focus (applying very high discount rates in order to generate cash quickly, causes many potentially profitable possibilities to fail. Deferred maintenance costs will become greater. Assets might sometimes be sold at bottom prices).
- real costs borne *by other parties* (which are beyond the scope of Branch's review).

Branch's (2002: 53–54) results show that total bankruptcy costs incurred by the *firm* are between 9.45–16.35% of the firm's predistressed value[13] (PDV) and *claims holders'* costs between 3.25–4.15%. This means that on average the cost of dealing with distress consumes about 16% of PDV. From his literature survey he concludes that the average gross recovery rate for claims holders is about 60% . Thus, Branch (2002: 54) concludes:

1. the loss, which caused the bankruptcy, consumes about 28%;
2. the costs of dealing with distress consumes about 16%;
3. the net value available to distribute to the claims holder amounts to about 56%[14].

It is clear that a decrease of the costs of bankruptcy would result in an equal increase in the recovery rate. Franks and Sussman (2005: 92) report an attempt of the Royal Bank of Scotland (RBS) to diminish the costs of bankruptcy by requiring receivers to tender for bankruptcy appointments. This resulted in a 14.5% costs share in 31 RBS cases, compared to 18.5% and 26.8% (both median) as reported by Franks and Sussman for two other banks. Bris et al. (2006) compared the costs of bankruptcy between the US Chapter 7 (61 cases) and Chapter 11 (225 cases) proceedings[15]. They report (p. 1280) an average of 8.1% (Chapter 7; median 2.5%) to 16.9% (Chapter 11; median 1.9%) of pre–bankruptcy asset–value for direct, court–declared expenses, e.g. trustee, accountant, debtor attorney, and they conclude that these costs vary widely, anywhere between 2% and 20%. This is possibly in line with Couwenberg and de Jong (2008: 115) who report 16.0% (median: 11.2%) direct costs, as a percentage of realized proceeds, for the Netherlands; but much lower than the average 44.0% reported in table 1.3 for *all* Dutch concluded bankruptcies of legal persons. This difference might be explained by the sample bias in other research for relatively large companies.

What can be learned from the international research on bankruptcy costs and recovery rates? An important conclusion is that the figures are hardly comparable, as they are:

- collected in different situations (default versus bankruptcy), and
- in different bankruptcy systems (see chapter 2),
- by way of different definitions (average – median; secured – unsecured; omitting or estimating recovery by mortgage and pledge holders), and
- relate to different bases (pre–bankruptcy assets, total liabilities, realized proceeds), and
- originate from different sampling methods (medium–sized, large, or even all concluded bankruptcies).

The previous section also looked into the *macro–economic* effects of bankruptcy in the Netherlands. There is no international literature available that relates the annual loss of bankruptcies to e.g. the GDP as has been done in the previous section for the Netherlands. Research on the reversed causality, i.e. the causal relationship between the development of certain macroeconomic factors, e.g. variations in aggregate income; price level; interest rate, and the incidence of corporate bankruptcy has been done by Levy and Bar–Niv (1987) and Liu (2004). However, this is not the subject of this thesis.

The previous analysis shows that bankruptcy has a large impact on the financial system and on the society as a whole. This makes bankruptcy a relevant topic for research. By decreasing the number of bankruptcies and the amounts concerned, direct losses for creditors will diminish while risk–premiums will decrease in due course, an advantage for every citizen. Can the number of bankruptcies be influenced? To answer this question, the causes of bankruptcy must be studied. This is the topic of the next section.

1.2.3 Causes of bankruptcy

In order to see if the costs of bankruptcy can be avoided, an analysis of the causes of bankruptcy would be helpful. Altman (1993: 17) described a survey of 1,300 turnaround managers, wherein 88% of the respondents considered the quality of management the primary difference between success and failure. Van Amsterdam (2004) came to a similar conclusion. Ooghe and De Prijcker (2008) conclude as well that the management is at the origin of most problems. Table 1.5 presents a breakdown of the causes of concluded bankruptcies of Dutch legal persons. Table 1.5 reports in the right column that on average 29% of bankruptcies relate to the economy, 10% to problems in the holding company and 22% to other or unknown causes. Thus 61% of all bankruptcies, or less depending on the correct classification of the other or unknown category, have an external cause[16]. Of the remaining 39% due to internal causes, 32% had to do with mismanagement and 4% with

Table 1.5: causes of concluded bankruptcies of legal persons in the Netherlands

cause of bankruptcy	2006		2008		average 2000-2008 in %
	number	percentage	number	percentage	
economy-related	1,639	33	1,365	34	29
bankruptcy holding company	423	8	304	8	10
mismanagement	1,422	29	1,344	34	32
problems within the board	182	4	81	2	4
fraud	191	4	106	3	3
other causes	806	16	590	15	17
unknown	309	6	167	4	5
total	4,972	100	3,957	100	100

Source: CBS (2008, 2010)

problems within the board. A small minority was fraud-related (3%)[17]. Thus, at least 36% of bankruptcies are directly management-related[18]. Would the nature and organization of a legal person matter as regards the chance of bankruptcy? The next section searches for an answer.

Table 1.6: breakdown of declared bankruptcies in 2006 in relation to the number of registrations in the *Handelsregister*, per type of legal person

legal person	number of declared bankruptcies in 2006	total number registered in *Handelsregister*[20]	bankruptcies per 1000 registered (2)/(3)	total number active registered in *Handelsregister*	bankruptcies per 1000 active registered (2)/(5)
(1)	(2)	(3)	(4)	(5)	(6)
institutions	124				
foundations[21]	103	164,278	0.63	17,660	5.83
associations	3	96,955	0.03	5,720	0.52
co-operatives	18	4,502	4.00	1,850	9.73
companies	4,104				
limited form (Dutch)[22]	3,645	636,900	5.72	262,742	13.87
non-limited form[23]	392	157,047	2.50	140,567	2.79
maatschap, Ltd, Inc	67	6,290	10.65	3,919	17.10
one-man business	1,713	527,982	3.24	427,138	4.01
natural persons	3,238				
total bankruptcies	9,179				

Source: CBS, *Handelsregister*, Santen and de Bos (2006), www.rechtspraak.nl

1.2.4 Bankruptcy incidence per legal person

Table 1.6 gives a breakdown of bankruptcies that occurred in 2006 per legal person in relation to the number of (active) legal persons as registered in the *Handelsregister*[19]. Column 4 shows the number of bankruptcies per 1000 registrations for each type of legal person and column 6 shows the number of bankruptcies per 1000 *active* registrations. A registered company has been active according to the Chamber of Commerce if it displays economic activities[24]. From the results of both columns it is clear that the bankruptcy incidence for foreign limited forms is highest. This confirms the prejudice that foreign limited forms are often used (by Dutch nationals as well as others) to commit fraud and leave creditors with empty estates[25]. On the other hand, the incidence of bankruptcy for associations is persistently the lowest. Another clear observation can be made for non-limited company forms: the one-man business (3.24) and other non-limited company forms (2.50) have a much lower incidence of bankruptcy than the limited form (5.72). Column 6 is even clearer on that than column 4. One could conclude that the *certainty* of personal liability of the entrepreneur for the one-man business and the non-limited company forms is a stronger disciplinary mechanism than the *possibility* of personal liability for the limited forms. Other interesting findings are (1) the one–man business has a higher bankruptcy incidence than non–limited company forms of a partnership nature, suggesting that partners might correct each other and thus avoid failures; (2) co–operatives show a much lower bankruptcy incidence than limited companies, suggesting that the double relationship in a co–operative is a factor in avoiding failures, and (3) foundations do have much lower bankruptcy incidence than companies, but much higher than associations. Chapter 8 will empirically analyse the differences between legal persons.

1.2.5 Concluding remarks on the macro–economic analysis

Whilst the calculated average Dutch recovery rate in bankruptcies of legal persons of 17.4% might be an underestimation, international studies show recovery rates of around 35% (Sweden), 40% (US bond–loans) and up to 70% and more for secured bank loans. The resulting macro–economic loss on non–paid debt only amounts to an annual 0.39% of Dutch GDP for 1992–2008, and even 0.57% for 2006–2008. To this should be added unemployment expenses, lay–offs in supplying companies and wealth effects on the negative and allocation gains on the positive side. Human factors, i.e. mismanagement (32%), problems with the board (4%) and fraud (3%) cause at least 39% of bankruptcies. It seems worthwhile to attempt to reduce this percentage.

1.3 MICRO–ECONOMIC ANALYSIS OF BANKRUPTCY

This section analyses bankruptcy on a case study basis. It uses factors derived from literature to evaluate the causes of bankruptcy of two relatively small cases. These cases have been chosen to show the impact of bankruptcy on individual creditors. Bankruptcies of large, exchange–listed firms like Fokker (1996) or KPNQwest (2003) are well known, but it is the author's conviction that smaller ones do relatively more harm. Smaller companies often have a strong regional basis. They co–operate with other small firms from the region, which work often on a relatively small scale. Bankruptcies do more damage to these small companies than to larger companies with relatively well–spread activities (across regions, customers, or industries).

1.3.1 Case studies in the literature

Argenti (1976) analysed a large number of bankruptcies and concluded that either *management defects* (e.g. autocratic leadership), *system defects* (e.g. ineffective administration) or *change defects* (e.g. poor response to change) lie at the origin of bankruptcy. Chapter 5 builds on his theory. Couwenberg (1997) was the first to study financial distress in the Netherlands on a case study basis. Afterwards Van Amsterdam (2004) studied the success factors of 80 informal reorganizations in the Netherlands. He concluded (p. 273) that of all factors the perceived quality of management is, in fact, the only significant factor for success. In a case study analysis of 20 successfully and 15 non–successfully informally reorganized companies, Adriaanse (2005: 49 and 59) identified as the most frequent causes of financial difficulties:

- *inadequate management information systems (MIS)*: either the MIS is inadequate, or insufficient avction is taken;
- *poor management*: an unsatisfactory reaction to developments inside and outside the company; and
- *excessive costs* and investments.

One recognizes Argenti's issues. Jensen (1993: 854) argues that the strategic redirection of exchange–listed firms suffers from insufficient or unsatisfactory reactions. In his view, internal control systems have two faults: they react too late, and they take too long to effect major change. More recently, Roland Berger (2006) detected (1) management's commitment, (2) a comprehensive strategy and (3) quick implementation as the three crucial factors for successful restructuring. Their report shows that (at least for Germany

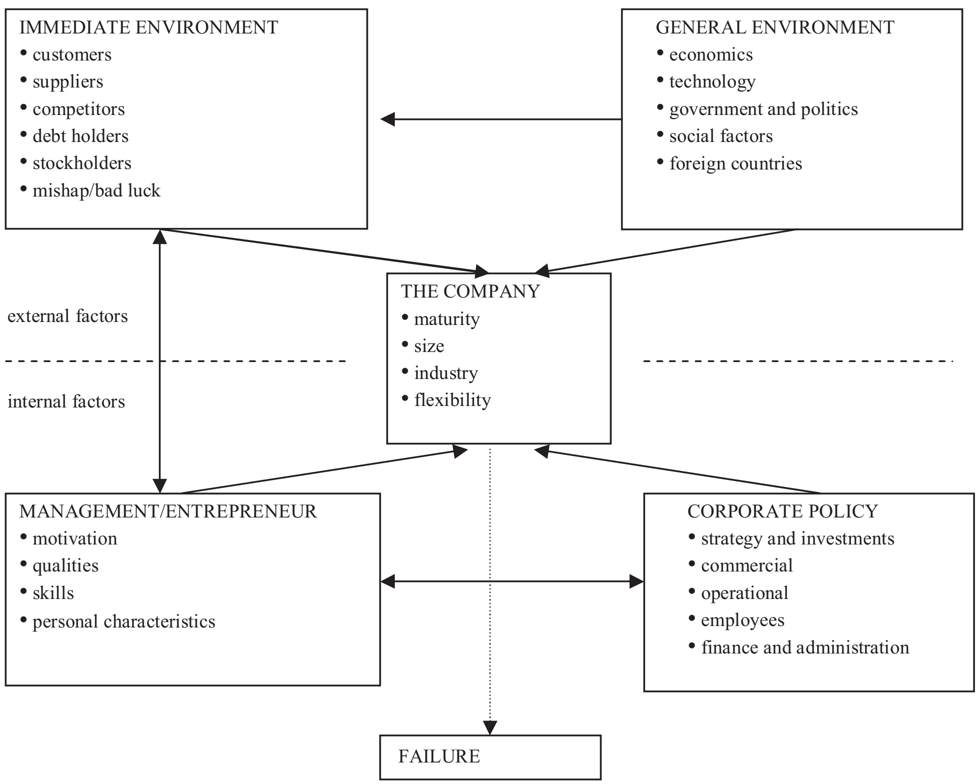

Figure 1.1: conceptual failure model of possible causes of bankruptcy
Source: Ooghe and Waeyaert (2004), Ooghe and De Prijcker (2008) and the author.

in 2006) companies respond rather slow to crises: it took in general 20 months to react after identifying a crisis, and the restructuring might take another year and a half. The *time cushion* (The Turnaround Finance Group, 2006: 16) is thus considerable.

Ooghe and Waeyaert (2004) developed a conceptual model of causes of bankruptcy, which is reported in figure 1.1. The model essentially shows that each specific company is influenced by external and internal factors. A wrong mix of factors might result in failure. The *external* factors consist of the general and the immediate environments. The *general* environment is the political, economic and social structure of a country and its global position. A change in the general environment is the excuse most often used by management in the case of bankruptcy (Ooghe and De Prijcker, 2008: 237). The *immediate* environment stands for the direct outside parties a company encounters: customers, suppliers, competitors, investors and banks. The loss of large customers may result in bankruptcy, as may the loss of a supplier, the arrival of new competitors or the lack of investors or credit. The processing of contaminated raw material or the importing of toys containing lead paint could be equally disastrous.

However, the general and the immediate environments of a distressed company normally play a subordinate role in the failure process. If apathetic management does not anticipate or respond to these changes, or if it cannot because it lacks the financial means to adjust, bankruptcy may be the result. Ooghe and Waeyaert (2004: 380) consider the *internal* factors, the quality of management and the corporate policy, of much more importance. Under *quality of management* they comprise such factors as:

- inadequate competences or experience; quite often the founding management is experienced in one specific area and lacks experience in overall management,
- personal characteristics such as being autocratic, often even charismatic, risk prone and blinded by success, labelled by Skeel (2005) as Icarean behaviour,
- an absence of systematic planning; decision-making is often intuitive, and
- an inability to recognize and react promptly. It takes time before management is prepared to recognize changing figures as a trend and not as an incident. Thereafter, a reaction should be formulated and implemented.

The other internal factor, *corporate policy*, has to do with all the processes within the firm, either relating to strategy or commercial policy, or operational, personnel, financial and administrative issues including fraud, and relating to the corporate governance of the company. The variety of potential distress causes under this heading runs from ill-advised takeovers and insufficient integration efforts, via defective products or product placement and inefficient production, to unhealthy financial ratios, creative accounting, outright swindle and inadequate supervision of management.

In the following section this model is applied to two anonymous case studies from the author's own administrator's practice to illustrate its usefulness.

1.3.2 Hector

Hector, a one–man business, provided national and international transport services. It employed some 30 drivers and rented 25 trucks. The owner started the firm in 1994 which grew fast until it went bankrupt by the end of 1997. Most of the employees and suppliers knew the owner from earlier jobs and believed in his skills as an entrepreneur. As there were no assets, the bank refused to finance the firm. It could only continue its services by collecting its receivables properly and on time. By the end of 1996 the firm was hit by two bankruptcies of major customers. These customers had paid their first orders well, the number of orders grew exponentially, payment gradually slowed down and bankruptcy was filed for these customers shortly afterwards. Over €250,000 had to be written down, and shortage of money and work hampered the continuance of the firm. Hector 'solved' the matter by borrowing criminal money, by illegally selling some rented trailers and by finding one new big client, who had lots of work, at rock bottom prices, but paid in cash. Fire was set in the office (April 1997), presumably by the criminal lenders, and the bookkeeping and administration were gone. Setting up a new administration had no priority due to the shortage of money. It was all cash, debt and promises that kept the firm in the air until the end of 1997. More fraud was committed right up to the end. Freight was stolen and strong suspicions of insurance–fraud were uttered. Other rented trailers were sold illegally. Just days before the bankruptcy date orders were placed and delivered for office equipment, an alarm installation and new tyres, seriously damaging some small suppliers. The only two trucks of Hector were sold around the bankruptcy date and the proceeds were not accounted for.

The administrator had to close down the shop. He provided information relating to fraud. After six years this resulted in two prison sentences for the owner of Hector, as well as some of his clients and relations. The court however released a seized Luxemburg–based bank account in the big client's name which, in the administrator's opinion, should have belonged to the estate of Hector. There was nothing left for the two preferred creditors (for over €300,000) and 90 unsecured creditors (for over €350,000). The recovery rate of pre–bankruptcy debt was zero. Even the estate–related bankruptcy costs could not be paid in full (recovery rate of 72%). The owner of Hector did not own any assets, other than his house which was sold by the bank. Towards the end of 1997 he was being used and instructed by others. Even during bankruptcy he tried a dubious restart twice. His bankruptcy lasted eight years, three of which he spent in prison.

Evaluation
Three out of four of the causes of the model have been prevalent in this bankruptcy:

1. *general environment:* the general environment did not play a role in this case.
2. *immediate factors:* after losing two customers, the owner of Hector had an urgent problem to solve. He could have downsized the company, but instead he started

looking for new customers. He obviously had not learned much from this writing–off experience, as for the second time he chose a rotten apple as a new client.

3. *corporate policy:* from the beginning, Hector's flaw was its financial policy, as it had no long–term investors or borrowers. This made it extremely fragile. Once it decided not to downsize but instead to seek criminal money and later on to commit fraud, all efforts at proper administrative behaviour were gone. Due to the absence of any corporate governance or monitoring efforts from outside the company, these actions were not stopped. Not the truck rental firm, which was caught in a prisoner's dilemma to accept a considerable loss or to proceed for better or worse, nor the tax authorities nor the partially unpaid drivers took timely action. It was the defrauded trailer rental company that finally filed for bankruptcy.
4. *management quality:* the owner of Hector was an experienced planner in a trucking department and he brought a portfolio of customers. He did not have any management experience. There was no business plan. He could not cope with bad news or the possibility of downsizing. He wanted to keep his powerful position and was prepared to go beyond boundaries. His charisma led creditors and employees to give him the benefit of the doubt for a long time. It was personal pride, not a struggle for private wealth, which led him to his fraudulent behaviour.

1.3.3 Pass BV

Pass BV produced entrance, loyalty and chip cards with originally some 60 employees in four divisions: retail, transport, telecom and banking. Retail loyalty cards and free travel permits for public transport were the core business. Due to the booming telecom business in the years up to 2000, Pass BV thought to have found new profitable activities. Against high turnover in this sector stood high costs (in personnel and kind) and low margins. When turnover in this sector fell in 2001 with around 70% Pass, convinced of better times to come, did not lay off its employees and downsize its costs. The earlier profits of the telecom business were invested in new production machinery for bankcards, which activity never generated any money. New investors were sought, in vain. Declaration of bankruptcy was inevitable. Interested parties subsequently withdrew. Five weeks after the declaration of bankruptcy a venture capitalist was found. The administrator was able to sell the retail and transport division, while closing down the telecom activities.

It turned out that the annual accounts had not been published in the *Handelsregister*[26]. Moreover, some months before bankruptcy the director had bought the debt of a former partner, thus equalizing his own private debt position to the company[27]. The director was held liable for non–disclosure and the equalizing transaction. This estate claim was settled by the administrator. There were two secured creditors (for over €500,000) and 120 unsecured creditors for over €2,500,000. The bank apparently overestimated its secured position (due to overstated receivables) and was one of the unsecured creditors for €470,000. The recovery rate of pre–bankruptcy preferred debt was 5% (unsecured debt: 0%). The estate–related bankruptcy costs were paid in full.

Evaluation
While trade and character of both cases differ, the prevalent aspects have a striking similarity:

1. *general environment*: the management did not recognize that the downfall in mobile telephone activities after 2000 had a permanent character and therefore did not adapt its corporate policy in a timely manner.
2. *immediate environment:* when the mobile phone business started to collapse, the management immediately went in search of new customers and new products but it did not have the expertise in place to develop the new banking cards division, nor could the company cope with the competition of other companies in the same area, looking for new opportunities.
3. *corporate policy:* the company had formulated certain policies but it could not realize them. The focus on the banking business was misguided, as it was a too specific product. The operational work of the other divisions was not very efficiently planned. It involved a lot of human effort, often on short notice and thus expensive. Although the financial position of the company was very weak, the bank did not monitor very actively. Corporate governance was hardly present, the executive director (ED)[28] was the only shareholder. The management team was weak, the auditor did not play a true monitoring role nor did the tax authorities, who knew the ED from a previous bankruptcy.
4. *management quality:* the ED was a charismatic man and could therefore bind his employees, his suppliers and his customers to the company, also in difficult times. This made it hard to challenge him. Even the bank could not get through. The ED was overly optimistic and could not cope with bad news. Even though no accounts were published, an AMX–listed company was convinced into doing business with Pass BV – and was never paid – for approximately €1 million on the basis of unpublished, manipulated figures. The anger of creditors after filing for bankruptcy can be seen as proof of the confidence in the management: they did not expect it at all.

1.3.4 Concluding remarks on the micro–economic analysis

The Ooghe and Waeyaert model as well as the previous analysis of two randomly chosen bankruptcy cases make clear that management plays a key role in situations of near financial distress. *First*, it should at least acknowledge that circumstances are changing, *second* it should actively decide whether it should or should not take any action and *third*, if it has been decided that action should be taken, it should decide on the nature of the action. Or in other words, management can make three categories of mistakes: it could overlook relevant changes in the environment, it could decide not to act where it should, and it could make the wrong decisions on the action to be taken. If the quality of the management concerned is considered as a given, the question is: what circumstances would have to be created to diminish the incidence of management mistakes and thus the number of financially distressed companies? The law provides for some answers as 1.4 shows.

1.4 LEGAL IMPACT OF BANKRUPTCY

The law usually provides for two sets of rules related to financial distress: those rules that *after* the filing for bankruptcy arrange either for the division of assets after liquidation or for a formal reorganization; and those that restrict or encourage specific behaviour of directors *before* bankruptcy. Chapter 2 discusses the *after* filing rules in functional terms. It describes the existing types of bankruptcy systems and compares the outcome between a formal reorganization or a liquidation process and an informal reorganization. These are the main solutions when financial distress is imminent. However, the *before* bankruptcy rules encourage directors to stay away from bankruptcy through behaviour-influencing measures. Especially when financial distress or bankruptcy is imminent, incorrect director's behaviour may result in personal liability, annihilation of contracts, directors' disqualification or a criminal offence. Chapter 5, which focuses on the situation of imminent financial distress, describes these measures. These measures are predominantly of a 'discouraging' nature. Shortcomings of this approach are: (1) instead of offering directors a mechanism to improve management quality, all they do is discourage undesirable management behaviour; (2) a large grey area between a good and a reproachable management decision remains; and (3) the threat of liability may not act as a meaningful deterrent for owner-managers, who often have few personal assets beyond their stake in the firm (Armour et al. 2009: 135).

Could there be a mechanism that goes beyond the shortcomings mentioned? Would it be possible to achieve better decision quality? Just as the number of traffic casualties dropped after the 1970's through a number of different legal measures, the number of bankruptcies may decrease by a mix of measures as well. Reflection on these issues leads to the research question of this thesis.

1.5 RESEARCH QUESTION: WHAT?

The analyses of the previous sections deliver four important conclusions. *One*: the macro economic analysis shows that the impact of bankruptcy on society is big. Unpaid debt after bankruptcy of legal persons in the Netherlands is as high as 0.39% of the GDP each year and growing. *Two*: human factors, i.e. mismanagement, problems within the board and fraud account for at least 39% of all bankruptcies. *Three*: the micro analysis indicated that management, by acknowledging changes, by deciding to react and if so, how, has a pivotal role. *Four*: thus far the law relies on 'discouraging' provisions to avoid bankruptcies.

The research question of this thesis derives from these conclusions. Given the impact of bankruptcies on society, and management's pivotal role on the one hand as the cause and on the other hand in taking action, one wonders how a management's performance can be improved in order to avoid financial distress. The legal answer formulated in the past decades is to hold directors personally liable to the company in general and to creditors specifically in situations of near financial distress where serious blame can be attributed to the directors (chapter 5 of this thesis). With Armour et al. (2009:135) one may presume that the legal approach normally works as a deterrent. It urges directors to stay away from the 'serious–reproach–area'. However, the legal approach does not necessarily act as an 'encouraging' stimulus to improve the decision quality above the minimum level required by the law. Despite the existing legal measures, 32% of corporate bankruptcies are still due to mismanagement. Should this percentage be accepted or could science possibly provide instruments to decrease it?

This is where the economic concept of monitoring comes into play (Alchian and Demsetz, 1972). Consultations on short notice with people connected to the company, if available, could prove of valuable assistance – sometimes management is in a dead lane, misses know–how or a network, overlooks alternatives which other people involved could offer, or simply needs an occasion to reflect. In short: management may need a monitor[29], meaning someone who *observes or comments on a process or activity*[30] and *who gives advice or warning as to conduct*[31]. Would monitoring, which is the activity monitors do, indeed improve management's performance in terms of financial distress? This is the subject of this thesis. The research question therefore reads:

> *What is the role of monitoring near financial distress from an economic and legal perspective?*

More specifically, the following questions are the subject of this thesis:

- *What does financial distress mean and what are the options of a financially distressed company?*
- *What is the role of monitoring from an economic perspective?*
- *How does the law organize monitoring?*
- *Are there any specific requirements for monitoring near financial distress?*
- *Is there any empirical evidence on the relationship between monitoring and the incidence of financial distress?*

This study focuses on monitoring in five categories of legal persons: public and private limited companies, co-operatives, associations and foundations, since all of these play a vital role in the private sector in society[32]. Religious societies, public legal entities and legal persons of a somewhat hybrid nature such as universities, which in the Netherlands are legal persons *sui generis* by law, are thus excluded. The legal study surveys the Dutch, German and UK corporate system. The empirical research is executed using Dutch data.

1.6 METHODOLOGY: HOW?

In order to find an answer to the above questions, three research methods are applied: literature search, comparison of law systems and empirical studies.

Literature search
For all the subjects discussed in this thesis, an international literature search has been conducted into the state-of-the-art on the matter. The search is generally limited to databases and journals available through the library of the Erasmus University Rotterdam (EUR). Two precautions should be made. The first is that the search machines predominantly focus on studies written in English. While some studies in Dutch and German have been consulted, the searches in these languages have been restricted. The second is that literature on corporate governance and related issues is quite extensive and grows by the month. If ever an inquiry could be exhaustive, it would certainly not be in this field. The focus has been on the developments in science, rather than on a complete overview of all the literature concerned.

Comparison of law
Where this thesis analyses monitoring near financial distress, it aims to do so on a systemic level and therefore uses a comparison between the UK, Germany and the Netherlands. Why these countries? The UK is chosen for its long-time shareholder orientation. Originally it was heavily oriented towards the US corporate system. Germany: as it takes rather the opposite position where it puts the stakeholder and specifically the employee in the centre. The Netherlands: because in quite a few aspects it is in between the German and the UK corporate system. Chapter 4 elaborates on the differences between the corporate systems. The analysis is on a stratigic level, as it is considered less interesting how exactly each corporate law system works, than to compare the political choices made with a focus on monitoring strategies.

Empirical studies
The second part of this thesis consists of three empirical studies on monitoring. Based on two major economic theories, the *agency theory* and the *resource dependence theory*, hypotheses are formulated and tested. Chapters 6 and 7 test these theories on Dutch

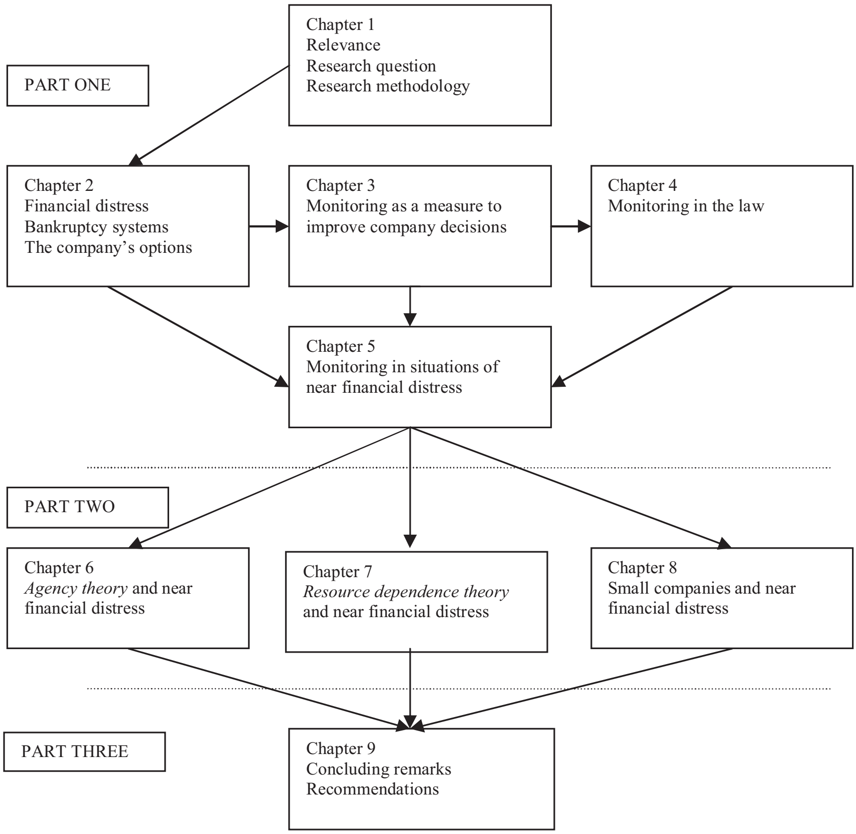

Figure 1.2: Arrangement of chapters of this thesis

listed companies. The database has been built from electronically available and manually collected data from annual reports. Chapter 8 tests the theories on small Dutch companies, using data downloaded from the *Handelsregister* system.

1.7 ARRANGEMENT OF CHAPTERS

Figure 1.2 shows the design of this thesis. Part *one* is of an analytical nature. This analysis mainly has an inductive character. Chapter 2 describes financial distress in terms of the concept and the legal and economic approach to a solution. Since CBS data for the Netherlands shows that 32% of bankruptcies originate from mismanagement which may occur, as Argenti (1986A) argued, at a rather early stage, chapter 3 studies whether the economic concept of monitoring could be a tool to improve management decisions in general. Chapter 4 studies the organisation of monitoring in the law over three different legal systems. The findings of the literature search and the comparative analysis from chapters 2, 3 and 4 are integrated in chapter 5 which is on monitoring in situations of near financial distress. This results in a model on the role of monitoring when financial distress nears.

Part *two* of this thesis is of an empirical nature. It tests the hypotheses derived from the economic and legal analysis of part one against two databases, one consisting of data on Dutch listed companies and another on small Dutch private companies and other legal persons.

Chapter 6 studies the relevance of the *agency theory* to near financial distress. Chapter 7 examines the relationship between individual board member characteristics, board diversity and financial distress, based on the *resource dependence theory*. Chapter 8 uses a database of 378 small Dutch legal persons to test hypotheses related to director's characteristics and board structure, and financial distress.

Part *three* (chapter 9) formulates recommendations and concludes.

1.8 SIGNIFICANCE OF THIS THESIS

Much research has been done on the relationship between corporate governance and the financial performance of companies e.g. Daily (1995), Dalton, Daily, Ellstrand and Johnson (1998), Klein (1998), Vafeas (1999), Postma, Ees and Sterken (2000), Bhagat and Black (2002), O'Connell and Cramer (2010). Whether a firm performs well or not, however, is essentially a shareholders' concern. Their profits depend on the development of the share price, presumably linked to performance, and share dividend. Other stakeholders might feel side effects when a company is performing less, for example lay-offs and re-structuring for employees, less tax income for the government, fewer goodwill activities for employees and society or fewer investment opportunities due to the lack of growth. But essentially the company will keep on meeting its contractual obligations.

This changes dramatically when a company enters bankruptcy. At that moment, the company stops meeting its contractual obligations. Employees, creditors and taxes are not paid, deliveries are not made or services not rendered. This is a much more severe event than a company not performing as expected, or as its peer group. The latter is a relative problem, the first is, certainly in creditor-oriented[33] bankruptcy systems, of a much more absolute nature. The company often dissolves; the shares become worthless. Few studies, e.g. Daily and Dalton (1994A), Elloumi and Gueyie (2001), Lee and Yeh (2004) and Donker, Santen and Zahir (2009), have been conducted on the relationship between corporate governance characteristics, e.g. board composition and ownership and financial distress. This thesis contributes to current literature in describing, analysing and testing the role of monitoring near financial distress. Since mismanagement causes 32% of bankruptcies, board problems 4% and fraud 3%, this thesis wonders if these percentages could decrease by applying monitoring mechanisms to the company. Monitoring is certainly not a panacea, nor will it be able to avoid all internal, mainly management-related errors. Monitoring might however be a factor in reducing the 39% internal causes of bankruptcy. Even a reduction of management errors resulting in 0.01% point less debt loss due to bankruptcy in GDP terms, e.g. from an average of 0.39% to 0.38%, would result in an efficiency gain of approximately €60 million annually (table 1.3 columns 6 and 2). The resulting insights and recommendations of this thesis may prove useful to directors, banks and other creditors, insolvency advisors, administrators and judges.

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ENDNOTES

1 This thesis applies ‘administrator’ as the generic term for administrators, liquidators, administrative receivers in the UK, *Insolvenzverwalters* in Germany, and *curatoren* and *bewindvoerders* in the Netherlands, unless otherwise noted.

2 see also 4.2.3. As chapter 4 shows, the UK Companies Act 2006 covers a broad range of organizations with legal personality; as does Titel 1 Boek 2 of the Dutch Burgerlijk Wetboek. Dutch law distinguishes between ‘the legal person’ and ‘the enterprise’ (s 2:140/250(2) BW *in fine*; Van Schilfgaarde/Winter, 2009: 20). Since UK law does not recognize such a distinction, this thesis regards ‘the legal person’ and ‘the company with legal personality’ as one and the same.

3 The median is the numeric value separating the higher half of a sample from the lower half (in common language: the middle observation). If the number of observations is even, the median is usually calculated as the average of both ‘middle’ observations.

4 CBS discerns data on bankruptcies of people, sole proprietorships and ‘institutions, corporations and similar’ (‘vennootschappen e.d.’). Annex 1 shows the data for all concluded bankruptcies. Since this thesis focuses on legal persons, the figures in the text relate to bankruptcies of legal persons only. Although the category ‘institutions, corporations and similar’ (‘vennootschappen e.d.’) contains non–legal–person–partnerships as well (‘vennootschap onder firma’ or ‘CV’), this concerns less than 10% of the cases (table 8.1). Therefore, this thesis considers those data as relating to legal persons only. See: CBS, 2010:8, Faillissementen: oorzaken en schulden in 2008, (Den Haag/Heerlen).

5 All figures in these and following tables are available online from CBS StatLine. The author is responsible for the presentation of the figures.

6 s 57 and 58 Faillissementswet (Fw). Column 4 therefore only states part of the total recovery by secured creditors (Boot and Ligterink, 2000: 27).

7 The ‘s’ in s 182 Fw stands for ‘section’ or ‘artikel’ (Dutch) or ‘§’(German). See also 4.3.7. Abbreviations of laws e.g. Fw for ‘Faillissementswet’ (Dutch) and their translations are found in the List of Abbreviations early in this thesis.

8 See Financieel Jaarverslag 2009 – Erasmus Universiteit Rotterdam: 63, 70 available on www.eur.nl.

9 Van Amsterdam (2004: 42) mentions that overestimation due to majoration by creditors and tax authorities happens as well. It is the opinion of the author of this thesis that a proper administrator should sort this out as much as possible.

10 s 64 b Werkloosheidswet (WW; Unemployment Insurance Act)

11 Couwenberg (2001: 267) argues that the recovery rates of liquidation–based systems (where all bankrupt companies are treated equally: they are either sold or liquidated) seem to be somewhat lower than those attained in reorganization–based systems (like in the US Chapter 11, wherein the company is reorganized). See also chapter 2 of this thesis.

12 A sample bias means that in a sample of a group all factors or participants are not equally balanced or objectively represented (Mosby’s Medical Dictionary, 8th edition, 2009, Elsevier, from http://medical–dictionary.thefreedictionary.com).

13 Predistressed value (PDV) means the market value of the firm before the financial distress was made public.

14 It should be noted that those conclusions are reached in opposite order. The 56% is the result of the calculation: 60% (average recovery rate) – 4% (average claims holders’ costs). Those 56%

added to the average 16% *total* cost of dealing with distress, comes to 72% and leaves 28% unexplained, being the loss.

15 Chapter 2 hereafter describes the difference between both procedures.

16 See for all figures over 2000–2008 Staat 3 p.5 and for the definitions of the causes CBS, 2010:15.

17 Note the difference between the *causes* of bankruptcy (Staat 3, CBS, 2010) with a minor share of fraud of 3% and the *incidence* of fraud which is the case in 22% of bankruptcies of BVs in 2008 (calculated from Staat 10, CBS, 2010).

18 Van Amsterdam (2004: 80) concludes, that even 70% of the bankruptcies are caused by mismanagement. A good entrepreneur, he argues, recognizes macro–economic and other problems and adapts company policy in time. See also section 1.3.1. of this thesis.

19 The *Handelsregister* (translated: Commercial Register) is held by the Chamber of Commerce (s 3(1) Handelsregisterwet (Hrgw). All legal persons and all firms should be registered (s 5–7 Hrgw).

20 On 22 March 2007. Main office only.

21 The breakdown of the number of bankruptcies for foundations, associations and cooperatives comes from chapter 8, table 8.2. The number of associations includes the category ‘undis–closed’.

22 Naamloze vennootschap (NV) and Besloten vennootschap met beperkte aansprakelijkheid (BV).

23 Vennootschap onder firma (VOF) and commanditaire vennootschap (CV).

24 As opposed to companies that display only financial activities (like pension BVs, financial holding companies, Stichtingen ‘Administratiekantoor’).

25 Calculations based on Staat 10 (CBS, 2010) show a fraud incidence for 2004–2008 of 8% for a partnership, of 10% for a one–man business, of 22% for BVs and of 22% for ‘other’. This ‘other’ category includes institutions with presumably a relatively low fraud rate, and foreign legal persons, with presumably a high fraud rate. See for fraud with foreign legal persons: Bunt, H.G. van de, T.J. Van Koningsveld, and M.J. Kroeze et al., 2008, *Overheidstoezicht op buitenlandse rechtspersonen.*

26 Disclosure is mandatory under s 2:394 BW. As a consequence of non–disclosure the director might become personally liable (s 2:248 BW).

27 As forbidden by law under s 53 and 54 Fw.

28 See 3.2.1. for a definition.

29 The Alchian and Demsetz, 1972: 782 definition of ‘monitor’ and ‘monitoring’ is much broader and does not apply here. See also: section 3.5.

30 Oxford English Dictionary, *monitor* (noun) under 11.a.

31 Oxford English Dictionary, *monitor* (noun) under 9.

32 See also section 4.2.3 of this thesis.

33 Chapter 2 elaborates on bankruptcy systems.

Chapter

2

The options for the company near financial distress

Bankruptcy is essentially a state–supervised system for breaking (or more politely rewriting) contracts that are mutually inconsistent and therefore, unenforceable. (Jensen, 1993: 849).

2.1 INTRODUCTION

This chapter aims at describing and evaluating the options for the company near financial distress. Financial distress is the starting point of this thesis. How should it be defined? Is this definition operational? Can it be measured? This is the subject of section 2.2. The next question is how financial distress should be handled. What options does the company have once it realizes that it is in financial distress? It becomes apparent in section 2.3 that there are quite a few. The most radical solution is bankruptcy. Section 2.4 defines the aims of a bankruptcy system and discusses different approaches in various bankruptcy systems. One of the less radical solutions to financial distress is an informal reorganization ('work-out'), which is the subject of section 2.5. This is a privately negotiated form of re-contracting which has been developed over the years especially in the UK. Research indicates that the work-out solution is widely applied. Section 2.6 compares the formal and informal reorganization routes. A clear picture of the advantages and disadvantages of the various possibilities facilitates the choice for the right route under the circumstances. Section 2.7 concludes.

2.2 FINANCIAL DISTRESS

The meaning of 'financial distress' is the topic of this section. After the evaluation of the early definition of Gordon derived from finance theory, some definitions used in empirical work will be reviewed. Finally, this thesis' definition will be chosen.

2.2.1 Gordon's definition of financial distress

Gordon (1971: 348) was the first to establish a theory on financial distress. His starting point is the theory of finance. In his view a firm is financially distressed *when a fall in its earning power creates a non-trivial probability that it will not be able to pay the interest and principal on its debt*. In that situation, Gordon proceeds, its bonds will sell at yields materially above the interest rates at which financial institutions are willing to extend credit to otherwise similar corporations. In a lively open bond-market as in the USA this may be a relevant definition. However, in Europe this market is relatively small as long-term loans are mainly provided by banks and other financial institutions. The 'fall in earning power' part of the definition is deemed irrelevant: any cause is good enough. The same goes for 'interest and principal': any non-payment causes trouble. However, the 'non-trivial probability' part of the definition is important, as it shows that financial distress covers a great number of situations and cannot be grasped in one event. The definition Wruck (1990: 421) gave of financial distress as a situation where cash flow is insufficient to cover current obligations, is therefore felt to be too restricted. If the firm knows it cannot meet its next-year's obligations, it might feel financially distressed as well. It is this variety of situations that inhibits a once and for all definition of financial distress.

2.2.2 Definitions of financial distress in applied research on listed companies

Applied research in this field should start with an operational definition of financial distress. One finds two approaches: a *multistage* approach with three or more stages of financial distress, and a *dichotomous* approach. An example of the *multistage approach* is found in Lau (1987: 127) who developed a five–states financial distress prediction model:

State 0 financial stability
State 1 omitting or reducing dividend payments
State 2 technical default and default on loan payments
State 3 protection under Chapter X or XI of the Bankruptcy Act
State 4 bankruptcy and liquidation.

While acknowledging that a financially stable firm might reduce or omit dividends for sound reasons, her decision to define state 1 is based on empirical studies, which have shown that a firm that is reducing dividends is typically encountering some financial distress. In their study, Johnsen and Melicher (1994: 273) choose a three–state model, wherein an explicit category of "financially weak" firms is used. Hill, Perry and Andes (1996) work with three categories – stable, financially distressed and bankrupt – as well. They define financially distressed firms as firms having cumulative negative earnings over a three–year period. This three–year requirement secures that the firms are indeed distressed and not just experiencing some fluke in earnings (p. 69).

The *dichotomous* approach discerns between non–distressed (control) and distressed or bankrupt companies. In Altman's original study the bankrupt group consists of manu–facturers that filed a bankruptcy petition under Chapter X of the US Chandler Act of 1938 (Altman 1993: 30, 184). Likewise Aziz and Lawson (1989: 56), in their article on financial distress models, only refer to firms that entered bankruptcy. Gilson (1989: 243) defines financial distress as an inability to meet the fixed payment obligations on debt. More specifically he considers a firm financially distressed if it is either in default on its debt, bankrupt, or attempting to restructure its debt to avoid bankruptcy (p. 246). In their study on dividend policy and financial distress, DeAngelo and DeAngelo (1990: 1416) focused on firms that experienced protracted financial trouble, as evidenced by at least three annual losses during 1980–1985. Opler and Titman (1994: 1019) reason along similar lines, when they define financially distressed firms as: highly leveraged firms. In more recent work however, the trend seems to be a retreat on bankruptcy. Charitou, Lambertides and Trigeorgis (2005: 9) investigate the monitoring role of institutional investors in highly distressed US firms. For them, financial distress is defined by having filed a US Chapter 11 bankruptcy petition. Nunez, Casado, Pacheco and Gomez (2005: 8) studied the problem of variable selection for financial distress. They equal financially distressed firms with failed firms, i.e. firms under temporary receivership or declared bankrupt.

Thus, research on financial distress in listed companies has covered various phases of financial distress.

2.2.3 Definitions of financial distress in applied research on non-listed companies

Listed companies have to disclose their financial difficulties, non-listed companies do not. In their research on small and medium-sized enterprises (SMEs), Franks and Sussman (2005: 74) define a non-listed company to be in distress once the local bank branch and the regional credit officer decide to transfer the account to the bank's *Business Support Unit* (BSU). While the test is objective, the decision itself is probably not, and the data is only available if the customer files of the bank are made available for research, as in Van Amsterdam (2004), Adriaanse (2005) or Davydenko and Franks (2008). This will not often be the case.

Another approach to studying financial distress in SMEs is to focus on bankrupt companies only. This is undoubtedly an objective and formal criterion. Whilst it is true that not all financially distressed companies will end bankrupt, it is also true that all bankrupt companies will have been financially distressed for some time. A study on publicly available financial and governance data of non-listed bankrupt companies over the period before bankruptcy, if available, might reveal information on the background of the financial distress. The use of another possible distress test, i.e. the one of three-years-consecutive-losses, would depend very much on the availability, reliability and to a certain extent subjectivity of financial data. For SME distress research therefore, bankruptcy is considered the best financial distress definition.

2.2.4 Concluding remarks on the concept of financial distress

Financial distress is a much broader concept than bankruptcy only. Therefore every study needs a clear definition of the subject. Moreover, an empirical study has to avoid subjective elements in the definition. Financial distress in part one of this thesis means *the existence of a non-trivial probability that the legal person will not be able to pay its debt within the terms of payment.* It is the Gordon definition without reference to the cause of the situation, which is deemed irrelevant, and with the extension to *all* debt. The empirical part two of the thesis defines the concept of financial distress in measurable terms.

2.3 THE UNROLLING OF FINANCIAL DISTRESS

Now, imagine a virtual company C, which is in financial distress according to the definition of 2.2.4. What are the possible outcomes for C? This section starts with an academic catalogue of possible outcomes. It presents a strategic model on the probable unrolling of financial distress, given the circumstances. The role of monitoring near financial distress is the subject of chapter 5.

2.3.1 Possible outcomes of financial distress

How threatening is it to become financially distressed? It would be wrong to consider financial distress as the first step of an unavoidable process, leading to formal bankruptcy. Instead, it should be seen as a challenge to turn the company around. One can think of five scenarios for unrolling financial distress (Berkovitch and Israel, 1998)[1]:

1. The company continues and hopes for a favourable change of circumstances,
2. The company merges with another, or is sold,
3. The company is voluntarily reorganized,
4. The company is voluntarily liquidated,
5. The company (or a creditor) files for bankruptcy and is liquidated or involuntarily reorganized.

In the *first* scenario financial distress extinguishes by 'a change in the firm's fortunes' (Gordon, 1971: 355). An upswing of the economy, favourable fiscal government measures, lifting import barriers for Chinese textiles or the permit system for cheaper East-European labour: these kind of events may signify the difference between life and death for some companies. There is a famous story of a Dutchman, who had invested all his money in dead stock of chemicals. When driving to the Court to declare bankruptcy, he heard the announcement of the 1973 oil embargo against the Netherlands. He realized that this embargo would make the dead stock valuable, returned home, and became a wealthy trader of chemicals[2].

The *second* scenario is where an investor becomes interested in merging with the company or in buying it. This investor might be a competitor who knows of adverse circumstances before the financial market does and makes a bid. Or it may be a private equity investor, who waits long enough to be able to buy the company for next to nothing. It may be that interested parties knock on the door, or that directors or investment banks have to invite third parties. But in the end, the original investors have less money left than the company's worth before the financial distress occurred, while the new investors think they have invested in a great opportunity.

An approach to the *third* scenario, voluntary reorganization, also known as *informal* reorganization or private work–out, will be discussed in 2.5. It is about reorganization in the broad sense: on an operational, managerial, as well as financial level.

The *fourth* scenario is voluntary liquidation. In the good old days the shop, the factory, or the office earned enough for its proprietors, but slowly, or all of a sudden, this is over. People shop on the internet, where they buy directly from e.g. Germany instead of from the shop around the corner. A new shopping centre, a new production technique, these can all be causes of running out of business sooner or later. A responsible entrepreneur or manager will decide to liquidate in good time. With a timely decision one buys time for an orderly process. And an orderly process guarantees the best proceeds.

Bankruptcy is the *fifth* scenario and points to liquidation or reorganization within an insolvency law framework. *Liquidation* means that the administrator sells the assets, either piecemeal or going concern. In the end the company is dissolved. Reorganization in this scenario is called *formal reorganization*, as it takes place within insolvency law. The company will be restructured in strategic, operational, financial and often property terms with the intention to survive as a going concern. The going concern option is indicated when the going concern value is higher than that of the individual assets (Brouwer, 2006: 10). Especially if investments are sunk, e.g. railroads or cable companies, or if human capital is a very valuable asset, a going concern sale or formal reorganization is the better solution. This fifth scenario will be discussed at some length in 2.4.

In scenario one the company turns around by itself, and in the scenarios two and four the firm ceases to exist as an independent legal person. The focus in this chapter is on efforts to save the legal person or its business activities independently, through the scenarios three, voluntary or informal reorganization, or five, liquidation or involuntary, formal reorganization.

2.3.2 Towards a model to strategically handle financial distress

Imagine that our virtual company C *acknowledges* it is in financial distress. It might already have lost valuable time in finding out, but now it knows. What should it strategically do? The model presented below indicates at what level a company should focus its reaction to financial distress. The approach developed below relies heavily on the conceptual failure model of possible causes of bankruptcy of Ooghe and Waeyaert (2004) and Ooghe and De Prijcker (2008). As already explained in 1.3.1 above, they distinguish four main causal factors, i.e. management and corporate policy as *internal* factors, and the immediate environment and the general environment of the company as *external* factors. The fifth relevant, though not causal, factor is the company itself: its size, industry, age and flexibility determine its reaction and its possibilities.

In this section the argument will be developed that in order to survive, the cause of financial distress should be cured. The company just has to react properly, either by challenging the cause itself directly or, if that is not possible or not desired, by adapting other circumstances it can influence. The model in figure 2.1 therefore presents the very same four factors of the *causal* model of Ooghe and Waeyaert (2004), now as the determining factors for the *outcome* of financial distress. What matters in financial distress is to determine the *real* cause as fast as possible, in order to react properly. Much time is lost in identifying that cause. The survival model developed in figure 2.1 implies that a solution should be found in the same box that holds the cause, or in a 'lower' box, meaning a box with a lower level of abstraction. The general environment is 'higher' or more abstract than the immediate environment, which is 'higher', more abstract than corporate policy, and this is 'higher' than management. The general environment is abstract, far away, and difficult to influence or to change. For the immediate environment this is easier: suppliers or customers receive the message that due to a changed general environment factor, the price or the term of payment will change. Corporate policy comes close to everything the manager believes in and has created to the best of his[3] knowledge and effort. It is often difficult for a manager to acknowledge that, so nearby, almost personal decisions have to change. And this goes even further if the management has to question itself: am I

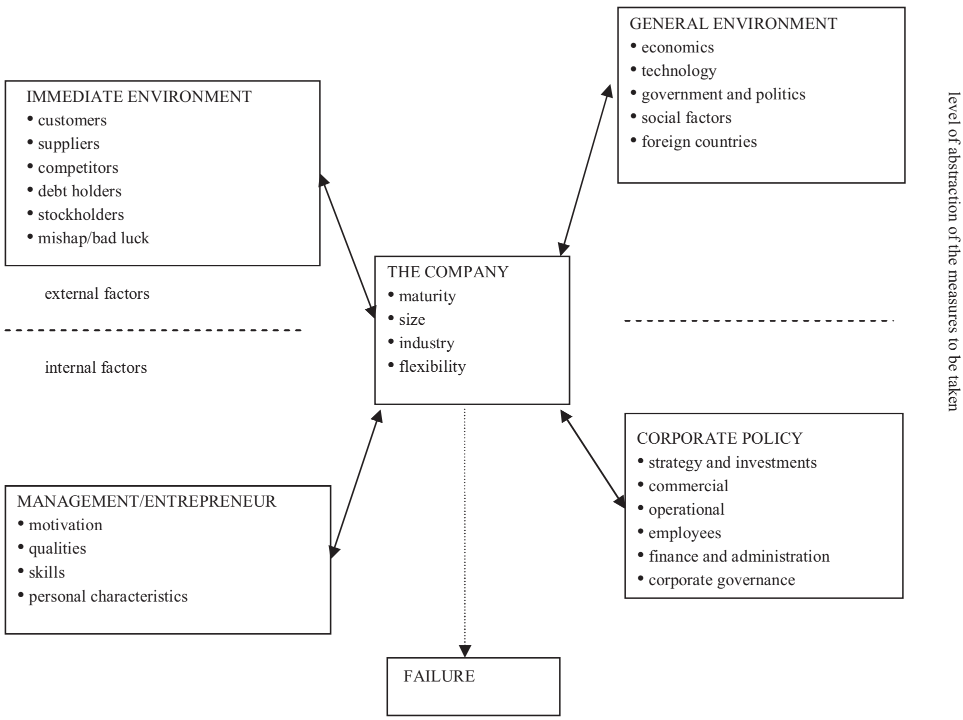

Figure 2.1: determining factors for the outcome of financial distress

the right person for the company in the current circumstances, or do I need advice from others, should I step down even?

It is the author's conviction that the mistake that is often made is that the cause is defined and therefore measures are taken in the wrong box, at a level that is too high and therefore wrong. Whether the measures taken will work also depends on the company's characteristics: is it large enough to survive a serious blow, is it flexible enough, is it in the right industry, and is it able to rejuvenate itself, if necessary. Usually, the first thing a company looks at when in financial distress is not the company itself, but its environment. *We* do the right thing, it is only the adverse circumstances that cause us trouble, is the excuse generally heard in financial papers as well as from management. The *general environment*, the highest level of abstraction involved, lies outside the company. It is normally a given, although it is possible for pressure groups or branch associations to push politics to a favourable change, e.g. a relaxation of fiscal tariffs, of trade barriers, or of a labour permit policy. The *immediate environment* will generally be the focus of management in situations of near financial distress. It is still outside the company, but on this level the company may influence events. A search commences for new or better paying customers through a new advertising campaign; for more, cheaper or more reliable suppliers or more efficient production techniques; for ways to do better than competitors; for new capital. It is a process of repositioning the company (Adriaanse, 2005: 23). If the immediate environment is indeed the cause of financial distress, then this approach might work, provided management is able to find the appropriate mix of measures. The danger however, is that the management focuses on symptoms and not on the real cause of distress (Ooghe and Waeyaert, 2004). If the cause of distress lies internally, at the relatively abstract level of *corporate policy,* or at the more fundamental level of *management* itself, then change should start there. Whether this will be possible depends on the level of separation between ownership and management of the company. Where there is not much separation, as in SMEs, it will be very difficult for management to concede that it has not been capable of doing its job under the present circumstances, or that its often self-defined corporate policy proved to be wrong. To replace itself under such circumstances, or to reformulate corporate policy, requires self-criticism that people in such situations often lack (Skeel, 2005). However, if there is a high level of separation between ownership and management, as usually is the case in listed companies, and provided shareholders are informed in time, shareholders might call for a change of management and/or corporate policy. The uprising of shareholders and the following dismissal of Jean-Paul Votron, CEO of Fortis NV, after an unexpected emission of shares on 26 June 2008 forms an example. But even then, one has to look out for symbol policy and to seek real change in order to survive the distressed situation.

The previous section described five scenarios for unrolling financial distress. This section is about four different levels of causes and solutions for financial distress. Table 2.1

Table 2.1: strategies for surviving financial distress

company / cause of distress	no separation of ownership and control (SME)	full separation of ownership and control (listed company)
general environment	• favourable change • reorganization (production, distribution) • options in boxes below	• lobbying (depending on size and industry) • reorganization (production, distribution) • formal reorganization through bankruptcy • options in boxes below
immediate environment	• primary focus on new customers, new suppliers • related new products • financial restructuring • (M&A or liquidation as a last resort) • options in boxes below	• new markets • new production process • new products • M&A with competitor, customer or supplier • financial restructuring • options in boxes below
corporate policy	• rigorous change in policy • reorganization: back to the core business • options in box below	• rigorous change in policy • reorganization: back to the core business • options in box below
management/ entrepreneur	• self-invention of management • appointment of an heir	• appointment of new non-executive directors • replacement of executive directors

combines both and summarizes the possible scenarios for each box of causes for SME and listed companies. The table is based on Ooghe and De Prijcker (2008) and the author's own experience. The second column of table 2.1 shows that SME companies have fewer strategies than listed companies when confronted with financial distress. When distress is due to general causes, lobbying will not be effective because of the relatively small size of the SME. Reorganization of production or distribution is an option often executed rather late, since the personal relationships in a SME as well as the often essential skills of the workers stand in the way of quick dismissals. If the causes lie in the immediate environment sphere, an SME will have fewer possibilities to invest, for example in new products. Usually its scope will be on doing better with the existing products through new advertisements, by lowering prices or even by lowering quality. Financial restructuring will often not be considered, because the owner/manager should in that case be prepared to share his power and his property. An M&A transaction will be a difficult option for the same reason. If the SME has the wrong corporate strategy or incapable management, then it should have to reinvent almost itself, as the owner/manager should be prepared to give up or change all that he has believed in over the past years. These managers will often rely on their hope of a favourable change and wait, convinced as they are that they have made the right choices. They will stimulate their employees to work harder. It will be bankers or auditors who suggest 'last resort' solutions such as an M&A, a voluntary reorganization or voluntary liquidation. This analysis implies that if the *real* cause of financial distress lies in management or corporate policy–related issues, the chances of survival of SME companies are small. Management will seldom be able to criticize and replace itself and/or its policies and will search for solutions in the general or immediate environment sphere. If the issue is not there, the company has a big chance of going bankrupt. If however, the real distress cause lies in the general or immediate environment and one takes appropriate measures, the company has a good chance of surviving.

For companies with full separation of management and control there are more survival options, but as there are often many shareholders involved, the transparency required by law, at least for listed companies, might feel like a constraint. The favourable change option can seldom be considered because once the financial distress is disclosed, shareholders, trade unions and banks require immediate action. There is no time for a thorough analysis of the problem. If the economy is in a recession, or the whole industry suffers, stakeholders accept that the reorganization will be led by the incumbent management. If the problem lies in the general or immediate environment sphere, management might very well come up with the right reorganization plan. A merger or sale of the company or part of it is highly probable, especially when the imminent distress is discovered at an early stage and has not been disclosed to the market. Management might save its job during the process, the shareholders will get a relatively good price and there is no reputational damage. For these reasons, liquidation is highly unlikely. A search for new products, new markets and new techniques might be viable but takes a long time; a reorganization of the existing production process might be faster, if the company thinks the problem is in the immediate environment sphere. There will often be considerable pressure, especially if the company's results lag behind those of the peer group, to sacrifice the management and afterwards, during the big bath, also the corporate policies formulated by them. This might be the right reaction if it is indeed the real cause of the distress, but it means a loss of time and effort if it is not.

The conclusions drawn from the survival model developed above are:

- If one knows the real cause of financial distress, one can often find the solution in the same direction.
- If an SME becomes financially distressed due to inadequate management or errors in corporate policy, chances of survival are small, as it will be very difficult for the management to reinvent itself.
- If a listed company becomes financially distressed, stakeholders often call for changes in management or in corporate policies, whereas this will only help if the real cause lies there; otherwise one loses precious time.

2.4 BANKRUPTCY: LIQUIDATION AND FORMAL REORGANIZATION

The worst outcome of financial distress for a company and its stakeholders is bankruptcy. Management, shareholders and creditors all have their own interests in delaying bankruptcy as long as possible: to keep its job, to preserve value and to avoid costs. The step from financial distress to bankruptcy partly depends on the maturity structure of the debt and the amount of non–operating liquid assets (Gordon, 1971: 355).

The word bankruptcy is said to originate from *bancus ruptus*, the literally broken table of the banker who was not able to meet his obligations. Bankruptcy is a somewhat old–fashioned concept. Nowadays legal systems present several options for responding to a bankruptcy filing. Besides bankruptcy there are other declarations with different legal consequences, i.a. *administration* (England), *redressement judiciaire* (France), *Insolvenzverfahren* (Germany), *reorganization bankruptcy* under Chapter 11 (USA), or *schuldsanering* (debt rescheduling; the Netherlands). Modern theory and law therefore use the concepts of insolvency and insolvency system to indicate that there are more solutions for a distress problem than bankruptcy only. From an economic viewpoint, Altman (1993: 4) discerns technical insolvency, when a firm cannot meet its *current* obligations, and insolvency in a bankruptcy sense, a *chronic* condition, when total liabilities exceed a fair valuation of its total assets. The first requires a cash–flow or a liquidity test and the second a balance sheet test. As 5.4.2.3 shows legal systems may apply either one, or even both criteria. Thus, the legal meaning of 'insolvency' depends on the legal system. Sometimes one uses 'formal insolvency' meaning that a legal person is declared insolvent formally i.e. by means of legal proceedings. Normally this procedure involves court interference, but as the English Insolvency Act (IA) 1986 shows, where e.g. the directors of a company may appoint an administrator[4], this is not necessary. Since bankruptcy remains a current concept in the literature, both the bankruptcy and the insolvency concept will be used in this thesis.

A bankruptcy system can be studied from various viewpoints. What is its aim? How often is it used? Is it predominantly debtor or creditor–friendly? What role does the legal origin of the bankruptcy system have? Is it liquidation or reorganization–based, or in Hart's words: is it asset sale or structured bargaining–oriented (Hart, 2000)? An economist could inquire whether there is a financial criterion available for bankruptcy or whether it can be predicted. All these questions will be touched upon in the next subsections. The section concludes with a search for the optimal bankruptcy system.

2.4.1 Aims of a modern bankruptcy system

What should be the aims of a modern bankruptcy system? According to German insolvency law, it serves to satisfy creditors collectively[5]. Dutch and UK law do not formulate such an explicit aim. However, economists have their ideas. According to Boot and Ligterink (2000: 11), a bankruptcy system should comply with the requirements of speed, timeliness, unilateral goals and efficiency. More specifically, Hart (2000: 3) formulates three characteristics of a good bankruptcy procedure:

1. *Ceteris paribus, it should deliver an ex post efficient outcome.*
2. *It should preserve the bonding role of debt by penalizing managers and shareholders adequately in bankruptcy states (ex ante efficiency).*
3. *It should preserve the absolute priority of claims, except that some portion of value should possibly be reserved for shareholders, to avoid the incentive 'to go for broke'.*

The *first*, 'efficient outcome' characteristic means that the procedure should guarantee the maximum net value of the estate. This implies that the law should consider the optimal method of transferring assets into cash, as well as the costs of the bankruptcy procedure incurred by the estate and by third parties. The *second*, 'bonding role of debt' characteristic stresses that the *ex ante* commitment of the company to repay borrowed money is valuable only if shareholders and management are penalized in the event of non-commitment. This penalty could be the loss of their stake, their job, their reputation, or even personal liability. The *third,* 'absolute priority rule' (APR) characteristic 'means only that contractual obligations of priority in distribution are to be honoured' (Easterbrook, 1990: 412). Brouwer (2006: 9) formulated this characteristic as 'an orderly assessment of claims.'

A similar, though slightly different approach is taken by Franks and Torous (2002), who judge a bankruptcy code efficient if:

1. *it encourages adherence to the terms of the debt contract,*
2. *it minimizes the probability of both premature as well as deferred liquidations, and*
3. *it minimizes the direct costs of insolvency.*

Their *first* criterion is based on the notion that violations of the original contract between lender and borrower may affect the pricing of debt and in the end even the availability of credit. This is in fact the APR criterion mentioned above. The *second* means to avoid the liquidation of an insolvent but economically viable company, as well as the deferral of a necessary liquidation. This is felt to be only one factor of Hart's (2000) broader optimal asset sale criterion. The *third*, efficiency criterion focuses on the direct cost, not only for the estate, but also for the stakeholders.

To resume the discussion, a bankruptcy code should play a bonding role *ex ante*, as well as a value maximizing role *ex post*. As regards the distribution of the proceeds, the terms of contract should be honoured as much as possible.

2.4.2 Liquidation and formal reorganization: the facts

Once a bankruptcy case has commenced, the law usually provides two options: liquidation or formal reorganization. Since Chapter 11 of the US Bankruptcy Act 1978 is often considered as *the* successful formal reorganization procedure, table 2.2 presents the related figures.

Table 2.2: bankruptcy cases commenced by a chapter of the US–Bankruptcy code, USA 1990 and 2007

filings	total	Chapter 7		Chapter 11		Chapter 12		Chapter 13	
total 1990	782,960	543,334	69.4%	20,783	2.6%	1,346	0.2%	217,468	27.8%
total 2007	850,912	519,364	61.0%	6,353	0.7%	376	0%	324,771	38.2%
business 1990	64,853	36,394	56.1%	18,282	28.2%	1,346	2.1%	8,802	13.6%
business 2007	28,322	18,751	66.2%	5,736	20.3%	376	1.3%	3,412	12.1%

Source: www.uscourts.gov/uscourts/statistics.
The totals of the data do not always fully add up.

Chapter 7 incorporates the liquidation option, applied in 61% (2007) of all filings and in 66.2% (2007) of all business filings. A large minority of 30–40% reorganizes formally through Chapters 11, 12 and 13[6]. Chapter 11 is the formal reorganization provision for companies. Table 2.2 shows that it concerns only a tiny percentage of all filings. From the viewpoint of total business filings, the Chapter 11 proceedings, with 20.3% in 2007, are still important. It should be noted though, that according to Brouwer (2006: 10) the confirmation rate[7] is only 20%, which leads her to the conclusion that formal reorganization emerges in about 5% of all US corporate bankruptcy cases.

Formal reorganization, meaning the rescue of the company as a going concern, has first priority in present French and English insolvency law. In German law and in a proposal for a new Dutch law it is mentioned as an option for satisfying creditors, but liquidation is mentioned first. In the USA, the filer initially makes a choice for one of the options, which the court might or might not endorse. Research shows that formal reorganization is used less in Europe than in the USA. Brouwer (2006: 19) describes the difficulties encountered in reorganization under US and European bankruptcy law. She concludes from an analysis of Dutch, German, French and English insolvency laws that the reforms in the ‘80s and ‘90s in a more reorganization friendly direction have not raised the share of formal reorganizations in Europe substantially. She reports that the percentage of reorganizations under bankruptcy law as a percentage of total corporate bankruptcies is on average well below five. Wood (2007: 31 and 49) mentions a percentage between 0.5 and 10. Especially for France, where keeping the firm in operation has first priority by law, the 2.5% figure of corporate bankruptcies ending in a formal reorganization is surprising. Brouwer’s explanation is that the management is not interested in reorganization under insolvency law, since it will lose its job, whilst the protection of the rights of secured creditors, tax authorities and employees in France and other countries inhibits the flexibility needed for such reorganization. Couwenberg (2001: 52) found that over a period of 25 years (1970–1995) the number of requests for the Dutch form of formal reorganization, i.e. suspension of payments, has been between 200–800 a year on average[8]. Of this number, over 60% ended in bankruptcy. Luttikhuis (2007: 36) reports that out of all 4,167 concluded corporate bankruptcies in the Netherlands during 2004[9], 23 (0.6%) reorganized formally, while in 261 cases (6.3%) the company was, entirely or partially, sold going concern. Franks and Sussman (2005: 93) report, tentatively, higher figures for going concern sales in the UK after bankruptcy.

The figures show a remarkable difference in the use of formal reorganization procedures between the USA and Europe. The following subsections elaborate on the background of this difference, by explaining the differences in bankruptcy systems.

2.4.3 Debtor or creditor–oriented system

If a company cannot meet its debt obligations and restructuring attempts have proved unsuccessful, it is virtually bankrupt. As long as creditors go along and do not undertake any legal action, the company can proceed. Creditors (and often the trade creditors amongst them) quite often finance a company in distress. However, if one of the creditors wants to withdraw its money, there is a problem to be solved, because the pie is too small to give every creditor its share. The law has to make a choice: either to protect the pie, and arrange a solution for the creditors, or to protect the creditors, and optimize the value of the pie. This dilemma is known as the choice of a debtor or a creditor–oriented bankruptcy system, or more tendentiously, as the choice of a 'soft' or a 'hard' system (Boot and Ligterink, 2000; Franken, 2004: 650) . The US Chapter 11 proceedings exemplify the debtor–oriented system. After filing for bankruptcy under Chapter 11, the management retains control of the business, albeit under detailed court supervision; interest payments to unsecured creditors are suspended; and creditors are restrained from taking actions to collect their debts or enforce their security since the law provides for an automatic stay. The debtor generally remains in possession. The management has an exclusive right to propose a reorganization plan during the first 120 days, which may be extended. The plan should be approved by the various classes of creditors and can be 'crammed down' by the court by forcing the non–assenting class to accept proceeds, in accordance with absolute priority, from a hypothetical liquidation (Franks and Torous, 2002). The aim is to increase the likelihood of survival of the firm through a formal reorganization.

The English 'administrative receivership' procedure, frequently used until the Enterprise Act 2002 came into force, exemplifies the creditor–oriented bankruptcy system on the other side of the spectrum. Here, a creditor with a floating charge may appoint a representative who has a wide range of statutory powers and may, if necessary to satisfy the claim of the charge holder, sell it as a going concern or liquidate it (Franks and

Torous, 2002: 457). It is all about changing assets into money. The management is wiped out; there is no automatic stay and no court involvement. The principal responsibility of the receiver is to repay the creditor that appointed him. Normally though, there is court involvement in a creditor-oriented system. The upholding of the APR is the main characteristic. A limited stay provision of assets for the estate is its consequence.

European law is generally classified as creditor-oriented, since none of the systems know the US Chapter 11 provisions for reorganization under insolvency, that is the debtor-in-possession, unrestricted automatic stay and a loss-sharing distributive rule between creditors and shareholders, meaning that creditors and shareholders could agree on an APR-deviating distribution (Franken, 2004: 650; Brouwer, 2006:11). Even the French system, which has evaluated in the direction of a debtor-oriented system, does not know this distributive role (Davydenko and Franks, 2008). The aim of a creditor-oriented system remains primarily to repay the creditors according to their priority, although more and more attention is given to rescuing the company.

2.4.4 Origin of the bankruptcy procedure

A valuable distinction in origin seemed to be that between common-law and civil-law systems. La Porta, Lopez-de-Silanes, Shleifer and Vishny (1998) discern four origins of law: the common-law system (e.g. UK, USA), the French civil-law system (e.g. France, the Netherlands), the German civil-law system and the Scandinavian-origin system. They found 'that common-law countries generally have the strongest and French civil-law countries the weakest legal protection of investors, with German and Scandinavian civil-law countries located in the middle.' However, their study does not distinguish between the enormous differences in investor protection within the systems. The Netherlands for example scores far above the French system average value on all eight characteristics under research and only below that of Germany, the UK and the USA on two. That the Djankov et al. (2006: 24) study shows results to the contrary regarding the investor protection in the Netherlands may therefore not come as a surprise. They conducted research on the hypothetical outcome of an artificial case: an insolvent hotel firm with a given number of employees, capital and ownership structure, a value as going concern and a value if sold piecemeal. Practitioners in 88 countries answered a questionnaire on the outcome of the case in their country. The Djankov efficiency measure, defined as the present value of the terminal value of their hypothetical firm after bankruptcy costs, was as high as 94.2 on a scale of 100 for the Netherlands, 90.7 for the UK, 85.8 for the USA, 55.7 for Germany and a low 54.1 for France. In general, their results indicate that the efficiency of debt enforcement in the 43 French civil-law countries in their research is low, while rich countries are vastly more efficient than the poorer ones. Here again the Netherlands does not fit into this conclusion.

In sum, empirical research has shown that common-law countries are more efficient than French civil-law countries in the enforcement of debt and investor's rights. However, this conclusion does not necessarily apply to an individual country.

2.4.5 Asset sale or structured bargaining system

Hart (2000: 6) distinguished bankruptcy procedures according to the predominance of asset sale (or cash auction) or structured bargaining. In an asset sale system, the estate is liquidated by selling the assets piecemeal or going concern, either through private negotiations or through a public auction, whichever generates the highest value. As soon as the firm is transformed into a pile of cash, the proceeds are distributed according to the absolute priority. However, the problem is to determine the actual value of the assets, and to realize it. The market, despite the growing advantages and possibilities of the internet, is not transparent. Potential bidders wait along the side lines till the price comes down. Hart concludes that all discussions and changes have not been in the direction of cash auctions, but on structured bargaining. The idea is that the company's claimants are encouraged to bargain about the future of the company in terms of liquidation, reorganization and value distribution, according to predetermined rules (Hart, 2000: 7). He signals a problem here, as bargaining tries to make two decisions at once: what to do with the company and who should get what in the event of restructuring of claims. As long as the proceeds are not clear, the prospect of a speedy liquidation with a recovery rate of 60% might be preferred over the possible but still uncertain sale to a private equity party, with a recovery rate of over 80%, thus possibly jeopardizing a profitable future for the company. Hart therefore proposes the cancelling of all debt, and attributing it to the former creditors' shares instead. Through this debt-for-equity swap, a conflict of interests between various creditors and shareholders is avoided, as by then they all have the same rights. Thereafter it will be easier to decide about the future of the company.

Hart works according to the property rights tradition, which takes the view that the owner of a nonhuman asset possesses residual control rights over that asset, and that there is an optimal allocation of such residual control rights[10]. Hart's approach is more directed to the allocation process of control rights than to the outcome (survival or debt recovery). That rethinking the efficiency of the process is worthwhile follows from the relatively low recovery rates shown in chapter 1.

2.4.6 A financial bankruptcy criterion

In the UK the court may issue an administration order if the company is or is likely to become unable to pay its debts[11]. One of the criteria for a winding-up order is the company's inability to pay its debts[12]. According to the Insolvency Act (IA) this inability happens i.a. if it is proved to the satisfaction of the court that the company is unable to pay its debts as they fall due[13]; and also if the value of the company's assets is less than the amount of its liabilities, taking into account its contingent and prospective liabilities[14]. German law has two similar criteria for instituting insolvency proceedings for a legal person: actual or imminent illiquidity (*Zahlungsunfähigkeit*)[15] and over-indebtedness (*Überschuldung*)[16]. If the debtor has ceased making payments, German law presumes illiquidity[17]. This is similar to present Dutch bankruptcy law which requires that the debtor must have ceased making payments for some time[18]. The *commissie Kortmann*, in a proposal for a new Dutch insolvency law[19], maintains this Dutch 'situation of ceased payments' criterion and adds to it the German 'imminent illiquidity' criterion.

Would it be possible to translate these verbal criteria into financial criteria to be derived from the balance sheet? Van Eeghen (2006B), interpreting the Dutch criterion as actual illiquidity, formulated two criteria a company should comply with. The first is that the company should be able to meet its current obligations in order to avoid technical insolvency. In symbols this formula is:

(1) $CCE \geq CLS$

where: CCE = cash and cash equivalents, including tradable securities, open credit lines, accounts receivables to be received shortly
CLS = current liabilities to be paid shortly.

This formula can best be calculated from a cash planning survey, instead of from a balance sheet. By using a cash forecast, future considerations may be taken into account.

The second criterion is that the company should also be able to meet its obligations in the long term to avoid economic insolvency. From:

(2) $OA + CCE = TA$
(3) $E + L + PR + CLS = TA$
(4) $E = s * TA = s * (OA + CCE)$
(5) $CCE = CLS$ (minimum condition)

where: E = equity
L = loans
OA = other assets
PR = provisions
s = required solvency ratio (E / TA)
TA = total assets.

follows:

(6) $L = (1-s) * OA - s * CCE - PR$

This formula offers the minimum condition. When the amount of the loans comes close to the number calculated with this formula, the company is on the brink of insolvency. When the loans equal the formula, the debtor should file for bankruptcy. The criticism levelled at this approach is fourfold (see also van Eeghen, 2006B: 202):

- Future developments are inadequately taken into account (for example: as a consequence of new products, new human capital);
- The formula is vulnerable to creative accounting (for example by increasing OA or decreasing PR);
- The semi-exactitude of the formula is false in as far as taxations of values[20] are like profit: they are not a fact, but an opinion;
- The quality of management has not been taken into account.

Others have tried to derive criteria from the balance sheet in order to predict bankruptcy. Beaver (1966), Altman (1968), Ohlson (1980), Zmijewski (1984), Aziz and Lawson (1989) and Daily and Dalton (1994) made considerable contributions to this field. Chapter 6 of this thesis will elaborate on that. This subsection only intends to explain how an economic approach to bankruptcy works, and what its limitations are.

Altman's original work of 1968[21] is based on a sample of 66 companies of which 33 were bankrupt. Based on ratios and multiple discriminant analysis (MDA), he calculated a Z-score which is often presented as follows:

$$Z = 1.2\,X1 + 1.4\,X2 + 3.3\,X3 + 0.6\,X4 + 0.99\,X5$$

where: X1 = working capital/total assets (liquidity ratio)
X2 = retained earnings/total assets (earned surplus measure)
X3 = earnings before interest and taxes/total assets (productivity measure)
X4 = market value of equity/book value total liabilities (buffer)
X5 = sales/total assets (capital-turnover ratio), and
$Z > 2.67$ means no errors in non-bankruptcy classification
$Z < 1.81$ means no errors in bankruptcy classification,
Z between those values signals a grey area for the company.

Altman developed revised Z-score models for private sector companies (p. 202):

$$Z' = 0.717\,X1 + 0.847\,X2 + 3.107\,X3 + 0.420\,X4 + 0.998\,X5$$

where: X4 = book value of equity/book value total liabilities (buffer)
$Z > 2.90$ means no errors in non-bankruptcy classification
$Z < 1.23$ means no errors in bankruptcy classification.

The potential industry effect of the sales/total assets ratio is avoided by leaving it out:

$$Z'' = 6.56\,X1 + 3.26\,X2 + 6.72\,X3 + 1.05\,X4$$

where: X4 = book value of equity/book value total liabilities (buffer)
$Z > 2.60$ means no errors in non-bankruptcy classification

Z < 1.10 means no errors in bankruptcy classification.

Later on, Altman refined his initial findings in a ZETA model, published in 1977. The parameters are not disclosed, as it has become a commercial product. The correct prediction of non–bankrupt firms, most important to avoid losses of bankruptcy, of both models is impressive. For the Z–models it is 97.0% at t = –1 and 93.9% at t = –2, while for the ZETA models it is 89.7% at t = –1, 93.1% at t = – 2 and is still 82.1% in t = –5. The Z–score and ZETA models remain popular tools for bankruptcy prediction, but should be treated cautiously:

(a) bankruptcy caused by bad luck can never be predicted,
(b) due to permanently changing industry sectors, the relevance of the model may become less,
(c) due to a change in modes of production, the ratios might change over time, and
(d) due to a continuous adjustment in the desired values of ratios, the grey area may contract or expand.

Van Eeghen's threshold and the other prediction models apply only financial factors in the analysis. Issues as the quality of management (Altman, 1993: 17; Van Amsterdam, 2004: 265) or the incidence and quality of monitoring are left aside. The empirical part of this thesis works on that.

2.4.7 Concluding remarks: in search of an optimal bankruptcy system

In the previous sections bankruptcy has been discussed from various viewpoints. What bankruptcy system is optimal? Table 2.3 analyses the advantages and disadvantages of a

Table 2.3: a survey of advantages and disadvantages of different bankruptcy systems

bankruptcy system	advantages	disadvantages
debtor-oriented	• incentive for early reorganization for management and shareholders (thus avoiding *ex ante* over-investment) • incentive to go along for secured creditors • survival of profitable companies (thus avoiding *ex post* under-investment) • survival of trading opportunities for other companies	• higher creditors risk, thus higher cost of capital (risk of *ex ante* under-investment) • unjustified protraction of the renegotiation process by shareholders and unsecured creditors • survival of unprofitable companies (risk of *ex post* over-investment) • higher risk of new bankruptcies
creditor-oriented	• creditors know exactly what to rely upon • creditors give more credit (no incentive for *ex ante* under-investment) • quicker solution of bankruptcy (no *ex post* over-investment) • cheaper solution of bankruptcy	• no incentive for management or shareholders for early filing (thus providing an incentive for *ex ante* over-investment) • no incentive for shareholders for new investments • creditors risk mainly borne by unsecured creditors • untimely liquidation of (potentially) profitable companies (*ex post* under-investment)

debtor and a creditor-oriented system, based on Hart (2000), Franks and Torous (2002), and Franken (2004). From table 2.2 it seems clear that an absolute superior bankruptcy system does not exist. In fact, *ex ante* inefficient investment behaviour is traded off against *ex post* efficiency and *vice versa* (Franken, 2004: 653). An investor under a debtor-oriented system will *ex ante* be prepared to invest relatively less, which might cause under-investment[22], since he runs the risk that his rights will be curtailed in bankruptcy. But *ex post*, the debtor-oriented system avoids inefficient *ex post* under-investment, as it may lead to survival of the company. And while a creditor-oriented system foregoes the risk of *ex ante* under-investment, it might cause *ex post* under-investment insofar as it steers towards liquidation and inhibits survival of the company.

Gilson et al. (1990: 323) pointed to the importance of the information asymmetry between shareholder and creditor. The extensive Chapter 11 disclosure requirements diminish this asymmetry. Frouté (2007) signalled this as the reason for the evolution of creditor-friendly bankruptcy laws to more debtor-friendly systems. In his view, inefficient investment is due to information asymmetry between debtor and creditor. If these two cannot agree on the necessary measures for a reorganization, 'courts become the key actor of the credit relationship, whose aim is to provide information' (p. 207). By deciding to liquidate or to reorganize a company, the judge reveals a debtor's type of risk and allows the separating of good companies from the bad (p. 212). However, this theory is only relevant *ex post* and not *ex ante*.

Franken (2004) qualified corporate bankruptcy as a governance system. On the one hand there is the typical SME, characterized by concentrated equity ownership, a long-term lending relationship with one main bank that holds strong security positions, and dispersed trade creditors. In a creditor-oriented system the bank has a very powerful position; it is the only monitor of importance and it has strong legal instruments. Under bankruptcy, the bank's position does not weaken as its position is secured, provided there is only a limited automatic stay. Management's position on the contrary does weaken, as it will lose control. This induces financially distressed companies to restructure outside of bankruptcy. This is efficient *ex ante*, Franken notes, because the costs of these out-of-court restructurings are relatively low as negotiation only takes places between the debtor and the relational bank lender (p. 659). The downside of *ex post* lower proceeds in a creditor-oriented system should be balanced against the higher efficiency *ex ante*. The latter exceeds the costs, at least for SME companies, as is shown by Franks and Sussman (2005). Brunner and Krahnen (2008) analysed the problem of multiple banking in borrower's distress empirically. They found that the existence of *small* bank pools, by means of which banks in Germany coordinate their actions opposite distressed borrowers, significantly increases the probability of work-out success, while *large* pools do not.

On the other side of the governance spectrum is the large publicly held firm with a dispersed ownership structure. Here again, if there is a strong consortium of banks working together, there will be a strong monitoring function of the lenders. A creditor-oriented system will do, as it will force the management to reorganize whenever deemed necessary by the lenders. However, if there is no such banking consortium, nor one other large creditor, security holders only monitor specific assets and there is no central warning system for financially distressed companies. As Gilson et al. (1990: 316) showed, private negotiation is less likely to succeed when there are more distinct classes of debt. When a large company is in financial distress, a debtor-oriented system simplifies negotiating with creditors as the requirement of an affirmative vote by a majority constraints holding-out policies of creditors, and courts can impose a settlement on creditors. Nevertheless, in practice senior creditors often offer junior creditors or stockholders a small distribution, to avoid the costly and time-consuming cram down procedure (Gilson et al.,1990: 318; Baird, Bris and Zhu, 2007: 7).

The previous analysis concludes that the *creditor-oriented* system urges the management to reorganize in time as it runs the risk of (a) being ousted and (b) personal liability (see chapter 5 of this thesis) in bankruptcy as a penalty. Since the APR is honoured, there are no additional risk-related costs of credit. In *debtor-oriented* systems the APR can be violated and the management can retain its position. Due to the exculpatory provision authorized by s 102(b.7) of the Delaware General Corporation Law, which enables charters to provide for the elimination of the personal liability of a director to the corporation or its stockholders for breach of the duty of care, personal liability in the USA is less of an issue (Black, Cheffins and Klausner, 2006). This implies: there is less pressure to reorganize in time and the costs of credit will be higher. Especially if there is one large creditor (or one strong consortium of creditors) who monitors effectively, the creditor-oriented system is the superior reorganization system. A filing for bankruptcy in a creditor-oriented system therefore usually implies that the company really is not viable. In a debtor-oriented system one cannot be sure of that, because the filing might also be a move of the management to change the rules. However, if the creditors are dispersed, mostly in larger companies, the monitoring function of the creditor will be absent (Franks and Torous, 1994: 366), and bankruptcy in that case does not *ipso facto* indicate that the company is lost. The court should do research on that. In such a case, a debtor-oriented system will be superior, as more solutions for financial distress will remain.

Neither the debtor nor the creditor-oriented regime of corporate bankruptcy law is clearly the more efficient. However, a bankruptcy regime may have a comparative advantage if it is more responsive than other regimes to the governance mechanisms at work in specific firms, for example listed or SME-firms (Franken, 2004: 647).

2.5 REORGANIZATION OUTSIDE BANKRUPTCY

2.5.1 An economic approach to informal reorganization

Reorganization should be preferred to liquidation or acquisition if more value is preserved in that way (Brouwer, 2006: 6). Reorganization of financially distressed companies can be done through a formal procedure laid down in insolvency law, or through private negotiations outside insolvency law. The choice depends on two factors: which alternative is cheapest, and: can claimholders agree on the division of the saving (Gilson et al. 1990: 318).

Table 2.4: summary of some studies on informal reorganization ('work–outs') of distressed companies

author	subject	successful informal reorganization		formal reorganization results	
		in % of sample	recovery rate	in % of sample	recovery rate
Gilson, John and Lang (1990)	169 financially distressed US firms (insufficient cash flows to meet debt payments)	47.3%		52.7% of which: 24.9% (survived) 5.9% (merger) 2.4% (liquidated) 19.5% (unknown or in progress)	
Franks and Torous (1994)	161 financially distressed US firms (debt issue downgraded to CCC or worse)	47.2%	median 80.1% (bank debt 86.6%)	52.8% of which: 10.5% survived 12.4% in progress 25.5% unknown 4.3% no procedure	median 50.9% (bank debt 86.4%)
Van Amsterdam (2004)	989 financially distressed Dutch SME companies (account transferred to Business Support Unit, BSU)	54.5%	median bank 70-100% (depending on the bank)	unknown	
Franks and Sussman (2005)	542 financially distressed SME companies in the UK (account transferred to BSU)	33.5% (going concern) 16.4% (rebanking) 18.6% (ongoing in BSU)	no write down	31.5% bankrupt	75% for banks (median 87.9 to 100%); unsecured zero
Davydenko and Franks (2008)	2,280 heavily distressed firms in the UK, France and BRD (Basel II default)	UK 24.6% France 22% BRD 13.1%	median for banks: UK 100% France 100% BRD 79%	UK 75.4% France 78.0% BRD 86.9% piecemeal liq. UK 42.9% France 62.0% BRD 56.9%	median for banks: UK 82% France 39% BRD 61%

In an informal reorganization, also called a '(private) work–out', the firm and its creditors renegotiate their contracts privately, resolving distress without resorting to the bank–ruptcy courts (Wruck, 1990: 425). Literature shows that an informal reorganization is very popular in practice among financially distressed companies, 'at a guess 75% or more of the cases' (Wood, 2007: 49). Table 2.4 shows that on average around 50% of the informal reorganizations succeed. The Davydenko and Franks (2008) results are lower, because their definition of distress is biased towards the rather severe cases. The high recovery rates in informal reorganization might explain their success: in all cases they are substantively higher than in a formal reorganization. Unsecured creditors often receive even 100%. The costs of informal reorganization are lower as well (Gilson et al. 1990: 319, 337); they might well be over 4.5% of firm value (Franks and Torous, 1994: 369).

2.5.2 A legal approach to informal reorganization ('work–out')

Formal reorganization is a detailed arrangement provided by insolvency *law*. Informal reorganization is of a *contractarian* nature (Baird, 2007: 9). Essentially parties can agree on any financial restructuring within the boundaries of the law. With regard to the orderly management of work–outs, the Bank of England outlined the "London Approach" in 1990 (Wood, 2007: 626). Its key features are:

> (a) a responsible and supportive attitude by bank lenders towards companies in dis–tress, (b) the role of the Bank of England as a neutral chairman and intermediary, (c) a lending standstill, (d) the gathering of the fullest possible information to support the analysis and subsequent judgement, and (e) the duty of the lead bank to inform all other banks involved.

Although these rules are not binding, they are still considered good banking practice (Wood, 2007: 627). The INSOL principles issued in 2000 also focus on buying time with–out losing legal, preferred or secured, positions. They essentially[23] are:

> (1) all relevant creditors should be prepared to co–operate with each other to give suf–ficient time (a "Standstill Period") to the debtor for information and for proposals for resolving the debtor's financial difficulties to be formulated and assessed; (2) during the Standstill Period, all relevant creditors should agree to refrain from taking any steps to enforce their claims against the debtor and are entitled to expect that their position relative to other creditors and each other will not be prejudiced; (3) during the Standstill Period, the debtor should not take any action which might adversely affect the prospective return to relevant creditors as compared with the position at the Standstill Commencement Date; (4) the interests of relevant creditors are best served by coordinating through co–ordination committees and by the appointment of professional advisers; (5) during the Standstill Period, the debtor should provide, and

allow relevant creditors reasonable and timely access to all relevant information, in order to enable proper evaluation to be made of its financial position and any proposals to be made to relevant creditors; (6) proposals for resolving the financial difficulties should reflect applicable law and the relative positions of relevant creditors at the Standstill Commencement Date; (7) information obtained should be made available to all relevant creditors and should be treated as confidential; (8) if additional funding is provided during the Standstill Period the repayment of such additional funding should be accorded priority status.

Wood (2007: 627) mentions that a number of countries have adopted similar rules, mostly by means of self-regulation. The Netherlands has not, and neither the Netherlands Bankers' Association (NVB) nor the DNB apparently feels itself compelled to take the lead. From an economist's point of view this attitude is inefficient, since it necessitates avoidable transaction costs. With some creativity these INSOL principles could also be introduced in the Dutch legal system (Santen and Verhoeff, 2006: 154). Introduction of this or a similar set of rules would be helpful to reduce transaction costs and to avoid the risk of litigation. At present, holding companies that try to rescue their subsidiaries risk being sued by Dutch administrators for improper behaviour since the boundaries of such an operation are not yet clear[24]. And a bank that closes a new credit arrangement with additional securities in a rescue-operation just a month before its bankruptcy faces the voidance of this arrangement if it cannot prove that at the moment of closing 'neither the debtor nor the bank could reasonably foresee bankruptcy and a deficit' (HR 22 December 2009, NJ 2010, 273, *ABN AMRO BANK/ Van Dooren q.q. III*)[25].

2.6 FORMAL AND INFORMAL REORGANIZATION COMPARED

One may compare the formal and informal reorganization procedures from an economic as well as from a legal viewpoint. The economic comparison is about costs and economic impact, the legal comparison mainly about proceedings.

2.6.1 An economic comparison of reorganization routes

Wood (2007) and Santen and de Bos (2008) described a number of economic advantages of an informal reorganization:

- *Capital preservation*: as soon as it is publicly disclosed that the company is in financial distress, the value of its assets and by consequence of its shares will decrease. Moreover, the company and its management will suffer from reputational damage. If, by using the informal route, disclosure can be avoided, capital will be preserved, at least better than through a formal reorganization (Franks and Torous, 1994: 350). Bris et al. (2006: 1264) show that the decline of the pre-bankruptcy values of Chapter 7 (liquidation) is worse than the Chapter 11 decline.

- *Costs*: according to Gilson et al. (1990: 319) it is widely believed that direct as well as indirect costs are significantly higher for bankruptcy than for private renegotiation. Franks and Torous (1994: 350) estimate 'incremental costs of formal over informal reorganizations of at least 4.5% of firm value'. Bris et al. (2006) conclude that the costs of Chapter 7 and Chapter 11 proceedings range between 2% and 20%. Although the company will incur high costs for hiring professionals during informal reorganization, formal proceedings tend to be more costly as they take much longer and require more creditor involvement (Wood, 2007: 39).
- *Recovery-rate*: as a consequence of a higher preservation of capital and lower costs, the recovery rate in an informal route is higher than in a formal route, especially for non-secured debt. Bank debt has a recovery rate of around 80–100% in informal reorganization and less (39%–86.4%) in formal reorganization. However, for non-secured debt the differences are even clearer: whilst they often would not receive a cent in formal reorganization, they might even receive 100% of their claim through the informal route. Ordinary creditors' losses will thus be lower in an informal route.
- *Employment*: does the loss of employment differ between both routes? Luttikhuis (2007) studied the employment effects of liquidation and formal reorganization in the Netherlands. She found that 15% of the jobs concerned in bankruptcy are preserved by a formal reorganization. Since generally speaking informal reorganization is less rigorous than a formal reorganization, one may hypothesize that informal reorganization costs less in terms of loss of employment. There are no data available to test this hypothesis.
- *Cascade effects*: what are the economic effects of reorganization on third parties? These effects come in two ways. *Firstly*, as a result of write-downs on debt by creditors after reorganization, the amount of tax to be paid by these creditors will decrease. The higher the write-downs, the less tax income to the government. The fiscal loss compensation for the debtor might, depending on national law and the mode of reorganization, have a similar or an opposite effect on tax income.
  Secondly, for creditor companies the write-downs mean a lower solvency as well as less turnover if the debtor has downsized its activities. Reorganization may thus seriously hamper the prospects for other companies. Whilst the downsizing-effect may remain in an informal route, the high recovery rates in that case diminish the effects of write-downs. Informal reorganization is therefore the preferred solution.
- *Pareto-optimality*: in an informal reorganization route it is the market, represented by the parties directly related to the company, such as banks and shareholders, which determines the price the reorganization is worth. As a consequence of a formal route the problems of the company have to be disclosed. Price signals are distorted because of reputational damage, court interference, hold-out behaviour by creditors, the wipe-out of equity holders (Baird et al. 2007: 5) and irrational behaviour. For

example, governments may come under heavy pressure of their voters to save virtually bankrupt companies (RSV, Fortis, Alitalia). The market will only save a company if that is deemed worthwhile after a *financial* judgement (due diligence research).

Informal reorganization holds one clear risk: that of information asymmetry, meaning that directors hold all the information which they do not necessarily share with other parties in the process (see 3.3.1.2.). Parties involved in the negotiation process should be aware of that. However, taking all economic arguments into account, informal reorganization is by far to be preferred over a formal reorganization procedure.

2.6.2 A legal comparison of reorganization routes

If there is a choice, what legal arguments are there to prefer informal reorganization and which arguments can be found against? (Wood, 2007: 35). Informal reorganization has the following advantages from a legal point of view:

- *Evasion of personal liability*: in many creditor-oriented systems directors face the risk of personal liability in bankruptcy either for the total deficit or for specific damage (see chapter 5 of this thesis). After a successful informal reorganization this risk no longer exists.
- *Less creditor involvement*: where informal reorganization normally involves the company and its large creditors, for example the bank, bondholders, the tax authorities and social security funds, formal reorganization requires the full-fledged involvement of all the creditors. The mass of creditors and the noise they may produce could influence the probability, the content and the speed of a final composition.
- *No court involvement*: every court involvement as required under insolvency law takes time, costs money and is to some extent unpredictable in its outcome. It furthermore requires public disclosure of business figures, normally kept secret from competitors.

However, formal reorganization has its advantages too:

- *Clean assets*: the assets bought from an auction during bankruptcy are clean in the sense that it is certain that there will not be any third-party rights to the asset, nor may they have to be returned due to 'voidable preference' or 'fraudulent transfer' (Gilson et al. 1990: 321). Such claims may jeopardize informal reorganization.
- *Abandonment of onerous obligations, guaranties, contracts or litigations*: loss generating guaranties, environmental obligations, contracts or litigations may be a reason to seek formal reorganization. If there is no chance of survival once the claim is final, formal reorganization through a newly established legal person might facilitate survival of the activities of the company.
- *Court decision power:* courts have mandatory rights to require information or decide on the case, whilst informal reorganization is based on mutual agreement. Thus, courts (1) will require information of directors and administrators, thus reducing the

information asymmetry; (2) preserve the rights of all parties involved, especially those that do not have secured rights, for example trade creditors (Chapter 11)[26], and other stakeholders, for example employees (France); and (3) may 'cram down' a plan or may preside at a creditors' meeting where 'holding out creditors' in a formal reorganization may be overruled[27].

- *Automatic stay*: formal reorganization might be the only way to inhibit foreclosure of essential assets by a dissentient creditor[28]. Although formal reorganization differs in details on this respect over the various legal systems, secured creditors are essentially free to foreclose their assets in formal reorganization, with the exemption of France (Davydenko and Franks, 2008: 604) and, under strict regulation, of Chapter 11 (Bris et al. 2006:1263).
- *Debtor in possession*: this characteristic of Chapter 11, that the management generally stays in position and can keep on doing business with the present assets, is found to a much lesser extent in France during the *réglement amiable* or the early phase of the *redressement judiciaire* (Davydenko and Franks, 2008: 603). Although management may certainly consider this a shelter, and a hope to keep their jobs in this way, usually they do not (Gilson, 1989; Baird, 2007).

What choice should the distressed company make? There may not always be a choice. Some jurisdictions, for example Germany, require that management files for bankruptcy if fair value equity falls below zero. Bankruptcy need not always be the less efficient solution. A Chapter 11 filing with a composition proposal, the so-called prepackaged filings or prepacks, can significantly reduce the time and the costs involved (Gilson et al. 1990: 325). Bris et al. (2006: 1257) even mention prepacks that took only two weeks to solve. In the Netherlands, a well-prepared going concern sale in a formal reorganization could take less than two weeks, and a vote on a composition after suspension of payments can be organized in 4–6 weeks, provided everything goes smoothly. The disadvantage is that during this short period, the owner/manager loses control and has to indulge an administrator. To avoid this and the accompanying uncertainty, the company should, if it is not in a position that it absolutely needs the legal advantages of formal reorganization summed up above, avoid the legal route, as the economic analysis is in strong support of informal reorganization. The court-route is needed only as a fall-back (Wood, 2007: 49).

2.7 SUMMARY AND CONCLUDING REMARKS

This chapter concludes by defining financial distress as *the existence of a non-trivial probability that the legal person will not be able to pay its debt within the terms of payment.* Financial distress can unroll in five scenarios from (1) a favourable change in the circumstances, or (2) a merger, to (3) a voluntary reorganization, (4) a voluntary liquidation or (5) an involuntary liquidation or reorganization. The chapter continues with a focus on saving the economic activities of the company independently through scenarios 3 and 5. It argues that a thorough analysis needs to be made of the *true* causes of distress, before starting the reorganization, and offers a model to that effect. After a discussion into the nature and the effects of involuntary, i.e. formal reorganization on the one hand and informal reorganization, i.e. a 'work–out' on the other, the chapter compares the two reorganization forms. It concludes that informal reorganization is the efficient solution to financial distress, provided that the market deems reorganization Pareto–optimal and that the quality of management is sufficient. This is an important restriction, since the lack of quality of management is often considered the main cause of bankruptcy (Altman, 1993: 17; Ooghe and De Prijcker, 2008: 234). One mechanism to improve the quality of management decisions could be the introduction of monitors in the company. This is the subject of chapter 3.

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ENDNOTES

1 These authors do not consider the merger scenario.
2 This company became Caldic BV.
3 Manager, director, agent and other functions will be referred to throughout the text by 'he', 'him' or 'his' as the case may be. The choice is made since the majority of managers, directors and agents are still male.
4 IA 1986 Schedule B1 s 22(2).
5 s 1 InsO.
6 Chapter 7 of the US–Bankruptcy Code provides for liquidation, i.e. the sale of a debtor's non-exempt property and the distribution of the proceeds to creditors. Chapter 11 provides for reorganization, usually involving a corporation or partnership. A Chapter 11 debtor usually proposes a plan of reorganization to keep its business alive and pay creditors over time. People in business or individuals can also seek relief in Chapter 11. Chapter 12 is designed for "family farmers" or "family fishermen" with regular annual income. It enables financially distressed family farmers and fishermen to propose and carry out a plan to repay all or part of their debts. Chapter 13 provides for adjustment of debts of an individual with regular income. A Chapter 13 bankruptcy is also called a wage earner's plan. It allows a debtor to keep property and pay debts over time, usually three to five years. (www.uscourts.gov/uscourts).
7 Baird, 2007, p. 13 speaks of a dismissal of two–thirds; Bris et al. (2006: 1256) of 'about half'.
8 CBS StatLine reports that the number of concluded bankruptcies after the requisition of suspension of payments was on average 230 (varying between 166–320) for the 1992–2008 period.
9 Of the reported 5,939 concluded bankruptcies in 2004 (table 1.1), 4,167 are corporate bankruptcies which include bankruptcies of sole proprietorships (CBS, 2010: 5).
10 This sentence comes from Oliver Hart and John Moore, *Incomplete contracts and ownership: some new thoughts*, p. 1, not dated, found on *www.aeaweb.org/annual_mtg.../0105_1015_1702.pdf.*
11 s 11 Schedule B1 to the Insolvency Act.
12 s 122(1.f) IA.
13 s 123(1.e) IA.
14 s 123(2) IA.
15 s 17 and 18 InsO.

16 s 19 InsO. It should be noted that s 5 Finanzmarktstabilisierungsgesetz (FMStG) from 17–10–2008 added to s 19(2) InsO the possibility to relieve the requirement to file for insolvency in the event of *Überschuldung* 'if the company's going concern is predominantly likely under the circumstances'. s 6 (3) FMStG intends to change s 19(2) InsO by 1–1–2014 so that the present addition is replaced by reference to a going concern valuation of the assets if the company's going concern is predominantly likely. See: s 7 FMStG on www.buzer.de/gesetz/8396/index.htm. Also: Hirte, H., B. Knof, and S. Mock, 2008, Überschuldung und Finanzmarktstabilisierungsgesetz, *Zeitschrift für das gesamte Insolvenzrecht (ZInsO)* 2008, 1217.
17 s 17(2) InsO.
18 s 1 Fw; especially the word situation (*toestand*).
19 s 2.2.1 of the proposal (to be found at: www.justitie.nl/onderwerpen/wetgeving).
20 See for an introduction to the German approach on valuation of near financial distress: Hirte, H., B. Knof, and S. Mock, 2008, Überschuldung und Finanzmarktstabilisierungsgesetz, *Zeitschrift für das gesamte Insolvenzrecht (ZInsO)* 2008, 1217.
21 This part is based on Altman, E.I., 1993, *Corporate financial distress and bankruptcy* (John Wiley and Sons, inc.).
22 Under–investment occurs if the company fails to invest in projects with a positive NPV. In case of over–investment the company has invested in projects with a negative NPV (Berkovitch and Israel, 1998; Franken, 2004).
23 The full text of the INSOL principles is on the INSOL website, www.insol.org.
24 HR 18 September 2009, LJN BI5912 (*Coutts*). Although the Hoge Raad rejects the appeal based on 81 RO, the conclusion of AG Timmerman deserves attention (a) for its survey of relevant case law (3.4–3.11) on holding company liability in situations of financial distress and (b) for the analysis of the differences between the much cited HR 21 December 2001, NJ 2005, 96 (Sobi/Hurks II) case and the underlying case (4.11, 4.18). In Sobi/Hurks II the holding company was held liable whilst in the Coutts case the Court of Appeal accepted its behaviour.
25 Criticism of this judgment: A. van Hees in 'het Financieele Dagblad' 19 January 2010.
26 Unsecured creditors often receive more because of their negotiating position, than they would according to the law (Baird, 2007)
27 E.g. s 173b Fw.
28 E.g. s 33 Fw.

Chapter

3

The role of monitoring in the broader perspective of corporate governance – an economic approach

We currently have little which could be glorified by the title of a "Theory of monitoring" and yet this is a crucial building block of the analysis. (Jensen and Meckling, 1976: 354)

3.1 INTRODUCTION

Chapter 1 showed that at least 32% of all bankruptcies are due to management errors. This is the very same management that, according to chapter 2, should attempt to solve financial difficulties when they occur. If these difficulties cannot be dealt with by the company on its own, management may have to negotiate for an informal reorganization. This negotiation process will only succeed if creditors have confidence in management's capabilities. Management's role is apparently crucial in running a company near financial distress. Good monitors and well–designed monitoring structures may add to its quality[1].

This chapter aims to explore the role of monitoring in the broader context of the governance of the company from an economic viewpoint. Section 3.2 sets out to survey the various parties a company may come across. The topic of 3.3 is the economic theory behind corporate governance. Section 3.4 describes the mechanisms by which corporate governance actually works. Monitoring of the company is the focus of 3.5. Section 3.6 concludes.

3.2 PARTIES RELATED TO THE COMPANY

Any company functions in the broader context of society. Its relationships with shareholders, lenders, employees, customers, suppliers, trade unions, the government, journalists and so on determine its success. How are these relationships organized and how powerfully do they influence the company's policies and its success? That is the subject of this section.

The analysis starts with the relationship with the company. A *corporate* relationship means that the party belongs to the structure of the company. In a *commercial* relationship, a party contracts with the company from outside the company structure. And in a *public* relationship, the public function concerns itself with the company. An analysis of each follows in sections 3.2.1 – 3.2.3.

3.2.1 Corporate relationships

Corporate relationships relate to the *structure* of the company. Most of the relationships shown in figure 3.1 are established in corporate law, but they may originate in e.g. labour law as well. Founders are at the origin of the company. The participants, *members*, convene at least once a year in the annual general meeting (*AGM*), which discusses the policy and the state of the affairs of the company. This AGM is also the moment to take decisions, assigned to the members by law or by the articles. *Directors* are appointed in the memorandum or later on by a decision of the members or others in accordance with the law and the company's articles. Economists describe the relationship between directors and members as an agency relationship (see 3.3.1.1). The member, called the *principal*, orders the director, called the *agent*, to direct the company and pursue his interests. Larger companies usually have *executive* (*EDs*) as well as *non-executive directors* (*NEDs*). *EDs* normally have a full-time employment contract with the company. Their prime responsibility is the running of the company's business[2]. *NEDs* do not hold managerial roles in the company[3]. They are outsiders and make their services available to the company part-time. As the UK Code on Corporate Governance (UKC) puts it, 'they should constructively challenge and help develop proposals on strategy'[4]. *Management* or *manager* is not a legal term. Management usually means the ensemble of EDs and senior-managers. A manager is a person who runs part of a company. However, management happens to indicate senior management only as opposed to EDs as well. The wording differs also between US and British literature. Careful reading is necessary. In a *one-tier system* as in the UK the *board* is a company organ consisting of EDs and NEDs together. According to the UKC 'its role is to provide entrepreneurial leadership of the company within a framework of prudent and effective controls which enables risk to be assessed and managed. The board should set the company's strategic aims, ensure that the necessary financial and human resources are in place for the company to meet its objectives and review management performance'[5]. In a *two-tier system* such as in Germany and the Netherlands, EDs and NEDs are organized in two separate boards, the *executive board* [6](EB) and the *supervisory board* (SB). The Dutch corporate governance code (DC) describes the role of the supervisory board as 'to supervise the policies of the management board and the general affairs of the company and its affiliated enterprise, as well as to assist the management board by providing advice'[7]. The supervision includes i.a. the functioning of the management board[8], corporate strategy and risks[9]. Thus, in both systems NEDs have a control, service and strategy role[10] (Zahra and Pearce, 1989: 303; Brennan, 2006: 580[11]). Or as Chancellor Allen of the Delaware Court of Chancery once said[12]:

> *outside directors should function as continuous active monitors of corporate management; have an active role in the formulation of long-term strategic, financial and organizational goals and should approve plans to achieve those goals; engage in periodic performance review and be prepared to press for correction when in their judgment there is need.*

This makes their position hybrid: they have to monitor and supervise the EDs *and* to co-operate with them through their service and strategy formulating role for the better of the company (Jungmann, 2006). Members appoint NEDs if the law so requires or as soon as they feel that closer supervision of management than they themselves can offer is needed or appropriate. Again, an agency relationship comes into existence between members and NEDs. If NEDs appoint EDs, which is the case in some corporate systems, there even exists an agency relationship between the EDs and the NEDs.

The establishment of a *works council* depends on the circumstances, e.g. legal system, number of employees and an employee request. This council, although established by labour law, is considered a part of the structure of the company here, because through its rights to advise or to approve it directly influences management decisions. Moreover, a works council in the Netherlands may *de facto* nominate candidates for the SB. The UK system prescribes a *company secretary*, which is essentially a compliance officer. Figure 3.1 gives a schematic overview of the one-tier corporate structure, found in the UK and therefore called the 'Anglo-Saxon Model' and the two-tier structure with its employee involvement, also called 'the Rhineland Model'. The arrows in figure 3.1 indicate a monitoring relationship.

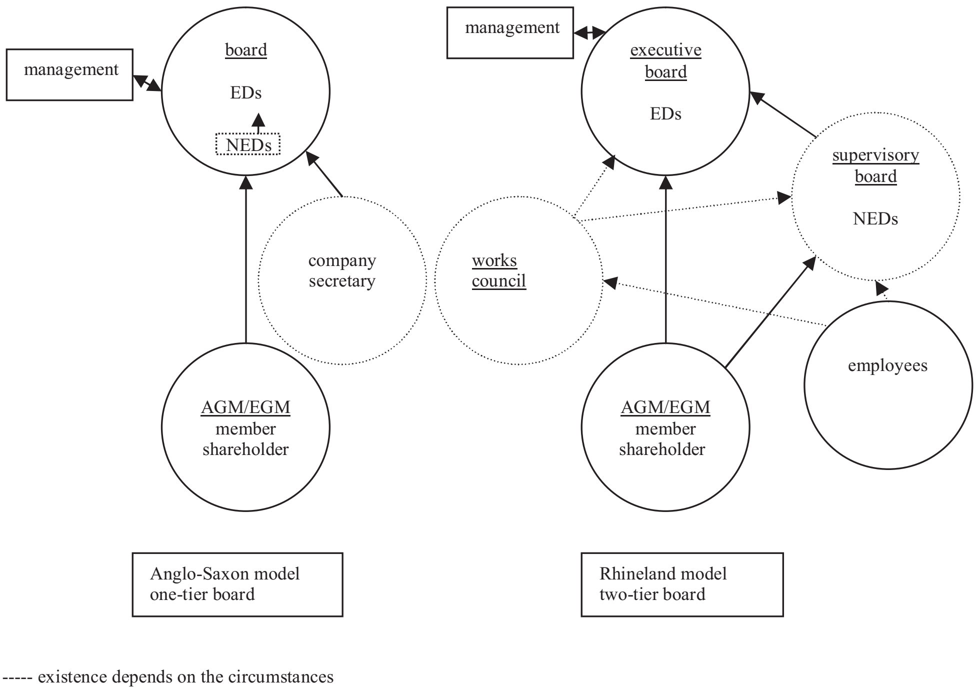

Figure 3.1: corporate relationships

It is important to note that where legal scholars would make a difference between a person, e.g. a member, and a corporate organ, e.g. the AGM of the company[13], an economist, studying relationships rather than legal structures, would not. A *member* with a large stock, a so-called blockholder, might exert influence by talking to the (executive) board about proposals he has, in 'one-on-ones' outside the company structure. He may even have the right to convene an extraordinary general meeting (EGM) if he has a certain percentage e.g. 10% of the shares (see i.a. chapter 4.4). But the final decision is up to the

EGM, and he may lose a contest if more than 20% of the shareholders are present and he is the only supporter of his proposal.

Employees may have *direct* influence on the membership of the works council or the SB and *indirect* influence by voting with their feet or by blowing the whistle. After its incorporation in US law (Sarbanes–Oxley) and European governance codes the whistle-blowing mechanism may become a powerful instrument. *NEDs* and *EDs* are marked individually as well as collectively by 'board' in the figure, since the law addresses them in some cases as an individual and in others as part of the board.

Corporate law organizes most of the corporate relationships. It aims at proper checks and balances between the various constituents in the company, often based on the findings of economists on the subject of corporate governance. Other relationships are vital to the company as well, as the next section shows.

3.2.2 Commercial relationships

Every company does business with outside parties. After the establishment of the company, a search commences for a director, for housing, for utility connections, for other employees. Thereafter follow suppliers of all kinds of goods and services and customers. Often, investors will finance the company and keep a close watch. The auditor checks the truthfulness of the annual report. If a company becomes listed, it contracts with the stock exchange. Investor-analysts and credit-rating agencies come into play. This is the full-blown concept of the company as a nexus for contracting relationships (Jensen and Meckling, 1976).

Companies do not always understand the importance of these relationships. For investor relations they usually do; all the websites of listed companies have a button 'investor relations' but not all of the information is easily accessible, and after some time the information is often removed from the web. But it is not only investments that a company needs; just as important are suppliers, customers, applicants for jobs. In order to remain an attractive business partner, a company should, by means of its directors, listen to signals from the market and react to them. If companies neglect signals this might lead to additional legal obligations, e.g. mandatory product guarantee regulations for customers; whistle-blowing provisions and a labour-union right to request a court for an inquiry; and on the reverse side obligations for the company, e.g. the obligations for insurance and investment companies to disclose their margins.

3.2.3 Public relationships

The company has various relationships with the outside world that are not of a commercial nature. The *government* and its constituencies are most important: the tax authorities, the competition authorities, inspection services for production quality or for labour conditions, authorities for certain permits or grants, the *Handelsregister*, and so on. For listed companies there is usually a market regulator, and for listed financial companies there is the supervision of the central bank as well. Courts play an important role in criminal, commercial, labour or corporate conflicts a company might encounter. Other relationships of a public nature are pressure groups, e.g. Greenpeace which inhibited the sinking of Shell's oil platform Brent Spar. Trade unions, journalists or an ombudsman who brings dubious practices of a company to daylight also fall into this category. All these relationships might produce signals to the market in as far as those relationships and its results are disclosed to the public.

3.2.4 Relationships: concluding remarks

A company develops various relationships in the course of its business. Each relationship might bring warnings, insights or opportunities. If the company does not recognize these signals, it might miss necessary options for renewal or correction, which may usher in the end of the company. How to organize the company to avoid this loss of potential? This is the subject of the next section.

3.3 CORPORATE GOVERNANCE

This section elaborates on the economic insights on governance of the company, better known as corporate governance. Section 3.3.1 is about the concept and its underlying economic theories. Definitions of corporate governance found in the literature are discussed in section 3.3.2. Section 3.3.3 touches on the question whether such a definition should be positive or normative. Section 3.3.4 concludes.

3.3.1 Evolution of the concept

The concept of 'corporate governance' is relatively new. The *Principles of corporate governance and structure: restatement and recommendations* of the American Law Institute (ALI) of the early 1980s[14] can be considered a starting point[15]. Ever since, the flow of literature on corporate governance has grown. This subsection explores some of its basic theoretical foundations.

3.3.1.1 *Agency theory*

The idea of an existing conflict of interests between investors and directors is very old. Seeds can already be found in Plato's The Republic, when he describes that guardians should not acquire property of their own beyond what is necessary, in order to be able to do a proper job as a guardian[16]. Theoretical development started with Smith (1776) who wrote:

> *The directors of such (joint-stock) 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 (Book Five, Chapter 1, part 3, article 1).*

Berle and Means (1932) convincingly showed the crucial insight of the separation of ownership and control in large corporations. They observed:

> *If we are to assume that the desire for personal profit is the prime force motivating control, we must conclude that the interests of control are different from and often radically opposed to those of ownership; that the owners most emphatically will not be served by a profit-seeking controlling group (Berle and Means, 1932: 114).*

Later on, Alchian and Demsetz (1972: 781) concluded that in team production, due to metering problems of the individual effort, shirking arises, which can only be reduced by monitoring the input performance of team members. The crucial question remained: who will monitor the monitor (p. 782)? Their answer is: the specialist who receives the residual rewards, the residual claimant. The seminal article of Jensen and Meckling (1976) on the theory of the firm elaborated on those insights. Their starting point is the agency relationship, defined as a contract under which one or more persons – the principal(s) – engage another person – the agent – to perform some service on their behalf which involves delegating some decision-making authority to the agent (p. 308). The relationship between a shareholder, the *principal*, and the manager, the *agent*, is the standard example of an agency relationship in company law[17]. There are others, like the relationship between majority (agent) and minority (principal) shareholders; and that 'between the controllers of the company, whether directors or shareholders (agents) and those other groups whose contribution is vital to the success of the company, such as investors, lenders, employees, suppliers and customers (Davies, 2010: 29; Kraakman et al. 2009: 2, 35). If both parties to a contract are utility maximizers, there is good reason to believe that the agent will not always act in the best interests of the principal (p. 308). Such *agency conflicts* may arise in any form of jointly owned enterprise (Kraakman et al. 2009: 2). Exemplary for an agency conflict is the manager's tendency to appropriate perquisites out of the firm's resources for his own consumption (Jensen and Meckling, 1976: 313). To minimize agency problems, costs have to be incurred. Jensen and Meckling (1976: 308) define these agency costs as the sum of:

1. the *monitoring* expenditures by the principal (e.g. costs of management supervision and external auditing costs),
2. the *bonding* expenditures by the agent (e.g. obligations to disclose properly; to abstain from corporate opportunities or related party transactions; to accept an option-scheme, a lock-up for earned shares, variable rewards or personal liability), and
3. the *residual loss* (this is the result of the divergence between the agent's decisions and those decisions which would maximize the welfare of the principal).

Later on Jensen (1994) pointed out that not only rational behaviour causes agency costs, but also *nonrational* behaviour of the agent, i.e. non-functional behaviour that systematically harms the individual as well as those around them.

In Jensen and Meckling (1976) as well as in Alchian and Demsetz (1972) monitoring is predominantly present. Not surprisingly, it is predominant in corporate governance as well. What does monitoring mean exactly? This will be the subject of section 3.5. To be able to monitor well, disclosure of information is indispensable, as will be shown now.

3.3.1.2 *Bounded rationality, opportunism and information asymmetry*

(Neo-)classical economic theory assumes rational behaviour of economic individuals. As Simon (1957: 196) puts it:

> *There are two principal species of economic man: the consumer and the entrepreneur. Classical economics assumes the goals of both to be given: the former wishes to maximize his utility, which is a known function of the goods and services he consumes; the latter wishes to maximize his profit. The theory then assumes both of them to be rational. Confronted with a pair of alternatives, they will select that one which yields the larger utility or profit, respectively.*

Simon (1957) stated that for an analysis of the specific problems with which organizational theory is concerned, this idealization is inappropriate. Instead, he introduced the concept of bounded rationality (p. 198):

> *The capacity of the human mind for formulating and solving complex problems is very small compared with the size of the problems whose solution is required for objectively rational behaviour in the real world – or even for a reasonable approximation to such objective rationality.*

Of the numerous often complex alternatives, the individual is able to choose and work out only a few, the presumably realistic ones. The span of control of an individual is limited. Moreover, Williamson argued that the classical assumption of trustworthiness and reliability of the agent should be dropped. He introduced the concept of *opportunism*.

> *Opportunism effectively extends the usual assumption of self–interest seeking to make allowance for self–interest seeking with guile (Williamson, 1981: 1545).*

Acknowledging that the alternatives the manager has scrutinized are limited and that he might behave opportunistically, the problem of information disclosure arises. Obviously, as the manager has bounded rationality, supervisors suffer the same. How can a monitor be sure that the agent provides him with all the relevant information and that this information is true? This is known as the problem of information–asymmetry. It comes in three ways. Akerlof (1970) describes the *adverse selection* problem. This is the *ex ante* information asymmetry problem, referred to by Douma and Schreuder (1998) as essentially a problem of unobservability. Before contracting, one does not know whether all the relevant information has truly been given. The buyer of a car keeps in mind that the offered second–hand car might be a *lemon* (a Monday–morning car) and bids accordingly. The owner of a good car will refrain from using the open market, which in the end gives rise to the speculation that all second–hand cars in the open market will tend to be lemons or worse. Likewise, the offeror of an insurance policy takes the possibility of a new client being a bad risk into account (although he himself does not know). The insurance policy is therefore offered at a relatively high premium, making it only acceptable for bad risks. Finally the policy will disappear from the market. In terms of a company, this implies that new directors should be interviewed thoroughly about their backgrounds, experiences and expectations. The directors should do proper research themselves as well on the terms of their contract and on their new employer. Jensen (1993: 863) calls this directional due diligence[18]. *Moral hazard* is the second information asymmetry problem. It has been described by Knight (1921, as reprinted in 1933: 249) and can be considered as the *ex post* information asymmetry problem (Williamson, 1981: 1545). It refers to actions which parties in a transaction may take after they have agreed to execute the transaction, e.g. sloppy behaviour, creative accounting or even fraud. The problem is often unobservable too. The challenge is to make this behaviour controllable in some way (e.g. through standards, contractual arrangements, disciplinary law). Thirdly, as Boot and Macey (2004: 373) argued, it is the *timing* of the information that is essential. Late intervention as a consequence of information received too late is costly in terms of financial and reputational losses.

The conclusion is that every agency relationship will suffer in some degree from the aforementioned phenomena: bounded rationality, opportunism and information asymmetry.

3.3.1.3 *Shareholder and stakeholder model, stewardship theory and good agents*

Apart from agency conflicts and noise in the agency relationship, whose interests should the agent ideally serve? Blair (1995) discusses two approaches. The *first* states that since managers are appointed by shareholders, they should serve, only[19] or mainly, the shareholders' interests. An enlightened version of this approach adds that this can be done through serving the interests of the company. Anyhow, either direct or through the interests of the company as a means, the shareholders' interests should be served. This is the shareholder value approach or *shareholder approach*. The *other* approach acknowledges the nomination of the managers by the shareholders, but adds that the shareholders do not nominate as such, but act as a legal organ of the company. So, the nomination is not made by the shareholders but by the company (according to its articles) and hence the managers should serve the interests of the company. Since it is in the interests of the company not only to have good accessibility to the capital markets, but also to other markets e.g. the labour and consumer market, and players, such as competitors and the government, in the latter approach the scope of interests an agent should look after is by far broader. This approach is called the *stakeholder approach*. 'Stakeholder' refers to those groups without whose support the organization would cease to exist (Freeman and Reed, 1983). In the narrow sense it means the corporate and commercial relationships described in 3.2.1 and 3.2.2. In the wide sense[20], it includes the public relationships of 3.2.3. as well.

It is easy to see that the shareholder approach originates directly from the early development of corporations[21]. Individuals collected capital for a venture. Those individuals were called members (Davies, 2002: 28). The members appointed a manager to let the venture happen. Ideally that manager should look after the interests of the members. Later on, these ventures received legal status upon request, and the corporate form with limited liability came into being (Davies, 2002: 1). By introducing this third legal person, a new field of force arose. As long as only the shareholders have a say in the company, this view is somewhat theoretical[22]. But even then, judges started to distinguish between the interests of the shareholders and those of the company[23]. This is the origin of the more enlightened version of this shareholder approach, in which the ultimate goal of a company became to generate maximum value for shareholders, later on redefined in: corporate wealth, during the life cycle of the company[24]. With this approach, the company itself got a position: decisions made in the immediate interests of the shareholder might very well not be in the interests of the company in the long run. The latter should prevail[25].

In fact one could consider the stakeholder approach as a further development of the enlightened approach described before. During the reconstruction period in Europe after World War II it became clear that tying in as many interests as possible in the company was the best approach to fast growth. Avoid strikes and motivate labour, was the motto.

That is why labour has a rather important position in German and Dutch company law, and in EU law (at least relative to that of the USA) in general. As Blair (1995: 179) shows, a development towards considering other interests (through the 'best interests of the corporation' criterion) – at least for the take–over context – can be seen in the USA as well. While it is still mainstream in the USA to acknowledge the predominant position of capital[26] in companies, the importance of the interests of labour, creditors, consumers, other interested parties and the government is at least in Europe gradually accepted[27]. In the USA as well as in Europe the member approach has been left behind; the company is seen nowadays as a separate legal person with interests of its own. These interests should be prevalent in company decisions, by law[28].

A further development in the goals to be served by the agent shows the *stewardship theory*. Davis, Schoorman and Donaldson (1997: 24) write:

> *In stewardship theory, the model of man is based on a steward whose behaviour is ordered such that pro–organizational, collectivistic behaviours have higher utility than individualistic, self–serving behaviours.*

Stewards work in the best interests of the group. They are 'motivated to maximize organizational performance, thereby satisfying the competing interests of shareholders'. The essential assumption underlying the prescriptions of stewardship theory is that the behaviour of the executive directors is aligned with the interests of the corporation and its principals (p. 25). This implies that interested parties should trust the agent almost unconditionally. A related concept is that of a '*good agent*' (Cooter and Eisenberg, 2001: 1732). Agents should internalize firm–specific fairness norms, making them less inclined to opportunism and more able to cooperate. 'Agents who internalize firm–specific fairness norms acquire good agent character and act authentically from internalized values, whereas agents with bad character act instrumentally and opportunistically.'

All this, it is felt, is too far from reality. Reality shows that human beings are by definition fallible. The principle of opportunism suits practice therefore better, since it covers *all* types of agents, than the concept of the steward or that of the 'good agent'. This does *not* imply that agents are supposed to work only for their own direct personal benefit. There is nothing inconsistent between self–interested and altruistic behaviour (Jensen, 1994)[29]. In the Resourceful, Evaluative, Maximizing Model (REMM; Jensen and Meckling, 1994), which can be seen as an elaboration of Simon's work, there is room for maximization of other values than money. The individual cares about intangible values, such as the environment, friends, culture, and he is resourceful. Still each individual is a maximizer: he acts so as to enjoy the highest level of value possible. Altruistic values may be one of them and in pursuing them, self–interest is served as well. Since the agency theory proves flexible enough to cover the full range of human behaviour, it is the paradigm of this thesis.

3.3.2 Towards a definition of corporate governance

With the agency theory in mind, the question of the precise definition of corporate governance will now be turned to. Governance comes form gubernare in Latin (to steer; also to be used in connection with rem publicam) and κυβερνάω in Greek (with a similar meaning). Corporate steering would not be a bad start for a definition, and indeed one of the first definitions found in literature defines corporate governance as the purposes and method of how we structure and control our companies large and small (Barker, 1980: vii in: Midgley, 1982). Bookshelves full have ever since been published on corporate governance[30] and more often than not the author or report decides on a new definition[31]. It is instructive to scrutinize a few authoritative definitions. Some are compact, as the one of the Report of the Committee on the Financial Aspects of Corporate Governance (better known as the Cadbury Report, 1992, after the Chairman of the committee):

> *Corporate governance is the system by which companies are directed and controlled* (Cadbury, 1992, par. 2.5).

Clarke (2004: 1) calls this a *functional* definition. Hart's (1995: 678) approach is of a *property rights* nature, thus focussing on the optimal allocation of residual control rights (see 2.4.5). He explains that corporate governance issues arise in an organization whenever two conditions are present: (1) the existence of an agency problem or a conflict of interest between members of the organization; and (2) transaction costs are such that this agency problem cannot be dealt with through a contract. In a world, Hart continues, of incomplete contracts that faces agency problems, a governance structure can be seen as a mechanism for making decisions that have not been specified in the initial contract. More precisely the

> *governance structure allocates residual rights of control over the firm's nonhuman assets; that is the right to decide how these assets should be used, given that a usage has not been specified in an initial contract (p. 680).*

In this line of thinking, Transaction Costs Economics (TCE), which is predominantly concerned with economizing on transaction costs, considers debt and equity principally as governance structures rather than as financial instruments (Williamson, 1988: 579; 2007: 3)[32]. Shleifer and Vishny (1997: 737) approach the issue from this *investment* viewpoint as well. Their widely–cited article opens with the sentence:

Corporate Governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment.

While Cadbury focuses on the company, which can be considered a European approach (e.g. Mallin (2009), figure 4.1.: 64), the American approach represented by Hart (1995), Williamson (1988) and Shleifer and Vishny (1997) focuses on the investor[33]. The more elaborated OECD Principles of Corporate Governance (OECD, 2004: 11) combine both worlds:

Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate Governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined.

The present Dutch Corporate Governance code (DC) describes (good) corporate governance as follows:

Good entrepreneurship, which includes integrity and transparency of the management board's actions, as well as effective supervision of their actions and accountability for such supervision, are essential conditions for stakeholder confidence in management and supervision. These are the two pillars on which good corporate governance is founded and which are the basis of this Code.

A famous American textbook however, Monks' Corporate Governance (Monks and Minow, 2004: 2) adds a new element, by placing *sustainability* in the centre:

Corporate Governance is the structure that is intended to make sure that the right questions get asked and that checks and balances are in place to make sure that the answers reflect what is best for the creation of long-term, sustainable value.

Although this explicit long-term perspective sounds more sympathetic to Europeans than Shleifer and Vishny's 1997 definition which might strike one as 'short-termish', the value (thus: the shareholder) also remains in the centre in this case. Mallin (2009) refrains from providing a new definition, but instead presents some important features of corporate governance:

- *It helps to ensure that an adequate and appropriate system of controls operates within a company and hence assets may be safeguarded;*
- *It also prevents any single individual having too powerful an influence;*
- *It is concerned with the relationship between a company's management, the board of directors, shareholders and other stakeholders;*

- *It aims to ensure that the company is managed in the best interests of the shareholders and the other stakeholders;*
- *It tries to encourage both transparency and accountability which investors are increasingly looking for in both corporate management and corporate performance.*

The conclusion is that the European approach (represented by Cadbury, Mallin and including the first sentence of the OECD description) is based on the company. The rules by which the company has to be governed are given in *its* interests. The American approach, however, primarily sees the company as an investors' vehicle. This is clear from the property rights approach of Hart (1995) as well as from the description of Shleifer and Vishny (1997). The second sentence in the OECD description, speaking of setting the objectives of the company and the means of attaining those, indicates a similar direction. This study chooses the European approach as research is done on European data in a European setting. As Cadbury's definition is short, clear and workable, this study will use the definition of corporate governance as *the system by which companies are directed and controlled* as is indicated in figure 3.2. The figure shows that in a corporate governance system 'direction', i.e. the actual running of the company, is surrounded by various control mechanisms.

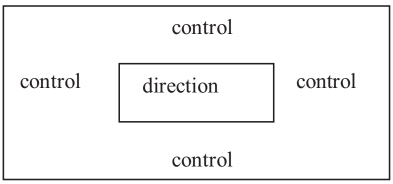

Figure 3.2: the system of corporate governance

3.3.3 A positive or a normative approach to corporate governance

As may be concluded from the last subsection, corporate governance in itself is a positive concept. It should describe the actual organization of the interrelationship between company, agent, shareholders and stakeholders, without being normative. The normative or prescriptive use of the corporate governance concept is to be avoided. A personal preference for a *desired* set of rules of the game should go by the term *good corporate governance*, which indicates clearly enough that the author takes a position. Monks (2004: 2) and Mallin (2009: 8) describe corporate governance normatively when using wording such as: intended, the right questions, aims, encouragement. The Dutch corporate governance code has a similar normative approach, but concludes by naming this *good* corporate governance, as it should be. The OECD code (2004: 11) makes the distinction properly:

Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interest of the company and its shareholders and should facilitate effective monitoring.

While acknowledging that there is no single model of good corporate governance, the OECD claims to have identified some common elements that underlie good corporate governance. They are:

I. Ensuring the Basis for an Effective Corporate Governance Framework
The corporate governance framework should promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities.

II. The Rights of Shareholders and Key Ownership Functions
The corporate governance framework should protect and facilitate the exercise of shareholders' rights.

III. The Equitable Treatment of Shareholders
The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.

IV. The Role of Stakeholders in Corporate Governance
The corporate governance framework should recognise the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.

V. Disclosure and Transparency
The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.

VI. The Responsibilities of the Board
The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders.

It should be noted that the OECD (2004) brings in new elements, being as Jensen (1993: 850) puts it, the legal/political/regulatory system (number I) and the role of stakeholders (number IV). A similar approach can be read in Mallin's (2009) work. This implies that in this approach good corporate governance surpasses the boundaries of the firm.

3.3.4 Concluding remarks on corporate governance

This section explained the choice for the agency theory as the basis for further theoretical analysis. It seems a flexible and widely applicable approach. Agents, who direct the company, should be kept on the right track by control through monitors. This is the essence of corporate governance. This thesis therefore defines corporate governance as *the system by which companies are directed and controlled*. This system is not restricted to the company; outside monitors have their role as well, as 3.5 shows.

3.4 DIRECTION AND CONTROL

If, using Cadbury's definition, corporate governance is about direction and control of the company, the division between direction and control remains to be determined. This has never been done as transparently as by Fama and Jensen (1983: 303) in their description of the four stages of the decision process:

1. *initiation* – generation of proposals for resource utilization and structuring of contracts;
2. *ratification* – choice of the decision initiatives to be implemented;
3. *implementation* – execution of ratified decisions; and
4. *monitoring* – measurement of the performance of decision agents and implementation of rewards.

Obviously, the first and the third stage, which they call decision management, are in the hands of the management. This is the *direction* part of corporate governance. The second and the fourth stages, decision control, are executed by the board. Here the *control* part of the corporate governance definition comes into play. This clear distinction of the decision process in decision management and decision control should be at the heart of every analysis of corporate governance. It is in fact a principle of proper administration policy. However, the required distribution of tasks is not always possible in small companies with few employees.

Tricker (1984: 6), in a similar analysis, states that the *management role* is running the business operations efficiently and effectively, while, by contrast, the *governance role* is concerned with giving overall direction to the enterprise, with overseeing and controlling the executive actions of management and with satisfying legitimate expectations for accountability and regulation by interests beyond the corporate boundaries. The following subsections present an analysis of both the direction and the control part of corporate governance.

3.4.1 Direction

Direction of a company, the abstract initiation and implementation phase of Fama and Jensen (1983), concerns more specifically the way management operates. It is

> *(..) about the product design, procurement, personnel, management, production, mar-keting and finance functions, and so on, within the boundaries of the company under which it trades. (..) The focus is on managing the business (Tricker, 1984: 6).*

This is essentially what executive directors and the management teams working for them do. As long as things work out all right, no one bothers. There is a risk of free–rider behaviour of all stakeholders. But the agency theory shows that agents and principals have different objectives. Inevitably this difference of objectives will surface. It is at that moment that the principals should be able to control their interests, the latter half of Cadbury's definition.

3.4.2 Control

Why is control necessary? The necessity derives from the insight based on the agency theory that the interests of the agent and the principal (management and shareholder; majority and minority shareholder; shareholder and creditor or employee) diverge and should be aligned in order to avoid expropriation of the principal by the agent. Although the analysis below focuses on the management/shareholder agency conflict, it applies *mutatis mutandis* to the other two sources of agency conflicts as well. Generally control is divided in internal and external control. *Internal control* is defined as *organizationally based mechanisms of corporate control designed to bring the interests of managers and shareholders into congruence* (Walsh and Seward, 1990: 421, 423) and *external control* as *market and government based control mechanisms.* As Jensen (1993: 850) puts it:

> *There are only four control forces operating on the corporation to resolve the problems caused by a divergence between managers' decisions and those that are optimal from society's standpoint. They are the*
> - *Capital markets,*
> - *Legal/political/regulatory system,*
> - *Product and factor markets, and*
> - *Internal control systems headed by the board of directors.*

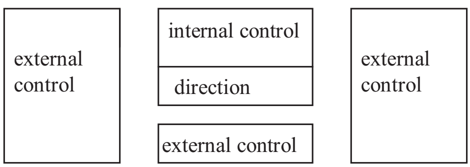

Figure 3.3: corporate governance and the dual control system

The elementary corporate governance system of figure 3.2 now evolves to figure 3.3. The figure shows that the internal control system is part of the company, just like management, whilst the external control systems stand outside the company structure.

3.4.2.1 *Internal control*

Internal control means different things to different people (COSO, 2006)[34]. Maijoor (2000: 106) described three perspectives on internal control to be distinguished within the accounting literature: (1) the external auditing, (2) the management control and organization theory, and (3) the economic perspective, the last dominated by the agency theory. The agency theory research focuses on top-level control problems like those between outside capital suppliers and (inside and outside) directors (Maijoor, 2000: 105)[35]. Jensen (1993: 862–867) listed some of these control problems from the US perspective:

- *Board culture*: the emphasis on politeness and courtesy at the expense of truth and frankness, which Davies (2002) described as 'mutual back-scratching'.
- *Information and expertise problems*: the CEO almost always determines the agenda and the information given to the board and (financial) expertise might be lacking on the board.
- *Legal liability*: legal incentives are more often consistent with minimizing downside risk or reputational damage rather than maximizing value.
- *Lack of management and board equity holdings*: encouraging new board members to hold substantial equity interests would force them to recognize that their decisions affect their own wealth as well as that of remote shareholders.
- *Oversized boards*: keeping boards small can help improve their performance.
- *Attempts to remodel the process after political democracy* in which various constituencies are represented are likely to make the process even weaker.
- *Separation of CEO and chairman positions* is required for an effective board. The challenge for such a board is to rise early to the challenge of correcting a failing management system.
- *Resurrecting active investors (promoting shareholder activism)*: active investors are important to a well-functioning governance system because they have the financial interests and independence to view firm management and policies in an unbiased way.

To these internal control problems should be added:

- *Adequate composition of the board*, (Hillman and Dalziel, 2003) to be analyzed in terms of:
  - o insider/outsider: is the director employed by the company?
  - o dependent/independent: does the director have business ties with the company?
  - o education and expertise, and
  - o personal characteristics.

- *Distribution of power between the internal organs*: management, board and shareholders determine the corporate governance structure of a firm (Boot and Macey, 2004: 373). The law and the articles of association provide the framework, but the behaviour and weight of the participants influences the actual position as well.

It is these kind of top-level problems, as referred to by Maijoor (2000), which are perfectly covered by the aforementioned definition of Walsh and Seward (1993), to which this thesis will refer: *Internal control is the system of organizationally based mechanisms of corporate control designed to bring the interests of managers and shareholders into congruence.*

For Jensen (1993: 862) the very purpose of the internal control mechanism[36] is to provide an early warning system to put the organization back on track before difficulties reach a crisis stage. This is a crucial insight for answering the question *why* internal control is that important. Only when internal control is ineffective will external control be necessary to replace and discipline managers (Fama, 1980: 295; Walsh and Seward, 1990: 434; Berkovitch and Israel, 1996: 20). Figure 3.4 fits these internal control mechanisms into the upper-middle block. Section 3.2 already described the corporate relationships of the monitors of the internal control mechanism in the middle block of figure 3.4. Employees are an internal control 'mechanism' as well insofar as they vote for representatives in company organs, blow the whistle, or 'vote with their feet'. The other blocks of figure 3.4 show the external control mechanisms of corporate governance, to be discussed in the next section.

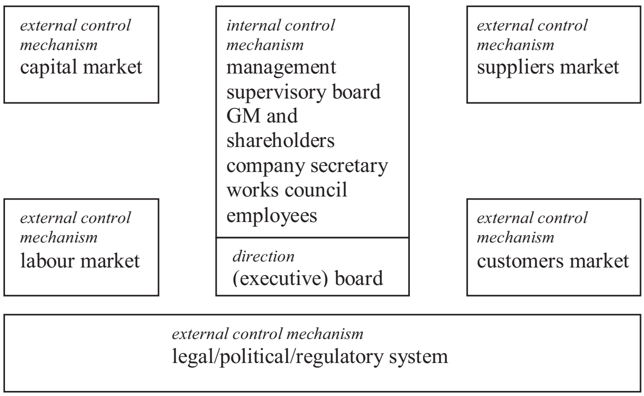

Figure 3.4: corporate governance, the dual control system and its mechanisms

3.4.2.2 *External control*

External control is the system of market and government–based control mechanisms. An important force is the capital market, also called the market for corporate control (Manne, 1965). Walsh and Seward (1990: 435) describe this force as follows:

> *(..) as top managers engage in self–interested behaviour, their company's performance is likely to increasingly diverge from its maximum potential. This underperformance is reflected in the value of the company's stock. Under such circumstances, other management teams are likely to offer themselves to the shareholders as alternatives to the incumbent management. The "market for corporate control" then, is the competition among these management teams for the rights to manage corporate resources.*

In the literature external control and the market for corporate control are sometimes erroneously identified (Berkovitch and Israel, 1996: 210; Weir, 1997: 156).

Although Jensen (1993: 850) regards the legal/political/regulatory system as far too blunt an instrument to handle the problems of wasteful managerial behaviour effectively, it should be acknowledged that e.g. the mandatory audit for large firms, anti–cartel measures, the US Sarbanes Oxley Act (2002) and subsequent various EU regulations in the field of securities regulations, effectively do have major influence on the behaviour of directors. For fine–tuning at an individual company level however, this system seldom appears to be effective. Only courts and to a certain extent auditors are able to provide custom–built signals. Courts since they ultimately decide whether specific behaviour is acceptable; and auditors since their statement contains a judgment on the reliability of the annual accounts[37] which should be made available to the shareholders[38]. At the individual company level, the product and factor markets directly identify the need for corrections to the management team. Firms that do not supply the product consumers desire at a competitive price cannot survive (Jensen, 1993: 850). A similar mechanism can be observed for the demand for management on the market for managerial labour (Fama, 1980: 292). If the proposition is not attractive, the firm will not be able to acquire new management.

The aforementioned factors originate from outside the company. The capital market factor, however, is only effective when shareholders are not satisfied with the performance of the incumbent management and are prepared to sell their shares to a bidder. Usually this will only be the case when the internal control does not work sufficiently. How can the actual functioning of the internal control system be ascertained? Stakeholders have a role here as will be discussed in the next section.

3.5 MONITORING

Whether the internal control mechanisms actually work can only be established by stakeholders who watch over the firm[39]. These are called *monitors*. Alchian and Demsetz (1972: 782) attach primarily a *disciplinary connotation* to the term monitor, as do Jensen and Meckling (1976: 308):

> *(..) the term monitoring includes more than just measuring or observing the behavior of the agent. It includes efforts on the part of the principal to 'control' the behavior of the agent through budget restrictions, compensation policies, operating rules etc.*

So, a monitor indeed observes, comments, advises and warns as indicated in 1.5 but in order to be more effective its functioning should have a 'controlling' and disciplining connotation. Boot and Macey (2004: 357) have identified a variety of monitors: directors, auditors, credit–rating agencies, stock market analysts, take–over firms, arbitrageurs, large shareholders, outside lenders, and even customers and suppliers[40]. Some studies have introduced more specific monitoring roles. The next sections elaborate on these roles and the specific interests a monitor may have. Section 3.5.6 poses the question whether one monitoring system would fit all companies. Section 3.5.7 concludes.

3.5.1 Internal monitoring

Internal monitoring means monitoring through control mechanisms from inside the company structure. EDs are monitored by their managers, the company secretary and by NEDs; managers are monitored by the board (Fama and Jensen, 1983), their colleagues (Fama, 1980: 293), the company secretary and employees; and the board should be monitored by itself (the collegial board principle to be discussed in chapter 4), by the shareholders and the works council. Unfortunately, as Hart (1995: 681) explained, monitoring happens to be a public good and each shareholder will free–ride in the hope that other shareholders will do the monitoring, which they do not. So internal monitoring is essentially an activity of control between executive directors, managers, NEDs and employees, with the shareholders in the backseat. While acknowledging that monitors are crucial to effective corporate governance, Boot and Macey (2004: 357) argue that a trade–off exists between *objectivity* in monitoring and *proximity* in monitoring

> *(..) because monitors that obtain close proximity necessarily forego objectivity and objective monitors must maintain sufficient distance from management, which results in loss of the advantages of proximity.*

Proximate monitors are susceptible to bias, as the board of directors may become too reliant on, and captured by, the judgement of the management (p. 372). The upper–middle block of figure 3.5 describes the internal control mechanisms that may be present. Below each mechanism the figure indicates the relevant monitor: management controls the running of the company through EDs and senior management; the supervisory board controls EDs and senior management through NEDs; in a one–tier system the board controls senior and executive management through directors; the GM as a collective and shareholders through one–on–ones control management and the supervisory board; and so on, each monitor restricted by its function and legal competences. The next section describes the external monitoring control mechanisms of figure 3.5.

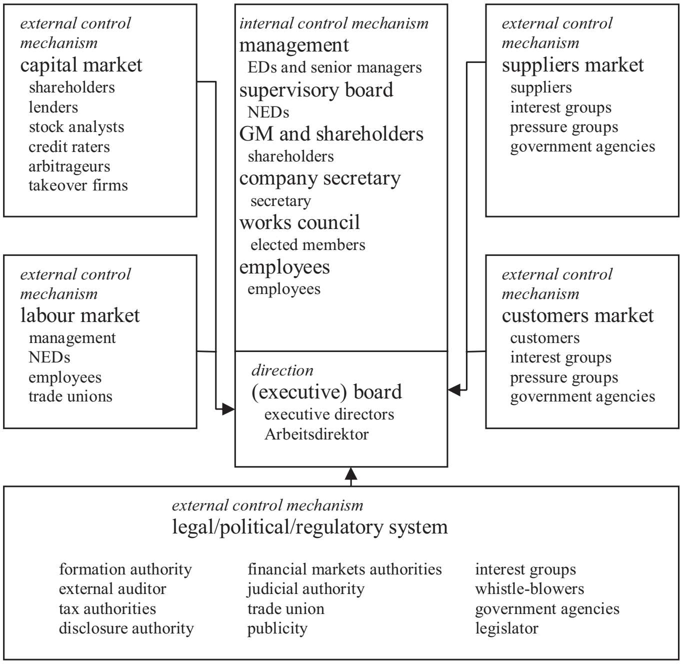

Figure 3.5: corporate governance, the dual control system, its mechanisms and its monitors

3.5.2 External monitoring

According to Ang, Cole and Lin (2000: 104) external monitoring is monitoring by external parties, like banks or bondholders. To this can be added: auditors, credit–rating agencies, stock market analysts, take–over firms, arbitrageurs, customers and suppliers, as mentioned by Boot and Macey (2004), and in some sense even pressure groups, journalists, whistle–blowers and judges. These are all external parties, so *external monitoring is defined as monitoring by control mechanisms from outside the company structure*. In the wide sense, these mechanisms except the legislator can all be considered as *stakeholders* of the company (see 3.3.1.3). In figure 3.5 each block represents a separate monitoring mechanism, e.g. the capital market and its monitors, e.g. shareholders, lenders. Monitors are each in their own respect responsible for the efficient and effective functioning of the specific control mechanism. Most external monitors in figure 3.5 are *market*–related. Their role is either on the input markets for capital, labour and supplies or on the product market. Market–related external monitors differ to a large extent per company and industry. However, the external monitors originating from the *legal/political/regulatory system* exist in principle for all companies. The *formation* authority brings the legal person into being; the *external auditor* reports annually to the members on the reliability of the annual accounts; the *tax* authorities correct company policy if they detect administrative errors; the *disclosure* authority collects and checks financial and other data from the company and opens some of it to the public; the *financial market* authorities concern themselves with the prudential and behavioural side of financial companies, e.g. banks, insurance companies, financial intermediaries; the *judicial* authority either checks behaviour of the company (public prosecution) or settles conflicts (courts); the *trade union* may have a right to call on a judge, e.g. for an inquiry into company mismanagement in the Netherlands; *publicity* and *interest groups* make the public aware of dangers or abuse; *whistle–blowers* tell their employer, a regulator, customers, the police or the media about a dangerous or illegal activity that they are aware of through their work[41]; *government agencies* check whether the production process and products are in conformity with legislation; and finally the *legislator* decides whether the time has come to translate signals from society into new legislation. In fact, each citizen may at times play an external monitoring role, e.g. when filling out customer questionnaires on the internet. Since shareholders usually do not know more than any external monitor and do not often actively participate in the company, one might wonder whether they are internal or external monitors. This is the topic of the next section.

3.5.3 Shareholder monitoring

The question rises whether shareholders qualify as internal or external monitors. Huson, Parrino and Starks (2001: 2267–2271) loosely describe boards and institutional investors as *internal monitoring mechanisms*. Are they right? One has to admit that shareholders can monitor through different channels: through the AGM/EGM; through one–on–ones between large shareholders and the board; through preparatory research on a take–over bid; through their reaction to a take–over bid by someone else; by offering the shares or not; by buying or selling. Or, as Boot and Macey (2004: 367) put it:

> *Shareholders can exercise control through their impact on the board of directors and through interventions in the market for corporate control.*

It is not immediately clear which shareholder activity should be classified as internal or external monitoring. This difference matters, as external monitoring is a free, un–

formatted activity, while internal monitoring is made possible by special contractual or legal provisions and restrictions. In this study shareholder monitoring will be considered *internal* monitoring, if the shareholder *while monitoring uses information or legal or contractual rights conferred to him as shareholder*. If the shareholder uses other means of control, e.g. through the market for corporate control, this is external monitoring.

3.5.4 Institutional monitoring

Chung, Firth and Kim (2002: 31) studied the effectiveness of *institutional monitoring*, which they described as external monitoring by institutional investors. Charitou, Lambertides and Trigeorgis (2005) used the concept *outsider monitoring* to indicate monitoring by institutional investors. Should monitoring by institutional shareholders be labelled as internal or external monitoring? Tricker (1984: 15) wrote:

> *The institutional shareholders may be able to influence matters directly, without the involvement of the whole body of members, not necessarily acting in the interests of the whole. Meetings of members are felt by many to be inadequate and inappropriate vehicles for exercising governance (..).*

From this angle, institutional monitoring seems predominantly to have an external monitoring nature. However, the importance of internal monitoring behaviour is apparent in e.g. the UKC (Schedule C) and the DC (IV.4.1–3) jo. s 5:86 Wft which prescribe justification of voting behaviour in the AGM/EGM by institutional investors i.a. on their websites. Whether institutional shareholders will use the internal or the external procedure may also depend on their goals. Coffee (1991: 1329) argues that modern public shareholders, which are often institutions, in fact purchase liquidity at the cost of control[42]. He concludes[43] that the *optimal institutional monitor* has an ability to hold large equity stakes, an inclination to hold them for the longer term over which improved monitoring can pay off and has no substantial conflict of interest (p. 1367).

Each institutional monitor will use his blockholder power and his actual power on the market in its own way, depending on its goals, its bias and its time horizon. This provides them with a special mix of powers that can exert influence far beyond the actual voting power, as e.g. was the case for TCI in the ABNAMRO case. For each separate action though, one can easily discern whether it involves internal or external monitoring, on the basis of the definitions provided above.

3.5.5 The interests of monitors

A monitor is an economic man. For him, monitoring is an economic activity which he will only undertake if it makes him better off in terms of his personal utility. That is why small shareholders show free–rider behaviour: their effort never pays off and so they leave monitoring to others. It also explains why institutional shareholders in listed companies often choose to leave their assessment of board performance to intermediate institutions such as RiskMetrics. Or why a large blockholder such as TCI decided to write a letter and disclose it, since it felt it was not being taken seriously. This insight implies that truly effective monitoring only takes place if it adds to the utility of the monitor in terms of money, reputation, information, network or otherwise.

Moreover, every monitor unavoidably takes his own specific view. An ED–monitor may see career opportunities in a risky take–over plan or may oppose it, afraid of losing his reputation and being held personally liable. The secretary–monitor has to do and keep his job, to build up his reputation, to avoid mistakes in the legal requirements he has to meet and negative publicity as well. So he will have a legal, risk–avoiding attitude. For an employee–member of the works council job security and career development play a constant role in the background of his performance. A banker–NED is certainly interested in the well–being and growth opportunities of the company, but his focus of interest will be finance and the risks for the bank. A supplier–NED will be interested in the market of his supplies and in growth of the user–company. In a situation of near financial distress his focus may be on minimizing his risk. And even the truly independent NED will judge from his own experiences and cannot objectively oversee all the relevant aspects of a business case.

Thus, a director pondering the weight of a monitors' opinion will always have to answer these two questions: (a) did the monitor really invest in the monitoring activity; and (b) from what interests or background did the monitor come to his advice or conclusion?

3.5.6 Monitoring: one size fits all?

Figure 3.5 shows the dual control system of internal and external control, its mechanisms and its monitors. Does this system apply to all companies, no matter the size, the specific legal form, or its objectives? Whilst the answer would certainly be in the affirmative on a systemic level, one has to admit that in practice a one–man business cannot afford e.g. managers, NEDs or a company secretary. This does not imply that a one–man business may not hire a manager to straighten out production problems; an external advisor to develop new markets; or someone to organize bookkeeping, disclosure and taxes, which is often the accountant. However, a one–man business may do with 'lighter', i.e. informally and/or ad hoc organized forms of monitoring than a larger firm or a listed firm. An expanding firm may need more NEDs than a consolidating one. A firm near financial distress may need other monitoring mechanisms or other monitors since, as chapter 5 shows, financial distress marks a shift of interests from shareholders to creditors and employees. Eventually, every company should implement the monitoring system that best fits its present and foreseeable future needs within the framework of the law. The latter is the subject of chapter 4.

3.5.7 Concluding remarks on monitoring

The monitoring concept derives from the agency theory. Monitoring should lessen shirking (Alchian and Demsetz, 1972) or opportunistic behaviour in general (Williamson, 1981) and may reduce the probability of mistakes (Jungmann, 2006). One discerns *internal* monitoring, which is monitoring by stakeholders from inside the company structure, and *external* monitoring, by stakeholders from outside the company structure. Which is the shareholders' position? Some see institutional shareholders as internal, others as external monitors. If a shareholder, while monitoring, uses information or legal or contractual rights conferred to him as a shareholder, it is *internal* shareholder monitoring. It is external if the shareholder uses other means of communication, as one-on-ones, road shows, analysts meetings, interviews in the media or court procedures. Likewise, banks (Bolton et al. 2005) and bondholders can profit from internal monitoring through a representative on the board. But normally they[44] will only receive extra financial information because this is agreed upon in a debt covenant. This again is external monitoring. In appreciating a monitors' opinion it is important to know if the monitor did really invest in the monitoring activity as well as its background. Every company should implement the monitoring system that bests fits its needs within the framework of the law.

3.6 SUMMARY AND CONCLUDING REMARKS

This chapter explored the role of monitoring in the broader context of the governance of a company. In each company, various parties are involved in the daily routine but only one party, management, is committed full-time to its direction and control. *Agency theory* stresses that the principal, i.e. the member, and the agent, i.e. the manager, by definition have a different utility function (Jensen and Meckling, 1976). This is the *paradigm* of this thesis. Moreover, proper performance by agents in the interests of the principal may severely be hampered by other factors. These are *bounded rationality* (Simon, 1957), i.e. every agent can cope with only a few alternative solutions, and *information asymmetry,* i.e. the agent does not share all the relevant information with the principal (Knight, 1921; Akerlof, 1970) which may even result in 'self-interest seeking with guile' (Williamson, 1981). Managers may become blinded by their power and unable to recognize adverse developments or new opportunities. They may even completely lose touch with reality (Skeel, 2005). Proper control of the agent is therefore essential. This is what corporate governance is about, defined based on the Cadbury Report of 1992 as the system by which companies are directed and controlled.

Control, according to Jensen (1993), is a warning system. The control structure envelops the 'direction' activities by management through internal monitoring mechanisms, e.g. shareholders and supervisors, and external monitoring mechanisms such as markets, the auditor and a court. The control process is executed through monitors, i.e. all stakeholders from inside and outside the company. It is a form of corporate democracy (Freeman and Reed, 1983). Well-executed monitoring is primarily in the interest of the members of the company, because their financial or ideological interests are at stake. But, at least in the long run, well-executed monitoring turns out to be in the interest of all stakeholders of the company, including management. Every means to avoid blindness or Icarean behaviour; to improve results, to preserve one's job or to avoid reputational damage should be welcomed by management if honest and in good faith. Management should only be prepared to listen sincerely. In order to remain efficient, it should not lose to monitors much of its discretionary power to direct the company. However, by listening to the various signals, arguments and opinions, the probability of mistakes will be reduced and management's decisions will be improved. Monitoring comes at a cost. As long as it reduces the whole of agency costs i.e. reduces the residual loss for a larger amount than the monitoring investment, the company is better of.

Based on this analysis, a more elaborate definition of corporate governance could be:

> *Corporate governance is the entire system of internal and external monitors, executing the mechanisms of internal or external control, in order to have agents direct the company in an efficient and effective way.*

Thus, management acts sensibly in organizing effective internal and external control, adapted to the needs of the company and to be performed by effective monitors.

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ENDNOTES

1 This is an underlying factor of the various corporate governance codes for listed companies, to be discussed in this chapter and in chapter 4.
2 UKC A.2.
3 Davies 2010: 103 footnote 1.
4 UKC A.4.
5 UKC A.1.
6 In Dutch, the executives form '*het bestuur*' (e.g. s 2:129 BW) which is translated either by 'management board' in e.g. the DC or by 'executive board' in e.g. the Annual Report of Heineken N.V. Since '*het bestuur*' unites the executive directors rather than the managers of a company, this thesis chooses 'executive board' (EB).
7 DC III.1.
8 DC III.1.7.
9 DC III.1.6(b).
10 See more specifically on these roles: chapter 7, 7.2.1. However, the implementation of those roles and their emphasis in the law differs among the various legal systems.
11 Brennan (2006) studied the existing expectation gap on the role of boards. See on the board's contribution to strategy: Brennan (2006: 583) and Pugliese et al. (2009).
12 quoted in Lipton, M., and J.W. Lorsch, 1992: 62.
13 See e.g. HR 9 July 2010, LJN BM0976 (ASMI), r.o. 4.6.
14 See on this project: Epstein, E.M., 1987, The corporate social–policy process and the process of corporate governance, *American Business Law Journal* 25, 361–383. and Smith, R.B., 1993, An underview of the principles of corporate governance, *Business Lawyer* 48, 1297–1311. In the final 1992 draft the word 'restatement' was replaced by 'analysis'.
15 Becht, M, P. Bolton, and A. Roëll, 2005, Corporate governance and control, ECGI working paper series in finance (ECGI)., p. 2 states that the term "corporate governance" has been used first by R. Eels, 1960, The meaning of modern business: an introduction to the philosophy of large corporate enterprise, Columbia University Press, p. 108.
16 As read in Gray, A., 1946, *The development of economic doctrine* (Longmans, Green and Co, London). p. 19.
17 The relationship in the Dutch two–tier system between the supervisory board and the shareholders can be characterized as an agency relationship as well. Becht et al. (2005: 8) describe corporate governance as a problem involving an agent and multiple principals, the shareholders, creditors, suppliers, clients, employees and other business parties.
18 See Jensen's (1993: 863) example on John Hanley, former Monsanto CEO.
19 See on this Blair (1995: 176).
20 Freeman and Reed (1983: 91) define 'the wide sense of stakeholder' as 'any identifiable group or individual who can affect the achievement of an organization's objectives or who is affected by the achievement of an organization's objectives.'
21 See on this Blair (1995: 175–176).
22 As can be seen in the Dodge v. Ford Motor Co. case before the Michigan Supreme Court, as cited by Blair (1995: 176).
23 See HR 18 January 1901, W. 7553 (*de Hoop*).
24 See Blair (1995: 179)
25 See Blair (1995: 178 r.c.).
26 See Blair (1995: 181 l.c.) and recently e.g. Delaware Court of Chancery in *eBay Domestic Holdings, Inc. v. Newmark,* C.A. No. 3705–CC (Del. Ch. 2010), September 9, 2010. Opposing to this viewpoint: Soppe, A.B.M., 2006, Finance as an instrument to a sustainable company, diss. Erasmus University Rotterdam, p. 60.

27 see 4.4 and e.g. for the UK s. 172 CA 2006; for the Netherlands HR 24 February 1995, NJ 1996, 472, (*Sigmacon II*) and HR 19 April 1996, NJ 1996, 727 (*Maclou and Provost*). See Assink, 2007: 91 for the US Delaware position in the vicinity of insolvency.

28 As mentioned in the Netherlands for the supervisory board in s 2:250(2) BW (Civil Code) and confirmed for the executive board by the Hoge Raad in Bank of America/ VEB and ABN AMRO Bank, 13–07–2007, LJN: BA7971 in r.o. 4.5.: 'Ook hier geldt dat het bestuur bij de vervulling van zijn bij wet of statuten opgedragen taken het belang van de vennootschap en de daaraan verbonden onderneming behoort voorop te stellen en de belangen van alle betrokkenen, waaronder die van de aandeelhouders, bij zijn besluitvorming in aanmerking behoort te ne–men.' See for the US Delaware approach: Blair (1995: 178 r.c) and recently Assink (2007: 102).

29 Cooter and Eisenberg (2001: 1724) posit in discussing whether self–interest should be defined narrowly or broadly: 'the debate about whether all behaviour is ultimately self–interested seems tautological and relatively sterile'. Why would it not be right to encompass all options for the individual in his utility function?

30 One, on the practical aspects of corporate governance, by the author and others: Santen, B.P.A., A. de Bos, and D. de Rooij, 2006, *Praktische aspecten van corporate governance* (Kluwer).

31 See: http://corpgov.net/library/definitions.html (visited on 30 November 2006) for more than 20 definitions. This thesis offers one as well in 3.6.

32 Williamson (1988:588) argues: TCE posits that debt (rule–based governance) is the original form of finance and introduces equity (discretionary governance) only when the cost of debt financing becomes prohibitive. Regarding debt and equity as alternative governance structures, rather than merely as financial instruments with different tax implications, is central to the TCE theory.

33 From a legal point of view, *The principles of corporate governance: analysis and recommendations*, of the ALI comes to an identical analysis, see Eisenberg (1993: 1275).

34 As taken from the Executive Summary on 'Internal control – integrated framework', COSO–website on 21 September 2006.

35 The Internal control – Integrated framework, published by the Committee of Sponsoring Organizations of the Treadway commission (COSO), New York, 1992, more or less combines the external auditing and management control perspectives (Maijoor, 2000: 105). The cross–fertilization between the three sub–areas studying (internal) control is minimal (Maijoor, 2000, 106).

36 A 'mechanism' approach is also found in Williamson, O.E., 1996, *The mechanisms of governance* (Oxford University Press, New York). and Roosenboom, P.G.J., 2002, Corporate governance mechanisms in IPO firms, (Universiteit van Tilburg, Tilburg).

37 See e.g. s 2:393(5, 6) BW for the Netherlands.

38 See e.g. s 2:102(1) jo 392(1.a) BW for the Netherlands.

39 "Monitors are crucial to effective corporate governance", Boot and Macey (2004: 357).

40 They do not mention personnel, which is an important monitor especially when it comes to the observance of lower levels of internal control. Individuals at every level in an organiza–tion may have some monitoring responsibility, states the Guidance on monitoring internal control systems, COSO (2007: 22).

41 This definition is from the Public Concern at Work (PCaW) website (www.pcaw.co.uk) and clearly shows that whistle–blowing has an internal as well as and external side. Since the threat of going external will often be decisive in the way the information is handled, this thesis considers whistle–blowing as an external control mechanism. Section 4.4.3.4 deals with the UK Public Interest Disclosure Act 1998 (PIDA). On whistle–blowing: Santen, B.P.A., and C.C.E.J. Verbeeten, 2007, Omarm de klokkenluider, *Tijdschrift Controlling* 22, 14–19.

42 Coffee (1991: 1336) discerns a characteristic bias for each institutional monitor: (1) the *exiting* monitor might be prone to bail out when crises loom; (2) the *market–dominated* monitor lets a volatile market interfere with its long–term planning; (3) the *risk–preferring* monitor searches for a higher risk profile (through high leverage) than management; (4) the *disruptive* monitor – often after a hostile change of control – puts aside the implicit contracts (for example on job security) (p. 1329–1334); (5) the *opportunistic* monitor (strives for his own

good; has conflicts of interest) and (6) the *unaccountable* monitor (of which public pension funds are an example).

43 Coffee concludes that pension funds and closed–end mutual funds are therefore better institutional monitors than banks and other creditor–shareholders.

44 See on this and related bonding costs issues: Jensen and Meckling (1976: 338).

Chapter

4

The mandatory monitoring structure of the company in the perspective of corporate governance – a legal approach

By nature, organizations abhor control systems, and ineffective governance is a major part of the problem with internal control mechanisms. (Jensen, 1993: 852)

4.1 INTRODUCTION

The previous chapter portrayed the role of monitoring from an economic perspective. The *agent* or executive director (ED) directs the company. His utility function differs by definition from that of the *principals* or members. To avoid a too wide diversion of interests, EDs are monitored primarily by non-executive directors (NEDs), if present (Hillman and Dalziel, 2003: 384), and members, as well as by others. These internal and external monitoring mechanisms are important to keep companies on track and to avoid expropriating or otherwise opportunistic behaviour of directors. The prime research question of this chapter therefore is whether and how corporate law[1] applies the aforementioned agency theory-based insights to the desirability of internal and external monitoring. If the adoption is incomplete or inadequate, this may implicate that, at least from the point of view of economic theory, the legal person in question is inadequately looked after. This may cause undesirable social costs, varying from an inefficient operation of the company up to its bankruptcy.

The analysis has three limitations. *First*, the external monitoring structure of figure 3.5 shows five categories of external monitoring mechanisms. For reasons of feasibility, the market-type external monitoring mechanisms at the left and the right hand side of the figure are set aside. The study focuses exclusively on the internal monitoring structure and on the external monitoring structure of a legal/political/regulatory nature. *Second*, the analysis focuses on *mandatory* mechanisms. The legislator apparently determined these to be the minimal monitoring mechanisms required. Although individual companies may voluntarily adopt more monitoring mechanisms through their articles or through contracts, these mandatory provisions determine the minimal level of stakeholder protection. *Three*, the company is not in financial distress. Therefore this chapter does not go into the rules framing directors' behaviour in a situation of near distress especially as regards to creditors. This is the subject of chapter 5. In the meantime these rules for distress situations *do* however play a role in the background of any of the directors' major decisions.

Figure 4.1 presents an overview of the flow of this chapter. Section 4.2 describes the method and objects of study. It accounts for the choice to review and compare the mandatory monitoring structure of five corporate forms in the Netherlands, Germany and the UK. Section 4.3 develops an analytical approach based on the models of Davies (2010), Kraakman et al. (2009) and Timmerman (2009). Based on the approach developed in section 4.3, sections 4.4 to 4.8 examine the mandatory monitoring structure for the five selected legal forms. Each section contains a comparison between the various legal systems. Section 4.9 offers an analysis of the strengths and weaknesses of the different systems based on Davies' legal strategies approach. Section 4.10 evaluates the systems

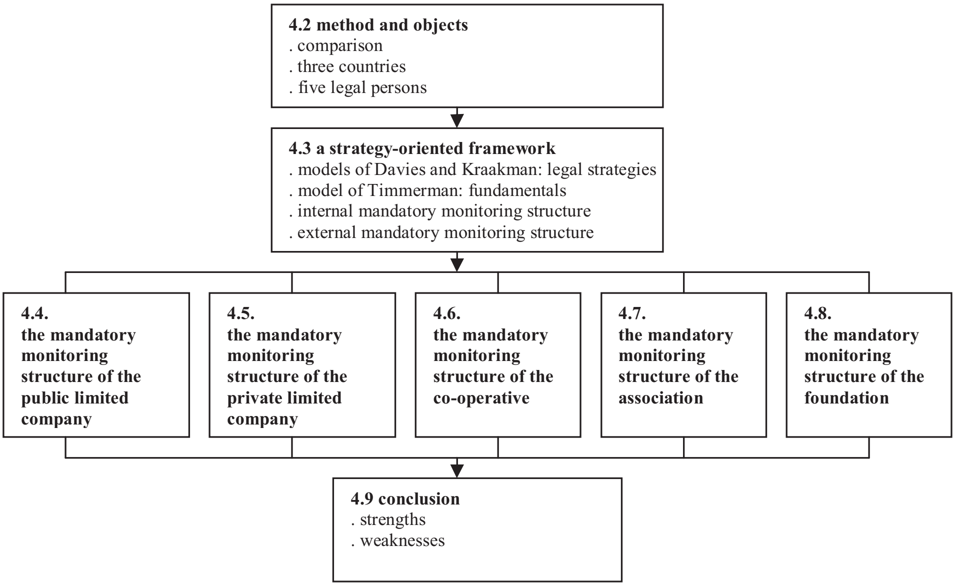


Figure 4.1: overview of chapter 4

along the fundamentals of Timmerman. Section 4.11 ponders which legal system monitors best.

4.2 METHOD AND OBJECTS

This section explains the aim and method of the study on the mandatory monitoring structure. It justifies the choices made regarding the objects of the study.

4.2.1 Comparison: aim and method

Why would one take up the challenge of a legal comparison? To understand one's native legal system is hard enough. However, it is curiosity about how other nations go about similar problems that drives the literature to set itself this task. As Zweigert and Kötz (1998) put it:

> *The primary aim of comparative law, as of all sciences, is knowledge. (..) comparative law can provide a much richer range of model solutions than a legal science devoted to a single nation, simply because the different systems of the world can offer a greater variety of solutions than could be thought up in a lifetime by even the most imaginative jurist who was corralled in his own system.* (p. 15)

Comparative law has various objectives (Zweigert and Kötz, 1998; Glenn, 2006). The aim of comparison in this thesis is to provide the reader with:

- a *survey* of the mandatory control mechanisms of five legal persons;
- an *analysis* of the differences between those legal persons in three legal systems;
- *recommendations* of improvements to the present system.

Instead of a *functional* approach (Kraakman et al. 2009: 3; Örücü, 2006: 443, 448) this study chooses a *strategic* approach through a prescribed format, which is developed in 4.3. Such a strategic approach enables a comparison of the 15 legal persons involved as will be shown later in this chapter.

A proper comparison of legal systems requires a thorough understanding of their environment (Örücü, 2006). This suggests that the comparatist must be something of a polymath, highly learned in a variety of disciplines and extremely conversant with the socio-cultural backdrop to the subject matter of comparison (Cruz, 1999). Upholding this requirement would probably make any comparison impossible, and certainly so within the framework of this thesis. In the meantime, the results of the presented comparison should be interpreted with caution, as the comparison concerns only elements of a larger framework, society, and should be understood in that specific context. Solutions that work in the Netherlands do not necessarily work in the UK or Germany and vice versa. Attempts to pick the best elements in various systems may eventually lead to lengthy processes with, in the end, impractical solutions, if any at all, as e.g. the European SE-process has shown.

4.2.2 Three legal systems

The analysis contains three legal systems in order to study how similar problems are solved in different systems or to detect blind spots. Company law systems can be looked at from various angles, as there are:

- *The origins of the law system*: the UK has a common law system. The Netherlands and Germany have a civil-law system, where the Dutch law system is based on French roots and the German system is of a younger date. La Porta et al. (1998: 1116) find that common-law countries give shareholders and creditors relatively the strongest, and French civil-law countries the weakest protection, with Germany somewhere in between.
- *The corporate governance system*: as already discussed in 3.3.1.3 common-law countries generally favour shareholder value as the goal of the company, either in an enlightened or in a raw form, whilst Germany, Austria, the Netherlands and the Nordic states have chosen for a broader, stakeholder-oriented approach. In most of those stakeholder-oriented countries, the law prescribes a form of co-determination by the labour-factor.

- *The monitoring system*: UK shareholdings are said to be more dispersed than in continental Europe, with the Netherlands somewhere in between (Kraakman, 2004: 46). This is due to large family and bank shareholdings predominant in France, Germany and Italy. This difference, it is maintained, means that ownership, control and monitoring issues require different solutions for different countries.
- *The efficiency of the capital market*: as a consequence of the previous remark, capital markets in continental Europe are said to be less developed, because of these large, illiquid shareholdings (Kraakman, 2009: 302).
- *Competitiveness*: the present wave of proposals and laws throughout Europe for a more flexible organization of private company forms, combined with an ongoing strive for lower tax rates, has been described as 'a race to the bottom' (Rammeloo, 2007). Some countries, such as Ireland and Luxembourg, made considerable success in attracting economic activity through more flexible and less costly solutions, as a result of which others (e.g. Germany and the Netherlands) had to react and follow. In the UK there is competition between new forms and the Ltd. In the Netherlands and especially in Germany, one sees a competitive influence emerging from the EU freedom of establishment. Around 25% of the newly established German private limited companies have a foreign form (Verbrugh, 2008).

Based on the differences summarized in table 4.1, this thesis compares between the UK, Germany and the Netherlands. The UK is chosen because it is exemplary for the shareholder approach. Germany is included as it takes rather the opposite position, where it assigns a stakeholder, i.e. the employee, the right to be represented on the supervisory board. The Netherlands has been selected because it bridges in quite a few aspects the difference between the German and the UK corporate system[2]. A summary of these classifications is shown in table 4.1.

Table 4.1: a categorization of the legal systems of the UK, Germany and the Netherlands

legal system / criterion	UK	Germany	the Netherlands
legal origin	common law	civil law (modern)	civil law (French roots)
corporate governance system	enlightened shareholder value	stakeholder value; direct labour influence	stakeholder value; indirect labour influence
monitoring system	dispersed/institutions	blockholders	dispersed/institutions
efficiency capital market	high	medium high	medium high
competition legal forms	only British alternatives	high impact	medium high

4.2.3 Five legal persons

In creating a legal form, the legislator could focus on variables such as ownership, liability, object, origin of capital, ease of exit, size and impact. Hansmann (1996) argued that there are essentially two sorts of legal persons depending on the property rights to the residue. He calls these profit and nonprofit organizations.

> *The defining characteristic of a nonprofit organization is that the persons who control the organization – including its members, directors and officers – are forbidden from receiving the organization's net earnings. This does not mean that a nonprofit organization is barred from earning profits; rather, it is the distribution of the profits to controlling persons that is forbidden. Thus by definition, a nonprofit organization cannot have owners (p. 17).*

Apparently, in his view the legal possibility to distribute profits discerns legal forms. Therefore Hansmann (1996: 17) sees no fundamental reason to have specialized business corporation statutes. The business corporation is nothing more than a formalized form of a lenders' co-operative, wherein members of a capital co-operative supply, i.e. lend, to the firm a given sum of money with residual rights, just as the members of a dairy producers co-operative would supply their milk (p. 13). A separate business corporation statute may only have a transaction costs advantage.

Some questions arise. The *first* is whether this difference between profit and nonprofit companies can be traced in the mandatory monitoring structure of the various legal persons. The *second* is whether the various profit forms are indeed alike in organizational form, as Hansmann suggests. And the *third* is whether the differences in organizational form are functional or just an outcome of 'accidental' legislation. To answer these questions, one needs to study the public and private limited form, the co-operative and the nonprofit forms of association between people. As Davies (2008: 82) points out public and private companies fulfil different economic purposes. These are: to raise capital from the public to run the corporate enterprise for the *public company*[3]; and to confer a separate legal personality on the business of a single trader or a partnership for the *private company*. The specific characteristic of a *co-operative* is the dual role of its members. Since they are members of the co-operative as well as its consumer or supplier there is no reason to impose a nondistribution constraint (Hansmann, 2010: 69). In *nonprofits* however, the nondistribution constraint protects consumers from exploitation and thus provides trust in its products and services especially in situations of severely asymmetric information (Hansmann, 2010: 62). Nonprofits form the social infrastructure of civil society (Anheier, 2010: 8). On average about 6% of the total employment in OECD countries is in the nonprofit sector and nearly 10% if volunteer work is taken into account (Anheier, 2010: 3). Moreover, through the 'new public management' (NPM) approach (Anheier, 2010: 5–8) as well as the rise of markets and quasi-markets in areas that have long been part of the state, nonprofits are developing into real corporations. In the *associative nonprofit* form people work together towards a common object of which they are often the primary beneficiaries. The other nonprofit form is the *foundation*. Instead on membership (*uni-*

versitas personarum) it is based on some core asset, the ancient Roman *universitas rerum* (Anheier, 2005: 50). Hopt and Hippel (2010: xliv) point out that the term 'foundation' may be unfamiliar to certain legal systems, e.g. that of the UK, or have a rather different use and organization. In the Netherlands, foundations are important suppliers of e.g. housing, health, education and welfare services. To a lesser extent this applies to Germany as well. In the UK such activities are organized through private limited companies, industrial and provident societies, trusts or charities.

A strategic comparison of the legal mandatory monitoring structure of these legal persons along the framework developed in the next sections is the topic of this chapter.

4.3 A STRATEGY-ORIENTED FRAMEWORK

This section develops a framework for the analysis of the mandatory monitoring structure of legal persons. It starts with a discussion of the models of Davies and Kraakman et al. in 4.3.1 and of Timmerman in 4.3.2. Section 4.3.3 develops a model for the analysis of the internal mandatory monitoring structure. The special position of directors is the subject of 4.3.4. Section 4.3.5 discusses why and how the analysis takes the external mandatory monitoring structure into account. The benchmark of comparison is the subject of 4.3.6. Section 4.3.7 concludes.

4.3.1 The models of Davies and Kraakman: legal strategies

The existing set of corporate rules for each legal person can be explored by means of the concepts developed by Davies (2010) and Kraakman et al. (2009). Both are agency theory inspired and consider reducing the occasions for opportunistic behaviour as a demanding task for company law (Davies, 2010: 28; Kraakman, 2009: 2). In their approach, the law has five pairs of legal strategies[4] to address these agency problems. They are summarized in table 4.2.

Table 4.2: legal strategies for the regulation of principal/agent relationships

Kraakman (2009)	regulatory strategies		governance strategies		
legal strategies	agent constraints	affiliation terms	appointment rights	decision rights	agent incentives
ex ante	rules	entry	selection	initiation	trusteeship
ex post	standards	exit	removal	veto	reward
Davies (2010)			enhancing the principal's control		
			structuring the agent's decisions		

Source: Kraakman et al. (2009): 39 combined with Davies (2010): 113[5].

Each pair consists of an *ex ante* and an *ex post* strategy. The *agent constraints* strategy attempts to restrict the agent's freedom by prescribing do's and don'ts in the form of specific (rules) or more abstract (standards) norms of conduct for directors. Rules form an *ex ante* specific code of conduct, while the proper application of a standard can only be judged *ex post*, given the facts. The *affiliation terms* strategy is about the terms on which a principal may enter, or leave, the legal person. *Ex ante*, when entering the legal person, the law may prescribe transparency through disclosure by means of a prospectus and annual reports in order to avoid adverse selection. *Ex post*, this strategy focuses on the possibilities of selling the shares: by prescribing or forbidding certain restrictions, by giving a duty or a right to sell to a majority shareholder; by organizing the existence of a free float, and most essentially by not inhibiting the market for corporate control. The *appointment rights* strategy concerns the *ex ante* regulation of the appointment of directors: by shareholders or by the board, by recommendation by special groups of shareholders or even by third parties, such as the employees. The *ex post* appointment strategy concerns the reverse side: who is competent to suspend and dismiss directors. In the *decision rights* strategy the law attributes specific decision rights to the shareholder instead of to the specialized management. In order to avoid the loss of the advantages of specialized management, only a few categories of decisions are apt for this strategy: (1) infrequent ones, such as alterations to the company's constitution; (2) decisions where the agent lacks specialized know–how, such as the issue of new shares; (3) highly important decisions, such as a merger or a large acquisition; and (4) decisions with a high risk of possible conflict between the interests of the principals and the agent, such as related party transactions, or the reaction to a take–over bid (Davies, 2008: 376). The *ex ante* strategy offers principals the possibility of making a proposal. More often only an *ex post*, or *veto* strategy is established. The *agent incentives* strategy concerns itself with avoiding a conflict of interest (*ex ante*) or aligning the interests (*ex post*) of principal and agent. A means to avoid the conflict of interests is to attribute the decision right to certain issues to a 'trustee', e.g. the supervisory board in a two–tier system or to ensure that 'independent NEDs[6] are to be a significant part of the board as a whole and dominant on the committees where the conflicts of interest might be expected to be most prominent' (Davies, 2010: 200). An auditor or a court might perform this 'trustee' role as well (Davies, 2002: 207). This is a *negative incentive strategy*, in the sense that it reduces or removes the self–interest of the agent (Davies, 2010: 192). The *ex–post* strategy is a *positive* strategy since it aligns the interests of principals and agents in a reward strategy, for example by a proper long–term incentive plan (LTIP).

Although the strategies of Davies and Kraakman are identical, the analysis differs. The upper–half of table 4.2 depicts the approach of Kraakman et al. The first row of the table shows two subsets of strategies. *Regulatory strategies* are prescriptive. They describe either the content (*agent constraints*) or the formation and the dissolution (*affiliation*) of the principal–agent relationship. *Governance strategies* attempt to protect the principals indirectly, either by enhancing their power or by moulding the incentives of the agents (p. 23). The lower half of table 4.1 shows Davies' (2010) division of the same five strategies in a subset focused on *enhancing the control of the principal* over the agent and another on directly structuring *the exercising by the agent of his discretion* (p. 119). The checks and balances nature of corporate governance is better expressed, it is felt, in Davies' approach. Many rights can be formulated as: “The principal shall decide (..)”, thus enhancing the principal's control, or as “The agent shall disclose (..)” , thus constraining the agent's discretion. The choice will be influenced by the importance attached to the often very advantageous *specialized management* feature of a company. By requiring direct control the principal loses the advantages of fast action executed by specialized agents.

Section 4.3.3 develops a framework based on these strategies for the analysis of the internal mandatory monitoring structure of a legal person. However, first follows an introduction to an alternative analytical tool of corporate law, that will function as a means to control the results of the strategy–oriented approach.

4.3.2 The model of Timmerman: fundamentals

Timmerman (2009) recently presented a pragmatic approach to the fundamentals of company law. In his view the main goal of company law is to invent legal structures that function successfully in (international) economic life. They must be effective and efficient and therefore have an economic component as well. The importance of the development of the fundamentals of company law is that they may function as a *substance over form*. Under circumstances these fundamentals may even outweigh an actual legal or regulatory provision. Timmerman derives those fundamentals from actual company law. He upholds that they are neither absolute nor eternally true. They evolve over time[7]. His approach is useful for the present study since it is another means of comparing the three legal systems under review. The results found through the strategy approach will therefore be evaluated from this perspective at the end of this chapter. The questions to be answered would be (1) whether all three legal systems adhere to the same fundamentals and, if not, (2) which of the fundamentals are omitted, (3) which fundamentals are to be detected elsewhere, and (4) whether this difference in fundamentals is mirrored by a difference in legal strategies respectively mandatory monitoring mechanisms.

Timmerman lists eight actual and two nascent fundamentals. Five of them are of a *structural* nature – they picture the décor of the company, and are therefore called décor fundamentals – and the other five are of a *behavioural* nature. The *structural* fundamentals[8] are those of: (1) *transparency* of the company regarding its structure and its financial situation; (2) the *freedom of restructuring* in or outside the present legal form, either through amendment of the articles or through a change in legal form; (3) *partition of assets* between the legal person and the members, and limited liability of the members;

(4) a principal division between *the inside and the outside* of the legal person: third parties doing business with the legal person should not suffer from an (internal) deficiency in the power of representation; and a nascent fundamental: (5) company law should only be *mandatory law* for specific reasons.
The *behavioural* fundamentals[9] are those of: (6) *pluralism of interests* to be taken into account, either through a structural measure, e.g. co-determination in Germany, or through the application of standards concerning the behaviour of participants; (7) *free and undisturbed ownership*; (8) *no conflict of interests*; (9) a *collegial board* system, meaning that the board functions as a whole. Whilst a certain distribution of tasks may be efficient, this does not dismiss directors from their responsibility for the general and financial policy of the legal person as well as a duty to monitor colleagues and intervene if necessary; and a nascent fundamental: (10) the court should avoid judging with hindsight and *examine with restraint.*

An examination of those fundamentals vis-à-vis the strategies approach follows in 4.10.

4.3.3 The internal mandatory monitoring structure

The internal monitoring structure of a legal person as shown in figure 3.5 contains all the functions and organs within the legal person provided for in the law and the articles that monitor the 'direction' of the company [10]. A function[11] may be a director, a company secretary, a shareholder or a general meeting. In economic terms these are monitors. An organ[12] may be the executive board (EB) and the supervisory board (SB) in the two-tier system, the board in the one-tier system, the general meeting (GM) or the works council. In economic terms these are monitoring mechanisms. Not all systems incorporate a function in an organ. For example, there is no board in the German GmbH and the general meeting in the UK is not an organ as it is in the Netherlands[13]. These functions or organs of the company, and the people in it, are responsible for the proper internal monitoring of the company. Functions and organs are created by the law or by the articles. This analysis only sees to mandatory functions and organs inherently created by the law. Legal scholars doubt whether a works council is an organ of a legal person[14]. From an economic point of view it is, since it certainly influences company policy. Van Schilfgaarde/Winter (2009) remark that *de facto* it will often function as an organ. In this research it will be considered as such.

The analysis of the internal mandatory monitoring structure of a legal person will be centred on a figure like figure 4.2 (see 4.4.1). The upper part of the figure shows the internal mandatory monitoring structure of a Dutch *NV*. It opens with a flowchart with arrows, denoting the monitoring influence of an organ on, mostly, executive directors. In order to perform its monitoring tasks, every organ has been assigned several mandatory rights. The boxes in the middle of the figure list these rights along the various legal strategies described in 4.3.1. The *agents constraints strategy* is not mentioned in the figure, since it directly assigns duties to directors. It is analyzed separately in the text (see also 4.3.4). *Instrumental rights* are a new feature, added to the figure by the author. These cover 'preliminary' rights, such as the right to information, to convene an AGM or to vote, necessary to execute the legal strategies. Davies (2010: 115–120 and 127–130) describes these rights elsewhere in the text and not under a separate heading since in his view they are functionally a way of implementing the identified strategies. Whilst this may be true, a comparison of these rights is also deemed important for the underlying study.

The figures may be compared horizontally, i.e. between identical forms in various legal systems, and vertically, i.e. between forms of one legal system. The idea is that this comparison will reveal whether and how the law implements economic insights on monitoring.

4.3.4 The position of directors

Broadly speaking, the law leaves the 'running of the company's business' (UKC A.2) to the executives and senior management in the one–tier system, and to the executive board (EB) in the two–tier system. The law directly restricts the freedom to manage–at–will through the *agent constraints strategy*. Directors owe their duties to the company as formulated in rules and standards. Moreover the law often prescribes that the board acts as *one* organ and that directors are in principle jointly and severally liable to the company[15] for acts of the board or of the board members. This implies a duty for directors to monitor each other. One may consider this strategy as part of the 'bonding' mechanism developed in economic theory.

The position of the non–executive directors (NEDs) on the board and that of the supervisory board (SB) is hybrid. On the one hand they have a control function and as such they are important internal monitors of the company. This function requires that the executive function must be kept at a certain distance. On the other hand NEDs have a service and strategy function. In performing these, they co–operate more (one–tier) or less (two–tier) closely with the executives for the benefit of the company. In both roles, NEDs have considerable freedom. The law applies the same strategy as those for executives to restrict this freedom as well.

The best way to make full use of the directors' capabilities is to offer full freedom and to restrict the *use* of this freedom through a system of legal duties in order to prevent abuse. Thus, in the analysis of the position of the board in this chapter the focus will be threefold: (1) on its structure, (2) on its task and (3) on the directors' duties.

4.3.5 The external mandatory monitoring structure

For the comparison and evaluation of the internal monitoring structure of a legal person one needs to know the external monitoring structure. A severe internal monitoring structure may require less external monitoring and vice versa[16]. This trade–off complicates the analysis considerably. Two choices have been made. The *first* is to exclude the market-type external monitoring mechanisms from the analysis. Since these markets work more or less similarly between the countries under review, this is probably not a great loss for the analysis. The *second* is to restrict the analysis of the external mandatory monitoring mechanisms to a *strategic* analysis: what is the monitoring strategy they perform?

The lower part of figure 4.2 shows the external mechanisms under review. The common denominator of the agencies presented is that they are all non–market and company-independent monitors of the company. Some the legislator has created intentionally: the formation authority, the monitoring task of the auditor, the disclosure authority, the financial authority, the judicial authority and whistle–blowing arrangements. Others have the monitoring function of legal persons as a by–effect: the tax–authorities, the trade union (as petitioner of an inquiry), publicity, interest groups, government agencies or the legislator. All these institutions function as monitors in the feedback they give to the legal person.

4.3.6 The monitoring capacity as a benchmark

The study in this chapter evaluates each legal person on the mandatory capacity to monitor its board. The evaluation is restricted to the power of *internal* monitoring of appointments and dismissal, accountability and disclosure, veto on company decisions, company structure, directors' duties; and to the power of *external* monitoring mechanisms. Each section concludes in a table like table 4.3 (see 4.4.1.6) to indicate the strengths and weaknesses of these six issues seen from the viewpoint of the mandatory capacity to monitor the board. In section 4.9 these evaluations end in a broad horizontal and vertical analysis of the legal persons being studied.

4.3.7 Concluding remarks

Whilst the agent constraints strategy and the agent incentive strategy focus directly on the behaviour of the agent, the affiliation, appointment and decision strategies aim to empower the members. These five strategies form the framework of the internal monitoring analysis of the legal person. An additional evaluation of the external monitoring mechanisms puts the internal monitoring arrangements in perspective. This external analysis will be done on a functional level. The analysis of each legal person ends with an evaluation based on the criteria (1) appointment/dismissal, (2) accountability, (3) veto, (4) company structure, (5) directors' duties and (6) external monitoring. Finally, the results based on the strategy approach are compared with those obtained by means of the fundamentals of Timmerman (2009).

The analysis does not strive to achieve full coverage of all the legal details. The aim is to keep a helicopter view. To that end, some shortcuts are necessary. The notation of legal provisions has for efficiency reasons been shortened to an *s* for section, followed by the section number and, if necessary and space is available, which is sometimes a problem in the tables, the relevant subsection between brackets. The Dutch *art* for *artikel* and the German *§* for paragraph to indicate a section, are thus omitted. Another shortcut concerns reference to the literature. Each of the following sections 4.4 – 4.8 will start with a short description of the general materials used. Referrals to this or other literature in the text is omitted, unless for specific issues of interest or importance.

4.4 THE MANDATORY MONITORING STRUCTURE OF THE PUBLIC LIMITED COMPANY

A public limited company is a capital association characterized by a separate legal entity and limited liability for its members, designed to run the corporate enterprise with capital raised from the public (though it may not in fact have done so)[17]. This section evaluates sequentially the mandatory monitoring structure of the Dutch *NV* (4.4.1), the German *AG* (4.4.2) and the UK *Plc* (4.4.3). Section 4.4.4 concludes.

4.4.1 The Dutch naamloze vennootschap (NV)

The forthcoming analysis rests on Kroeze, Timmerman and Wezeman (2007), Van Schilfgaarde/Winter (2009), Kluwer *Rechtspersonen* (groene losbladige serie), Klaassen (2007), Vink and Van het Kaar (2009) for the works council and Van der Heijden/Van der Grinten (1992) for historic reference.

4.4.1.1 *Formation and institutional structure*

Book 2 of the Dutch Civil Code (BW) contains all the laws regarding the formation and organization of companies. All company law is mandatory unless mentioned otherwise. Titel 1 of Boek 2 BW(s 2:1–25) applies to *all* legal persons. S 2:64–174a BW[18] contain public limited company law in the Netherlands. One person suffices to form a Dutch public company (*naamloze vennootschap;NV*). The company's name should contain the full title or the abbreviation[19]. A notarial deed, to be executed after government clearance[20], constitutes the formation moment. It is a legal person with transferable shares[21]; the minimum capital to pay up is €45,000. The NV may emerge in two forms: as an ordinary or a ‘structure NV’. Both forms can be listed. The ordinary NV has a mandatory EB and GM. A separate SB – Dutch law still maintains a two–tier system[22]– is only mandatory for the ‘structure NV’. Non–company law may require a supervisory board in specific cases or for specific economic activities. An NV becomes a ‘structure NV’ if (1) the sum of its issued share capital and its positive reserves is at least €16 million[23]; (2) there is a mandatory established works council; (3) its workforce in The Netherlands counts at least 100 people; and (4) if this situation lasts during three consecutive years[24]. The structure regime is mandatory but exemption or mitigation[25] is provided for in specific cases[26] which are notably multinational holding companies (Van het Kaar, 2009)[27]. Voluntary adoption of the regime is allowed[28]. A ‘structure NV’ is not necessarily listed or vice versa. The law obliges *every* institution that employs at least 50 people on a regular basis to establish a works council[29]. Institutions that employ at least 10 people (and less than 50) have to organize a meeting between the employer and the employees twice a year[30].

Dutch listed NVs have to comply with the listing rules, comprised in the Rule Books I and II of NYSE Euronext and with the Dutch corporate governance code, hereinafter referred to as the *Dutch Code* (DC). The DC is connected to company law through a ‘comply or explain rule’ and other disclosure requirements mentioned in a decree based on the annual report section of the BW[31]. Finally, the *Sociaal–Economische Raad* (social and economic council of the Netherlands, *SER*) has adopted the *SER–Fusiegedragsregels 2000* (Merger Code 2000), to be applied on a voluntary basis by merging companies, of which one has at least 50 employees. It contains rules for the protection of employees’ interests in the merger.

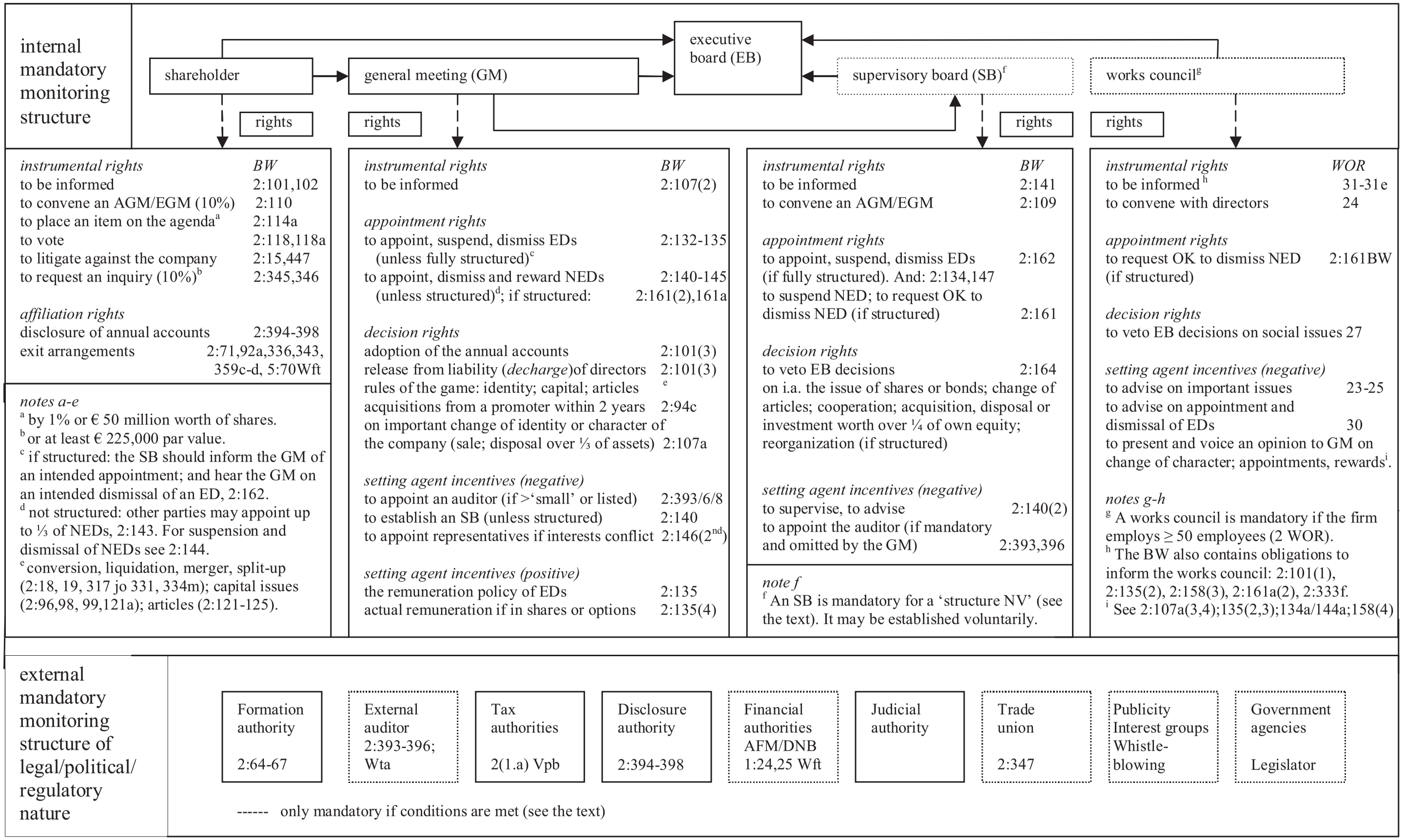
4.4.1.2 *Internal mandatory monitoring structure*

Figure 4.2 shows the mandatory monitoring structure of an NV. The upper and lower side of the figure show that in the full–blown picture the NV has five internal and possibly nine external monitoring mechanisms. The one–man NV still encounters at least four external monitoring mechanisms. The text below analyses the internal mandatory monitoring structure in the figure from left to right. It discusses the mandatory rights of each function or organ as mentioned in the boxes in the middle of the figure. The executive board is dealt with in 4.4.1.3.

Shareholders

Shareholders have, as figure 4.2 shows, several *instrumental* rights. They are entitled to an inspection copy of the annual accounts and the annual report. They may request that a GM be held or an item be placed on the agenda[32], but collective action problems may inhibit execution of these rights (Davies, 2010: 127). Their voting right may be restricted in the articles through a voting–cap[33]. For non–depositary receipt holders, the trustee may restrict the voting right e.g. in case of a hostile take–over bid[34]. However, their rights

Figure 4.2: Dutch public limited company (NV): mandatory monitoring structure



provide shareholders with negotiation power in one–on–ones with the management[35]. Any litigation, either on the validity of decisions or resolutions[36], on the content of the annual accounts[37] or aimed to provoke an inquiry (*enquête*) into 'the policy and the course of business' (Assink, 2007) carries risks, costs and reputational damage which any sensible director would preferably avoid. Concerning *affiliation rights*, Dutch law requires the NV to disclose its annual accounts and annual report through the *Handelsregister*, more or less in detail, depending on its size, which may be small, medium or large[38]. If the NV is 'small' and does not aim to make profit, it may under certain conditions even be exempt from public disclosure[39]. Full disclosure is required for listed NVs[40]. For a small fee, much of the data is electronically available to the public. Listed companies should disclose through their website and to the AFM[41]. And *ex post*, the exit arrangements are in place. A block of shareholders holding 30% of the votes is obliged to make a public bid[42]. If a bidder has acquired 95% of the shares of the listed target, both parties can litigate to sell respectively to obtain the lacking shares. In any case, an owner of 95% of the shares may legally pursue a buy–out. An expel and resign arrangement only exists for a closed NV[43].

General meeting (GM)

Once shareholders convene, the GM should receive all the information requested, unless it were against the company's weighty interests[44]. The GM decides by majority and is not subject to quorum requirements unless otherwise required by the law or the articles[45]. If *not structured*, the GM *appoints* the EDs and NEDs. The articles may provide for the appointment of up to one–third of the NEDs by other parties[46]. Other restrictions in the articles may contain specific requirements a director has to meet[47], or a regime of obligatory recommendation of nominees by other parties[48]. However, mandatory law enables the overruling of these restrictions by a majority of two–thirds of the votes, representing over half of the issued capital. If *structured*, the GM may be sidelined almost completely. In that case, the SB appoints the EDs. The default rule is that the GM appoints the NEDs on the recommendation of the SB[49]. The GM and the works council[50] may nominate candidates to the SB. The SB may ignore these nominations, unless they stem from the *de facto* recommendation right the works council has for one–third of the NEDs[51] (Santen and Plusquin, 2009). If the GM vetoes[52] the SB recommendation, the SB is entitled to a new recommendation. Although this procedure is much cited as mandatory law[53] and is much copied in the articles, it is a default rule. The law enables other appointment arrangements to be made by the articles provided the SB and works council agree beforehand[54]. However, the GM's rights in the 'structure NV' to request[55] the OK to dismiss a NED for e.g. negligence, or to dismiss the *full* SB are mandatory.

For *all* NVs, the Dutch GM *decides* on the adoption of the annual accounts. The release from liability (*décharge*) of directors should be a separate agenda item. Changes in corporate identity, including mergers, split–ups and liquidation[56], in capital or in the articles[57] are primarily assigned to the GM, albeit usually in the form of a right to veto

EB proposals. However, the GM right is probably better qualified as a *co–decision* right if the articles contain the permitted clause that those changes be made on the proposal of a third party or an organ, or with its (prior) consent[58]. Actually, it seems quite logical in legal forms of an associative nature like the NV that 'the rules of the game' including corporate identity, articles and (new) membership, i.e. new shares, as well as a change of identity or character of the company, are the GM's domain (Klaassen, 2007: 79). In 2004 the GM acquired an additional decision right, in the form of a right to veto an important proposed change in the identity or character of the NV that would essentially leave the shareholder with an altered company (Klaassen, 2008). From HR 13 July 2007, JOR 2007, 178 (*Bank of America/ VEB and ABNAMRO*)[59] it became clear that this right should be interpreted restrictively. Another GM decision right applies if the company wants to buy property from the incorporator within two years of its existence. A typical example of the *negative agent incentives strategy* is the provision that the GM is the primary party for appointing the auditor. An auditor is mandatory if the NV is either listed or categorized as larger than 'small'[60]. The other example is the GM's indirect right to establish an SB through an amendment to the articles. On the *positive agent incentives* side, the GM determines the remuneration policy of EDs and their actual remuneration only as far as it is in shares or options. The articles often attribute the actual remuneration to the SB.

Although the law, within the limits defined by the law and the articles[61], assigns all competences to the GM, unless assigned to the EB or others, the GM is *not* allowed *to instruct* the EB[62]. This principle of board autonomy (Dijk/Van der Ploeg, 2007: 185, 187) is vested in HR 21 January 1955, NJ 1959, 43 (*Forum–bank*). Or to paraphrase Klaassen (2009): the EB is responsible for the management (*bestuur*), the GM for the structure (*structuur*).

Supervisory board (SB)

The Dutch SB is a collegial board (Galle, 2007). NEDs may be held jointly and severally liable in the event of serious reproach or apparent mismanagement[63], which is a monitoring mechanism in itself[64]. The SB has a hybrid task: it monitors ('supervision') the EB on the one hand, and it co–operates ('assist with advice') with the EB on the other hand. The guideline of the members of the supervisory board in the performance of their duties is the interests of the company and the enterprise connected with it[65]. The directors' duties of NEDs are similar to those of EDs. The description is in the next section on the executive board. However, NEDs are not responsible for the mismanagement of an ED, but if they detect it when supervising, they should take immediate action for redress, HR 28 June 1996, NJ 1997, 58 (*Bodam Jachtservice*).

The SB is entitled to adequate information[66]. The determination of the *strategy* is in principle an EB task, to be supervised by the SB, ruled HR 13 July 2007, JOR 2007, 178 (*Bank of America/ VEB and ABN AMRO*, r.o. 4.3)[67]. For the 'ordinary NV' the law leaves it at that. In a 'structure NV' the SB *appoints*, suspends and dismisses the EDs. The SB may suspend a NED or request[68] the OK to dismiss a NED for e.g. negligence. The SB has a *decision* right in the form of a right to veto important EB decisions listed in the law such as the issue of new shares or large investments[69]. The articles may extend this list. For all NVs the *negative agent incentives strategy* applies in the SB right to supervise the management's policy and the general course of affairs of the company and to advise the EB. Applying those rights, e.g. in a take–over contest, may eliminate conflicting interests. Usually, the SB convenes together with the EB about six to eight times a year and only once or twice a year as a separate board. The law clearly assigns the management of the company to the EB[70].

Works council

The works council has a right to be informed and to convene with directors. It has a *decision* right in the form of a required approval of intended EB decisions on social matters such as regulations on working hours, holidays, rewards and job assessment systems, staff training programmes, promotion policy, and complaint procedures. The *negative agent incentives strategy* is important since it facilitates smooth transitions and avoids strikes. The right to advise on *company matters* concerns a planned merger, take–over, disposal, liquidation, important reorganization, new investment including new technologies and environmental measures, important financial arrangement, sick–pay risk bearing, and the commissioning of an expert to advise on such matters[71]. Moreover, the works council has the right to advise on the appointment and dismissal of an ED[72] and to formulate an opinion to be forwarded to – and if so desired by the works council to be clarified in – the AGM/EGM on the occasion of (1) an important change of identity or character of the NV[73]; (2) the appointment, suspension or removal of an ED or a NED[74]; (3) the adoption of the remuneration policy of EDs[75]. Moreover, in the 'structure NV' it has the right to nominate NEDs to the SB – and one–third of them even *de facto* to the GM – unless it consented to another regime in the articles[76]; to forward – and to clarify – its opinion to the GM on the recommendation of a NED[77]; or to request[78] the OK to dismiss a NED for e.g. negligence. Dutch law does not assign company law–related rights directly to employees. With one exception: in the absence of a works council in the case of a cross–border merger, the employee himself is entitled to information[79].

4.4.1.3 *Executive board (EB) and duties of directors*

Just like the SB, the EB is an internal monitor in itself since it is a collegial board and members may be held jointly and severally liable in the event of serious reproach or apparent mismanagement[80]. However, a director who proves to be not responsible for the failure and, depending on the situation, not negligent in taking measures for redress, is not liable[81].

The law assigns to the EB the internal ('charged with the *management* of the company') and external *representation* of the legal person[82]. In order to exploit the specialized management advantage of a legal person, the EB should have free rein. However, to avoid expropriation and other opportunistic behaviour, this free rein should be constrained through rules and standards. *Rules* can be found throughout the law and relate to two main areas of corporate life, the production of the annual accounts and the regular administration of the company (Davies, 2008: 377). *Standards* guide directors, EDs as well as NEDs, in performing their tasks, without limiting their options beforehand, as rules do. Dutch company law recognizes four of these standards. The *first* is that the *interest of the company* is the guideline. One recognizes a similarity to the *duty of loyalty* in UK law, which 'requires the director, when exercising discretion, to act *bona fide* in what he thinks is the best interests of the company' (Davies, 2002: 159; also 4.4.3.3). However, the UK standard is originally of a subjective nature, while the Dutch standard is formulated more objectively. Dutch law determines this standard for NEDs[83] and case law does for EDs[84]. The standard implies that the interests of all concerned should be part of the decision process. The *second* standard is that the legal person and parties concerned with its organization should behave according to the requirements of *reasonableness and fairness*[85]. This broad standard applies e.g. in minority shareholder cases. The Hoge Raad ruled in HR 13 July 2007, JOR 2007, 178 that the Dutch Code co-defines these requirements depending on the circumstances[86]. The *third* standard is that directors should *perform their functions with due care*, which resembles the *duty of care* in UK law. In the UK this has evolved into 'a reasonable person test' (Davies, 2002: 154). For the Netherlands, the Hoge Raad ruled in HR 10 January 1997, NJ 1997, 360 (*Staleman/Van de Ven*) that liability under this duty requires a 'serious reproach' to be determined depending on the circumstances as well as on 'the insight and care that can be expected of a suitable and conscientious director'. The *fourth* standard is on *conflict of interests* and is rather diffuse for various reasons. The law provides by default that NEDs should represent the company in the event of conflicting interests between executive directors and the company[87]. In HR 9 July 2004, NJ 2004, 519 (*Duplicado*), the Hoge Raad explained that this duty is aimed at preventing an executive director from being guided by (mainly) his personal interests instead of (exclusively) the interests of the company that he should serve. In HR 29 June 2007, NJ 2007, 420 (*Bruil*) the Hoge Raad required substantiation of the *specific* circumstances that could have influenced the directors' decision process. However, this default rule is often 'disabled' in the articles such that the executive director may represent the company at any rate. Of a mandatory nature is the provision that enables the GM to appoint *at any time* representatives for the company when interests conflict[88]. The Hoge Raad ruled in HR 3 May 2002, NJ 2002, 393 (*Joral*) that the EB is obliged to be transparent and to inform the GM in a timely manner about a conflict of interests in order to enable the GM to exercise this right. If the EB does not inform the GM in a timely manner, the decision taken may be nullified. The conflicting interest provision will be replaced shortly for the NV and the BV. The 'representation angle' will be replaced by a 'decision angle' wherein the director is forbidden to participate in the decision process if he has a 'direct or indirect personal interest that conflicts with the interests of the company'[89]. The DC

even requires the approval of the supervisory board in material transactions in which there are conflicts of interest[90].
A director owes the aforementioned duties primarily to the company. A director may breach his duties to a shareholder, and consequently a shareholder may sue a director personally, *only* in the event of a serious reproach related to *specific, individually assigned* rights to this individual shareholder (HR 20 June 2008, NJ 2009, 21, *Willemsen/NOM*). Chapter 5 of this thesis discusses whether and how these duties are owed to creditors.

4.4.1.4 *Pending changes in NV law*

There are changes pending in NV law on (1) the facilitation of a one–tier structure in Dutch law (NV and BV); (2) the prevention of abuse of legal persons (all legal persons); (3) an increase from 1% to 3% of the threshold to place an item on the agenda of an AGM/ EGM (NV only); and (4) a 'claw–back' of retrospectively unjustified bonuses (NVs and other financial legal persons). Annex 2 shows their status and content in some detail.

What would be their consequences in terms of *legal strategies*? The analysis follows figure 4.2. The *shareholder instrumental rights* in the NV will be fewer since the threshold will increase to 3%. The *GM* loses its *negative agent incentives* right to appoint representatives if interests conflict. Instead, the one–tier proposal introduces a director's duty to abstain from the decision process if interests conflict. The rights of the SB only change – if the NV decides to opt for a one–tier board – insofar as it is not an independent organ anymore and thus follows the rules directed at 'the board'. This implies that the *SB negative agent incentives strategy* changes into a collegial monitoring mechanism. In fact, the one–tier structure upholds as much as possible the internal mandatory structure as outlined in figure 4.2 since it assigns the competences presently assigned to the SB to the NED faction of the board. The *SB positive agent incentives strategy* will be strengthened through the possibility to 'claw–back' unjustified bonuses. The works council rights do not change. The *external* monitoring changes since the *ex ante* control of the formation authority is replaced by continuous monitoring. Thus, external monitoring will increase.

4.4.1.5 *External mandatory monitoring structure*

The lower part of figure 4.2 contains the *external monitoring mechanisms* of a legal/ political/regulatory nature. The *formation authority* is the notary who has a formal role. Government clearance is essentially directed at the antecedents of the people involved in its incorporation and in its board. The *external auditor* is mandatory if the NV is either listed or larger than 'small'. He should be appointed, in priority, by the GM, SB or EB. The *Wet toezicht accountantsorganisaties* (Wta) in 2006 strengthened the requirements for auditors of listed NVs and other important NVs (*organisatie van openbaar belang*; OOB). The *tax authorities* require an annual declaration and have the right to verify. In doing so, they can redress failures or even fraud. It does so generally in silence, although sensational dawn raids, seizures or prosecution cases sometimes become public[91]. The *disclosure authority* receives the data that a company is legally required to disclose. Negligence is a criminal offence[92] and may trigger the company's dissolution[93]. Of the *financial market authorities*, DNB is responsible for the macro and micro prudential supervision of financial companies[94], whilst AFM supervises the behaviour of financial market parties. Any party that has offered shares or bonds to the public falls under the AFM supervision, unless (1) the offer is directed at less than 100 people, or (2) the par value is at least €50,000, or (3) the total sum to be collected is less than €100,000 over 12 months[95]. Moreover, the AFM may check the compliance of the annual accounts and reports of securities–emitting institutions[96] (Santen and de Bos, 2006). The *judicial authority* may be the district court (*Rb*) (e.g. for the validity of corporate decisions; dismissal of directors; suppression or dissolution of the legal person[97]), the Enterprise Division of the Amsterdam Court of Appeal (*Ondernemingskamer, OK*; e.g. dismissal of NEDs in the 'structure NV'; the inquiry procedure 'in a *prima facie* case of mismanagement'[98]), the Rotterdam District Court (e.g. if the DNB refuses to clear candidates for a director's position in a financial institution[99]) or even the public prosecution service (*Openbaar Ministerie, OM*; e.g. if it requests the OK for an inquiry in the public interest[100]; or the EB of a *stichting* for information[101]). The *trade union* is not only a labour market factor but also an external monitor of a general nature, since it could request an inquiry if it has members amongst the company employees. The indistinct *publicity, interest groups and whistle–blowing* mechanisms are never mandatory in the actual sense of the word, but they are always in place as optional external monitors. Publicity and interests groups actually do influence company policy quite often. Whistle–blowing culture is not much developed. The DC forces listed companies to have a whistleblower procedure but there is no disclosure of its effect. Dutch judicial authorities are not very protective of whistleblowers. *Government agencies* may monitor NVs from their own specific point of view e.g. as regards construction, safety or health. Finally the *legislator* may see to an efficient but balanced approach of the governance system and change the law where it sees a flaw or a failure[102].

4.4.1.6 *Concluding remarks on the **NV***

Table 4.3 shows the strengths (+) and weaknesses (–) in the mandatory monitoring structure of the Dutch *NV*. Note (again) that the analysis only implies mandatory rights. The table evaluates six points of view: (1) appointment and dismissal (who appoints, suspends, dismisses, rewards), (2) accountability (all issues related to the accountability of directors for their activities), (3) veto (who has a veto right and on what issues; a decision right is classified as a veto right, since it may block any action), (4) company structure (mandatory organs), (5) directors' duties (including corporate model and co–determination) and (6) external monitoring. The evaluation scores mean:

- \+ predominantly strong on the issue from a monitoring point of view

+– strong as well as weak points on the issue from a monitoring point of view
– predominantly weak on the issue from a monitoring point of view.
The results stem directly from the above analysis and need no further comment.

Table 4.3: an evaluation of the mandatory monitoring structure of the Dutch NV.

internal monitoring	+/–	description
appointment / dismissal	+	not 'structure NV': GM appoints EDs and (two-thirds of) NEDs. A binding recommendation can be overruled by a qualified majority. GM determines the remuneration policy (all NV)
	–	'structure NV': SB appoints EDs. Default: GM appoints NEDs from an 'overrulable' binding recommendation by SB. Works council recommends $^1/_3$ NEDs. Articles may sideline GM.
accountability	+	GM adopts annual accounts, appoints auditor and releases directors from liability. Public disclosure through *Handelsregister*
	–	no mandatory audit for 'small' NVs unless listed
	–	DC requirements (listed) may dissolve in mandatory disclosure rules only
veto	+ –	GM decides on identity, capital, articles subject to approval or proposal provisions in the articles; and on major change of identity or character
	+	SB veto on important company decisions as listed in the law and in the articles
	+	works council veto on social matters
company structure	+ –	SB only mandatory for a 'structure NV'; mandatory works council if ≥ 50 employees
directors' duties	+	stakeholder approach / interests of the company *(het belang van de onderneming)*
	+ –	clear standards often need court clarification on issues e.g. conflict of interests, minorities
external monitoring	+	at least four. Easy access to OK in order to request an inquiry (*enquête*).
	–	no whistle-blowing culture

4.4.2 The German Aktiengesellschaft (AG)

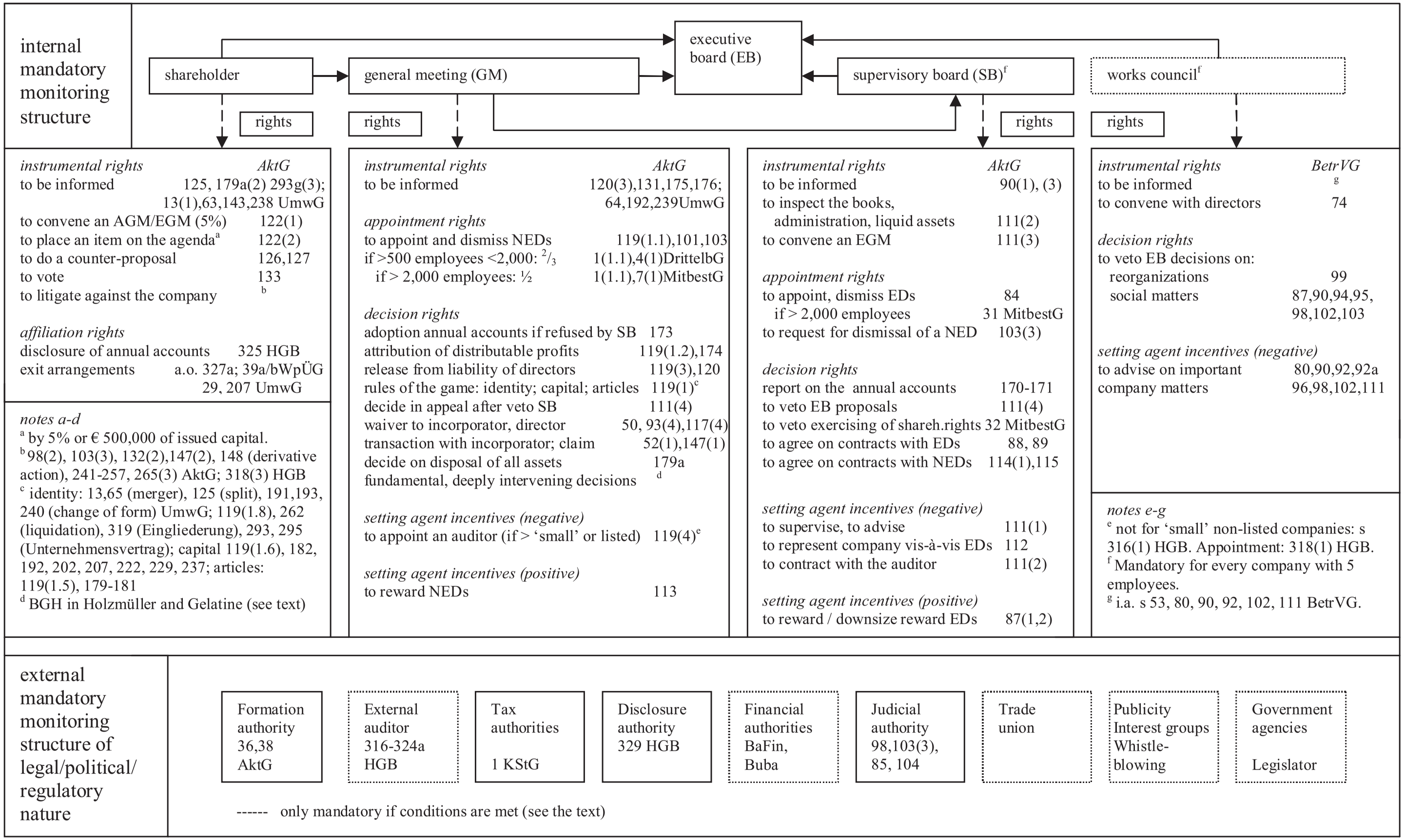
The forthcoming analysis rests on Schaub (1988), Schmidt (2002), Klaassen (2007), Maitland–Walker (2008), Schmidt and Lutter (2008) and Andenas and Wooldridge (2009).

4.4.2.1 *Formation and institutional structure*

Book 1 of the *Aktiengesetz* (AktG) essentially[103] defines the German public limited company (*Aktiengesellschaft;* AG). It contains mandatory law unless otherwise noted[104]. The AG is a legal person[105], which can already be formed by one person[106]. The word *Aktiengesellschaft* or a generally understandable abbreviation should be part of the company's name[107]. An AG is established once it is registered in the *Handelsregister*[108]. The court to which the request for registration is referred to performs a material check and may deny registration[109]. The articles, to be established in a notarial form[110], should contain the objects and branch[111]. The AG should have a minimum capital of €50,000[112] of which at least 25% is to be paid up before registration[113]. It may, but need not, be listed[114].

By law, an AG has a two–tier governance structure, with an EB[115] (*Vorstand*), a GM (*Hauptversammlung*) and *always* an SB (*Aufsichtsrat*) that consists of at least 3 people[116]. The composition of the EB and SB is partly determined by various co–determination laws[117].

Figure 4.3: German public limited company (AG): mandatory monitoring structure



If the AG counts over 500 employees[118] the *Drittelbeteiligungsgesetz* (DrittelbG) requires one–third of the NEDs to be directly elected employee–representatives of which at least two should be employed by the AG[119], whilst reflecting the gender ratio in the company[120]. If there are over 2,000 employees the *Mittbestimmungsgesetz* (*MitbestG*) applies. It prescribes the mandatory appointment of a personnel director[121] (*Arbeitsdirektor*) in the EB and the appointment of half of the NEDs[122] by the employees, either directly or indirectly[123]. One of the NEDs must be a manager[124]. A mandatory division of the labour–appointed NEDs between employees and representatives of trade unions is provided for[125]. The Chair of the SB, who has a casting vote[126], is to be chosen by either a two–thirds majority or, if this does not work out, by the GM–appointed NEDs[127]. The *Betriebsverfassungsgesetz* (BetrVG) makes a works council (*Betriebsrat*) mandatory for every institution[128] with five employees, of which three are eligible[129]. It consists of one (for up to 20 employees) to 35 members (for 9,000 employees)[130] and should reflect gender proportions[131]. The law provides for working in smaller committees[132]. Some members may be exempt from their duties[133].

Germany has its own corporate governance code for listed companies[134], the *Deutscher Corporate Governance Kodex*, hereinafter referred to as the *German Code* (GC). It is enforced through a 'comply or explain rule' in the AktG[135].

4.4.2.2 *Internal mandatory monitoring structure*

Figure 4.3 shows the mandatory monitoring structure of an AG. It is clearly a rather stakeholder–oriented model of corporate governance (Glozbach, 2008). In the full–blown picture, the AG has four internal and possibly nine external monitoring mechanisms. The one–man AG still encounters at least one internal monitor and four external monitoring mechanisms.

Shareholders

Shareholders have the *instrumental* right of information at the GM about items relevant to the agenda[136]. The EB may deny information e.g. if this would cause a non–insignificant disadvantage[137]. The shareholder may appeal to the court in the case of a refusal[138]. With 5% of the issued shares one may request a GM; and with 5% or €500,000 one may request that items be placed on the agenda[139]. The court may authorize a shareholder to convene a meeting[140]. Every shareholder has a voting right. Polls are decided by a simple majority, unless otherwise noted[141]. The articles may contain a voting cap[142]. Shareholder litigation often relates to the protection of minorities, e.g. regarding information, nullity of decisions. 1% of the shareholders (or holders of €100,000 issued capital) can already request permission from the court for a 'derivative action'[143]. A shareholder representing 10% of the issued capital may request the court to dismiss a GM–appointed NED[144]. *Affiliation* rights are provided for regarding the mandatory disclosure of the annual accounts[145] as well as exit arrangements for minority shareholders.

General meeting (GM)

The list of GM competences in s 119 AktG is by no means complete[146]. The GM has the *instrumental* right that the annual accounts and report as well as attachments defined in the law be made available to the GM before the meeting. The EB and the chairman of the SB should clarify their contributions to the reports[147]. The GM *appoints* and dismisses[148] the NEDs, insofar as they are not appointed by employees[149] or other parties[150]. It *decides* on the adoption of the annual accounts only if the SB has vetoed, or if the EB and SB decide it should be left to the GM[151]. It in any case decides on the attribution of the distributable profits and on the release from liability of directors. The decisions on '*alle mit dem wirtschaftlichen und rechtlichen Aufbau der Gesellschaft zusammenhangende Fragen*', i.e. the legal and economic structure of the company, belong to the GM (Kropff, 1965: 165). Such GM decisions may not, unlike under Dutch law, be subject to the approval of other company organs (Klaassen, 2007: 148). The law lists those mandatory competences[152]. They are limited as well: the GM may decide only if the law or the articles so prescribe, or if the EB so requests[153]. However, this strict division between 'structure' and 'management' has been mitigated[154]. In BGH, 25.02.1982, BGHZ 83, 122 (Holzmüller), the *Bundesgerichtshof* ruled that in 'fundamental decisions (..) intervening deeply into the member and equity rights of the shareholders, the EB could not reasonably hold that it could decide itself without involvement of the shareholders[155].' The legislator subsequently incorporated a provision, requiring a GM decision if a company wishes to transfer all of its assets[156]. In BGH 26.04.2004, BGHZ 159, 30 (Gelatine) the *Bundesgerichtshof* clarified the earlier decision and limited the decisions to be laid before the GM as 'touching the core competence of the GM to determine the articles and coming close to an effect that could only be achieved by amendment of the articles'[157]. The *negative incentives* strategy is deployed in the GM right to appoint the auditor if the AG is categorized as larger than 'small'[158] or if it is listed[159]. One recognizes the *positive incentives* strategy in its right to determine the reward of NEDs. Recently, this strategy was extended for listed companies by a right to decide on the rewards system for EDs. However, this vote is not mandatory[160].

Supervisory board (SB)

The task of the SB is primarily of a supervisory nature[161] but the literature as well as the GC stresses the advisory role as well[162]. The list of competences in s 111 AktG is by no means complete[163]. The *instrumental* rights in figure 4.3 contain the right to convene an EGM '*wenn das Wohl der Gesellschaft es fordert*' ('if the interests of the company so require'); the right to inspect the administration and the liquid assets; the right to be informed by the EB at regular intervals prescribed by law on intended strategy, planning, results, important issues; and the right to require information from the EB at any time on company related issues[164]. Jungmann (2006: 452) points out that this right to information on strategy implies an increased involvement of the SB in strategic decisions. This is reflected in GC 3.2 which states that the EB 'coordinates the strategic approach with the SB and discusses the current state of *strategy* implementation with the SB in regular intervals'. The *appointment*, dismissal and reward[165] of EDs by the SB are arranged for in the *Aktiengesetz* but for proper application one also has to consult, if applicable, the *Mitbestimmungsgesetz*[166]. Dismissal of EDs is only possible in the case of gross negligence, incompetence and withdrawal of confidence by the GM[167]. Unlike in the Netherlands, a court may reverse a dismissal. The SB may request the court to dismiss a NED on important grounds concerning the person of the NED[168]. The *decision* rights of the SB may stem from the law, from the articles or from a decision by the SB itself, that specific kinds of decisions need their approval[169]. However, management tasks cannot be transferred[170]. The SB veto right is a means of taking supervision seriously and preparing a list of issues to be approved by the SB is considered an SB duty[171]. If a company is a shareholder in another *mitbestimmte* company, it can apply its shareholder rights – in short those concerning appointment and the rules of the game – only if the majority of the shareholder-NEDs agree[172]. Moreover, the SB has to approve loans to EDs and NEDs. EDs should ask permission of the SB to transact, either personally or through another company or partnership, in the company branch, or to be an ED in another company[173]. Activities of a NED for the company in addition to the non-executive duty should be approved by the SB. Payments to NEDs that are not approved should be reimbursed[174]. The SB has to examine the annual accounts, although it is not exactly clear what this implies[175]. The SB should report to the GM on the results of the examination[176]. Normally the SB approves the annual accounts, unless EB and SB decide to leave it to the GM[177]. The *negative incentive* strategy applies since the SB supervises and advises the EB. It represents the company vis-à-vis the EDs. This is stricter than Dutch regulation[178]. And although the GM appoints the auditor, the SB negotiates the contract with the auditor[179]. The law deploys a *positive incentive* strategy to fix the rewards of EDs or even to adapt them downwards if the situation of the company so requires[180].

From 1998 the law requires the SB to convene at least two times each half year[181]. Jungmann (2006: 454) refers to studies showing this frequency was common practice up to 1998, resulting in a shockingly low NED workload calculated at 14 hours and 13 minutes per year.

Works council

The works council is elected directly by and from the employees[182]. Trade unions do not play a role: their task is exclusively restricted to wage negotiations[183] although a representative may be invited to works council meetings[184]. Concerning the *instrumental* rights, the works council meets once a month with the employer[185]. Disclosure of *information* is prescribed in general[186] and in respect of specific subjects, e.g. investments in factories[187], planning of personnel[188], dismissal[189], the annual accounts and company reorganizations[190]. The law accounts for a large number of *decision* rights. A *veto* right exists in case of company reorganizations albeit on limited grounds mentioned in the law[191]. *Co–determination* is arranged for in social matters[192] (e.g. company regulations, working hours, holidays, labour conditions, security, salary systems) unless these issues have already been settled with the trade union; for company training measures[193], personnel forms[194], order of dismissal[195], assessment principles[196] and dismissal in special cases[197]. The law urges parties to strive seriously for a solution and to consider an intermediate solution[198] and provides for a settlement arrangement (*Einigungstelle*) in case parties cannot reach agreement[199]. The *negative agent incentives strategy* is deployed through a large number of consultation rights. *Hearing* is provided for in respect of proposals to the employer[200] or dismissal[201]. *Consultation* is obliged in the case of e.g. large investments[202] or company reorganization[203]. The council has a right of *initiative* in respect of personnel planning and other labour conditions[204] (e.g. job security, part–time employment, flexible working hours), and in respect of vocational training[205]. A corporate works council throughout the corporation may be established at the request of the individual works councils[206].

Employee democracy is substantiated by some other measures. *Firstly* by the prescription of a general meeting of all employees (*Betriebsversammlung*), to be held four times a year or on request[207]. *Secondly*, 5% of the employees are entitled to propose agenda items for the works council[208]. *Thirdly* employees have a right to elect, directly or indirectly, and dismiss their representatives in the SB if co–determination applies[209].

4.4.2.3 *Executive board (EB) and duties of directors*

The EB is responsible for the management as well as the representation of the company[210]. It coordinates the firm's strategic approach with the SB[211]. German law applies the collegial board principle. Directors act within the framework of the EB respectively SB[212]. If they have divided up their work, one director is only then liable for the other's failure, if he neglected his monitoring duty. This is the case if there were signs of negligence, and the other director did not react[213]. The AktG contains an identical provision for the *duty of care* and the responsibility of EDs and NEDs[214]. They should apply the 'care of a careful and conscientious businessman' (*die Sorgfalt eines ordentlichen und gewissenhaften Geschäftsleiters*). Their information should be in conformity with 'the principles of a rigorous and faithful account'[215]. For EDs and NEDs the law contains the Business Judgement Rule (BJR), which means that a decision is supposed to have been taken with care if the director could have reasonably thought, based on relevant information, that the decision was in the interests of the company[216]. The BJR had already been formulated by the *Bundesgerichtshof* in BGH 21.04.1997, BGHZ 135, 244 (ARAG/Garmenbeck) where the BGH attributed to the EB 'a wide free space to act'[217]. The judgement is rather general in its formulation and Schmidt (2002: 425) is of the opinion that the BJR applies throughout German law. The law reminds both EDs and NEDs explicitly of their duty of confidentiality (*Verschwiegenheitspflicht*)[218]. In the case of asserted dereliction of duty, the burden of proof is on the directors[219]. If the company has paid for D&O insurance, only EDs have an excess of 10% with a maximum of 150% of their annual fixed pay[220]. One would look in vain for a general *duty of loyalty* in the AktG. However, a similar concept derives from the *Bürgerliches Gesetzbuch* (BGB), the *Treuepflicht*[221]. In every legal relationship, and consequently in every association, there are duties of loyalty (Schmidt, 2002). The *Treuepflicht* should be understood as 'a general appraisal and restriction on the interests and competences of the members'[222]. It applies as opposed to the members as well as to the company[223]. The provisions on the use of corporate opportunities, business judgement rule, secrecy, conflict of interests and non-competition originate from this *Treuepflicht*[224]. The law provides for joint and several liability of executive directors to the company[225] and eventually, in the event of coarse negligence, to the creditors as well.[226] The same rules apply, *mutatis mutandis*, to NEDs.

4.4.2.4 *External mandatory monitoring mechanisms*

The *registration* authority has already been discussed above. The verification made is not purely formal. The external *auditor* is to be appointed by the GM unless the AG is not listed and small[227]. Every company, from AG to Stiftung, has to file an annual *tax* return[228]. Corporations that, according to their articles *and* their actual activity, only and directly serve public benefit, charitable or religious purposes are exempt[229]. The *disclosure* authority checks whether the disclosure is made in time and is complete. One risks a fine for negligence[230]. BaFin (*Bundesanstalt für Finanzdienstleistungsaufsicht*) supervises credit institutions, insurance undertakings, financial services institutions and investment companies. BaFin and Deutsche Bundesbank share banking supervision. Their co-operation is governed by section 7 of the Banking Act, which stipulates that the Deutsche Bundesbank will i.a. analyse the reports and returns that institutions have to submit and assess whether their capital and risk management procedures are adequate. The *trade unions'* role is not only labour market-related, since they also have representatives in the SB (not in the works council). *Whistle-blowing* protection is in practice restricted to scarce safety-related provisions. Schmidt (2005) explains that case law focuses on the dismissal risk. The duty of loyalty of an employee to the employer requires that any concern be raised internally first. External whistle-blowing however is not principally forbidden, but it should be clear to the court that the interests of society in clarification must outweigh the loyalty obligation[231].

4.4.2.5 *Concluding remarks on the AG*

Klaassen (2007: 58) concludes that the organization of the AG is characterized by equiva–lence of the GM, EB and SB. Table 4.4 underlines this conclusion by showing the strengths (+) and weaknesses (–) in the mandatory monitoring structure of the German *AG*. The results stem directly from the above analysis and need no further comment.

Table 4.4: an evaluation of the mandatory monitoring structure of the German AG.

internal monitoring	+/–	description
appointment / dismissal	+	GM appoints, dismisses (at least half of) NEDs and determines their remuneration
	+ –	SB appoints, dismisses EDs and determines their remuneration
accountability	+ –	SB or GM adopts the annual accounts. GM appoints auditor, releases directors from liability
	+	Disclosure through *Handelsregister*
	–	no mandatory audit for 'small' AGs unless listed
	–	GC requirements (listed) may dissolve in mandatory disclosures only
veto	+ –	Limitative list of GM rights. No instruction right. GM decides on identity, capital, articles
	+	GM veto on disposal of all assets; and on fundamental, deeply intervening decisions with a similar effect as an amendment to the articles (Holzmüller/Gelatine)
	+ –	SB veto on EB decisions listed in the articles
	+	works council veto on social matters
company structure	+	mandatory SB + co-determination > 500 empl.; mandatory works council if ≥ 5 employees
directors' duties	+	stakeholder approach / interests of the company (*zum Wohle der Gesellschaft*)
	+ –	*Sorgfalt*, *Treuepflicht*, *Verschwiegenheitspflicht*; no conflict, no corporate opportunities; BJR
external monitoring	+ –	at least four. Manifold court access. No whistle-blowing culture

4.4.3 The UK public limited company (Plc)

The forthcoming analysis rests on Davies (2008), Andenas and Wooldridge (2009), Maitland–Walker (2008), Davies (2010) and Pettet (2001) for historic references.

4.4.3.1 *Formation and institutional structure*

The UK *Companies Act 2006* (CA) defines one generic broadly applicable company form[232] for the public limited company (*Plc*)[233], the private limited company (*Ltd,* see 4.5.3)[234] and the community interest company (*CIC*, see 4.7.3)[235]. Since the company's objects are unrestricted[236] profit as well as not–for–profit companies can use it. CA sections and regulations[237] based on the CA may contain specific provisions applicable to one specific form. The public limited company may emerge in two forms: as a company limited by shares or as a company limited by guarantee and having a share capital. Formation of the latter form is not allowed any more[238]. The name of a limited company that is a public company must end with 'public limited company' or 'Plc'[239]. One person may already form a Plc[240]. The certificate of incorporation should state that it is a public company[241]. It is established by registration[242]. The registrar registers once the requirements of registration have been complied with[243]. It is a legal person with a minimum allotted share capital of £50,000[244] of which one-quarter of its nominal value and the whole of any premium on it should be paid up[245]. A Plc may be quoted and unquoted[246]. The CA contains specific provisions for quoted companies[247].

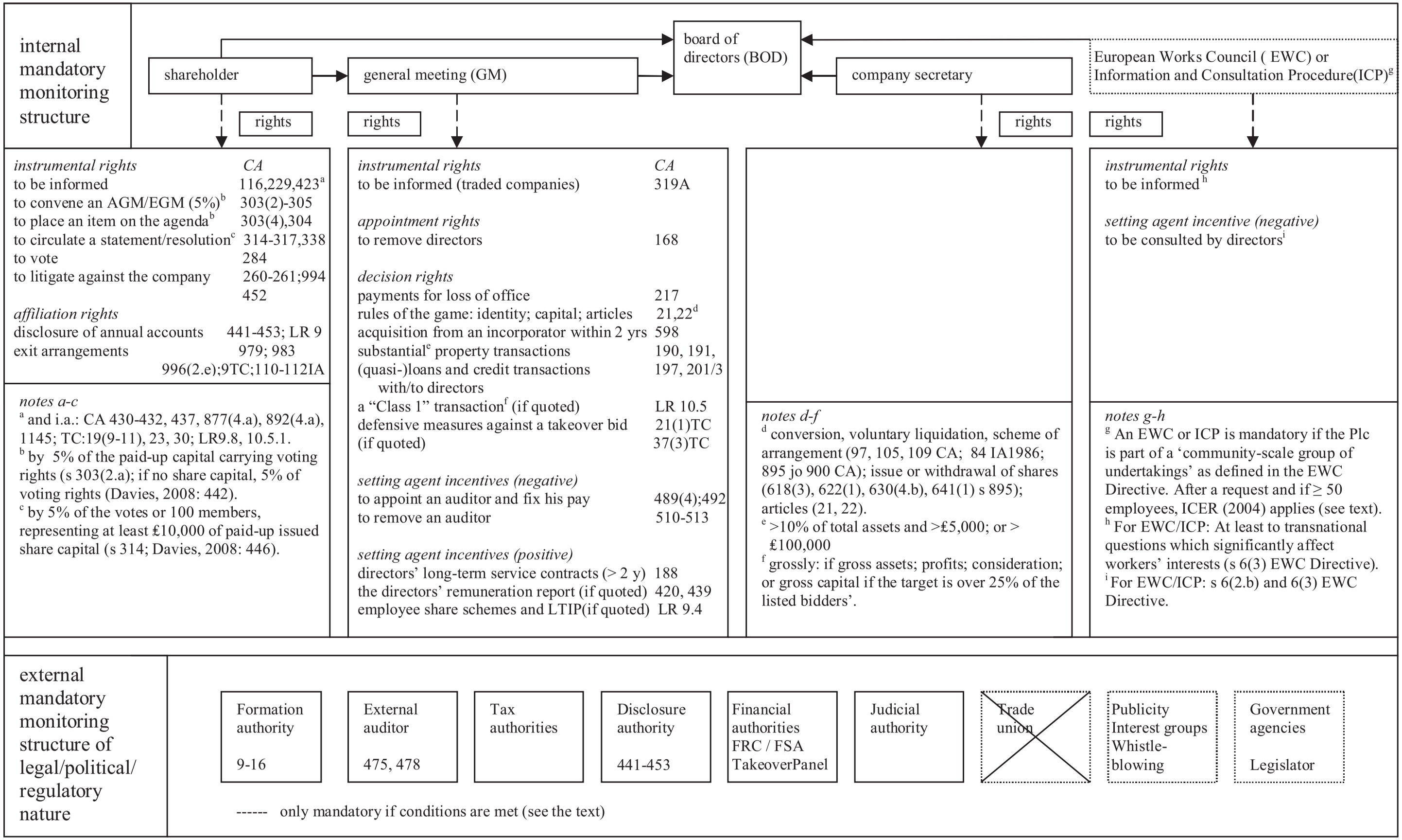
The CA provides mandatory law but it leaves many institutional choices to the articles[248]. The Model Articles for Public Companies contain default rules[249]. Mandatory for the Plc is a one-tier governance structure with at least two directors, one of which should be a natural person[250]; members, who may pass a resolution at a meeting[251]; and a company secretary[252]. Although the law refers mostly to the director, it refers to a board of directors (BOD) as well[253]. UK law does not consider the GM to be a company organ[254]. If a resolution is passed, it becomes a company resolution[255]. A works council is still a rare phenomenon in the UK due to the special position trade union representatives have in the company[256]. However, if a Plc is part of a 'Community-scale group of undertakings', being a group of at least two undertakings in different member states with at least 1,000 employees and at least 150 employees in each of two member states, the Council Directive on the establishment of a European Works Council (EWC)[257] applies. The Directive prescribes either the establishment of an EWC or of 'an information and consultation procedure' (ICP)[258] to which section 4.4.3.2. *in fine* refers.

Listed Plcs have to abide by additional sets of rules[259]. The *UK Code on Corporate Governance* (UKC), issued by the Financial Reporting Council (FRC), is 'soft law'[260] enforced by a hard obligation to 'comply or explain'. The Listing Rules require UK registered companies with a primary listing in the UK to disclose the extent to which they have complied with the UKC and to give reasons for non-compliance[261]. Both the *Listing Rules (LR)*, regulated by the FSA, and the *Takeover Code (TC)*, regulated by the Panel on Takeovers and Mergers[262], contain mandatory rights for shareholders to be discussed below.

4.4.3.2 *Internal mandatory monitoring structure*

Figure 4.4 shows the mandatory monitoring structure of a Plc. In the full-blown picture the Plc has five internal and possibly eight external mandatory monitoring mechanisms. The one-man-Plc still encounters internally a company secretary and externally six external monitoring mechanisms. The UK legislator has chosen to organize the company through a default system. Therefore there are relatively few mandatory rights. Regulations issued by the Secretary of State contain different model articles for the Plc and the Ltd. However, a company may adopt or exclude all or any of the provisions of the model articles[263].

Figure 4.4: UK public limited company (Plc): mandatory monitoring structure



Shareholders

The predominant *instrumental rights* of shareholders are to be informed and sometimes to receive copies or to inspect. This ranges from the index of member names, via the director's service contract[264] or the information related to a public offer, to the annual accounts and reports. The latter are the directors' report (DR) and, only for listed companies, the directors' remuneration report (DRR)[265], including the auditor's report. If the requirement to disclose directors' benefits is not met, the auditor must include in his report a statement giving the required particulars[266]. Five percent of the voting rights are sufficient to require directors to call an EGM. The request may include a resolution and if so, the notice of the meeting must include notice of the resolution[267]. Five percent or one hundred members may require circulation of a statement or a resolution for the AGM[268]. The articles may circumvent the 'one share, one vote' principle[269]. Shareholders have several judicial procedures open to them. Three important ones are mentioned. The *derivative suit* is open to each shareholder in respect of a cause of action vested in the company, and seeking relief *on behalf of the company*. The cause of action should arise from an actual or proposed act or omission involving negligence, default, breach of duty or breach of trust by a director of the company[270]. A shareholder who brings a derivative claim must apply to the court for permission to continue[271]. A second procedure is the *unfair prejudice* procedure. It applies on the ground that the company's affairs are being or have been conducted in a manner that is unfairly prejudicial to the interests of members in general or of some part of its members (including at least the petitioner), or that an actual or proposed act or omission of the company is or would be so prejudicial[272]. The third important action of a shareholder relates to the *annual accounts*. Members may apply to the court for an order directing directors to file accounts and reports if they did not comply with this duty[273]. Shareholders do not have a role in the case of defective accounts. Although these judicial procedures are of an *ex post* nature, one may consider their mere existence as a *negative agent incentive strategy* in the sense that directors have a reputational incentive to avoid them.

The first *affiliation* right of shareholders is the required public disclosure of the annual accounts through the registrar, *Companies House*. A 'small company regime' for the Plc does not exist[274]. The second category of affiliation rights contains the various *exit* rights. In the event of a takeover offer[275] the offeror who has acquired 90% of the shares has the right to buy out ('squeeze-out'[276]) the minority shareholders, whereas likewise the minority shareholder has a right to be bought out by the offeror ('sell-out'[277]). The merger procedure through liquidation contains an *appraisal* right, meaning that a member may require the liquidator to purchase his interest at a price to be determined by agreement or by arbitration[278]. The 'unfair prejudice' procedure has a similar arrangement[279].

General meeting (GM)

An AGM is to be held at least once a year[280]. Recently a new provision was added concerning the right to ask questions in the GM of a traded company[281]. The GM of a public company decides at meetings by ordinary or by special resolution[282]. If the law mentions a 'resolution' or an 'ordinary resolution' it requires a simple majority. The articles may provide for a higher majority. A legal provision for a 'special resolution' requires a 75% majority. Two members are the quorum subject to the articles[283]. On the *appointment* side, the GM only has a mandatory right to remove directors[284]. However, it has a fairly broad range of *decision* rights. The members decide on the structure of the company through their mandatory rights concerning the corporate identity, capital-issues and an amendment to the articles[285]. For amendment to the articles a special resolution is needed, but 'provisions for entrenchment' to the effect that conditions have to be met or procedures have to be complied with that are more restrictive than a special resolution are valid[286]. To which the law adds that any power of a court or other authority to amend a company's articles remains unaffected[287]. A 'fusions and mergers' chapter does not exist[288]. The 'schemes of arrangement' fill this function and can be used in a number of other cases[289]. A wide range of BOD *decisions* are subject to GM approval as well. The CA forbids acquisitions from an incorporator (*promoter*) within two years after the trading certificate has been issued[290]. It forbids as well substantial property transactions, loan, guarantee or credit transactions and payment for loss of office with or to directors or connected persons, without shareholder approval. The Listing Rules provide for shareholder involvement in major decisions that are outside the ordinary course of the listed company's business and may change a security holder's economic interest[291]. For a large, so-called "Class 1" transaction[292] the company must send an explanatory circular to its shareholders and obtain their prior approval at an EGM for the transaction[293]. The Takeover Code requires shareholder approval of defensive measures to be taken once a takeover offer is imminent[294]. Regarding the annual accounts and reports, the BOD approves them and the GM has no approving role[295]. In addition to the obligation to send accounts and reports to the members, directors of public companies must lay the accounts and reports before the GM[296]. The GM must be afforded an opportunity to discuss them[297]. A *(negative) setting agent incentives* right is the GM right to appoint or remove the auditor. There is no exemption for 'small' Plcs[298]. A *(positive) setting agent incentives* right is that the GM should approve service contracts with directors if they last over two years. Another is the GM's 'advisory vote' in quoted companies on the annual remuneration report, which is advisory in the sense that no director's entitlement is conditional on a positive vote[299]. The LR require shareholder approval of employee share schemes and long-term incentives plans (LTIPs).

The division of powers between board and shareholders is mainly a matter for the articles[300]. If they follow the default rule of the Model Articles that 'subject to the articles, the directors are responsible for the management of the company's business'[301], then modern doctrine expresses that 'they, and they alone can exercise these powers'[302]. However, the Model Articles present an escape in a 'shareholders' reserve power' as they may, by *special* resolution (as would be needed to change the articles), direct the directors to take, or refrain from taking, specified action[303]. On top of this, the GM may remove directors at any time by ordinary resolution. This all may induce directors to follow the shareholders' vision[304].

Company secretary

The law does not define the company secretary's role. Much will depend on the articles, the contractual terms of employment and the size of the company involved. Essentially, the tasks are of a compliance and organizational nature[305].

European Works Council (EWC) or Information and Consultation Procedure (ICP)

In the circumstances described in 4.4.3.1 an EWC[306] has to be established unless parties negotiate and settle for an ICP. Either way, at the very least an information and consultation duty of the board is to be arranged for[307]. As a consequence of the EU Information and Consultation Directive of 2002[308] the ICER (2004) has extended this duty 'on receipt of a valid employee request'[309] to all undertakings[310] employing at least 50 employees in the UK. Consultation means the exchange of views and establishment of a dialogue between employees' representatives and management[311]. Parties are under a duty to work in a spirit of co-operation and with due regard for their reciprocal rights and obligations, taking into account the interests of both the undertaking and the employees[312]. Since in the European context parties are free to settle for an ICP and determine its content and in the UK context a negotiation is foreseen as well, a mandatory minimum on the content of the information and consultation cannot be filled out in figure 4.4. However, if the standard provisions of ICER 2004 come to apply, consultation is only foreseen on 'the situation, structure and probable development of employment' and 'decisions likely to substantial changes in work organisation or in contractual relations'[313].

4.4.3.3 *Board (BOD) and duties of directors*

UK company law says little or nothing about the structure and composition of the BOD which makes its position in company law deeply ambiguous (Davies, 2008: 361). However, the UKC provides for a clear framework as it states: 'Every company should be headed by an effective board, which is collectively responsible for the long-term success of the company'[314]. This is the collegial board principle[315]. Its role is threefold: (1) to provide *entrepreneurial leadership* of the company within a framework of prudent and effective controls which enables risk to be assessed and managed; (2) to set the company's *strategic aims*, ensure that the necessary financial and human resources are in place for the company to meet its objectives and review management performance; (3) to set the company's *values and standards* and ensure that its obligations to its shareholders and others are understood and met[316]. Although the CA 2006 does not recognize NEDs, the

UKC does: 'The board should include an appropriate combination of executive and non-executive directors (and, in particular, independent non-executive directors) such that no individual or small group of individuals can dominate the board's decision taking'[317]. Executive directors are responsible for the running of the company's business[318], whilst non-executive directors have a role in service, control and strategy. Or in the wording of the UKC[319]: 'As part of their role as members of a unitary board, non-executive directors should constructively challenge and help develop proposals on *strategy*. Non-executive directors should *scrutinise* the performance of management in meeting agreed goals and objectives and *monitor* the reporting of performance. They should satisfy themselves on the *integrity* of financial information and that financial controls and systems of risk management are robust and defensible. They are responsible for determining appropriate levels of *remuneration* of executive directors and have a prime role in *appointing*, and where necessary removing, executive directors, and in succession planning.' The Institute of Directors considers the main principles of the Code a useful starting point for reviewing governance structures and processes[320]. The CA provides only that the BOD is *externally* unrestricted to bind the company[321], but *internally* it is only by default rule[322], as discussed above, that 'the directors are responsible for the management of the company's business' which means 'they, and they alone'.

UK company law is beyond doubt the most detailed in describing directors' duties. Whilst these duties used to be derived from common law (and they still are for non-CA companies, see 4.6.3.3), for companies they have been provided for in the CA since 2006. Table 4.5 summarizes them in wording close to the text of the law. One easily detects the main duties of the common-law system. The *duty of care* provision in s 174 CA[323] clarifies that the objective 'reasonable person' test delivers the bottom line quality, which may be enhanced by the (subjective) specific director's skills. The pure form of the *duty of loyalty* in s 172 CA is rephrased as the duty 'to promote the success of the company for the benefit of its members as a whole'. In doing so, it should have regard to e.g. the consequences in the long term; and the interests of the employees, suppliers, customers, community and environment. This reflects an enlightened shareholder approach. Whilst this duty of loyalty is essentially of a subjective nature, common law derived four objective duties from this standard and the law even five. The first is to act within powers, which is a conjunction of *obeying the constitution.* Note that 'the constitution' means the articles as well as resolutions and agreements[324]. The *no fettering rule*, rephrased as the duty to exercise independent judgement[325], implies that directors owe independent judgement to the shareholders, which is based on their fiduciary duties to the shareholders. This is even so for directors who are appointed to represent specific interests. For them too, the interests of the company as a whole precede (Davies, 2010: 183). Sections 175, 176 and 177 CA all deal with different manifestations of the no-conflict principle (Davies, 2008: 559). The first focuses on exploitation by a director of property, information or (other) corporate opportunities. In common law this is 'the rule against secret profits',

Table 4.5: overview of directors' duties according to the Companies Act 2006

CA	header	shortened description of directors' duty
171	Duty to act within powers	(a) to act in accordance with the company's constitution, and (b) only exercise powers for the purposes for which they are conferred.
172	Duty to promote the success of the company	to act in the way the director considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to (a) the likely consequences of any decision in the long term, (b) the interests of the company's employees, (c) the need to foster the company's business relationships with suppliers, customers and others, (d) the impact of the company's operations on the community and the environment, (e) the desirability of the company maintaining a reputation for high standards of business conduct, and (f) the need to act fairly as between members of the company. (3) This duty has effect subject to any rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company.
173	Duty to exercise independent judgment	to exercise independent judgment. This duty is not infringed by his acting (a) in accordance with an agreement duly entered into by the company that restricts the future exercise of discretion by its directors, or (b) in a way authorised by the company's constitution.
174	Duty to exercise reasonable care, skill and diligence	to exercise reasonable care, skill and diligence. This means the care, skill and diligence that would be exercised by a reasonably diligent person with (a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company, and (b) the general knowledge, skill and experience that the director has.
175	Duty to avoid conflicts of interest	to avoid a situation in which he has, or can have, a direct or indirect interest that conflicts, or possibly may conflict, with the interests of the company. (2) it is immaterial whether the company could take advantage of the situation. (3) this duty does not apply to a conflict of interest arising in relation to a transaction or arrangement with the company. (4) it is not infringed (a) if the situation cannot reasonably be regarded as likely to give rise to a conflict of interest; or (b) if the matter has been authorised by the directors. (5) authorisation may be given by the directors (see s 175 and the constitution). (6) The authorisation is effective only if (a) any requirement as to the quorum at the meeting at which the matter is considered is met without counting the director in question or any other interested director, and (b) the matter was agreed to without their voting or would have been agreed to if their votes had not been counted.
176	Duty not to accept benefits from third parties	not to accept a benefit from a third party conferred by reason of (a) his being a director, or (b) his doing (or not doing) anything as director. (4) This duty is not infringed if the acceptance of the benefit cannot reasonably be regarded as likely to give rise to a conflict of interest.
177	Duty to declare interest in proposed transaction or arrangement.	to declare to the other directors the nature and extent of any interest, directly or indirectly, in a proposed transaction or arrangement with the company. (4) Any declaration required must be made before the company enters into the transaction. (5) A declaration of an interest in a transaction of which the director is not, or ought not reasonably be, aware of is not required. (6) A director need not declare an interest (a) if it cannot reasonably be regarded as likely to give rise to a conflict of interest; (b) if, or to the extent that, the other directors are already aware of it (and for this purpose the other directors are treated as aware of anything of which they ought reasonably to be aware); or (c) if, or to the extent that, it concerns terms of his service contract that have been or are to be considered (i) by a meeting of the directors, or (ii) by a committee of the directors appointed for the purpose under the company's constitution.

Note: In the table various paragraphs are omitted. Numbers and letters between brackets are the original numbers and letters from the text of the CA.

also known as the 'no–profit' rule[326]. The duty is not infringed if the matter has been authorized by the directors[327]. *Bribery* is forbidden in s 176 CA (Davies, 2010: 182). The common law *rule against self–dealing* is specified in s 177 CA and focuses on the director, interested in a proposed transaction or arrangement with the company. Directors must declare their interests to the other directors beforehand.

More than one of the general duties may apply in any given case[328]. With the text and Davies (2008, Chapter 16) in mind, there is a lot to comment on as regards these sections and it is tempting to do so, e.g. on the curious cohabitation of statutory law in the CA and the interpretation of these principles *in the same way as common law rules or equitable principles*[329]. This however would go far beyond the scope of this comparative chapter of this thesis. Finally it should be noted that directors owe their duties to the company, and not directly to the shareholders, unless there is 'a special factual relationship' between the directors and the shareholders in a particular case[330].

4.4.3.4 *External mandatory monitoring structure*

Of the external monitoring mechanisms, the *registrar (Companies House)* is the formation authority. It is a formal type of monitoring as the registrar may accept the statement of compliance to be issued by the incorporators as sufficient evidence of compliance[331]. The *auditor's profession* is heavily regulated, influenced by the early new millennium events as well as European plans and Directives[332]. The FRC oversees the whole auditors–related spectrum, from qualifications and standards to discipline, through a number of operating bodies[333]. The tax authority, *HM Revenue & Customs (HMRC)*, requires every company to file its Company Tax Return annually. Exemption is only possible for a charity (see 4.8.4). Under special conditions the commissioners of HMRC may disclose information to third parties[334]. The *registrar of companies* is responsible for filing all the documents delivered by the company. If the company is in default, the registrar may give notice to the company requiring that it comply within 14 days[335]. The rate of compliance with the filing deadlines is around 95%[336]. An unlimited company is not required to deliver accounts and reports[337]. The *FSA* is responsible for the prevention of (financial) market abuse. It issues the Listing Rules (LR) and the Code of Market Conduct[338]. Every quoted company has to comply with the rules and competences of the FSA[339]. The *Panel* on Takeovers and Mergers (the "Panel") is an independent body whose main functions are to issue and administer the City Code on Takeovers and Mergers and to supervise and regulate takeovers and related matters. Its central objective is to ensure fair treatment for all shareholders in takeover bids[340]. In the case of defective accounts, the *Financial Reporting Review Panel (FRRP)*, an operating body of the FRC, is authorized by the Secretary of State to apply for a court order to prepare revised documents[341]. As for the *Judicial authorities*, the CA opens the possibility to apply to a court on a number of occasions[342] and defines to which court jurisdiction is conferred[343]. The *trade union* does not have a role as external monitor of a legal/political/regulatory nature, since its role is purely designed as a labour–market role. *Whistle–blowing* is regulated by the Public Interest Disclosure Act 1998 (PIDA). Ever since, employees have been protected against retaliation by their employers (public or private) if they properly disclose information of a criminal offence; non–compliance; a miscarriage of justice; dangers to the health or safety of any individual; damage to the environment; or information concerning deliberate concealment of these matters. The law describes exactly what 'proper disclosure' is[344]. In the Department for Business Innovation & Skills (BIS), and the former Departments of Business, Enterprise and Regulatory Reform (BERR) and Trade and Industry (DTI) the UK has active *government agencies* on modernizing and keeping company law up–to–date.

4.4.3.5 *Concluding remarks on the Plc.*

Davies (2008: 366) reminds us that the division of powers in the CA is a matter for private ordering by the members of the company rather than something to be specified as mandatory in the company's legislation. Table 4.6 underlines this by showing the strengths (+) and weaknesses (–) in the relatively 'light' mandatory monitoring structure of the UK Plc. The results stem from the previous analysis and need no further comment.

Table 4.6: an evaluation of the mandatory monitoring structure of the UK Plc.

internal monitoring	+/–	description
appointment / dismissal	–	GM may remove a director; has no mandatory appointment right for directors
accountability	+	GM appoints auditor; no exception for 'small' Plcs neither as regards auditing nor reporting; public disclosure through Companies House
	–	no approval of annual reports by the shareholders; no release from liability of directors
	–	UKC requirements for listed companies may dissolve in mandatory disclosure rules only
veto	+	GM decides on identity, capital, articles
	+	GM decides on payments for loss of office; on long-term service contracts
	+	GM veto on a wide range of EB decisions with a possible conflict of interests
	+	GM veto on 'Class 1' transactions and defensive measures (listed companies)
company structure	–	no mandatory presence of NEDs; no 'organic' employee representation (works council)
directors' duties	+ –	shareholder approach / *the benefit of its members as a whole* (+ have regard to)
	+	an integrated system of duties
external monitoring	+	at least six; Takeover Panel, FSA, FRC; whistle-blowing system through PIDA

4.4.4 Concluding remarks on the public limited company

The NV, AG and Plc have a lot in common. This is essentially due to the European attempts to harmonize company law. Andenas and Wooldridge (2009) present a comprehensive survey of these harmonization activities. The more striking are the important differences in mandatory law from a monitoring point of view as table 4.7 reveals. This is in line with the analysis of Goergen, Manjon and Renneboog (2008) that the German system still

Table 4.7: a comparative evaluation of the mandatory monitoring structure of the NV, AG and Plc.

internal monitoring	+/–	description
appointment / dismissal	NV+ AG+ Plc–	In 'ordinary NV' GM appoints, suspends, dismisses EDs and (the majority of) NEDs; in a 'structure NV' as well as in an AG > 500 employees the GM appoints and dismisses *de facto* two-thirds of the NEDs (AG > 2,000 employees: 50%) whilst the SB appoints the EDs. Plc: CA only recognizes a GM right to remove directors.
accountability	NV+– AG+– Plc+–	Plc: annual accounts and reports to be approved/adopted by the board; AG: by the SB or if refused or agreed upon, by the GM; NV: by the GM. Release from liability only for NV, AG. GM appoints auditor. If small+non-listed: Plc only. Auditor's fee: GM in Plc, SB in AG.
veto	NV+– AG+– Plc++	GM decides on identity, capital, articles; has no instruction right (all). In Plc GM decides on payments for loss of office, long-term service contracts, a wide range of EB decisions with a possible conflict of interests (e.g. property, (quasi-)loans). GM veto on: (Plc:) 'Class 1' transactions (>25%) and defensive measures (listed companies); (AG:) disposal of all assets or deeply intervening; (NV:) major change of identity or character (e.g.100% sale). SB veto on items listed in the law (NV) or the articles (AG, NV); works council veto on social matters
company structure	NV+– AG+ Plc–	no mandatory presence of NEDs (Plc); only if 'structure NV' (NV) mandatory works council if ≥ 5 (Germany) or 50 (the Netherlands) employees Plc: no co-determination or works council (unless EWC)
directors' duties	NV+– AG+– Plc+–	stakeholder approach in Germany and the Netherlands (enlightened) shareholder approach in the UK an integrated system of duties (Plc). Clear standards often need court clarification (NV, AG)
external monitoring	NV+ PLC+	Takeover Panel; whistle-blowing system through PIDA (Plc); easy access to specialized OK (NV).

differs significantly from a market–based system, i.e. that of the UK, despite a degree of convergence. As regards *appointment/dismissal* the CA assigns the GM the right to remove at any time, whilst the BW and the AktG arrange for mandatory appointment procedures as well. In the AktG rewards are determined by the GM for NEDs and by the SB for EDs (the Netherlands: GM for NEDs *and* ED reward policy and option schemes for EDs). In the UK, the Listing Rules recognize an *advisory* vote on the DRR. *Accountability* and public disclosure is largely EU harmonized. However, the approval (or adoption) of the annual accounts is as a rule assigned to the board (UK) or the SB (Germany), whereas in the Netherlands it is assigned to the GM. Striking differences are the lack of legal safeguards for auditors' remuneration in the Netherlands and for release from liability in the UK as well as the mandatory audit for small, non–listed Plcs in the UK. The right to *veto* is more widely attributed to the GM in the Plc than in the NV or the AG; in all forms, GM instruction of the board is generally forbidden. The GM decides on the rules of the game; in the Netherlands and the UK the articles may contain a 'provision for entrench–ment'. Moreover, the SB and the works council have veto rights in the NV and AG. The *company structure* largely differs between the Plc, which does not require the presence of NEDs[345] or a works council, and the AG, which requires both, or the NV, where NEDs are only required in a 'structure NV'. Remarkably, the CA does not even mention NEDs. It must be admitted that the two–tier system with its broader scope on the well–being of the company does not always work well (Hopt and Leyens, 2004: 145, 165; Andenas and Wooldridge, 2009: 298, 307, 311; Jungmann, 2006).

The system of *directors' duties* is much more developed in the UK than it is elsewhere. Hopt and Leyens (2004: 142) conclude for German law 'that the issues at the heart of directors' duties are not adequately covered.' This difference may be a consequence of (a) fewer mandatory provisions[346] and (b) the originally unequivocal shareholder focus of the system. As for *external monitoring*, the difference in whistle–blowing arrangements between the UK (PIDA) and Germany and the Netherlands is striking, as well as the specialized and easily accessible court (OK) in the Netherlands.

In evaluating the NV/AG/Plc one should bear in mind that the 'legal' public limited company and the 'listed' public limited company become more and more distant relatives instead of identical twins (Van Schilfgaarde/Winter, 2009: 5). The various governance codes are not taken into account in the analysis since they are not mandatory law. However, these codes 'codify' principles which could in specific cases have their influence outside listed companies – and outside the public limited sphere as well for that matter. The evaluation scores for this evaluation are:

++ relatively very strong on the issue from a monitoring point of view
+ predominantly strong on the issue from a monitoring point of view
+– strong as well as weak points on the issue from a monitoring point of view
– predominantly weak on the issue from a monitoring point of view
–– relatively very weak on the issue from a monitoring point of view.

A final remark: nowhere does the law assign the ultimate responsibility, and thus the lead, of the *audit process* to the SB. The German approach[347] comes nearest, but Schmidt and Lutter (2008: 1210) tone down the expectations. At present, auditors co–operate intensively with the CFO and other EB members during the audit process. This threatens the auditor's independence. Auditors assess the work and the performance of EDs. EDs, or their subordinates, are the chief suppliers of information to the auditor. They are the principal interested parties in a successful audit. Therefore, and in line with their ultimate monitoring responsibility, NEDs, if available, should be in the lead of the audit process.

4.5 THE MANDATORY MONITORING STRUCTURE OF THE PRIVATE LIMITED COMPANY

A private company confers a separate legal personality on – usually – the business of a single trader or a partnership[348]. It is not necessarily a capital association, since it is quite often a one–man shop. Nor is limited liability a necessary condition as the UK private unlimited company shows. It may not offer securities to the public. This section evaluates sequentially the mandatory monitoring structure of three types of private limited companies: the Dutch *BV* (4.5.1), the German *GmbH* (4.5.2) and the UK *Ltd* (4.5.3). Section 4.5.4 concludes.

4.5.1 The Dutch besloten vennootschap met beperkte aansprakelijkheid (BV)

The forthcoming analysis rests on Kroeze, Timmerman and Wezeman (2007), Van Schilfgaarde/Winter (2009), Kluwer *Rechtspersonen* (groene losbladige serie), Klaassen (2007) and Van der Heijden/Van der Grinten (1992) for historic reference.

4.5.1.1 *Formation and institutional structure*

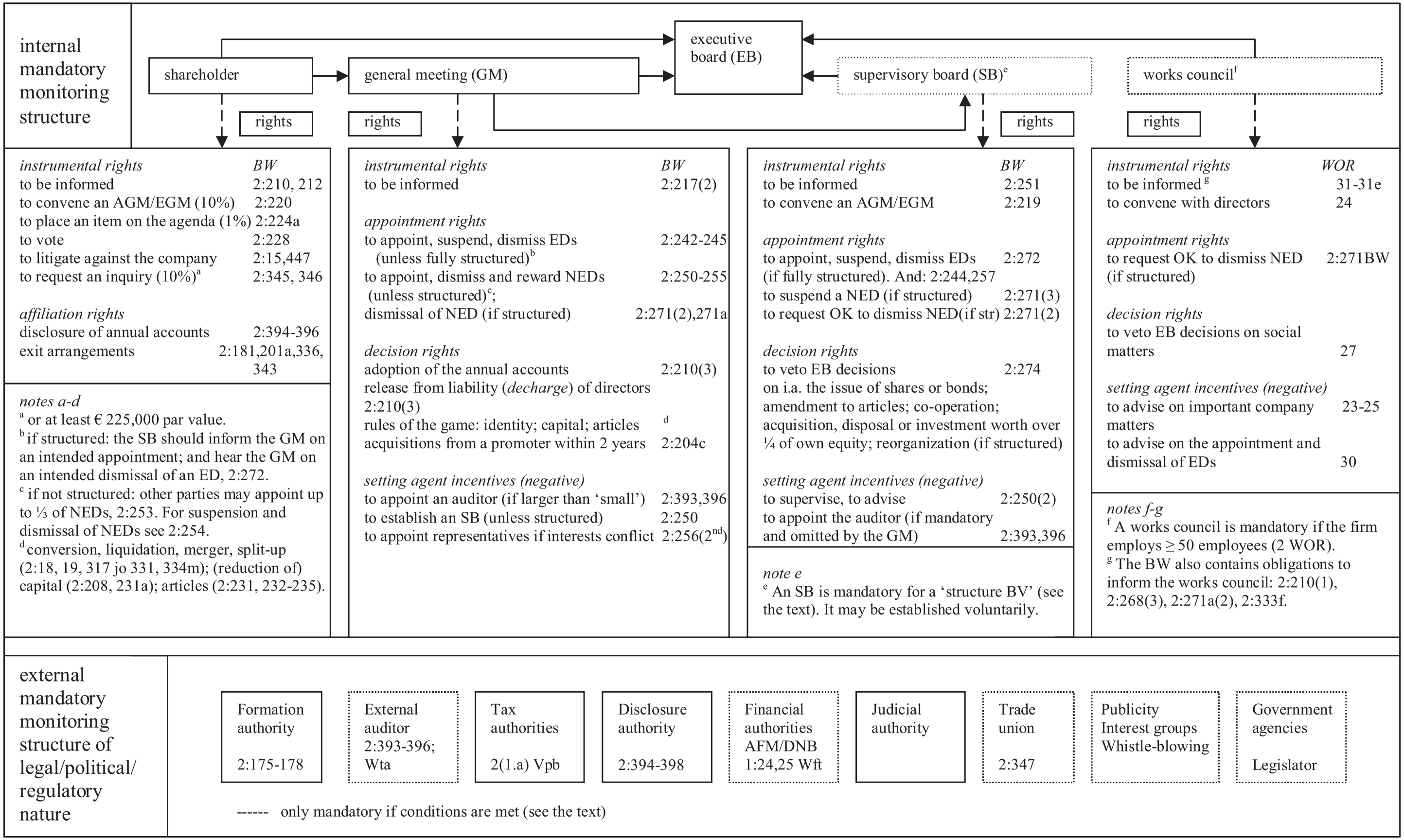
S 2:175–284a BW contain private limited company law in the Netherlands. One person suffices to form a Dutch private company (*besloten vennootschap met beperkte aansprakelijkheid;BV*). The company's name should contain the full title or the abbreviation[349]. A notarial deed to be executed after government clearance[350] constitutes the formation moment. The BV is a legal person with shares that are not freely transferable[351]. The minimum capital to pay up is €18,000. The BV has only registered shares. Listing of a BV is thus not possible. The BV may emerge in two forms: as an ordinary or a 'structure BV'. The ordinary BV has a mandatory EB and GM. A separate SB – Dutch law still maintains a two-tier system for the BV as well[352] – is only mandatory for the 'structure BV'. The criteria for a 'structure BV' are the same as for the NV, as are the arrangements for exemption or mitigation[353]. The establishment of a works council depends on the conditions described in 4.4.1.1.

4.5.1.2 *Mandatory monitoring structure and duties of directors*

Figure 4.5 shows the mandatory monitoring structure of a BV. In the full-blown picture, the BV has five internal and possibly nine external monitoring mechanisms. The one-man BV still encounters at least four external monitoring mechanisms. The text below analyses the internal and external mandatory monitoring structure of the BV. Since these structures are almost identical to that of the NV and only slightly adapted to the closed structure of the BV, the text focuses on their differences.

The *internal* mandatory monitoring structure of the BV differs for *shareholders* on the *instrumental* side with the absence of a voting right for holders of depositary receipts. For the BV – and the closed NV – the law has created an *exit* through a dispute arrangement for conflicts between shareholders[354]. The *GM* lacks a mandatory *decision* right in respect of the issue or buy–back of shares since the articles may attribute this competence to another organ[355]. Nor is the GM explicitly entitled to approve EB decisions on the change of the identity or character of the company. However, Klaassen (2009) argues based on the literature and case law to the contrary. In her view, the GM *always* has a right of approval if the rules of the game ('structure') of the legal person are at stake[356]. Concerning *positive setting incentives* the GM lacks mandatory involvement in the remuneration of the EDs[357]. The mandatory rights of the *SB* are identical to the NV. The differences between

Figure 4.5: Dutch private limited company (BV): mandatory monitoring structure



NV and BV may be explained as a consequence of the supposed shareholders' proximity to the EB. If they are not so close however, e.g. in second or third generation shareholders, shareholders may lack important rights.

The *works council* rights of the WOR apply to the BV as they do to the NV (4.4.1.2). However, the recently added rights to attend and be heard in the GM apply only to the NV. The role of the *board* and the duties of directors (4.4.1.3 for the NV) are identical in the BV.

The *external monitoring mechanisms* are essentially the same as for the NV, without the specific arrangements for listed companies. The AFM will encounter BVs mostly as financial intermediaries on the market.

4.5.1.3 *Pending changes in BV law: the Flex-BV*

The proposal intends to make the BV a 'less regulated entity with more autonomy for its shareholders' (Timmerman, 2007: 326). It contains four main issues: (1) deletion of minimum capital requirement and mandatory blocking clause; (2) enhanced freedom in structure and decision; (3) new creditor protection rules; and (4) adaptation of conflict rules. Annex 2 describes the details. In terms of the legal strategies the proposal enhances in figure 4.5 the *shareholder instrumental rights* by decreasing the threshold for convening an AGM/EGM to 1% of the shares; and decreases them by allowing shares without voting rights[358]. The *GM appointment rights* may be restricted in the articles to at least one ED/NED for a certain class of shares[359]. Under strict conditions the *GM* loses its *decision rights* in respect of the adoption of the accounts and release of liability of directors if all the shareholders are directors, and its right to scrutinize acquisitions from an incorporator[360]. When interests conflict, the GM no longer has a special role[361]. Whilst one may, *grosso modo*, conclude that in effect no strategy redistribution occurres, it seems that the aims to regulate less, be more flexible and enhance the autonomy for the shareholder will to a certain degree be achieved.

4.5.1.4 *Concluding remarks on the BV*

Table 4.8 shows the strengths (+) and weaknesses (–) in the mandatory monitoring structure of the Dutch *BV*. The results stem directly from the above analysis and need no further comment.

4.5.2 The German Gesellschaft mit beschränkter Haftung (GmbH)

The forthcoming analysis rests on Schmidt (2002), Klaassen (2007), Lutter and Hommelhoff (2009) and Andenas and Wooldridge (2009).

Table 4.8: an evaluation of the mandatory monitoring structure of the Dutch BV.

internal monitoring	+/–	description
appointment / dismissal	+	not 'structure BV': GM appoints EDs and (two-thirds of) NEDs. A binding recommendation can be overruled by a qualified majority
	–	'structure BV': SB appoints EDs. Default: GM appoints NEDs from an 'overrulable' binding recommendation but GM may be sidelined through the articles
accountability	+	GM adopts annual accounts, appoints auditor and releases directors from liability. Public disclosure through *Handelsregister*
	–	no mandatory audit for 'small' BVs
veto	+ –	GM decides on identity, capital (by default), articles subject to approval or proposal provisions in the articles. No GM veto on major change of identity or character decisions.
	–	no voting right for depositary receipt holders
	+	SB veto on important company decisions as listed in the law and in the articles
	+	works council veto on social matters
company structure	+ –	SB only mandatory for a 'structure BV'; mandatory works council if ≥ 50 employees
directors' duties	+	stakeholder approach / interests of the company *(het belang van de onderneming*)
	+ –	clear standards often need court clarification on issues e.g. conflict of interests, minorities
external monitoring	+	at least four. Easy access to OK in order to request an inquiry (*enquête*).
	–	dispute arrangements including expel and resign rights do not work satisfactorily
	–	no whistle-blowing culture

4.5.2.1 *Formation and institutional structure*

German private limited company law dates from 1892 (*Gesetz betreffend die Gesellschaften mit beschränkter Haftung*; GmbHG). It is largely of an enabling nature, unless otherwise indicated[362]. One person suffices to form a GmbH[363]. The articles (*Gesellschaftsvertrag*) should be drawn up in a notarial from[364]. Its name should contain *Gesellschaft mit beschränkter Haftung* in full or an abbreviation[365]. It comes into existence[366] once it is registered in the *Handelsregister*[367] and is thereafter a legal person[368]. The court to which the request for registration is referred to performs a material check and may decline registration e.g. if the payment in kind is overvalued[369]. Its capital is divided in shares[370] that are in principle freely transferable through a notarial form[371]. Names of shareholders are kept in the *Handelsregister*[372]. The minimum capital is €25,000 of which at least half is to be paid up before registration[373]. The articles may provide for a GM right to determine that additional payments should be made by the shareholders (*Nachschusspflicht*)[374]. In an attempt to counter the competition from the UK Ltd form, the German legislator recently created an *Unternehmergesellschaft (haftungsbeschränkt)* or in short *UG haftungsbeschränkt*[375]. This UG follows the GmbHG with a few exceptions. It is to be formed by at most three people, with standard articles (*Musterprotokoll*) and without a minimum capital[376]. However, it has to retain 25% of its profits until the €25,000 amount is reached[377]. Then it may opt for the full GmbH status[378].

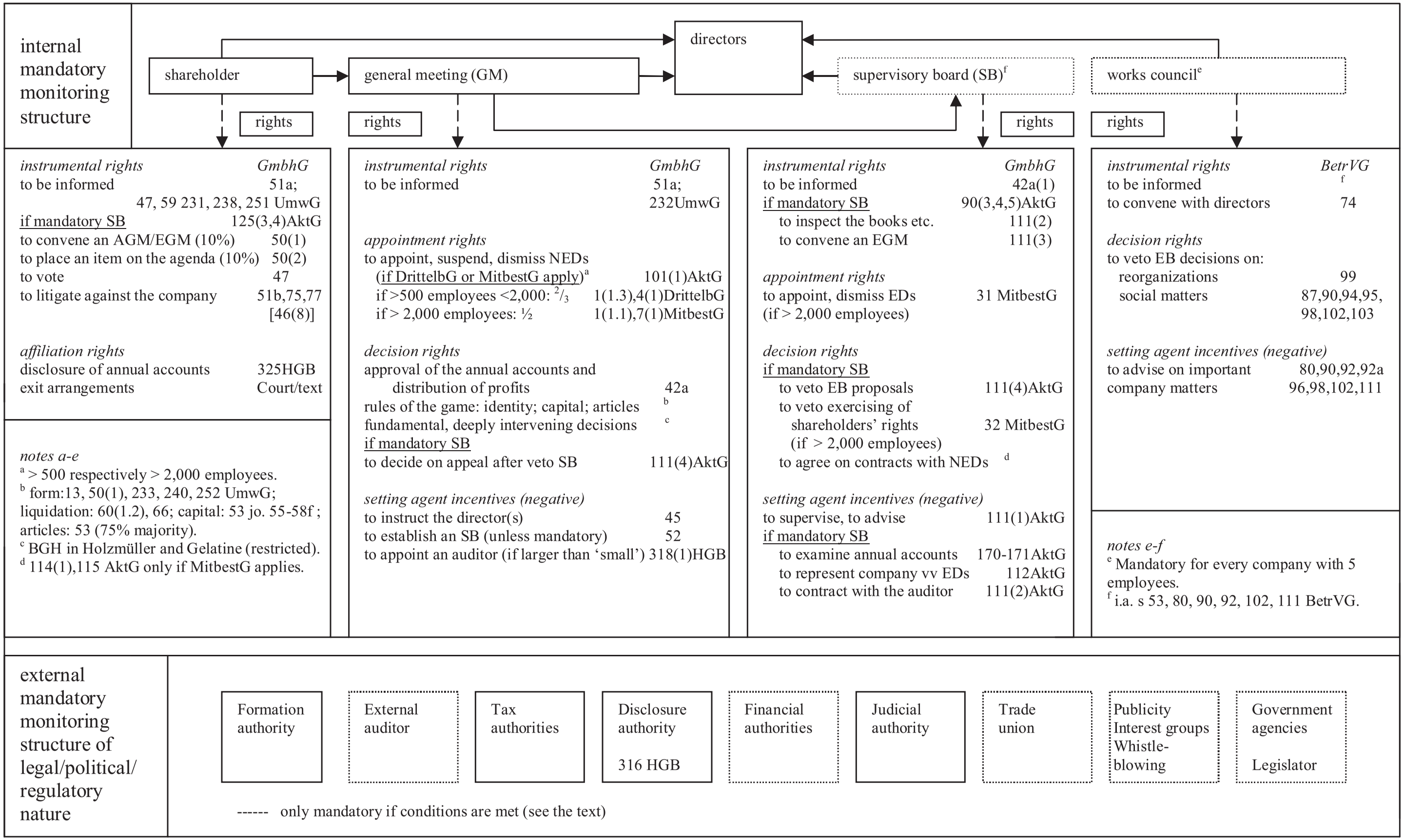
The GmbH appears in two forms. By its legal nature it has a two-tier governance structure, with one[379] or more directors (*Geschäftsführer*)[380] who should be natural persons[381] and a GM (*Gesellschafterversammlung*)[382]. The law does not mention a board. An SB is optional[383]. This changes once the GmbH employs over 500 people and the co-determination laws come into play. Then the law requires the establishment of an SB and with it a number of other provisions come into force. A works council (*Betriebsrat*) is mandatory if the conditions are met as described in 4.4.2.1.

4.5.2.2 *Mandatory monitoring structure and duties of directors*

Figure 4.6 shows the mandatory monitoring structure of a GmbH. In the full-blown picture, the GmbH has four internal and possibly nine external monitoring mechanisms. The one-man GmbH may have only four external monitoring mechanisms.

Shareholders and general meeting (GM)
The first of the *instrumental* rights is the information right. *Every* shareholder is entitled to immediate information and to inspection of the books. A director may refuse information or inspection for 'non-company-related purposes' for fear of abuse[384]. The shareholder may appeal to the court[385]. The convening of a meeting may be requested by 10% of the issued capital[386]. This percentage may also request that certain subjects be placed on the agenda[387]. Every shareholder has a voting right for each euro of issued share capital[388]. To pass a resolution, a simple majority suffices[389]. A written resolution instead of a meeting is permitted if all the shareholders agree either with the written poll or with the proposal[390]. Shareholders should abstain from voting in certain cases where they have an interest in the outcome[391]. The *affiliation* right of disclosure of the annual accounts is provided for in one general clause for equity companies in the *Handelsgesetzbuch* (HGB)[392]. An *exit* right is not provided for in the GmbHG, and if it is not provided for in the articles[393], the court may assist to oust a shareholder in the last resort[394]. As regards the *decision* rights of the GM, the law provides a list with shareholder competences, e.g. the adoption of the annual accounts, appointment and removal of directors as well as directors' release from liability, audit and supervision arrangements. However, this is default law[395]. The GmbHG provides for only a few mandatory arrangements: *Satzungsautonomie* prevails. One of the mandatory rights is that the appointer may always withdraw the appointment of an ED, notwithstanding contractual claims[396]. The others relate, as figure 4.6 shows, to the 'rules of the game'. The GmbHG *does* place the shareholder at the heart of the company. It is generally thought that the GM is the supreme organ of the company which has competence in *all* company matters, except where the law or the articles provide otherwise. It has the power of giving instruction to the management (Andenas and Wooldridge, 2009: 305)[397] and strategy should be discussed with it (Schmidt, 2002: 1079). In the same line, the *Holzmüller/Gelatine* doctrine will not easily apply since fundamental decisions belong to the GM *in any case*[398]. Thus, whilst the GM has a very large role in the operation of the company, there are few mandatory rules. This changes if the *co-determination laws* apply. Then, generally speaking, the rules from the *Aktiengesetz* relating to the appoint-

Figure 4.6: German private limited company (GmbH): mandatory monitoring structure



ment of NEDs by the GM apply, as figure 4.6 shows. The DrittelbG[399] or the MitbestG[400] prescribe exactly which of the AktG provisions apply. The default GM right to appoint EDs remains unaffected by the DrittelbG.

Supervisory board

A SB may be established either voluntarily or mandatorily. For a voluntarily established SB the law refers to the provisions in the *Aktiengesetz*, unless otherwise provided for in the articles[401]. The supervisory tasks, however, cannot be bypassed[402]. The articles sometimes opt for a *Beirat*, an advisory forum without SB competences[403]. If a SB is mandatory[404], then the *Mitbestimmungsgesetz*[405] and the *Drittelbeteiligungsgesetz*[406] determine the SB's tasks mandatorily, largely according to the description in 4.4.2.2.

Works council

The mandatory requirements for establishment of a works council and its tasks were described in 4.4.2.

Directors and directors' duties

Directors manage the company subject to the law, their service contracts, the internal rules, the articles and instructions of the GM. Managers are collectively entrusted with the management and the representation of the company, unless the articles provide otherwise[407]. In company affairs, directors must employ the 'degree of care and skill of a conscientious businessman'[408]. This *duty of care* is an objective test. The BJR applies[409] but since the GM is the '*höheste Willensorgan*' a good director will mostly refer important company decisions to the GM. The *Treuepflicht*[410] and the other duties referred to in 4.4.2.3 in principle exist here as well[411]. As a consequence, the BGB forbids a director to act for both parties but the articles can determine otherwise[412]. Loans to directors out of the *Stammkapital* (issued capital[413]) as well as payments to the shareholders out of the same are forbidden[414]. Directors are jointly and severally liable to the company for neglecting their duties[415]. A director is not allowed to vote on a resolution relating to the release from liability[416].

External mandatory monitoring mechanisms

The external mandatory monitoring mechanisms are equal to those of the AG, without the specific arrangements for listed companies.

4.5.2.3 *Concluding remarks on the GmbH*

Table 4.9 shows the strengths (+) and weaknesses (–) in the mandatory monitoring structure of the German *GmbH*. The results stem directly from the above analysis and need no further comment.

Table 4.9: an evaluation of the mandatory monitoring structure of the German GmbH.

internal monitoring	+/–	description
appointment / dismissal	+	GM appoints, dismisses NEDs (if an SB; and subject to co-determination law)
accountability	+ –	GM adopts the annual accounts and appoints the auditor. Disclosure through *Handelsregister* no mandatory audit for 'small' GmbHs
veto	+ + + – +	GM has an instruction right in respect of all company matters GM decides on identity, capital, articles. The Holzmüller/Gelatine doctrine applies restrictedly if mandatory SB: SB veto on EB decisions listed in the articles works council veto on social matters
company structure	+ – +	no mandatory SB (unless > 500 employees); mandatory works council if ≥ 5 employees *Satzungsautonomie*
directors' duties	+ + –	stakeholder approach if co-determination applies (> 500 employees) *Sorgfalt*, *Treuepflicht*, *Verschwiegenheitspflicht*; no conflict, no corporate opportunities; BJR (restricted)
external monitoring	+ –	at least four. Manifold court-access. No whistle-blowing culture

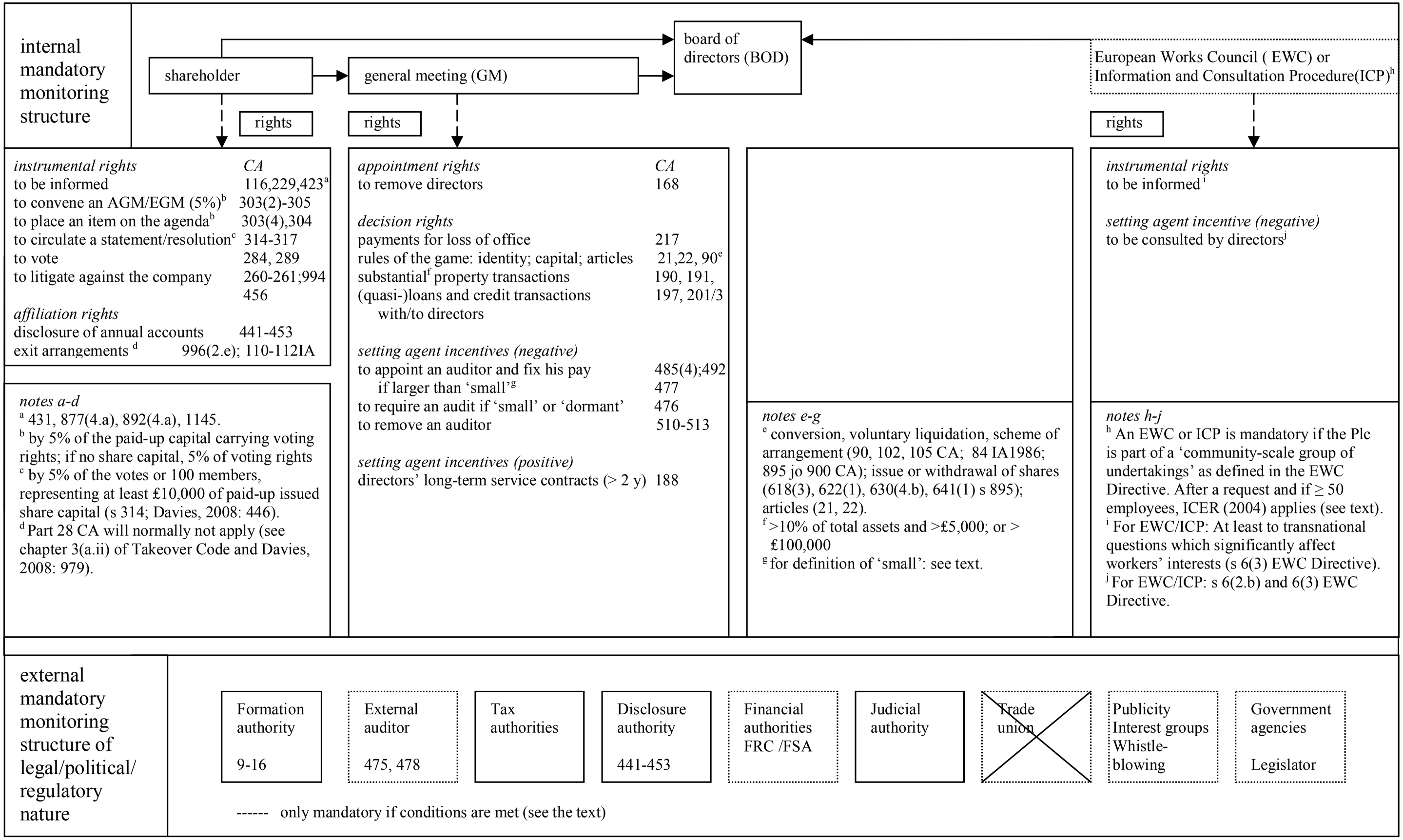
4.5.3 The British private limited company (Ltd)

The forthcoming analysis rests on Davies (2008), Maitland–Walker (2008) and Andenas and Wooldridge (2009).

4.5.3.1 *Formation and institutional structure*

A 'private company' is any company that is not a public company[417]. A private company may either be a 'limited company', which may be 'limited by shares' or 'limited by guar–antee[418]', or an 'unlimited company'[419]. The name of a limited company that is a private company must end with 'limited' or 'Ltd'[420], unless it is exempt, e.g. for being a charity[421]. The *Companies Act 2006* (CA) regulates both the *Ltd* and the *Plc*. And although basically similar, there are some important differences between the two[422]. This may stem from provisions in the law specifically for quoted[423], public[424] or private[425] companies; and of course from the non–applicability of the Listing Rules, Combined Code and Takeover Code. The remarks in 4.4.3.1 on establishment and on registration broadly apply to the Ltd. The deregulation of the Ltd was one of the wishes behind the corporate reform of 2006. Therefore the Ltd is a legal person *without* a minimum capital[426], without a manda–tory company secretary[427] and without the obligation to hold an AGM annually[428]. It has a one–tier governance structure. It should have at least one director, who should be a natural person[429]. It has one or more members, who may pass a resolution in or outside a meeting[430]. The law leaves many institutional choices to the articles. The Model Articles for Private Companies give only default rules[431]. If the Ltd is an international company with holdings in the EU, it might have a European Works Council (EWC) or an ICP.

Figure 4.7: UK private limited company (Ltd): mandatory monitoring structure



4.5.3.2 *Mandatory monitoring structure and duties of directors*

Figure 4.7 shows the mandatory monitoring structure of a Ltd. In the full–blown picture the Ltd has four internal and possibly eight external mandatory monitoring mechanisms. The one–man Ltd may encounter no internal and four external monitoring mechanisms.

Internally, the *shareholders'* instrumental rights in the Ltd go into less detail than in the quoted Plc, due to the non–applicability of the LR, TC and UKC. To facilitate[432] decision-making shareholders may vote by a special resolution form outside a meeting, the 'written resolution'[433]. Directors and members may propose a written resolution[434]. It can be an 'ordinary' or a 'special' resolution, the first requiring 50% of the voting rights for approval, and the second 75%[435]. However, this procedure is not available, and an *AGM/EGM* is required for two decisions: on the removal of directors or that of the auditor[436]. The threshold for calling a GM by members is 5% of the voting rights[437]. An auditor only has to be appointed if the Ltd is categorized as larger than 'small'[438]. However, shareholders may always require an audit[439].

Although not a corporate organ, the *information and consultation* of employees provided for in the ICER 2004 (see 4.4.3.2) provides, as and when requested, negotiated and established, for an internal monitoring mechanism of the Ltd. Its content is determined either by the result of the negotiation between employer and the employee representatives or, if the parties do not reach a negotiated agreement, by the standard provisions of the law[440].

The *board of directors* and directors' duties are arranged identically to those of the Plc.

Externally, the lifted requirement for an audit of a 'small' company implies one mandatory monitoring mechanism less. There is no monitoring from the Takeover Panel. The FRC is in place only in the case of defective accounts of larger Ltds. The FSA only has a role in the case of financial sector companies.

4.5.3.3 *Concluding remarks on the Ltd*

Table 4.10 shows the strengths (+) and weaknesses (–) in the mandatory monitoring structure of the UK Ltd. The results stem from the previous analysis and need no further comment.

4.5.4 Concluding remarks on the private limited company

As table 4.11 shows, the BV, GmbH and Ltd differ more than their larger brothers, due to less EU involvement. The 'associative' origin is clearly felt in the GM position in the Ltd and the GmbH as the 'highest organ' in the legal person. In the 'structure BV', the

Table 4.10: an evaluation of the mandatory monitoring structure of the UK Ltd.

internal monitoring	+/–	description
appointment / dismissal	–	GM may remove a director; has no mandatory appointment right for directors
accountability	+ – –	GM appoints auditor; exception for 'small' Ltds; public disclosure through Companies House no approval of annual reports by the shareholders; no release from liability of directors
veto	+ + + +	GM decides on identity, capital, articles GM decides on payments for loss of office; on long-term service contracts GM veto on a wide range of EB decisions with a possible conflict of interests decision-making ('written resolution') possible outside GM with two exemptions
company structure	–	no mandatory presence of NEDs; no 'organic' employee representation (works council)
directors' duties	+ – +	shareholder approach / *the benefit of its members as a whole* (+ have regard to) an integrated system of duties
external monitoring	+	at least four; whistle-blowing system through PIDA

'MitbestG GmbH' and to a lesser degree in the 'DrittelbG GmbH' the SB takes over this position. It should not be forgotten that numerous private limited companies have less than the required number of employees and therefore do not have a mandatory SB. In the continental system, however, there are usually works councils, which means at least a form of monitoring, which the Ltd lacks, unless there is an EWC. *Internally*, the *appointment/dismissal* rights are the same as in the NV/AG/Plc. Although the *accountability* is

Table 4.11: a comparative evaluation of the mandatory monitoring structure of the BV, GmbH and Ltd.

internal monitoring	+/–	description
appointment / dismissal	BV+ GmbH+ Ltd–	In 'ordinary BV' GM appoints, suspends, dismisses EDs and (the majority of) NEDs; in a 'structure BV' as well as in a GmbH > 500 employees GM appoints and dismisses *de facto* two thirds of the NEDs (GmbH > 2,000 employees: 50%) whilst the SB appoints the EDs (for the GmbH >500 and < 2,000 employees: GM appoints EDs) Ltd: CA only recognizes a GM right to remove directors
accountability	BV+ – GmbH+– Ltd––	Annual accounts and reports to be approved/adopted by the board (Ltd); for BV, GmbH: by the GM. Release from liability only for BV by GM Appointment of auditor: all by GM. No auditor mandatory if small
veto	BV + – GmbH+ Ltd++	GM decides on identity, capital, articles (all) with (small) exception on capital in BV. On major change of identity or character: BV unclear, GmbH: Holzmüller/Gelatine. Ltd: GM decides on payments for loss of office, long-term service contracts, a wide range of EB decisions with a possible conflict of interests (e.g. property, (quasi-)loans) GmbH: GM has instruction right in respect of all matters. SB veto on items listed in the law ('structure BV') or in the articles (GmbH, BV); works council veto on social matters
company structure	BV+ – GmbH+– Ltd––	no mandatory presence of NEDs (Ltd); only if > 500 empl. (GmbH) or if 'structure BV' (BV) mandatory works council if ≥ 5 (Germany) or 50 (the Netherlands) employees Ltd: no co-determination or works council (unless EWC)
directors' duties	BV+ – GmbH+– Ltd+ –	stakeholder approach in Germany and the Netherlands (enlightened) shareholder approach in the UK an integrated system of duties (Ltd)
external monitoring	BV+ Ltd+	easy access to specialized OK (BV) whistle-blowing system through PIDA (Ltd)

largely identical as well, here the GM of the GmbH approves the annual accounts. The GM decides mandatorily in the BV and by default in the GmbH on the release from liability of directors. The *veto* rights for the GM are again present in the Ltd more than in the GmbH/BV. Only in the GmbH the GM has an instruction right and a right to decide on a major change of identity or character within the Holzmüller/Gelatine doctrine. In the GmbH and the BV the SB if present and the works council have veto rights as well. The *company structure* in the GmbH/BV often recognizes a works council and an SB subject to the number of employees.

Directors' duties are identical to those in the NV/AG/Plc. *External* monitoring is mainly provided for by the auditor. If the company is small an auditor is not required. In all systems the private limited company must publicly disclose through the *Handelsregister*. The *tax* authorities monitor as well. In Germany the commercial and tax reporting concepts are identical. In the Netherlands this has recently been provided for as an option[441].

4.6 THE MANDATORY MONITORING STRUCTURE OF THE CO-OPERATIVE

A co-operative is an association characterized by a double relationship with its members: as equity suppliers and as business partners. This section evaluates sequentially the mandatory monitoring structure of the Dutch *coöperatie* (4.6.1), the German *Genossenschaft* (4.6.2) and the UK *Industrial and Provident Society* (4.6.3). Section 4.6.4 concludes.

4.6.1 The Dutch *coöperatie*

The forthcoming analysis rests on Dijk/Van der Ploeg (2007), Galle (2007) and Asser-Van der Grinten II (de Rechtspersoon) (1986) for historic references.

4.6.1.1 *Formation and institutional structure*

S 2:53-63j BW specifies co-operative law in the Netherlands. Since the Dutch co-operative (*coöperatie*) is essentially an association[442], its formation requires at least two people. The coöperatie is defined as an association established as a coöperatie by a notarial deed. It is a legal person. A minimum capital is not required. Its objects must be to provide for the specific material needs of its members under contracts, other than insurance contracts, concluded with them in the business it conducts[443] for the benefit of its members. Contrary to an ordinary association, profit-distribution to members is allowed[444]. In its articles, a coöperatie may opt for full (WA; *wettelijke aansprakelijkheid*), restricted (BA; *beperkte aansprakelijkheid*) or exempt (UA; *uitgesloten aansprakelijkheid*) member liability in the case of a deficit. The latter is usually the case. The name of the coöperatie should contain the word *coöperatief*[445], as well as the indication WA, BA or UA[446]. Depending on its size, the coöperatie is an ordinary or a 'structure coöperatie'. The ordinary coöperatie has a mandatory EB and GM. The GM usually consists of all of the members, but the articles may determine that the GM consists of representatives of the members only. In the latter case, the articles may list GM decisions that are subject to a poll of all the members[447]. A separate SB – Dutch law also maintains a two–tier system for a coöperatie[448] – is only mandatory for the 'structure coöperatie'. A coöperatie becomes a 'structure coöperatie' if (1) its equity is at least €16 million, (2) there is a mandatory established works council, (3) its workforce in the Netherlands counts at least 100 people, and (4) if this situation lasts during three consecutive years[449]. The structure regime which differs from that in the NV or BV[450] is mandatory but exemption is provided for in specific holding company structures or can be requested from the Minister of Justice[451]. Voluntary adoption of the regime is allowed[452]. Initiatives for better governance of coöperaties have resulted in the *NCR Code voor coöperatief ondernemerschap*[453]. This code is meant as a tool for modernization and evaluation of the governance structure of a coöperatie and contains no mandatory rules. The establishment of a works council depends on the conditions described in 4.4.1.1.

4.6.1.2 *Internal mandatory monitoring structure*

Figure 4.8 shows the mandatory monitoring structure of a coöperatie. In the full–blown picture, the coöperatie has five internal and possibly nine external monitoring mechanisms. The one–man coöperatie, a legally admitted[454] *contradictio in terminis*, still encounters at least four external monitoring mechanisms. The text below analyses the internal and external mandatory monitoring structure of the coöperatie. It starts with the *internal* mandatory monitoring structure. Again, it focuses on the differences with the NV.

Members

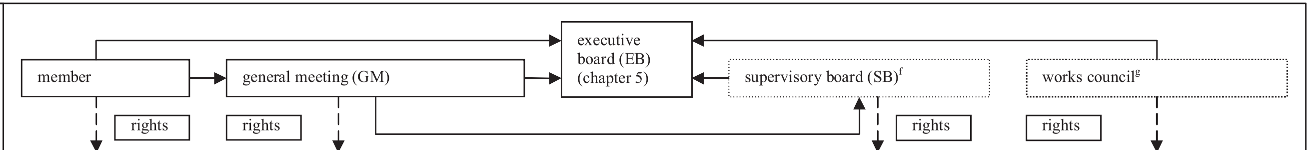
Members have the usual *instrumental* rights: in respect of information, to convene, to vote, to litigate and to petition an inquiry. There is no mandatory right to place items on the agenda. This is one of the indications that *coöperatie* law needs modernization[455]. The law gives due attention to the *exit* side, which is important because members have a dual relationship with the coöperatie: member *and* supplier or customer. Expel and resign arrangements are in place.

General Meeting (GM)

Although the literature[456] assumes that the *instrumental* right to be informed exists, there is no such provision in the law. As regards *appointment* the essential characteristic is that the GM appoints the majority of the executive as well as the non–executive directors. The articles may provide for the appointment of a minority by others than members[457].

Figure 4.8: Dutch co-operative (coöperatie): mandatory monitoring structure

internal mandatory monitoring structure



member

instrumental rights	*BW*
to be informed	2:48-50,58
to convene an AGM/EGM (10%)	2:41
to vote	2:38,39
to litigate against the company	2:15,447
to request an inquiry (10%)[a]	2:345,346
affiliation rights	
disclosure of annual accounts	2:394-396
exit arrangements	2:35,36, 2:55,60

notes a-e
[a] by at least 300 members; or 10% of the members; or 10% of the votes (2:346(a)).
[b] not in the law, but assumed in the literature.
[c] if structured, *all* NEDs are appointed by GM.
[d] if structured, suspension is assigned to the SB and dismissal to the OK (2:63i).
[e] conversion, liquidation, merger, split-up (2:18, 19, 42(4), 317 jo 331, 334m); member issues (2:33,34,34a,59-61); articles (2:42,43).

general meeting (GM)

instrumental rights	*BW*
to be informed[b]	
appointment rights	
to appoint, suspend, dismiss (a majority of) the EDs	2:37
to appoint (a majority of) the NEDs (if SB)[c]	2:57a,63f
to suspend and dismiss NEDs[d] (not structured)	2:57a/37
to nominate a NED (if structured)	2:63f
to request OK to dismiss NED (if structured)	2:63i(2)
decision rights	
adoption of the annual accounts	2:58(1)
release from liability (decharge) of directors	2:58(1)
rules of the game: identity; members; articles	e
setting agent incentives (negative)	
to appoint an auditor (if larger than 'small')	2:393,396
or a committee of investigation (if no SB and auditor not mandatory)	2:58,48
to establish an SB (unless structured)	2:57
to appoint representatives if interests conflict	2:47

supervisory board (SB)

instrumental rights	*BW*
to be informed	2:57(8)
appointment rights	
to suspend a NED (if structured)	2:63i(3)
to request OK to dismiss NED (if structured)	2:63i(2)
decision rights	
to veto EB decisions on i.a. the issue of bonds; change of articles; cooperation; acquisition, disposal or investment worth over ¼ of own equity; reorganization (if structured)	2:63j
setting agent incentives (negative)	
to supervise, to advise	2:57(2)
to recommend NEDs	2:63f(2)
to appoint the auditor (if mandatory)	

note f
[f] An SB is mandatory for a 'structure coöperatie' (see the text). An SB may be established voluntarily at any time.

works council

instrumental rights	*WOR*
to be informed[h]	31-31e
to convene with directors	24
appointment rights	
to request OK to dismiss NED (if structured)	2:63i(2)BW
decision rights	
to veto EB decisions on social matters	27
setting agent incentives (negative)	
to advise on important company matters	23-25
to advise on the appointment and dismissal of EDs	30
to nominate NEDs (if struct)	2:63f(4)BW
to object to recommended NED (if structured)	2:63f(6)BW

notes g-h
[g] A works council is mandatory if the firm employs ≥ 50 employees (2 WOR).
[h] The BW also contains obligations to inform the works council: 2:63f(4), 2:333f.

external mandatory monitoring structure of legal/political/ regulatory nature

Formation authority 2:53,54	External auditor 2:393-396; Wta	Tax authorities 2(1.a) Vpb	Disclosure authority 2:394-398	Financial authorities AFM/DNB 1:24,25 Wft	Judicial authority	Trade union 2:347	Publicity Interest groups Whistle-blowing	Government agencies Legislator

------ only mandatory if conditions are met (see the text)

Suspension and dismissal follow the same rules. The nomination of NEDs is mandatorily regulated in a 'structure coöperatie'. The GM, works council and EB may nominate a NED. The SB delivers a binding recommendation to the GM. The GM's choice of a NED may be restricted to one person recommended by the SB. If the GM objects, the OK may ultimately decide on the recommended nominee's suitability[458]. There are no *decision rights* in respect of transactions proposed by the EB[459]. Concerning the *rules of the game*, the decision on membership is delegated to the EB with a right of appeal to the GM. There is a lively debate about whether the GM's right to amend the articles can be restricted. Whilst Dijk/Van der Ploeg (2007)[460] argue that the right to propose an amendment to the articles cannot be restricted, Asser/Van der Grinten (1986)[461] and for the NV/BV Van Schilfgaarde/Winter (2006)[462] and Klaassen (2007)[463] take a different stand. Restrictions in the articles, e.g. the approval of an amendment by an organ or a third party, are permitted[464]. The *(negative) setting incentives* strategy has an interesting feature in the investigation committee (usually called: *kascommissie*). Its nomination is required if there is neither an SB nor a judgement of an external auditor. The committee, which consists of ordinary members, has an audit function and should receive all the information it requests[465]. Again, as in the BV, the *(positive) setting incentives* strategy has not been applied. The law has no provisions on ED remuneration and leaves remuneration of NEDs by default to the GM[466].

Analytically the monitoring structure of a *coöperatie* is essentially identical to the NV and the BV. And although the principle of board autonomy holds, and the EB is in that sense the 'highest authority', Dijk/Van der Ploeg, 2007, argue[467] that due to the appointment rights of the GM[468] the latter is the 'ultimate authority' of the coöperatie. It may even instruct the EB on the strategy, if the articles so determine[469].

Supervisory board (SB)

The *instrumental* and *decision* rights are largely identical to those of an SB in a NV or a BV. The SB, however, cannot *appoint* EDs, unless provided for in the articles and even then only a minority. The right to nominate NEDs to the GM categorizes as a *negative agent incentives* right. It may facilitate smooth co–operation between EB and SB.

Works council

The works council rights of the WOR apply to the coöperatie as they do to the NV (4.4.1.2). Since the rights of the works council in the 'structure coöperatie' are mandatory, figure 4.8 presents a right to nominate NEDs and to object to a NED recommendation by the SB. The *de facto* right in the 'structure NV/BV' to nominate one–third of the NEDs does not exist here; nor does the right of the NV works council to attend and be heard in the GM.

4.6.1.3 *Executive board (EB) and duties of directors*

Much of what is said in 4.4.1.3 applies. Both EB and SB have a *collegial structure* and their *tasks* are identical to those in the NV[470]. In a number of coöperaties the EB consists of laymen (representatives of members) and has hired a team of managers, often called 'directors'. These have the same executive role as the senior managers who are not executive directors in the NV or BV. The directors' duties are largely identical to those in an NV. The provisions in the event of conflicting interests are much the same[471]. The Hoge Raad ruled that the director owes his duties to the coöperatie, just as in the NV, and not to the members, unless the director neglected his duty to one member specifically (HR 13 October 2000, NJ 2000, 699, *Heino Krause*). The pending proposal[472] to enable a one-tier board system for the NV/BV does not apply to the coöperatie. After its enactment, the board systems for the cooperative and the NV/BV will diverge even more.

4.6.1.4 *External mandatory monitoring structure*

The *external monitoring mechanisms* are essentially the same as for the NV. However, *members* have a double relationship with the coöperatie: they are a member as well as a supplier or customer. Their 'double monitorship' bridges somewhat the gap between the external suppliers or customers market (see figure 3.5) and the company and brings these monitors closer to the company. The law creates an additional external monitor of the coöperatie where it provides for an interested party or the OM to request its liquidation if it lacks members[473].

4.6.1.5 *Concluding remarks on the coöperatie*

Table 4.12 shows the strengths (+) and weaknesses (–) in the mandatory monitoring structure of the Dutch coöperatie. The results stem from the previous analysis and need no further comment.

4.6.2 The German eingetragene Genossenschaft (eG)

The forthcoming analysis rests largely on Lang/Weidmüller (2006).

4.6.2.1 *Formation and institutional structure*

The *Genossenschaftsgesetz* (GenG)[474] defines German co-operative law. It is of a mandatory nature[475]. The German co-operative (*Genossenschaft)* is essentially an association with specific objects, namely to promote the business or the private interests of its members, or their social or cultural interests, through a collective business organization[476]. The co-operative is established by signing the founding agreement and the articles[477].

Table 4.12: an evaluation of the mandatory monitoring structure of the Dutch coöperatie.

internal monitoring	+/–	description
appointment / dismissal	+ –	GM appoints (the majority of) EDs and NEDs (and *all* NEDs if structured) if structured, 'non-overrulable' binding recommendation by the SB for a NED nominee (court mediation is provided for)
accountability	+ –	GM adopts annual accounts, appoints auditor and releases directors from liability. Public disclosure through *Handelsregister* no mandatory audit for 'small' coöperaties
veto	+ – + +	GM decides on identity, articles; on membership: in appeal; all, subject to approval or proposal provisions in the articles. No GM veto on change of identity or character decisions SB veto on important company decisions as listed in the law and in the articles works council veto on social matters
company structure	+ –	SB only mandatory for a 'structure coöperatie'; mandatory works council if ≥ 50 employees
directors' duties	+ + –	stakeholder approach / interests of the company *(het belang van de onderneming)* clear standards often need court clarification on issues e.g. conflict of interests, minorities
external monitoring	+ –	at least four. Easy access to OK in order to request an inquiry (*enquête*). no whistle-blowing culture

The German co–operative may appear in a registered[478] and in a non–registered form. A non–registered co–operative has no legal personality (*nicht rechtsfähig*). After registering (*Eintragung*) in the *Genossenschaftsregister*[479], a process that involves extensive court examination[480], a co–operative becomes a registered co–operative (*eingetragene Genossenschaft*, *eG*[481]), which is a legal person[482]. The name of the co–operative should contain the addition *eG* or *eingetragene Genossenschaft*[483]. One needs at least three people[484] to establish a co–operative. The court is to dissolve it once the number of members falls below[485]. The articles (*Satzung*[486]), to be drawn up in written form, should choose whether the member liability to the co–operative for a deficit (*Nachschusspflicht*) will be full, restricted or exempt[487]. Profit–distribution to members is allowed[488].

The *eG* has a mandatory EB, SB and GM. The EB (*Vorstand*) consists of at least two natural persons who should be members[489]. An election of a candidate on the condition that he becomes a member (*Vorratswahl*[490]) is permitted. The GM appoints the EB by default[491]. The mandatory SB (*Aufsichtsrat*), to be appointed by the GM, should consist of at least three natural persons who should be members[492]. As long as the number of members does not exceed 20, the articles may lift the SB requirement as well as the two EB member requirement[493]. In that case the GM in principle[494] also observes the rights and duties assigned to the SB. If the eG has over 1,500 members and the articles so determine, the GM (*Generalversammlung*)[495] may be replaced by a meeting of representatives (*Vertretersversammlung*)[496]. The articles may provide that certain decisions remain in the domain of the GM. The co–determination provisions of the DrittelbG (for over 500 employees) and the MitbestG (for over 2,000 employees) apply here as well[497]. A works council (*Betriebsrat*) is mandatory if the conditions are met as described in 4.4.2.1.

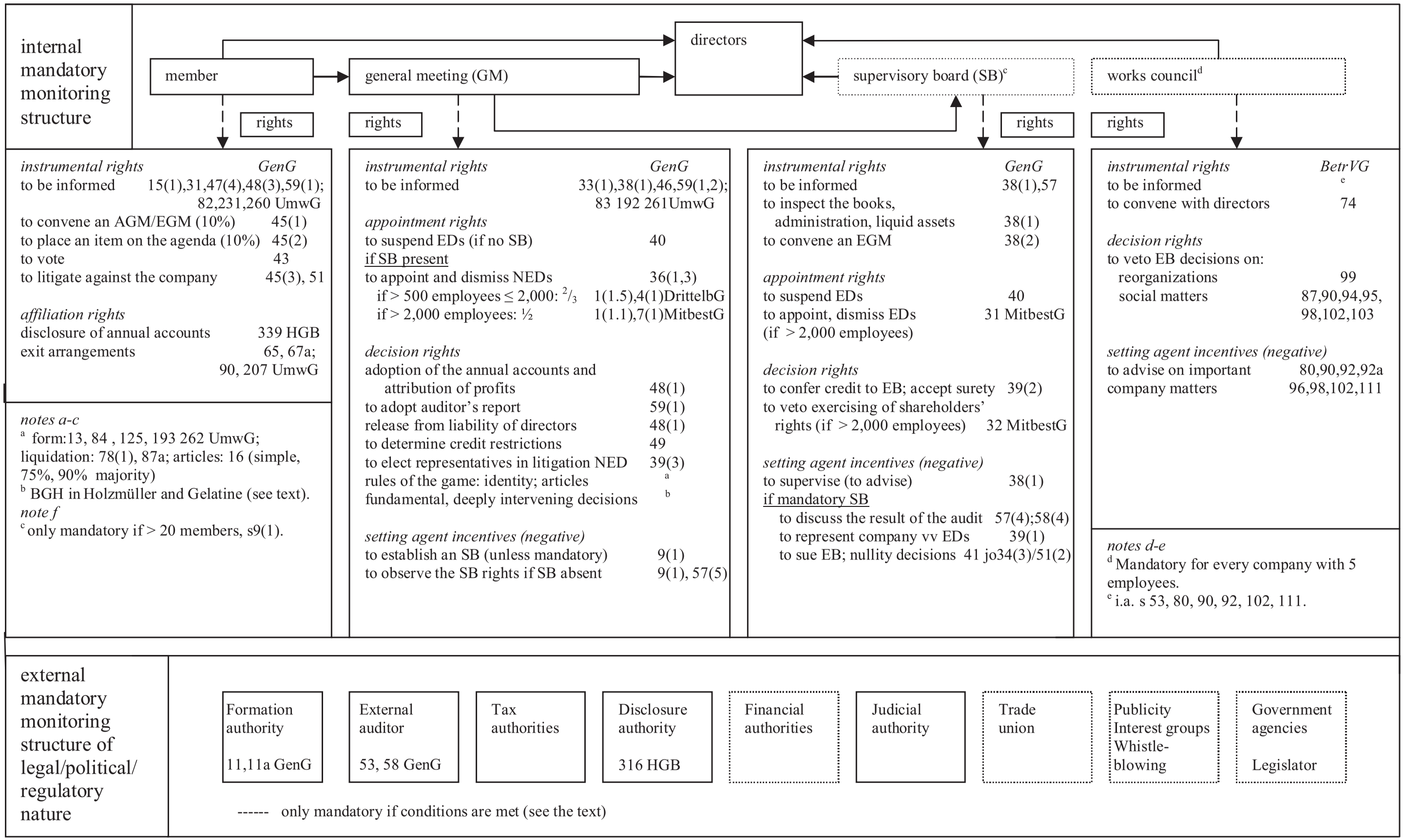
4.6.2.2 *Internal mandatory monitoring structure*

Figure 4.9 shows the mandatory monitoring structure of an *eG*. In the full–blown picture, the eG has five internal and possibly nine external monitoring mechanisms. In the smallest possible option, it may still have three internal monitors and four external monitoring mechanisms.

Shareholders
The legal relationship between the eG and its members is characterized by a *Gleichbehandlungspflicht*[498], the *genossenschaftliche Treuepflicht* and the *genossenschaftliche Duldingspflicht*[499]. The *Gleichbehandlungspflicht* means that every member has to be treated equally. The *Treuepflicht*, based on general association law, implies the duty to observe and promote the interests of the company and to refrain from everything that could harm the company unless exceptional general or personal interests with higher priority require otherwise[500]. The *Duldingspflicht* means that members have to accept duties imposed by the articles or by a decision of the required majority[501]. The first of the *instrumental* rights is the right to be *informed*. This right stems from the associative relationship between member and eG[502] (see also 4.7.2.2.). Every member has an information right[503]. Normally the information has to be given in the AGM/EGM. The *Treuepflicht* applies, i.e. the member should not abuse his right[504]. If 10% of the members request an *EGM*, the EB is obliged to organize one. If the EB does not, the members may require court permission to organize one themselves. The same minority has the right to put items on the agenda. Every member has one *vote*, but the articles may attribute more votes to one member[505]. Every member may *litigate* the eG in case of formal or material faults in the decision process in the GM[506].

General Meeting
Although the GM is still considered the *oberste Willensorgan* of the eG, Lang/Weidmüller recognizes that the strengthened power of management in the law stands in the way of full GM competence regarding management issues[507]. A general instruction right does not exist. The AGM is to be held at least once a year within six months of the end of the financial year[508]. The *information* right contains the right to examine the annual accounts and the annual report[509]. The information right of the GM mirrors the *Berichtspflicht* of the EB and SB. This means that in principle they should inform the GM about all issues necessary for responsible decision–making including those uncommon in size or in nature[510]. The GM *appoints* the EDs by default[511] and the NEDs mandatorily, or a part of them if the co–determination rules apply. Appointment of EDs may be for an undetermined period, subject to the articles[512]. The appointment of a NED is for a period fixed by the articles or by the GM[513]. Both appointments can be dissolved at any time[514]. The remuneration of directors is the competence of the appointing organ[515]. The GM *decides*[516] in principle by simple majority on the approval of the annual accounts and on the attribution of profits;

Figure 4.9: German co-operative (eG): mandatory monitoring structure



on the release from liability of directors; and on credit restrictions to members. As regards the 'rules of the game', the GM approves identity changes and amendments to the articles,[517] specific subjects with a 75% or 90% majority. For membership the law requires a unilateral declaration as well as admission by the eG[518], the later usually provided for by the EB[519]. The *Holzmüller* and *Gelatine* doctrine applies here as well[520]. The *negative agent incentives rights* contain the right to establish an SB if not yet established; and, if no SB is established, to observe the SB rights in general and to attend to the SB rights regarding the auditor specifically through a delegate[521].

Supervisory board (SB)
The SB acts as a collegial forum. Its *instrumental* rights are to require from the EB any *information* on all company matters; to inspect the books[522]; and to convene an AGM/EGM. The auditor has to announce the start of the audit to the Chairman, as well as to inform him of important, immediate measures requiring findings[523]. The SB *appoints* the EDs mandatorily if the *Mitbestimmungsgesetz* applies, otherwise it is a default right. There is no long mandatory list of *decisions* to be taken or approved by the SB, except some provisions on credits to, or guarantees from EDs, should the articles so determine[524].

The *negative agent incentive* strategy charges the SB, if present, with the supervision (*Űberwachung*) of the management of the EB[525]. The law assigns to the *Vorstand* as *Exekutive* an unambiguous and severe management accountability, whilst the control is transferred to the *Aufsichtsrat* as independent *Judikative*[526]. The supervision extends[527] e.g. to the organization of the eG, including the internal control and risk system; the important business decisions, relating to strategy, finance and investment policy; and daily management. As regards company strategy, the articles often prescribe that the EB should acquire the approval of the SB[528]. An important part of its task is the examination of the annual accounts and reports. The SB has to attend the meeting where the auditor reports on the results of the audit[529]. EB and SB should meet immediately after to discuss the report[530]. The law requires that the SB send an annual examination report to the GM[531]. Moreover, the SB represents the eG in dealings with EDs and, should the situation arise, with the company, e.g. in law suits against former EDs or regarding nullities.

If co–determination applies, the SB should convene at least twice every half year[532]. NED rewards may not depend on the results of the eG[533].

Works council
The rights of the works council are the same as described in 4.4.2.2.

4.6.2.3 *Executive board (EB) and duties of directors*

The EB is internally and externally responsible for the management of the eG[534] subject to the articles. These article provisions must refer to specific decisions and cannot contain a general right of approval by another organ[535]. It is a collegial board[536] with an *Arbeitsdirektor* if the *Mitbestimmungsgesetz* applies[537]. An eG may have *hauptamtliche* (full–time), *nebenamtliche* (part–time) and *ehrenamtliche* (honorary) EBs[538]. The presence of honorary EBs is an essential characteristic of the eG[539]. Each ED has a monitoring duty regarding his colleagues and a *Berichtspflicht* in respect of the decisions made by him, since the collective accountability of the board also remains when a division of tasks has taken place[540]. An EB has to observe the *Sorgfaltpflicht*, *Verschwiegenheitspflicht* and *Treuepflicht. Sorgfalt*[541] means that directors have to apply 'the care of a prudent and conscientious director of an eG'[542]. This is an objective test: a director should do everything objectively possible and subjectively reasonable (a surplus) to preserve the eG, its members and its creditors from harm[543]. The BJR applies, thus attributing considerable freedom to act to the EB[544]. The *Verschwiegenheitspflicht* means a duty of secrecy[545]. The *Treuepflicht* means that in all eG–related decisions an ED has to be guided by the interests of the eG and its members and not by his own[546]. A breach of duty makes EDs jointly liable and the burden of proof is theirs[547]. The law lists a number of specific decisions that cause a breach of duty. However, if a decision relies on a GM decision, EDs cannot be held liable[548]. All this applies between the ED and the eG. However, if the breach of duty relates to causes specifically mentioned in the law, i.e. payments of interest or profit to members without GM consent, then even creditors may sue directors directly[549].

4.6.2.4 *External mandatory monitoring structure*

The external mandatory monitoring structure is essentially identical to that of an AG. However, for the audit (*Prüfung*) the law contains special arrangements[550]. Each *eG* should be member of an auditors' association (*Prüfungsverband*)[551]. The State confers and withdraws the right to audit *eG*s[552]. Such a *Prüfungsverband* is in turn examined as a mandatory member by the Auditors Chamber[553] and by the government[554]. The examination of an eG by the auditor includes an audit, but is broader than that. It extends to an analysis of the organization itself, the financial system and situation, the management, the internal risk and control system, employee policy and the like. It should take place annually, with exceptions for small *eG*s[555].

4.6.2.5 *Concluding remarks on the eG*

Table 4.13 shows the strengths (+) and weaknesses (–) in the mandatory monitoring structure of the German eG. The results stem from the previous analysis and need no further comment.

Table 4.13: an evaluation of the mandatory monitoring structure of the German eG.

internal monitoring	+/–	description
appointment / dismissal	+	GM appoints, dismisses NEDs (if an SB; and subject to co-determination law)
	+ –	GM competences regarding remuneration of NED, not ED (unless appointed by GM)
accountability	+	GM decides on adoption annual accounts, auditor's report, release from liability EDs/NEDs.
	+	Disclosure through *Handelsregister*
	–	audit for eGs with total assets below €2 Million only mandatory once every two years
veto	+	GM decides on identity, articles; Holzmüller/Gelatine applies; credit restrictions
	+ –	SB decides on issues listed in articles; credit to/surety by ED
	+	works council veto on social matters
company structure	+	double monitorship of members through double relationship (member and supplier / customer)
	+	no mandatory SB if ≤ 20 members; mandatory works council if ≥ 5 employees
directors' duties	+	stakeholder approach / co-determination
	+ –	*Sorgfalt*, *Treuepflicht*, *Verschwiegenheitspflicht*, *Gleichbehandlungspflicht, Förderpflicht*, *Duldpflicht*; BJR
external monitoring	+ –	at least five. Manifold court access. Specific auditor regulations for eG. Mandatory membership of *Prüfungsverband.* No whistle-blowing culture

4.6.3 The UK Industrial and Provident Society (IPS)

The forthcoming analysis rests on the Industrial and Provident Societies Act 1965 (IPSA 1965), the Friendly and Industrial and Provident Societies Act 1968 (FIPSA 1968), on Mills and Snaith (1997), on information found on the websites of The Co-operative Group, Co-operatives UK and the FSA and on Southern and Rose (1961) for historic references.

4.6.3.1 *Formation and institutional structure*

A co-operative in the UK can operate on an unincorporated basis, as a private company limited by guarantee/ shares, as a community interest company (CIC) limited by guarantee/ shares, or as an Industrial and Provident Society (IPS). The latter is the stronger form for a co-operative[556] and is therefore chosen as the object of analysis. The IPSA 1965 defines an industrial and provident society as an organization conducting an industry, business or trade, either as a 'bona fide co-operative society' (for the mutual benefit of its members who will participate in the business of the society) or 'for the benefit of the community' (for people other than its own members)[557]. For the latter the law requires 'special reasons' as they should normally register as companies[558]. For registration a society needs three members and a secretary or, if the members are registered societies, at least two of them[559]. The Mutual Societies Registration section of the FSA is the registration authority[560]. Unlike the registration procedure of a company, here the FSA scrutinizes the articles, which are called 'rules'[561]. The FSA has developed a strict set of requirements a society should adhere to before it can be registered as an IPS[562]. For a bona fide co-operative these are: (1) the existence of a community with a common economic, social or cultural need or interest, wherein (2) the business is run for the mutual benefit of all members, (3) the control of the society lies with all members, 'one member, one vote' should apply, and officers are elected by the members, (4) interest on share and loan capital should be limited to a rate necessary to obtain and retain enough capital to run the business[563], (5) profits, if the rules allow distribution at all, should be distributed to the extent that the members have participated in the business, (6) membership should in principle be open to all, and (7) the applicants are able to convince the FSA that the rules demonstrate that the society will be a bona fide co–operative[564]. Upon registration the society becomes a body corporate with limited liability[565]. The maximum shareholding for natural persons is £20,000[566]. The last word of the registered society's name should be 'limited'. However, if its objects are 'wholly charitable or benevolent' the FSA may accept a name without the addition of 'limited'[567].

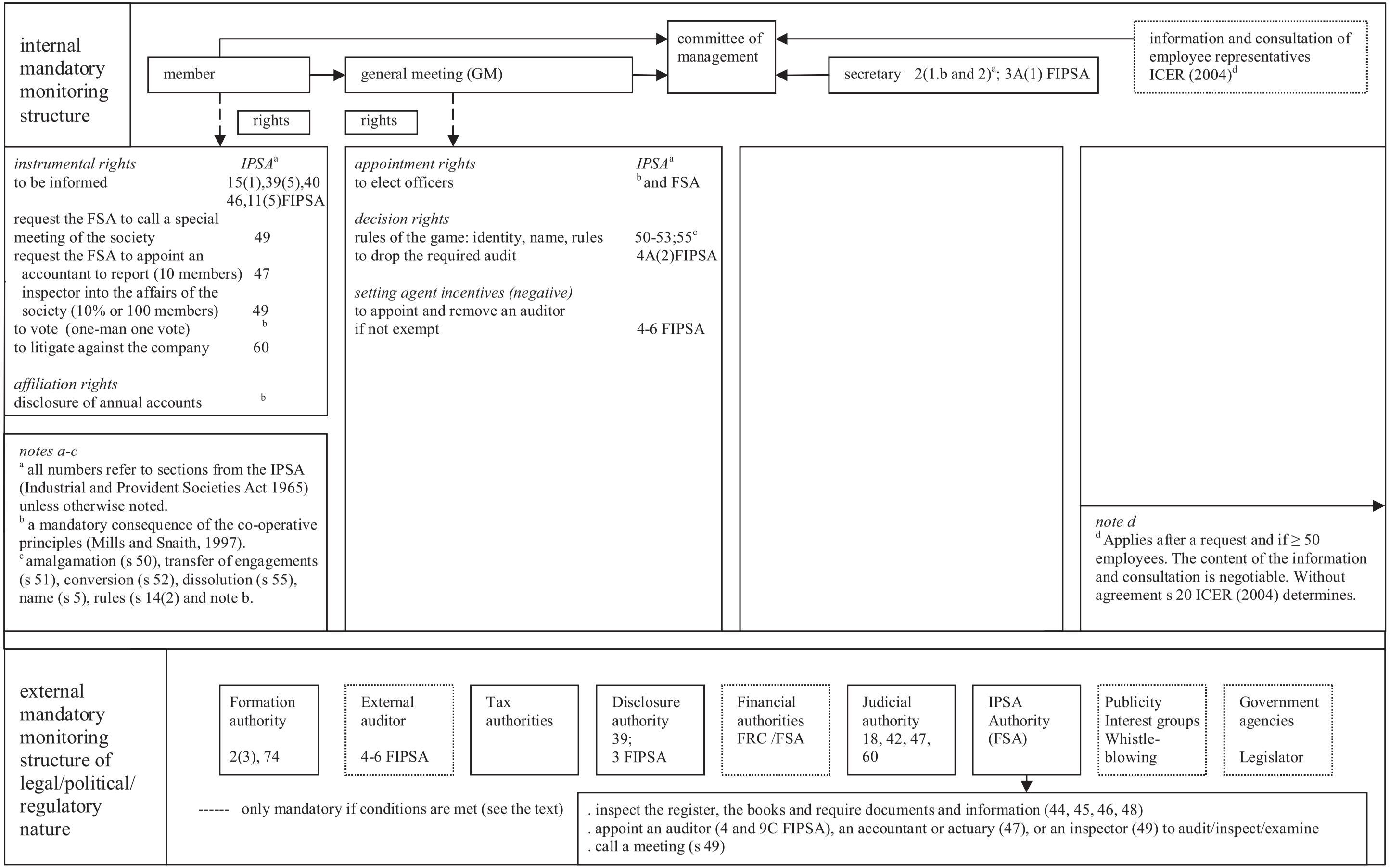
As regards the institutional structure of the IPS the law speaks of members, a general meeting, which may be a delegate meeting if the society's rules so allow[568], a committee, and a secretary, receiver, manager or officer [569]. The rules should contain further arrangements. Schedule 1 IPSA 1965 lists the matters to be provided for in a society's rules, which are e.g. the terms of admission of the members; the mode of holding meetings, the scale and right of voting and the mode of altering the rules; the appointment and removal of a committee, of managers or other officers and their respective powers and remuneration; and the mode of application of profits. There are no mandatory provisions on these issues. The IPS may also be subject to additional legislation and be entitled to different privileges, depending on the nature of their business[570]. If an IPS is a member of Co–operatives UK, it is required to adhere to the Corporate Governance Code of Best Practice for consumer co–operative societies 2005 and to disclose in its annual reports the extent to which it has followed the best practice recommendations and to give reasons for non–compliance. A whistle–blowing procedure is part of the code.

4.6.3.2 *Internal mandatory monitoring structure*

Figure 4.10 shows the mandatory monitoring structure of an IPS. In the full–blown picture, the IPS has five internal and possibly nine different external monitoring mechanisms. The three–man IPS may encounter legally four and *de facto* no internal and five external monitoring mechanisms.

The *internal* monitoring mechanisms of a bona fide co–operative are the members, a general meeting, a secretary and a committee, often called the board. If the conditions are met an information and consultation mechanism of employee representatives may be in place.

Figure 4.10: UK Industrial and Provident Society: mandatory monitoring structure



As figure 4.10 shows, few mandatory rules apply. Members' *instrumental* rights are restricted to a request to the FSA to appoint an inspector or call a special meeting (see below) and to information through a copy of the rules and of the latest annual return; to a display of the latest balance sheet in a 'conspicuous position at the registered office of the society' and to inspection of his own account and (part of) the members' register. The mandatory GM *decision* rights relate to the amalgamation, transfers of engagement and conversion and to the name of the company, as well as, not through the law but based on the 'bona fide co-operative' requirement, the rules and the receipt of financial statements (Mills and Snaith, 1997). The appointment of the auditor is also GM territory[571]. The 'organic theory of power distribution' developed in common law prevails, meaning that 'if powers of management are vested in the directors, they and they alone can exercise these powers' (Mills and Snaith (1997). There are no specific provisions as to the role of the *secretary*.

4.6.3.3 *Board (BOD) and duties of directors*

Mills and Snaith (1997) explain that executives can be appointed either based on a requirement in the rules or as a matter of delegation from the board. How this may work out in practice is shown by the structure of the largest British co-operative, the Co-operative Group[572]. It has a Board consisting of 20 non-executives only, elected by the members. They are lay directors who depend on the expertise of the executives to run the business[573]. There are two executives, appointed by the Board. The responsibility of the Board is to direct the business of the Society, in particular (1) ensuring that its affairs are conducted and managed in accordance with its objects and in accordance with the best interests of the Society and its members, (2) determining the vision and strategy in consultation with the executives, and (3) overseeing the executives in the day-to-day management of the business[574].

As indicated in 4.4.3.3 above, British law has a concise system of directors' duties, developed in common law. Whilst this system is – in a way – codified in the CA 2006, for the IPS common law is still the guiding principle. As explained by Davies (2002), directors have two main duties in common law: a duty of care and a duty of loyalty also described as a duty to act bona fide. Every director should take care in the exercise of his duties, either as far as he himself is capable (the subjective test), or according to what one can expect of a 'reasonable person' (the objective test). This is what the *duty of care* implies. Whereas in common law the subjective test used to prevail, at present the Insolvency Act (IA) 1986 formulates an objective test, at least as a minimum level (Davies, 2002: 154)[575]. The *duty of loyalty* requires that the director, when exercising discretion, acts bona fide in what he thinks are the best interests of the company (Davies, 2002: 159[576]). This is essentially a subjective, and thus not very valuable, criterion. However, common law has supplemented the duty of loyalty by equitable rules, which has resulted in objectively-based rules as there are: the rule to obey the constitution, the no–fettering rule, the rule against self–dealing and the rule against secret profits. These are largely identical to the statutory regulations of the CA 2006. In addition, the IPSA enables the rules to require from officers 'having receipt or charge of money' that they provide security 'either by becoming bound (..) with or without a surety' or 'by giving the security of a guarantee society'[577]. Moreover, such an officer shall on demand render an account to the society and half–yearly deliver a return tot the FSA showing his receipts and his payments[578]. The IPSA also provides for the liability of directors in the case of fraud and misappropriation[579].

4.6.3.4 *External mandatory monitoring structure*

The FSA is the leading external monitoring mechanism. It is not only a scrutinizing formation authority, the disclosure authority for the annual returns[580] and, as the case may be, the relevant authority under the FSMA[581]. The IPSA 1965 and the FIPSA 1968 attribute deeply intervening investigation rights to the FSA as well. The FSA may e.g. inspect the society's register[582], appoint an accountant to inspect the books and to report thereon[583], require the production of the books, documents and other information[584], appoint an inspector to examine the affairs of the society at the request of 10% of the members and call a special meeting of the society[585], and require from an exempt society to appoint an auditor to audit its current or previous accounts[586]. The public may request access or copies of a society's public file, which includes the annual returns and accounts[587]. A full professional *audit* by a qualified auditor is always required by societies which in the preceding year of account had a turnover in excess of £5,600,000 (£250,000 if charitable) or total assets in excess of £2,800,000[588]. Below these thresholds and with a turnover higher than £90,000 an accountant's report [589]will suffice, provided the rules allow this and the GM has passed a resolution to that end with less than 20% of the votes cast, and less than 10% of the members voting against[590]. Below £90,000 a society may produce unaudited accounts. For very small societies, the IPSA 1968 created the form of a lay audit[591]. IPSs are companies for *tax* purposes and are liable to corporation tax in respect of their profits with some exemptions[592]. The *judicial* authority is a court of appeal against FSA decisions or may decide disputes between the society and a member.

4.6.3.5 *Pending changes in IPS law*

The Co–operative and Community Benefit Societies and Credit Unions Act 2010 (CCBSA) received Royal Assent on 18 March 2010. It is not yet in force. It renames the various 'Industrial and Provident Societies Acts' in 'Co–operative and Community Benefit Societies and Credit Unions Acts'[593]. In future, societies will be registered as either a co–operative society or a community benefit society. Moreover, the act applies to registered societies the provisions relating to directors disqualification[594].

4.6.3.6 *Concluding remarks on the IPS*

An IPS is a not much regulated but externally heavily supervised body corporate suitable for a strong co–operative form. The FSA supervision will have the effect of sustaining confidence in the IPS in the markets. Table 4.14 shows the strengths (+) and weaknesses (–) in the mandatory monitoring structure of the UK IPS. The results stem from the previous analysis and need no further comment.

Table 4.14: an evaluation of the mandatory monitoring structure of the UK IPS.

internal monitoring	+/–	description
appointment / dismissal	+	democratic structure requirements of the FSA require members to appoint directors
accountability	+ – +	GM appoints, removes auditor (if not exempt from audit) no GM approval of annual accounts; no release from liability of directors members may request FSA for inspection (10) or examination (100) into the society's affairs
veto	+ + –	GM decides on identity, rules (common law may assign additional rights)
company structure	+ –	representation of members on the board no 'organic' employee representation (works council)
directors' duties	+	an integrated common law system of duties
external monitoring	+	at least five; strong monitoring/supervising role of FSA; whistle-blowing system through PIDA

4.6.4 Concluding remarks on the co–operative

The difference in possible objects is striking. The Dutch and UK co–operative emphasize *material* needs, whilst in Germany idealistic objects can be served within a co–operative as well. All systems recognize the GM as the 'highest organ'. Table 4.15 shows that *appointment/dismissal* is basically a GM right, with an exception for the ED in a 'MitbestG eG'. Directors are *accountable* for the annual reports to the GM (coöperatie, eG) or the FSA (IPS). The GM appoints the auditor (eG: mandatory membership of a *Prüfungsverband*[595]). There is no mandatory audit for small IPS or coöperatie. The GM can *veto* changes in the rules of the game; in the Netherlands the articles may attribute a right of denial to an organ or a third party. Moreover, the SB and the works council have veto rights in the coöperatie and eG. The *company structure* largely differs from the other forms since there is a double monitorship due to a double relationship between members and the co–operative. The coöperatie and eG, if large enough, require the presence of a *SB* and/or a *works council*.

The system of *directors' duties* relies on common law (IPS) and on legal standards and case law in the Netherlands and in Germany. As for *external monitoring*, the UK recognizes strong governmental monitoring through the FSA as well as a whistle–blowing arrangement (PIDA). Germany recognizes specialized and very detailed arrangements for the audit of the eG. The specialized and easily accessible court (OK) is the Dutch external monitoring feature, although it should be acknowledged that coöperaties seldom use it.

Table 4.15: a comparative evaluation of the mandatory monitoring structure of the coöperatie, eG and IPS.

internal monitoring	+/–	description
appointment / dismissal	coöperatie+ – eG+ IPS+–	GM appoints (BV, IPS), dismisses (the majority of) directors (BV). In 'structure coöperatie' GM votes on 'non-overrulable' SB-nomination for NED. In eG > 500 employees GM appoints and dismisses two thirds of the NEDs (eG > 2,000 employees: 50%). If eG ≤ 2,000 employees: GM appoints EDs by default; if > 2,000 employees SB appoints EDs
accountability	coöperatie+ eG+ IPS–	GM appoints auditor if not exempt (coöperatie; IPS), adopts annual accounts (coöperatie; eG), releases directors from liability (coöperatie, eG). Public disclosure (all). Members may request FSA that examination of society's affairs be inspected
veto	coöperatie+– eG+ IPS–	GM decides on identity, articles; has no instruction right (all). No provision on major change of identity or character (unless for eG: Holzmüller/Gelatine). SB veto on items listed in the law (coöperatie) or the articles (eG, coöperatie); works council veto on social matters (eG, coöperatie)
company structure	coöperatie+– eG+ IPS––	double monitorship of members through double relationship (member, supplier/customer) no mandatory presence of NEDs (IPS); mandatory if > 20 members or > 500 employees (eG); and if 'structure coöperatie' (coöperatie) mandatory works council if ≥ 5 (Germany) or 50 (the Netherlands) employees IPS: no co-determination or works council (unless EWC)
directors' duties	coöperatie+– eG+– IPS+ –	stakeholder approach in Germany and the Netherlands member approach in the UK (*mutual benefit of its members*) an integrated system of duties based on common law (IPS)
external monitoring	coöperatie+ eG+ IPS+	easy access to specialized OK (coöperatie) specialized auditors' requirements and regulations (eG) FSA supervision/monitoring; whistle-blowing system through PIDA (IPS)

4.7 THE MANDATORY MONITORING STRUCTURE OF THE ASSOCIATION

An association is a group of persons, members, working together towards a common object of which they are often the primary beneficiaries. This section evaluates sequentially the mandatory monitoring structure of the Dutch *vereniging* (4.7.1), the German *Verein* (4.7.2) and the UK *community interest company* (4.7.3). Section 4.7.4 concludes.

4.7.1 The Dutch *vereniging*

The forthcoming analysis rests on Galle (2002), Dijk/Van der Ploeg (2007), Van der Ploeg (2010) and Asser–Van der Grinten (1986) for historic references.

4.7.1.1 *Formation and institutional structure*

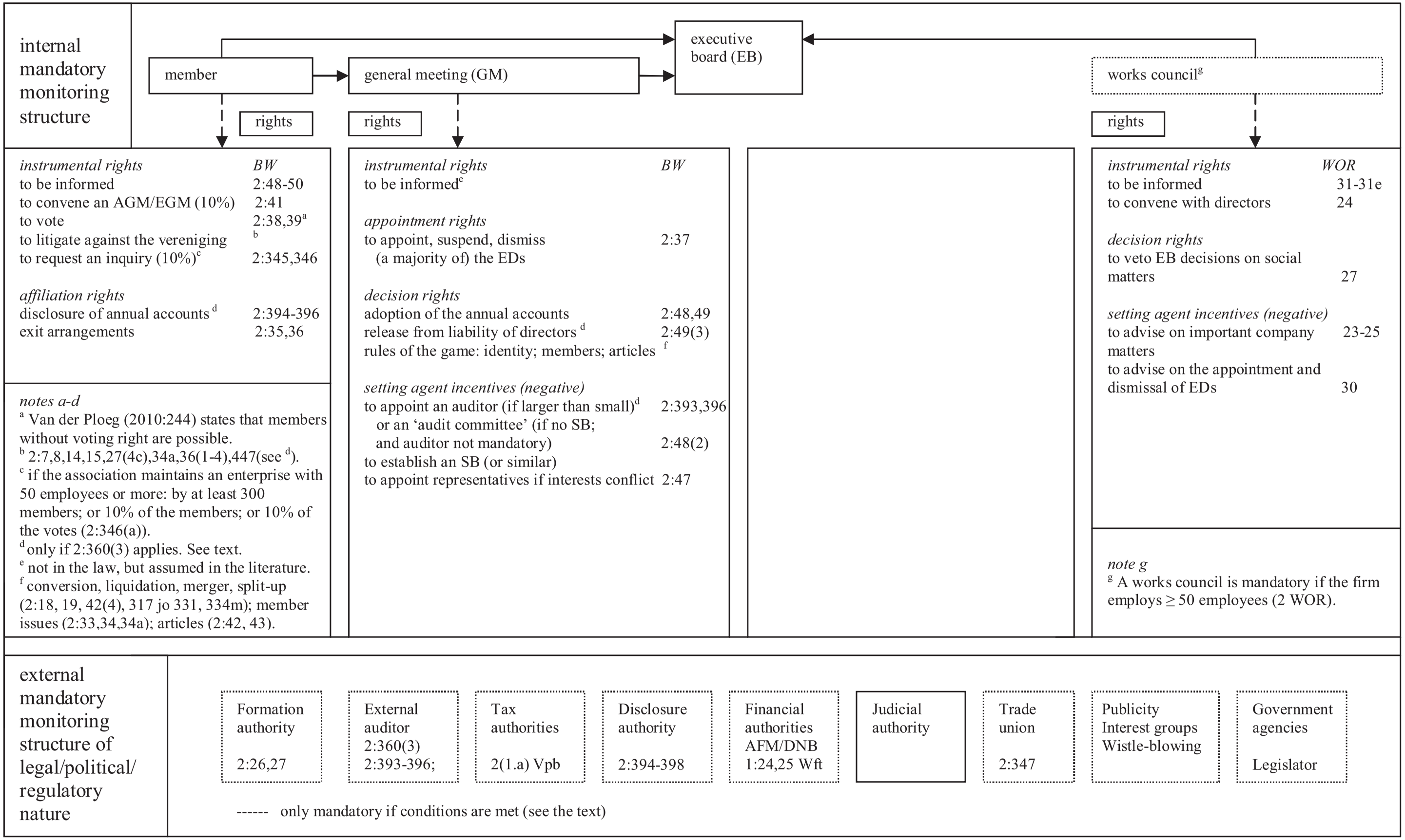
S 2:26–52 BW specifies association law in The Netherlands. The law requires at least two people for the formation of a Dutch association (*vereniging*). The formation takes place through a multilateral legal act. The law defines a *vereniging* as a legal person with members, directed towards a certain object which is not of a co–operative nature[596]. Profit–distribution to members is not allowed[597]. A *vereniging* may emerge in two forms: with and without full legal competence[598]. It obtains full legal competence once its articles are drawn up in a notarial deed[599]. The mention of the word '*vereniging*' in the association's name is not mandatory[600]. The vereniging has a mandatory EB and GM. The GM usually consists of all the members, but the articles may determine that the GM consists of representatives of the members only. In the latter case, the articles may list GM decisions that are subject to a poll of all the members (s 2:39 BW). Although the law explicitly mentions NEDs[601], the establishment of an SB is optional. Non–company law may require the establishment of an SB, e.g. in health care, housing or education. The establishment of a works council depends on the conditions described in 4.4.1.1.

4.7.1.2 *Mandatory monitoring structure and duties of directors*

Figure 4.11 shows the mandatory monitoring structure of a *vereniging*. In the full–blown picture, the vereniging has three internal and possibly nine external monitoring mechanisms. The one–man vereniging[602], a legally admitted *contradictio in terminis*, may encounter only one mandatory external monitor. The text below analyses the internal and external mandatory monitoring structure of the vereniging.

The *internal* mandatory monitoring structure analysis starts with the *instrumental member* rights. Members are to be informed; 10% may convene an EGM; they have a voting right; and may even litigate or request an inquiry if the appropriate thresholds are met. As concerns the *affiliation member rights*, only a vereniging that maintains one or more enterprises with a total net turnover of over €4,4 million[603] follows the disclosure and related litigation rules from Titel 9 Boek 2 BW (see 4.4.1.2). However, if these thresholds are not met litigation concerning the annual accounts and annual report through the special procedure established in the law or petitioning an inquiry is not possible[604]. Nor should a vereniging by then apply the accounting and disclosure rules of Titel 9 Boek 2 BW or is an auditor provided for, whatever the size of its membership. In that case its financial reporting may be rather basic[605]. Concerning the *GM instrumental* and *appointment rights*, they are similar to those of the coöperatie. Important is the *GM decision* right to adopt the financial reports, and the *negative incentive* rights to appoint an independent audit committee (*kascommissie*) to check the books[606] and to appoint representatives in case of conflicting interests with the EB.

Figure 4.11: Dutch association (vereniging): mandatory monitoring structure



The *internal* monitoring mechanisms of a *vereniging* are very basic and designed for the needs of a small *vereniging*[607]. Thus, especially for a large *vereniging*, and there are quite a few, i.a. the ANWB, public broadcasting and Natuurmonumenten, a proper governance is almost entirely left to the articles. They will, as have been shown by Santen and Kloosterman (2007) for the NV, most likely choose the least governance-friendly alternative. The *works council* rights of the WOR apply to the *vereniging* as they do to the NV (4.4.1.2). However, it lacks the special rights assigned to the NV works council by the BW.

The *executive board* (EB) and *duties of directors* resemble the coöperatie (4.6.1.2) in its collegial board structure, its tasks and its duties of directors. In case the vereniging creates an SB, the articles should define its tasks in line with those of the NV/BV/coöperatie[608]. The same duties apply. However, for a vereniging which is not subject to Corporation Tax (VpB) there are exceptions[609].

Given the weak internal monitoring structure, the importance of *external* monitors grows. However, the *vereniging* has few. The *formation* authority comes into the picture if the vereniging is fully legal competent, which is in the majority of cases (86.5%[610]). *Financial disclosure* is only mandatory if the vereniging maintains an enterprise with a standing turnover for two years of at least €4,4 million. For the mandatory appointment of an *external auditor* that enterprise should in addition be larger than 'small'. However, the receipt of government subsidies normally implies a mandatory audit[611]. The *tax* authorities may be evaded for some time if the association declares that it does not maintain an enterprise or compete in the market sector[612]. As regards the *judicial* authorities, an inquiry can only be requested of the OK if (a) the *vereniging* is fully competent and (b) maintains an enterprise with (c) 50 employees[613] and in that case by (1) at least 300 members; or (2) at least 10% of the members; or (3) at least as many members as represent 10% of the votes[614]; or (4) through a qualifying *trade union*; or (5) by the solicitor-general[615] in the public interest. The suppression and dissolution provisions mentioned in 4.4.1.5 apply here as well. An additional external monitor forms the provision that an interested party or the OM may request its liquidation if there are no members left[616].

4.7.1.3 *Concluding remarks on the vereniging*

Table 4.16 shows the strengths (+) and weaknesses (–) in the mandatory monitoring structure of the Dutch vereniging. The results stem from the previous analysis and need no further comment.

4.7.2 The German eingetragener Verein (eV)

The forthcoming analysis rests on Galle (1998), Schmidt (2002), Stöber (2004), Beuthien and Gummert (2009), Meckling (2010) and Von Hippel (2010).

Table 4.16: an evaluation of the mandatory monitoring structure of the Dutch vereniging.

internal monitoring	+/–	description
appointment / dismissal	+ –	GM appoints and dismisses (majority of) EDs no GM competences regarding remuneration
accountability	+ + –	GM adopts annual accounts, appoints committee of investigation or, if need be, an auditor if 2:360(3) (enterprise and turnover ≥ €4,4 Mio) applies: GM releases directors from liability; disclosure through the *Handelsregister* no mandatory audit unless with enterprise; then, only mandatory if not 'small'
veto	+ – +	GM decides on identity, articles; on membership: in appeal; all, subject to approval or proposal provisions in the articles; no GM veto on change of identity or character decisions works council veto on social matters
company structure	+ –	no mandatory SB; mandatory works council if ≥ 50 employees
directors' duties	+ + –	stakeholder approach / interests of the association *(het belang van de vereniging)* clear standards often need court clarification on issues e.g. conflict of interests, minorities
external monitoring	+ – –	at least one. Easy access to OK in order to request an inquiry (*enquête*). easy initial avoidance of tax related obligations; no whistle-blowing culture

4.7.2.1 *Formation and institutional structure*

The sections 21–79 BGB specify the basics of German association law. It is mainly of a mandatory nature [617]. The law does not define the association (*Verein*), but the literature maintains that it is a sustainable, institutionalized organization of people directed at a common object[618]. It may be established by two, but for registration it needs at least seven people[619]. The BGB discerns two sorts of private[620] associations: the *idealistic* or *nichtwirtschaflicher* (non–economic) and the *wirtschaflicher* (economic) *Verein*[621]. Both may be legal persons or not[622]. The non–economic association obtains legal personality by registration in the register (*Vereinsregister*)[623] and then becomes an *eV* (*eingetragener Verein*)[624]. One of the two should be added to the name[625]. The approval of the objects, which should not be directed at the economic exploitation of a company, is implicit in the registration procedure[626]. The economic association obtains legal personality once it has been approved by the State (*Bundesstaat*[627]). In order to avoid unequal competition[628] between companies with different legal forms, this concession is only granted in those few cases in which the petitioner succeeds in proving that the desired organization form cannot be created as an AG, GmbH, or eG (*Subsidiaritätsprincip*)[629]. Legal personality can be withdrawn by the court once the number of members falls below three[630], or e.g.[631] if a non–economic association pursues an economic goal[632]. The *Verein* has a mandatory EB (*Vorstand*) and GM (*Mitgliederversammlung)*[633]. The GM usually consists of all the members, but the articles may determine that the GM will consist of representatives of the members (*Delegiertenversammlung*[634]). An SB is permitted, though not required or regulated. Co–determination regulation does not apply. A works council (*Betriebsrat*) is mandatory if the conditions are met as described in 4.4.2.1.

4.7.2.2 *Mandatory monitoring structure and duties of directors*

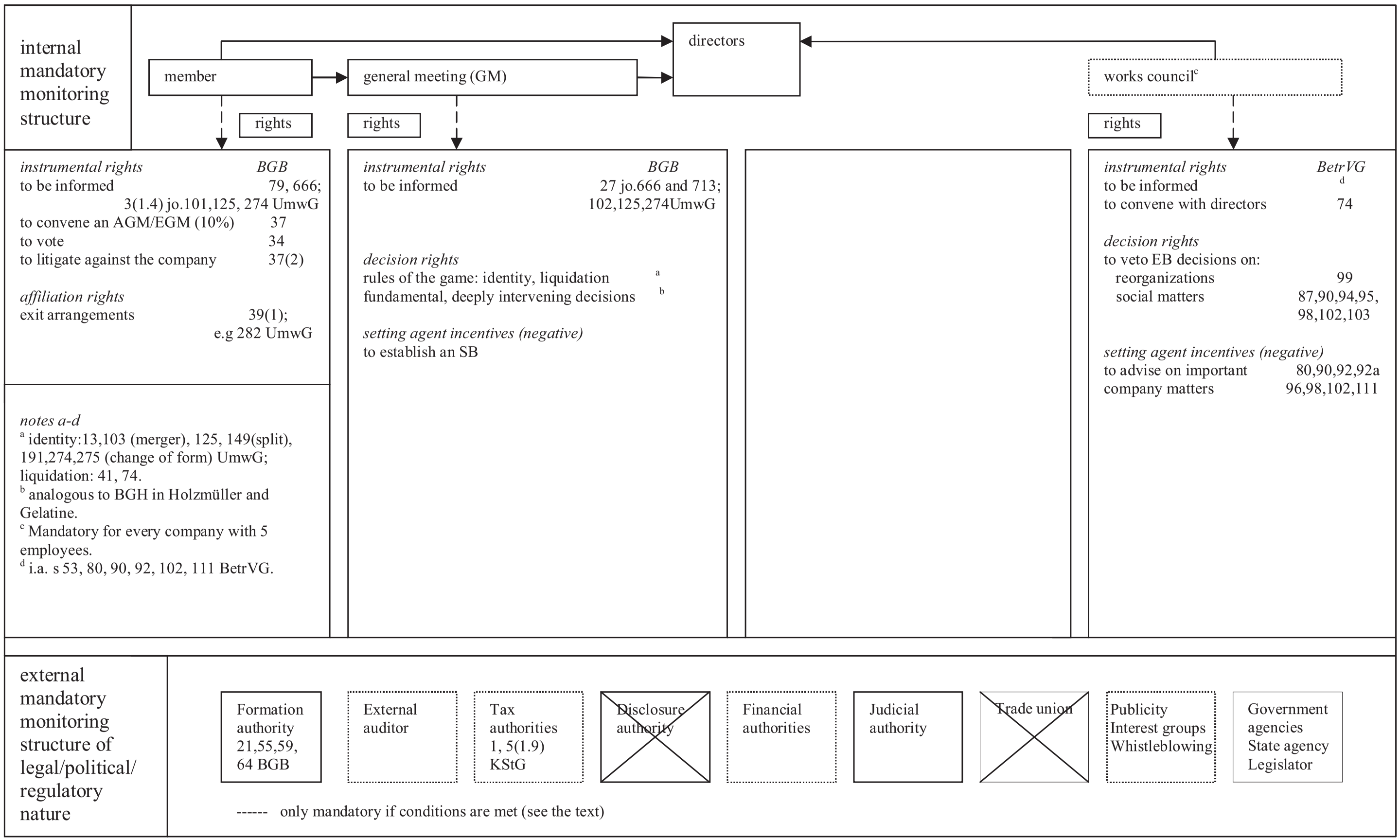
Figure 4.12 shows the mandatory monitoring structure of an *eV*. In the full–blown picture, the *eV* has four internal and possibly seven external monitoring mechanisms. In the three–man *eV* there are still three internal and three external monitoring mechanisms. The principle of *Satzungsautonomie*[635] results in a rather rudimentary legal regulation (Schmidt, 2002: 83; Galle, 1998). The *internal* mandatory monitoring structure is at follows.

Member
The first *instrumental* member right is to request the EB to convene a meeting or a court authorization to do so if the EB does not agree[636]. Each member has a voting right. Voting outside a meeting is allowed[637]. A member may have special rights[638]. Based on general legal principles (*mitgliedschaftliches Grundrecht*), Stöber (2004: 179) and Schmidt (2002: 626) hold that members are entitled to information, annual accounts and inspection of the membership list. Members have a *Förderpflicht*[639], a *Treuepflicht*[640] and a *Gleichbehandlungspflicht*[641]. Accordingly, the articles may require the appointment of special representatives for specific transactions[642]; a member is not allowed to vote on an agenda item concerning litigation against him[643]; and it is generally thought that a member should not vote on items relating to release from liability or dismissal concerning himself[644].

General meeting (GM)
The GM is fundamentally the highest organ of the *Verein* (Segna, 2002: 3) . The law provides for GM's *instrumental* information right based on the *Bürgerliches Gesetzbuch* (BGB)[645] although literature pleads for an analogous application of the AktG arrangement[646] of an information right for every member in the GM (Segna, 2002: 19). Schmidt (2002) constructs from the general BGB duty to inform[647] an individual right to information. The GM *appoints* EDs[648] and it may repeal the appointment at any time, unless the articles restrict this right[649]. It has *decision* rights in respect of all items concerning the *Verein*, insofar as they are not attributed to the EB or another *Vereinsorgan*[650]. The articles may be amended by a 75% majority, and to change the objects 100% is necessary[651]. And although most *Vereine* are organized accordingly (Segna, 2002: 13), this is all default law[652]. Mandatory is the liquidation decision[653]. Normally, the GM decides by a simple majority[654]. Since the GM is the highest organ[655] in the *Verein*, the EB should accept its instructions unless the law provides otherwise[656].

The board (EB) and duties of directors
The EB functions as a collegial board[657]. It directs and represents the Verein[658]. Directors need not be members[659]. The articles may restrict its power of representation with external effect[660]. The *Förderpflicht, Treuepflicht* and *Gleichbehandlungspflicht* apply to directors as well[661]. Additionally, the BGB requires the *care* from each of the members

Figure 4.12: German Verein (eV): mandatory monitoring structure



that one would exercise this for one's own good[662]; avoid abuse and negligence, and – if a *Kaufmann* in the sense of the HGB – perform with 'the care of a conscientious tradesman'[663].

The law leaves all the other issues to the articles[664] e.g. relating to membership and contribution; composition of the board; the organization of the GM. According to Schmidt (2002: 700) the *Holzmüller/Gelatine* doctrine applies here as well, which implies that the EB should request approval for decisions which *in effect* amend the articles. On the nullity of Verein decisions, Schmidt (2002: 697) is of the opinion that the sections in the *Aktiengesetz* should be applied *per analogiam*. Since directors' liability refers to the BGB (Schmidt, 2002: 691) which may cause unreasonable consequences for the honorary (*ehrenamtliche*) director, the law has been recently changed in order to in principle exempt directors earning less than €500/year[665].

The first of the *external* monitoring mechanisms is the *formation authority*. For the *eV* this is the local court. This checks whether the Verein to be registered satisfies the legal requirements. This is more than a formal check, e.g. the objects are scrutinized[666]. An *audit* of a Verein is generally not required (Vogelbusch, 2008). If the *eV* is not exempt (see 4.4.2.4) *tax law* may require annual reporting in general[667] or for certain categories e.g. for hospitals[668].

Public *disclosure* of financial data of an *eV* is not mandatory. For an *eV* that is not a *Kaufmann* according to the HGB there are no regulations for bookkeeping at all[669]. And even if the HGB applies, i.e. if the *eV* exploits an enterprise, the law prescribes bookkeeping procedures and no public disclosure. There is no government monitoring after registration.

4.7.2.3 *Concluding remarks on the Verein (eV)*

Table 4.17 shows the strengths (+) and weaknesses (–) in the mandatory monitoring structure of the German *eV*. The results stem from the previous analysis and need no further comment.

4.7.3 The UK Community Interest Company (CIC)

The forthcoming analysis rests on Davies (2008), Eijsbouts, Kristen, Jongh, Schild and Timmerman (2010) and materials downloaded from www.cicregulator.gov.uk.

4.7.3.1 *Formation and institutional structure*

Although it is possible to run an incorporated 'association' type of company as a Ltd[670], the UK legislator created a special form in 2004 for not–for–profit, non–charitable com–

Table 4.17: an evaluation of the mandatory monitoring structure of the German Verein (eV).

internal monitoring	+/–	description
appointment / dismissal	–	legal requirements in State law
accountability	–	legal requirements in State law. EB has a *Berichtspflicht.* No disclosure requirements.
veto	+ + – +	GM may instruct EB GM decides on identity; no veto on articles or membership; Holzmüller/Gelatine applies works council veto on social matters
company structure	–	no mandatory SB; mandatory works council if ≥ 5 employees; *Satzungsautonomie*
directors' duties	+ –	*Sorgfalt*; *Treuepflicht, Verschwiegenheitspflicht, Gleichbehandlungspflicht, Berichtspflicht, Förderpflicht*; BJR
external monitoring	+ – +	for 'nicht wirtschaftlicher Verein' a 'check at the gate' for 'wirtschaftlicher Verein' a State executed / supervised concession and monitoring system

panies whose aims are to promote the interests of the community or a section of it[671]. These *community interest companies* are either public (abbreviated as: community interest Plc) or private (CIC[672]) limited companies. They may be formed either as limited by shares or as limited by guarantee[673]. Essentially, their institutional structure equals that of a Plc or a Ltd as the case may be. The Companies Act 2006[674] has effect subject to Part 2 of the *Companies (Audit, Investigations and Community Enterprise) Act 2004 (CA 2004)*, which established the CIC[675]. The memorandum of a CIC must state that the company is to be a CIC. A company satisfies the 'community interest test' if a reasonable person might consider that its activities are being carried out for the benefit of the community[676]. The range of activities is broad. The CIC register contains e.g. counsellors, foster care, theatre and lawn sports CICs[677]. A CIC, although established for charitable purposes, cannot be a *charity*[678]. A 'charity' has a legal connotation to be explained in 4.8.3.1. Due to the special object of the CIC, the law forbids a CIC to distribute assets including dividends to its members, unless regulations provide otherwise[679]. Payments of interest on debentures may be limited as well[680]. These are called *asset lock* provisions, meant to satisfy third parties that the assets and profits are used solely for community benefit.

To the usual institutional structure of a Plc or Ltd, the CA 2004 has added external institutions of a supervisory nature. They are: a Regulator, an Appeal Officer and an Official Property Holder[681]. In short, the Regulator, an officer to be appointed by the Secretary of State, must facilitate, supervise and regulate the CIC sector. He clears a CIC for registration[682]. The subsequent registration by the registrar creates the body corporate[683]. The Appeal Officer has the function of determining appeals against decisions and orders of the Regulator[684]. The Official Property Holder[685] holds functions relating to the property of a CIC, e.g. to secure this property in the interest of the CIC.

4.7.3.2 *Mandatory monitoring structure and duties of directors*

Figure 4.13 shows the mandatory monitoring structure of a private limited CIC. In the full–blown picture, the CIC has four internal and possibly nine external monitoring mechanisms. Although theoretically not impossible, the presence of an EWC/ICP is deemed highly improbable. Only the possibility of an information and consultation procedure is mentioned in the figure. The one–man CIC may encounter no internal and five external monitoring mechanisms.

The *internal* mandatory monitoring structure and the provisions related to the board and directors' duties are identical to those of the Ltd or the Plc, as the case may be. This section focuses on the private CIC.

Externally, the CIC is supervised by the Regulator[686] from the cradle to the grave. The flexible governance form of the CA 2006 is still present, but the Regulator may take measures against any abuse discovered. It is entitled e.g. to investigate the affairs of a CIC[687]; to require an audit and appoint an auditor[688]; to appoint, suspend and dismiss a director[689]; to appoint a manager[690]; to transfer shares or extinguish membership[691]; or petition to wind–up the CIC[692]. Moreover, the Regulator may 'vest in the Official Property Holder any property held by or in trust for a CIC' or may order a person who holds property on behalf of a CIC not to part with the property without the Regulator's consent[693]. However, the law states[694] that the Regulator should exercise his supervisory powers 'only to the extent necessary to maintain confidence in community interest companies'. In order to keep the Regulator informed about the whereabouts of the CIC, the mandatory annual 'community interest company report'[695] should be forwarded to the Regulator[696] and to the registrar of companies[697]. This important role of the Regulator counterbalances the role of the members. Their decisions are often subject to the Regulator's approval[698].

4.7.3.3 *Concluding remarks on the CIC*

A CIC is a heavily regulated and supervised Plc or Ltd with a community interest object. The regulation and supervision will have the effect of sustaining confidence in the CIC on the markets. Table 4.18 shows the strengths (+) and weaknesses (–) in the mandatory monitoring structure of the UK Ltd. The results stem from the previous analysis and need no further comment.

4.7.5 Concluding remarks on the association

Table 4.19 evaluates the differences in the mandatory monitoring structure of the *vereniging*, *eV*, CIC. All these forms endorse the idea of the GM as the 'highest organ'. Regulation of this type of association is rather 'rudimentary'. In Germany one relies on a strict

Figure 4.13: UK private limited community interest company (CIC): mandatory monitoring structure

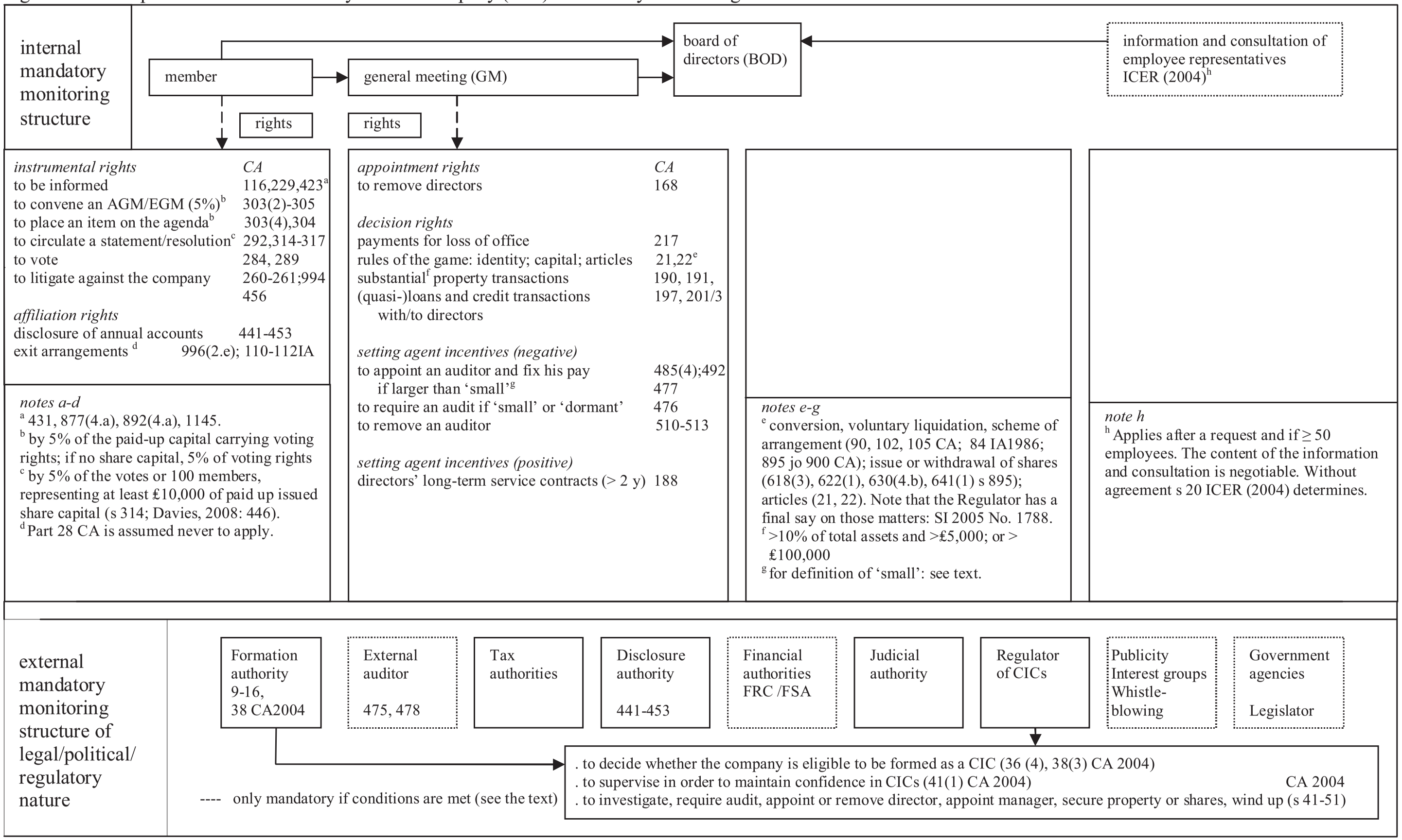


Table 4.18: an evaluation of the mandatory monitoring structure of the UK CIC.

internal monitoring	+/–	description
appointment / dismissal	–	GM may remove a director; has no mandatory appointment right for directors
accountability	–	no approval of annual reports by the shareholders; no release from liability of directors
veto	+ + +	GM decides on identity, capital, articles GM decides on payments for loss of office; on long-term service contracts GM veto on a wide range of EB decisions with a possible conflict of interests
company structure	–	no mandatory presence of NEDs; no 'organic' employee representation (works council)
directors' duties	+	an integrated system of duties
external monitoring	+ +	at least five; strong monitoring / supervising role of CIC-Regulator whistle-blowing system through PIDA

'entrance check' and detailed regulation by State law, which has not been the subject of this study. The choice in the UK is for connection to the CA and State monitoring/ supervision through the FSA. In the Netherlands it is all rather 'liberal': no checks 'at the gate' and no State supervision. As a result the regulations between the three are rather different.

For *appointment and dismissal* only the *vereniging* recognizes strict provisions, and the CIC only for removal. With regard to *accountability* this is the same. Dutch law requires

Table 4.19: a comparative evaluation of the mandatory monitoring structure of the Vereniging, eV, CIC.

internal monitoring	+/–	description
appointment / dismissal	vereniging+ eV+– CIC–	GM appoints and dismisses (majority of) EDs (vereniging); State law (Germany); right to remove director and no mandatory appointment right (UK)
accountability	vereniging+ eV– CIC–	GM adopts annual accounts, appoints committee of investigation or, if need be, an auditor. Public disclosure and release from liability, if 'entrepreneur' (vereniging). No approval of annual reports by GM; no release from liability of directors (CIC). State law (eV)
veto	vereniging+ eV– CIC++	GM may instruct EB. GM decides on identity (only: eV), articles, membership (all three: CIC, vereniging) subject to approval or proposal provisions in the articles (vereniging). No GM veto on change of identity or character decisions (vereniging, CIC). CIC: CA applies. Thus: GM decides on payments for loss of office; on long-term service contracts; on a wide range of EB decisions with a possible conflict of interests. eV: State law. works council veto on social matters.
company structure	vereniging+– eV+ – CIC––	no mandatory presence of NEDs mandatory works council if ≥ 5 (Germany) or 50 (the Netherlands) employees
directors' duties	vereniging+– eV+ – CIC+ –	stakeholder approach in Germany and the Netherlands member approach in the UK (*mutual benefit of its members*) an integrated system of duties (CIC)
external monitoring	vereniging+– eV+– CIC+	easy access to specialized OK (vereniging). Strong monitoring and supervising role of CIC Regulator; whistle-blowing system through PIDA (CIC). Easy initial tax avoidance (vereniging). Thorough check 'at the gate'(Verein)

public disclosure for certain large *verenigingen*, which seems unique. A right to *veto* an amendment to the articles is recognized in the Netherlands and the UK. Moreover, the CIC recognizes the veto rights from the CA. The *company structure* shows the absence of mandatory NEDs, and the presence of a works council in the *vereniging* and eV. *Directors' duties* essentially follow the private limited provisions with additional membership duties if the director is a member as well. The *external monitoring* by the CIC regulator (UK) and the State (Germany) whether 'at the gate' or as a monitor *ex post* is remarkable.

4.8 THE MANDATORY MONITORING STRUCTURE OF THE FOUNDATION

A foundation is an entity working towards an object of which primarily third parties are the beneficiaries. This section evaluates sequentially the mandatory monitoring structure of the Dutch *stichting* (4.8.1), the German *Stiftung* (4.8.2) and the UK *charity* (4.8.3). Section 4.8.4 reviews shortly the European Foundation Statute (EFS) project and 4.8.5 concludes.

4.8.1 The Dutch *stichting*

The forthcoming analysis rests on Dijk/Van der Ploeg (2007), Van der Ploeg (2010) and Asser–Van der Grinten II (de Rechtspersoon) (1986) for historic references.

4.8.1.1 *Formation and institutional structure*

S 2:285–304 BW specifies foundation law in the Netherlands. The law requires one person for the formation of a Dutch foundation (*stichting*). The formation takes place through a notarial deed[699]. The law defines a *stichting* as a legal person without members, aimed at realizing the objects stated in its articles by means of an amount of capital allocated to those objects. The objects may not include distribution to any incorporator or to those participating in its constituent organs or to other parties, unless, as regards the latter, the distributions have an idealistic or social purpose[700]. Note that the law does not require a minimum endowment for the foundation. The law does however provide for the dissolution of the foundation if it is very unlikely that adequate (sources of) funding to achieve the objects will be tapped[701]. The mention of the word '*stichting*' in its name is mandatory[702]. The EB is the only mandatory organ of the stichting. There is no GM as there are no members. A supervisory board is optional. For specific branches, e.g. health care, housing or education, the applicable law may require an SB with specific competences. The establishment of a works council depends on the conditions described in 4.4.1.1.

4.8.1.2 *Mandatory monitoring structure and duties of directors*

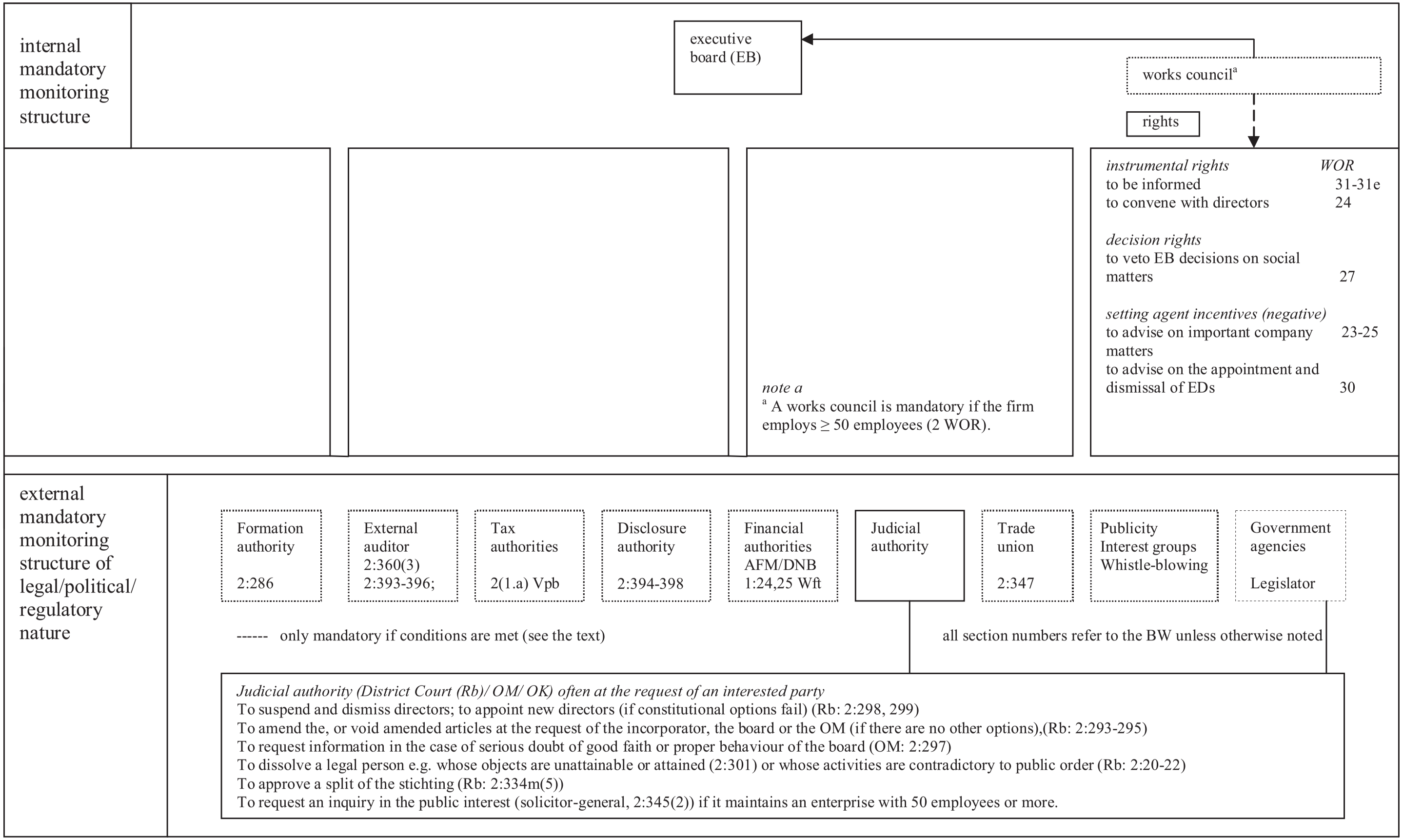
Figure 4.14 shows the mandatory monitoring structure of a *stichting*. In the full–blown picture, there are two internal monitoring organs (unless the articles provide for an SB) and possibly nine external monitoring mechanisms. The one–man stichting may encounter only one mandatory external monitor.

Of the *internal* monitors, only the EB and the works council exist in the stichting. The *works council* rights of the WOR apply to the stichting as they do to the NV (4.4.1.2). However, it lacks the special rights assigned to the NV works council by the BW. The law allows for a 'supervisory organ' but gives no further provisions[703]. The articles may be changed if and as provided for in the articles[704]. Santen and de Bos (2006) conclude that the internal mandatory monitoring structure of the stichting is virtually non–existent.

The remarks for the previous legal persons (see 4.4.1.3, 4.6.1.3, 4.7.1.2) basically apply to the *executive board* (EB) and the *duties of directors* of a stichting as well, as a consequence of Titel 1 of Boek 2 BW. However, for a stichting which is not subject to Corporation Tax (VpB) there are exceptions[705]. Moreover, a general provision on conflict of interests lacks, although the default provisions to restrict directors' competence can be interpreted in this line[706]. Dijk/Van der Ploeg (2007: 236) holds that without a provision in the articles to the contrary, directors cannot act in the case of conflicting interests. Foreign literature adds another duty to the usual duties of care and loyalty, that of *obedience*. According to Atkinson (2010: 570) it is the root of the fiduciary relationship in a foundation: 'serve the one the principal designates, as the principal designates'. He works towards a Trinitarian theory of fiduciary duty, consisting of obedience, loyalty and care. This thesis adheres for reasons of comparability in analysis to the approach of 4.4.3.3 which designates the duty to obey the constitution as one of the rules deriving from the duty of loyalty.

The weak internal monitoring structure is remedied by a reinforcement of the *external* monitoring mechanisms. In addition to the remarks made on external mechanisms in 4.7.1.2 concerning the *vereniging*, four aspects need to be stressed for the *stichting*. The *first* is the dual role of the *tax authorities*[707]. On the one hand, it is fairly easy to evade the annual tax filing obligation (4.7.1.2). On the other hand however, and this is a common characteristic for foundations, specifically sanctioned foundations (in the Netherlands: ANBI, *Algemeen Nut Beogende Instelling*) are exempt from inheritance taxes. An ANBI qualification is in a way a safeguard. The ANBI regulations require disclosure to the tax authorities at their request. The *second* aspect is the important governance role that is attributed to the *judicial authorities*. However, this is a passive role (Santen and de Bos, 2006). The Public Prosecution Service (OM) may take action if it identifies serious neglect or definite illegal acts[708] (Santen en de Bos, 2006; de Meijer, 2005). This may end in a court decision to dismiss and disqualify directors[709], to amend the articles[710], or even to dis–

Figure 4.14: Dutch foundation (stichting): mandatory monitoring structure



solve the *stichting* if its activities are contrary to the public order[711]. However, the OM is hardly equipped for this task[712]. The *third* aspect to be mentioned is the role of interested parties. In the case of serious neglect or definite illegal acts, such parties may petition the District court to dismiss a director. They may request annihilation of a decision to change the articles[713] and even the dissolution of the *stichting*[714]. An incorporator may, if the objects are unattainable, petition for an amendment to the articles[715]. The *fourth* aspect relates to the inquiry to be requested from the OK. In case of a stichting this is only possible (1) if the stichting maintains an enterprise, (2) with 50 employees or more[716], and (3) if the right is attributed by the articles or by special contract to a party: by that party[717], or (4) by a qualifying trade union[718], or (5) by the advocate general[719].

4.8.1.3 *Pending changes in stichting–law*

Despite all these measures, Schmieman (2008) concludes that their effectiveness is poor, which he relates to a lack of information on the foundation's whereabouts. To remedy these and similar (Van der Ploeg, 2010: 262) observations, several proposals to change corporate law are pending. Annex 2 under 3 describes a proposal pending in Parliament to enhance the quality of supervision in a large *stichting*. Annex 2 under 4 shows how the law will shortly aim to prevent abuse of *all* legal persons through a continuous check of the registers. Recently a consultation document was circulated containing a legal duty for all *stichtingen* to disclose their annual accounts, including data about donations and subsidies. The reactions were unequivocally adverse[720].

4.8.1.4 *Concluding remarks on the stichting*

Table 4.20 shows the strengths (+) and weaknesses (–) in the mandatory monitoring structure of the Dutch *stichting*. They prove the remark in Asser/Van der Grinten (1986: 333) that 'Dutch law is very liberal in respect of foundations, more liberal than in any other legal system.' The results stem from the previous analysis and need no further comment.

4.8.2 The German *Stiftung*

The forthcoming analysis rests on Versteegh (1998), Hof (2001), Schmidt (2002), Adloff, Schwertmann, Sprengel and Strachwitz (2007), Beuthien and Gummert (2009), Meckling (2010), Von Hippel (2010) and www.stiftungen.org[721].

4.8.2.1 *Formation and institutional structure*

Sections 80–89 BGB specify the basic principles of German foundation law, but additional State law (*Landesstiftungsgesetz*) and fiscal law plays an important role. However, the

Table 4.20: an evaluation of the mandatory monitoring structure of the Dutch stichting.

internal monitoring	+/–	description
appointment / dismissal	–	(none)
accountability	+ – –	if an SB: NEDs entitled to inspection copy of the annual accounts/ report. It decides on the adoption of the annual accounts[2] and, if 2:360(3) BW, on the appointment of the auditor if no SB: EB decides on the adoption of the annual accounts; and in the case of 2:360(3) BW on the appointment of the auditor an auditor is not mandatory for a stichting without an enterprise; and if it is 'small'
veto	– +	articles may provide that the EB is capable of changing the articles works council veto on social matters
company structure	+ –	no mandatory SB; mandatory works council if ≥ 50 employees
directors' duties	+ + –	stakeholder approach / interests of the stichting *(het belang van de stichting)* clear standards often need court clarification on issues e.g. conflict of interests, minorities
external monitoring	+ + – –	court competence to change articles or veto a decision to change the articles; to appoint and, if need be, dismiss and disqualify directors; to dissolve if it acts contrary to the public order interested parties and an incorporator may petition court (Rb) to act reluctant OM attitude; easy initial avoidance of tax-related obligations at least one; a request for an inquiry (*enquête*) to the OK is only possible if the articles so provide or through a contract (and for the competent trade union); no whistle-blowing culture

latter two are not the subject of this study. The law does not define the *Stiftung*, but Schmidt (2002: 173) holds that it is a non–associating organized legal person, established to pursue a specific object[722]. One person[723] suffices to establish a foundation; in fact the bond between the founder and the foundation is characteristic of German foundation law (Versteegh, 1998). German law recognizes civil–law and public–law based foundations, the former based on the BGB and State law, the latter established by separate administrative laws (e.g. universities). This thesis focuses on civil–law based foundations. Such a foundation becomes a legal person (*rechtsfähige Stiftung*[724]) after admission by the State authority. This admission is granted if the legal requirements[725] in respect of the *Stiftungsgeschäft* (the memorandum of association) are met: a written declaration by the founder to dedicate a capital[726]; articles[727] with name, place, objects, capital, EB; assurance of a sustainable realization of the objects; no endangering of the public interest by the objects. This is a material check (*Konzessionsystem*)[728]. The funding requirement is taken seriously: the proposed capital should stand in reasonable relationship to the proposed objects[729]. The literature is unclear about whether a non–legally competent foundation might already exist in the pre–admission stage[730]. To complicate matters even more, the literature discerns between dependent and independent and private and public foundations. Only an independent foundation is a legal person[731]. It is private if it has a private object, e.g. family foundations, or public, if it is directed towards a public cause, which is generally the case[732].

Membership of a German foundation is not possible[733]. Distribution to the founders only is forbidden (*Eigenstiftung*). Distributions to family members of the founder are not prohibited as long as its object is not the providing of subsistence only[734]. Control of a company by a private foundation is in principle accepted[735]. The foundation has a mandatory EB (*Vorstand*)[736]. An SB, often in the form of a *Kuratorium*, is permitted, though not required or regulated. The State may examine whether attaining the object is still possible, or whether the object is still in the public interest, and in actual fact it does[737]. In the Stiftung as well, a works council (*Betriebsrat*) is mandatory if the conditions are met as described in 4.4.2.1.

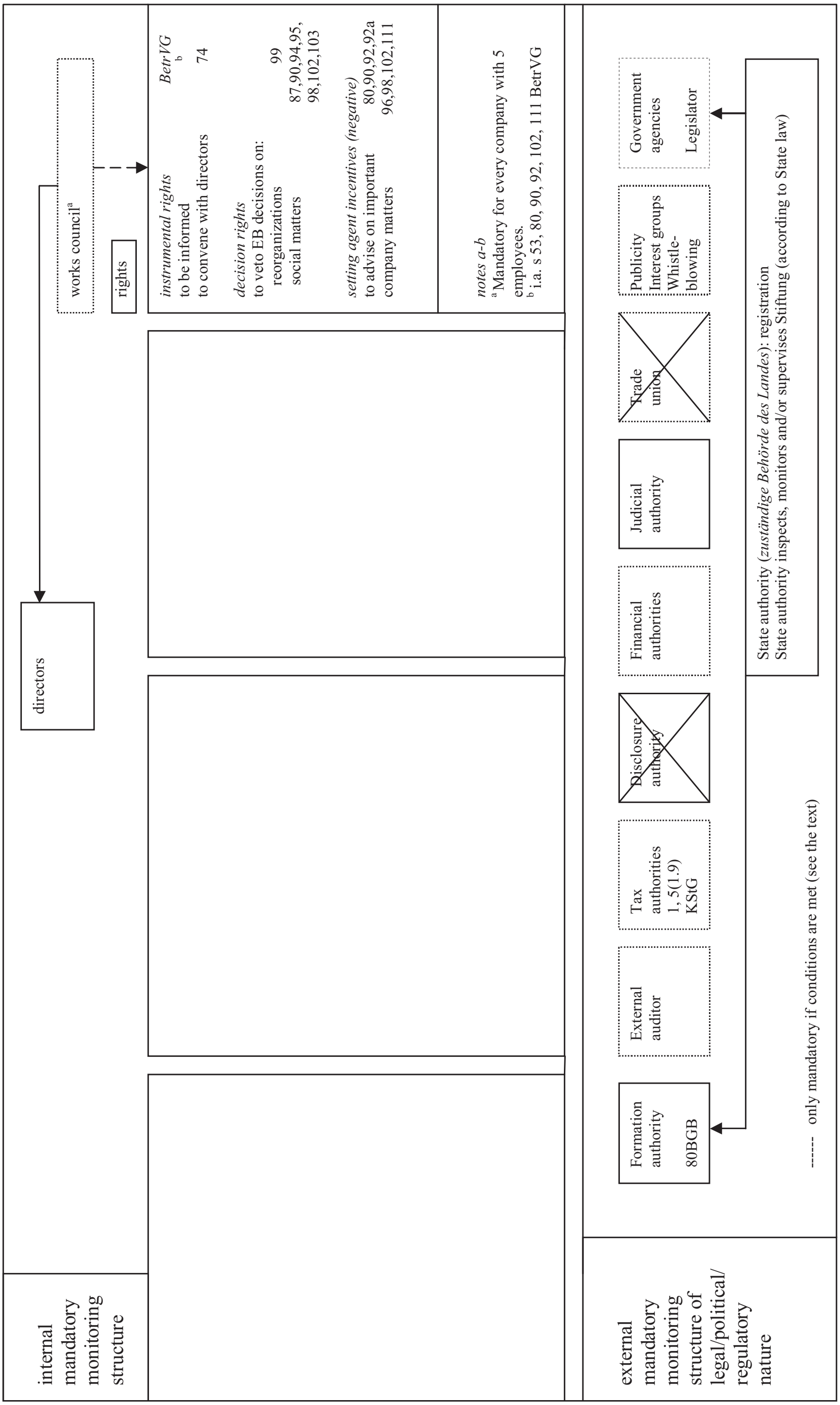
4.8.2.2 *Mandatory monitoring structure and duties of directors*

Figure 4.15 shows the mandatory monitoring structure of a *Stiftung*. In the full–blown picture, the *Stiftung* has two internal and possibly six external monitoring mechanisms. In the one–man *Stiftung* there may be only two external monitoring mechanisms left. *Internally* the characteristic of the *Stiftung* is that a structure is missing (*fehlende Verbandsstruktur*; Schmidt, 2002: 174). The *Stiftung* is not able to merge[738] but it is able to demerge (*Ausgliederung*)[739]. A change in legal form is not possible[740]. The federal arrangements mentioned below, partly referring to association–law[741], are rather rudimentary. However, contrary to association law they are mandatory[742].

The EB functions as a collegial board[743]. It directs and represents the *Stiftung*[744]. The articles may restrict its power of representation with external effect[745]. They may contain provisions on special representation of the Stiftung[746]. The *Treuepflicht*[747] and the duty of obedience (Hütteman, 2010) apply. The law requires the director to inform the EB and to account for his acts[748]. The exemption in principle from liability for directors earning less than €500/year is valid here as well[749].

The most powerful *external monitoring* mechanisms are the registration check on establishment and afterwards the governmental monitoring at State level. The latter varies for each State. Versteeg (1998) describes four categories of supervision to be found in the State laws: (1) inspection and information rights sometimes connected with advisory tasks, (2) right to approve certain transactions, (3) to undo decisions, and (4) to claim damages. Versteeg (1998), Van der Ploeg (1999), Schmidt (2002) and Von Hippel (2010: 216–218) stress the importance and substance of this monitoring. *Tax* authorities monitor as well since a *Stiftung* often applies for tax exemption described in 4.4.2.4. Adloff et al. (2007) mention that approximately 98% of all foundations are tax exempt. The tax authorities decide whether a foundation conforms to the required notion for exemption, namely ‘furthering the public good’. *Disclosure* is barely arranged for. The State laws require an annual report, including a report on the realization of the foundation’s objects, and annual accounts to be sent to the State supervisory authority[750]. The HGB requirements of bookkeeping and

Figure 4.15: German foundation (Stiftung): mandatory monitoring structure



administration[751] apply if the *Stiftung* is a *Kaufmann*, i.e. if it has, or is closely connected to, an enterprise. But even then, public disclosure is not mandatory.

4.8.2.3 *Concluding remarks on the Stiftung*

Table 4.21 shows the strengths (+) and weaknesses (–) in the mandatory monitoring structure of the German *Stiftung*. The results stem from the previous analysis and need no further comment.

Table 4.21: an evaluation of the mandatory monitoring structure of the German Stiftung.

internal monitoring	+/–	description
appointment / dismissal	–	legal requirements in State law
accountability	–	no public disclosure, (rudimentary) disclosure to State authority
veto	+	works council veto on social matters
company structure	–	no mandatory SB; mandatory works council if ≥ 5 employees; *Satzungsautonomie*
directors' duties	+ –	*Sorgfalt*; *Treuepflicht*,*Verschwiegenheitspflicht*,*Berichtspflicht*,*Förderpflicht*; BJR
external monitoring	+	extensive State monitoring on establishment; and afterwards

4.8.3 The UK *charity (CIO)*

The forthcoming analysis rests on Davies (2008), Pearce and Stevens (2006), Leat (2007), Webb and Akkouh (2008), Picarda (2010), Dawes (2010) and materials available from the website of the Charity Commission.

4.8.3.1 *Formation and institutional structure*

The Charities Act 2006 defines a charity[752] as 'an institution established for charitable purposes only'[753]. Charitable purposes[754] must be 'for the public benefit'[755] and fall within one of the following purposes: the prevention or relief of poverty; the advancement of education, religion, health or the saving of lives; of citizenship or community development; of the arts, culture, heritage or science; of amateur sport; of human rights; of environmental protection or improvement; of animal welfare; the relief of those in need by reason of youth, age , ill health, disability, financial hardship or other disadvantage; the promotion of the efficiency of the armed forces, the police, fire and rescue services or ambulance services[756]; and any purposes that may be reasonably regarded as analogous to, or within the spirit of, one of these charitable purposes[757]. Although not identical, these objects come close to the usual objects of a *stichting* or a *Stiftung*. A charity is not necessarily a legal person[758]. It is often a 'trust', which is a separation of the legal and beneficial ownership of property (Pearce and Stevens, 2006: 157). A trust need not be a body corporate. It may be an 'unincorporated association' which is an organization of people who have decided to co–operate in furthering what the organization is set up to do and without legal personality[759]. A charity may also be formed as a 'guarantee company' under the CA which is widely used for schools, colleges and the "Friends" of museums[760]. Such a company has to abide by the CA as well as the Charities Act and suffers dual obligations e.g. regarding registration and disclosure[761]. For the purpose of comparison, this thesis focuses on the Charitable Incorporated Organisation (CIO[762]) which is a specialized body corporate[763] established in the Charities Act 2006. According to Dawes (2010: 854) it is the nearest UK equivalent to the foundations of the civil–law countries. The Charities Act 2006 sets out the broad legal framework for CIOs but secondary legislation, expected for 2011, is required to provide the details on how CIOs will be established and operated[764]. Any one or more persons may apply to the Charity Commission for a CIO to be constituted and to be registered as a charity[765]. A CIO only comes into existence and becomes a body corporate once it is registered with the Commission[766]. The CIO may be either an 'association' type of charity, which has a membership as well as a trustee body, or the 'foundation' type, wherein the only members are the trustees[767]. Its directors are called charity trustees[768]. A trustee may, but need not, be a member. The members may be either not liable to contribute to the assets of the CIO if it is wound up, or up to a maximum amount each[769]. It is said that EC company–law directives will not apply to CIOs[770].

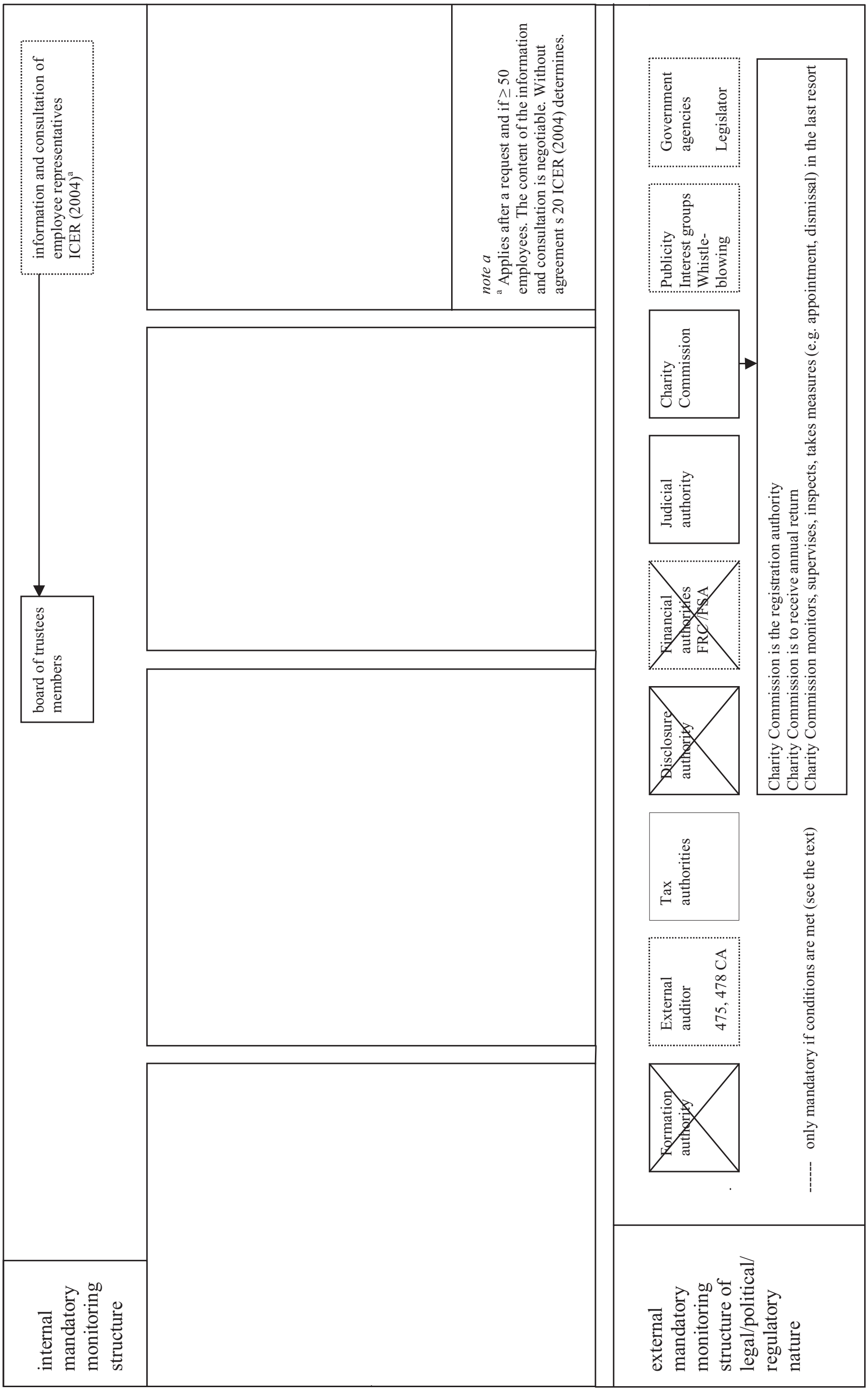
4.8.3.2 *Mandatory monitoring structure and duties of directors*

Figure 4.16 shows the mandatory monitoring structure of a 'foundation' type CIO. In the full–blown picture, the 'foundation' type CIO has two internal and possibly six external monitoring mechanisms. The one–man CIO may encounter no internal and only three external monitoring mechanisms.

The *internal* monitoring structure of the CIO is at present only available in draft form. A final version is not yet available. In broad terms, the draft forms the structure of the CIO in accordance with the CA[771]. Picarda (2010) describes the duties for a charity trustee as those of loyalty, including observance of the declared objects and avoidance of conflict of interest situations, and the duty of care, adapted to the specific situations in nonprofit companies[772].

The presence of the Charity Commission determines the *external* monitoring structure. Its legal objectives are fivefold: (1) to increase public trust and confidence in charities, (2) to promote awareness of the public benefit requirement, (3) to promote compliance by charity trustees with their legal obligations, (4) to promote the effective use of the charitable resources and (5) to enhance the accountability of charities to donors, beneficiaries and the general public[773]. It is a formation, disclosure, and financial authority in one. It determines whether institutions are or are not charities; it encourages and facilitates the

Figure 4.16: UK 'foundation' type charity incorporated organisation (CIO): mandatory monitoring structure



better administration of charities; and it identifies and investigates apparent misconduct or mismanagement and takes subsequent remedial or protective action[774]. An audit is required for the larger charitable companies; for smaller ones an accountant's report will suffice[775]. Every charity should submit an annual return to the Charity Commission[776] unless its income is below £25,000. In the draft regulations all CIOs will have to submit accounts and annual returns to the Commission regardless of income. The Summary Information Return (SIR) forms part of the annual return that charities with an income of over £1 million have to complete and submit. The public can inspect a charity's SIR from a link on its register entry. The Charity Commission is very powerful[777] as it may institute inquiries[778], call for documents and search records[779], disclose information to other government agencies[780] and, as either the auditor or the accountant, have a duty to report matters of importance to the Charity Commission[781]. The *tax monitor* is, due to the possibility of exemption, not always in place. A charity, once accepted as being a charity for tax purposes, is exempt from tax on income from land, interest, gifts, annual payments or profit from trading, within certain boundaries[782]. Most charities do not automatically receive a tax return every year[783]. The Charities Act 2006 strengthened the *judicial authority* by creating a Charity Tribunal in order to create a low profile, less formal appeal procedure against Charity Commission decisions[784]. Moreover, the Charity Commission is a 'prescribed person' under PIDA allowing it to accept disclosures ('whistle-blowing') from charity workers.

4.8.3.3 *Concluding remarks on the CIO*

A CIO is a legal person created by the Charities Act 2006. As a charity, it is heavily regulated and supervised by the Charity Commission. Table 4.22 shows the strengths (+) and weaknesses (–) in the mandatory monitoring structure of the 'foundation' type CIO. As much is yet to be determined, the table is only completed for the external monitoring mechanism.

Table 4.22: an evaluation of the mandatory monitoring structure of the UK 'foundation' type CIO.

internal monitoring	+/–	description
appointment / dismissal		
accountability	+	supposedly: as arranged in the Charities Act
veto		
company structure	–	supposedly: no mandatory supervision function
directors' duties	+	supposedly: based on the directors' duties developed in common law
external monitoring	+	at least three; strong monitoring / supervising role of Charity Commission

4.8.4 Concluding remarks on the foundation

All the foundation law studied above is rather basic. This apparently goes with the subject, although the fact that the German State law has not been studied, and that the UK CIO regulation is still underway, has helped to give this impression. As table 4.23 shows, *internal mandatory monitoring* is weakly provided for in all systems. There are no mandatory NEDs, an occasional works council may be present, but the burden of mandatory monitoring comes from external authorities. Here is a clear distinction between Dutch law on the one hand, and German and UK law on the other. Dutch law is fairly liberal. There is no government control 'at the gate' and no systematic control *ex post*. The public prosecution service (OM) and the court have some correcting competences but they are seldom used, and even then, with little success. This is clearly different in Germany and the UK. Both have created monitoring and supervising institutions *ex ante* and *ex post* with strong competences. A common trait is the lack of public disclosure. One would expect transparency especially since the objects of all foundations are public–interest related. Instead, a mandatory general public–disclosure regulation lacks in all legal systems.

Table 4.23: a comparative evaluation of the mandatory monitoring structure of the Stichting, Stiftung and CIO.

internal monitoring	+/–	description
appointment / dismissal		
accountability	Stichting– Stiftung– CIO+	Stichting: public disclosure only if it has an enterprise of some size (2:360(3) BW) Stiftung: no public disclosure; disclosure to State authority CIO: full disclosure to the Charity Commission (very small CIOs probably exempt)
veto	Stichting+ Stiftung+	Stichting, Stiftung: A works council if present monitors through a veto right in respect of social matters.
company structure	Stichting– Stiftung– CIO– –	no mandatory NEDs.
directors' duties	Stichting+– Stiftung+– CIO++	The UK common-law based duties system is more developed than the Dutch (based on general company law) and the German (based on Sorgfalt, Treuepflicht, Förderpflicht, Verschwiegenheitspflicht)
external monitoring	Stichting– Stiftung+ CIO+	despite the supervision arrangements made in Dutch law, in practice it does not work. *De facto* stichting directors are practically free of any monitoring. In Germany and the UK this is different: strong supervision 'at the gate'; annual return required and monitored as well as information-on-request by State or State-sponsored institution

4.9 THE LEGAL STRATEGY APPROACH: AN EVALUATION OF THREE LEGAL SYSTEMS

The previous sections provided a survey of 15 types of legal persons along six criteria: (1) appointment/dismissal, (2) accountability, (3) veto, (4) company structure, (5) directors' duties and (6) external monitoring. This section briefly discusses, in three subsections 4.9.1 – 4.9.3, the mandatory monitoring systems of legal persons in the Netherlands, Germany and the UK, along the same criteria. A further evaluation follows by means of the questions posed earlier this chapter. Section 4.1 formulated the main research question of this chapter:

- are the agency theory based insights implemented in the internal and external monitoring mechanisms in corporate law, and is this implementation adequate?

Section 4.2.3 derived three other questions:

- does the mandatory monitoring structure of the various legal persons differ between profit and nonprofit companies?
- are the profit forms alike in organizational form?
- are the differences in monitoring structure functional?

The evaluation and the answers to the questions offer a vista of the monitoring structure of legal persons in different systems. Section 4.10 provides an analysis on a similar level of the legal persons along the Timmerman fundamentals. Section 4.11 concludes by answering the question which legal system monitors best.

4.9.1 The mandatory monitoring mechanisms of Dutch company law

4.9.1.1 *An overview of Dutch company law*

Table 4.24 presents an overview of the strengths and weaknesses of Dutch company law based on the previous analysis of Dutch legal persons. 'Member' in the table includes 'shareholder'. Table 4.24 clearly shows that shareholders and members have an important role in the Dutch legal person. Although the articles may curtail their *appointment/ dismissal* rights, in the end they may break a binding recommendation by an enforced

Table 4.24: an evaluation of the mandatory monitoring structure of Dutch company law

internal monitoring	+/–	description
appointment / dismissal	+	GM appoints (the majority of) EDs and NEDs ('structure NV/BV': NEDs only). A binding recommendation can be overruled by a qualified majority (unless structured)
	–	GM may be sidelined in a 'structure NV/BV'
accountability	+	GM adopts annual accounts, appoints the auditor and - except for non-360(3)-vereniging and stichting - the release from liability of directors. Disclosure of financial reporting through the *Handelsregister*, except for vereniging and stichting if no enterprise with > 4,4 Mio turnover
	–	no mandatory audit for 'small' NV/BV/coöperatie (unless listed NV); and not at all for vereniging and stichting without enterprise with > 4,4 Mio turnover
veto	+ –	GM veto on rules of the game may be subject to proposal or approval of another organ
	+	GM veto on major change of identity or character decisions (NV; others unsure)
	+	SB veto in 'structure NV/BV/coöperatie'; works council veto on social matters
company structure	+ –	mandatory SB for 'structure NV/BV/coöperatie'; mandatory works council if ≥ 50 employees
external monitoring	+	easy access to OK in order to request an inquiry (*enquête*)
	–	no whistle-blowing culture

majority and appoint at least a majority of EDs (unless ‘structure NV/BV’) and NEDs of their choice (in the ‘structure’ regime other arrangements to voice disagreement are provided for). *Accountability*–wise shareholders and members are entitled to an inspection copy of the annual accounts. The GM has an information right as well, legally or according to literature, which may be blocked by important company interests, to be determined by the directors. The rights to adopt – or veto – the annual accounts and the annual report, to release directors from liability and to appoint the auditor, if mandatory, make the GM quite powerful in the financial field. Collective action problems may impede the actual and successful exercising of these rights. Other *veto* rights are sparsely attributed in order to maintain the advantage of agent specialization. In a ‘structure NV/BV/coöperatie’ the SB has a right to veto specific EB decisions listed in the law and the articles. And in the NV, a major change of identity or character of the company is subject to GM approval. The works council has a veto right in respect of social matters, as listed in the law. The *Hoge Raad* explicitly ruled that the GM does not have a right to instruct the EB. The determination of the strategy of the legal person is therefore primarily a matter for the EB. Klaassen (2009) puts this in another perspective. She argues that policy matters are attributed to directors, and structure matters to the GM. The important GM role as regards the *rules of the game* may however be – and often: is – mitigated by provisions in the articles. Thus, shareholders’ or members’ rights are not always what they seem. The reasonableness and fairness provision of s 2:8 BW may counterbalance this weakness in clear cut cases of abuse. Klaassen (2007)[785] argues, correctly, that provisions in the articles that submit changes to the rules of the game to a proposal or the approval by a company organ, which is still allowed, should on analytical as well as corporate governance related grounds be forbidden. The obligatory presence of an SB – or of NEDs in the expected option of a one–tier system – for much smaller legal persons than is at present mandatory, and their right to lead the audit process, would seem worthwhile considering[786].

The *external* monitoring structure in the Netherlands seems to be well–established. *Weaknesses* are the rather easy circumvention of prior government approval for the formation of NVs and BVs, the lack of prior clearance for other legal persons and the relatively poor compliance with public disclosure requirements for the BV and the coöperatie (chapter 8). The poorly developed whistleblower culture may be considered a weakness too. *Strengths* are the presence of well–educated and guarded auditors, of modern financial authorities, of critical media, and above all, of a flexible judicial system. Especially the Enterprise Division of the Amsterdam Court of Appeal (OK) is easily accessible by 10% of the shareholders or members in the case of suspected mismanagement. And it may work quickly: in the exceptional case of the sale of LaSalle by ABN AMRO Bank, the period between the purchase and sale agreement and the final sentence by the *Hoge Raad* (with the Enterprise Division ruling in between) was only 12 weeks!

As the *stichting* has no members, much that has been said above does not apply. This lack of internal monitoring is counterbalanced by a host of virtual external monitoring mechanisms for the *stichting*. However, in reality these do not work out satisfactorily since they are not an OM priority. Would it be a solution to assign the OM attributed competences to a newly established 'SPSS' (*Stichting Publieke Supervisie Stichtingen*; a government sponsored Foundation for Public Supervision of Foundations) agency? Or to provide for a mandatory SB? For these questions, 5.5.3 may provide an efficient approach.

4.9.1.2 *An answer to the research questions for the Netherlands*

- *are the agency theory based insights adequately implemented?*

On the appointment and dismissal of directors, the approval of the annual reports and the rules of the game, shareholders have the final say. Monitoring by NEDs is only mandatorily put in place for rather large companies, and not for the *vereniging* en *stichting*. External monitoring mechanisms are well-established for the profit sector, but they are inadequate for the non-profit sector since there is no regulatory institution in that field.

- *does the mandatory monitoring structure differ between profit and non-profit companies?*

It does. For non-profit, there is no mandatory SB structure. Generally, from the *NV* to the *stichting* the arrangements become less detailed.

- *are the profit forms alike in organizational form?*

Yes they are. They all have a mandatory SB depending on their size; they have to comply with the accounting, audit and disclosure rules of Titel 9 Boek 2 BW; and their members have access to the OK. Two differences: in the 'structure coöperatie' (1) EDs are appointed by the GM instead of by the SB as in the 'structure NV/BV' and (2) NEDs are chosen from a 'non-overrulable' binding recommendation by the SB (subject to OK-access).

- *are the differences in monitoring structure functional?*

The double monitoring position of members in the coöperatie may explain the direct choice of EDs by the GM (if structured). It is unclear why the NED election procedure in the 'structure coöperatie' has not been adapted in the Structuurwet 2004 to that in the 'structure NV/BV'.

4.9.2 The mandatory monitoring mechanisms of German company law

4.9.2.1 *An overview of German company law*

Table 4.25 presents an overview of the strengths and weaknesses of German company law based on the previous analysis of German legal persons. 'Member' in the table includes 'shareholder'. German law designs the AG, GmbH and eG in separate laws. Whilst the eV and Stiftung partly refer to the same BGB provisions, State law provides for most of their essential arrangements. The restriction of the present analysis to the Federal

Table 4.25: an evaluation of the mandatory monitoring structure of German company law

internal monitoring	+/–	description
appointment / dismissal	++	GM appoints, dismisses NEDs (if an SB)
	+ –	SB appoints, dismisses EDs; and determines their remuneration in AG
accountability	+	GM (normally SB in AG) adopts the annual accounts; no regulation for eV / Stiftung
	+	GM appoints auditor (or approves auditor's report, eG); no regulation for eV / Stiftung
	+	disclosure through *Handelsregister*; no regulation for eV / Stiftung
	+	GM releases EDs/NEDs from liability; no regulation for eV / Stiftung
	–	no audit for 'small' AG (unless listed)/GmbH; bi-annual audit if eG has TA < €2 Million
veto	+	GM has no instruction right (AG; eG); full instruction right (GmbH, eV)
	++	GM decides on identity, capital, articles (structure); Holzmüller/Gelatine applies
	+ –	if mandatory SB: SB veto on EB decisions listed in the articles
	++	works council veto on social matters
company structure	+ –	mandatory SB in AG (eG>20 members); co-determ. requires SB in GmbH, eG if > 500 empl.
	++	mandatory works council if ≥ 5 employees
	–	*Satzungsautonomie* for GmbH, eV and Stiftung.
directors' duties	+	stakeholder approach / co-determination
	+ –	*Sorgfalt*, *Treuepflicht*, *Verschwiegenheitspflicht*; no conflict, no corporate opportunities; BJR; in eG and eV: *Gleichbehandlungspflicht, Förderpflicht*, *Duldpflicht* (latter: if member)
external monitoring	+	more or less material check at registration; strong court access; special monitoring of eG through audit and of *wirtschaftlicher Verein* and *Stiftung* through State authority
	–	no whistle-blowing culture

level is sufficient to analyse the political choices of the legislator vis–à–vis the other legal structures. Each design is adapted to the specific situation of the type of company. The *AG* strongly relies on the SB since on the one hand the companies are large and need good monitoring whilst on the other hand shareholders tend to show free–rider behaviour. The GM however has a final say in the structure issues of the company. In the *GmbH* this differs, since it is a close associative form, where shareholder monitoring is expected to be intensive. Therefore its organization form is more flexible. The GM may instruct the board and a SB is only mandatory if the employee interests become substantial. The *eG* is not so flexible due to the legislator's emphasis on the interests of the members. The advantage of a double monitoring relationship, due to the double relationship members have with the eG, may turn against them if the eG goes bankrupt: members lose (part of) their wealth as well as their source of income, trade platform or supplier. The GenG appears unbalanced since it leaves the tasks of the SB largely to the articles, but regulates the mandatory eG audit in detail. Apparently, the legislator's idea of the *Verein* and *Stiftung* is that they predominantly have a regional function and should therefore be organized locally. The registration as well as the registers themselves are organized locally. In times of 'globalization' one would consider this inefficient. The same remark is valid where government monitoring is concerned. With 17,372 *Stiftungen* in Germany ultimo 2009, State monitoring may still be feasible but, since the number grew by 914 in 2009, it will no longer be feasible somewhere in the near future.

4.9.2.2 *An answer to the research questions for Germany*

- *are the agency theory based insights adequately implemented?*

The AG, often the eG and if > 500 employees, the GmbH have an SB. However the articles should determine the tasks of the SB, except supervision which is mandatory. The GM appoints the NEDs (partly if co-determination applies). The appointment of EDs is either by the SB (AG) or arranged for by default. Generally the GM holds the structure-related rights and in the case of the GmbH and the eV it may instruct the EB on company matters as well. Generally, a works council is in place. External monitoring is strong 'at the gate' and for *Stiftungen* also afterwards. Inadequate implementation concerns the non-mandatory nature of the SB in the GmbH ≤ 500 employees; the lack of a mandatory list of issues to be decided by the SB; the formal and often inefficient working relationships in the SB due to the co-determination arrangements; the lack of GM adoption of the annual accounts in the AG; the lack of uniform mandatory provisions for the *Verein* and the *Stiftung*.

- *does the mandatory monitoring structure differ between profit and non-profit companies?*

Yes it does. Profit companies are regulated on a federal level with detailed and often mandatory regulations. The non-profit companies are rudimentarily provided for in federal law, and rely heavily on State law and State monitoring.

- *are the profit-forms alike in organizational form?*

Although due to the co-determination laws they may appear to be largely identical especially if > 2,000 employees, in fact they are not. The GM is important in the GmbH, but loses much of its importance in the mandatory regulated AG and eG. A board is important in the AG, but not even mentioned in the GmbHG and often contains *ehrenamtliche* members in the eG.

- *are the differences in monitoring structure functional?*

The differences are functional since Germany decided to have separate laws, tailor-made for the specific needs of the AG (many shareholders), the GmbH (few shareholders) and eG (double relationship). For the *Verein* and the *Stiftung* the legislator delegated further legislation to the States in order to facilitate adaptation to local needs.

4.9.3 The mandatory monitoring mechanisms of UK company law

4.9.3.1 *An overview of UK company law*

Table 4.26 presents an overview of the strengths and weaknesses of UK company law based on the previous analysis of British legal persons. 'Member' in the table includes 'shareholder'. As Davies, 2008: 366 puts it, 'unlike in many, perhaps most, other jurisdictions, the division of powers as between the board and the shareholders is a matter for private ordering by the members of the company, rather than something to be specified mandatorily in the company's legislation.' This helps, he continues, 'to underline the shareholder–centred nature of British company law'. And indeed, table 4.26 shows remarkably few mandatory rights. However, two factors counterbalance this assumed freedom of directors. The *first* factor is the important common law (and presently CA) system of directors' duties and the (often consequently) mandatory approval of company transactions with directors. The *second* factor is that despite the contractual tradition, there is heavy central ordering as well: the Model Articles (which could be by–passed), the UK Code, Listing Rules and Takeover Code for the Plc and the CIC–regulator for CICs, the Charity Commission for charities (of which the CIO is an example) and the FSA for the IPSs. Thus it seems that a balance of powers is achieved not by means of mandatory monitoring rights assigned to the shareholders, the GM or NEDs, but through duties, transaction vigilance and external monitoring mechanisms.

Table 4.26: an evaluation of the mandatory monitoring structure of UK company law

internal monitoring	+/–	description
appointment / dismissal	–	no mandatory appointment of directors by GM; mandatory removal right in Plc,Ltd,CIC
accountability	+ –	appointment and dismissal of auditor by GM no GM right of approval of the annual accounts and reports
veto	+ +	GM veto on change of identity or character decisions (Plc) GM veto on important transactions with directors
company structure	+ –	GM decision on the rules of the game no mandatory NEDs; no 'organic' employee representation (works council)
directors' duties	+	an integrated system of duties through common law or CA
external monitoring	+	strong external monitors (FSA, FRC, CIC-regulator, Charity Commission); whistle-blowing system through PIDA

4.9.3.2 *An answer to the research questions for the UK*

- *are the agency theory based insights adequately implemented?*

UK law does not mandatorily attribute the appointment of directors, the approval of the annual reports or the release from liability of directors to shareholders or another monitoring body. On the rules of the game shareholders have the final say. Monitoring by NEDs or a works council (except the EWC) is not mandatory anywhere, although the IPS *de facto* comes close to a system with NEDs. As a result relatively strict directors' duties and external monitoring mechanisms are put in place, the latter with a wide range of controlling competences.

- *does the mandatory monitoring structure differ between profit and non–profit companies?*

No, not really. The directors' duties from the CA and the common law basically form the institutional structure of the legal person. The greatest difference is formed by the external monitoring mechanisms organized for each form except the Ltd.

- *are the profit forms alike in organizational form?*

The Plc and Ltd are, since they are based on the CA. The IPS differs essentially since it has a strong external monitor, the FSA.

- *are the differences in monitoring structure functional?*

Yes they are, since the outside monitor should assist in ensuring that the IPS is a reliable debtor.

4.10 THE FUNDAMENTALS APPROACH: AN EVALUATION OF THREE LEGAL SYSTEMS

The previous section analysed UK, German and Dutch corporate law along the legal strategies developed by Davies (2010) and Kraakman et al. (2009). As shown in 4.3.2, Timmerman provides a different framework of analysis. He suggests assessing corporate law along five behavioural and five structural ('décor') fundamentals. Table 4.27 shows the results. Of the *structural fundamentals*, the first is *transparency*. For the public and private limited company forms EU law harmonized the requirements in this respect. Differences are especially evident where disclosure for association and foundation forms is concerned, with a more stringent disclosure obligation through the Charities Act in the UK than is common in the Netherlands and Germany. The second structural fundamental is the *freedom to restructure*. All legal systems recognize this possibility, whilst ensuring through some form of supervision that creditors' and minority shareholders' interests are not neglected and that funds collected for the public benefit cannot be passed through to the individual members ('asset-lock'). The third structural fundamental concerns *partition of assets* and the consequential *limited liability of shareholders and directors*. Partition of assets between the legal person and its members/shareholders is common for all the legal persons under review (by definition). However, mitigation of the strict rule is found (a) since a shareholder has to contribute to the extent of any sums unpaid on shares held by him[787] or to the extent of his guarantee[788], (b) a German GmbH may recognize in its articles the duty to pay up some extra money in the event of distress, and (3) the articles of German and Dutch co-operatives may recognize a certain amount of money to be paid by its members in bankruptcy (WA; BA). Moreover, directors may be liable to the company or in incidental cases even to third parties, e.g. in the event of intentional harm or gross negligence. The fourth structural fundamental refers to the *inside/outside division,* which means that the legal full power of representation of directors may very well internally be constrained by the articles or by resolutions, without any consequences to third parties unless acting in bad faith. Bad faith requires more than knowing that the act is beyond directors' power[789]. Only the German *eV* and *Stiftung* rules still protect the legal person if the director exceeds his authority. The number five structural fundamental, a nascent one, proposes *non-mandatory law* unless justified. Especially British and to a lesser extent Dutch company law offer numerous options. Timmerman considers s 2:25 BW, which recognizes Dutch corporate law to be mandatory, as a technical provision and indeed it

table 4.27: a comparative evaluation of Dutch, German and UK corporate law by means of the Timmerman (2009) fundamentals of corporate law

no	fundamental	noT	the Netherlands	Germany	United Kingdom
1	*structural fundamentals* transparency	2	*Handelsregisterwet* requires registration of all entrepreneurs and legal persons. Mandatory financial public disclosure for *NV, BV*, *coöperatie*; for *vereniging* and *stichting* only required if they own an enterprise of a certain size (2:360(3) BW).	Registration in the *Handelsregister* is a condition for the existence of *AG, GmbH or eG*. Registration in separate local registers (600) for *eV*. Admission by State authority for Stiftung. Mandatory financial public disclosure for *AG, GmbH, e.G.* Not for *e.V and Stiftung*.	Establishment of Plc, Ltd, IPS, CIC, CIO by registration in public registers held by Companies House, FSA, CC. s 441-453 CA arrange for public disclosure of all CA companies. Charity: s 47 Charities Act 1993. IPS: 13(7)FIPSA, 39(5) IPSA.
2	freedom to restructure	3	Conversion for all LP: s 2:18 BW. Court authorization needed from/to Stichting; and from NV/BV to vereniging. Court guards capital preservation of former Stichting. Merger only if equal form or in specific cases 2:310BW.	The Stiftung is not able to merge or convert. It is able to demerge (*Ausgliederung*). All other legal persons may merge and convert, s 3(1), 191(1) UmwG but only in specific cases e.g. 226, 258, 272 UmwG.	Companies under the CA may conditionally re-register in another company form (s 89). An IPS may convert into a company (50-54 IPSA). For CIC, CIO(?) and IPS: 'asset-lock'.
3	partition of assets / limited liability of shareholders and directors	5	for all LP partition unless *coöperatie* WA (or BA). No piercing of corporate veil; identification of LP sometimes allowed. Director is personally liable to the company only in the case of serious reproach; personal liability to creditor / shareholder only in the case of a specific illegitimate act.	full partition unless articles in *GmbH* or *eG* provide otherwise. BJR: *freies Ermessen* for directors. Company has *Ersatz-anspruch* e.g s 88(2), 93, 147 AktG. Derivative suit s 148 AktG. Also against third parties which unduly influenced NED or ED: s 117 AktG.	full partition unless in private unlimited company or in limited by guarantee (Ltd; also: IPS). Director IPS may be bonded by surety or guarantee. Duty of care: reasonably diligent person test with subjective plus. Occasionally: lifting corporate veil. Derivative suit.
4	division inside / outside	7	Outside full representation: *NV/BV*: 2:130/240 BW; *coöpe-ratie* 2:53a jo.45 BW; *Vereniging*: 2:45 BW; *Stichting* 2: 292 BW. Inside: duty to obey the constitution (Schwandt).	Outside full representation, inside duty to obey constitution s 78(1),81,82 AktG; s 35,37 GmbHG; 27 GenG. For *eV* and *Stiftung* restrictions work externally:26/68/70/86 BGB	Externally directors may bind 'free of any limitation' (s 40 CA). Internally: exceeding director risks liability. Former *ultra vires* rule out of use.
5	non-mandatory corporate law	(10)	for all LP: corporate law in the Netherlands is mandatory law (s 2:25; also s 2:52 BW). However, many provisions are of a default or enabling nature and can be overruled.	AktG for *AG,* GenG for *eG*, BGB for *Verein* (except s 40 BGB) and Stiftung are predominantly mandatory; GmbHG is more of default or enabling nature. *Satzungsautonomie*	CA contains predominantly enabling law. IPSA and Charities Act are more of a mandatory nature. Davies, 2008, p 366: reflects partnership origins.
6	*behavioural fundamentals* pluralism of interests organized through structure or standard	1	all parties concerned in an LP should behave reasonably and fairly towards each other (s 2:8 BW). For directors the leading standard is the interests of the company (s 2:140 BW). Structure: influence on NED nomination in 'structure' *NV/BV/ coöperatie*. For LP > 50 works council.	all parties concerned in an LP have *Treuepflicht, Förderungspflicht*. Directors should act '*zum Wohle der Gesellschaft'* (s 93(1) AktG; *ARAG/Garmenbeck*). Structure: *Mitbestimmung* and *Betriebsrat* for LP > 5.	All parties should act 'bona fide for the benefit of the company' (common law). Directors should promote the success of the company (enlightened shareholder value framework, s172 CA). No mandatory structural mechanisms.
7	free and undisturbed ownership	4	No additional duties to shareholders: s 81, 192 (*NV, BV*). *Cooperatie*: liability if WA/BA in articles (55,56).	No additional duties in AG: s 54, 55 AktG. GmbH*: Nach-schusspflicht* possible (s26-28 GmbHG). eG:s 15a GenG.	No additional duties to shareholders (s 74(2.d) IA). Liability if limited by guarantee; or if unlimited (75).
8	no conflict of interests	6	Principle follows from 2:8, 2:140 BW and HR13-07-2007: interests of the LP come first. If *personal* interest threatens proper judgment: in NV/BV default representation by NEDs (s 146/256 BW) or if desired by a GM appointee. *Coöperatie* and *vereniging* if desired by a GM appointee (2:47 jo. 53a BW); *stichting* no arrangement.	Follows from requirement to act '*zum Wohle der Gesellschaft'* (s 93(1) AktG). Conflict of interests rules derive from the '*gesellschaftlicher Treuepflicht'* (s 242 BGB). Specific also for members: 47(4) GmbHG; prohibition to compete for ED: s 88 AktG. NEDs represent AG towards ED (s 112 AktG).	Strict and detailed conflict of interests rules derived from the duty of loyalty in common law. From 2006 in s 175-177 CA for CA companies, common law for IPS.
9	collegial board	8	for all LP: 2:9; 129/140; 239/250; 44, 47 jo.53a; 291BW	for all LP: 76,77 AktG; 35 GmbHG; 24,25 GenG;26 BGB	for CA companies: 414,419,421 CA.
10	restrained court examination	(9)	no BJR in the Netherlands. The Court takes any entrepreneurial decision under full consideration. Examina-tion with restraint: liability in the case of *serious* reproach.	BJR in s 93(1) AktG and for other LP: BGH in *ARAG/Garmenbeck*.	No BJR but 'reasonably diligent person' test with 'subjective-plus' (s 174(2) CA). Courts are sensitive to avoid the use of hindsight (Davies, 2008, p 494).

BGH	*Bundesgerichtshof*	GM	general meeting	noT	original number of fundamentals in Timmerman (2009)	AktG, GmbHG, GenG, BGB: German Acts
BJR	Business Judgment Rule	HR	*Hoge Raad*	(noT)	original number of nascent fundamentals in Timmerman (2009)	BW: Dutch Act
CC	Charity Commission	LP	legal person(s)			CA, IPSA, FIPSA, Charities Act: UK Acts
ED	executive director	NED	non-executive director			

leaves many choices open to the shareholders. However, many monitoring mechanisms in all the legal systems are mandatory to prevent abuse and failure: the UK Secretary, CIC regulator, FSA and Charity Commission; the German *Mitbestimmung* and *Betriebsrat*, and the Dutch *Structuurwet* and *Ondernemingsraad*.

Moreover, Timmerman discerns five *behavioural* fundamentals. The first is the observation that a legal person contains a *pluralism of interests* to be handled either through the development of *structures*, i.e. the nomination of NEDs, the establishment of a works council, different committees of directors; or through *standards*, i.e. the duty of care and of loyalty and their derived norms. All the systems recognize this pluralism of interests. However, Germany and the Netherlands predominantly choose a stakeholder-value orientation which not only organizes the behavioural norms, but also the structure accordingly. In the UK an enlightened shareholder-value approach reigns, in which the benefit of the members as a whole comes first and the interests of e.g. employees are a matter of 'regard' in the process of promoting the success of the company[790]. The second behavioural fundamental concerns that of *free and undisturbed ownership*. This means that a shareholder cannot be burdened by other obligations than to pay up the amount due at the time the share is offered. This fundamental applies to all *public limited forms* and to the Dutch BV. However, in Germany the GmbH articles may enable its GM to create a *Nachschusspflicht*, i.e. a duty to pay up additional funds[791]. For the Dutch and German co-operatives similar provisions exist. If a British private limited is limited by guarantee, the members are liable to contribute a specific amount[792] if the assets are insufficient to cover the liabilities. If the private company is unlimited, the members' duty to contribute is unlimited[793]. The third behavioural norm is that a director should *avoid a conflict of interests.* This norm is very explicit in Dutch and UK law, but is much more detailed in the UK (s 175-177 CA). The lack of detailed arrangements in the Netherlands (s 2:146/256 BW) has recently caused a wave of new HR sentences cumulating in the requirement of the absence of a direct or indirect personal interest. Germany recognizes some specific provisions on conflicts of interests but its law largely rests on the principle of the *Treuepflicht* and related case law. The fourth behavioural norm concerns the *collegial board* principle. This monitoring norm is common to all systems, although the German AktG and the Dutch BW elaborate much more on the role of the executive board as such than does the GmbHG, or British law on the function of the board of directors in general. The fifth and nascent behavioural fundamental concerns *restrained court examination.* It underlines 'the desirability of avoiding the luxury of substituting the courts' hindsight for the directors' foresight' (Davies, 2008: 494). German law applies the BJR, thus providing directors a *freies Ermessen* (free space of judgement)[794]. In the UK this free space exists since the duty of loyalty still depends on good faith of the director (s 172 CA) and the duty of care on the care 'that may reasonably be expected' (s 174 (2a) CA) although the 'subjective plus' of the director in s 174 (2.b) CA reigns in this freedom somewhat. In the Dutch approach the *Hoge Raad* distinguishes between the *behavioural norm,* i.e. 'proper fulfilment of the task assigned' and the *liability norm,* i.e. 'serious reproach' (Timmerman, 2009).

In order to evaluate the three systems along the 'fundamentals', section 4.3.2 formulated four questions to be answered after the previous analysis.

(1) do all three legal systems adhere to the same fundamentals?
Essentially they do, although some fundamentals may not apply to a specific legal person and the details may differ amongst legal systems.

(2) which of the fundamentals are omitted?
Lacking fundamentals are those of *transparency* for the association and foundation forms. In the UK information on charities is available on request from the Charity Commission whilst that on IPSs is available from the FSA. In Germany and the Netherlands information on associations and foundations is often not publicly available. The *inside/outside division* is lacking for the eV and Stiftung in Germany, since the old-fashioned right to annihilate agreements based on unauthorized representation is still in the law. UK law is far ahead as regards the *non-mandatory* fundamental although Dutch law and German GmbH law provide for flexibility through the articles. The *pluralism of interests concept* is strictly arranged in wording and structure in Germany and to a far extent in the Netherlands, whilst the UK relies mostly on directors' standards.

(3) which fundamentals are to be detected elsewhere?
The analysis did not detect a new 'fundamental' in the UK or German legal system.

(4) is a difference in fundamentals mirrored by a difference in legal strategies or mandatory monitoring mechanisms respectively?
Less structure and less mandatory law in the UK seems to be compensated by more explicit directors' duties and more supervisory agencies (e.g. Takeover Panel and FSA; CIC regulator; Charity Commission).

4.11 WHICH LEGAL SYSTEM MONITORS BEST?

Despite the EU harmonization efforts each legal system still has its own peculiarities. An objective full coverage of all legal persons resulting in a 'monitoring ranking' is not possible since one also has to consider the peculiarities of the country and its culture. What follows is a thorough analysis-based, but in the end intuitive evaluation.

The *Dutch* system relies in principle on shareholder/member rights to appoint directors, to adopt the annual accounts, to release directors from liability, to appoint an auditor or to alter the rules of the game. Directors' free space is restricted by a GM, SB and works council veto on specific issues and standards of care and loyalty owed to the legal person and the members. Easy court access to the OK is the general coping stone besides some court (Rb) intervention competences, especially for the *stichting*.

The *German* system is principally inclined towards supervision either by a mandatory SB (AG; eG may abandon if ≤ 20 members; GmbH if DrittelbG or MitbestG applies), by a works council, or by State authorities (a 'check at the gate' for all legal persons, especially the Verein and Stiftung and supervision *ex post* for the Stiftung). Directors' free space is enlarged by the BJR (Arag/Garmenbeck) and restricted by a GM, SB and works council veto on specific issues. The GM determines the rules of the game, but its rights are otherwise somewhat curtailed. In the AG they are restricted by law; in general the GM lacks a mandatory right to appoint EDs; or in AG or eV to adopt the annual accounts. However, the *Holzmüller/Gelatine* doctrine goes beyond Dutch law where it grants the GM a right to veto fundamental, deeply intervening decisions with a similar effect as an amendment to the articles. There is no mandatory list of SB rights except for supervision and audit-related tasks. Standards of care in the AktG, GmbHG, GenG, HGB (for *Kaufmann*) and BGB (for *Gesellschafter*) and a duty of loyalty in the HGB are owed to the members.

The *UK* system principally grants members freedom to organize their legal person. The principal focus of company law is to limit directors' free space. This is done on the one hand by a thorough and detailed system of directors' duties either in the CA (for Plc, Ltd, CIC) or in common law. On the other hand the law assigns to the GM a mandatory right to veto a list of transactions between directors and the legal person. Obviously the UK legislator does not believe in mandatory supervision through NEDs or a works council. The whistle-blowing system (PIDA) is in that sense indeed a stranger. However, apparently this system needs some outside supervision. For the listed Plc, there are the Takeover Panel and the FSA. Since the FSA determines the Listing Rules and the Code, it has a stronger position than its peers in the Netherlands or in Germany. Moreover, the law grants the FSA (for IPS), the CIC Regulator (for CIC) and the Charity Commission (for charities e.g. the CIO) impressive inspection, supervision and monitoring competences.

This analysis, just like the one on the Timmerman fundamentals, is not conclusive. There is no 'best monitoring system'. This fits in with Jungmann's (2006) conclusion that both the German and the UK systems are effective means of control. None of the systems has applied all the theoretical findings economists come up with. One determines 'monitoring' aspects in the structure and legal strategies, and 'bonding' aspects in the directors' duties. The legislator has obviously tuned in to the needs of each particular legal person and the circumstances it has to cope with in society. Apparently every system builds its own monitoring framework and achieves its own equilibrium. Remarkable though is the relative lack of internal mandatory supervision in the UK corporate system and the relative overweight of external supervisors in a system that is proud to see ‘the division of powers as between the boards and the shareholders (..) as a matter for private ordering by the members of the company rather than something to be specified mandatorily in the companies legislation’ (Davies, 2008: 366).

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ENDNOTES

1 With 'corporate law' this thesis refers to *corpus* in Latin, i.e. to the law on legal persons. The term is used interchangeably with 'company law'. It would be wrong to assume that a 'company' should be a profit–oriented institution, as the UK Companies Act 2006 (CA) shows. Although 'corporate law' is the US term and 'company law' is British, e.g. 'corporation' is found in s 323, 1173 CA and 'body corporate' in s 16(2), 1173 CA. The Dutch word 'corporatie' has no legal meaning and is exclusively assigned to a housing society in an association or foundation form.

2 Davies (2010: 3 footnote 6) points out that companies must register in England and Wales, Scotland or Northern Ireland. 'There is no such thing, technically, as a 'British' or 'UK' company, even if the Companies Act 2006 now applies across all three jurisdictions.'

3 Which is forbidden for the private company: s 755 CA.

4 Kraakman et al. (2009: 37) define a *legal strategy* as a generic method of deploying substantive law to mitigate the vulnerability of principals to the opportunism of their agents. Davies does not define the concept, but takes a more neutral stand by speaking of strategies available for the regulation of agency relationships.

5 Davies' (2010) figure 1 (p. 113) which is the same as the Davies' (2002) figure 1 (p. 120), refers to the, still forthcoming in 2002, figure of Kraakman et al. (2004: 23) which is at present in 2009: 39, without discussing the differences. Kraakman et al. do not refer to Davies' figure.

6 See on this chapter 6.

7 Timmerman, 2009: 5.

8 Timmerman, 2009: 10: nos. 2, 3, 5, 7, and (nascent) 10.

9 Timmerman, 2009: 10: nos. 1, 4, 6, 8, and (nascent) 9.

10 This is the legal translation of the economic approach of internal monitoring given in 3.5.1.

11 Dutch company law directs itself in s 2:8 BW to "those who are concerned with the company through the law or the articles". This implies that executive directors (EDs), non–executive directors (NEDs), shareholders, depositary receipt holders, usufructuaries and security holders of shares with voting rights (Van der Heijden / Van der Grinten, 1992: 245) and holders of profit–sharing notes (De Monchy and Timmerman, 1991: 50) are subject to company law as well.

12 Dutch law lists company organs in s 2:78a BW for specific purposes. It cannot be interpreted as a general definition.

13 Andenas and Wooldridge, 2009: 39. The articles of association of Heineken N.V. of 11 May 2009 distinguish between the Shareholders' Meeting and the Shareholders' Body. The latter is the company organ. This thesis does not make this distinction since this would not contribute to the analysis.

14 The idea is that a works council's primary concern is with the enterprises, and not with the legal person. It is an academic debate (De Monchy and Timmerman, 1991: 51; Van der Heijden/ Van der Grinten, 1992: 246; Van Schilfgaarde/Winter, 2009: 25–26). On the one hand: the works council is established in the WOR, not in the BW; the legislator never meant to apply e.g. the general rules of s 2:14–16 BW to the WOR; the works council may litigate against the legal person e.g. s 2:158(8) BW and s 36(2) WOR. On the other hand: the works council may recommend a nominee for a NED position in the structured NV; e.g. s 2:101 and 2:135 require information to be sent to the works council; s 2:158 (12) BW requires approval of the works council; a proposal to give the right to speak to the works council in the GM is pending in Parliament (31877).

15 This may change into a liability to creditors in a situation of near financial distress; see chapter 5.

16 On the intriguing relationship between company law and securities law see for example: Hijink, J.B.S., 2006, *Vennootschapsrecht en effectenrecht: een aanzet tot een afbakening* (Boom Juridische uitgevers, Den Haag).

17 Kroeze et al, 2005: 6 and Davies, 2008: 13 and p. 82.

18 S 2:64 BW means: section 64 of Book 2 of the Dutch Civil Code (Burgerlijk Wetboek).

19 s 2:66(2) BW.

20 s 2:64(2) BW: the *Dienst Justis* of the Minister of Justice screens the financial and criminal antecedents and the intentions of the incorporators. Based on this information the '*verklaring van geen bezwaar*' (vvgb; certificate of no objection) is obtained or denied. This *ex ante* government clearance of s 2:64(2) BW is expected to be replaced shortly by a continuous screening *ex post* through the *Handelsregister* and other data. At present, government clearance is also required for an amendment to the articles, s 2:125(2) BW. See on the status of the proposal: Annex 2 under 4.

21 See s 2:64 BW; the articles may contain a lock–up provision for registered shares: s 2:87–87a BW.

22 A one-tier system is *de facto* possible in the Netherlands, as e.g. Fortis NV, Reed Elsevier NV, Unilever NV, and the Dutch Code (DC IV.3) show. A proposal to enable a one-tier system also *de iure* is pending in Parliament (31763). See on the status of the proposal: Annex 2 under 3.

23 *Rechtspersonen*, artikel 153 BW, defends on historic grounds that if the issued share capital is over €16 million, the company qualifies to be structured in *any* case, independently of whether the reserves are positive or negative. Van Schilfgaarde/Winter (2009: 417) agrees and adds that the criteria should be calculated based on the fair value of the assets.

24 s 2:153(2), 154(1) BW.

25 In the structure regime the SB basically has two extra competences: to appoint the EDs (s 2:162 BW) and to approve EB decisions related e.g. to the issue or listing of debenture or shares; to investments to an amount of over 25% of equity; to important acquisitions, cooperation-agreements or reorganization; to proposals for an amendment to the articles (s 2:164 BW). Mitigation means that s 2:162 BW, prescribing the appointment of EDs by the SB, does not apply (s 2:155, 155a BW). It remains a GM competence.

26 An exemption (s 2:153(3) BW) is e.g. granted by law if the 'structure NV' is a subsidiary of a structure SE, NV, BV; or if the 'structure NV' is merely a holding structure that controls and finances its subsidiaries, while the majority of employees works outside the Netherlands. Mitigation (s 2:155, 155 a BW) is possible e.g. if the company is a subsidiary of a foreign multinational company; or if it is a joint venture (both unless the majority of employees works in the Netherlands); or if the company has a sole owner, who is a natural person, or a foundation, or an association.

27 The law also provides for an exemption through a request to the Minister of Justice (s 2:156 BW).

28 s 2:157 BW.

29 s 2(1) WOR.

30 s 35b WOR.

31 s 2:391(5) BW and the 'Besluit van 23 december 2004' (Staatsblad 2004, 747) as changed by 'Besluit van 10 december 2009' (Staatsblad 2009, 545). The explicit mention in the BW to a corporate governance code dates from 2008 (31508). The Hoge Raad incorporated the content of the Dutch Code in Dutch company law when ruling in HR 13 July 2007, JOR 2007, 178 (Bank of America/VEB and ABN AMRO, r.o. 4.8) that the DC contains 'the in the Netherlands accepted corporate governance views', to be applied in interpreting the 'reasonableness and fairness principle' of s 3:12 and 2:8 BW. Moreover the Hoge Raad ruled there that the DC also contains requirements for proper management as meant in s 2:9 BW. The DC is also incorporated in s 5:86 Wft where it requires disclosure from institutional investors regarding their adherence to the DC.

32 A proposal to raise the threshold from 1% to 3% is pending in Parliament, *Kamerstukken II* 2008/09, 32014. This only concerns the NV.

33 s 2:118 BW. See also 2:117b BW which refers to the date of ownership.

34 s 2:118a(2) BW permits the trustee to restrict, exclude or withdraw a mandate given to a non-depositary receipt holder to vote in the case: (a) of a hostile bid; (b) of a blockholder of over 25%; (c) that the exercising of the voting rights were essentially against the interests of the company. In IV.2 however the DC requires a non-restricted mandate in any case.

35 Bearing the famous TCI letter of 20 February 2007 to ABN AMRO in mind, a threat to seek publicity on the matter may already work more than adequately.

36 s 2:14-16 BW.

37 s 2:447-455 BW.

38 The size-criteria are:

company	small (2:396)	medium (2:397)	large (2:394)
total assets (2:396 (1.a))	≤ €4,4 million	> €4,4 and ≤ €17,5	> €17,5 million
net turnover (2:377(6))	≤ €8,8 million	> €8,8 and ≤ €35	> €35 million
employees (average)	< 50	< 250	≥ 250

A company is 'small' or 'medium' if two out of three of the criteria apply on two successive balance sheet dates (s 2:396(1), 2:397(1); for new companies s 2:398(1) BW). The disclosure criteria are given in s 2:396 for 'small' and s 2:397 BW for 'medium' companies. This system applies to the NV, BV, coöperatie; and to a vereniging or a stichting maintaining an enterprise with a two–year consecutive annual turnover of at least 4,4 Mio (s 2:360(3) BW) *unless* the vereniging or stichting is already obliged by another specific law to adequate disclosure. See on public disclosure: De Jong and Nieuwe Weme (2006), Taelemans and Huybrechts (2008) and Hendrikse (2010).

39 s 2:396(9) BW.

40 s 2:398(3a) BW.

41 s 5:25m and 25o Wft. The AFM should send copies to the *Handelsregister* (s5:25o(4) Wft). The AFM holds an on–line freely accessible register of these data.

42 s 5:70 jo 1.1 Wft.

43 See for the specific requirements: s 2:335(2) BW. A proposal is pending in Parliament to make this procedure more efficient: see Annex 2 under 1.

44 See s 2:107(2) BW, s 9 EU–Directive no. 2007/36 of 11 July 2007 and HR July 2010 (ASMI) r.o. 4.6. The latter explicitly mentions that every shareholder has the right to ask questions and that the company should answer these. However, the right to obtain 'all the desired information' is a GM right.

45 s 2:120(1) BW on majority and s 2:120(2) BW on quorum; exceptions e.g. 2:132(2), 133(2), 134(2) BW.

46 s 2:143 BW.

47 s 2:132(2) and 142(1) BW.

48 s 2:142(2) jo 133 BW.

49 s 2:158 BW contains the appointment procedure in the 'structure NV' which is partly default law (s 2:158(12) BW). The SB recommendation may be rejected by a majority. A new recom–mendation would be required (s 2:158(9) BW).

50 s 2:158(5) BW.

51 For one–third of the NED positions, the SB is obliged to recommend the works council nominees (s 2:158(6) BW). If the SB does not agree with the works council nominee, it could request the OK to validate its objection. If the OK agrees, the works council is entitled to a new nomination (s 2:158(7) BW).

52 s 2:158(9) BW. If the GM vetoes, but with less than one–third of the issued capital, a (new) EGM is to be organized. In this new EGM, the qualified majority requirement is dropped.

53 e.g. Klaassen, 2007: 44.

54 Which will not be easy to accomplish. See *Rechtspersonen*, art. 158, aant. 15. The impression that s 2:158(9) jo (12) in *any* case requires GM involvement would be wrong.

55 s2:161(2) BW. The law specifies the conditions as well as the criterion the court has to apply.

56 Van Schilfgaarde/Winter (2006: 349) and Van der Heijden/Van der Grinten (1992: 654) posit that the articles may restrict the competence of the GM to decide on liquidation. Although De Monchy and Timmerman (1991) do not mention such a possibility, this restriction is indeed found, see e.g. the articles of Brunel International N.V. of 8 June 2009, s 22.

57 Logically, the decision to declare bankruptcy would belong to this array of rights. However, the declaration of bankruptcy is assigned to the GM by default rule (s 2:136 BW) and for a 'structure NV' the decision is subject to the approval of the SB, 2:164(1.h) BW.

58 E.g. the articles of Brunel International N.V. of 8 June 2009, s 5(2), 8(1) and 22. See for the legal doctrine on the matter: Klaassen, 2007: 33 and 137–144, 148–152 e.g. arguing *a contrario* on s 2:101(4) BW and on the text of 2:317(3) BW. In this author's view the court may lift such a requirement in the articles based on s 2:8 BW if a refusal to co–operate would definitely not meet the requirements of reasonableness and fairness. Similarly: Dijk/Van der Ploeg, 2007: 319.

59 HR 13 July 2007, JOR 2007, 178, LJN: BA7971, r.o. 4.7.

60 Medium and large companies have to appoint an auditor, s 2:396(7) BW. Listed NVs should always appoint an auditor (s 2:398(3a) BW). For the size–criteria: fn. 38.

61 s 2:107(1) BW.
62 The articles may entitle an organ to give general suggestions on specific areas, s 2:129(4) BW.
63 s 2:149 referring to 2:9 and 2:138 BW for EDs. See also 2:150 for NEDs and s 2:139 for EDs.
64 Dijk/Van der Ploeg, 2007: 243–244.
65 s 2:140(2) BW.
66 s 2:141 BW requires (1) 'all the information necessary for the execution of its task' and (2) information on the 'outline of the strategy, on general and financial risks and on the control and monitoring system of the company'.
67 This is in accordance with principle II.1 of the DC. In best practice II.2 however, the DC requires SB approval of the strategy. Are the supervision of the HR and the approval of the DC identical? It is hard to imagine that a NED of a company will remain seated if he is not able to subscribe to the strategy the EDs proposed/determined and that the other NEDs subscribe too. What would be the position of EDs if the SB were to disagree with a newly proposed strategy by the EB? If structured, approval of the strategy may *de facto* be a mandatory monitoring right of the SB after all because of its right to dismiss EDs. Otherwise, the EDs may remain seated and the NEDs should resign.
68 s 2:161(2) BW. The law specifies the conditions as well as the criterion the court has to apply.
69 See footnote 25.
70 s 2:129(1) BW.
71 s 25 WOR.
72 s 30 WOR. It should be noted that the WOR uses a peculiar definition of an ED ('person who directly exercises the highest authority in managing employees within an enterprise'). Especially in the case of more enterprises within one legal form the question might arise whether an EB member is to be considered an ED *for this enterprise* (Van Schilfgaarde/Winter, 2009: 266; idem Vink/Van het Kaar).
73 s 2:107a(3;4) BW from 1 July 2010.
74 s 2:134a/144a BW from 1 July 2010.
75 s 2:135(2,3) BW from 1 July 2010.
76 See s 2:158(6) and (12) BW and above under 'General Meeting (GM)'.
77 s 2:158(4) BW from 1 July 2010.
78 s2:161(2) BW. The law specifies the conditions as well as the criterion the court has to apply.
79 s 2:333f BW.
80 to the company (s 2:9) or to third parties (s 2:138, 139, 149, 150 BW).
81 s 2:9, 138(3), 139, 149, 150 BW.
82 s 2:129 and 130 BW.
83 s 2:57(2), 140(2), 250(2). The literature argues that the same applies for SBs established for associations and foundations. Another approach in the articles is felt to be contradictory to the nature of Dutch company law.
84 See HR 13 July 2007, JOR 2007, 178, r.o. 5: 'It also applies in this case that in the performance of their duties the executive board shall put first and foremost the interests of the company and the enterprise connected therewith and should in deciding take into account the interests of all concerned, amongst which those of the shareholders.' See also Annex 2 sub 3 (proposal 31763) which adapts s 2:9 new accordingly.
85 See: Timmerman, L., 2007B, Company law and the Dutch Supreme Court, *Ondernemingsrecht* 3.
86 See s 3:12 BW for the approach to find and define these requirements.
87 s 2:146 BW first sentence. If there is a conflicting interest and if the default rule has not been disabled in the articles, the consequence based on s 2:130 BW is improper representation by the company, and the nullity of the legal act/agreement. The third party is protected however if he did not know, and could not have known, of the conflicting interest (HR 11 September 1998, NJ 1999, 171 (*Mediasafe II*). See Kroeze et al. 2005: 111–114. The literature on recent developments: Schwarz, C.A., 2008, Tegenstrijdig belang in beweging; enige actuele ontwikkelingen in rechtspraak en wetgeving, *Tijdschrift voor Ondernemingsbestuur* p. 74–

82.; Blanco Fernández, J.M., 2008, Tegenstrijdig belang en de Hoge Raad, *Ondernemingsrecht* p. 416–428.
88 s 2:146 BW second sentence.
89 See Annex 2 under 3 (s 2:129/239(5) new) and DC II.3.3.
90 See DC II.3.4.
91 Spectacular examples are the Guus Hiddink affair and the Bouwfonds–real estate affair.
92 Although non–listed companies often neglect this duty, it seldom comes to a penalty or a court sentence (see chapter 8).
93 By the Chamber of Commerce: s 2:19a BW.
94 Banks, clearing institutions, financial providers and the like, as defined in s 1:1 Wft. They are not necessarily listed.
95 See s 5:2, 5:3 Wft.
96 See the Wet Toezicht Financiële Verslaggeving (Wtfv) and s 2:448(2) jo 447(2) BW.
97 See s 2:14–16 BW; s 131 BW; s 2:19–22 BW (at the request of the OM or 'an interested party'). Also: Van der Ploeg (2010: 233).
98 Timmerman, 2007B sub 11. See s 2: 161–161a BW; s 2:344 BW. A request can only be awarded if there appear to be sound reasons to doubt that the policy of the legal person is correct, Van der Ploeg (2010: 251) and s 2:350(1) BW.
99 See s 3:8, 3:9 and 3:10 Wft and the 'Besluit prudentiële regels Wft'; and s 4:9, 4:10, 4:11 and the 'Besluit Gedragstoezicht financiële ondernemingen Wft'.
100 s 2:345(2) BW; or for an 'annual report procedure' in the public interest, s 2:448(1.b) BW.
101 See s 2:297(1) BW.
102 And it may be a direct and mandatory monitor where it reacts directly to changed circumstances, for instance in the s 2:391(5) BW proposal to incorporate the DC or in the one–tier proposal. See also: Annex 2.
103 Other laws, e.g. the *Handelsgesetzbuch* (HGB) and *Umwandlungsgesetz* (UmwG) as well as the employee participation laws mentioned in s 96 AktG and discussed below, contain relevant company law as well.
104 s 23(5) AktG.
105 s 1(1) AktG.
106 s 2 AktG. See s 42 AktG.
107 s 4 AG.
108 s 29, 36, 41 AktG. On the *Handelsregister*: s8 HGB.
109 s 38 AktG. See for the necessary preliminary research (*Gründungsprüfung*): s 33–35 AktG.
110 s 23(1) AktG.
111 s 23(3.2) AktG.
112 s 7 AktG.
113 And the share premium, if any in full: s 36a(1) AktG.
114 See e.g. s 110(3) AktG. See also Klaassen, 2007: 65, fn. 345.
115 The EB should consist of at least two (natural, s 76(3) AktG) people if the issued share capital exceeds €3 million, unless the articles determine otherwise (s 76(2) AktG). On the requirements for EDs see: s 76(3) AktG.
116 And must be a multiple of three, s 30, 95 AktG unless the MitbestG applies (see text). On the specific requirements for NEDs see s 100 AktG which mentions a – conditional – maximum number for NEDs of 10 NED positions in companies; and a two–year waiting term in principle before an ex ED can become a NED.
117 See s 96 and 103(4) AktG and the laws referred therein. Of these, the *Montan–Mitbestimmungsgestz* (for *Montan* companies, i.e. coal and steel producing companies), the *Mitbestimmungserganzungsgestez* (holding companies in coal and steel), the *SE–Beteiligungsgesetz* (for SEs) and the *Gesetz über die Mitbestimmung der Arbeitnehmer bei einer grenzüberschreitenden Verschmelzung* (cross–border mergers) will be left out of consideration.
118 s 1(1) DrittelbG contains some nuances for family–owned companies.
119 See s 4(1) DrittelbG. The first two labour NEDs should be employees (s 4(2) DrittelbG.
120 s 4(4) DrittelbG.

121 s 33 MitbestG.
122 This means six NEDs each, if the AG employs less than 10,000 employees, up to 10 each above 20,000 (s 7 MitbestG).
123 s 9 MitbestG.
124 s 15 MitbestG speaks of a *leitender Angestellter.*
125 s 7(2) MitbestG.
126 s 29(2) MitbestG.
127 s 27 MitbestG.
128 This means: any institution, whatever its legal form, with the exception of e.g. governmental institutions, s 130 BetrVG.
129 s 1 BetrVG.
130 For every 3,000 employees more, another two members: s 9 BetrVG.
131 s 15(2) BetrVG.
132 s 27 BetrVG.
133 s 38 BetrVG; e.g. 11 members if the institution has 9,000 employees.
134 Some of the articles in the AktG discern between a listed and a non–listed AG, e.g. s 110(3) AktG. Based on the name of the law that introduced this difference, one speaks of a 'small AG' (see Klaassen, 2007: 65). The general organization form however, is identical to both.
135 s 161 AktG.
136 s 131(1) AktG.
137 s 131(3) AktG.
138 s 132 AktG.
139 Glozbach, 2008: 158 stresses that the subject may not concern management issues (s 119(2) AktG). However, it is permitted to demand a meeting on the grounds of dismissal of board members and to deal with management issues in the context of this agenda item (p. 159).
140 s 122(3) AktG. Glozbach, 2008: 159 writes that the 'kann' from the text of the law is a *de facto* 'must' unless the condition mentioned in the previous footnote is present.
141 s 133 AktG, e.g. s 179(2) AktG.
142 s 134 (1) AktG.
143 s 148 AktG, introduced on 1 November 2005 by the UMAG.
144 s 103(3) second sentence AktG.
145 s 325 HGB. For small and medium–sized companies: s 326 and 327 HGB. A listed company is always 'large': s 267(3) jo 264d HGB. See footnote 158.
146 Schmidt and Lutter, 2008: 1290–1292 for all GM competences.
147 s 176(1) AktG
148 s 101(1), 103(1) AktG.
149 s 101(1) AktG, s 5, 12 DrittelbG, s 9, 23 MitbestG.
150 s 101(1) for co–determination and 101(2) AktG for shareholders, the latter up to max. one–third.
151 s 172 AktG.
152 s 119 AktG. The provisions of the AktG are mandatory, see 23(5) AktG. Not all provisions are listed in s 119, as figure 4.3 indicates. For the full scale of GM competences, see Klaassen (2007): 56.
153 This is clear from s 76(1) AktG '*unter eigene Verantwortung die Gesellschaft zu leiten*' and from s 119(2) AktG '*über Fragen der Geschäftsführung kan die Hauptversammlung nur entscheiden, wenn der Vorstand es verlangt*'.
154 See for a comparative analysis of the issue between the Netherlands, the UK and Germany: Klaassen, A.G.H., 2008, Het goedkeuringsrecht van artikel 2:107a BW in rechtsvergelijkend perspectief, *Ondernemingsrecht* 16, 568–577.
155 BGH, 25.02.1982, BGHZ 83, 122. From r.o. 2c: "*Zwar steht es, soweit das Gesetz nichts anderes bestimmt, grundsätzlich im Ermessen des Vorstands, ob er nach § 119 Abs. 2 AktG eine Entscheidung der Hauptversammlung herbeiführen will, um seine Verantwortlichkeit zu mindern (§ 93 Abs. 4 Satz 1 AktG). Es gibt jedoch grundlegende Entscheidungen, die durch die Außenvertretungsmacht des Vorstands, seine gemäß § 82 Abs. 2 AktG begrenzte Geschäftsfüh–*

rungsbefugnis wie auch durch den Wortlaut der Satzung formal noch gedeckt sind, gleichwohl aber so tief in die Mitgliedsrechte der Aktionäre und deren im Anteilseigentum verkörpertes Vermögensinteresse eingreifen, daß der Vorstand vernünftigerweise nicht annehmen kann, er dürfe sie in ausschließlich eigener Verantwortung treffen, ohne die Hauptversammlung zu beteiligen. In solchen Fällen verletzt der Vorstand seine Sorgfaltspflicht, wenn er von der Möglichkeit des § 119 Abs. 2 AktG keinen Gebrauch macht (vgl. Barz in Großkomm. AktG 3. Aufl. § 119 Anm. 7 a. E.; Timm, Die AG als Konzernspitze, § 16 D S. 175 ff.)."

156 s 179a AktG. Schmidt and Lutter, 2008: 1914 speak of a 'sale of assets squeeze–out'.

157 BGH 26–04–2004, BGHZ 159, 30 from r.o. III.2.a.cc: "*Danach kann eine im Gesetz nicht ausdrücklich vorgesehene Mitwirkung der Hauptversammlung bei Geschäftsführungsmaßnahmen des Vorstands nur in engen Grenzen, nämlich dann in Betracht kommen, wenn sie an die Kernkompetenz der Hauptversammlung, über die Verfassung der Gesellschaft zu bestimmen, rühren und in ihren Auswirkungen einem Zustand nahezu entsprechen, der allein durch eine Satzungsänderung herbeigeführt werden kann.*"

158 This refers to disclosure criteria given in s 267 HGB. These criteria are:

company	small (267.1)	medium (267.2)	large (267.3)
total assets	≤ €4,840,000	in between	> €19,250,200
turnover	≤ €9,680,000	in between	> €38,500,000
employees (average)	≤ 50	≤ 250	> 250

A company is small if two out of three of the criteria apply on two succeeding balance sheet dates (s 267(4) HGB). Only medium and large companies have to appoint an auditor, s 316(1) HGB. A listed company is always 'large': s 267(3) jo 264d HGB.

159 s 264d HGB.

160 s 120(4) AktG. See Meier–Wagenaar, 2010.

161 s 111(1) AktG: 'überwachen'.

162 Schmidt and Lutter, 2008: 1205 ('*Beratung is die präventive Kontrolle des Vorstands*'); German Code, Foreword: 1.

163 See Schmidt and Lutter, 2008: 1201.

164 s 90(1 and 3) AktG.

165 s 84, 87. German law has explicit provisions for downgrading rewards if the circumstances so require: s 87(2) AktG.

166 s 84–87 AktG, s 30–33 MitbestG. S 31(2) MitbestG requires a 75% majority in the SB for an EB nominee.

167 s 84(3) AktG. For the *Arbeitsdirektor* the provisions of 30–33 MitbestG apply.

168 s 103(3) AktG: '*wenn in dessen Person ein wichtiger Grund vorliegt.*'

169 s 111(4) AktG, second sentence.

170 s 111(4) AktG, first sentence.

171 Schmidt and Lutter, 2008: 1211.

172 32 MitbestG.

173 s 88 AktG, *Wettbewerbsverbot.*

174 s 114 AktG.

175 Lutter and Hommelhof, 2009: 1268.

176 s 171(2) AktG.

177 s 172 AktG.

178 s 112 AktG jo s 2:146 BW.

179 s 111(2) *in fine* AktG; s 119(1.4) AktG; s 318(1) fourth sentence HBG. Schmidt and Lutter, 2008: 1210 describe this as the *'Geschäftsbesorgungsvertrag mit werkvertraglichem Charakter*'.

180 s 87(1 and 2) AktG.

181 s 110(3) AktG. Maitland–Walker, 2008: 370: 'Quarterly board meetings are the rule'. Schmidt and Lutter, 2008: 1206 plea for a higher frequency in times of crisis.

182 s 42, 61 BetrVG.

183 s 2(1) '*unter Beachtung der geltenden Tarifverträge*'; also: s 72 (2), 80 BetrVG.

184 s 31 BetrVG.
185 s 74 BetrVG.
186 s 80 BetrVG.
187 s 90 BetrVG.
188 s 92 BetrVG.
189 s 102 BetrVG.
190 s 111 BetrVG.
191 s 99(2) BetrVG. S 102 BetrVG provides for co–determination in the case of lay–offs. The employer may dismiss regardless of the opinion of the works council. However, this opinion plays a role in the subsequent trial.
192 s 87, s 90 BetrVG.
193 s 98 BetrVG.
194 s 94 BetrVG.
195 s 95 BetrVG.
196 s 94(2) BetrVG.
197 s 102, 103 BetrVG.
198 s 74 BetrVG.
199 s 76 BetrVG.
200 i.a. s 80(1) BetrVG.
201 s 102(1) BetrVG.
202 s 90(2) BetrVG.
203 s 111 BetrVG.
204 s 92, 92a BetrVG.
205 s 96(1) and 98(3) BetrVG.
206 s 54 BetrVG.
207 s 42, 43 BetrVG.
208 s 86a BetrVG.
209 s 5, 12 DrittelbG; s 9, 18, 23 MitbestG.
210 s 76(1), 78(1) AktG.
211 GC 3.2.
212 e.g. s 76(1), 77, 78(1), 108(1), 112 AktG; s 33(2) MitbestG.
213 Schmidt and Lutter, 2008: 1067; Stöber, 2004: 172.
214 s 93, 116 AktG. Near financial distress, this criterion is valid as well: s 92(2) AktG. The *Sorgfalt* criterion stems from s 276 BGB (to avoid intent and negligence) and the higher exigency of s 347 HGB (*Sorgfalt eines ordentlichen Kaufmanns*). See Lang/Weidmüller (2006) comm. s 34 no. 13–15.
215 s 90(4), 131(2) AktG: '*den Grundsätzen einer gewissenhaften und getreuen Rechenschaft*.' In line with this general association law is the *Berichtspflicht*, stemming from 713 jo. 666 BGB.
216 s 93 AktG second sentence: '*Eine Pflichtverletzung liegt nicht vor, wenn das Vorstandsmitglied bei einer unternehmerischen Entscheidung vernünftigerweise annehmen durfte, auf der Grundlage angemessener Information zum Wohle der Gesellschaft zu handeln*.' Schnidt and Lutter, 2008: 1063 explain that '*zum Wohle der Gesellschaft*' must be understood as '*wenn Entscheidungsmasstab das Unternehmensinteresse and der Erhaltung des Bestandes, der Förderung der nachhaltigen Rentabilität und der Steigerung des nachhaltigen Unternehmenswertes ist*.'
217 BGH 21.04.1997, BGHZ 135, 244 (ARAG/Garmenbeck) r.o. II.2.b (partially): (..) '*dem Vorstand bei der Leitung der Geschäfte des Gesellschaftsunternehmens ein weiter Handlungsspielraum zugebilligt werden muß, ohne den eine unternehmerische Tätigkeit schlechterdings nicht denkbar ist*.'
218 s 93(1) third sentence, 116 AktG. '*Verschwiegenheitspflicht*', violation is a reason for dismissal (s 84(3) AktG, 626 BGB) and a criminal offence (s 404 AktG). Also: Schmidt and Lutter, 2008: 1067.
219 s 93(2) in fine, 117(2) second sentence AktG.

220 s 93(2) last sentence AktG, inserted in German law on 5 August 2009. See: Meijer–Wagenaar, I., 2010, Het Duitse 'VorstAG': een voorbeeld voor de Nederlandse wetgever of niet?, *Ondernemingsrecht* 10/11, 453–456.
221 s 242 BGB. '*Die Plicht der Gesellschaft loyal zu dienen und das Interesse der Gesellschaft zu wahren*', Schmidt und Lutter, 2008: 1064.
222 Schmidt, 2002: 593: '*Vielmerhr geht es um eine allgemeine Abwägung und Begrenzung mitgliedschaflicher Interessen und Befugnisse.*'
223 Schmidt, 2002: 1035–1036.
224 See sequentially: s 88, 93(1) second sentence, 93(1) third sentence AktG; 4.3 DC (5.5 DC). Schmidt, 2002: 595–599 and Schmidt and Lutter, 2008: 1064.
225 s 93(2) first sentence AktG and Andenas and Wooldridge, 2009:310. See on the effect of GM approval s 93(4) first sentence (release from liability) and of SB approval s 93(4) second sentence AktG (no release).
226 company: s 93(2) first sentence, (4), (5) and s 117 AktG; shareholders: 147, 148 AktG; third parties s 93(5) last sentence, 280(1), 311(3) AktG; and 823(2) BGB. See also: s 89(1) jo. 31 BGB.
227 s 316(1) jo. 318 HGB. See footnote 158.
228 s 1 KStG (Körperschafsteuergesetz).
229 s 5(9) KStG. See also: 51–68 AO (Angabeordnung). Von Hippel, 2010: 205–210.
230 s 335(1.1) HGB.
231 Bundesarbeitsgericht BAG, Urteil vom 7. 12. 2006 – 2 AZR 400/ 05.
232 Davies, 2008: 14.
233 s 3–5, 58 CA. Davies (2008: 15) quotes a number of 11,500 in March 2006.
234 s 3–5, 59 CA. Davies (2008: 15) quotes a total number of registered companies of over 2 million in March 2006.
235 s 58 CA and s 33 (3 and 4) Companies (Audit, Investigations and Community Enterprise) Act 2004 (further: CA 2004) and Davies, 2008: 84. On 19 October 2009 3,172 CICs were registered.
236 Unless the law or the articles specify otherwise, s 31(1) CA.
237 These Parliamentary resolutions may be subject to a negative resolution procedure, e.g. s 19(5) CA, or to an affirmative resolution procedure, e.g. s 82(5) CA. S 1288–1292 CA explain these procedures.
238 s 4(2) and 5(1) CA; see also 3 CA and Davies, 2008: 18 fn. 79.
239 The law says 'p.l.c.', s 58(1) CA. However, Plc is common. See also for names and abbreviations: s 65–74 CA and regulations of the Secretary of State based on these sections.
240 s 7 CA.
241 s 4(2) CA.
242 See s 16 CA; also 7, 13, 14 CA. This is an administrative, rather than a judicial procedure, Davies, 2008: 95. A Plc needs a 'trading certificate' as well, s 761 CA.
243 s 14 CA. See also s 4(2.b) CA as to registration as a public company.
244 s 763 CA.
245 s 586, 761 CA.
246 s 385 CA defines. Recently The Companies (Shareholders' Rights) Regulation 2009 introduced 'traded companies' meaning companies quoted on a regulated market in an EEA (European Economic Area) State (360C CA).
247 e.g. Part 13, Chapter 5 CA, on the appointment of an 'independent assessor' on polls taken (s 343 CA).
248 Davies, 2008: 62'remarks on the issue: 'This is not stated explicitly in the Act, but it is rather an assumption upon which the Act is drafted, too obvious to be worth stating.'
249 s 20(1.b) CA. There are Model Articles for Private Companies Limited by Shares, for Private Companies Limited by Guarantee and for Public Companies. See SI 2008 No. 3229 The Companies (Model Articles) Regulations 2008, Schedules 1, 2 and 3 respectively.
250 s 154, 155 CA. The requirement of a natural person is met if the office of director is held by a natural person as a corporation sole or otherwise by virtue of an office.
251 s 112, 301 CA.

252 s 271–280 CA.
253 e.g. s 450(1) CA.
254 Unlike Dutch company law, see footnote 12. UK law thinks in terms of output i.e. resolutions at meetings': CA 2006 Part 13.
255 e.g. s 168, s 188 (2.A) and 492(1) CA.
256 The 'shop–stewards'. See Andenas and Wooldridge, 2009: 419. The s 42 of the Employment Relations Act 2004 based Information and Consultation of Employees Regulations 2004 *(ICER 2004)* provide for either a negotiated (s 7–17) or a standard (s 20) information and consultation procedure of employee representatives starting from undertakings employing 50 employees in the UK. The basis forms the EU Information and Consultation Directive (European Parliament and Council Directive 2002/14/EC of 11 March 2002). This procedure cannot be considered as a company organ.
257 Council Directive 94/95/EC of 22 September 1994.
258 s 4(1) Council Directive 94/95/EC of 22 September 1994.
259 The CA speaks of 'quoted companies' e.g. in s 385CA. In this thesis 'quoted' and 'listed' are used as identical terms.
260 It is soft law as the UKC has no statutory status. However the UK Listing Rules (LR) – based on s 73A(2) and 101 FSMA 2000 – require disclosure of the extent to which the listed companies have complied to the UKC and to give reasons for areas of non–compliance. S 46A of the Fourth Directive on annual accounts formulates a similar requirement. See Davies, 2008: 405 and 492; also Hopt, K.J., and P.C. Leyens, 2004, Board models in Europe – recent developments of internal corporate governance structures in Germany, the United Kingdom, France and Italy, *European Company and Financial Law Review* 2004, 135–168.
261 LR 9.8.6(5) and (6). The sanctions for non–compliance are extensive (Davies, 2008: 405).
262 s 942 CA. The Panel and Code have a statutory basis in Part 28 CA (s 942–991) (Davies, 2010: 141).
263 s 19, 20 CA. See also BERR, Companies Act 2006, Private company information, November 2007: 6 no. 13.
264 s 227–229 CA.
265 See s 431, 432 and Davies, 2008: 395. Moreover, the LR 9.4.1 requires approval of the employees' share scheme or long–term incentive scheme by an ordinary resolution of the shareholders of the listed company at a general meeting before it is adopted. The Large and Medium–Sized Companies and Groups (Accounts and Reports) Regulations 2008/410 only require disclosure of aggregated remuneration figures, for all companies unless small (see s 412 CA and Davies, 2008: 383, 388).
266 s 498(4) CA.
267 s 304(2) CA.
268 s 338(3) CA.
269 s 284(4) CA. See Davies, 2008: 412.
270 s 260–269 CA.
271 s 261(1) CA.
272 s 994–996 CA.
273 s 2:452 CA.
274 s 384(1.a) CA. Also 384(2.a) CA.
275 s 974 CA gives the definition.
276 s 979–982 CA.
277 s 983–985 CA.
278 s 111(2) IA. Davies, 2008: 1060.
279 s 996(2.e) CA.
280 s 336 CA, to be held roughly within the first year half. This meeting, before which the company's annual accounts and reports are to be laid, is also known as 'the accounts meeting' (s 437)3; 439(6)).
281 s 319A through The Companies (Shareholders' Rights) Regulation 2009. In the related consultation report it is said by some that a similar obligation exists in common law and by

others that by now it is made clear under which circumstances the board may refuse an answer. The consultation paper and the Regulations are available at http://www.berr.gov.uk/files/file48662.pdf.
282 s 282, 283 CA.
283 One will do for a one–man company: s 318(1) CA.
284 s 168 CA. The Model Articles for Public Companies provide in s 20 for appointment of directors by directors and by the GM.
285 See also: Davies, 2008: 375.
286 s 21–22 CA.
287 s 22(4) CA.
288 Davies, 2008: 1059.
289 Davies, 2008, p 1061. See s 895–901 and for the similarity with mergers s 900(1) CA.
290 s 598 CA.
291 LR 10.1.4.
292 A "Class 1" transaction: a transaction exceeding in assets, profit, consideration or capital 25% of that of the acquiring listed company (LR 10.2.2).
293 LR 10.5.1.
294 Davies, 2008: 376 and 986; Rule 21.1(a) and 37.3 of the Takeover Code.
295 s 414(1); 419(1); 422(1) CA.
296 s 423 CA; s 437(1) CA.
297 Seen as a consequence of s 437–438 CA. See Davies, 2008: 756.
298 s 475 (1.a) jo 477, 478(a) CA. Moreover, there are no exemptions for Plcs on reporting or filing requirements: 384(1.a: small) and 467(1.a: medium–sized) CA. However, see for 'dormant companies: s 480 CA.
299 Davies, 2008: 396.
300 Davies, 2008: 366.
301 s 3 of both the Model Articles.
302 Davies, 2008: 370, citing case law on the matter.
303 s 4(1) of both the Model Articles. See Davies, 2008: 371.
304 Davies, 2008: 371, 390.
305 Pettet, 2001: 204.
306 The competence of the EWC is limited to matters concerning the Community–scale undertaking.
307 s 1(1) Council Directive 94/45/EC of 22 September 1994.
308 see footnote 256.
309 s 7(1) ICER (2004).
310 'undertaking' means a public or private undertaking carrying out an economic activity, whether or not operating for gain (s 2 ICER (2004).
311 s 2(1.f) Council Directive 94/95/EC of 22 September 1994.
312 s 21 ICER (2004).
313 s 20(3) ICER 2004.
314 UKC A.1 Main principle.
315 Also called the *unitary* board principle: UKC A.4 Main principle.
316 UKC A.1 Supporting principles.
317 UKC B.1. Supporting principles.
318 UKC A.2.
319 UKC A.4 Main and Supporting principle.
320 Institute of Directors, *The revised combined code, Fact sheet*. Found on www.iod.com/policy.
321 s 40 CA.
322 s 3 Model articles for public companies.
323 See also this thesis, section 4.6.3.3.
324 s 17 CA.
325 s 173 CA.

326 s 175 CA. See Davies, 2002: 183, 186. For a full explanation of the topic: Davies, 2008: 559–574.
327 s 175(4.b;5;6) CA.
328 s 179 CA.
329 s 170 (4), 178; contrary 180 CA.
330 See Davies, 2008: 480–482: ‘Such ad duty will certainly arise where, on the facts, the directors place themselves, as against shareholders individually, in one of the established legal relationships to which fiduciary duties are attached, such as agency.’
331 s 13(2) CA.
332 Directive 2006/43/EC (OJL157/87,9.6.2006), ‘Audit Directive’.
333 Davies, 2008: 60; 789.
334 458 CA.
335 s 1060–1120 CA. On the notice: s 1113(3) CA.
336 Davies, 2008: 749:”and just over a million pounds was raised in late filing penalties in 2005–2006.”
337 s 448 CA. See Davies, 2008: 749: “This is a good example of the link between limited liability and public financial disclosure.”
338 See on the LR s 73A FSMA and Davies, 2008: 59; and on this Code: s 119 FSMA and p. 1113.
339 See Davies, 2008, e.g. p 59; Chapter 30.
340 The Panel has been designated as the supervisory authority to carry out certain regulatory functions in relation to takeovers under the EC Directive on Takeover Bids (2004/25/EC). Its statutory functions are set out in and under Chapter 1 of Part 28 of the Companies Act 2006 (www.thetakeoverpanel.org.uk).
341 s 2:456–462 CA. Davies, 2008: 746. The FRC seeks to ensure that the annual accounts of public companies and large private companies comply with the requirements of the Companies Act 2006 and applicable accounting standards. The FRRC reviews accounts for compliance with the law and accounting standards. Anyone can make a complaint to the FRRC; membership is not necessary (www.frc.org.uk).
342 e.g. s 98 (application to cancel resolution on re-registration of a public limited as a private limited); s 125 (application for rectification of the register of members); s 260 (derivative claim); s 306 (to order a meeting); s 317 (application not to circulate members’ statement); s 452 (duty to file accounts and reports is not complied with); s 456 CA (application in respect of defective accounts or reports)
343 s 1156 CA.
344 This goes in three levels (Schmidt, M., 2005, “Whistle Blowing” regulation and accounting standards enforcement in Germany and Europe – an economic perspective, *International Review of Law and Economics* 25, 143–168. from the employer, a legal adviser, or the Minister of the Crown, even to third parties (i.a. the media) if the employee has informed his employer once before (s 43G PIDA) provided e.g. he acts in good faith, he reasonably believes that the information disclosed, and any allegation contained in it, are substantially true; and, in all the circumstances of the case, it is reasonable for him to make the disclosure.
345 *Governance*, February 2007 issue no 160 p. 3 reports that at that moment nine FTSE companies did not have a NED.
346 The free space for directors in UK law becomes evident from s 3 Model Articles: “Subject to the articles, the directors are responsible for the management of the company’s business, for which purpose they may exercise all the powers of the company.”
347 s 171 AktG.
348 Davies, 2008: 82.
349 s 2:177 BW.
350 This will change shortly. See Annex 2 under 4.
351 s 2:175 BW.
352 A proposal to enable a one-tier system for the BV is pending in Parliament (31763). See Annex 2 sub 3.

353 See for the criteria: s 2:263, 264 BW. Exemption or mitigation is provided for in s 2: 263, 265, 265a BW or can be requested from the Minister of Justice (s 2:266 BW). Voluntary adoption is arranged in s 2:267 BW. See also footnote 25.
354 s 2:335–343 BW. Since it has to be brought before the district court, with the possibility of appeal, it may take long before a final verdict has been reached. See Annex 2 sub 1 for pending changes on the issue.
355 s 2:206, 207 BW.
356 However, Pres. Rb. Leeuwarden, 17–09–2008, LJN BF1056, pronounced an opposite judgment based on the Parliamentary history.
357 s 2:245 BW.
358 s 2:220(1) and 228(5) new. The requirement to hold an annual AGM may be lifted, if all potential participants have agreed, s 2:238(1) new.
359 s 2:242(1) and 252(1) new.
360 s 2:238(3) new; s2:204c will be dropped.
361 s 2:256 will be dropped and replaced by a no–decision rule for the conflicting director. See Annex 2 under 3.
362 e.g. s 25, 51a(3) GmbHG.
363 s 1, 2 GmbHG.
364 s 2(1) GmbHG; see also s 3.
365 s 4 GmbHG.
366 For obligations before the establishment of the GmbH, parties themselves are jointly and severally liable (s 11(2) GmbHG).
367 s 7, 11 GmbHG; art 8 HGB.
368 s 13 GmbHG.
369 s 9c GmbHG. According to Maitland–Walker (2008) the GmbH is less complicated to form than an AG.
370 s 5 GmbHG.
371 s 15(1) GmbHG.
372 s 8(1.3) jo 16(1), 40 GmbHG.
373 s 5(1), 7(2) GmbHG.
374 s 26, 27, 28 GmbHG.
375 s 5a GmbHG. A company based on 2a and 5a GmbHG should not contain GmbH (or in full) but *UG (Haftungsbeschränkt)* (or in full), s5a(1) GmbHG, due to the *Gesetz zur Modernisierung des GmbH–Rechts und zur Bekämpfung von Missbräuchen* (MoMiG) from 23 October 2008. See on this: Verbrugh, M.A., 2008, De herziening van het GmbH–recht in een concurrerende omgeving. Het wetsvoorstel MoMig, *Ondernemingsrecht* 10/11, 401–406.
376 s 2(1a) and 5(2) GmbHG. Formally, the minimum capital should be paid in full (s 5a (2)), but this may be as much as €1 (s 5a(1).
377 s 5a(3, 5) GmbHG.
378 s 5a(4) GmbHG provides that if the company increases its issued capital (*Stammkapital*) then the special provision of s 5a i.e. to use *UG (haftungsbeschränkt)* in the name instead of GmbH does not apply. This conversion is not mandatory: Lutter and Hommelhof, 2009: 242.
379 s 2(1a) GmbHG requires only one director in the case of an *UG (haftungsbeschränkt).*
380 s 6, 35 GmbHG.
381 s 6(2) GmbHG. The section also lists the incompatibilities for an ED.
382 s 48 GmbHG.
383 s 52 GmbHG.
384 s 51a GmbHG.
385 s 51b GmbHG.
386 s 50(1) GmbHG.
387 s 50(2) GmbHG.
388 s 47(2) GmbHG.
389 s 47(1) GmbHG. Exceptions to this rule may be made in the law (e.g. s 53(2)) and the articles.
390 s 48 (2) GmbHG.

391 s 47(4) GmbHG. Schmidt, 2002, takes the view that shareholders are prohibited from voting in any case where a conflict of interests arises. Lutter and Hommelhof, 2009: 1010 are more precise and describe a number of cases where the director should not vote.
392 s 325 HGB.
393 s 34 GmbHG.
394 Schmidt, 2002: 1058.
395 s 46; also s 45(2) GmbHG.
396 s 38(1) GmbHG and whoever the appointer is: this may be the GM (s 46(5)) or another organ, s 45(2) GmbHG. However, see 38(2) for restrictions. Claims may result from a service contract that may, and may not, have been closed with the director.
397 s 45(1), 48 GmbHG.
398 Schmidt, 2002: 1069.
399 s 1(1.3) DrittelbG.
400 s 25(1.2) MittbestG.
401 s 52(1) GmbHG.
402 s 52(1) GmbHG and s 111(1) jo. 111(4) AktG. See: Andenas and Wooldridge, 2009: 303.
403 Andenas and Wooldridge, 2009: 305.
404 s 1(1.3) DrittelbG and s 1(1) and 6(1) MitbestG.
405 s 25 MitbestG; see also 30–33 MitbestG.
406 s 1(1) DrittelbG.
407 s 35(1) and 35(2) GmbHG. See for limitations on the power of representation: s 37 GmbHG. Andenas and Wooldridge, 2008: 301.
408 s 43(1) GmbHG: '*die Sorgfalt eines ordentlichen Geschäftsmannes*.' The quoted translation is from Andenas and Wooldridge, 2008: 301. Other translations are possible, e.g. 'the diligence of an orderly businessman.' For payments in a situation of near financial distress the director may be personally liable: s 64 GmbHG.
409 Lutter and Hommelhof, 2009: 1010; Schmidt, 2002: 1079 with hesitation.
410 s 242 BGB.
411 Lutter and Hommelhof, 2009, comprise a duty to avoid conflict of interest and to refrain from using corporate opportunities under this *Treuepflicht*: 1263.
412 s 181 BGB. This also applies to sole owners: s 35(4) GmbHG.
413 s 5(1) GmbHG.
414 s 43a; s 30(1) GmbHG.
415 s 43(2) GmbHG. A claim expires after five years (4). For NEDs: s 52(3) GmbHG. See Andenas and Wooldridge, 2008: 301. For the duty of indemnification of incorporators: s 9a–9c GmbHG.
416 s 47(4) GmbHG.
417 s 4(1) CA. It may not issue shares to the public s 755 CA.
418 Davies (2008: 9 fn. 34) quotes a number of guarantee companies of 40,000 in 1998.
419 s 3 CA. See Davies, 2008: 8, 9, 18 fn. 79, 82.
420 s 59(1) CA.
421 s 60(1.a) CA. See about other exemptions: s 60–63 CA.
422 For the differences between a Plc and a Ltd: Maitland–Walker, 2008, p954–955.
423 e.g. s 439, 440; Part 13 Chapter 5 CA.
424 e.g. s 437, 438; Part 13 Chapter 4 CA.
425 e.g. s 270, 485 CA.
426 Part 20 Chapter 2 CA.
427 s 270(1) CA.
428 s 336 CA a contrario. See Davies, 2008: 415 fn. 15.
429 s 154, 155 CA. The requirement of a natural person is met if the office of director is held by a natural person as a corporation sole or otherwise by virtue of an office. If there are more directors, at least one should be a natural person.
430 s 301 CA. See also: Chapter 2 Part 13 on 'written resolutions'. Davies, 2008: 415.
431 s 20(1.b) CA. There are Model Articles for Private Companies Limited by Shares and for Private Companies Limited by Guarantee.

432 Davies, 2008: 416.
433 s 281(1.a), Chapter 2 Part 13. Every company must keep records comprising those resolutions. The same applies to a sole member Ltd (s 355, 357 CA).
434 s 291, 292 CA. 5% of the members is sufficient. They may require a statement of not more than 1,000 words on the matter to circulate in addition (s 292(3–5) CA).
435 Thus not of members voted. See: s 288(4,5), 289, 296(4) CA. Davies, 2008: 417.
436 s 288(2) CA.
437 Previously 10% and 5% only under specific circumstances: Davies, 2008: 442.
438 See s 475, 485. 'Small' refers to disclosure criteria given in s 382, 383, 465 CA. These criteria are:

company	small (382.3)	medium (466.4)	large
total assets	≤ £3,260,000	in between	> £12,900,000
turnover	≤ £6,500,000	in between	> £25,900,000
employees (average)	≤ 50	≤ 250	> 250

A company is small if two out of three of the criteria apply on two succeeding balance sheet dates (s 382 CA). For a parent company, the CA introduces 'gross' figures (before set–offs and inter–company eliminations) which are not reported here (see s 383(4,6) CA). The accounts to be filed depend on being small or medium–sized: s 441 CA. See also: Davies, 2008: 749.
439 s 476 CA.
440 s 18(1.b) jo 20 ICER 2004.
441 s 2:396(6) BW and 'Besluit van 28 augustus 2008' (Besluit fiscale waarderingsgrondslagen).
442 Until 1989 it was a sub–form of the association (*coöperatieve vereniging*). S 2:53a BW determines that Titel 2 Boek 2 BW on associations is fully applicable to co–operatives, except for the ban on profit–distribution (s 2:26(3) BW) and the prohibitive rule in the association on certain contracts (s 2:44(2) BW).
443 Or causes to be conducted to that end, s 2:53(2) BW.
444 s 2:53 jo 26 BW.
445 s 2:54(2) BW. Chapter 8 reveals this is quite often not the case. The label *coöperatief* is protected (s 2:63 BW).
446 s 2:54–56 BW.
447 s 2:39 BW.
448 See on the possibility of a *de facto* one–tier system in the ordinary regime, and on the impossibility for the 'structure coöperatie': Galle, R.C.J., 2007, De bestuurlijke inrichting van de moderne coöperatie. Coöperaties van A t/m Z, in G.J.H. van der Sangen, R.C.J. Galle, and P.J. Dortmond, eds.: *De coöperatie, een eigentijdse rechtsvorm* (Boom Juridische uitgeverij, Den Haag). The present proposal to enable a one–tier system also *de iure*, pending in Parliament (31763), does not apply to coöperaties.
449 s 2:63b, 63c BW. See Staatsblad 2004, 370 and 405.
450 The main differences are: (1) equity capital is lower; (2) not the SB, but the GM appoints the EDs; (3) in the appointment procedure of NEDs (a) the GM, works council and EB may nominate candidates (s 2:63f(4)); (b) a *de facto* right of recommendation for the works council, which is the default rule in the structure NV and BV, does not exist.
451 s 2:63d BW.
452 s 2:63e BW.
453 See www.cooperatie.nl.
454 s 2:19(1.d) BW a contrario.
455 Others are: (1) the different required equity amounts for the 'structure' forms; (2) the nomination right of the EB in s 2:63f(4) BW; (3) the lack of a recommendation right for NEDs, albeit by default, for the works council (s 2:158(6) BW); (4) the lack of a provision on dismissal of the SB identical to the 'structure NV/BV' (s 2:161a/271a BW). One might argue that the character of a coöperatie requires that the right to appoint EDs in *any* case belongs to the GM.

456 Dijk/Van der Ploeg, 2007, pp. 173, 248. Their argument is that the relationships between GM, EB and SB in a company and a co-operative are similar.
457 s 2:37(3) jo 57a(1) BW.
458 s 2:63f(5–10) BW.
459 Again, the view of Klaassen, A.G.H., 2009, Geldt het goedkeuringsrecht van art. 2:107a BW ook voor de AVA van een BV?, *Ondernemingsrecht* 1, 45–48. that the GM *always* has a right of approval if the structure of the legal person of the company is at stake could prove useful. The conflicting interest provision of s 2:27 BW, to be discussed below, is relevant as well.
460 p. 314, 318, 356.
461 p. 263.
462 p. 376.
463 see footnote 58.
464 See s 2:43(3) BW and Dijk/Van der Ploeg, 2007: 356.
465 s 2:48(2) BW.
466 s 2:57(6) BW.
467 p. 185, 189.
468 Albeit balanced: if the SB and GM or works council have a different opinion on the suitability of a nominee, the OK decides (s 2:63f(8) BW).
469 Dijk/Van der Ploeg, 2007: 189.
470 s 2:9, 2:57(2), 2:50a jo. 2:53a BW.
471 s 2:47 BW is identical to 2:146 (second sentence), and s 2:57(4) to that of 2:146 (first sentence). See on the matter from the viewpoint of the coöperatie: Dijk/Van der Ploeg, 2007: 234–236.
472 See Annex 2 under 3.
473 s 2:19(1.d jo 2) BW.
474 The co-operative is an association with a special object. Therefore, s 20–79 BGB (*Bürgerliches Gesetzbuch*) on the association (*Verein*) may be relevant as well (Lang/Weidmüller (2006), s 1, comm. no. 9–10).
475 s 18 GenG. Lang/Weidmüller (2006) comm. s18 no. 4 lists where the articles may diverge from the law.
476 s 1 GenG. Lang/Weidmüller (2006) s 1, comm. nos. 26–40; for a catalogue of types of co-operatives, nos. 42–59.
477 Lang/Weidmüller (2006) etc. s 1, comm. no. 89; see also s 5 comm. no. 7 and s 13 comm. no. 4.
478 A registered co-operative may be ordinary or *mitbestimmt*, i.e. governed by the *Mitbestimmungsgesetz* (see below), in which case the EB is chosen by the SB instead of by the GM.
479 See: s 10–11a; 156–161 GenG. Lang/Weidmüller (2006) comm. s 10 no. 1.
480 s 11a GenG.
481 s 13 GenG.
482 s 17 GenG.
483 s 3 GenG.
484 s 4 GenG.
485 s 80 GenG.
486 See on the mandatory content of the articles s 5–9; 18 GenG. Lang/Weidmüller (2006) lists on p. 239 the permitted deviations from the GenG.
487 s 2; 6 (3); 22a GenG.
488 Provided for in s 19 GenG, although the articles may determine otherwise (s 20–21a GenG).
489 s 9(2) jo. 24(2) GenG. The membership requirement does not apply to an *Arbeitsdirektor*, s 33(3) MitbestG.
490 Lang/Weidmüller (2006), s 9 GenG, comm. no. 14.
491 s 24(2) GenG. This does not change when co-determination applies. In practice, the SB usually appoints the *hauptamtliche* EBs, whilst the GM appoints the *nicht hauptamtlichen* (see 4.6.2.3), Lang/Weidmüller (2006), comm. s 24 no. 38.
492 s 9, 36, also: 37 GenG. If the DrittelbG applies, then the articles should fix the number at a multiple of three, s 1 (1.5) DrittelbG. In that case some GenG provisions do not apply,

according to s 1(3) DrittelbG, e.g. the membership requirement of s 9(2) GenG for employee representatives.
493 s 9(1) and s 24(2) GenG.
494 s 9(1) GenG. Lang/Weidmüller (2006) comm. s 9 no. 8.
495 s 9, 43 GenG.
496 s 43a GenG.
497 s 1(1.5) and 1(3) DrittelbG; s 1(1.1) jo. 6(1,2,3) jo. 25(1.3) MitbestG.
498 Lang/Weidmüller (2006) comm. s 18 no. 5.
499 Lang/Weidmüller (2006) comm. s 18 no. 4 p. 239.
500 Lang/Weidmüller (2006) comm. s 18 no. 37. More on the *Treuepflicht*: pp. 250–256.
501 Lang/Weidmüller (2006) comm. s 18 no. 49, pp. 256–257. See for the obligations concerned: no. 50. Generally a majority of 90% is required: s 16(3) GenG.
502 Lang/Weidmüller (2006) comm. s 43 no. 31–42.
503 Lang/Weidmüller (2006) comm. s 43 no. 32.
504 Lang/Weidmüller (2006) comm. s 43 no. 38, explaining e.g. that the regulation of s 131 AktG cannot simply be applied due to the different relationship a member has with an eG.
505 s 43(2) and (3) GenG.
506 Lang/Weidmüller (2006) comm. s 51 no. 27 lists a number of circumstances that may lead to a nullity.
507 s 27(1) GenG; Lang/Weidmüller (2006), s 43 comm. no. 3.
508 s 48(1) GenG.
509 s 48(3) GenG.
510 Lang/Weidmüller (2006) comm. s 48 no. 4.
511 s 24 GenG for EDs; s 36 GenG for NEDs. And unless the co–determination rules apply.
512 Lang/Weidmüller (2006), s 24, comm. no. 47, 49.
513 s 36(3) GenG; Lang/Weidmüller (2006), s 36, comm. no. 42.
514 s 24 (3); 36 (3) GenG.
515 Lang/Weidmüller (2006) s 24 comm. 50 p. 305 (referring to 87 AktG); s 36 comm. 34 p. 435.
516 Lang/Weidmüller (2006), s 43 comm. 9.
517 s 16 GenG.
518 s 15 GenG.
519 s 27(1) GenG. See Lang/Weidmüller (2006), comm. s 15 no. 11.
520 Lang/Weidmüller (2006), comm. s 43 no. 10; s 27 no. 19, 20.
521 s 57(5) GenG.
522 s 38(1) second, third, fourth sentence GenG.
523 s 57(2 and 3) GenG.
524 s 38(3) GenG; Lang/Weidmüller (2006), comm. s 38 no. 30.
525 s 38(1) first sentence GenG.
526 Lang/Weidmüller (2006) s 36, comm. no. 5, p 424.
527 Lang/Weidmüller (2006) s 38 comm. no. 1, 3–27. A list of SB obligations is presented by Lang/Weidmüller (2006), comm. s 38 no. 29a.
528 Lang/Weidmüller (2006), s 38, comm. no. 1: 464; s 41, comm. no. 15.
529 s 57(4) GenG.
530 s 58(4) GenG.
531 s 38(1) last sentence GenG.
532 s 1(5) DrittelbG. It would not be logical if this would not apply in a MittbestG situation.
533 s 36(2) GenG.
534 s 24, 27 GenG.
535 Lang/Weidmüller (2006), comm. s 27 no. 2.
536 Lang/Weidmüller (2006), comm. s 27 no. 26, 30.
537 s 33 MitbestG.
538 s 24(3) GenG. Lang/Weidmüller (2006), comm. s 24 no. 28–32.
539 Lang/Weidmüller (2006), comm. s 24 no. 31.
540 Lang/Weidmüller (2006), comm s 27 no. 26, 33; s 34 no. 39–40; s 48 no. 4.

541 s 34(1) GenG.
542 s 34(1) GenG: "*die Sorgfalt eines ordentlichten und gewissenhaften Geschäftsleiters einer Genossenschaft.*"
543 Lang/Weidmüller (2006), comm. s 34 no. 23.
544 Lang/Weidmüller (2006), comm. s 34 no. 19, 47.
545 s 34(1) last sentence GenG. See Lang/Weidmüller (2006), comm. no. 96–106.
546 Lang/Weidmüller (2006), comm. s 24 no. 65.
547 s 34(2) GenG.
548 s 34(4) GenG, this is not the case if their decisions rest (only) on SB approval.
549 s 34(5) GenG.
550 s 53–64c GenG and s 336–339 HGB.
551 s 11(2.3) and 54(1) GenG. Also: s 54a, 64b GenG.
552 s 63–63g, 64a GenG.
553 s 63g GenG.
554 s 64 GenG.
555 s 53 GenG: if Total Assets are below €2 Mio, the examination should take place every two years; annual accounts, annual report and financial administration only for *eG*s with TA over €1 Mio and turnover over €2 Mio.
556 See Chapter 5 of: *Starting a co-operative*, Cabinet Office of the 3rd sector and Co-operatives UK, downloaded January 2010.
557 s 1(2.a. and 2.b.) IPSA.
558 s 1(2.b) IPSA and FSA, *Mutual Societies Application Form*, April 2008: 9 (available from: www.fsa.gov.uk).
559 s 2(1) IPSA; s 16 IPSA for cancellation of registration if the number has been reduced below 3 respectively 2; and s 19(2) IPSA for the secretary's involvement.
560 s 1(1) jo. 74 (1) IPSA. Registered societies to be found in the FSA Mutuals Public Register. The registration function is separate from the FSA's role as regulator of the financial services industry in the UK, as provided for by the Financial Services and Markets Act 2000 (FSMA) and the statutory instruments made under FSMA.
561 s 2(1.b) IPSA. See also s 9–15 and Schedule 1 ('matters to be provided for in the society's rules) of the law.
562 See: FSA, *Mutual Societies Application Form*, April 2008, available from: www.fsa.gov.uk.
563 See also s 1(3) IPSA: A co-operative society does not include a society with the object of making profits mainly for the payment of interest, dividends or bonuses on invested, deposited or lent money.
564 FSA, *Mutual Societies Application Form*, April 2008, pp. 8–9 (available from: www.fsa.gov.uk).
565 s 3 IPSA.
566 s 6 (1) IPSA. See the other subsections for lower maximum amounts. The Co-operative Group has shares of £1 each.
567 s 5(2) and 5(5) IPSA.
568 s 74 IPSA 1965.
569 Secretary s 2.1.b; GM 5.3.a and 50.2, 74; .an officer 41,44 62 74; manager 43; receiver 43 IPSA 1965. Remarkably, the system provides in Schedule 1 under 6 for a two-tier system with a committee and managers.
570 See Mutual Societies Application Form available from the FSA website www fsa.gov.uk.
571 s 4-6 FIPSA 1968.
572 Over 2008 The Co-operative Group had a turnover of £10,435.2m and a Profit before payments to and on behalf of members of £217.6m. At 10 January 2009 it employed 82,359 persons (Annual Report and Accounts: 35 and 45). As at 6 January 2010 the Group employs 123,000 people, has 3 million members and around 4,900 retail outlets according to its website.
573 This distinction will be relevant to a court assessment of the level of care and skill expected in the event of a negligence claim (Mills and Snaith, 1997).
574 The Co-operative Group, Annual Report and Accounts: 27.

575 s 214(4) IA 1986 describes this test as a reasonably diligent person having (..) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by the director in relation to the company.
576 Davies adds to this quote: "(which, for the time being, we are equating with the best interests of the shareholders). "
577 s 41 IPSA and Schedule 4.
578 s 43 IPSA.
579 s 64; see also 61–68 IPSA.
580 s 39 IPSA. To be sent before 31st March.
581 See s 19 FSMA. Mutual societies such as building societies and credit unions come under FSA's regulatory jurisdiction as defined in the FSMA because they are authorized to conduct financial services business.
582 s 44(4) IPSA.
583 s 47(2) IPSA.
584 s 48 IPSA.
585 s 49(1) IPSA. If the society has over 1,000 members, 100 members is sufficient.
586 s 4(6 and 7), 4A(5.b) and 9C FIPSA 1968.
587 Electronic information available is basic. Annual returns and accounts are not electronically available. See for the procedure the FSA website, at 'Mutual Societies Public Records section' (seen 22 April 2010).
588 See section 4.2 of Mutuals AR 30, pp. 10–12 available from the FSA website www fsa.gov.uk. Some other categories such as (most) Housing Associations and societies which are or which have subsidiaries do have this obligation irrespective of the thresholds (s 4A(3) FIPSA 1968). See for the thresholds: s 4A FIPSA 1968 and s 2 of The Friendly and Industrial and Provident Societies Act 1968 (Audit Exemption) (Amendment) Order 2006, 2006 No, 265.
589 The accountant's report must state whether, in the opinion of the qualified auditor making the report (1) the revenue account and the balance sheet are in agreement with the books of account kept by the society, (2) the accounts comply with the IPSA 1965 and the FIPSA 1968, and (3) the financial criteria to refrain from a full audit have been met. See FSA, Mutual Societies Annual Return: 11.
590 s 3A(3 and 5), s 4A(2) and 9A FIPSA 1968. This vote must be held annually in each accounting period a society wishes to disapply.
591 s 4(5.b) FIPSA 1968.
592 See HMRC CTM40505 which also specifies the differences with companies.
593 s 2 CCBSA.
594 s 3 CCBSA.
595 s 11(2.3) and 54(1) GenG.
596 Dijk/Van der Ploeg, 2007: 19.
597 s 2:26 BW.
598 s 2:27–30 BW. Van der Ploeg (2010) calls these informal associations. They cannot obtain registered goods; directors may be held personally liable for the debts of the association. This thesis focuses on associations with full competence.
599 An association with full legal competence has to be registered in the *Handelsregister*; if it has only restricted legal competence, which means that it cannot inherit or obtain registered goods (e.g. real estate), it is (only) allowed to (s 2:29, 30 BW; s 6 Hrgw).
600 This leaves the legal status in the open and it may make the 'person' difficult to retrieve.
601 s 2:48(2) BW.
602 Which may exist, see *a contrario* s 2:19(1.d) BW.
603 See s 2:360(3) BW. The net turnover of €4,4 million should be attained during two consecutive years, and not be interrupted during two consecutive years. The requirement to apply the accounting and disclosure rules of Titel 9 of Boek 2 BW is lifted if the association concerned is legally obliged to follow similar rules (Hendrikse, 2010).
604 s 2:447–455 and 345 BW respectively. For an inquiry in case of a vereniging or a stichting also at least 50 employees are required (s 2:344(b) BW).

605 s 2:49(4) jo 48(1) BW. See also s 2:50 BW, which assigns the right to inspection copies only to members of a '360(3)' association.
606 s 2:48(2) BW.
607 Proof of some attention for larger associations is provided by the delegated membership regulation in s 2:39 BW as well as the mention of NEDs in s 2:48 BW.
608 Dijk/Van der Ploeg, 2007: 247 on s 2:47, 48 and 57 BW. Also Van der Ploeg 2010: 245.
609 Directors' behaviour guiding norms s 2:131, 138, 139, 149 and 150 BW do not apply to a Corporation Tax (VpB) exempt vereniging (s 2:50a BW).
610 *Handelsregister* as of March 2007.
611 s 4:78 Awb.
612 s 2(1.e) jo s 4 VpB.
613 s 2:344(b) BW.
614 2:346(a) BW.
615 s 2:345(2) BW.
616 s 2:19(1.d jo 2) BW.
617 s 25; 40 BGB. Galle, 1998: 173. Otherwise: Von Hippel, 2010: 201.
618 Ein auf Dauer angelegter, korperschaftlich organisierter Zusammenschluss von Personen zu einem gemeinsamen Zweck (Beuthien and Gummert, 2009: 27; Schmidt, 2002: 668).
619 s 56 BGB requires seven members for *Eintragung*; and s73 BGB provides for withdrawal of legal personality if the number of members is under three. Stöber, 2004: 9.
620 There is also an association concept in public law This is broader, but as this law (*Vereinsgesetz*) is directed at the abuse of the freedom of association, as laid down in s 9 Grundgesetz, this is not relevant to our topic.
621 s 21, 22 BGB.
622 s 54 BGB. See Schmidt, 2002, p 667. Since this thesis studies only legal persons, the *nicht-rechtsfähige Verein* is not the object of study.
623 There are approx. 600 *Vereinsregister* in Germany which in 2010 registered around 600,000 e.V.s (Von Hippel, 2010: 200).
624 s 21 jo 65 BGB.
625 s 65 BGB.
626 Schmidt, 2002: 667. See on the *wirtschaftlichen Verein*: Schmidt, 2002: 667–675. On the Verein with subsidiaries: Schmidt, 2002: 671. Often the articles contain a provision such as: 'Der Zweck des Vereins is nicht auf einer wirtschaftlichen Geschäftsbetrieb gerichtet', which is a copy of the text of the law (s 21 BGB). Schmidt, 2002: 677 deems this inadequate.
627 s 22 BGB.
628 e.g. on disclosure requirements: Beuthien and Gummert, 2009: 34, 35.
629 Schmidt, K., 2002, *Gesellschaftsrecht* (Carl Heymannns Verlag, Köln)., Beuthien, V., and H. Gummert, 2009, *Münchener Handbuch der Gesellschaftsrechts, Band 5, Verein, Stiftung bürgerlichen Rechts* (Verlag C.H. Beck, München).
630 s 56, 59(3) jo 73 BGB.
631 s 43 BGB: (1) in the case of behaviour contrary to the law; (2) if a *nichtwirtschaflicher Verein* pursues economic objects; or (3) if a *wirtschaflicher Verein* pursues other objects than stated in the articles.
632 s 43 BGB.
633 s 26, 32 BGB.
634 Beuthien and Gummert (2009) p 477.
635 s 25 BGB.
636 s 37 BGB. Also: 36 BGB.
637 s 32(2) BGB.
638 s 35 BGB.
639 s 705 BGB: to co-operate in the common goal.
640 s 242 BGB: to perform in good faith.
641 Galle, R.C.J., 1998, De vereniging in het Duitse recht, *Stichting & Vereniging* 169–173.
642 s 30 BGB.

643 s 34 BGB.
644 Schmidt, 2002: 696.
645 s27(3) jo. 666 BGB.
646 s 131 AktG.
647 s 14(2) jo. 713 jo. 666 BGB. Schmidt, 2002: 629 and 1749.
648 s 27(1) BGB.
649 s 27(2) BGB.
650 s 32(1) BGB.
651 s 33 BGB.
652 s 40 BGB.
653 s 41 BGB.
654 s 32(1) BGB which by default goes for the EB (s 28(1) BGB). Note that 'majority' is interpreted as the majority of the 'yes' and 'no' votes. Abstentions do not count (Schmidt, 2002: 695).
655 See Schmidt, 2002: 693 and s 665 BGB.
656 e.g. s 42(2) BGB.
657 s 28(1) jo. 32(1) BGB.
658 Schmidt, 2002: 688.
659 Fremdorganschaft, Schmidt, 2002: 688.
660 s 26(2) BGB and s 70 BGB.
661 Also 4.4.2.3. Von Hippel, 2010: 211–213 denies the existence of specific rules regarding the duty of loyalty for nonprofit companies in Germany but mentions rules against self–dealing and of obedience.
662 s 708 BGB. Critically: Schmidt, 2002: 705, 1743.
663 s 31a, 276, 277 BGB. Lang/Weidmüller (2006), comm. s34 no. 13–15.
664 s 58 BGB.
665 s 31a BGB.
666 Stöber, 2004: 475–481; Von Hippel, 2010:201–202, 216.
667 s 140, 141 AO.
668 s 5 EstG.
669 Vogelbusch, 2008: 1. See 1,2 HGB for *Kaufmann* and 238 HGB for bookkeeping provisions.
670 Preferably as a limited by guarantee: see Davies, 2008: 8.
671 Davies, 2008: 10–11, 20.
672 s 33 (3 and 4) CA 2004.
673 s 6(1.a) CA. Note that a company limited by guarantee and having a share capital may *become* a CIC, but may not be formed as such (s 6(1.b) CA).
674 The CA mentions the CIC in the sections: 2(1.b); 6; 58(3); 59(4); 1087(1.j); 1154(2.c); Schedule 2, Part 2, s 59.
675 s 6 (2) CA. Also: 32(5) CA 2004. See for detailed regulation: Statutory Instrument 2005 No. 1788 The Community Interest Company Regulations 2005.
676 s 32(1) and s 35(2) CA 2004. An object stated in the memorandum should pass the same test (s 35(3) CA 2004). The Regulator decides: s 36(4) and (5) CA 2004. S 4 of Statutory Instrument 2005 No. 1788, The Community Interest Company Regulations 2005 rules 'an activity is to be treated as not being an activity which a reasonable person might consider is an activity carried on for the benefit of the community if, or to the extent that, a reasonable person might consider that that activity benefits only the members of a particular body or the employees of a particular employer.'
677 See www.cicregulator.gov.uk, "List of CICs registered". On 16 October 2009 3,172 CICs were registered.
678 s 26(3.a) CA 2004.
679 s 30(1) CA 2004. And in that case after the Regulator's consent: see part 6 of SI 2005 No. 1788 e.g. s 17(5.a). Also: de Jongh, Schild and Timmerman in Eijsbouts et al 2010: 228.
680 s 30 CA 2004. Part 6 of SI 2005 No. 1788 gives detailed regulations on the matter.
681 s 27–29 CA 2004.
682 s 36(4 and 5.b) CA 2004.

683 s 14–16 CA.
684 s 28(3) CA 2004.
685 s 29 CA 2004.
686 s 41–51 CA 2004.
687 s 42 CA 2004.
688 s 43 CA 2004.
689 Which cannot be dismissed by the company, s 45(7) CA 2004.
690 s 47 CA 2004.
691 s 49 CA 2004.
692 s 50 CA 2004.
693 s 48 CA 2004.
694 s 41 CA 2004. The director, manager, and property-related powers may only be used under circumstances defined in s 41(3), e.g. misconduct or mismanagement.
695 s 34(1) CA 2004. Also: part 7 of SI 2005 No. 1788. Available for members: s 29 SI 2005 No. 1788.
696 s 34(4) CA 2004.
697 s 34(2) Ca 2004.
698 see SI 2005 No. 1788.
699 s 2:286(1) BW, or in a will, s 2:286(2) BW.
700 s 2:285 BW.
701 s 2:301 BW.
702 s 2:286(4.a) BW.
703 s 2:300(2,3) BW. See on the voluntary SB also 4.7.1.2.
704 s 2:293–295 BW. Often, the EB is competent to amend the articles. The mandatory rule of s 2:293 BW that an amendment to the articles has to be passed by a notarial deed and is to be deposited at the *Handelsregister* is only a small safeguard against abuse.
705 Directors' behaviour guiding norms s 2:131, 138, 139, 149 and 150 BW do not apply to a Corporation Tax (VpB) exempt stichting (s 2:300a BW).
706 s 2:291(2) BW.
707 See on tax issues: Van der Ploeg, 2010: 234–235.
708 s 2:20, 295, 297 and 298 BW.
709 s 2:298(1.b and 3) BW.
710 s 2:296 jo 294, 295 BW.
711 s 2:20 BW.
712 This citation comes from de Meijer (2005) p. 384 and is taken by her from the report of the '*Enquêtecommissie opsporingsmethoden*'. Also: Van der Ploeg, 2010: 251.
713 s 2:295 BW.
714 s 2:301 BW.
715 s 2:294(1) BW.
716 s 2:344(b) BW.
717 s 2:346(c) BW. See on this: Hendrikse (2010: 62) who shows that such agreements are actually closed.
718 s 2:347 BW. The request is only admitted if the requirements of 2:347 and 349 BW are adhered to.
719 s 2345(2) BW.
720 See e.g. the letter of the Commissie Vennootschapsrecht of 17 September 2010, available on the internet (www.rijksoverheid.nl/...commissie-vennootschapsrecht...stichtingen/advies-inzake-publicatieplicht-stichtingen.pdf). Also G. van Solinge, Symboolwetgeving tegen foute stichtingen, *Ondernemingsrecht* 2010, 13, 519–520.
721 The website of the Bunderverband Deutscher Stiftungen.
722 *Die Stiftung ist eine juristische Person, die zur Verwirklichung bestimmter Sonderzwecke geschaffen ist und nicht aus einem Personenverband besteht.*
723 Beuthien and Gummert, 2009: 1124 no. 122.
724 s 80 BGB.

725 s 80, 81 BGB. A Stiftung may be established in a will as well: see s 81(1) last sentence, s82(2), s 83 and s 84 BGB. If its Stiftungsgeschäft is inadequate, it should be completed by '*die zuständige Behörde des Landes*' (the competent Authority).
726 s 82 BGB.
727 s 85 BGB.
728 See the text of s 80(2) BGB. Schmidt, 2002: 312 speaks of a '*sorgfältigen Uberprufung*'. Von Hippel (2010: 202) states that the registration is not discretionary. However, he considers it indeed a form of preventive supervision (216).
729 The approving authorities regularly require an amount of €100,000 (Von Hippel, 2010, 202).
730 Schmidt (2002: 1177) is firmly negative on the matter, while Beuthien and Gummert (2009,V: 1098) are affirmative. Von Hippel (2010: 203) mentions the existence of '*unselbständige Stiftungen*'.
731 Beuthien and Gummert (2009) 1086, 1114. A dependent foundation is in fact a legal relation–ship between the donor and the executor.
732 For over 90% of all foundations. Ultimo 2009 Germany counted 17,372 civil–law foundations (www.stfiftungen.org).
733 Schmidt, 2002: 174. A 'Stiftung' may take another legal form: e.g. the Robert Bosch Stiftung is a GmbH.
734 These distributions endanger the tax exemption if they exceed one–third of the distributions: 58(5) AO. Rawert, P., 2001, Die Stiftungsbegriff und seine Merkmal, in K.J. Hopt, and D. Re–uter, eds.: *Stiftungsrecht in Europa* (Carl Heymanns Verlag, Köln).:*'Zulässig soll eine Stiftung nur dann sein, wenn sie ihr Zweck nicht lediglich in reinen Unterhaltsleistungen erschöpft* (..)' (p. 119). According to Von Hippel (2010: 200) both the *Verein* and *Stiftung* are subject to the non–distribution constraint.
735 Otherwise: Schmidt, 2002: 175.
736 s 26, 86 BGB.
737 s 87 (1) BGB and State laws. Beuthien and Gummert (2009) V p. 1093: *etwaige Verletzung oder Gefahrdung des Stftungszwecks.*
738 s 3(1) UmwG.
739 s 124, 161–167 UmwG.
740 s 191(1) UmwG.
741 s 86 BGB.
742 s 86 does not mention s 40 BGB.
743 s 86 jo. 28(1) BGB.
744 s 86 jo. 26 BGB. See also 4.7.2.2 since the law refers in s 86 BGB to the sections on the Verein.
745 s 86 jo. 26(2) BGB. And although s 86 does not refer to s 70 or 68 BGB, according to Hof (2001) p. 310 the restriction may only be called upon if the opposing party knew about it: Hof, H., 2001, Stiftungen im deutschen Recht, in K.J. Hopt, and D. Reuter, eds.: *Stiftungen im Europa* (Carl Heymanns Verlag, Köln).
746 s 86 jo. 30 BGB.
747 s 242 BGB. See also 4.4.2.3.
748 s 86 jo. 27(3) jo. 666 BGB. The reference to s 664–670 BGB does not apply to public founda–tions.
749 s 31a BGB jo s 86 BGB (new).
750 Von Hippel, 2010: 218.
751 s 238 HGB; also s 140, 141 AO.
752 Pearce and Stevens, 2006: 479 report the existence of 189,531 registered charities by 2005.
753 s 1(1.a) Charities Act 2006.
754 s 2(1) Charities Act 2006.
755 s 2(1.b) and s 3 Charities Act 2006. See on this 'public benefit test' p. 529–538 of Pearce and Stevens, 2006, and p. 121–124 of Webb, C., and T. Akkouh, 2008, *Trusts law* (Palgrave MacMillan, Basingstoke).
756 s 2(2) Charities Act 2006.

757 s 2(4) Charities Act 2006. Further on this: Webb and Akkouh, 2008: 110–121 and Pearce and Stevens, 2006: 488–515.
758 As chapters 7, 8 and 10 Charities Act 2006 show.
759 See www.charity-commission.gov.uk/publications/cc22.
760 Davies, 2008: 8.
761 See: www.charity-commission.gov.uk/registration on Charitable Incorporated Organization (CIO). Dual registration means: to the Companies House (the registrar of the CA) and the Charity Commission.
762 If 'CIO' is not part of the name, either in full or in abbreviated form, then the fact that a CIO is a CIO should be stated in all outgoing documents. Schedule 7 Charities Act 2006, s 69C(3/5/1).
763 Chapter 8 Charities Act 2006 and Schedule 7 e.g. s 69A(25). It is a body corporate upon the registration of the CIO in the register of charities, 69F(2). Dual obligations do not exist.
764 Three sets of Regulations are necessary: the General Regulations; the Insolvency and Dissolution Regulations and the Charity Tribunal (Amendment Order).
765 Schedule 7 Charities Act 2006 s 69E(1). The CIO should be established exclusively for charitable purposes.
766 Schedule 7 Charities Act 2006 s 69F(2). There is no minimum income registration threshold for CIOs.
767 Schedule 7 Charities Act 2006, 69A(5). A trust cannot have members, an unincorporated association by its nature does. The consultation document on the CIO proposes two model constitutions. One is for the 'association' type of charity (has a membership as well as a trustee body) and the other is for the 'foundation' type (the only members are the trustees).
768 Schedule 7 Charities Act 2006 s 69B(2.b).
769 Schedule 7 Charities Act 2006 s 69A(6).
770 www.charity-commission.gov.uk/registration on Charitable Incorporated Organisation (CIO) under 'What are the advantages of being a CIO'?
771 The consultation of the Office of the Third Sector (OTS) and the Charity Commission on the detailed legal framework for CIOs is closed on 10 December 2008. See on the similarity: Davies, 2008: 20. According to the Charities Commission CIOs will have to comply with the other additional responsibilities outlined in the Charities Act 2006 and the CIO Regulations.
772 Also: s 54 Charities Act 1993. S 41 (duty to keep accounting records)
773 s 7 Charities Act 2006 sub 1B.
774 s 7 Charities Act 2006 sub 1C(2).
775 A charitable company with an annual income of more than £500,000 or of more than £250,000 if its assets exceed £3.26 million must have a professional audit. An accountant's report will do if the annual income is between £25,001 and £500,000 or £250,000 if the assets exceed £3.26 million. If the income is less than £25,000 and the assets are less than £3.26 million, no audit or accountant's report is required. Also: Dawes (2010: 860–869, 874).
776 s 23(3) Charities Act 1992. Dawes (2010: 874) mentions the thresholds.
777 The Charities Commission may even apply those rights to 'exempt' charities, which are supervised by a 'principal regulator' such as the Housing Corporation, at the request of the principal regulator.
778 s 8 Charities Act 1993.
779 s 9 Charities Act 1993.
780 s 10 Charities Act 1993.
781 See for this 'whistle-blowing arrangement' s 33 Charities Act 2006.
782 See www.hmrc.gov.uk and search for Annex I– Charitable Tax Exemption. Also: s 505(1) Income and Corporation Taxes Act 1988 (ICTA).
783 See www.hmrc.gov.uk and search for 'charities and tax: the basics' under 'types of tax return'.
784 s 8 Charities Act 2006.
785 Klaassen (2007): 149.

786 For example: for larger than 'small' legal persons. With 50 employees, it seems worthwhile to have the interest of all concerned (HR 13–07–2007, Bank of America/ABNAMRO and VEB, r.o. 4.5) considered not only by directly involved EDs, but by (a) more distanced NED(s) as well.
787 e.g. s 74(3) IA.
788 e.g. s 11, 33(2) CA.
789 s 40(2.b.iii) CA.
790 s 172(1) CA.
791 An unrestricted duty to pay up may be countered by the shareholder by returning the share instead (s 27 GmbHG).
792 s 74(3) IA.
793 s 74(1) IA.
794 This is not a panacea: Davies (2008: 493 and footnote 54) regards Smith v Van Gorkom (1985) 488 A. 2d 858 as an example of a 'risk with the BJR that the courts will come to regard cases where the procedural standards have not been met as presumptively negligent.'

Chapter

5

On the role of monitoring near financial distress – a multidisciplinary approach

It could never have made sense to shower praise upon a manager whose company succeeds yet when it fails to let him blame the government or workers or just 'bad luck'. (Argenti, 1976: 2)

5.1 INTRODUCTION

The previous chapters defined financial distress (chapter 2); presented the economic theory on monitoring in the framework of corporate governance (chapter 3); and showed the actual implementation of monitoring mechanisms in the law (chapter 4). This chapter concentrates on the role of monitoring near financial distress. Does financial distress require other monitoring mechanisms, a different type of monitors, or other rules? The approach of this chapter is multidisciplinary. Section 5.2 summarizes the results of chapter 2 and elaborates on these. Section 5.3 does the same for chapter 3 and focuses on the economic aspects of monitoring near financial distress. The legal aspects of monitoring near financial distress are discussed in 5.4. The feedback of these results to the model on the outcome of financial distress presented in chapter 2 figure 2.1, follows in 5.5. It presents a model on the role of monitoring near financial distress. From these economic and legal analyses as well as from the redrafted model in 5.5 section 5.6 presents research directions. It provides the connection with the empirical part of this thesis laid down in the chapters 6, 7 and 8. Section 5.7 concludes.

5.2 FINANCIAL DISTRESS

A firm is in financial distress if there is *a non-trivial probability that the legal person will not be able to pay its debt within the terms of payment*. This is the simplified Gordon (1971) definition presented in 2.2.4. The essence is that default is probable. Whether this is caused by a shortcoming inflow, or an underestimated outflow of cash, does not matter. Chapter 1 showed that mismanagement is a major cause of financial distress. It stressed that management's commitment, a comprehensive strategy and quick implementation are the three crucial factors for successful restructuring. Several restructuring approaches were presented in chapter 2. A work-out turned out to be the preferred solution since it is more efficient than a liquidation[1].

The Ooghe and Waeyaert (2004) inspired figure 2.1 in chapter 2 on the determining factors for the outcome of financial distress examined the capabilities a manager should have at his disposal to turn around the financially distressed company and to avoid bankruptcy: he should be highly motivated, highly qualified and skilled, and have the right personal characteristics. Moreover, during the turn-around process he should often 're-invent' himself as well as 'his' corporate policy. One wonders what economic and legal mechanisms exist to achieve that.

5.3 MONITORING NEAR FINANCIAL DISTRESS: AN ECONOMIC APPROACH

This section takes a closer look at the economic highlights on monitoring (5.3.1) and relates these subsequently to financial distress in 5.3.2 and corporate failure in 5.3.3. Section 5.3.4 concludes.

5.3.1 Economic highlights on monitoring

Chapter 3 aimed to explain the role of monitoring in the broader perspective of the total corporate governance concept. Some of the relevant issues were:

1. a company is a nexus of contracts. Directors and shareholders contract with each other through the company just like labour, banks, suppliers and customers do;
2. by definition, every contracting partner has a different utility function. E.g. directors and companies do not necessarily have the same goal. This is the *agency* problem that exists between parties that contractually rely on each other to realize an object;
3. the director, as the '*specialized manager*', represents the company. In order to guide the director to function solely in the interests of the company that appointed him, the company has to put properly structured contracting and monitoring mechanisms in place;
4. one cannot expect that a director, as a representative of the company, would optimally structure and monitor his own position in the interests of the company. Alchian and Demsetz (1972) therefore ask: Who will monitor the monitors? Their reply: the residual claimants! According to the theory only the parties that have interest in the residual will abstain from free-rider behaviour and will be effective monitors;
5. in structuring the contract, the company, represented by its residual claimants, acts wisely by aiming to align the director's interests with its own;
6. in monitoring directors, the company, represented by its residual claimants, has to ensure that monitors maintain their objectivity. Appointment or even selection of monitors by the CEO should therefore be avoided. Monitors' proximity to the executive management, i.e. in terms of independency, should be transparent. Objectivity is best guarded by 'real' outside monitors;
7. monitoring comes with a cost. It is efficient only as far as it reduces the whole of the agency costs;
8. the decision process in the company should separate management (responsible for initiation and implementation) and control (responsible for ratification and monitoring) of decisions if possible;
9. in order to shield against agency-infected, inadequate or corrupt monitors, external monitoring mechanisms organized by the markets and by the government are a necessary monitoring supplement.

The mode of implementation of these issues will depend i.a. on the size of the company, the requirements of the markets and the alertness of the government and legislator. At any rate the focus in the *internal* monitoring theory is on the residual claimant. The idea is that all contracts will be adhered to by the company (Davies, 2006: 305), and that the residual claimant, i.e the shareholder (Alchian and Demsetz, 1972) or as the case may be the member or the beneficial owner, receives what is left. Does this conclusion hold in situations of near financial distress? This is the subject of the next section.

5.3.2 Monitoring near financial distress: an economic analysis

Indeed, as long as there is cash and financial obligations are met, not many external parties will bother to monitor and most will free ride on the internal monitoring efforts. However, in situations of near financial distress this monitoring behaviour will change for all primary parties concerned: shareholders, creditors, employees and directors (Davies, 2006; Eidenmüller, 2006). In one thing they can unite: none of them wants the company to fail (Argenti, 1976: 174). In their reasons and their approach to solve financial distress they differ.

Shareholders
In situations of near financial distress equity has almost vanished, and so has the shareholders' value. As a result the focus of shareholders has shifted from guarding their wealth to 'gambling' on new corporate opportunities in an attempt to re-establish their equity position (Davies, 2006; Lennarts, 2006: 5; Eidenmüller, 2006: 243). These are often high-risk adventures. However, since equity has vanished, these corporate opportunities are *de facto* financed by creditors. In other words: shareholders' risk is externalized to the creditors.

Creditors and employees
This *externalization of risk* (Davies, 2010: 89) concept implies that in situations of near financial distress the true residual claimants are not the shareholders but the non-secured creditors, i.e. the employees and the trade creditors (Davies, 2006: 307, 337; Armour, Hertig and Kanda, 2009: 122) The secured creditors take the first bite of the estate, employees and trade creditors go for the residual. This economic approach explains why investors, banks, suppliers or customers regularly have their 'own' non-executive director (NED) appointed to the board; or why employee-nominated NEDs or works councils have a voice in the management of the company. Creditors and employees may be the actual residual claimants in the end since there is usually nothing left for the shareholders[2]. They suffer losses on their claims on accounts payable or wages; on commercial guarantees or on pension; on the value of their commercial portfolio; on job security and ultimately on their job economic security. Thus, in situations of near financial distress

creditors and employees will evaluate whether continuation or liquidation is the relatively advantageous solution.

Directors
From their jobs directors derive income, perks, wealth, status and reputation. Their aim is to maintain or improve this situation. In situations of near financial distress their wealth in terms of shareholder value vanishes whilst their risk of liability claims increases. As a result they may decide to leave the company (Gilson, 1989). However, this is not always feasible and there may still be enough for them to achieve within the company (Davies, 2006: 308). Generally directors will go for the turn–around of the company and try to avoid bankruptcy (Grossman and Hart, 1982: 131). Thus, directors should continue what they are paid for and presumably good at. For executives this is: to manage, reorganize and eventually turn around the company. As Adriaanse (2006) explains, they should start (1) to *stabilize* the current situation of the company and stop the cash–drain; then (2) *analyse* its problems and look into its perspectives for the longer term, culminating in a turn–around plan; (3) *re–position* the company in its markets according to the turn–around plan; and finally (4) *reinforce* the capabilities of the firm through e.g. restructuring its finance, management and corporate policy.

For non–executive directors this turn–around process implies extensive monitoring, supervising and providing of advice or other available resources e.g. access to networks. Monitoring in this phase is especially important, since (1) reorganization is a precarious process with a low fault tolerance; (2) directors and shareholders may have an incentive to take a gamble (Eidenmüller, 2006: 240) or go for a dirt profit; and (3) the additional resources of non–executive supervisors/monitors may be decisive factors in a turn–around process. Jungmann (2006: 473) reflects on the additional value of monitoring:

> *Of course, we can hardly say that outsider directors, non–executive directors, independent directors, etc. or competent, well paid, full–time working members of the supervisory board have a degree of foresight and wisdom that makes them, in any case, superior to the executive directors or members of the management board. Both groups can be wrong in their decisions; both might take too many risks and thus lead the company into a period of financial distress. Thus, neither integrating the monitors into the decision–making process nor strengthening the role of those involved in the decision–making process as monitors would automatically bring an end to business failures. However, an enhanced level of control would reduce the probability of mistakes that occur at the managerial level remaining undetected. Consequently, there is an increased chance that wrong or harmful decisions can be corrected and that injury to creditors, shareholders, employees and the general public can be reduced.*

Thus, whilst the EDs have to take the initiative and have to come up quickly with a plan and solutions, one important task of monitors is to reduce the chance of managerial mistakes during the process.

5.3.3 Monitoring near financial distress: a corporate failure analysis

Another angle to the subject of monitoring near financial distress is presented by the corporate failure analysis by Argenti (1976), Richardson, Nwankwo and Richardson (1994), Bollen, Mertens, Meuwissen, Raak and Schelleman (2005) and Ooghe and De Prijcker (2008). They essentially arrive at a similar result. They discern three (Argenti) or four (the other authors) types of failure processes, defined by Ooghe and De Prijcker (2008) as *type 1*: an unsuccessful start-up; *type 2*: an ambitious growth company; *type 3*: a dazzled growth company; and *type 4*: an apathetic established company. Without going into the details of their analyses, they all conclude in one way or another that management is at the origin of most problems. Argenti (1976: 179) presents a 'company survival kit'. On the specific issue of management composition he remarks:

> *When starting a business, avoid taking into partnership only people with the same knowledge as yourself – a top team composed of all talents helps to ensure that none of the complexities of the modern world outwits you. Indeed, any unbalanced top team in any company is a clear warning of trouble in store. In particular (..) take a strong finance man into the top team. Avoid putting people on the board who do nothing, say nothing, know nothing and do not even care. (..) Above all, make sure that when a company grows beyond a certain point (..) that one-man rule is gradually diluted. Or that an autocrat is supervised by someone who represents the interests of people not in the executive hierarchy but outside the company – shareholders or banks or customers or the community. Many supervisory devices are possible (..). An independent chairman is an excellent concept.*

Similarly, Richardson, Nwankwo and Richardson (1994: 10) aim to improve the managerial ability to spot inappropriate leadership as a prerequisite to deciding what to do about it. Moreover, Bollen et al. (2005: 48) conclude that an important reason for business failures is the lack of adequate checks and balances within a company's corporate governance system regarding e.g. shareholder rights, the position and role of supervisory boards (and non-executive directors in a one-tier system), management compensation, disclosure and transparency. And Keough (2008) describes serious management mistakes in his 'Ten commandments to business failure'. Thus, also from the failure analysis angle, monitoring of directors is key to diminish the risk of mistakes, to promote the orderly checks and balances in the company, and eventually to avoid financial distress.

5.3.4 Concluding remarks on economic aspects of monitoring near financial distress

Economic theory shows that company monitoring is important to protect the residual claimholders against expropriation by the management. Moreover, monitoring, either by shareholders in smaller sized companies or by NEDs on order of the shareholders in larger companies, could reduce the probability of undetected mistakes. From this point of view, monitoring is essentially a shareholder's interest. Since the residual claim of shareholders decreases in situations of near financial distress, they tend to lose their interest in the company or to gamble on its future. However, in situations of near financial distress unsecured creditors and employees come into play as residual claimants. Then monitoring essentially becomes a creditor's interest. It would be unwise to replace shareholder–monitors by creditor and employee appointed monitors in situations of near financial distress, since in order to be a good monitor one needs to be acquainted with the company and its management for some time. Consequently it would be wise to apply both groups of residual claim holders as monitors long before financial distress and to merge their different interests in 'the interests (or the success) of the company' as the law actually does.

5.4 MONITORING NEAR FINANCIAL DISTRESS: A LEGAL APPROACH

This section begins with the findings of chapter 4. In 5.4.2 it takes a closer look at the legal provisions aimed at influencing directors' behaviour in situations of near financial distress. The effects of the law on shareholders' behaviour in such situations form the subject of 5.4.3. Section 5.4.4 focuses on legal provisions relating to the monitoring of directors in situations of near financial distress. Section 5.4.5 concludes.

5.4.1 Legal highlights on monitoring

Chapter 4 studied how the law implemented mandatory monitoring mechanisms in the company. It showed that:

1. company law confers in specific cases legal personality to what is essentially a contract or a legal act (one recognizes the economic concept of a nexus of contracts);
2. the legal organization of a legal person differs according to the legal system and the specific needs of the type of legal person concerned. In most situations, management is exclusively conferred to executive directors who have the highest authority (albeit not necessarily the *ultimate* authority) in the legal person. As a result,
3. the rights of shareholders or members are often curtailed by the law and by the articles;
4. internal monitoring through non–executive directors is seldom mandatory; and

5. an 'organic' employee consultation system lacks in some legal systems;
6. in the absence of close supervision, the corporate legal system relies on imposing restrictions on executive directors' behaviour through the formulation of directors' duties;
7. inadequate monitoring, either by equals in the collegial board, or by other organs, may in specific circumstances lead to personal liability of EDs or NEDs;
8. the *ex ante* external mandatory regime often suffers from a lack of material checks (most checks are purely formal); the *ex post* external mandatory regime suffers from a time lag between the omission or mistake and the action by the external monitor, if any. Court interference remains important throughout all legal systems.

Probably as a consequence of the importance attached to the company characteristic of centralized and specialized management (Davies, 2010: 12), chapter 4 showed that executive directors are relatively free in performing their tasks and that mandatory monitoring is often rather poorly arranged for. The risk of abuse, and possibly financial distress, is waiting around the corner. However, as the economic analysis showed, in situations of near financial distress the focus of a director's interests should shift from those of the company[3], as discussed in chapter 4, to those of the creditors (Nolan, 2001; Davies, 2006; Van Eeghen, 2006A; Ribstein and Alces, 2006; Olaerts, 2007; Armour et al. 2009: 209). Hence, the law provides for additional regulations, e.g. personal liability of directors, to be discussed in the next section.

5.4.2 Legal provisions influencing directors' behaviour in situations of near financial distress

In situations of near financial distress, executive directors (EDs) would prefer to go on as usual (Lennarts, 2006) Once the market knows, the going–concern value of the firm declines sharply (Eidenmüller, 2006: 243). Therefore private companies regularly decide to forego mandatory disclosure, which happens quite often (de Jong and Nieuwe Weme, 2006) as e.g. chapter 8 shows for private limited companies and co–operatives in the Netherlands. Consequently the law steers executive directors' behaviour through a standards strategy in order to protect corporate creditors when financial distress nears (Armour et al. 2009: 134). It sanctions these provisions by an ascending and cumulating directors' liability and monitoring intensity of the company on the road to bankruptcy, as figure 5.1 shows for the Netherlands. Initially (*phase 1*), a healthy company has to cope with the basic standards of a collegial board, reasonable and fair behaviour of concerned parties and the primacy of the interests of the company. Depending on the size of the company the law prescribes some mandatory monitoring mechanisms such as a works council, an SB and public disclosure of the annual accounts. However in *phase 2*, once the company rides in the teeth of the wind, directors may additionally come across an inquiry procedure, a dismissal, a liability claim from the company or even a directors' disqualification measure taken by a court, all resulting in heavy reputational damage. Unlike in phase 2, financial problems gradually become predominant in *phase 3*. From three years before bankruptcy a director risks above the previous measures an extra personal liability to the estate for apparent mismanagement, a risk that may only materialize once the bankruptcy is there (*phase 5*). *Phase 4* depicts the financial distress situation. It normally starts a few months before bankruptcy. Creditors originating from this period may hold 'knowing' directors personally liable, once the company is in default. Transactions concluded in this period may be declared null and void afterwards if the transaction is 'undervalued' as in the UK or 'Paulianeus' as in the Netherlands and disturb the *paritas creditorum*[4]. It should be noted that while the measures in figure 5.1 may have a monitoring and disciplining effect on the road to bankruptcy, they will often actually be effectuated once the bankruptcy has been declared and the director or his D&O insurance company is the only one who may offer redress.

Chapter 4 studied the 'normal-type' company, indicated in figure 5.1 as a healthy company or a 'phase 1 company'. The next subsections analyse the sanctions and monitoring mechanisms of the phases 2 – 5 of figure 5.1 towards bankruptcy with a focus on the Netherlands.

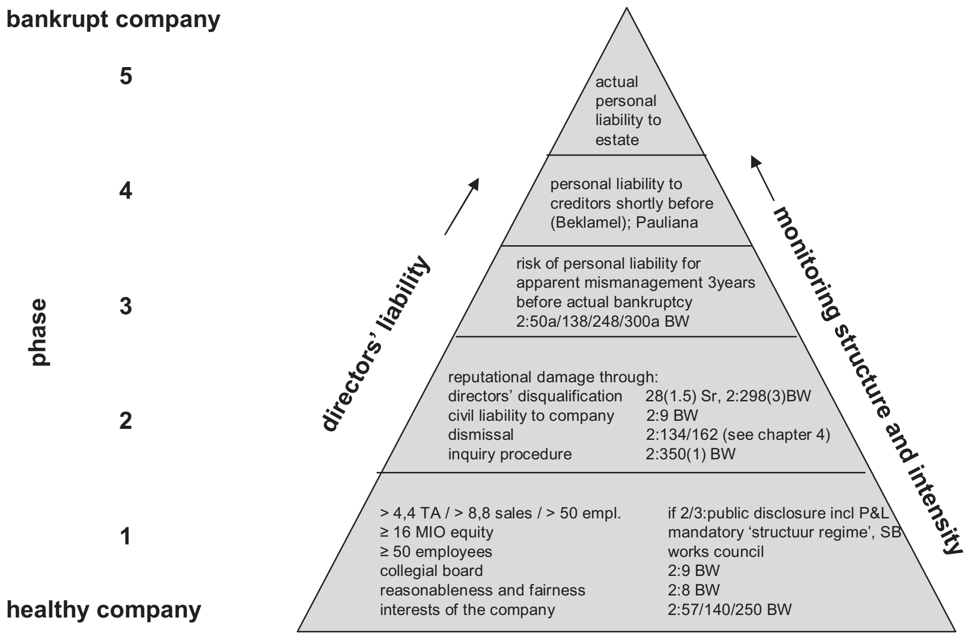

Figure 5.1: monitoring and directors' liability pyramid towards bankruptcy in the Netherlands

5.4.2.1 *Reputational damage (phase 2)*

In phase 2 the company, still in apparent health, faces difficulties with shareholders or the trade union. This may result in a request for an inquiry procedure before the Enterprise Division of the Amsterdam Court of Appeal (4.4.1.5) or in an expel or resign procedure in a closed NV or a BV (4.4.1.2). In search of a solution to its problems the company may dismiss a director and even sue him if his mismanagement was seriously reproachable (4.4.1.3)[5]. The latter does not happen very often since it adds new reputational damage to the company.

Moreover, a court may disqualify a director. This approach is particularly successful in the UK. The idea behind the UK Company Directors Disqualification Act (CDDA) is to have more serious and compliant directors once they know that they may be wiped out from job opportunities if they take the legal requirements too lightly. The UK court *may* disqualify a director as soon as he is convicted of an indictable offence in connection with e.g. the promotion, formation, liquidation or striking-off of a company[6]; or where it appears that a director has been persistently in default in relation to provisions of the CA requiring any return, account or other document to be filed with, delivered or sent to the registrar[7]. The court *will* issue a disqualification order if it is satisfied that the conduct of a person as a director makes him unfit to be concerned in the management of a company. Schedules 1 and 2 to the CDDA[8] contain the criteria for unfitness[9]. An application for the making of a disqualification order may be made by the Secretary of State, the official receiver, the liquidator, a member or a creditor[10]. Enforcement in the UK is very intensive and 100 times more common than a private suit against directors of an insolvent company[11] (Armour et al. 2009).

Directors' disqualification in the Netherlands is a rather unexplored area[12], with only a provision for foundation directors in civil law[13]; provisions for the screening of directors in general[14] and of the financial sector in the Wft[15]; a general but seldom applied additional penalty to deprive a person of his right to perform a profession e.g. being a director, for certain offences in criminal law[16]; and a recent law not yet in force to widen the application of the latter[17] (Doorenbos, 2008). De Jong and Nieuwe Weme (2006: 98) in their government commissioned study on the compliance of the duty of public disclosure conclude to an intensification of criminal sanctions and plea for new and additional administrative sanctions.

German law disqualifies persons from being an executive director in specific cases[18], notably after a conviction for failure to file for insolvency in time (*Insolvenzverschleppung*)[19] and some other insolvency-related criminal offences[20]. This thesis abstains from a discussion of criminal measures against abuse in financial distress situations.

5.4.2.2 *Personal liability for apparent mismanagement (phase 3 and 5)*

In phase 3 the problems of the company gradually become predominantly of a financial nature. Here Dutch law has a typical, successful legal approach. It urges directors to scrutinize their behaviour long before bankruptcy, since during bankruptcy a Dutch administrator may sue the EDs and NEDs for 'apparent mismanagement' in a period going back three years. If the administrator is able to prove that this 'manifestly improper performance of duties' over the past three years was plausibly an important cause of the bankruptcy, EDs, NEDs and a shadow director may be held personally liable to the estate for the entire deficit in bankruptcy[21]. The burden of proof is on the administrator. The court may mitigate the liability[22]. This provision applies basically to all Dutch legal persons[23].

This unique Dutch procedure is especially successful since non–compliance with the Dutch mandatory rule for EDs to conduct a proper administration and to disclose through the *Handelsregister* in a timely manner[24] may easily lead to personal liability under this provision. In the event of bankruptcy, the law qualifies non–compliance with this administration and public disclosure rule as mismanagement and presupposes it is the cause of the bankruptcy, unless the director proves the contrary[25]. As a consequence of the collegial board principle *each* director is at risk of being sentenced to pay up jointly and severally the bankruptcy deficit[26] unless he proves 'that the improper performance of his duties is not attributable to him and that he has not been negligent in taking measures to prevent the consequences thereof'[27]. This includes the NED who knew of the deficiency and did not act properly to seek redress (HR 28 June 1996, NJ 1997, 58, *Bodam Jachtservice*).

5.4.2.3 *Personal liability to creditors (phase 4 and 5)*

In phase 4 typically, a director risks personal liability 'for net increases in losses to creditors resulting from the board's negligence or fraud to creditors when the company is, or is nearly, insolvent' (Armour et al. 2009: 134). The British 'fraudulent trading' and 'wrongful trading' concepts are common examples. *Fraudulent trading*[28] happens if in the course of the winding up of a company 'it appears that any business of the company has been carried on with intent to defraud creditors of the company or for any fraudulent purpose'. The *wrongful trading rule*[29] holds that if a director knew or ought to have concluded that there was no reasonable prospect that the company could avoid going into insolvent liquidation[30], the court, on the application of the liquidator, may declare that that person is to be liable[31] to make such contribution to the company's assets as the court thinks proper:

- unless that director took every step with a view to minimising the potential loss to the company's creditors as he ought to have taken, and

- unless the directors' behavior has been that of a reasonably diligent person having both
    - o the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to the company, and
    - o the general knowledge, skill and experience that that director has.

Thus, trading whilst insolvent is not by itself either a criminal offence or a civil wrong (Davies, 2006: 314). From the moment a director[32] should have felt that 'insolvent liquidation' was inevitable, UK law requires that he ought to have taken every step with a view to minimising the potential loss to the creditors. According to Davies (2006) and Hirte, Knof and Mock (2008) this will often imply the decision to initiate formal insolvency proceedings. The 'should have felt' and 'ought to have taken' are judged by the court on the 'duty of care plus' (4.4.3.3) basis. However, if the *de facto* insolvent company is not formally put into insolvent liquidation 'the section 214 machinery will not operate' (Davies, 2006: 321). Directors thus seem to be able to escape liability if they appoint an administrator out of court, to which they are entitled[33]. A countervailing power in this respect form the *common law* developments regarding directors' duties to take account of the interests of creditors[34], which can be invoked in all insolvency proceedings. According to Davies (2006:327–329)

> *The modified directors' duty exposes directors to personal liability if they embark on overly risky projects in the vicinity of insolvency, and in consequence the downside of potential projects (..) becomes of relevance to their decision making.*

The Dutch version of the wrongful trading rule seems more fine–tuned. Contrary to the British rule, only applicable if the company has gone into insolvent liquidation, the Dutch wrongful trading rule formulated in HR 6 October 1989, NJ 1990, 286 (*Beklamel*) applies to a range of *actual* financial distress situations (Van Eeghen, 2006A: 17–95). HR 8 December 2006, JOR 2007/38 (*Ontvanger/Roelofsen*) formulated the rule as follows:

(a) in general, a director only then acts illegitimately towards a creditor and is consequently, along with the company, personally liable if he acted towards the creditor in a sufficiently seriously reproachable manner e.g. with regard to his duty to manage properly as mentioned in s 2:9 BW; which is specifically the case

(b) if a director closed a transaction whilst he knew or reasonably ought to have concluded that there was no prospect that the company would neither meet its obligations nor would offer redress, unless the director is able to make it plausible that he cannot be reproached for the injury (this is the original '*Beklamel*' ruling); or

(c) if a director effectuated or accepted that the company did not meet its obligations whilst his role in that decision shows such carelessness in respect of the creditor that this justifies a case of serious reproach[35].

German law has a different focus in wrongful trading situations. It recognizes two criteria for instituting insolvency proceedings for a legal person: actual or imminent illiquidity (*Zahlungsunfähigkeit*)[36] which is a cash-flow test, and overindebtedness (*Überschuldung*)[37] which is a balance sheet test, i.e. the liabilities exceed the assets. The *civil* focus orders executive directors to reimburse the company for payments made after they recognized the (imminent) illiquidity or the overindebtedness unless the payment has been made with due care[38]. In specific cases e.g. a not-permitted payment as mentioned in the previous sentence, creditors unable to receive payment from the company may pursue this claim to the executive directors personally as long as no insolvency proceedings are pending[39].

A specific personal liability to creditors is created by the Dutch Collection of State Taxes Act (*Invorderingswet 1990*). It obliges a company to inform the tax authorities if it is not able to pay its tax debt in time, and to provide them with necessary proof[40]. The law provides for joint liability of executive directors if the company has not paid its taxes and this non-payment is a plausible consequence of 'manifestly improper management' in a period up to three years before the non-payment[41]. However, if the executive director did *not* inform the tax authorities of the company's inability to pay, he is liable and the burden of providing proof to the contrary is on him[42].

5.4.2.4 *Annihilation or avoidance of transactions (phase 4 and phase 5)*

Unlike the previous measures (5.4.2.3) that focussed on creditor relief, annihilation or avoidance direct at restoring the previous position. In the Netherlands generally, based on the *actio Pauliana*, any damaged creditor could declare any non-compulsory transaction null and void if both parties to the transaction knew that violation of creditors' rights of redress would be its consequence[43]. Specifically, an administrator in bankruptcy may declare any non-compulsory transaction null and void if both parties knew that infringement of creditors' rights would be its consequence[44]. The burden of proof is laid upon the other party to the transaction if the transaction was concluded less than a year before the bankruptcy date[45]. Payments of claims due may be declared null and void by the administrator in bankruptcy in the case of a conspiracy between the debtor and creditor or if the creditor knew that a petition for bankruptcy had been filed[46].

In similar cases UK law recognizes an '*undervalue transaction*'. This is a gift, a transaction without consideration or a transaction with significant difference in the value of the consideration[47] within two years from insolvency[48]. The court may 'by such order as it thinks fit' restore the company in its previous position[49]. A similar fate meets an attempt to conduct '*preferential transactions*' – resulting in a particular creditor being placed in a better position[50]. Similarly, in HR 22 December 2009, NJ 2009, 273, *ABN AMRO/Van Dooren q.q. III,* the Hoge Raad ruled in r.o. 3.10 that a bank in considering a request for additional secured credit from a financially distressed firm has to analyse the financial figures of the company with the risk of bankruptcy and consequential infringement of other creditors' rights in mind. If the administrator can prove that the bank did not, the mortgage and pledge arrangements can be declared null and void. In the same line of thinking Davies (2006: 307) argues that the law should not provide recovery to creditors who have consented to embark on an overly risky project. Thus, UK law as well as the Dutch HR ruling guides directly the behaviour of the creditor.

5.4.2.5 *Concluding remarks on influencing directors' behaviour in situations of near financial distress*

Figure 5.1 shows in ascending and cumulating order the various legal measures that may influence director's behaviour on the road to bankruptcy. A director seems well–instructed by the law to avoid bankruptcy and if unavoidable, to structure it correctly. The higher the phase in the pyramid, the more chance of a personal liability claim. With it comes an increasing monitoring structure and intensity: to the court and individual shareholders in phase 2 are added creditors in phase 4 and the bankruptcy court and the administrator in phase 5.

5.4.3 Legal provisions influencing shareholders' behaviour in situations of near financial distress

Liability may even extend to shareholders if they have been deeply involved in the management of the subsequently distressed company. This involvement may have had the character of a shadow directorship[51]; or it may have brought a duty of care for the creditors' interests as a consequence of the company structure[52]. Moreover, Dutch law solves the liability issue of shareholders once in a while by identifying the legal person and the natural person (or other company) behind it and holding them both liable[53]. The concept of 'piercing the corporate veil', meaning that shareholders under certain circumstances can be held liable for the company's debts or other liabilities, known in the USA and the UK but only so in extreme circumstances as such does not apply in Dutch law (Easterbrook and Fischel, 1991; Armour et al. 2009; Davies, 2010: 32).

Rules restricting asset distribution to shareholders bite after insolvency as well (Lennarts, 2006: 8–17). As long as the company meets its obligations, not many people will care about e.g. dividend payments or even the reduction of capital. However, as soon as the company becomes insolvent and an illegitimate asset distribution to shareholders is discovered, shareholders and/or (executive) directors may be held personally liable for reimbursement[54].

5.4.4 Legal provisions relating to the monitoring of directors in situations of near financial distress

A 'light' legal provision on the monitoring of directors in situations of near financial distress is the legal provision to call an EGM as soon as 'the net assets of a public company are half or less of its called–up share capital (..) to consider whether any, and if so what, steps should be taken to deal with the situation[55].' Although the provisions originate from the Second EEC Directive on Company Law[56] a similar provision exists for the GmbH and eG[57]. Another 'light' provision is in Dutch tax law, where it obliges a company that is not able to pay its taxes when due to inform the tax authorities immediately and to provide them with subsequently requested information (see 5.4.2.3). Both provisions imply an intensification of the monitoring of directors.

When financial distress nears, the law sometimes creates a new outside monitoring mechanism of the board. Exemplary is the UK 'nominee' in case of a company voluntary arrangement (CVA)[58] or the '*bewindvoerder*' if a Dutch company files for suspension of payments. From that moment on, the 'bewindvoerder' and the board can only conclude contracts together[59]. French law provides two pre–insolvency procedures for preventive reasons: (1) the alert procedure (*procédure d'alerte*) where an auditor uncovering facts likely to compromise the continuity of the business may, if his efforts to redress fail – in the end – inform the president of the *Tribunal de Commerce*[60]; and (2) the *mandat ad hoc* where at the request of the debtor, the president of the commercial court could appoint a *mandataire ad hoc*, determining his purpose and the duration of his mission[61]. The *mandataire ad hoc* works under confidentiality[62]. One could consider the Court appointment of a '*stille bewindvoerder*' (undisclosed administrator) at the request of the debtor before bankruptcy, which the commissie Kortmann proposes should be part of the new Dutch insolvency law, to be a late stage monitor as well.

Chapter 1 argued that 'suspension of payments' often leads to bankruptcy. There is no information as to the effect of the other measures mentioned.

5.4.5 Concluding remarks on legal aspects of monitoring near financial distress

Reading through the legal provisions influencing directors' behaviour in situations of near financial distress, these could very well make directors anxious about liability. This however would not be right: *bona fide* directors should have nothing to fear from (Dutch) law (Kroeze, 2005: 9). The overview showed that all the legal systems under review provide rules and standards protecting creditors in situations of near financial distress. However, one may argue that these measures (1) apply at a very late stage (Davies, 2006: 313) and (2) do not have any positive influence on the fate of the company[63]. Moreover, (3) they do not necessarily encourage directors to improve their management decisions, whilst (4) the limited wealth of shareholders/directors often inhibits the effectiveness of financial sanctions (Eidenmüller, 2006: 244). Legal monitoring measures relating to situations of near financial distress such as in France can only be effective if there is no immediate time constraint, no publicity and sufficient manoeuvring space for financial reorganization. In practice these conditions are difficult to meet.

5.5 MONITORING NEAR FINANCIAL DISTRESS: A MULTIDISCIPLINARY APPROACH

What do we have: chapter 2 showed that a turn–around or a work–out is a complicated process. Chapter 3 stressed the surplus value of monitoring. Chapter 4 showed that in the law the specialized management feature generally prevails over mandatory monitoring requirements. The previous sections showed that economists promote monitoring by residual claimants as a panacea against expropriation by the management and for improvement of management decisions. Due to the ever–existing possibility of financial distress, *all* residual claimants should have a right to monitor. Remarkably, the law, implicitly or explicitly, influences directors' behaviour in situations of near financial distress mainly through personal liability. Could the economic concept of monitoring have a role in the law as well?

5.5.1 The analysis of Argenti

Argenti (1976; 1986A; 1986B) analyses that failure is not an event but a process which evolves in four sequential phases[64]. In *phase one* there are either (1.a) *management defects* e.g. an autocratic CEO, a weak CFO, the available skills are primarily of a technical and not of a general executive nature, or directors do not participate; or (1.b) *systems defects* e.g. ineffective budgetary control, inaccurate costing systems or poor cash–flow planning; or (1.c) *change defects* i.e. poor response to change or the company is significantly old–fashioned. In this phase the company appears to be in good health. However:

> *the first signpost pointing down the path to failure, years ahead, is the autocrat.(..) His great strength is that when he says 'jump' the whole company jumps; marvellous – until he tells them to jump in the wrong direction. (Argenti, 1986A).*

In *phase two* it actually happens, only it goes undetected. Management makes one of the three mistakes that is going to lead directly to failure (Argenti, 1986B). These are either (2.a) *overtrading* which occurs when a company expands faster than its capital base, or (2.b) embarking on a *project that is too big* which, if it goes wrong, will bring down the company, or (2.c) allowing *too high gearing* 'which leaves no room for manoeuvre should a stroke of bad luck occur'. Autocrats tend to wave away financial restrictions;

they neither reckon with the risk that the project is not going to succeed nor with bad luck. Once one of these mistakes has been made, the company will enter the *third phase* in which the signs and symptoms of failure begin to appear:

> *So here at last we find the financial symptoms which most people regard as the first indications of failure – of course we know now that they are among the last. (Argenti, 1986B)*

The third phase shows (3.a) *deteriorating ratios and Z–scores*, or in order to avoid that: (3.b) *creative accounting*, which may occasionally be fraudulent but often some re–arrangements on the balance sheet may be sufficient, or (3.c) *non–financial signs* such as a cut of capital expenditures; directors who are getting indecisive, start reducing the size of orders to their suppliers; a suffering product quality; discounting selling prices and falling market share. *Phase four* is marked by the *actual insolvency*.

> *Writs start flying, staff begin to resign, and rumours spread. Finally the dreadful day arrives (Argenti 1986B).*

In short, most corporate failures find their origin in phase one: in *management* defects, in *system* defects or in *change* defects. In order to diminish financial distress monitoring should focus on these defects.

5.5.2 Towards a model to diminish financial distress

Now refer to figure 5.2. It is essentially the same figure as figure 2.1 with the heading 'determining factors for the outcome of financial distress'. Argenti's management defects, system defects and change defects are all related to the two boxes mentioned in the lower half of the figure: the MANAGEMENT/ENTREPRENEUR and CORPORATE POLICY boxes. So, what should be done in order to avoid the defects is *to improve the quality of these boxes*. This improvement is sought by adding monitoring mechanisms to each of these two boxes in figure 5.2. In one way or another, and depending on e.g. the size of the company, outside and essentially independent monitoring mechanisms should be organized around these two boxes to avoid the ultimate devastating effect of Argenti's defects. For large companies one could think of more than one ED, thus establishing a collegial board; of an SB with a creditor and an employee voice; of a works council; of an internal auditors department; or of a better equipped or more experienced auditor. For smaller companies less formal mechanisms will often do, such as an advisory board; a family council; a regular discussion with an industry consultant, a banker, or an accountant or an auditor; and meetings with employee–representatives. As has been concluded in 3.6, in order to remain efficient, management should not lose to monitors much of its discretionary power to direct the company. However, as long as monitoring

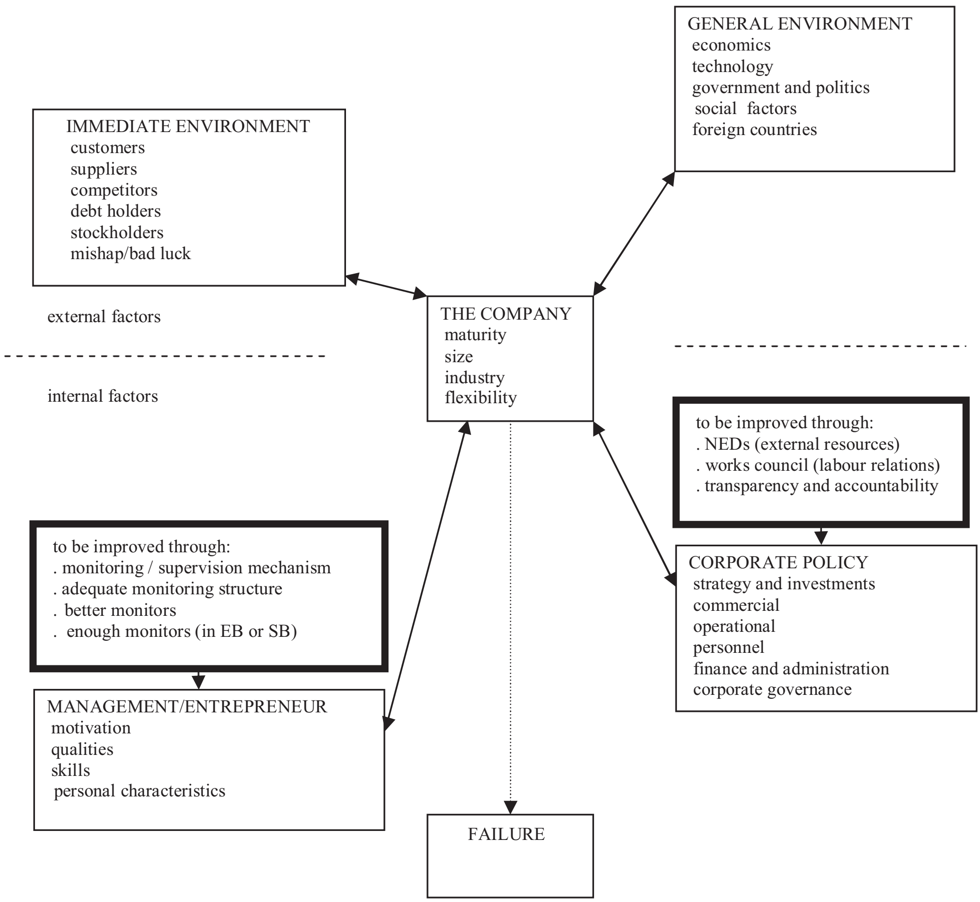

Figure 5.2: measures to counteract the occurrence of Argenti's financial distress causing defects

reduces the whole of agency costs i.e. reduces the residual loss for a larger amount than the monitoring investment, the company is better of.

The working of the MANAGEMENT/ENTREPRENEUR box can be improved through either the implementation of a monitoring mechanism, or, if there is such a mechanism, by a more adequate monitoring structure; by searching for better monitors; or by putting enough monitors in place i.e. by adding a monitoring organ or a director. Monitoring is preferably implemented by relative outsiders, since insiders may suffer from tunnel vision, or from autocratic leadership. Executives/insiders should be forced to hear the advice of these outsiders, either by law, by the articles and company resolutions, or by covenants with lenders, investors and interest groups. Since they are specialized agents, the decision should remain mostly theirs. And since these measures intend to create a balanced governance structure, management decisions will improve at least with the bottom line that the risk to overlook aspects will be diminished.

The working of the CORPORATE POLICY box can be improved though new *external resources* for the board. These may be new experience, know–how and networks originating from (more or better) NEDs on the (supervisory) board. In smaller companies these resources may come from industry consultants, from colleague–entrepreneurs or from banks or investors. These resources may improve company policy, strategy, corporate governance and even operations. A *works council* or some form of co–determination may ameliorate an important aspect of corporate policy, labour relations. Tying employees to the company may avoid strikes and promote more flexible production processes such that e.g. in the early 2009 crisis, KLM pilots were inclined to do ground–personnel work. Better *transparency and accountability* show you have nothing to hide; make you clearly present the choices you have made and the reasons for them; and ensure that surprises and angry stakeholders are avoided if things turn out wrong. The advantage being that, if things do go wrong and the company nears financial distress, directors do not lose precious time in appeasing shareholders, creditors and employees, and can instead start working directly on constructive turn–around solutions within an adequate monitoring structure.

5.5.3 A legal implementation of the model

Would there be a place for such a monitoring concept in the law? Chapter 4 already showed that the law actually provides for monitoring mechanisms. As it is, it seems that private investors are well protected through the regulated capital market in NVs, AGs and PLcs. Moreover, the UK heavily protects investors in charities and other investments for the benefit of the public, in order to vest confidence in this market. However, protection of private investments outside the regulated capital market is often rather thin e.g. depending on the size and legal form of the company.

A plea for new mandatory monitoring provisions in the law would be politically senseless; economically inefficient since mandatory law often cannot cope with the specific circumstances of the company; and therefore legally almost impossible. On the other hand, monitoring has its advantages over the legal measures discussed earlier this chapter. Whilst disqualification and liability are remedies of an *ex post* nature and need outside parties e.g. a court or an administrator to apply, monitoring is an *ex ante* and primarily internal remedy with efficiency advantages in terms of time, costs and uncertainty. Although both may add to the quality of company management in their own way, ensuring an appropriate monitoring structure for the company to start with would seem wise. If monitoring does not work out as predicted because it is either not in place at all, or inadequately designed or inappropriately implemented, then the existing legal standards may well fill the gap.

It seems that the open norm that directors should pursue the *belang van de onderneming* / the success of the company / the *Wohle der Gesellschaft* leaves room for a solution. Would this duty not require 'the implementation and actual application of a tailor-made monitoring structure in the company' as one of the important tasks for a director? Such a requirement would neatly fit into corporate law since the first principle of the DC starts with the phrase: 'The management board and the supervisory board are responsible for the corporate governance structure of the company' and the Hoge Raad ruled – for Dutch listed companies – that these principles fill in the open norms of s 2:8 and s 2:9 BW[65]. The UKC (A.1) requires every company to be headed by an effective board. This finding is visualized in figure 5.3. Figure 5.3 adds a new *bottom-line criterion* to the pyramid, derived from economic theory and embedded in the duty of care: *at any rate and in any company directors are obliged to implement and actually apply a monitoring structure tailored to the needs of the company.* This is the conclusion of the theoretical multidisciplinary part of this thesis. It is based on the economic analysis of chapter 3 which showed the importance of monitoring; on the perceived relative lack of mandatory monitoring mechanisms in chapter 4; on the apparent lack of *ex ante* measures in situations of near financial

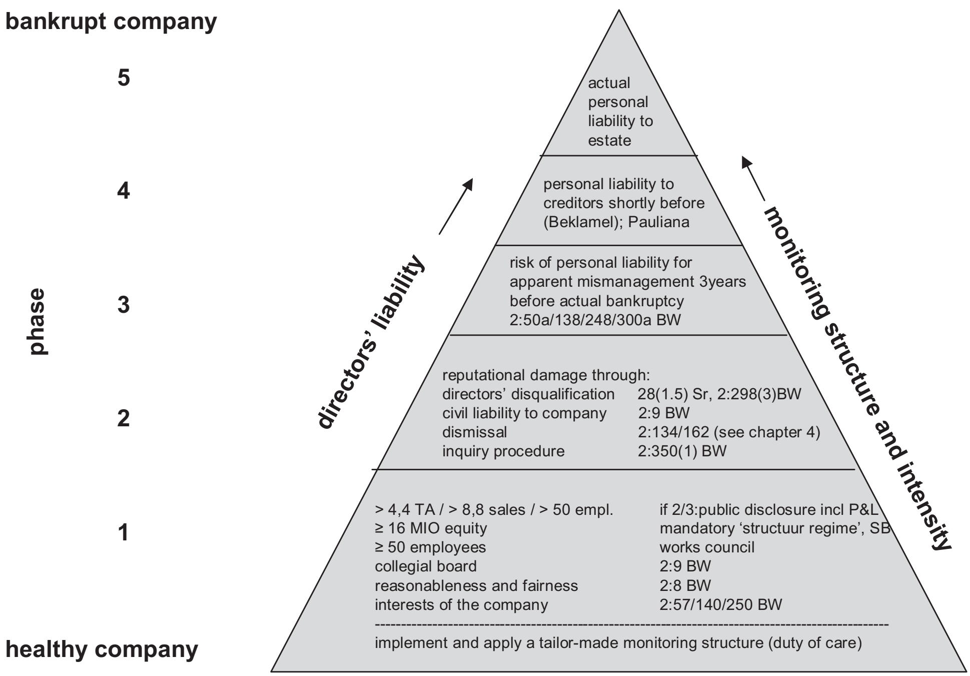

Figure 5.3: a monitoring-based directors' liability pyramid towards bankruptcy in the Netherlands

distress as found in chapter 5; and on the Ooghe and Waeyaert model. One may argue that this kind of obligation already exists, since (1) UKC (C.2) prescribes that 'The board should maintain sound risk management and internal control systems'; (2) DC (II.1.3) contains that 'The company shall have an internal risk management and control system that is suitable for the company'; (3) through a broad interpretation of Hoge Raad *dicta*[66] this best practice may already apply to all legal persons by means of s 2:9 BW; and (4) Dutch NV and BV law[67] provides for an EB duty to inform the SB in writing on 'the essence of the strategy, the general and financial risks and the control systems of the company' thus implying that control systems should be present. However, the above presented general duty as an element of the 'proper management' obligation has the advantage of being clear and generally applicable, i.e. to *all* types of companies / legal persons, and that it requires a working, tailor–made system instead of just reporting on it.

5.6 RESEARCH

The previous analysis is induced from the economic and legal analysis. The addition of the two boxes in figure 5.2 gives rise to the formulation of seven groups of research questions on monitoring near financial distress:

(1) on the influence of the 'monitoring / supervision mechanism' through the MANAGEMENT/ENTREPRENEUR box on the company
(2) on the influence of an 'adequate monitoring structure' through the MANAGEMENT/ENTREPRENEUR box on the company
(3) on the influence of 'better monitors' through the MANAGEMENT/ENTREPRENEUR box on the company
(4) on the influence of 'enough monitors' through the MANAGEMENT/ENTREPRENEUR box on the company
(5) on the influence of 'NEDs and external resources' through the CORPORATE POLICY box on the company
(6) on the influence of 'works council and labour relations' through the CORPORATE POLICY box on the company
(7) on the influence of 'transparency and accountability' through the CORPORATE POLICY box on the company.

The influence of these to be investigated measures of the two added boxes on the MANAGEMENT/ENTREPRENEUR box respectively the CORPORATE POLICY box is hardly measurable since these are rather 'black boxes' and, if at all, presumably not by an economist but by a psychologist. However, it ís possible to skip the MANAGEMENT/ENTREPRENEUR box respectively the CORPORATE POLICY box altogether in the analysis and to analyse whether a direct relationship can be discovered between the measures proposed in the added boxes and the status of the company i.e. financially distressed or not. This is what the chapters 6, 7 and 8 do[68].

Chapter 6 departs from a structural, agency theory based orientation. It researches for Dutch listed financially distressed companies and a control group of listed companies the relevance of the shareholders', non–executives' and employees *monitoring rights* (research questions group 1, 6 and 7 above), the issue of the adequate *monitoring structure* in terms of board size, insider/outsider ratio, independency of the board and financial expertise on the board (research questions group 2 and 4) and the *monitoring output* (research questions group 3).

Chapter 7 explores for Dutch listed bankrupt and control companies the relevance of the quality of the supervisors in terms of the personal characteristics and resources they bring about as well as the relevance of board diversity to the issues mentioned (research questions group 3 and 5).

Chapter 8 researches for Dutch non–listed *BV's*, *coöperaties, verenigingen* and *stichtingen* the influence of monitors on the likelihood of financial distress (research questions group 1); the influence of the number of directors, as well as certain of their characteristics, on the likelihood of financial distress (research questions groups 3 and 4); and the issue of adherence to the obligation of financial disclosure (research questions group 7). It discusses a Hansmann (1996) inspired theory on the difference of monitoring characteristics between for–profit legal forms on the one hand and nonprofit legal forms on the other hand.

5.7 CONCLUDING REMARKS

Section 5.1 formulated three questions: Does financial distress require other monitoring mechanisms, a different type of monitors, or other rules? Starting from figure 3.5 the chapter upholds the importance of monitoring for any company. For small companies however, formal *mechanisms* are not feasible and informal monitoring mechanisms should be organized. As for the different *type of monitors*, the chapter showed that creditor and employee originating monitors have a countervailing function against the tendency of excessive risk–taking by directors and shareholders in situations of near financial distress. One may tend to answer the third question, on the *necessity of other rules*, in the affirmative, since the law does indeed provide for numerous provisions to guide directors' behaviour in situations of (near) financial distress. However, from the analysis it seems that those extra rules are essentially either existing rules or rules derived from existing principles. Maybe it is not the extra rules, but the explicit warning of personal liability that makes the real difference in situations of (near) financial distress.

However, from the theoretical analysis of chapters 1, 2, 3 and 4 the model developed in this chapter derives the necessity of monitoring mechanisms to counteract the occurrence of *management* defects, *system* defects or *change* defects since these may cause the financial distress of the company (Argenti, 1986B). The legal consequence of this model is this thesis' recommendation to consider the implementation and actual application of a tailor–made monitoring structure in the company as part of the director's duty to conduct proper management. The chapter subsequently formulated research questions on the actual execution of these monitoring mechanisms. Chapters 6, 7 and 8 make these research questions operational in hypotheses and test them on Dutch data.

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ENDNOTES

1 Provided the market is transparent and market parties invest, which proves the Pareto optimal–ity of the proposed informal restructuring.
2 In a debtor–oriented bankruptcy system, shareholders may squeeze out a reimbursement or a reduced shareholder interest in the negotiating process. In a creditor–oriented system, shareholders may claim the residual, if any, e.g. s 2:23b BW.
3 Or, depending on one's view of the true nature of the company, on that of the shareholders.
4 s 3:277 BW.
5 The new s 2:216(2,3) BW (see Annex 2) holds directors jointly and severally liable to the BV if they agreed to pay out dividend, knowing or reasonably having to have known that thereafter the BV would become insolvent. See also footnote 53.
6 s 2(1) CDDA.
7 s 3(1) CDDA. 'Persistent' means three or more convictions in five years (s 3(2) CDDA).
8 based on s 6, 9 CDDA.
9 Examples of the most commonly reported conduct are: (1) allowing the company to continue to trade when it was unable to pay its debts; (2) failure to keep proper accounting records; (3)

failure to prepare and file accounts or make returns to Companies House; and (4) failure to submit returns or pay the Crown any tax due (www.insolvency.gov.uk).

10 s 16(2) CDDA. See also: de Jong and Nieuwe Weme, 2006: 107.

11 Administrators, liquidators and receivers are obliged to report to the Insolvency Service any matters coming to their attention which suggest unfitness: s 7(3, 4) CDDA and Davies, 2010: 93 footnote 66.

12 See the report of NCSR, 2009, available on www.overheid.nl under 31386 ek–H. It mentions (p. 76) 132 cases for the period 1995–2009.

13 s 2:298 BW.

14 s 2:64(2)/175(2) BW. This system will shortly change into a system of continuous screening of the *Handelsregister*. See Annex 2 under 4.

15 s 3:8–3:10 Wft.

16 s 28(1.5) Sr.

17 See Annex 2 under 2 (*Kamerstukken II* 2007/08, 31386, no. 1–2 especially on s 349 Sr).

18 s 76 AktG; s 6 GmbHG.

19 s 76(3.a and b) AktG and 6(3.a and b) GmbHG jo s 15a InsO. These are inserted in 2008 in the law by the MoMiG. See: Lutter/Hommelhof, 2009, comm. s 6 no 22 p. 256.

20 s 76(3.c–d) AktG and s 6(3.c–d) GmbHG.

21 For ED: s 2:138/248 BW. Shadow director: s 2:138/248(7) BW. NED: s 2:149/259 BW.

22 s 2:138/248(4) BW.

23 s 2:50a (association), 2:53a (coöperatie), 300a BW (stichting). For stichting and vereniging: only if subject to corporation tax (VpB; see 4.7.1.2).

24 s 2:10 and 394–398 BW.

25 This is in short what s 2:138/248 BW is about. For additional literature see: Olaerts, 2007:169; Bossema–de Greef, P., and R.J. Versteeg, 2009, Bestuurdersaansprakelijkheid ex artikel 2:248 lid 2 BW: past and present, *Tijdschrift financiering, zekerheden en insolventierechtspraak* 83–86; Brink–van der Meer, J.E., 2009, Artikel 2:138–248 BW: Een loterij? Recente ontwikkelingen in jurisprudentie, *Tijdschrift voor Insolventierecht* 5, 145–155; Andel, W.J.M. van, 2010, Hoe crisisbestendig is art 2:138/248 lid 2 BW?, *Tijdschrift voor Insolventierecht* 1, 1–3.

26 s 2:138/248(1) BW; mitigation is possible, see subsection (4).

27 s 2:138/248(3) BW.

28 s 213 IA 1986.

29 s 214 IA 1986. See on this: Davies, 2006: 316–327; Olaerts, 2007: 229.

30 Insolvent liquidation means that 'the assets of the company are insufficient for the payment of its debts and other liabilities and the expenses of the winding–up' (s 214(6) IA). However, in determining whether the company has no reasonable prospect of avoiding insolvent liquidation, courts use a cash flow test (Davies, 2006: 319).

31 Additionally, 'wrongful trading' may cause prosecution (s 218 IA) or directors' disqualification (s 10 CDDA) for a maximum period of 15 years.

32 A 'director' includes a 'shadow–director' (s 214(7) IA) meaning 'a person in accordance with whose directions or instructions the directors of the company are accustomed to act' (s 251(1) CA).

33 Davies, 2006: 323 and s 22, 27, 29 Schedule B1 to the IA. Davies argues that this is understandable since administration focuses on the rescue of the company, for which good cooperation with the former directors will often be necessary (2006: 324).

34 Davies, 2006: 327–329 defends the existence of this duty but he seems to support 'the majority view (..) that this duty is not in fact owed directly to creditors, but is an extension of directors' duties as traditionally understood and so is a duty owed to the company'. Even stricter on this 'development': Ribstein, L.A., and K.A. Alces, 2006, Directors' duties in failing firms, (University of Illinois College of Law). See on the related impact of the Credit Lyonnais bank Nederland NV v. Pathe Communications Corporation decision of the Court of Chancery of Delaware, December 30, 1991 (especially no 34) also Lennarts, 2006: 20. However, Assink, 2007: 83–93 explains that the Delaware Supreme Court still attains to the primacy of the interests of the shareholder.

35 Again applied in: HR 26 March 2010, NJ 2010, 189 (*Zandvliet/ING Bank*).
36 s 17 and 18 InsO.
37 s 19(2) InsO. It should be noted that s 5 Finanzmarktstabilisierungsgesetz (FMStG) from 17–10–2008 added to s 19(2) InsO the possibility to relieve the requirement to file for insolvency in case of *Überschuldung* 'if the company's going concern is predominantly likely under the circumstances'. s 6 (3) FMStG intends to change s 19(2) InsO by 1–1–2014 so that the present addition is replaced by reference to a going–concern valuation of the assets if the company's going concern is predominantly likely (s 7 FMStG on www.buzer.de/gesetz/8396/index.htm). See for a clear introduction into the criteria as well as the changes in s 19(2) InsO and its backgrounds: Hirte, H., B. Knof, and S. Mock, 2008, Überschuldung und Finanzmarktstabilisierungsgesetz, *Zeitschrift für das gesamte Insolvenzrecht (ZInsO)* 2008, 1217.
38 s 92(2) AktG; s 64 GmbHG; s 34(3.4) GenG.
39 s 93(5) AktG; s 34(5) GenG. Less clear: s 43(3) GmbHG.
40 s 36(2) Iw and s 7–9 Uitvoeringsbesluit Invorderingswet 1990 for the details.
41 s 36(3) Iw.
42 s 36(4) Iw. A director is only then admitted to this proof if he makes it plausible that he cannot be blamed for not informing the tax authorities.
43 s 3:45–47 BW.
44 s 42 Fw.
45 s 43 Fw.
46 s 47 Fw.
47 s 238(4) IA.
48 s 240(1.a) IA.
49 s 238(3) and 241 IA. Also: 423–425 IA.
50 s 239, 240, 241 IA.
51 s 2:138/248(7) BW and HR 23 November 2001, NJ 2002, 95 (*Mefrigo*); s 251 CA.
52 HR 21 December 2001, NJ 2005, 96, (*Sobi/Hurks II*); HR 11 September 2009, NJ 2009, 565 (*Comsys/Van den End q.q.*). See on the latter: Bartman, S.M., 2010, Gevaarzetting en doorbraak van aansprakelijkheid, *Ars Aequi* 102–105. Also: Van Eeghen, 2006A, chapter X.
53 HR 9 June 1995, NJ 1996, 213 (*Krijger–Citco*); HR 13 October 2000, NJ 2000, 698 (*Rainbow*) and HR 27 February 2009, NJ 2009, 318 (*Stichting Waaldijk 8/Aerts q.q.*) r.o. 3.2.2.
54 For the Netherlands see 2:105/216 BW, HR 8 November 1991, NJ 1992, 174 (*Nimox*), HR 6 February 2004, JOR 2004, 67 (*Reinders*) and the discussion on the new text of 2:216 BW in the flex–BV proposal (see Annex 2 under 1). Remarkable is the present absence for the BV of the duty to reimburse for the shareholder who received in bad faith (2:105(8) BW). However, see Van Schilfgaarde/Winter (2009: 93) for a solution. In the UK: s 831–846, 847 (consequences) CA. In Germany: s 30, 64 GmbHG.
55 s 2:108a BW; 92(1) AktG; 656 CA. In Germany this is called the '*Verlustversammlung*' and in the Netherlands the '*verliesvergadering*'. Literature doubts the usefulness (Davies (2008: 264). Van der Heijden/Van der Grinten (1992:544) calls it a 'shot in the dark'.
56 Article 17 of the *Second* Council *Directive* 77/91/*EEC* of 13 December 1976.
57 s 5a(4) and 49(3) GmbHG; s 33(3) GenG. Neglect is an offence in Germany s 401(1) AktG; s 84(1) GmbHG; s 148(1) GenG and in the UK: s 656(4,5) CA.
58 s 1, 2 IA 1986.
59 s 228 Fw.
60 s L234–1 Code de commerce.
61 s L611–3 Code de commerce.
62 s L611–15 Code de commerce.
63 Such as the US Chapter 11 has (Davies, 2006: 315).
64 Although less compelling, the analysis of Keough (2008) on the Ten commandments for business failure provides interesting reading as well.
65 HR 13 July 2007, JOR 2007/178, *Bank of America/ VEB and ABN AMRO Holding* and HR 9 July 2010 LJN: BM0976 (*ASMI/Hermes*).

66 HR 13 July 2007, JOR 2007/178, *Bank of America/ VEB and ABN AMRO Holding* and HR 9 July 2010 LJN: BM0976 (*ASMI/Hermes*)

67 s 2:141/251(2) BW.

68 By doing so, this thesis follows Brennan's (2006: 591) advice: 'Research might re–focus on the differences between failed and non–failed firms to see whether we have more to learn from bankruptcy.'

Chapter

6

Relevance of the agency theory to monitoring near financial distress: an empirical approach

Separation of the management and control of decisions contributes to the survival of any organization where the important decision managers do not bear a substantial share of the wealth effects of their decisions (Fama and Jensen, 1983: 309)

6.1 INTRODUCTION

The previous chapters described the economic theory and legal practice of monitoring. Chapter 5 developed a theoretical model on monitoring near financial distress. This chapter aims (1) to formulate testable monitoring-related hypotheses based on the agency theory described in chapter 3 and the research model developed in 5.6; and (2) to test these hypotheses on data for financially distressed Dutch companies listed on the Dutch stock exchange in the period 1993–2003. Section 6.2 presents an overview of previous research relevant to the topic. From there it develops testable monitoring related hypotheses within the framework of the model developed in chapter 5 and within the constraints of the available data. Section 6.3 describes the data. Section 6.4 explains the applied research methods. The results are reported in 6.5. Section 6.6 concludes and discusses the results.

6.2 THEORY AND HYPOTHESES

This section examines the empirical research relevant to the subject and formulates the hypotheses that will eventually be tested in 6.5. There is relatively little research done on the relevance of the agency theory to near financial distress. Leading studies are those of Gilson (1989), Daily and Dalton (1994), Gales and Kesner (1994), Daily (1995), Elloumi and Gueyie (2001) an Parker, Peters and Turetsky (2002). Because of this relative lack of material the discussion below also considers studies on the neighbouring topic, i.e. the relationship between the agency theory (or corporate governance in general) and firm performance. Financial distress is, arguably, a binary firm performance measure: it distinguishes between a 'sustainable' and a 'non-sustainable' financial situation of the firm without considering the different performance levels within the categories. Research on financial distress is important as the reason why firms succeed or fail is perhaps the central question on strategy (Porter, 1991: 95). Brennan (2006: 591) stresses the importance of this kind of research to clarify the role of boards.

6.2.1 Approach to the theory

The agency theory shows, as explained in 3.3.1.1, that the agent is to be thoroughly monitored by the principal or by a supervisor in his name, in order to avoid expropriation (Fama, 1980; Fama and Jensen, 1983; Hillman and Dalziel, 2003). Applied to the Dutch two-tier system this implies that the agent is to be monitored by its equals (Fama, 1980) as well as by the supervisory board (SB). Transaction Cost Economics (TCE) considers the (supervisory) board principally as an instrument for safeguarding equity finance (Williamson, 1988: 571). Thus, for an agency-theory and TCE-economist the SB primarily has a monitoring and a disciplining role. Chapter 4 showed the legal organization of this role.

This chapter aims to test statistically the relationship between monitoring and financial distress in terms of *monitoring rights*, *monitoring structure* and visible *monitoring output*. Such a test is only possible if companies differ amongst each other i.e. if there are either different mandatory regimes e.g. the 'ordinary NV' and the 'structure NV' or if mandatory rules lack e.g. on the number of executive directors (EDs) and non–executive directors (NEDs).

The relevance of the *monitoring rights* regime for financial distress is tested for the characteristics 'structure NV' (6.2.2.1) and 'share certificate NV' (6.2.2.2). The *monitoring structure* could not be tested on the existence of a SB or a works council since they existed in nearly all the firms. However, it can be measured in terms of the number of EDs and NEDs (6.2.2.3) as well as in terms of (a) the insider/outsider directors ratio in the company, (b) the presence of independent NEDs and (c) the presence of financially experienced NEDs (6.2.2.4). Board structure is a potentially important predictor of a company's financial performance (Zahra and Pearce, 1989). Daily and Dalton (1994A) and Aziz and Dar (2006) conclude that governance structures do contribute to the incidence of bankruptcy beyond financial and size considerations. *Monitoring output* is generally kept secret and therefore immeasurable. However, this study incorporates board turn–over (6.2.2.5) as an indicator of effective control (Jungmann, 2006: 435).

6.2.2 Hypotheses

This section discusses agency theory related characteristics of the firm in terms of monitoring rights (6.2.2.1 and 6.2.2.2), monitoring structure (6.2.2.3 and 6.2.2.4) and visible monitoring output (6.2.2.5) in situations of near financial distress. Every discussion ends with the formulation of a testable hypothesis.

6.2.2.1 *Supervisory board rights*

A listed Dutch NV may be an 'ordinary NV' or a 'structure NV', the latter either mandatorily, mitigated or voluntarily (see chapter 4). In a structure NV the SB (1) appoints the EDs[1], (2) it has to ratify EB decisions listed in the law and the articles, and before 2004, when the law was changed, the SB (3) appointed the non–executive directors (NEDs) through co–option and (4) it adopted the annual accounts. The competences (3) and (4) are at present assigned to the shareholders. However, during the period under investigation the SB in the structure NV held all four competences which made it definitely a more powerful monitoring organ than the SB in the ordinary NV. According to the model in chapter 5, more powerful monitoring reduces the chance of financial distress.

Research by Van Ees, Postma and Sterken (2003) and Cuijpers, Moers and Peek (2004) claims that the co–option feature hinders the alignment of SB and shareholder interests.

Although this may clearly hinder optimization of shareholder interests, one cannot reasonably suppose that this lack of alignment has a negative effect in situations of near financial distress. The SB will look after the interests of the firm as it legally should do, and after its own interests e.g. in terms of reputational damage. The SB will undoubtedly do its utmost to avoid financial distress by means of the rights assigned to it. The first hypothesis therefore reads:

H_1: being a "structure NV" is negatively related to financial distress.

6.2.2.2 *Shareholder rights*

In the near past the shares of many Dutch NVs were under "certification". This system means that all or a large quantity, often a majority, of the shares of an NV are held by a trust (*Stichting Administratiekantoor*) which in turn offers listed tradable depositary receipts (*certificaat van aandeel*) without voting rights but with full dividend rights. De Jong, DeJong, Mertens and Wasley (2005) showed that this loss of voting right has a significant negative impact on Tobin's *Q*, commonly indicated as the *Dutch discount*[2]. In the wave towards more shareholders' rights, this certification of shares was largely abolished[3] during the early 2000's, but for the research period it was (and in fact for a number of listed companies e.g. ING NV it still is) relevant. Certification means in practice that one shareholder, the *Administratiekantoor*, holds the majority of the votes present at the general meeting (GM). The Administratiekantoor presumably monitors the firm in one–on–ones with the EB. Normally it will vote for the EB proposals. Donker, Santen and Zahir (2009) report evidence of a negative relationship between the percentage of the votes a trust holds and the likelihood of financial distress. However, Morck, Shleifer and Vishny (1988) and Short and Keasey (1999) find a non–linear relationship between firm performance and managerial ownership. Management aligns with shareholders' interests if its own share in the company is either small or large; in between it entrenches i.e. 'divides and rules' in its own and not (necessarily) in shareholders' interests. One may speculate whether the share of the Administratiekantoor is to be added in this respect to that of the management.

This research focuses on the curtailing of shareholders' rights by 'certification' and therefore researches only whether a firm has listed tradable depositary receipts. Neither theory nor evidence indicates an *a priori* clear direction of the argument. Therefore the hypothesis reads:

H_2: "certification" of shares is not related to financial distress.

H_1 and H_2 relate to *monitoring rights* of the SB and the shareholders respectively. The following two sections focus on the *monitoring structure.*

6.2.2.3 *Board size*

During the research period, Dutch company law prescribed the two–tier system for a firm with NEDs[4]. The minimum number of EDs – and of NEDs if a SB has been installed – is one, unless in a 'structure NV' where the SB is mandatory and the minimum number of NEDs is three[5]. The *monitoring structure* is initially determined by the number of EDs to monitor the EB and the number of NEDs to monitor the SB and EB. If there is only one ED internal monitoring of the EB cannot take place since one cannot monitor oneself. Usually there will be more EDs. Moreover, in practice the Dutch SB often meets with the EB. In terms of the one–tier system one could maintain that the insider directors who are employed by the firm meet with the outsider directors who are not. Such meetings are to some extent comparable with board meetings in the one–tier system, e.g. chairmanship (not the CEO), strategy, policy and monitoring issues to be discussed. They differ from one–tier meetings on e.g. voting rights at the meeting since the ED has none, on the lack of operational issues on the agenda and on (in most cases) frequency. In order to compare as much as possible with international literature, this chapter focuses not only on the size of the SB as the organ the law delegates monitoring to, but also on the size of the EB since EDs monitor each other, and on that of the *de facto* board (executive board plus supervisory board, EBSB) since this is an important monitor as well.

The law defines a minimum number of directors and leaves it at that. What is the optimal number? A lot of research exists especially on the one–tier board (further: the board). Lipton and Lorsch (1992) argued that the size of the board may inhibit a meaningful dialogue.

> *When a board has more than ten members, it becomes more and more difficult for them all to express their ideas and opinions in the limited time available. This contributes to the expectation (..) that directors are not supposed to voice their opinions freely and frequently (p. 65).*

In fact, they conclude, the norms of behaviour in most boardrooms are dysfunctional. Ten years later, Epstein, Jones and Roy (2002: 7) made a similar assertion. Whilst Lipton and Lorsch (1992) opted for a board size limited to a maximum of ten, favouring eight or nine, Jensen (1993), on similar grounds (he calls it 'board culture': 863), advised a maximum of seven or eight (p. 865). Baker and Gompers (2003: 574) reported for 1,116 companies around their IPO a board size of six (mean and median), while the vast majority of the boards numbered between four and seven. Yermack (1996: 186) reported for a panel of major (Forbes–500 listed) US companies a mean and median board size of twelve. It should be noted that although US firms are on average four times bigger than Dutch companies, the Dutch boards are on average two–thirds the size of US boards (Van

Ees, Postma and Sterken, 2003). It may be concluded that boards grow degressively with the size of the firm.

There is some empirical information on the relationship between board size and performance. Yermack (1996) concludes that small boards are more effective. He reports an inverse association between firm value and board size. Andres, Azofra and Lopez (2005), in a sample of 450 companies from ten countries, found a negative relationship between firm value and board size[6]. They concluded that the disadvantages with regard to communication, flexibility and coordination[7] outweigh the potentially better manager control as a result of a larger board (p. 208). Van Ees, Postma and Sterken (2003) reported for the Netherlands that the size of the EB has no impact, and that of the SB a negative impact on performance. Beiner, Drobretz, Schmid and Zimmerman (2004), however, did *not* find a significant relationship between board size and firm valuation. They concluded that their sample of Swiss firms with a median one–tier board size of six seemed in fact to have chosen their board size optimally: depending on and varying with the underlying environment in which they operated.

The predominant negative relation from the empirical evidence between size and performance allows for the following three hypotheses:

> H_{3a}: *the number of EDs is positively related to financial distress*
> H_{3b}: *the number of NEDs is positively related to financial distress*
> H_{3c}: *the total number of directors is positively related to financial distress.*

H_{3a} and H_{3b} allow for the peculiarities of the Dutch two–tier system, whilst H_{3c} facilitates comparison with international results.

6.2.2.4 *Structural board characteristics*

The *monitoring structure* issue discussed in the previous section was the size of the executive and supervisory board. The monitoring issue of this section concerns the structural composition of the boards in terms of (a) the distribution of insider/outsider directors, (b) independence of, and (3) financial expertise on the supervisory board. Fama (1980), Fama and Jensen (1983), Jensen (1993) argue that a higher proportion of outsider/independent directors on corporate boards would result in more effective monitoring by boards and limit managerial opportunism. As a result corporate governance codes e.g. the Dutch Code III 2; UK Code B.1; and German Code 5.4 (further: DC, UKC and GC) stress the need for independent NEDs and financial know–how on the board. The times when a NED 'was generally chosen by the CEO and expected to do little or nothing other than to attend a reasonable number of board meetings and, (..) broadly, to do as the CEO wished' (Davies, 2008: 402) are over, at least for listed companies. On *outsiders* and *independence*, the UKC prescribes 'Except for smaller companies, at least half the board, excluding the chairman, should comprise NEDs determined by the board to be independent. A smaller company should have at least two independent NEDs' (B.1.2). In Germany, 'the SB shall include what it considers an adequate number of independent members' (GC, 5.4.2). The DC accepts a maximum of one non-independent NED on the board (DC, III.2.1).

Results of empirical studies on the issues are unclear. Monks and Minow (2004) report a steadily increasing number of *outsiders* on the board. Daily (1995 p. 1049) showed that successful reorganizations are characterized by a board which is 65% outsider dominated. It is not clear whether it is the absolute number of outsiders rather than the proportion of outsiders that matters (Gales and Kesner, 1994: 276). Dalton, Daily, Ellstrand and Johnson (1998) found in their meta-analysis of 54 studies no evidence of a link between insider-outsider ratio and company financial performance. Van Ees, Postma and Sterken (2003) even reported a negative relationship between the increased involvement of outsiders and corporate performance in Dutch firms[8]. However, management knowledge and business relations of the board of directors can be highly useful for both the running and the control of the company (Hopt and Leyens, 2004: 164). Thus, the insider/outsider ratio evidence results in a neutral hypothesis:

H_{4a}: the insider/outsider ratio of directors is not related to financial distress

As regards the non-independence issue, Klein (1998) convincingly showed the importance of non-independents on the board. Becht, Bolton and Roëll (2005: 23) report that the findings concerning the effects of independent directors are mixed[9]. Boone, Field, Karpoff and Raheja (2007) found that larger firms have larger and more independent boards. Since the control companies are generally larger (table 6.9) one can expect the control sample to show a more independent board. Therefore, the hypothesis reads:

H_{4b}: the incidence of non-independent NEDs is positively related to financial distress

Another essential SB characteristic is *financial expertise* (Jensen, 1993). At present the UKC (C.3.1) as well as the DC (DC III.3.2) require the presence of financial expertise on the board. Jeanjean and Stolowy (2009) find that financial expertise is positively associated with board independence. Therefore the hypothesis reads:

H_{4c}: the incidence of NEDs with financial expertise is negatively related to financial distress.

H_3 and H_4 derived in the last two sections relate to the *monitoring structure* in the company. The following section focuses on the *monitoring structure.*

6.2.2.5 *Board turnover*

The last agency theory related issue to be tested is the visible *monitoring output* i.e. director turnover. For the Dutch two–tier system this is to be separated in ED and NED turnover.

Most of the literature concerns the American one–tier system. There, the evaluation of the senior management of the company is one of the important responsibilities of the board. Especially outside directors have a specific role in this process because inside directors' careers are more tied to the CEO's (Weisbach,1988). Outside directors have a reputational incentive (Fama and Jensen, 1983) to do so. It signals their competence to the market. Weisbach (1988) found that firms with outsider–dominated boards are significantly more likely to remove the CEO on the basis of performance than firms with insider–dominated boards. The overall number of resignations between the two board types did not differ (p. 454). Gilson (1989) was among the first[10] to study the relationship between management turnover and financial distress. He observes (p. 241):

> *Several types of corporate policy decisions seem likely to be influenced by the personal costs that managers incur if their firms default on their debt. To avoid these costs, managers will rationally favour investment and financing policies that reduce the probability of financial distress.*

Gilson (1989: 242) concluded that managers' default–related losses are significant. He proxies these losses by turnover of senior managers (CEO, president, and chairman of the board). Of all the financially distressed firms 52% experienced a senior level management change, whilst for not distressed but highly unprofitable firms this figure was only 19% (p. 246). None of the departing managers held a senior management position in another exchange–listed firm during the next three years (p. 242). Gilson's (1989) goal was to show that managers *do* incur personal costs when their former firms enter financial distress. Or vice versa: his research also implies that a high turnover of managers in a certain year might be a herald of financial distress. Gilson (1989) describes the relationship between performance and management turnover as follows:

> *There is evidence that less profitable firms show higher turnover, consistent with firms' poor performance being blamed on managers. (..)Financial distress will independently engender higher turnover if an increased probability of default conveys negative information about managerial performance beyond that conveyed by low profits. (p. 256).*

The first relationship can be characterized as *ex post* and the second as *ex ante.* Gilson's (1989: 260) results, as those of Yermack (1996), Lausten (2002), Parker, Peters and Turetsky (2002) and Jostarndt and Sautner (2008), show a significantly higher turnover just before a firm defaults. Daily (1995) describes the years immediately preceding a bankruptcy as typically tumultuous. On the one hand, this could be the result of a voluntary decision of the director to leave the sinking ship in order to avoid the legal, reputational and financial risks of bankruptcy (Daily, 1995: 1042; Gales and Kesner, 1994: 279). On the other hand directors might be looking for a scapegoat and sacrifice a CEO or another executive to show their decisiveness (Weisbach, 1998; Hermalin and Weisbach, 1988; Walsh and Seward, 1990). Dismissal is the most meaningful task for those entrusted with managerial control (Jungmann, 2006: 431). Parker, Peters and Turetsky (2002) report that after CEO change, bankruptcy is twice as likely. It may be a warning of financial distress.

Since the two–tier system recognizes two boards, the EB monitoring itself and the SB monitoring the EB and itself, directors' turnover is tested from three angles:

> H_{5a}: *executive board (EB) turnover is positively related to financial distress*
> H_{5b}: *supervisory board (SB) turnover is positively related to financial distress*
> H_{5c}: *(total) board turnover is positively related to financial distress.*

6.3 DATA

This section describes the collection of the data. It explains the problems met and decisions taken during the process. It subsequently discusses the research period, rights–related data, the board–related data and the financial data. The sampling method is explained in 6.3.6. The section concludes with a general data analysis in 6.3.7. The focus is on data for years t = –2 and t = –3 (t = 0 is the year in which financial distress actually happens) as for bankrupt companies especially financial data for t = –1 is often unavailable.

6.3.1 The research period

This research is on listed Dutch NVs that became financially distressed in the period 1993–2003. This period is chosen because it is a complete economic cycle as figure 6.1 shows. The Dutch economic cycle indicator (CPB–conjunctuurindicator) shows the actual development of the GDP volume in relation to the trend (CPB, 2008). The lowest points in figure 6.1 are in 1993 and 2003, with in between a period of growth followed by a downturn around 2000. Thus, the period 1993–2003 is a complete economic cycle.

6.3.2 Rights–related data

If a company is a 'structure NV' (variable name: STRUCTURED[11]), this implies that the SB has more and the shareholders have fewer rights than in the ordinary NV. If the shares of a company are under certification (CERTIFICATION) shareholders' rights are even more

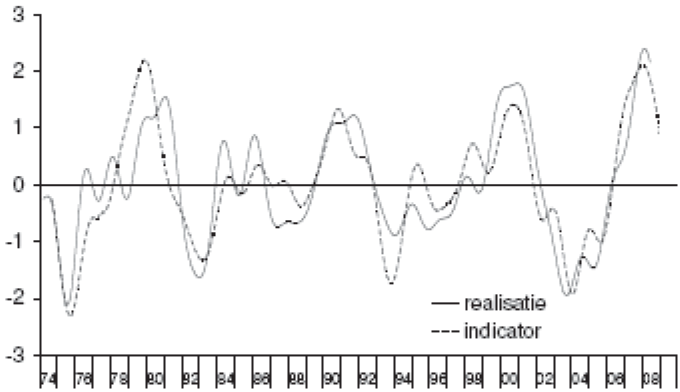

Figure 6.1: Dutch economic cycle indicator
Source: CPB, Macro Economische Verkenning 2009: 45.

curtailed. The data is derived from the annual accounts, REACH[12] or the *Handelsregister*, in that order.

6.3.3 Board–related data

As the Netherlands has a two–tier system, data is collected on the size of the EB (EB), the SB (SB) and the *de facto* total board (EBSB). Thus the *insider/outsider ratio* can be calculated since in the Dutch legal system the EB by law consists of insiders and the SB of outsiders. As for the *independency* of directors, all EDs are non–independent by definition since they are employed by the firm. Therefore, this variable is only measured for the SB. A NED is deemed *independent* if he, or his wife, partner or family member in the second degree, has not been employed by the company in the past five years; does not receive personal benefits from the company; has not had a business relationship (consultancy, counsel, banker and the like) in the year previous to the appointment; is not or does not represent a 10% shareholder; and is not an ED of a company in which an ED of the company he supervises is a NED (cross–directorship)[13]. For *financial expertise* the RA title (AUD), representing an education at university level as certified public auditor (CPA), is the proxy measure. Other reliable and complete data on financial expertise was not available as full disclosure of experience of NEDs was not required at the time. *Directors' turnover* data contains the number of leaving executive (DEB) and non–executive directors (DSB) as well as their total (DEBSB).

Data is (in order of preference) derived from the annual accounts, the *Handboek voor directeuren en commissarissen*[14], REACH, the *Handelsregister*, the WMZ[15] register, journals and in the last resort from reliable internet sources.

6.3.4 Financial data

Based on the current literature e.g. Ohlson (1980), Hill et al. (1996) and Pompe and Bilderbeek (2000) four financial control variables are chosen, which relate to size, leverage, profitability and liquidity. For *size* this study applies LNTA, the natural logarithm of total assets (TA) in millions of Euro. CETA, the *leverage* variable, is the quotient of common equity (CE) and TA. It measures *de facto* the opposite of leverage: solvability, which of course does not influence the results. Pompe and Bilderbeek (2000) show that the best measure of *income* is NITA, the quotient of net income (before extraordinary items; NI) and TA. As a measure of *liquidity* they advise CASHVV (total cash flow divided by all liabilities). Financial data is retrieved from Thomson Worldscope and, in the case of non-availability, from the annual accounts.

6.3.5 Industry data

The data is classified according to the CBS–*Standaard Bedrijfsindeling* 2008 (SBI 2008), based on the *Nomenclature statistique des activités économiques dans la Communauté Européene* (NACE). The first two digits of the SBI 2008 are identical to those of NACE and of the UN International Standard Industrial Classification of All Economic Activities (ISIC). This thesis discerns the economic activity of the companies at the highest description level, called section[16]. The data is retrieved from REACH[17].

6.3.6 Sampling method

The earlier definition of financial distress of 2.2.4 as *the existence of a non–trivial probability that the legal person will not be able to pay its debt within the terms of payment* has to be made operational. In line with Hill, Perry and Andes (1996: 63), Gilson (1989) and Mumford (2003) this study considers a company to be in financial distress if (1) it went bankrupt, was granted suspension of payments or qualified for suspension of listing (*code 1*) or (2) if it suffered at least three years of unintended[18] sequential losses (*code 2*).

Of all the companies listed on the Amsterdam Stock Exchange for three or more years during 1993–2003, 57 became financially distressed. Of these, 34 went bankrupt, were granted suspension of payments or qualified for suspension of listing (code 1). For two out of these 34 companies it was impossible to retrieve data. The other 23 companies of the sample suffered at least three years of unintended sequential losses (code 2). A company with that record normally faces serious financial difficulties. Of these 23 cases, two companies were excluded as they did not meet the additional requirement of a three–year listing[19] before the situation of distress. This requirement was formulated in order to have sufficient data. One foreign company was excluded as it does not have to comply with Dutch company law. As a result the financially distressed sample consists of 32 bankrupt and 20 otherwise financially distressed companies. Table 6.1 shows the composition of both the financially distressed and the control sample.

As Zmijewski (1984) showed, this type of research mostly works with a matched-pairs control sample in order to study the differences between a financially distressed and a 'normal' non-distressed company, further referred to as a 'control' company. A matched-pairs approach presupposes the availability of comparable companies in industry and size in the control sample to match with those of the distressed sample. Since the Netherlands is a relatively small country, these (listed) comparable companies are often lacking. There is no match for bankrupt companies such as Fokker (aviation); DAF (heavy trucks); Homburg (meat processing); Verto (ropes); Tulip (computer assembly); UPC (cable-network); KPN Quest (data storage). This makes a matching approach rather tricky. Therefore the choice has been made to report the results based on a 'complete' control sample as explained below in the text, and to present the 'as-good-as-it-gets' matched-pairs results in Annex 3 and Annex 4. Moreover, Zmijewski (1984: 80) argues that the resulting bias 'does not appear to affect the statistical inferences or overall classification rates.'

The 'complete' control sample used in the chapters 6 and 7 consists of 149 companies listed for five or more years during 1993-2003. The five-year criterion is set in order to have stable and well-organized companies in the control sample. If a company merged or de-listed after two years of consecutive losses it fell out of the control sample because

Table 6.1: composition of the control sample and the financially distressed sample over the years

year	distressed firms				control sample	
(1)	*code 1* (2)	*code 2* (3)	*total* (4)	*%* (5)	*code 0* (6)	*%* (7)
1993	7	1	8	15.4	22	14.8
1994	0	1	1	1.9	3	2.0
1995	1	0	1	1.9	3	2.0
1996	2	0	2	3.8	5	3.4
1997	1	0	1	1.9	3	2.0
1998	1	0	1	1.9	3	2.0
1999	1	1	2	3.8	6	4.0
2000	2	5	7	13.5	20	13.4
2001	7	2	9	17.3	26	17.4
2002	9	3	12	23.1	35	23.5
2003	1	7	8	15.4	23	15.4
total	32	20	52	100	149	100

Code 0: a control sample company (a company not coded 1 or 2)
Code 1: a company in bankruptcy, suspension of payments, default or (qualifying for) suspension of listing
Code 2: a company with three years of sequential losses.

this merger or delisting could indicate financial distress. In the case of a merger between listed companies, either the new or the merged company could qualify for the control sample. Banks, insurance companies, investment funds, real estate funds and foreign companies were excluded from the study (Hermalin and Weisbach, 1988). Companies from the control sample were proportionally and randomly assigned over the years according to the percentage of financially distressed companies in each year. As a result the percentages of table 6.1 column 7, indicating the percentages of control companies assigned to a given year, are almost identical to those of column 5, indicating the percentage of financially distressed companies in each of the 11 years under research. Due to data shortage, a 100% identical distribution could not be organized.

6.3.7 General data overview

Table 6.2 presents a first glance at the monitoring rights, monitoring structure, and monitoring output related data. The statistical analysis follows in section 6.5. For now it is striking that the control sample firms are predominantly 'structure NVs' with larger, less often fully independent boards suffering considerably less directors' turnover than their financially distressed equals.

Table 6.2: an overview of the NED rights, shareholders' rights, board size, board composition and board turnover related data for the control sample and the financially distressed sample of listed Dutch companies from 1993 to 2003, based on data for t = –2 and t = –3 before the financial distress event occurred.

	control sample		distressed sample		full panel	
	number	percentage	number	percentage	number	percentage
number of observations	298	74	104	26	402	100
rights-related:						
structure NV (STRUCTURED°)	186	62	40	38	226	56
certificaat (CERTIFICATION°)	92	31	26	25	118	29
board- related:						
total board (EBSB) > 9	76	26	18	17	94	23
total board (EBSB) < 5	32	11	15	14	47	12
fully independent board (DEPDM)	139	47	63	62	202	50
financial expert on the SB (AUDDM)	36	12	15	14	51	13
board turnover related:						
total director turnover (DEBSB)> 2	23	8	20	19	43	11
total director turnover (DEBSB)= 0	140	47	39	38	179	45

° Based on research on t = –2.

6.4. METHOD

This section explains the statistical and econometric methods applied in this study. The explanation restricts itself to the aim of the method applied. The theoretical underpinning of the various methods applied may be found in statistical and econometric handbooks, e.g. Studenmund (2001), Rijken Van Olst (1974).

6.4.1. Panel analysis

Panel analysis means an analysis of the data for different frames, in this case for the time frames t = –2 and t = –3. It allows for comparison of results and for the detection of an evolutionary pattern. The time frame t = –1 is lacking since bankrupt companies seldom disclose the results of their last year.

6.4.2. Data descriptives and analysis of mean and distribution

Data descriptives as minimum, maximum, mean and median, standard deviation are important to signal mistakes or omissions in the data or to control for outliers. A difference in mean and median indicates a skewness of the distribution of the data. In a normal distribution, the average of all observations (mean) and the middle observation (median) are equal. The skewness can be shown by a measure or through graphs or box plots, but the observation in a table of mean, median and standard deviation is deemed sufficient for the purpose. If mean and median differ unacceptably[20], the normal distribution presumption cannot hold and the *t–test* cannot be used to analyse the differences of mean between the samples. Moreover, in order to run a *t–test*, the variables should be of a scale nature. Quite a lot of the variables applied in this study are of a categorical, more specific: of a dichotomous, also called: dummy, nature. In these cases where a normal distribution cannot be presupposed, or the variables are not of a scale nature, *non–parametric tests* should be applied. Of these, the Mann–Whitney test (the result of which is the *z–value* in the tables) is applied to test whether a variable is equally divided over the control sample and the financially distressed sample. The null hypothesis is that the variable is equally divided over both samples. The Mann–Whitney test requires ordinal variables. However, a dichotomous, or dummy, variable can be considered ordinal (Rijken Van Olst, 1974). If the categorical variable has more than two categories, a *Pearson* χ^2*–test* tests the relationship with another variable. The null hypothesis is that the distribution of the one variable is independent of the other. The *t–values* are only reported in the tables if the variables are indeed normally distributed and of a scale nature.

6.4.3 Correlation and multicollinearity

A correlation table shows whether dependent variables are related. It should be thoroughly analysed since the nature and strength of the relationships is interesting information in itself and it may determine the model specification as well. One of the assumptions of the classical model of econometrics is that no explanatory variable is a perfect linear function of any other explanatory variable(s) (Studenmund, 2001: 90). If this assumption is fully or partly violated, perfect or imperfect multicollinearity is at hand and one may have to adjust the model, although this will not always be necessary (Studenmund, 2001: 265). At first, it is important to detect relationships between explanatory variables. For *categorical*, also called *nominal* variables there is the *Pearson* χ^2 *test*. The null hypothesis is that the variables are independent. If they are not, a *contingency coefficient* is calculated, to indicate the strength of the relationship. An example of such a coefficient is *Cramérs V*, where $0 \geq V \leq 1$; V = 0 means no relationship, V = 1 a perfect relationship. For *ordinal* variables, including dichotomous variables, *Spearman's rho* decides on the relationship ($-1 \geq \rho \leq 1$). For a perfect positive (negative) linear relationship $\rho = 1$ (-1); $\rho = 0$ signifies the absence of a relationship. For scale variables the *Pearson correlation coefficient r* determines the relationship question. The *determination coefficient* (r^2) signifies the percentage of variance explained. Then, if the contingency coefficient > 0.75 or if the correlation coefficient r > 0.8 (the numbers are somewhat arbitrary), this indicates[21] multicollinearity and one should critically rethink the model to be tested (Studenmund, 2001: 256, 258).

6.4.4 Control variables

Bankruptcy is essentially a financial problem. An approaching bankruptcy is visible in almost every dimension of a firm's position (Pompe and Bilderbeek, 2005). Therefore *financial* variables should always be added in a logit analysis of financial distress. These variables are called *control variables*, because without financial variables each regression analysis on the subject would be meaningless. A proper study in this field should also consider the effects of the *industry* of the company (Hill, Perry and Andes (1996); Mossman (1998); Andres, Azofra and Lopez (2005). The industry classification is a categorical variable, which is applicable in a logit analysis.

6.4.5 Hypothesis testing

Economic theory and empirical literature determine the formulation of the hypotheses in section 6.2. The actual hypothesis tested is always that dictated by statistical theory: a null hypothesis which states that there is no relation, and an alternative hypothesis which states that there is a relation irrespective of the direction of this relation. The outcome of this test can either support ('non-rejection') or falsify ('rejection') the formulated hypothesis. A theoretically more correct approach would have been to formulate two hypotheses for each issue: a null hypothesis that there is no relation or no difference and an alternative hypothesis that a variable is negatively or positively related to another variable or larger or smaller on one sample than in the other (Studenmund, 2001: 115). In order to ameliorate the readability of this thesis this is avoided. However, all hypotheses are tested two-tailed which means that no specific direction of the result is tested in order to cover results in another direction than expected as well.

6.4.6 Logit analysis

The analysis results in the presentation of a regression model, wherein independent variables calculate the likelihood of financial distress. Note that regression cannot confirm causality; it can only test the strength and direction of quantitative relationships involved (Studenmund, 2001: 8). Below two types of regression analyses are presented: univariate and multivariate regression. The *univariate* regression shows whether the dependent and the independent variable are related. The *multivariate* analysis shows the regression results of a specified model with several independent explanatory variables.

Financial distress is treated as a binary situation. Therefore, the model should only have an outcome 0 or 1 for the financially distressed state of the company. This can be achieved through a special form of logarithmic regression, *logit* analysis. Logit analysis estimates the *logit = ln (p/(1–p))* as the dependent variable, wherein p is the chance of financial distress. From:

(1) $ln\ (p/(1-p)) = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \varepsilon = z$

where p = the chance of distress, follows:

(2) $p/(1-p) = e^{z}$, or
(3) $p = 1 / (1 + e^{-z})$,
it is clear that $0 > p < 1$.

Logit analysis is essentially a regression analysis with a binary dependent variable (Studenmund, 2001: 442). Ohlson (1980: 112) showed logit analysis to be superior to Multiple Discriminant Analysis (MDA), as used by Altman (1968) and many others. And although Aziz and Dar (2006) find that MDA has been used more often than logit analysis in bankruptcy prediction research over the period 1968–2002, they also show that the predictive accuracy in logit is higher overall. This study therefore applies logit analysis.

6.4.7 Prospective analysis

With the logit analysis to be performed in section 6.5.9 comes a 'classification table' which confronts the 'observed' values with the 'predictions' by means of the model and reports a 'percentage correct' and an 'overall percentage correct' of the prediction. However, this 'overall percentage correct', sometimes indicated as 'classification accuracy' or 'overall predictive accuracy' (e.g. Aziz and Dar, 2006), is a disturbing figure since it adds up the accurate classification in *two* categories, i.e. the distressed and the control sample. Thus, this figure has no meaning for *one* of the categories. This thesis therefore presents both classification figures by means of the Type I error and the Type II error (Studenmund, 2001:116). The Type I error occurs if the null hypothesis is rejected when it is true. The Type II error occurs if the null hypothesis is not rejected when it is false. Remarkably economists often omit to define the null hypothesis (Altman (1968), Collins and Green (1982), Holmen (1988), Aziz and Dar (2006). In this case the null hypothesis should be: the company is *not* financially distressed i.e. it is a 'control sample company' since this is the normal type of company. The Type I error stands for a control sample company erroneously classified as a financially distressed company, also called: a False Positive. Here, positive means: a 'hit' i.e. a financially distressed company. The Type II error stands for a financially distressed company erroneously classified as a control company, also called: a False Negative. Here, negative means: classified in accordance with the null hypothesis i.e. as a non-financially distressed company. For banks a thus defined Type II error has a more serious effect than a Type I error: by missing a customer as a consequence of a Type I error the bank suffers opportunity costs, whilst a Type II error jeopardizes the total amount the customer has borrowed. Note that this logic reasoning leads to a Type I and Type II definition opposite to the current literature from Altman (1968) to Aziz and Dar (2006); and in line with Bollen, Mertens, Meuwissen, Raak and Schelleman (2005).

6.5 RESULTS

This section reports the statistical results of the various tests applied. In accordance with the state of the art, the tables report only those results with asterisks that are statistically significant at a $p < 0.001$ (***) level of reliability; at a $0.001 \le p < 0.01$ (**) level of reliability; and at a $0.01 \le p < 0.05$ (*) level of reliability. The tables do not show p-values. An often reported higher p-value ($0.10 \le p \ge 0.05$) is indicated with an ([a]) in the table.

6.5.1 Supervisory board rights

As described in chapter 4 and in 6.2.2.1, under the 'structure' regime the SB had some very strong rights, at least in the period under research. Due to data restrictions, the analysis is on the $t = -2$ panel only. Table 6.3 shows that whilst the majority of control

Table 6.3 : An analysis of the SB rights related 'structured' variable for the control sample and the financially distressed sample of listed Dutch companies from 1993 to 2003, based on data for t = –2 before the financial distress event occurred.

variable	control sample number	control sample min (max)	control sample incidence as % sub-sample	financially distressed sample number	financially distressed sample min (max)	financially distressed sample incidence as % sub-sample	difference in distribution (|z-value|)
t = -2							
STRUCTURED	149	0 (1)	62.42 %	52	0 (1)	38.46 %	(4.23)***

***, ** and * indicate statistical significance at a 0.1%, 1% and 5% level, respectively.
STRUCTURED dummy variable indicating the application of the 'structure' regime to the company.

sample companies is structured (93 out of 149, or 62.4%), the majority of financially distressed companies is not. Only 20 out of 52 financially distressed companies (38.5%) are 'structure NVs'. This may be due to the small size of financially distressed companies, or to their rapid growth, as the conversion into a 'structure NV' always lags behind[22]. From the results of the Mann–Whitney test in the last column it becomes clear that the distribution of the structured variable is significantly different over the samples. Financially distressed companies are significantly less often a 'structure NV' at the 0.1% level.

6.5.2 Shareholders' rights

The incidence of certification influences shareholders' rights. Without certification, shareholders have fewer impediments to exercise their rights. Due to data restrictions, the analysis is on the t = –2 panel only. Table 6.4 shows that a minority of control sample companies is certified (46 out of 149, or 30.9%). The same goes for financially distressed companies. Only 13 out of 52 financially distressed companies (25%) are certified, even less than the percentage for the control group. The low *z–value* from the Mann–Whitney test implies that there is no difference in distribution of the variable, meaning that the samples do not statistically differ significantly on the issue.

Table 6.4: An analysis of the shareholders' rights impeding 'certification' variable for the control sample and the financially distressed sample of listed Dutch companies from 1993 to 2003, based on data for t = –2 before the financial distress event occurred.

variable	control sample number	control sample min (max)	control sample incidence as % sub-sample	financially distressed sample number	financially distressed sample min (max)	financially distressed sample incidence as % sub-sample	difference in distribution (|z-value|)
t = –2							
CERTIFICATION	149	0 (1)	30.87 %	52	0 (1)	25.00 %	(1.13)

***, ** and * indicate statistical significance at a 0.1%, 1% and 5% level, respectively.
CERTIFICATION dummy variable indicating the certification of the shares of the company.

Table 6.5: An analysis of the board size related variables for the control sample and the financially distressed sample of listed Dutch companies from 1993 to 2003, based on panel data for t = –2 and t = –3 before the financial distress event occurred.

board variable	control sample				financially distressed sample				difference |t-value| (|z-value|)
	number	min (max)	mean (median)	standard deviation	number	min (max)	mean (median)	standard deviation	
t = –2									
EB	149	1	2.99	1.62	52	1	2.83	1.82	(1.24)
		(10)	(3)			(9)	(2)		
SB	149	2	4.90	1.94	52	2	4.27	1.88	(2.29)*
		(13)	(5)			(10)	(4)		
EBSB	149	3	7.89	3.08	52	3	7.10	3.18	(2.07)*
		(21)	(7)			(18)	(6)		
EBLNTA	149	0.19	0.54	0.24	52	0.13	0.64	0.35	(1.77)[a]
		(1.52)	(0.50)			(1.81)	(0.61)		
SBLNTA	149	0.40	0.90	0.27	52	0.25	0.99	0.42	(1.07)
		2.84	0.88			2.50	0.90		
EBSBLNTA	149	0.69	1.44	0.38	52	0.61	1.64	0.65	(1.87)[a]
		3.55	1.39			4.00	1.58		
t = –3									
EB	149	1	3.01	1.52	52	1	2.83	1.75	(1.18)
		(8)	(3)			(8)	(2)		
SB	149	2	4.89	2.01	52	2	4.29	1.82	(1.99)*
		(14)	(5)			(11)	(4)		
EBSB	149	3	7.91	3.06	52	3	7.12	2.89	(1.86)
		(18)	(7)			(17)	(6)		
EBLNTA	149	0.17	0.58	0.28	52	0.14	0.68	0.56	(0.69)
		(1.68)	(0.52)			(3.78)	(0.57)		
SBLNTA	149	0.39	0.93	0.28	52	0.37	1.00	0.42	(0.50)
		2.26	0.91			2.28	0.97		
EBSBLNTA	149	0.64	1.50	0.44	52	0.67	1.68	0.82	(0.80)
		3.76	1.40			5.67	1.53		

***, ** and * indicate statistical significance at a 0.1%, 1% and 5% level, respectively.
[a] indicates statistical significance at a 10% level.

EB	the number of members of the executive board (EDs) at year–end
SB	the number of members of the supervisory board (NEDs) at year–end
EBSB	the total number of members of the executive and supervisory board (directors) at year–end
MBLNTA	EB divided by the natural logarithm of totals assets (TA)
SBLNTA	SB divided by the natural logarithm of totals assets (TA)
EBSBLNTA	EBSB divided by the natural logarithm of totals assets (TA).

6.5.3 Board size

Table 6.5 presents a description of the data and the results of the tests on the difference in distribution (*Mann–Whitney*) for board size related variables. A *t–test* is not allowed since the distribution of the data is skewed. Each panel starts with the absolute numbers of directors. In median terms, the number of EDs (EB), NEDs (SB) and of total directors (EBSB) is larger by one person in the control group. The total number of directors in the control sample is eight (mean) respectively seven (median). This is in line with the number advised by Jensen (1993) and found by Baker and Gompers (2003) for IPO firms in the USA (see 6.2.2.3). The results of table 6.5 show a statistically significant difference in distribution of NEDs at the 5% level: there are fewer NEDs on distressed boards and fewer directors (t = –2 only). However, for the analysis of the number of directors the size of the company may play a role. A large company obviously needs more directors than a small one. Yermack (1996) and Andres et al. (2005) therefore took the logarithm of board size into account as well. This method reduces the differences between board sizes, but the (not–reported) results proved essentially identical to the results for the size numbers.

Intuitively it would be better to relate board size to firm size and to connect this with the finding of a degressive board size mentioned in 6.2.2.3. This results in three new variables wherein board size is divided by the natural logarithm of size (LNTA): EBLNTA for the EB, SBLNTA for the SB and EBSBLNTA for the 'total board'. Indeed, table 6.5 shows a higher mean and median for these standardized board–size variables in the financially distressed sample, albeit only significantly different for EBLNTA and EBSBLNTA for t = –2 at the 10% level. Note that here, as in the following tables, the high standard deviations are remarkable. This means that the spread of the results is large and that the mean should be interpreted cautiously.

6.5.4 Structural board characteristics

Table 6.6 presents the results of the structural characteristics insider/outsider ratio, SB independence and SB financial expertise. The table shows only *z–values* since the distribution of all variables is skewed. Table 6.6 shows that the control group SB in t = –2 is statistically significantly more often not fully independent (DEPDM) at the 5% level and that the percentage of non–independent NEDs on the control sample board is then higher at the 10% level. These results do not show in t = –3. However, the figures show a movement in the distressed sample from t = –3 to t = –2 towards fewer non–independents on the SB: DEPDM falls by 3.8% point and the average DEPPERC by 1.6% point. Neither the insider/outsider ratio nor the financial expertise variable shows a significant difference between the samples. The latter may have to do with the relatively low incidence of 12–14% of RAs on the SB.

Table 6.6: An analysis of the structural SB characteristics 'insider/outsider ratio', 'SB-independence' and 'SB financial expertise' for the control sample and the financially distressed sample of listed Dutch companies from 1993 to 2003, based on panel data for t = −2 and t = −3 before the financial distress event occurred.

board variable	control sample				financially distressed sample				difference in distribution (|z-value|)
	number	min (max)	mean (median)	standard deviation	number	min (max)	mean (median)	standard deviation	
t = −2									
EBRATIO	149	0.17	0.37	0.11	52	0.14	0.39	0.13	(0.31)
		(0.67)	(0.38)			0.67	(0.38)		
#DEP	149	0	0.89	1.09	52	0	0.85	1.56	(1.54)
		(4)	(1)			(8)	(0)		
DEPPERC	149	0	18.58	22.07	52	0	14.37	22.65	(1.67)[a]
		(100)	(12.50)			(88.89)	(0)		
DEPDM	149		54.36%		52		38.46 %		(1.97)*
AUDDM	149		12.08%		52		13.46 %		(0.26)
t = −3									
EBRATIO	149	0.14	0.37	0.11	52	0.17	0.38	0.15	(0.17)
		(0.67)	(0.38)			0.71	(0.34)		
#DEP	149	0	0.87	1.11	52	0	0.87	1.50	(0.92)
		(4)	(1)			(7)	(0)		
DEPPERC	149	0	18.05	22.22	52	0	15.96	23.81	(1.03)
		(100)	(11.11)			(87.50)	(0)		
DEPDM	149		51.68 %		52		42.30 %		(1.16)
AUDDM	149		12.08 %		52		15.38 %		(0.54)

***, ** and * indicate statistical significance at a 0.1%, 1% and 5% level, respectively.
[a] indicates statistical significance at a 10% level.
Of the dummy variables DEPDM and AUDDM only the incidence as a percentage of the relevant sample and the z-value is reported.

EBRATIO	the number of executive directors as fraction of the total number of directors
#DEP	the number of non-independent NEDs on the SB at year-end
DEPPERC	the percentage of non-independent NEDs on the SB at year-end
DEPDM	dummy variable indicating the presence of one or more non-independent NEDs on the SB at year-end
AUDDM	dummy variable indicating the presence of a CPA (Registeraccountant, RA) on the SB at year-end.

6.5.5 Board turnover

This study defines board turnover as EDs leaving the EB respectively NEDs leaving the SB, for whatever reason. The latter choice is made because a truly objective classification of reasons for resignation is not deemed possible (Jungmann, 2006: 442). As financially distressed companies' directors are generally younger (results presented in chapter 7) than the control group, it can be expected that these firms show less retirements. So, a bias might occur towards more 'resignations' in the control group.

The definition of the variables in table 6.7 is both *absolute* as the *number* of leaving directors on the EB (DEB), on the SB (DSB) and on the total board (DEBSB) as well as *relative* vis–à–vis the number of directors at year–end on the EB (EBTO), on the SB (SBTO)

Table 6.7: An analysis of board turnover variables for the control sample and the financially distressed sample of listed Dutch companies from 1993 to 2003, based on panel data for t = –2 and t = –3 before the financial distress event occurred.

turnover variable	control sample				financially distressed sample				difference in distribution (|z-value|)
	number	min (max)	mean (median)	standard deviation	number	min (max)	mean (median)	standard deviation	
t = –2									
DEB	149	0	0.51	0.70	52	0	0.94	1.17	(1.88)[a]
		(4)	(0)			(4)	(0)		
DSB	149	0	0.47	0.72	52	0	0.71	0.85	(2.04)*
		(3)	(0)			(3)	(1)		
DEBSB	149	0	0.98	1.07	52	0	1.65	1.70	(2.34)*
		(6)	(1)			(6)	(1)		
EBTO	149	0	20.63	41.28	52	0	39.65	57.70	(1.82)[a]
		(400)	(0)			(300)	(0)		
SBTO	149	0	10.61	18.08	52	0	22.04	34.12	(2.41)*
		(100)	(0)			(150)	(10.56)		
EBSBTO	149	0	13.39	20.42	52	0	26.57	31.26	(2.91)**
		(200)	(10)			(125)	(20.00)		
t = –3									
DEB	149	0	0.37	0.70	52	0	0.54	0.94	(1.13)
		(3)	(0)			(5)	(0)		
DSB	149	0	0.45	0.85	52	0	0.71	1.21	(1.18)
		(5)	(0)			(6)	(0)		
DEBSB	149	0	0.82	1.20	52	0	1.25	1.72	(1.40)
		(6)	(0)			(8)	(1.00)		
EBTO	149	0	15.50	37.10	52	0	30.22	76.76	(1.27)
		(300)	(0)			(500)	(0)		
SBTO	149	0	8.71	16.03	52	0	19.44	33.57	(1.50)
		(100)	(0)			(150)	(0)		
EBSBTO	149	0	10.21	14.47	52	0	21.63	36.90	(1.78)
		(62.50)	(0)			(200)	(10.00)		

***, ** and * indicate statistical significance at a 0.1%, 1% and 5% level, respectively.
[a] indicates statistical significance at a 10% level.

DEB	the number of members of the executive board (EDs) that resigned during the year
DSB	the number of members of the supervisory board (NEDs) that resigned during the year
DEBSB	the total number of members of the EB and SB (directors) that resigned during the year
EBTO	the quotient of DEB and EB (the number of EDs at this year's end)
SBTO	the quotient of DSB and SB (the number of NEDs at this year's end)
EBSBTO	the quotient of DEBSB and EBSB (the number of directors at this year's end).

and in sum (EBSBTO). This explains the rather high maximum turnover (TO) percentages reported. Since the distribution of all variables is skewed, only the *z–value* of the Mann Whitney test is reported in the table. Turnover of directors is, as expected, higher in the financially distressed group in all specifications both in t = –2 and t = –3. The differences between the control and the financially distressed sample are statistically significant in t = –2 at the 10% level for the EB related variables and at the 5% level for the SB and total directors–related variables. In t = –3 none of these variables prove significantly different.

6.5.6 Industry analysis

Table 6.8 presents the results of the analysis for the t = –2 panel. The first two rows show the division of the samples over the industry sectors. The main groups of the total sample are manufacturing companies (41%), followed by ICT–related companies (20%) and trading companies (17%). The Pearson χ^2 test value shows that the variables financial distress and industry sector are statistically significantly not independent at a 0.1% level of significance, or, to put it differently, that the incidence of financial distress is not stochastically distributed over the industry sectors. Indeed, it becomes clear from table 6.8 that 40.4% (21 out of 52) of all financially distressed companies are in ICT business, twice as much as would be expected from the incidence in the total sample. The strength of the connection however, shown by the Cramér's V contingency coefficient, is rather low and just surpasses the level of a weak relationship.

Table 6.8: An analysis of the economic activity ('industry') of the control sample and the financially distressed sample of listed Dutch companies from 1993 to 2003, based on panel data for t = –2 before the financial distress event occurred.

economic activity	*manufacturing*	*construction*	*trade*	*transport*	*ICT*	*services*	*other°*	*total*
control sample	66	13	29	13	19	6	3	149
financially distressed	17	0	6	1	21	5	2	52
as % of total sample	41.3	6.5	17.4	7.0	19.9	5.5	2.4	100
Pearson χ^2	54.51 ***							
Cramer's V	0.368							

***, ** and * indicate statistical significance at a 0.1%, 1% and 5% level, respectively.
° Column contains industries that did not meet the requirement of the test.

6.5.7 Financial control variables

Table 6.9 presents the results of the analysis of the financial control variables. Size (LNTA), income (NITA) and cash flow (CASHVV) are consistently higher for the control group and differ statistically significantly on all panels between the samples at the 1% level. Thus, size and the yearly income and cash flows are the important distinctive factors between the control and the financially distressed sample. Most striking from table 6.9

Table 6.9: An analysis of the applied financial control variables for the control sample and the financially distressed sample of listed Dutch companies from 1993 to 2003, based on panel data for t = –2 and t = –3 before the financial distress event occurred.

financial variable	control sample				financially distressed sample				difference
	number	min (max)	mean (median)	standard deviation	number	min (max)	mean (median)	standard deviation	|t-value| (|z-value|)
t = –2									
LNTA	149	1.41	5.61	1.97	52	1.96	4.67	1.93	2.95**
		(10.93)	(5.46)			(9.38)	(4.32)		(3.12)**
CETA	149	0.02	0.37	0.17	52	0.01	0.33	0.21	1.09
		(0.92)	(0.34)			(0.85)	(0.30)		(1.60)
NITA	149	–0.11	0.07	0.06	52	–3.08	–0.15	0.50	3.19**
		(0.31)	(0.06)			(0.27)	(-0.05)		(8.02)***
CASHVV	149	–0.06	0.24	0.29	52	–4.68	–0.14	0.75	3.58**
		(2.68)	(0.17)			(0.73)	(0.00)		(7.57)***
t = –3									
LNTA	149	1.33	5.42	1.94	52	1.05	4.68	1.87	2.42**
		(10.82)	(5.38)			(8.82)	(4.29)		(2.45)**
CETA	149	0.04	0.37	0.16	52	0.04	0.39	0.21	0.69
		(0.87)	(0.36)			(0.93)	(0.34)		(0.20)
NITA	149	–0.29	0.07	0.07	52	–1.58	–0.01	0.27	3.26**
		(0.32)	(0.06)			(0.20)	(-0.08)		(5.88)***
CASHVV	149	–0.20	0.24	0.23	52	–4.80	–0.05	0.76	2.70**
		(1.74)	(0.18)			(0.54)	(0.00)		(4.74)***

***, ** and * indicate statistical significance at a 0.1%, 1% and 5% level, respectively.

LNTA	the natural logarithm of total assets (TA) in millions of euros (size measure)
CETA	common equity (CE) divided by TA (leverage measure)
NITA	net income (before extraordinary items; NI) divided by TA (income measure)
CASHVV	cash flow (CASH) divided by TA (liquidity measure).

is the absence of any statistical significance of the leverage measure (CETA). Apparently, financial structure does not differ significantly between the groups over both periods.

6.5.8 Correlation and multicollinearity

Table 6.10 shows the correlation between the agency theory related variables as developed in this chapter. These variables will be applied in a regression analysis in the next section. The choice for these variables will be explained in the next section. Table 6.10 shows that a larger firm (LNTA) requires statistically significantly relatively less equity (CETA) and shows less cash flow (CASHVV). It is often a 'structure NV', it has 'certification' of shares, it has a relatively small and not fully independent supervisory board and change of executives happens relatively often. It is also clear that executive director turnover (DEB) is negatively related with leverage, income and cash flow thus: less turnover as long as the signs are green.

Table 6.10: A correlation analysis of the agency theory related variables for the control sample and the financially distressed sample of listed Dutch companies from 1993 to 2003, based on panel data for t = –2 and t = –3 before the financial distress event occurred.

	LNTA	CETA	NITA	CASH VV	STRUCT	CERT	SB LNTA	EB RATIO	DEPDM	AUD DM
LNTA	1									
CETA	–0.34**	1								
NITA	0.00	0.25**	1							
CASHVV	–0.12*	0.49**	0.83**	1						
STRUCTURED	0.15**	–0.08	0.02	0.06	1					
CERTIFICATION	0.10*	0.00	0.00	0.04	0.11*	1				
SBLNTA	–0.29**	0.22**	0.05	0.10	0.01	0.09	1			
EBRATIO	0.06	–0.04	0.11*	0.04	–0.09	–0.18**	–0.40**	1		
DEPDM	0.17**	0.05	0.09	0.08	–0.06	–0.07	0.13**	–0.06	1	
AUDDM	–0.01	–0.13**	–0.05	–0.07	0.04	0.15**	–0.02	–0.05	–0.08	1
DEB	0.22**	–0.11*	–0.12*	–0.10*	0.00	–0.02	–0.09	0.04	0.07	–0.06

** and * indicate statistical significance at a 1% and 5% level, respectively (two–tailed).
Variables defined in table 6.11.

In table 6.10 CASHVV and NITA present a correlation of 0.83. Whilst some argue that a correlation coefficient of 0.9 indicates multicollinearity, Studenmund (2001) suggests 0.8. The detected correlation is strange since the four elements of the ratios are by no means strictly related. The high correlation may be coincidental. At any rate this may be a case to apply the 'do–nothing' strategy of Studenmund since the literature prescribed the use of an 'income' variable and a 'liquidity' variable. Besides, a change of variables would not help very much. Alternative cash flow and income variables such as NICE (net income/ common equity) and CASHTA (cash flow/ total assets) show similar high correlation coefficients (not reported). Moreover, the aim of this chapter is not to develop a perfect model but to show whether agency theory related variables add explanatory power to a financial ratio based model.

6.5.9 Regression results

Univariate regression

The regression analysis starts with a univariate logit analysis to show the relationships between the agency theory related variables developed above and financial distress. Based on the theory and the results of table 6.11 four models have been developed. Their formulation is in the header of table 6.12. Model 1, the *financial control* model, contains the financial control variables on size, leverage, income and cash flow and the industry classification as explanatory variables of financial distress. This is the basic model, originating from the literature. Agency theory related variables subsequently adapt this model, as follows. The *monitoring rights model* (model 2) adds the STRUC–

Table 6.11: Univariate regression analysis on agency theory related characteristics of the control sample and the financially distressed sample of listed Dutch companies from 1993 to 2003, based on panel data for t = –2 respectively t = –3 before the financial distress event occurred.
model: $DISTRESS \approx \alpha + \beta_1(variable)$

variable	description	t = –2	t = –3
monitoring rights related STRUCTURED	structure NV	–0.98**	–0.98**
CERTIFICATION	dummy = 1 if depository share receipt	–0.29	–0.29
monitoring structure related *board size* EB	number of executive directors (ED)	–0.06	–0.08
SB	number of non-executive directors (NED)	–0.19*	–0.18[a]
EBSB	number of ED + NED	–0.09	–0.09
EBLNTA	EB divided by LNTA (degressive size measure)	1.24*	0.68
SBLNTA	SB divided by LNTA (degressive size measure)	0.85[a]	0.64
EBSBLNTA	EB divided by LNTA (degressive size measure)	0.82*	0.50[a]
structural SB characteristics EBRATIO	number of ED as percentage of total directors	1.07	0.56
#DEP	number of non-independent NEDs	–0.03	0.00
DEPPERC	percentage of non-independent NEDs on the SB	–0.01	–0.01
DEPDM	dummy = 1 if non-independent NED on the SB	–0.65*	–0.38
AUDDM	dummy = 1 if financial expertise (RA) on the SB	0.12	0.28
monitoring output related DEB	leaving EDs in year	0.53**	0.26
DSB	leaving NEDs in year	0.39[a]	0.26[a]
DEBSB	leaving EDs + NEDs in year	0.37**	0.21[a]
EBTO	leaving EDs in year divided by EB end of year	0.01*	0.01
SBTO	leaving NEDs in year divided by SB end of year	0.02**	0.02**
EBSBTO	leaving EDs + NEDs in year div.by EB+SB end of year	0.02**	0.02**
financial control variables LNTA	natural logarithm of total assets (degressive size measure)	–0.26**	–0.22*
CETA	common equity divided by total assets	–1.12	0.71
NITA	net income (before extraordinary items) divided by total assets	–25.21***	–12.21***
CASHVV	cash flow divided by total debt	–9.84***	–4.58***
SBICAT	industry classification	**	**

***, ** and * indicate statistical significance at a 0.1%, 1% and 5% level, respectively.
[a] indicates statistical significance at a 10% level. Distress = ln (p / 1–p).

TURED and CERTIFICATION variables to see if the additional SB rights or the curtailing of shareholders' rights have an additional explanatory value. The *monitoring structure model* (model 3) tests whether supervisory board size (SBLNTA) and supervisory board structure related variables such as the ratio insiders/outsider directors (EBRATIO), full independence (DEPDM), and financial expertise on the board (AUDDM) have additional

Table 6.12: A logit analysis of the financial control, and agency theory related variables for the control sample and the financially distressed sample of listed Dutch companies from 1993 to 2003, based on panel data for t =–2 and t = –3 before the financial distress event occurred.

model 1: $DISTRESS \approx \alpha + \beta_1 LNTA + \beta_2 CETA + \beta_3 NITA + \beta_4 CASHVV + \beta_5 industry + \varepsilon$

model 2: $DISTRESS \approx \alpha + \beta_1 LNTA + \beta_2 CETA + \beta_3 NITA + \beta_4 CASHVV + \beta_5 industry + \beta_6 STRUCTURED + \beta_7 CERTIFICATION + \varepsilon$

model 3: $DISTRESS \approx \alpha + \beta_1 LNTA + \beta_2 CETA + \beta_3 NITA + \beta_4 CASHVV + \beta_5 industry + \beta_8 EBRATIO + \beta_9 SBLNTA + \beta_{10} DEPDM + \beta_{11} AUDDM + \varepsilon$

model 4: $DISTRESS \approx \alpha + \beta_1 LNTA + \beta_2 CETA + \beta_3 NITA + \beta_4 CASHVV + \beta_5 industry + \beta_{12} DEB + \varepsilon$

	exp. sign[1]	*t =-2*				*t =-3*			
		model 1	model 2	model 3	model 4	model 1	model 2	model 3	model 4
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
financial variables LNTA	–	–0.40**	–0.41**	–0.33*	–0.53**	–0.16	–0.16	–0.08	–0.19
CETA	–	–1.74	–1.76	–2.13	–2.83	2.90	2.94	2.90	2.83
NITA	–	–20.60**	–21.09**	–22.60**	–18.18**	–6.80	–5.88	–7.04	–5.96
CASHVV	–	–2.05	–2.27	–1.40	–4.06	–5.30	–5.65[a]	–5.30[a]	–5.41[a]
industry°		a				**	**	**	**
construction		–18.55	–18.59	–18.55	–18.37	–19.41	–19.42	–19.73	–19.40
trade		0.06	0.05	0.21	0.19	–0.17	–0.19	–0.27	–0.13
transport		–0.37	–0.51	–0.28	–0.40	–0.81	–0.86	–0.95	–0.73
services		2.25*	2.28*	2.38*	2.28*	1.90*	1.91*	1.92*	1.95*
ICT		1.83**	1.90**	1.83**	1.64*	1.89***	1.89**	2.00***	1.91***
other		0.89	1.10	0.88	1.38	0.67	0.76	0.70	0.77
agency variables STRUCTURED	–		–0.34				–0.26		
CERTIFICATION	–		0.72				0.53		
SBLNTA	+			1.51[a]				0.82	
EBRATIO	+			1.41				–0.03	
DEPDM	–			–0.54				–0.38	
AUDDM	+			–0.31				0.58	
DEB	+				0.75*				0.30
constant		1.79[a]	1.86[a]	–0.12	2.21*	–0.53	–0.51	–1.60	–0.54
statistics (see text) number of observations		201	201	201	201	201	201	201	201
Nagelkerke R^2		0.62	0.63	0.64	0.65	0.42	0.43	0.44	0.43
LR statistics (χ^2)		110.54***	112.62***	113.90***	116.37***	67.94***	69.18***	70.93***	69.16***
Type I error (cut-off 0.5)		0.05	0.05	0.05	0.06	0.04	0.04	0.05	0.04
Type II error (cut-off 0.5)		0.27	0.31	0.27	0.33	0.54	0.50	0.50	0.54
Type I error (cut-off 0.1)		0.34	0.36	0.34	0.30	0.64	0.59	0.62	0.63
Type II error (cut-off 0.1)		0.10	0.08	0.06	0.08	0.06	0.04	0.06	0.06

***, ** and * indicate statistical significance at a 0.1%, 1% and 5% level, respectively.

[a] indicates statistical significance at a 10% level.

° manufacturing is the reference category.

[1] expected sign based on the previous analyses of distribution.

Distress = ln (p / (1–p)). Other variables defined in table 6.11.

explanatory value. Finally the *monitoring output model* (model 4) tests the additional explanatory power of supervisory board output in terms of directors' turnover. It reports on executive board turnover, as Gilson (1989) and Jungmann (2006) do, but the results on the turnover of the '*de facto*' board are similar. It is by no means the intention of this section to present a new or to refine an existing prediction model of financial distress. This would imply another research question. The results in table 6.12 intend to show (a) the explanatory capacity of the standard financial control variables and (b) the additional explanatory value of the agency theory related variables discussed above in three different models.

Remarkably, in table 6.12 industry is the important explanatory variable in t = –3 at the 1% level. Thus, being an ICT or services company in t = –3 explains financial distress in t = 0 better than any other variable. Of the financial variables only CASHVV proves a statistically significant explanatory variable but only at the 10% level and not in model 1. This implies that optimal use of debt in terms of cash flow helps in avoiding financial distress. This picture changes dramatically in t = –2. Now it is not the industry that discerns the control from the distressed sample, but individual size (LNTA) and income (NITA) figures of the company. The bigger and the more income per unit of assets, the less distress-prone the firm is. The *monitoring structure* (model 3) and *monitoring output* (model 4) models show that two governance variables have explanatory value: the size of the board and the turnover of directors. A board that is too large, expressed in man per unit of assets, proves explanatory for financial distress in all specifications.

One should keep in mind that regression analysis presents relationships and does not prove economic causality. Whether a relationship is causal should be established by economic theory. And even then *dual causality* and *feed back effects* (Studenmund, 2001: 66, 463) should be kept in mind, which the statistical significance of e.g. management turnover as an explanatory variable indicates. Table 6.12 presents the results on the supervisory board (SBLNTA) since its main task is to monitor, but the results in this model for the executive board (EBLNTA) and the total board (EBSBLNTA), also monitors, are more significant, the latter even at the 5% level (not reported). The other governance variable of significance is the turnover of directors which is positively related to financial distress in t = –2 at the 5% level. Annex 3.3 provides some additional statistical analyses and comments on table 6.12.

6.5.10 Bankrupt companies only

The idea behind this chapter, derived from Hill et al. (1996: 61), is to compare characteristics of financially distressed and other companies over the years. In the financially distressed sample however, two groups are collected, the bankrupt firms and the financially distressed firms that are not bankrupt. Out of the latter, only four became

Table 6.13: An analysis of the difference in distribution of financial control, and agency theory related variables between the control sample, the bankrupt sub–sample, and the financially distressed non–bankrupt sub–sample of listed Dutch companies from 1993 to 2003, based on panel data for t = –2 and t = –3 before the financial distress event occurred.

financial control variables	significance of difference between code 0 and code 1	significance of difference between code 0 and code 2	significance of difference between code 1 and code 2	*agency theory related variables*	significance of difference between code 0 and code 1	significance of difference between code 0 and code 2	significance of difference between code 1 and code 2
LNTA	**	**		STRUCTURED	***	*	
CETA	***	***	***	CERTIFICATION			
NITA	***	***		SBLNTA	**		*
CASHVV	***	***		EBRATIO			
				DEPDM		*	
				AUDDM			
				DEB		**	

***, ** and * indicate statistical significance at a 0.1%, 1% and 5% level, respectively.
Variables defined in table 6.11.
Code 0, 1, 2 defined below table 6.1 above.

insolvent and filed for suspension of payments or bankruptcy after 2003[23]. The implicit hypothesis that both groups do not differ statistically significantly on the characteristics under research, has to be tested. The non–parametric test performed on the financial and agency theory related variables reported in table 6.13, shows a statistically significant difference between the bankrupt (code 1) and the other financially distressed group (code 2) for only two variables: the leverage (CETA) and the size of the SB (SBLNTA). Indeed, the mean of CETA is 0.37 for code 0, 0.29 for code 1 and 0.49 for code 2 (not reported). So, one could conclude that bankrupt and distressed non–bankrupt firms in this respect originate from a different population. That CETA is significantly higher at the 0.1% level in the distressed non–bankrupt group than in the bankrupt group indicates that the former apparently has a buffer. Moreover, the code 2 group has a board size (SBLNTA) of approximately control group size, which provides another explanation – more efficient board culture – for their survival. CERTIFICATION, the insider/outsider ratio (EBRATIO) and financial expertise on the board (AUDDM) do not show any difference in distribution between the groups 0, 1 and 2 as table 6.13 shows. The significant difference in non–independence (DEPDM) between code 0 and 2 is explained by the mean number of 0.88 in the control sample (code 0); of 1.14 in the bankrupt sub–sample (code 1); and of 0.40 in the distressed non–bankrupt sample (code 2; not reported). The code 2 sub–sample SB is apparently less non–independent. The significant difference in EB turnover (DEB) between code 0 and 2 is explained by the difference in mean of 0.44 (code 0), 0.70 (code 1) and 0.80 (code 2). This signals a more effective SB for code 2 firms.

Are the regression results reported above valid then for the bankrupt subset of companies? Table 6.14 presents the regression results if only the relatively small group of

Table 6.14: A logit analysis of the financial control, and agency theory related variables for the control sample and the bankrupt sub–sample of listed Dutch companies from 1993 to 2003, based on panel data for t = –2 and t = –3 before bankruptcy occurred.

model 1: $DISTRESS \approx \alpha + \beta_1 LNTA + \beta_2 CETA + \beta_3 NITA + \beta_4 CASHVV + \beta_5 industry + \varepsilon$

model 2: $DISTRESS \approx \alpha + \beta_1 LNTA + \beta_2 CETA + \beta_3 NITA + \beta_4 CASHVV + \beta_5 industry + \beta_6 STRUCTURED + \beta_7 CERTIFICATION + \varepsilon$

model 3: $DISTRESS \approx \alpha + \beta_1 LNTA + \beta_2 CETA + \beta_3 NITA + \beta_4 CASHVV + \beta_5 industry + \beta_8 EBRATIO + \beta_9 SBLNTA + \beta_{10} DEPDM + \beta_{11} AUDDM + \varepsilon$

model 4: $DISTRESS \approx \alpha + \beta_1 LNTA + \beta_2 CETA + \beta_3 NITA + \beta_4 CASHVV + \beta_5 industry + \beta_{12} DEB + \varepsilon$

	exp. sign[1]	*t =-2*				*t =-3*			
		model 1	model 2	model 3	model 4	model 1	model 2	model 3	model 4
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
financial variables LNTA	–	–0.47**	–0.52**	–0.39*	–0.63**	–0.27[a]	–0.30[a]	–0.13	–0.27[a]
CETA	–	–5.05**	–5.53**	–6.98**	–5.66**	–1.43	–1.58	–2.34	–1.44
NITA	–	–9.90[a]	–9.82	–8.96	–8.91	–3.25	–1.22	–2.29	–3.41
CASHVV	–	–2.39	–2.68	–2.88	–3.74	–5.68	–6.75	–6.74	–5.64
industry°		a				*	*	*	*
construction		–18.57	–18.44	–18.60	–18.28	–18.96	–18.96	–19.42	–18.96
trade		–0.44	–0.35	–0.38	–0.21	–0.39	–0.41	–0.65	–0.39
transport		–18.21	–18.18	–17.87	–18.047	–18.66	–18.63	–18.72	–18.66
services		1.87[a]	2.20*	1.78[a]	1.92[a]	1.94[a]	2.43*	2.39[a]	1.94[a]
ICT		1.67**	1.83*	1.81*	1.60*	1.95**	2.18**	2.48***	1.96**
other		–19.02	–18.76	–19.22	–18.652	–19.21	–19.05	–19.77	–19.23
agency variables STRUCTURED	–		–0.61				–0.44		
CERTIFICATION	–		1.19[a]				1.17[a]		
SBLNTA	+			2.50*				1.83*	
EBRATIO	+			0.87				–2.17	
DEPDM	–			–0.43				–0.61	
AUDDM	+			–0.47				0.22	
DEB	+				0.73*				–0.05
constant		2.72*	3.02*	0.45	3.33*	0.88	0.91	–0.23	0.90
statistics number of observations		181	181	181	181	181	181	181	181
Nagelkerke R^2		0.56	0.58	0.60	0.58	0.46	0.49	0.51	0.46
LR statistics (χ^2)		74.26***	78.18***	81.60***	78.97***	59.49***	63.45***	67.18***	59.51***
Type I error (cut-off 0.5)		0.03	0.03	0.04	0.05	0.04	0.04	0.03	0.05
Type II error (cut-off 0.5)		0.47	0.44	0.41	0.41	0.53	0.47	0.44	0.53
Type I error (cut-off 0.1)		0.30	0.26	0.26	0.28	0.39	0.32	0.28	0.38
Type II error (cut-off 0.1)		0.16	0.09	0.09	0.09	0.03	0.06	0.09	0.03

***, ** and * indicate statistical significance at a 0.1%, 1% and 5% level, respectively.
[a] indicates statistical significance at a 10% level.
° manufacturing is the reference category.
[1] expected sign based on the previous analyses of distribution for the full distressed sample. Variables defined in table 6.11.

32 bankrupt firms is taken into account. A separate correlation analysis is not reported, because the results do not differ from those reported in table 6.10. Each model developed in this chapter shows significant variables in table 6.14. The *monitoring rights* model (model 2) shows that certification which is *de facto* a curtailing of shareholders' rights, is positively related to financial distress at the 10% level in both panels. The *monitoring structure* model (model 3) shows that a relative large SB is positively related to financial distress at the 5% level and on both panels, indicating that an inefficient board makes a firm distress-prone. The *monitoring output* model (model 4) shows a clear positive relationship between turnover and distress, but only in t = –2, indicating that that is apparently the moment the SB takes action.

6.6 CONCLUSION

Departing from the research model developed in 5.6, this chapter aimed to develop and subsequently test agency theory inspired hypotheses on monitoring rights, monitoring structure and monitoring output related governance issues. It formulated and tested the following hypotheses:

monitoring rights

H_1: being a "structure NV" is negatively related to financial distress.

H_2: "certification" of shares is not related to financial distress.

monitoring structure

H_{3a}: the number of EDs is positively related to financial distress

H_{3b}: the number of NEDs is positively related to financial distress

H_{3c}: the total number of directors is positively related to financial distress.

H_{4a}: the insider/outsider ratio of directors is not related to financial distress

H_{4b}: the incidence of non-independent NEDs is positively related to financial distress

H_{4c}: the incidence of NEDs with financial expertise is negatively related to financial distress.

monitoring output

H_{5a}: executive board (EB) turnover is positively related to financial distress

H_{5b}: supervisory board (SB) turnover is positively related to financial distress

H_{5c}: (total) board turnover is positively related to financial distress.

Tables 6.11, 6.12 and 6.14 essentially present the results.

The *analysis of differences* between the samples in tables 6.3 – 6.9 indicates that company structure, board size, non-independence and board turnover differ statistically significantly between the financially distressed sample and the control sample. The typical *control sample company* appears to be a 'structure NV' with five NEDs, a relatively low board turnover in t = –2 and 19% non-independent NEDs on the supervisory board. The *financially distressed* firm is statistically significantly different as regards these aspects. It is an 'ordinary NV' with four NEDs and a relatively high board turnover in t = –2 and 14% non–independent NEDs on the supervisory board. The mean control sample company is larger than the distressed company.

The *univariate regression results* from table 6.11 answer the hypotheses.

H_1 on the negative effect of the *'structure NV'* on distress cannot be rejected since the univariate regression analysis shows in table 6.11 that a 'structure NV' is a negative explanatory variable of financial distress. H_2 on the neutral effect of *certification* on distress cannot be rejected since table 6.11 shows no relationship for 'certification'. However, in the *monitoring rights* model for the bankrupt sample (table 6.14), certification appeared a positive explanatory variable of financial distress at the 10% level in both panels. Apparently there is an, albeit rather weak, significant relationship between curtailing shareholders' rights through 'certification' and actual bankruptcy.

The positive effects on distress of *board size* (H_{3a}, H_{3b} and H_{3c}) cannot be rejected since table 6.11 shows that the number of directors per unit of assets has indeed positive and significant explanatory power for distress. Note that, on the contrary, the absolute number of NEDs on the control sample SBs is higher than in the distressed group, but since it is argued that this absolute number is better related to the assets of the company, this finding is no longer relevant. Moreover, the number of NEDs per unit of assets proves positively related to financial distress in the distressed (table 6.12) as well as in the bankrupt regression (table 6.14). This may indicate that indeed a SB that is too large hinders effective communication and decision–making, always essential and especially in situations of near financial distress.

H_{4a}, H_{4b}, and H_{4c} on the effect of *composition structure* show that neither the insider/outsider ratio is related to financial distress (H_{4a} not rejected) nor the incidence of financial expertise on the SB (H_{4c} rejected). In table 6.11 non–independence appears negatively related to financial distress (H_{4b} rejected). This is interpreted as a result of a declining number of non–independents on the SB of financially distressed companies from t = –3 to t = –2. It is as if the non–independents in the distressed sample have a sharper eye than their independent fellow–NEDs and leave the sinking ship.

The positive association of turnover with distress (H_{5a}, H_{5b}, and H_{5c}) cannot be rejected since table 6.11 as well as the results for model 4 in tables 6.12 and 6.14 show a clear connection between distress and turnover, as was expected. It adds to the explanation of distress only in t = –2. Apparently in t = –3 there is still no such connection. This implies that presumably only in t = –2 directors see that dismissal is necessary, either as a visible output–related sign of their activity, or as a sign that they lost confidence in their executives, themselves, or in the company, thus trying to save their reputation.

The *logit regression* in models 1–4 presented in tables 6.12 and 6.14 show some additional explanatory value to the *control variables* model (model 1) by the added agency theory related variables. The *monitoring rights* model (model 2) shows for the bankrupt sample that 'certification', i.e. curtailing shareholders' rights, is positively related to financial distress. The *monitoring structure* model (model 3) shows that SBs that are too large have explanatory power for financial distress. This is interpreted as boards that are too large being inefficient monitors. The *monitoring output* model (model 4) showed that turnover of directors adds to the explanation of financial distress.

This research is the first agency theory inspired systematic analysis of monitoring rights, monitoring structure, and monitoring output related governance variables of financially distressed companies in the Netherlands. It adds to the literature for five reasons.

Firstly, it puts a question mark behind the much believed independency condition. The data show that the number as well as the percentage of non–independent NEDs on the control sample boards is higher than in the distressed sample. In the regression analysis full non–independence (or the percentage of non–independents; not reported) does not provide additional explanatory power. This is in line with the findings of Dalton, Daily, Ellstrand and Johnson (1998).

Secondly, the control group shows larger executive and supervisory boards, which can be interpreted as a logic consequence of larger companies in that group. If standard–ized for size, it appears from model 3 that large boards are an explanatory variable for financially distressed companies. This result could be interpreted as a warning to avoid boards that are too large compared with the boards of similar companies. The one with the smaller board could very well be the more effective one, which is in line with the literature (Yermack, 1996; Van Ees et al. 2003).

Thirdly, the predominant importance of financial variables and industry variables on the prediction of financial distress and the small additional contribution of governance variables is striking. The industry variable seems related to the period under research. In the 1993–2003 period it was the ICT and to a lesser extent the services industry that showed most financial distress. However, in another era, take 2010, this could very well be construction or expensive consumer goods and services. In predicting, it is important not to forget this changing picture (Grice and Dugan, 2007).

Fourthly, the one–tier system based results on board size and independence seem to fit in with the two–tier results presented here. Moreover the research shows positive effects of the powerful supervisory board in the '*structure–NV*'. Because the sample remains small compared to US research, new European research should concentrate on more countries, thus creating larger data sets.

Fifthly, although Altman (1993), Van Amsterdam (2004) and Adriaanse (2005) showed that the quality of management is key in situations of near financial distress, the agency–related factors presented in the chapter and the differences therein between both samples are auxiliaries in judging the company's perspectives.

The results confirm the *agency theory* since (1) the supervision structure, board size and directors' turnover prove to be statistically significantly differently distributed between the samples; and (2) these variables are significant explanatory variables for financial distress in the univariate analysis.

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ENDNOTES

1 Only for the full, mandatory regime.

2 One finds 'Dutch discount' e.g. in: (1) Staatssecretaris van Financiën J. Wijn on 25 January 2005 at the Dutch Financial Club lunch in New York; (2) D. Swagerman, E. Terpstra: Trends in Dutch executive compensation, Management, Vol. 14, 2009, 2: 62; (3) Financial Times 30 November 2006. It indicates lower share prices as a consequence of specific Dutch governance measures in general, of which 'certification' (depositary receipts without voting rights) is one.

3 Several companies have withdrawn certification by themselves or after pressure from share–holders. In October 2004 s 2:118a BW was created, which enables certificate holders to vote, except in times of a take–over battle. The Dutch Code pleads for an unlimited voting right (IV.2).

4 Note that a SB is only manadatory if the NV is structured: see 4.4.1.1.

5 s 2:158 (2) BW.

6 So did recently: Mashayekhi and Bazaz (2008) for Iran and O'Connell and Cramer (2010) for Ireland.

7 To which can be added: decision–making; see Beiner, Drobretz and Zimmerman (2004: 354).

8 This may have to do with their rather peculiar definition of an outsider, being a board member who holds board positions at other companies (p. 48).

9 Dalton et al. (1998) in their meta–analysis find no relationship. Mashayekhi and Bazaz (2008) report for Iran that the *presence* of outside directors strengthens the firms' performance. O'Connell and Cramer (2010) find a significant association between firm performance and the *percentage* of NEDs on the board.

10 Gilson (1989) cites two earlier studies (p. 248) with smaller samples and less turnover.

11 The variable names are between brackets.

12 REACH is an electronically available database (ultimately) published by ReedElsevier.

13 This is the definition of DC III.2.2. Although the DC did not apply in the research period, the definition facilitates an objective distinction between the NEDs.

14 A Dutch guide for data on directors. Taken as close as possible to the year the data were needed for.

15 Wet Melding Zeggenschap (WMZ), a former Dutch law, at present part of the Wft, that required shareholders passing certain thresholds, like 5%, to register this at the Authority Financial Markets (AFM).

16 Regulation (EC) No 1893/2006 of the European Parliament and of the Council, s 2.

17 As REACH only presents the actual industry classification, some companies that merged later on are at present categorized as financial companies. These categorizations were changed to the original industry activity.

18 Unintended: if a company predicted a long period of losses in its IPO prospectus, it was excluded from the sample (Crucell N.V.).

19 Measured by being quoted at year–end.

20 A skewness measure (not reported in the tables) indicates whether the difference is acceptable or not. The distribution of the data in this research is more often than not skewed.

21 It is an indication; a low r by no means proves otherwise, as variables could be acting together (Studenmund, 2001: 236).

22 S 2:154 BW: three years.

23 These are: RT Company NV, at present Vivenda Media Group NV (suspension of payments); DICO NV, DVRG NV and Innoconcepts NV.

Chapter

7

Relevance of the resource dependence theory on monitoring near financial distress: an empirical approach

The key to organizational survival is the ability to acquire and maintain resources.
(Pfeffer and Salancik, 1978: 2)

7.1 INTRODUCTION

With reference to the theoretical model on monitoring near financial distress developed in 5.6, this chapter aims (1) to formulate testable monitoring–related hypotheses based on the resource dependency theory; and (2) to test these hypotheses on data for financially distressed Dutch companies listed on the Dutch stock exchange in the period 1993–2003. Whilst chapter 6 analysed the relationship between monitoring and financial distress in terms of *monitoring rights*, *monitoring structure* and visible *monitoring output*, this chapter concentrates on the actual *supervisory board composition* in situations of near financial distress. The key question is whether the availability of resources on the supervisory board and whether the board's diversity in composition influence the likelihood of financial distress. This kind of research has not been done before. Section 7.2 explains the resource dependence theory and examines previous research. Based on these earlier findings and within the constraints of the available data, it develops testable hypotheses. Section 7.3 describes the data. Section 7.4 explains the applied research methods. The results, based on data for financially distressed Dutch companies listed on the Dutch stock exchange in the period 1993–2003, are reported in 7.5. Section 7.6 concludes and discusses the results.

7.2 THEORY AND HYPOTHESES

7.2.1 The resource dependence theory

Chapter 1 showed that a company has to adapt continuously to changes in its general and immediate environment. Chapter 3 indicated that non–executive directors (NEDs) have a control, service and strategy role in this process (Zahra and Pearce, 1989: 303). Pfeffer and Salancik (1978) argue that how an organization learns about its environment, how it attends to it, and how it selects and processes information to give meaning to its environment, are all important aspects for the survival of the company. From this posit they developed what is currently called the *resource dependence theory*. Their hypothesis is that formal organizations use their boards of directors as vehicles for co–opting important external organizations with which they are interdependent through nomination of their senior management as NEDs on their boards. In short, the resource dependence theory points out that in addition to the board roles of monitoring and disciplining developed in the agency theory, NEDs have *resource– related board roles*: (1) providing legitimacy or bolstering the public image, (2) access to complementary expertise, knowledge, advice and counsel, valued resources, information, (3) access to capital, (4) facilitation of inter–firm commitments, (5) linking to important stakeholders or other important institutions, (6) aiding in the formulation of strategy or other important company decisions, and (7) aiding in transitions (Pfeffer and Salancik, 1978: 2; Fama and Jensen, 1983: 313; Dalton, Daily, Ellstrand and Johnson, 1998: 273; Gales and Kesner, 1994: 272; Zahra and Pearce, 1989: 303; Hillman and Dalziel, 2003: 385–386; Goodijk, 2006: 22; Goodridge, 2007). Daily (1995: 1052) deems such access to external resources— otherwise often unavailable for the company— as potentially critical for financially distressed firms.

These *resource–related board roles* are directly related to the legal advisory (i.e. service/ expertise/ counsel) role of NEDs. The firm's resource bundle is critical to its path dependency (Kor, 2003). With the increasing uncertainty of firm environments, new important resources need to be secured e.g. international know–how and female representation (Ruigrok, Peck and Tacheva, 2007: 548). These subjects form part of a broader theme of board diversity which is often embedded in a resource dependence approach since diversity touches the *variety* of resources a company can rely on. Diversity could be defined as broad as diversity with respect to demographic attributes (Pelled, 1996: 616) or as narrow as the percentage of women or minorities on the board of directors (Carter, Simkins and Simpson, 2003: 36). Modern agency theorists favour board diversity as well as they believe that a greater diversity of opinions and interests on the board should keep managerial discretion within proper bounds (Francoeur, Labelle and Sinclair–Desgagné, 2007). A more diverse board might be a more activist board because outside directors with non–traditional characteristics could be considered the ultimate outsider (Carter et al, 2003: 37). In short, one could expect from the theory that more resourceful NEDs are less likely to oversee managerial mistakes which could lead to financial distress and that they will react more adequately once financial distress is at hand.

7.2.2 Hypotheses[1]

This section develops hypotheses on monitoring near financial distress based on the resource dependence theory. It starts with personal characteristics such as age, nationality, gender, education and independence of NEDs as these may be important in delivering the board role. These characteristics prepare the ground for the pure resource dependence related hypotheses on network and workload of the NED, developed subsequently.

7.2.2.1 *Age*

The literature on diversity categorizes *age* as a highly visible characteristic with low job–relatedness (Pelled, 1996: 617). However, Zahra and Pearce (1989: 307) and Kang, Cheng and Gray (2007) mention age as one of the relevant characteristics in their study on NEDs. Kor (2003) and Ruigrok, Peck and Tacheva (2007) apply age as a control variable. Age is relevant because it is a proxy for experience. Their correlation is significant at the 0.1% level (Kor, 2003). Experience is an important part of board capital (Hillman and Dalziel, 2003: 386). Board capital determines the maximum effect that can be expected from monitoring. Age surely is an ambiguous measure for experience but since it is impos–

sible to measure *relevant* experience in one single variable, it is the best proxy available. Other possible measures of experience, such as the number of present directorships or present workload, do not necessarily proxy experience better since these reflect *present* performance and not *historical* experience. That is why this research takes the factors experience, network and workload into account separately. Since it is envisaged here that more experience, thus more supervisory board capital, provides better monitoring, the experience covering hypothesis reads:

> *H_1: the incidence of older (for: more experienced) NEDs is negatively related to financial distress.*

7.2.2.2 *Nationality*

Although nationality appears to become an important dimension of board diversity (Ruigrok et al. 2007: 546) in the American literature the ethnic background is a more common feature of corporate governance research than nationality. Carter et al. (2003: 37) mention the argument that people with different gender, ethnicity or cultural background might ask questions that would not come from NEDs with more traditional backgrounds and could therefore be better monitors. Milliken and Martins (1996: 407), however, conclude that diversity in ethnic background may initially have negative effects in individual and group outcomes. Once a certain level of behavioural integration has been reached the benefits of diversification might be obtained. Ruigrok et al. 2007: 547 conclude on nationality that a foreigner on the board on the one hand brings different perspectives, skills and knowledge, but on the other hand different values, norms and understanding that may influence the effectiveness of communication. Moreover, foreigners often lack know-how of the legal and accounting system[2]. Li and Harrison (2008) suggest that national culture can have strong effects on corporate governance. Van Veen and Elbertsen (2008) show that in the Netherlands the level of nationality diversity is the highest in Europe. Since the accumulated effect of the contradictory aspects of foreign nationality of a NED is unclear, the neutral hypothesis reads:

> *H_2: the incidence of non-national NEDs is not related to financial distress.*

7.2.2.3 *Gender*

Burgess and Tharenou (2002: 40) and Carter et al (2003: 36) list a number of reasons why women are needed on company boards. These are: (a) increased diversity of opinions in the boardroom, (b) strategic input, (c) influence on decision-making and leadership styles, (d) providing female role models and mentors, (e) improving company image, (f) women's capabilities and availability, (g) insufficient competent male directors and (h) ensuring "better" boardroom behaviour. For all these arguments their paper quotes further research. Thus, greater gender diversity is generally believed to be good for the company since it improves the potential monitoring quality of the board (Carter et al. 2003: 36). And although Farrell and Hersch (2005) explain that greater gender diversity may simply be the firm's response to outside or inside pressure on the matter, the hypothesis tests whether gender is indeed a valuable resource factor for NEDs in avoiding financial distress:

H_3: the incidence of female NEDs is negatively related to financial distress.

7.2.2.4 *Education*

Another critical resource of a NED is education. Why else would students strive for a scholarship in one of the Ivy–league universities or are their alumni in high demand? Universities impart knowledge, develop analytical and psychological skills, and convey experience from case studies. This improves a person's monitoring capabilities. Educational background is one of the NED characteristics mentioned by Zahra and Pearce (1989: 307). D'Aveni (1990: 129), Daily and Dalton (1994: 1609) and Ruigrok, Peck and Tacheva (2007: 551) use education to capture the quality of a firm's board. In the Dutch two–tier system the question should rather be whether better education of a NED ensures better monitoring of a NED; and whether a higher than average educational level of a supervisory board lowers the likelihood of financial distress. The relationship of better monitoring through higher–educated NEDs is hypothesized as:

H_4: the incidence of better educated NEDs is negatively related to financial distress.

7.2.2.5 *Independence*

A non–independent NED is *a priori* not in the best position to monitor since his judgement is not objective and his ties to the firm and the CEO may inhibit prompt and adequate measures (Daily and Dalton, 1994). However, his knowledge of the company can be considered as a precious resource. Klein (1998) showed that it is important to have non–independents on the board. Harris and Shimizu (2004: 779) consider non–independent directors necessary to contextualize the rich external perspectives of outsider directors. A non–independent NED is resourceful, has the most knowledge of the firm of all the NEDs and often feels personally committed to the firm. Since boards in the Netherlands are collegial forums, decisions will usually be taken by unanimity. In times of distress one could even imagine that NEDs play safe and follow the advice of the knowledgeable former insider or otherwise non–independent NED. Thus, non–independence may be a positive as well as a negative characteristic when monitoring financial distress, which is hypothesized as follows:

H_5: the incidence of independent NEDs is not related to financial distress.

7.2.2.6 *Network*

The network of NEDs is key in the resource dependence theory since, to a large extent, it determines their resources. Part of that network is formed by 'interlocking directorates' or 'multiple directorships' which means that an ED or a NED occupies an ED or NED position in one or more other firms as well. As expressed by Pfeffer and Salancik (1978: 161):

> *Interlocking directorates[3] (..) are one form of a more general tendency to manage the environment by appointing significant external representatives to positions in the organization. (..) this is a strategy for accessing resources, exchanging information, developing inter-firm commitments and establishing legitimacy.*

Haunschild and Beckman (1998: 817) stress that such multiple directorships are valuable sources of information that are inexpensive, trustworthy and credible. More in general, interlocking directorates provide channels of communication and conduits of information between the firm and external organizations (Hillman and Dalziel, 2003: 387). They serve to reduce the transaction costs of dealing with uncertainties in the environment. Harris and Shimizu (2004: 791) report a favourable effect of busy NEDs on key strategic decisions. The hypothesis connecting a resourceful network through better monitoring and advice with less likelihood of financial distress therefore reads:

> *H_6: the incidence of multiple-director NEDs is negatively related to financial distress.*

7.2.2.7 *Workload*

Workload is a fiercely debated topic in resource dependence literature. Clearly, the resources a NED gains from being exposed to various challenges from numerous directorships and other jobs may make him 'overboarded': too busy to meet all the requirements attending his responsibilities properly (Harris and Shimizu, 2004). While Lipton and Lorsch (1992) argue that such NEDs have too little time to carry out their duties, Harris and Shimizu (2004) find that overboarded directors are important sources of knowledge, enhance acquisition performance and are an important complement for a board. In the analysis of Hambrick (1987: 90) time is only a sub-factor. Some may have more time than others, but, as Harris and Shimizu (2004: 793) observe, busy directors are busy for good reason – they are good contributors. That is why Kiel and Nicholson (2006: 544) object to this line of research: it is conceptually the wrong level of analysis and it neglects the various systemic benefits of multiple directorships. Instead, boards and individual directors should regularly be evaluated to see if they can still carry out the roles expected of them. One wonders whether in situations of near financial distress (a) there is time to execute this evaluation, (b) if a firm can permit to lose NEDs on those grounds just at that very moment, and (3) if 'overboarded' NEDs really have the opportunity to invest the extra time needed. Intuitively one would hypothesize that in situations of near financial distress a firm is better off with a non–overboarded NED:

H_7: the workload of NEDs is positively related to financial distress.

7.3 DATA

This chapter uses the same dataset as chapter 6. Section 6.5 comprises a full description. The dataset contains seven NED characteristics. These are age, nationality and gender, which are inborn resources, and education, independence, network and workload, which are acquired resources. Of these, age, network and workload are scale variables, education is an ordinal variable and the other three are categorical variables (dummies). This is important to note for a proper statistical analysis.

7.3.1 Age

The annual reports, the *Handelsregister* and the *Handboek voor directeuren en commissarissen* provided the data on the age of NEDs.

7.3.2 Nationality

It is not always simple to determine the nationality of a NED. People may have a double nationality. They may be born under Dutch rule in what is now Indonesia or Surinam. People may have petitioned for another nationality. Nationality data may simply not be available, which might be the case for some NEDs for the earlier years of this research. Nationality, if at all available in the *Handelsregister*, is not electronically retrievable. However the place of birth is registered. So, if nationality was not mentioned in the annual reports or elsewhere, the NEDs *not* born in the Netherlands were classified as foreigners.

7.3.3 Gender

Gender was not a topic in the period under review in the Netherlands. Especially for the earlier years of this research ‘gender’ is difficult to retrieve since first names or photographs of directors were not a regular part of the annual report, as they presently are. After checking and double checking various sources, the dataset is probably in order. As there were only 51 females out of 1,904 NEDs in the research period one should not attach much value to the results presented on the issue.

7.3.4 Education

By education this study means an academic master's degree, a doctorate[4] or a professor–ship. This is debatable, since a bachelor's degree or other training may be just as useful. However, the common use of the degrees mentioned in the Netherlands in connection with one's name made it relatively easy to collect the data. Most annual reports provide this information, as does the *Handboek voor directeuren en commissarissen.* However, this is a cultural phenomenon. Whilst Germany has a similar habit, in English and American annual reports this information is less readily available, if at all. It has been attempted to complete this data for non–Dutch nationals through directories and internet sources, such as alumni yearbooks, but altogether the data on the education of non–Dutch nation–als may be negatively biased. The results should therefore be interpreted cautiously.

7.3.5 Independence

As in 6.3.3 a NED is deemed *independent* if he, or his wife, partner or family member in the second degree has not been employed by the company in the past five years; does not receive personal benefits from the company; has not had a business relationship (consultancy, counsel, banker and the like) in the year previous to the appointment; is not or does not represent a 10% shareholder; and is not an ED of a company in which an ED of the company he supervises is a NED (cross–directorship)[5]. Data is derived from the annual accounts, the WMZ[6] register and journals.

7.3.6 Network

By network this research means the number of non–executive directorships the NED has in NVs or BVs . Data is derived from the annual reports and the *Handboek voor directeuren en commissarissen.* Each NED position is supposed to be of equal value in terms of network. However, the chairman position (*President–commissaris*) counts twice, since he is exposed to external contacts, e.g. with investors, banks, potential merger and acquisition parties, considerably more than other NEDs, if they are at all. Other important network positions, e.g. a non–executive directorship of an orchestra, a museum or of other important associations or foundations, have not been taken into account, since this data is unreliable[7].

7.3.7 Workload

To determine the workload of a NED, not only is his network in terms of NED positions important, but also whether he has a regular job. Job data is derived from the annual reports, the *Handboek voor directeuren en commissarissen* and personal websites of the NEDs concerned. If this job was described as executive director, advisor, professor, Member of Parliament, or if it was of a professional nature e.g. lawyer or auditor, it is classified as a full–time equivalent (FTE) which means it takes 1,800 hrs a year. This is arbitrary since part–time jobs exist more and more. Moreover NEDs may occupy directorships in foundations or associations, often of an honorary nature, which may, at least incidentally, take up a lot of a time as well. These posts have not been taken into account

Table 7.1: an overview of the NED resources for the control sample and the financially distressed sample of listed Dutch companies from 1993 to 2003, based on data for t = –2 and t = –3 before the financial distress event occurred.

	control sample		distressed sample		full panel	
	number	percentage	number	percentage	number	percentage
numbers:						
number of companies	298	74	104	26	402	100
number of NEDs	1,459	77	445	23	1,904	100
number of leaving NEDs [a]	137	65	74	35	211	100
increasing size of SB (t = -2)[a]	26	17	12	23	38	19
decreasing size of SB (t = -2)[a]	23	15	15	29	38	19
NED inborn resources:						
age						
> 60	744	51	155	35	899	47
< 50	149	10	107	24	256	13
nationality (non-Dutch)	225	15	115	26	340	18
gender (female)	37	3	14	3	51	3
NED acquired resources:						
education						
academic master's degree	1,030	71	269	60	1,299	68
Mr. (Dutch; = LL.M)	217	15	60	13	277	15
Ir. (Dutch; = MSc)	235	16	48	11	283	15
Drs. (Dutch; = MA or MSc)	252	17	72	16	324	17
other (MA and/or MSc)	79	6	35	8	114	6
PhD	97	7	26	6	123	6
Professor	150	10	28	6	178	9
independence	1,197	82	356	80	1,553	82
network						
> 4 NED positions	533	37	124	28	657	34
1 NED position	347	24	165	37	512	27
FTE (holds a full-time job)	659	45	274	62	933	49
workload 1 > 1	665	46	276	62	941	49
workload 2 > 1	728	50	287	64	1,015	53

Variables are explained in the text.
[a] A statistical analysis of leaving NEDs in situations of near financial distress is found in 6.5.5. The increase or decrease of the SB number is not related to financial distress (results not reported).

since the data is not complete by any means, and estimating the time involved would have been possible only with an unacceptable degree of subjectivity.

7.3.8 General data overview

Table 7.1 provides a first glance at the data. Most figures do differ substantially between the samples. Only *gender* is equally divided over both samples. *Education* shows an 11% difference on the incidence of academic degrees. However, the division over the various educational categories does not seem very different. Section 7.5 researches the statistical significance of these differences.

7.4 METHOD

The techniques applied in this chapter are essentially identical to those already described in 6.4 and applied in chapter 6. One technique, the use and calculation of a diversity indicator, is new and is introduced in 7.4.1. Section 7.4.2 explains the two approaches to the data applied in this chapter.

7.4.1 Diversity indicator

A diversity indicator quantifies the diversity of a certain characteristic within a group, e.g. the supervisory board (SB). For *scale* variables, e.g. age, network and workload, the standard deviation is an appropriate diversity measure. A large standard deviation (σ) indicates more variety than a small one, as its definition shows:

$$\sigma_{dj} = \sqrt{} \ 1/n \ \Sigma \ (x_i - x)^2$$

where d = the characteristic under research
i = NED i
j = the firm
n = the number of NEDs on the SB
x_i = the value of the variable for NED i on board j
x = the average value of the variable on the SB.

For *ordinal* and *categorical* variables the standard deviation is meaningless and other indicators are necessary. One of these[7] is the Blau–indicator[8] as applied by Van Ees, Hooghiemstra, Laan and Veltrop (2007) and Tacheva (2007). The definition[9] is:

$$Blau_{dj} = 1 - \Sigma \ (x_{ij} / n_j)^2$$

where x_{ij} = the number of NEDs with category i on board j.

If a variable may have values 1, 2 and 3 and there are three NEDs on the SB, the Blau–indicator varies between 0 (all the NEDs in the same category), 0.44 (two NEDs in one category) and 0.66 (all the NEDs in a different category). If the group is very large, the Blau–indicator will asymptotically tend towards one. For an SB of 10 with all the NEDs in a different category, the Blau–indicator is 0.90. If it concerns a dichotomous variable, the Blau–indicator does not discern between the 70% male and the 70% female situation. For an SB of 10 people both calculated Blau–indicators are 0.42. This shows that the *average* value provides additional valuable information.

7.4.2 Two approaches to the data

The hypotheses and data relate to financially distressed and control companies and their NEDs. Two research angles are possible here: the *supervisory board* and the *individual NED*. The *supervisory board* is a legal organ of the company. NEDs decide within the framework of the SB. This research angle focuses on the resources of the SB in terms of average and diversity vis–à–vis the situation of the company. This angle will conclude with a logistic regression with the diversity and the average characteristic variables as explanatory variables in 7.5.9 and 7.5.10.

The second research angle centres on the *individual NED* characteristics. The individual characteristics determine the efficiency and effectiveness of the SB. Would it be possible to detect a certain profile of NEDs for the financially distressed and for the control sample? What kind of people are attracted by potentially financially distressed companies, or: what kind of people are selected by potentially financially distressed companies? An analysis of the difference of means (*t–test*) or, if the data distribution is skewed or the data is not scaled, the difference of the distribution (*Mann–Whitney test*) of these individual NED characteristics over all the NEDs during t = –2 and t = –3, may give an understanding of the relevance of certain NED characteristics in avoiding financial distress.

7.5 RESULTS

The variables below with a –NED extension relate to the NED database of 1,904 NEDs. Variables with a –DIV extension are company–based and present a diversity measure of the characteristic within the SB. Variables with an –AV extension show the averages for the SB on a company basis. Although the average is not a diversity measure as such, it distinguishes clearly between a 70% male or 70% female situation, which the Blau– indicator used as a diversity measure does not (see 7.4.1). Moreover, the average allows the attaching of value to the ‘level’ of a characteristic, i.e. the average number of network positions of the NEDs on the SB, instead of (only) their diversity.

7.5.1 Age

The AGENED variable shows the age of a NED. It is defined as the event year less the year of birth of a NED, less two or three, since it is the company two or three years before the event that is the research object. The AGEAV shows the average age of the NEDs on the SB. The AGEDIV variable measures the diversity of age in the SB, expressed in the standard deviation of the board’s age. Table 7.2 presents the results on the age of the NEDs. Since the AGE variable as well as the AGEDIV variable have a normal distribution (not reported), both the *t- and z-values* are shown. It shows that control group NEDs are statistically significantly older by (almost) four years in the mean and median. The results on the average age on the SB (AGEAV) confirm this result. The diversity in age (AGEDIV) provides less significant results. Apparently the diversity in age is overall not so (very) different between the groups, which implies that generally all NEDs on control boards are older and thus more experienced, and all NEDs on distressed boards somewhat younger and less experienced.

Table 7.2: An analysis of the age of NEDs and of the age diversity of the SB for the control sample and the financially distressed sample of listed Dutch companies from 1993 to 2003, based on panel data for t = −2 and t = −3 before the financial distress event occurred.

board variable	control sample				financially distressed sample				difference |t-value| (|z-value|)
	number	min (max)	mean (median)	standard deviation	number	min (max)	mean (median)	standard deviation	
t = -2									
AGENED	730	33	59.74	7.50	222	34	56.24	8.46	5.55***
		(72)	(61)			(74)	(57.50)		(5.64)***
AGEAV	149	39.33	59.30	4.79	52	40.67	56.31	5.20	3.76***
		(67)	(59.75)			(68)	(56.10)		(4.19)***
AGEDIV	149	0.82	5.41	2.51	52	0.82	5.89	3.04	1.01
		(12.87)	(5.23)			(13.80)	(6.40)		(1.29)
t = -3									
AGENED	729	32	59.50	7.75	223	32	55.79	8.58	5.79***
		(72)	(60)			(73)	(57)		(5.80)***
AGEAV	149	38.33	58.98	4.79	52	45.33	55.60	5.15	4.18***
		(67)	(59.75)			(68)	(55.43)		(4.34)***
AGEDIV	149	0.82	5.63	2.64	52	0.50	6.32	3.00	1.58
		(15.33)	(5.39)			(13.80)	(6.82)		(1.99)*

***, ** and * indicate statistical significance at a 0.1%, 1% and 5% level, respectively.
[a] indicates statistical significance at the 10% level.
AGENED the age of a NED at t = −2 and t = −3
AGEAV the average age of the SB
AGEDIV the diversity in age of the SB measured in terms of the standard deviation.

7.5.2 Nationality

NATNED stands for the nationality of a NED. It is a binary variable: Dutch (0) or non–Dutch (1). NATAV signifies the percentage of foreign nationals on the SB. The NATDIV variable, expressed as a Blau–indicator, signifies the diversity of Dutch and other nationalities on the SB. Table 7.3 presents the results on the nationality of the NEDs. Since the NATNED variable is of an ordinal nature, and NATAV and NATDIV are skewed (not reported), only the *z–values* are reported. Table 7.3 shows that the financially distressed sample has statistically significantly more foreign NEDs than the control group at the 1% level. The same goes for foreign nationals in terms of average and diversity on the SB, albeit on levels varying between 1% and 10%.

Table 7.3: An analysis of the nationality of NEDs and of the nationality diversity of the SB for the control sample and the financially distressed sample of listed Dutch companies from 1993 to 2003, based on panel data for t = –2 and t = –3 before the financial distress event occurred.

board variable	control sample				financially distressed sample				difference
	number	min (max)	mean (median)	standard deviation	number	min (max)	mean (median)	standard deviation	|t-value| (| z-value|)
t = -2 NATNED	730		16%		222		27%		(3.88)***
NATAV	149		13%		52		22%		(1.82)[a]
NATDIV	149	0.00	0.12	0.19	52	0.00	0.18	0.22	(1.80)[a]
		(0.50)	(0.00)			(0.50)	(0.00)		
t = -3									
NATNED	729		15%		223		24%		(3.21)**
NATAV	149		12%		52		21%		(2.33)*
NATDIV	149	0.00	0.11	0.19	52	0.00	0.18	0.21	(2.06)*
		(0.50)	(0.00)			(0.50)	(0.00)		

***, ** and * indicate statistical significance at a 0.1%, 1% and 5% level, respectively.
[a] indicates statistical significance at the 10% level.
NATNED a dummy variable being 1 if the nationality of a NED is not Dutch
NATAV the average value of the dummy variable over the SB
NATDIV the Blau–indicator on the diversity in nationality of the SB.

7.5.3 Gender

GENNED stands for the gender of a NED. It is 1 if the NED is female. GENAV signifies the percentage of women on the SB. The GENDIV variable, expressed as a Blau–indicator, signifies the diversity in gender on the SB. Table 7.4 presents the results on the gender of the NEDs. Since the GENNED variable is of an ordinal nature and GENAV en GENDIV are skewed (not reported), only the *z–values* are reported. Table 7.1 already showed a low percentage of women on the boards. It may therefore not be surprising that the results in table 7.4 on the gender variable are by no means significant.

Table 7.4: An analysis of the gender of NEDs and of the gender diversity of the SB for the control sample and the financially distressed sample of listed Dutch companies from 1993 to 2003, based on panel data for t = –2 and t = –3 before the financial distress event occurred.

board variable	control sample				financially distressed sample				difference |t-value| (|z-value|)
	number	min (max)	mean (median)	standard deviation	number	min (max)	mean (median)	standard deviation	
t = -2									
GENNED	730		3%		222		3%		(0.08)
GENAV	149		2%		52		3%		(0.23)
GENDIV	149	0.00	0.03	0.10	52	0.00	0.04	0.12	(0.23)
		(0.50)	(0.00)			(0.50)	(0.00)		
t = -3									
GENNED	729		2%		223		4%		(0.90)
GENAV	149		2%		52		4%		(0.47)
GENDIV	149	0.00	0.03	0.09	52	0.00	0.05	0.14	(0.72)
		(0.44)	(0.00)			(0.50)	(0.00)		

***, ** and * indicate statistical significance at a 0.1%, 1% and 5% level, respectively.
GENNED a dummy variable being 1 if a NED is female
GENAV the average value of the dummy variable over the SB
GENDIV the Blau-indicator on the diversity in gender of the SB.

7.5.4 Education

The education level of NEDs is reported in nine categories: no academic degree, LL.M. (Dutch: mr.), MSc (Dutch drs: mainly economics or business school), MSc (Dutch ir.: technical), registered auditor (RA), two master's degrees, a foreign degree, PhD and professor. PhD degrees include honorary degrees, since the origin of the degree is not always clear. Table 7.5 presents the results of the Pearson χ^2 test. The variables academic education and financial distress are statistically significantly not independent at a 0.1% level of significance. Or, to put it differently, the various education levels are not stochastically

Table 7.5: An analysis of the academic education level of NEDs for the control sample and the financially distressed sample of listed Dutch companies from 1993 to 2003, based on panel data for t = –2 and t = –3 before the financial distress event occurred.

academic level	*no degree*	*LL.M*	*MSc (ec)*	*MSc (tech)*	*RA*	*two degrees*	*foreign degree*	*PhD*	*professor*	*total*
control sample	429	218	234	252	34	24	21	97	150	1,459
financially distressed	176	60	48	72	18	11	6	26	28	445
as % of total sample	31.8	14.6	14.8	17.0	2.7	1.8	1.4	6.5	9.4	100
Pearson χ^2	29.24 ***									
Cramer's V	0.124									

***, ** and * indicate statistical significance at a 0.1%, 1% and 5% level, respectively.

distributed over the NEDs in both samples. The strength of the connection however, shown by the Cramer's V contingency coefficient, does not surpass the level of a weak relationship. Almost 32% of all the NEDs have no academic master's degree. Thus, 68% of all the NEDs have an academic degree. Table 7.6 shows the distribution of the variables over the different samples. Since the DEGREENED variable is of a binary nature, and EDUDIV is skewed (not reported) only the *z-values* are reported for these. The 71% of control group NEDs with a master's degree (DEGREENED) is statistically significantly higher at the 1% level than the 60% for the distressed sample. The normally distributed average degree-on-the-SB variable (DEGREEAV) confirms the picture, i.e. the availability of master's degrees on the SB is significantly higher in the control sample at the 10% level or better. EDUDIV allows room for the subtleties of the different categories of education in the Blau-indicator. It varies between zero, i.e. all the NEDs are equally categorized, and 0.84, e.g. out of six NEDs, every NED is in a different category. The diversity in education is higher in the control sample than in the financially distressed sample, but only at the 10% level in t = −3. In t = −2 there is no result. This is as expected from the figures in table 7.2.

Table 7.6: An analysis of the academic education of NEDs and of the academic education diversity of the SB for the control sample and the financially distressed sample of listed Dutch companies from 1993 to 2003, based on panel data for t = −2 and t = −3 before the financial distress event occurred.

board variable	control sample				financially distressed sample				difference |t-value| (|z-value|)
	number	min (max)	mean (median)	standard deviation	number	min (max)	mean (median)	standard deviation	
t = -2 DEGREENED	730		71%		222		60%		(3.02)**
DEGREEAV	149	0.00	0.70	0.28	52	0.00	0.61	0.29	1.92[a]
		(1.00)	(0.75)			(1.00)	(0.67)		(2.00)*
EDUDIV	149	0.00	0.59	0.18	52	0.00	0.52	0.23	(1.57)
		(0.84)	(0.63)			(0.78)	(0.58)		
t = -3									
DEGREENED	729		71%		223		61%		(2.67)**
DEGREEAV	149	0.00	0.70	0.27	52	0.00	0.62	0.27	1.95[a]
		(1.00)	(0.75)			(1.00)	(0.67)		(2.18)*
EDUDIV	149	0.00	0.59	0.18	52	0.00	0.54	0.20	(1.83)[a]
		(0.83)	(0.64)			(0.81)	(0.62)		

***, ** and * indicate statistical significance at a 0.1%, 1% and 5% level, respectively
[a] indicates statistical significance at the 10% level.

7.5.5 Independence

In table 7.7 DEPNED stands for the non-independence of a NED. It is a binary variable. If a NED is non-independent it is 1. DEPAV signifies the percentage of non-independent NEDs on the SB. This section adds to 6.5.4 since it also analyses at a NED level, without new results,

Table 7.7: An analysis of the independence of NEDs and of the independence diversity of the SB for the control sample and the financially distressed sample of listed Dutch companies from 1993 to 2003, based on panel data for t = –2 and t = –3 before the financial distress event occurred.

board variable	control sample				financially distressed sample				difference
	number	min (max)	mean (median)	standard deviation	number	min (max)	mean (median)	standard deviation	|t-value| (|z-value|)
t = -2 DEPNED	730		18%		222		19%		(0.39)
DEPAV	149		19%		52		14%		(1.67)[a]
DEPDIV	149	0.00	0.21	0.21	52	0.00	0.14	0.19	2.03*
		(0.50)	(0.22)			(0.50)	(0.00)		(2.00)*
t = -3									
DEPNED	729		18%		223		20%		(0.84)
DEPAV	149		18%		52		16%		(1.03)
DEPDIV	149	0.00	0.20	0.21	52	0.00	0.16	0.19	1.24
		(0.50)	(0.20)			(0.50)	(0.00)		(1.29)

***, ** and * indicate statistical significance at a 0.1%, 1% and 5% level, respectively.
[a] indicates statistical significance at the 10% level.
DEPNED the non–independence dummy variable being 1 if a NED is non–independent
DEPAV the average value of the dummy variable over the SB
DEPDIV the Blau–indicator on the diversity in non–independence of the SB.

and it applies the Blau–indicator DEPDIV. Control firms have dependence–wise more diverse boards. Since the non–independence variable DEPNED is of an ordinal nature, and the AVDEP variable is skewed (not reported) only the *z–values* are calculated. The DEPDIV variable however is normally distributed and therefore the *t–values* are reported as well. The diversity (DEPDIV) as well as the average (DEPAV) in non–independence are higher in the control group and prove statistically significantly different only in t = –2 at the 5% respectively 10% level.

7.5.6 Network

NETNED stands for the network of a NED expressed in number of NED positions plus chairmanships. NETAV signifies the average network of the NEDs on the SB. The NETDIV variable, expressed as the standard deviation, signifies the network diversity on the SB. Table 7.8 presents the results on the network of the NEDs. Since the NETNED, NETAV and NETDIV variables are not normally distributed only the *z–values* are shown. Table 7.8 reports a maximum of 27 for NETNED. At one time, one NED had nine chairmanships in a NV and 12 in a BV, besides four ordinary NV and two ordinary BV positions. The NETNED and NETAV variables are statistically significantly higher in the control group at the 1% level over both panels. Control group NEDs occupy on average half a position more than their fellow NEDs in the distressed groups. The diversity variable NETDIV shows only a difference at the 10% level for t = –3. This indicates that generally *all* the NEDs in the control group occupy more NED positions than the NEDs on the distressed boards.

Table 7.8: An analysis of the network of NEDs and of the network diversity of the SB for the control sample and the financially distressed sample of listed Dutch companies from 1993 to 2003, based on panel data for t = −2 and t = −3 before the financial distress event occurred.

board variable	control sample				financially distressed sample				difference in distribution (|z-value|)
	number	min (max)	mean (median)	standard deviation	number	min (max)	mean (median)	standard deviation	
t = -2 NETNED	730	1	4.39	3.49	222	1	3.80	4.06	(4.12)***
		(23)	(4)			(27)	(2)		
NETAV	149	1.17	4.32	1.79	52	1	3.93	2.62	(2.21)**
		(13)	(4.00)			(12)	(3.33)		
NETDIV	149	0.37	2.58	1.42	52	0.00	2.52	2.14	(1.35)
		(7.59)	(2.36)			(9.76)	(2.02)		
t = -3									
NETNED	729	1	4.38	3.56	223	1	3.76	3.92	(3.72)***
		(23)	(3)			(27)	(2)		
NETAV	149	1.20	4.30	1.77	52	1	3.69	2.28	(2.66)**
		(13)	(4.25)			(11.25)	(3.00)		
NETDIV	149	0.35	2.62	1.46	52	0.00	2.46	2.14	(1.65)[a]
		(7.44)	(2.45)			(9.76)	(1.95)		

***, ** and * indicate statistical significance at a 0.1%, 1% and 5% level, respectively.
[a] indicates statistical significance at the 10% level.

NETNED the network of the NED at t = −2 and t = −3 in terms of the number of NED positions and chairmanships
NETAV the average network of the NEDs on the SB in terms of the number of NED positions and chairmanships
NETDIV the diversity in network of the SB measured in terms of the standard deviation.

7.5.7 Workload

Two workload variables are calculated. The first (WL1NED) supposes that each NV post and each NV chairmanship takes 100 hrs/year, and a BV post and each BV chairmanship 50 hrs/year. These hours are added to those resulting from a regular job, if any, and divided by 1,800. The alternative (WL2NED) calculates the NV post and NV chairmanship for 200 hrs/year, and the BV post and BV chairmanship for 100 hrs/year. The 200 hrs/year is in line with Winter and Cools (2008) and Goodridge (2007), whilst the 100 hrs/year is more in line with the 1990's culture described by Lipton and Lorsch (1992). Workload is considered as a resource if it is well below 1,800 hrs (thus <1). In that case, a NED may have spare time, will be less pressed, more thoughtful and more flexible in his availability. WL1AV and WL2AV signify the average workload of the NEDs on the SB. The WL1DIV and WL2DIV variables, expressed as the standard deviation, signify the workload diversity on the SB. Table 7.9 presents the results on the workload of the NEDs. Since all workload related variables are normally distributed, the *t-values* as well as the *z-values* are reported. The results of table 7.9 show a consistent difference for the variables between the samples. The workload of NEDs (WL1NED; WL2NED) in the financially distressed sample is statistically significantly higher than in the control sample at the 5% level or better (*t–test*; the variable is not skewed) in each specification (100 hrs/year and 200 hrs/

Table 7.9: An analysis of the workload of NEDs and of the workload diversity of the SB for the control sample and the financially distressed sample of listed Dutch companies from 1993 to 2003, based on panel data for t = –2 and t = –3 before the financial distress event occurred.

	control sample				financially distressed sample				difference
board variable	number	min (max)	mean (median)	standard deviation	number	min (max)	mean (median)	standard deviation	|t-value| (|z-value|)
t = -2									
WL1NED	730	0.06	0.68	0.48	222	0.06	0.79	0.47	3.31**
		(1.64)	(0.56)			(1.64)	(1.06)		(1.75)[a]
WL2NED	730	0.11	0.89	0.52	222	0.11	0.97	0.50	2.02*
		(2.28)	(1.11)			(2.28)	(1.11)		(1.34)
WL1AV	149	0.07	0.68	0.26	52	0.14	0.79	0.27	2.65**
		(1.29)	(0.67)			(1.28)	(0.83)		(2.88)**
WL2AV	149	0.15	0.89	0.28	52	0.28	0.97	0.29	1.80[a]
		(1.58)	(0.90)			(1.57)	(0.99)		(1.98)*
WL1DIV	149	0.05	0.42	0.15	52	0.00	0.36	0.21	1.76[a]
		(0.73)	(0.43)			(0.89)	(0.37)		(1.96)[a]
WL2DIV	149	0.03	0.38	0.14	52	0.00	0.33	0.19	1.69[a]
		(0.60)	(0.43)			(0.61)	(0.39)		(1.58)
t = -3									
WL1NED	729	0.06	0.65	0.48	223	0.06	0.79	0.47	3.50***
		(1.64)	(0.50)			(1.64)	(1.06)		(2.19)*
WL2NED	729	0.11	0.86	0.52	223	0.11	0.95	0.52	2.24*
		(2.28)	(1.00)			(2.28)	(1.11)		(1.77)[a]
WL1AV	149	0.07	0.66	0.27	52	0.07	0.78	0.29	2.57*
		(1.29)	(0.67)			(1.28)	(0.80)		(2.78)**
WL2AV	149	0.15	0.87	0.29	52	0.15	0.94	0.31	1.64
		(1.58)	(0.89)			(1.57)	(0.95)		(1.81)*
WL1DIV	149	0.05	0.41	0.15	52	0.00	0.36	0.21	1.41
		(0.73)	(0.43)			(0.89)	(0.39)		(1.55)
WL2DIV	149	0.03	0.37	0.15	52	0.00	0.34	0.19	1.20
		(0.60)	(0.43)			(0.62)	(0.40)		(0.95)

***, ** and * indicate statistical significance at a 0.1%, 1% and 5% level, respectively.
[a] indicates statistical significance at a 10% level.

WL1NED	the workload1 (a NED position in an NV takes 100 hrs/year) of the NED at t = –2 and t = –3
WL2NED	the workload2 (a NED position in an NV takes 200 hrs/year) of the NED at t = –2 and t = –3
WL1AV	the average workload1 of the NEDs on the SB in terms of full-time equivalents (FTEs)
WL2AV	the average workload2 of the NEDs on the SB in terms of full-time equivalents (FTEs)
WL1DIV	the diversity in workload1 measured in terms of the standard deviation
WL2DIV	the diversity in workload2 measured in terms of the standard deviation.

year per NED position). The average workload on the SB (WL1AV; WL2AV) is also higher in the distressed sample: for the 100 hrs/y variable, hereinafter also indicated as the 'workload1' variable, all values are statistically significantly different at the 5% level. The results on the 200 hrs/y specification ('workload2'), indeed for the period under review probably a rather high assumption, fall short especially on the t = −3 panel. Diversity in workload proves only statistically significantly different at the 10% level for t = −2, with a higher diversity in the control group than in the distressed group.

7.5.8 Correlation and multicollinearity

This section presents three correlation tables, i.e. for the resource dependence related individual NED characteristics (with extension – NED, table 7.10), for the average board value of the characteristics (with extension – AV, table 7.11) and for the board diversity on these characteristics (with extension –DIV, table 7.12). Table 7.10 shows that the *age* of a NED relates statistically significantly negatively with foreign nationality, gender, non–independence and workload, whilst the master's degree and network are positively related. Thus, older NEDs are often male, Dutch, university educated, independent, with a relatively large network and a relatively low workload. *Foreign* NEDs are younger, self–made, non–independent and have a relatively small network. A *degree* is negatively related to non–independence and positively related to network and workload. That *work–load* and *network* of a NED relate is not surprising, but the rather low coefficient is. Whilst table 7.10 presented a correlation analysis of NED related data, table 7.11 looks into *board* averages. It shows that a relatively large firm (LNTA) often has an older board, with

Table 7.10: A correlation analysis (Spearman) of the resource dependence theory related variables for the NEDs on the boards of the control sample and the financially distressed sample of listed Dutch companies from 1993 to 2003, based on panel data for t = −2 before the financial distress event occurred (N=952).

	AGENED	NATNED	GENNED	DEGREENED	DEPNED	NETNED
AGENED	1					
NATNED	−0.20**	1				
GENNED	−0.12**	0.06	1			
DEGREENED	0.12**	−0.42**	−0.06	1		
DEPNED	−0.22**	0.26**	0.06	−0.17**	1	
NETNED	0.27**	−0.28**	−0.08*	0.27**	−0.16**	1
WLNED1	−0.44*	0.05	−0.01	0.11**	0.04	0.26**

** Correlation is significant at the 0.01 level (2–tailed)
* Correlation is significant at the 0.05 level (2–tailed)

AGENED	the age of a NED at t = −2
NATNED	a dummy variable being 1 if the nationality of a NED is non–Dutch
GENDER	a dummy variable being 1 if a NED is female
DEGREENED	a dummy variable being 1 if a NED has an academic degree
NETNED	the network of the NED at t = −2 in terms of the number of NED positions and chairmanships
WLNED1	the workload1 (a NED position in an NV takes 100 hrs/year) of the NED at t = −2

Table 7.11: A correlation analysis (Spearman) of the average of the resource dependence theory related variables on the boards of the control sample and the financially distressed sample of listed Dutch companies from 1993 to 2003, based on panel data for t = –2 before the financial distress event occurred (N=201).

	LNTA	CETA	NITA	CASH VV	AGE AV	NAT AV	GEN AV	DEGREE AV	DEP AV	NET AV
LNTA	1									
CETA	–0.34**	1								
NITA	0.01	0.24**	1							
CASHVV	–0.09	0.44**	0.85**	1						
AGEAV	0.32**	0.01	0.15*	0.12	1					
NATAV	0.37**	0.00	–0.17*	–0.18*	–0.13	1				
GENAV	0.13	–0.02	–0.05	–0.03	–0.07	0.08	1			
DEGREEAV	0.02	0.05	0.12	0.13	0.17*	–0.34**	–0.03	1		
DEPAV	0.08	0.10	0.08	0.08	–0.19**	0.30**	0.08	–0.22**	1	
NETAV	0.24**	–0.13	0.04	0.04	0.36**	–0.20**	–0.01	0.31**	–0.20**	1
WL1AV	–0.09	0.01	–0.04	–0.05	–0.46**	0.06	0.02	0.02	0.03	0.02

** Correlation is significant at the 0.01 level (2–tailed)
* Correlation is significant at the 0.05 level (2–tailed)

LNTA	the natural logarithm of total assets (TA) in millions of euros (size measure)
CETA	common equity (CE) divided by TA (leverage measure)
NITA	net income (before extraordinary items; NI) divided by TA (income measure)
CASHVV	cash flow (CASH) divided by TA (liquidity measure)
AGEAV	the average age of the supervisory board (SB) at t = –2
NATAV	the average SB value of the nationality dummy variable being 1 if a NED is non–Dutch
GENAV	the average SB value of the gender dummy variable being 1 if a NED is female
DEGREEAV	the average SB value of the academic degree dummy variable being 1 if a NED has an academic degree
DEPAV	the average SB value of the non–independence dummy variable being 1 if a NED is non–independent
NETAV	the average SB value of the network of NEDs in terms of NED positions and chairmanships
WL1AV	the average SB value of the workload1 (each position takes 100 hrs/year) of the NEDs in terms of FTEs.

more foreigners, and a larger network, which is statistically significant at the 1% level. The *average* age and availability of a master's degree are significantly positively related, whilst the average degree and nationality are negatively related. This is in accordance with the results for the individual NEDs.

Table 7.12 on *board diversity* shows that SBs of larger firms are statistically significantly more diverse in nationality, education and network at the 1% level. At the 1% level diversity in nationality is positively related to diversity in age and diversity in non–independence. Diversity in network and education are related as well. This resembles the results of the previous table. Multicollinearity, apart from the relationship between NITA and CASHVV discussed in chapter 6, does not show.

Table 7.12: A correlation analysis (Spearman) of the diversity in the resource dependence theory related characteristics on the boards of the control sample and the financially distressed sample of listed Dutch companies from 1993 to 2003, based on panel data for t = –2 before the financial distress event occurred (N=201).

	LNTA	CETA	NITA	CASH VV	AGE DIV	NAT DIV	GEN DIV	EDU DIV	DEP DIV	NET DIV
LNTA	1									
CETA	–0.34**	1								
NITA	0.01	0.24**	1							
CASHVV	–0.09	0.44**	0.85**	1						
AGEDIV	–0.06	0.04	–0.10	–0.05	1					
NATDIV	0.38**	–0.01	–0.13	–0.14*	0.22**	1				
GENDIV	0.13	–0.02	–0.05	–0.03	0.11	–0.03	1			
EDUDIV	0.32**	–0.08	0.06	0.05	–0.02	0.07	0.01	1		
DEPDIV	0.06	0.11	0.09	0.10	0.12	0.20**	0.02	0.00	1	
NETDIV	0.24**	–0.11	0.05	0.01	–0.07	–0.07	0.03	0.31**	–0.02	1
WL1DIV	0.09	–0.01	0.06	0.06	0.07	–0.07	–0.03	0.13	–0.01	0.14*

* Correlation is significant at the 0.05 level (2–tailed)
** Correlation is significant at the 0.01 level (2–tailed)

LNTA	the natural logarithm of total assets (TA) in millions of euros (size measure)
CETA	common equity (CE) divided by TA (leverage measure)
NITA	net income (before extraordinary items; NI) divided by TA (income measure)
CASHVV	cash flow (CASH) divided by TA (liquidity measure)
AGEDIV	the diversity in age of the supervisory board (SB) at t = –2 (standard deviation)
NATDIV	the diversity in nationality on the SB (Blau–indicator)
GENDIV	the diversity in gender on the SB (Blau–indicator)
EDUDIV	the diversity in education on the SB (Blau–indicator)
DEPDIV	the diversity in non–independence on the SB (Blau–indicator)
NETDIV	the diversity in network on the SB (standard deviation)
WL1AV	the diversity in workload1 (each position takes 100 hrs/year) on the SB (standard deviation).

7.5.9 Regression results

This regression section starts with a univariate analysis in order to determine whether the variables analysed above are in fact *related* to financial distress. Many of the variables under research appear to be statistically significantly related to financial distress. The gender and non–independence variables show only a relevant result for one specification on one panel which is too weak for firm conclusions. However, age, education and network are indeed negatively related to financial distress, whilst foreign nationality and workload are positively related. The previous however is only a test and not a model. The Nagelkerke R^2, a measure for the goodness of fit of a model (see 6.5.9) is low: between 0.01 and 0.05 (not reported).

The full model specified above table 7.14 tests all resource characteristics in one as pleaded for and applied in Ruigrok, Peck and Tacheva (2007). The intention is to show the additional explanatory value of the resource characteristics. Model 1 is the basic

Table 7.13: Univariate regression analysis on resource dependence theory related characteristics of the supervisory boards of the control sample and the financially distressed sample of listed Dutch companies from 1993 to 2003, based on panel data for t = −2 respectively t = −3 before the financial distress event occurred.
model: $DISTRESS \approx \alpha + \beta_1(variable)$

variable	t = −2	t = −3	variable	t = −2	t = −3	variable	t = −2	t = −3
AGENED	−0.05***	−0.06***	AGEAV	−0.11**	−0.12***	AGEDIV	0.07	0.09
NATNED	0.70***	0.60**	NATAV	1.38*	1.53*	NATDIV	1.44 [a]	1.67*
GENNED	0.04	0.39	GENAV	0.92	3.16[a]	GENDIV	0.32	1.79
EDUNED	– [a]	– [a]	DEGREEAV	−1.05 [a]	−1.11[a]	EDUDIV	−1.58*	−1.40[a]
DEPNED	0.08	0.16	DEPAV	−0.92	−0.42	DEPDIV	−1.66*	−1.00
NETNED	−0.05*	−0.05*	NETAV	−0.10	−0.18[a]	NETDIV	−0.02	−0.06
WL1NED	0.53**	0.56**	WL1AV	1.68*	1.54*	WL1DIV	−1.96*	−1.53
n =	952	952		201	201		201	201

***, ** and * indicate statistical significance at a 0.1%, 1% and 5% level, respectively.
[a] indicates statistical significance at a 10% level
DISTRESS = ln (p/ (1−p))
other variables defined below tables 7.11, 7.12 and 7.13.

model with only financial control variables and industry already presented in chapter 6 (table 6.12). Model 5 is the *resources availability* model. Based on a resource dependence perspective it adds the *average* availability of the resource characteristics on the board to model 1 as explanatory variables. Model 6 is a *resources diversity* model. By adding the *diversity* in resources as explanatory variables to model 1, model 6 presupposes that diversity itself has a surplus value for the company. Since the ‘workload 1’ variables (those that calculate with 100 hrs/year for a NED position) differed statistically significantly more between the samples than the ‘workload 2’ variables (working with 200 hrs/year) the former are used in the models. Note that the –NED variables analysed in the previous sections cannot be applied as explanatory variables since they relate to an individual NED and not to (the board of) a company. Table 7.14 presents the results. Of the *control variables*, size (LNTA), leverage (CETA) and industry (services or ICT) are the significant explaining variables at the 5% level on panel t = −2. On the t = −3 panel industry (ICT) especially is a significant explaining variable. On the *resources availability model* (model 5; those with an –AV extension) non–independence (t = −3) is negatively and workload (t = −2) is positively significantly related to financial distress at the 10% level (the result for workload in the t = −3 panel is just outside the 10% boundary). On the *resources diversity model* (model 6; those with an –DIV extension) the diversity in nationality is significantly positively related to financial distress in both panels at the 10% level. Thus, so it seems, financial distress can be associated with an average high workload of NEDs on the board as well as with a high nationality diversity of NEDs on the board.

Table 7.14: A logit analysis of the financial control, resource dependence and diversity related variables for the control sample and the financially distressed sample of listed Dutch companies from 1993 to 2003, based on panel data for t =–2 and t = –3 before the financial distress event occurred.

model 1: $DISTRESS \approx \alpha + \beta_1 LNTA + \beta_2 CETA + \beta_3 NITA + \beta_4 CASHVV + \beta_5 industry + \varepsilon$

model 5: $DISTRESS \approx \alpha + \beta_1 LNTA + \beta_2 CETA + \beta_3 NITA + \beta_4 CASHVV + \beta_5 industry + \beta_6 AGEAV + \beta_7 GENAV + \beta_8 NATAV + \beta_9 DEGREEAV + \beta_{10} DEPAV + \beta_{11} NETAV + \beta_{12} WL1AV + \varepsilon$

model 6: $DISTRESS \approx \alpha + \beta_1 LNTA + \beta_2 CETA + \beta_3 NITA + \beta_4 CASHVV + \beta_5 industry + \beta_{13} AGEDIV + \beta_{14} GENDIV + \beta_{15} NATDIV + \beta_{16} DEGREEDIV + \beta_{17} DEPDIV + \beta_{18} NETDIV + \beta_{19} WL1DIV + \varepsilon$

	exp. sign[1]		*t = –2*			*t = –3*	
		model 1	model 5	model 6	model 1	model 5	model 6
(1)	(2)	(3)	(4) - AV	(5) - DIV	(6)	(7) - AV	(8) - DIV
financial variables							
LNTA	–	–0.40**	–0.42*	–0.55**	–0.16	–0.17	–0.25[a]
CETA	–	–1.74	–2.31	–1.99	2.90	3.17[a]	2.84
NITA	–	–20.60**	–22.37**	–19.80**	–6.80	–8.55	–6.66
CASHVV	–	–2.05	–2.02	–2.13	–5.30	–4.98	–5.25[a]
industry°		a			**	a	*
construction		–18.55	–18.35	–18.72	–19.41	–19.24	–19.60
trade		0.06	0.55	0.12	–0.17	0.10	–0.23
transport		–0.37	–0.59	–0.66	–0.81	–0.55	–0.78
services		2.25*	2.55*	2.56*	1.90*	1.73[a]	1.77[a]
ICT		1.83**	1.72*	1.64*	1.89***	1.77**	1.74**
other		0.89	0.97	1.14	0.67	0.75	0.66
resource variables							
AGE	–/+		0.02	–0.05		–0.04	–0.00
NATIONALITY	+/+		1.10	2.69[a]		1.57	2.48*
GENDER			0.17	1.19		2.62	2.19
EDUCATION	–/–		0.23	–0.50		–0.86	–0.69
NON-INDEPENDENT	–/–		–1.40	–1.17		–2.17[a]	–1.28
NETWORK	–/–		–0.11	0.20		0.01	0.10
WORKLOAD	+/–		2.60*	–1.04		1.64	–0.24
constant		1.79[a]	–0.67	2.96	–0.53	–0.67	1.22
statistics							
number of observations		201	201	201	201	201	201
Nagelkerke R^2		0.62	0.65	0.64	0.42	0.48	0.45
LR statistics (χ^2)		110.54***	117.31***	116.06***	67.94***	79.96***	73.06***
Type I error (cut-off 0.5)		0.05	0.05	0.03	0.04	0.04	0.03
Type II error (cut-off 0.5)		0.27	0.25	0.29	0.54	0.56	0.54
Type I error (cut-off 0.1)		0.34	0.30	0.34	0.64	0.50	0.48
Type II error (cut-off 0.1)		0.10	0.06	0.10	0.06	0.04	0.04

***, ** and * indicate statistical significance at a 0.1%, 1% and 5% level, respectively.

[a] indicates statistical significance at a 10% level.

° manufacturing is the reference category

[1] expected sign based on the previous analyses of distribution.

DISTRESS = ln (p / (1–p))

AV = average value of the resource on the supervisory board (SB)

DIV = diversity of the resource on the board (Blau–indicator or standard deviation)

Variables defined below tables 7.2–7.9 and 7.11.

7.5.10 Bankrupt companies only

Section 6.5.10 touched on the composition of the financially distressed sample. Would the results presented in table 7.14 hold if the tests were performed on a bankruptcy–only sample? Table 7.15 shows that the code 1 (bankruptcy) and code 2 (financially distressed/ non–bankrupt) samples differ in only two factors: age and leverage (CETA). Section 6.5.10 already explained the difference in CETA as the financial buffer that code 2 still had, and that was just burnt for code 1. The other difference between code 1 and code 2 forms the average–age (AGEAV) and age–diversity (AGEDIV) variables. The average age is 59 (code 0), 55 (code 1) and 57 (code 2) and the age diversity 5.5 (code 0), 6.8 (code 1) and 5.0 (code 2). Thus the distressed non–bankrupt sample (code 2) has an older, less age diverse SB than code 1. The control (code 0) and bankrupt (code 1) samples differ statistically significantly on all factors except gender and non–independence. The GENAV and GENDIV variables do not show a difference between the groups, which was to be expected after the weak results of table 7.4. Just like the dummy variable DEPDM in table 6.12, the average SB–dependence (DEPAV) and dependence–diversity (DEPDIV) show a difference between the code 1 and code 2 samples, but not between the bankrupt (code 1) and the control sample (code 0). As explained in 6.5.10 this is due to the rather odd pattern the DEP variable shows. The DEPAV variable is around 18% for the codes 0 and 1,

Table 7.15: An analysis of the difference in distribution of financial control, and agency theory related variables between the control sample, the bankrupt sub–sample, and the financially distressed non–bankrupt sub–sample of listed Dutch companies from 1993 to 2003, based on panel data for t = –2 and t = –3 (full panel) before the financial distress event occurred.

variables	significance of difference between code 0 and code 1	significance of difference between code 0 and code 2	significance of difference between code 1 and code 2	*variables*	significance of difference between code 0 and code 1	significance of difference between code 0 and code 2	difference of distribution between code 1 and code 2
LNTA	**	**		NITA	***	***	
CETA	***	***	***	CASHVV	***	***	
AGEAV	***	**	*	AGEDIV	***		**
NATAV	**			NATDIV	**		
GENAV				GENDIV			
DEGREEAV	*	*		EDUDIV	a	a	
DEPAV		*		DEPDIV		*	
NETAV	***			NETDIV	*		
WL1AV	***	*		WL1DIV	a	a	

***, ** and * indicate statistical significance at a 0.1%, 1% and 5% level, respectively.
[a] indicates statistical significance at a 10% level.
Variables defined under tables 7.2 – 7.9 and 7.11 above.
Code 0, 1, 2 defined under table 6.1 above.

Table 7.16: A logit analysis of the financial control, resource dependence and diversity related variables for the control sample and the bankrupt sub–sample of listed Dutch companies from 1993 to 2003, based on panel data for t =–2 and t = –3 before bankruptcy occurred.
model 1: $DISTRESS \approx \alpha + \beta_1 LNTA + \beta_2 CETA + \beta_3 NITA + \beta_4 CASHVV + \beta_5 industry + \varepsilon$
model 5: $DISTRESS \approx \alpha + \beta_1 LNTA + \beta_2 CETA + \beta_3 NITA + \beta_4 CASHVV + \beta_5 industry + \beta_6 AGEAV + \beta_7 GENAV + \beta_8 NATAV + \beta_9 DEGREEAV + \beta_{10} DEPAV + \beta_{11} NETAV + \beta_{12} WL1AV + \varepsilon$
model 6: $DISTRESS \approx \alpha + \beta_1 LNTA + \beta_2 CETA + \beta_3 NITA + \beta_4 CASHVV + \beta_5 industry + \beta_{13} AGEDIV + \beta_{14} GENDIV + \beta_{15} NATDIV + \beta_{16} DEGREEDIV + \beta_{17} DEPDIV + \beta_{18} NETDIV + \beta_{19} WL1DIV + \varepsilon$

	exp. sign		*t =-2*			*t =-3*	
		model 1	model 5	model 6	model 1	model 5	model 6
(1)	(2)	(3)	(4) - AV	(5) - DIV	(6)	(7) - AV	(8) - DIV
financial variables							
LNTA	–	–0.47**	–0.65*	–0.81**	–0.27[a]	–0.37[a]	–0.43*
CETA	–	–5.05**	–6.49**	–7.62**	–1.43	–1.58	–2.31
NITA	–	–9.90[a]	–10.10[a]	–9.86[a]	–3.25	–1.34	–1.38
CASHVV	–	–2.39	–1.93	–1.23	–5.68	–6.67	–5.96
industry°		a			*		
construction		–18.57	–18.55	–18.79	–18.96	–18.91	–19.32
trade		–0.44	–0.07	–0.51	–0.39	–0.40	–0.85
transport		–18.21	–17.88	–18.23	–18.66	–18.01	–18.46
services		1.87[a]	1.92[a]	2.05[a]	1.94[a]	2.28[a]	2.08
ICT		1.67**	1.54*	1.57*	1.95**	1.53*	1.57**
other		–19.02	–19.13	–19.14	–19.21	–19.34	–19.61
resource variables							
AGE	–/+		0.01	–0.03		–0.09	0.09
NATIONALITY	+/+		3.22[a]	4.90*		3.38*	3.81*
GENDER			1.93	2.45		3.97	3.30
EDUCATION	–/–		1.49	0.58		0.14	–0.25
NON-INDEPENDENT	–/–		–0.67	–1.27		–2.12	–1.68
NETWORK	–/–		–0.04	0.22		0.05	0.03
WORKLOAD	+/–		1.65	–0.84		0.36	–0.08
constant		2.72*	1.08	4.17*	0.88	5.79	1.30
statistics							
number of observations		181	181	181	181	181	181
Nagelkerke R^2		0.56	0.60	0.60	0.46	0.53	0.53
LR statistics (χ^2)		74.26***	81.29***	82.68***	59.49***	69.95***	70.14***
Type I error (cut-off 0.5)		0.03	0.04	0.04	0.04	0.03	0.03
Type II error (cut-off 0.5)		0.47	0.34	0.38	0.53	0.50	0.53
Type I error (cut-off 0.1)		0.30	0.26	0.26	0.39	0.32	0.30
Type II error (cut-off 0.1)		0.16	0.06	0.16	0.03	0.06	0.06

***, ** and * indicate statistical significance at a 0.1%, 1% and 5% level, respectively.
[a] indicates statistical significance at a 10% level.
° manufacturing is the reference category.
Distress = ln (p / (1–p)).
Variables defined under tables 7.2 – 7.9, 7.11 above.

whilst around 10% for code 2 (not reported). This means that the dependence diversity (DEPDIV) for code 2 is lower than for the codes 0 and 1.

Table 7.16 shows the regression results on the full models. Here again it shows that the financial *control variables* and the industry (ICT) are decisive explaining variables. However, striking in table 7.16 is the persistent significance of a nationality–related variable between the 5% and 10% level in *both models.* Thus, either many foreign nationals on the board (NATAV) or a high diversity in nationality (NATDIV) are both positively related to financial distress, with diversity as the slightly more important factor. Annex 4 contains additional statistical comments.

7.6 CONCLUSION

Departing from the research model developed in 5.6, this chapter aimed to develop and subsequently test monitoring–related hypotheses based on the resource dependency theory. It tested the following hypotheses:

- H_1: *the incidence of older (for: more experienced) NEDs is negatively related to financial distress*
- H_2: *the incidence of non–national NEDs is not related to financial distress*
- H_3: *the incidence of female NEDs is negatively related to financial distress*
- H_4: *the incidence of better educated NEDs is negatively related to financial distress*
- H_5: *the incidence of independent NEDs is not related to financial distress*
- H_6: *the incidence of multiple–director NEDs is negatively related to financial distress*
- H_7: *the workload of NEDs is positively related to financial distress.*

The *analysis of differences* between the samples presented in tables 7.2 – 7.9 showed that all variables under research, except gender, differ statistically significantly between the financially distressed sample and the control sample. The NEDs on the control sample board in t = –2 are 60 years old, 84% Dutch, 97% male, 71% have a university degree, 82% are independent, they have a 4.39 non–executive director position, and a 'workload1' of 0.68 FTE. NEDs on the financially distressed sample are significantly younger, more often foreign, less educated, somewhat less independent and have a smaller network and a higher workload. For a NED on the financially distressed sample in t = –2 this gives an age of 56, 73% Dutch, 97% male, 60% have a university degree, 81% are independent, have a 3.80 NED position with a median of 2, and a 'workload1' of 0.79 FTE.

The *univariate regression results* from table 7.13 answer the hypotheses.
H_1 on the negative effect of *age* on distress cannot be rejected since tables 7.2 and 7.13 show that being 'younger' and financial distress are positively related for the individual NED as well as for the SB. Nor should H_2 on the irrelevance of *nationality* be rejected

since tables 7.3 and 7.13 show that a non–Dutch nationality and financial distress are positively related for the individual NED as well as for the SB. H_3 on the negative effect of *gender* on distress should be rejected since only 3% of the NED population is female, the differences analysis shows no results, and therefore no meaning should be attached to the only significance of the average gender variable GENAV at the 10% level in table 7.13. Hypothesis H_4 on the negative effect of *education* on distress cannot be rejected since tables 7.5, 7.6 and 7.13 show that better education and financial distress are clearly negatively related. Since tables 7.7 and 7.13 show that especially the diversity in *non–independence* relates *negatively* to financial distress at the 5% level in t = –2, H_5 on the irrelevance of non–independence on distress should be rejected. H_6 on the negative effect of *network* on distress cannot be rejected since tables 7.8 and 7.13 show that a larger network relates negatively to financial distress. As for *workload*, H_7 on the positive effect of workload on distress cannot be rejected since tables 7.9 and 7.13 show that 'distressed' NEDs have a higher workload than their equals on control boards. Moreover, the workload diversity in control boards is higher, thus implying more flexibility. Indeed this workload diversity is negatively related to distress.

The *logit regression* results are presented in table 7.14 for the full–distressed sample and in table 7.16 for the bankrupt–only sample. The *resource availability* model (model 5) tests the additional explanatory power of the availability of resources on the SB. For the full–distressed sample, WORKLOAD is a positive explanatory variable for distress in panel t = –2. The NON–INDEPENDENT variable is a negative explanatory variable for distress but only at the 10% level. In the bankrupt–only sample, NATIONALITY proves a significant and positive explanatory variable for distress. The *resource diversity* model (model 6) tests the additional explanatory power of the diversity of resources on the SB. Both the full–distressed sample and the bankrupt–only sample show that diversity in nationality is a positive explanatory variable for distress. Apparently the disadvantages of a foreigner on the board in terms of culture and communication weigh heavier than the supposed advantages in terms of know–how and resources.

This is the first study that systematically explores the relationship between personal characteristics and resources of NEDs and financial distress. The variables age, nationality, education, independence, network and workload are in one specification or another statistically significantly different between the control and distressed samples. This shows that the firm's resource bundle significantly differs between these samples; and this bundle influences the path–dependence of the firm (Kor, 2003). Does this 'resource bundle' influence the quality of monitoring and does it have explanatory value for the chance of financial distress? Logit analysis presents non–independence (t = –3) as a negative and workload (t = –2) as a positive explanatory variable for financial distress. There is one outstanding result: the presence of foreign NEDs is a positive explanatory variable for financial distress in both panels. Since this is not *per se* a causal relationship, it would be too simple a statement to dissuade the appointment of foreign NEDs. However, a strong warning that with the entrance of foreigners on the board new processes and difficulties enter the board room seems appropriate.

Remarkably, the network hypothesis which is directly based on the resource dependence theory is by no means supported in the regression models. However, the univariate analysis shows a positive relationship for the network of an individual NED and a control company at the 5% level.

The results confirm the *resource dependence theory* as well as the quest for more *diversity* since (1) most resource variables specified in this chapter prove to be statistically significantly differently distributed between the samples in average availability and/or diversity; and (2) most variables are significant explanatory variables for financial distress in the univariate analysis.

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ENDNOTES

1 Part of the hypothesis development has been published in Santen, B.P.A., and A.B.M. Soppe, 2009, NED characteristics, board structure and management turnover in the Netherlands in times of financial distress: a theoretical and empirical survey, *Corporate Ownership & Control* 7, 285–301.

2 The first is said to be the case with Chairman Martinez of ABN AMRO Bank (*De Prooi*, J. Smit, 2006); the latter with the Chairman of the Audit Committee Fahlin in the AHOLD case (trial).

3 Pfeffer and Salancik define interlocking directorates as ‘the placing of representatives from environmental groups or organizations on advisory committees or boards of directors.’

4 A doctorate degree ‘honoris causa’ is counted as a doctorate from the year it was conferred.

5 This is the definition of DC III.2.2. Although the DC did not apply in the research period, the definition facilitates an objective distinction between the NEDs.

6 Wet Melding Zeggenschap, a former Dutch law, at present part of the Wft, that required shareholders passing certain thresholds, like 5%, to register this with the Netherlands Authority for the Financial Markets (AFM).

7 Even at present, s 2:142(3) BW requires NEDs to disclose other (former) occupations ‘in as far they are relevant in relation to the fulfilment of the NED position’ and other ‘commissaris’ positions in other legal persons.

8 Van Ees et al. (2007: 6) provide other indexes and literature.

9 The original publication: P.M. Blau, 1977, *Inequality and heterogeneity*, New York, Free Press, could not be made available to the author of this thesis.

10 Cited from Van Ees et al. 2007.

Chapter

8

Relevance of the agency theory and the resource dependence theory for non–listed companies near financial distress: an empirical approach

The common apex of the decision control system of organizations, large and small, in which decision agents do not bear a major share of the wealth effects of their decisions is some form of a board of directors (Fama and Jensen, 1983: 311)

8.1 INTRODUCTION

This chapter focuses on differences in corporate governance and resource variables between *non-listed* financially distressed and non-distressed legal persons. It tests *agency theory* and *resource dependence theory* inspired hypotheses on governance variables, governance structures and resources to a set of randomly selected, and therefore mainly small distressed legal persons and their non-distressed pairs. The sample consists of private limiteds (*BV's*), co-operatives (*coöperaties*), associations (*verenigingen*) and foundations (*stichtingen*). This research is unique. It adds to the literature by showing relevant relationships between governance and resource-related variables and *financial distress*. The chapter reads as follows. It starts with a theoretical analysis of the different types of legal persons under research in 8.2. This theoretical part ends in the formulation of hypotheses to be tested. After discussing the data in 8.3 and the research method in 8.4, section 8.5 presents the results for each type of legal person. The chapter ends with a conclusion and a discussion of the results in 8.6.

8.2 THEORY AND HYPOTHESES

8.2.1 Theory

Hansmann (1996) shows, as explained in chapter 4, that there are basically two forms of legal persons: those that distribute profit and those that do not. Of the former, the *co-operative* is the root in Hansmann's vision. The *private limited company* should be understood as a gradually developed, transaction costs saving form of a money lenders co-operative. One could argue that a co-operative is meant to procure the broader material needs[1] of its members, whilst the private limited company is ultimately directed at the financial, i.e. profit side of the firm.

The Dutch non-distributive legal forms are the *association* (vereniging) and the *foundation* (stichting). The *association* has members and its objective is generally to defend, further, or achieve a common interest of the members. While this may be of an idealistic nature, it is often about material needs of the individual concerning interests nearby (a tennis court, a parking lot) or further off (ANWB, the Dutch automobile association; VEB, the Dutch shareholders' association). The *foundation* can be used to a large degree to achieve the same objects, but legally it is not permitted to have members[2]. So any organizations in which members want to have a say should preferably not be organized as a foundation[3], although amendments to the articles relating to the mandatory form as described in chapter 4 are allowed. Foundations therefore often strive for objects in the longer term and of a more idealistic nature. Where private limiteds, co-operatives and associations have a board and a general meeting as the two central organs, the foundation has only one: the board, generally existing of highly motivated, often unpaid[4] directors. As indicated in chapter 4, foundations are hardly supervised. Since 'nine-eleven' the Dutch government works on amelioration of the supervision of foundations since these could supposedly be used by terrorists for financing and organizing activities[5].

This chapter aims to study the differences in governance characteristics of financially distressed[6] and non-distressed companies of the general (co-operative) and specific (limited) profit-distributing form, and of the self-interested (association) or altruistic (foundation) non-distributing form[7]. The study tests the *agency theory* and *resource dependence theory* based insights developed in chapters 3, 6 and 7 respectively. Whilst the previous chapters focused on supervisory boards (SBs) and non-executive directors (NEDs), the companies under research in this chapter show very few NEDs. Moreover, especially in the BV a lot of the members are directors themselves, implying none (for director-100% members) or fewer agency problems. Is it permitted then to apply these theories to the executive directors (EDs) of these legal persons? The answer is positive for two reasons. *First*, Fama (1980) explained that managers are each others best monitors. From his article there is no clue that this should only be restricted to non-executive board members. In fact and in line with Argenti (1976) 'the more monitors (up to a limit), the less chance of financial distress', is the leading thought of this thesis. *Second*, there is no reason to hypothesize that non-alignment of interests should only be found in listed companies, or companies with specialized management. The agency theory applies just as well in nonprofit companies (Steinberg, 2010). In *every* firm, there will be tensions of material or immaterial nature between the interests of the firm and those of the executive board members since by definition their utility functions are not equal. Thus, there will always be tension between the legal requirement that the board should act in the interests of the company, whatever they may be and however they should be determined, and the private interests of the individual executive director. This tension is researched through a number of hypotheses.

8.2.2 Hypotheses

The hypotheses formulated below find their origin in literature discussed in the previous chapters. Not all the references are repeated. The hypotheses to be tested are essentially based on the agency theory and the resource dependence theory. *Agency theory* based are the hypotheses H_1 to H_5, which relate to the *monitoring structure* of the legal person. They read as follows:

H_1: the number of directors is negatively related to financial distress
This hypothesis refers to chapter 6 that explained that directors are each others best monitors (Fama, 1980). If there are few directors, directors may demonstrate Icarean behaviour (Skeel, 2005). There are few 'equals' to correct them. Or as Argenti (1976: 173)

puts it: 'The key cause of failure is the one–man rule. (..) No man is infallible. Eventually all one–man rules *must* fail.' If the board is too large, it may not be efficient (Yermack, 1996). Since the size of the board in the sample is generally in the efficient range Yermack described, the hypothesis is formulated to test Fama's monitoring thesis.

$H_{2(a-c)}$: the number of additional control instruments is negatively related to financial distress
This hypothesis refers to the agency theory based decision process as explained in chapter 3 (Fama and Jensen, 1983). Separation of decision management and decision control is the most effective system to align the interests of member and agent. If therefore a third person or body is called upon to effectuate either the management or the control of the decision, less financial distress would be expected. This hypothesis is tested for the presence of another legal person on the board i.e. the holding company or a partner, since one might expect a more balanced and more rational view of a legal–person–director since he has to consider the interests of *both* legal persons, sometimes in different meetings (*hypothesis 2.a*); for the presence of NEDs (*hypothesis 2.b*); and for the presence of a manager outside the board (*hypothesis 2.c*).

$H_{3(a-b)}$: board turnover is positively related to financial distress
This hypothesis refers to chapter 6 which discussed the studies of Hermalin and Weisbach (1988) and Gilson (1989). Either through dismissal or through resignation for fear of reputational damage, financial distress may result in a relatively high outflow of directors in the financially distressed sample (*hypothesis 3.a*), whilst the inflow of new directors to financially distressed companies will be lower (*hypothesis 3.b*) than the control sample.

H_4: overdue disclosure is positively related to financial distress
Chapter 1 showed that an important cause of financial distress is mismanagement. One of the director's duties discussed in chapter 4 is the duty of disclosure. This chapter equates disclosure with the legal duty to file the annual accounts at the *Handelsregister*. Non–disclosure is an indication (even by law, s 2:138, 248 BW) of mismanagement. One may expect less non–disclosure (implying mismanagement) in the control group than in the distressed group. Experience shows that entrepreneurs often cut in costs for bookkeeping and auditing if distress is at hand. This hypothesis can only be tested for co–operatives and private limited companies, since Dutch law generally does not require foundations and associations to disclose.

H_5: the age of the company is negatively related to financial distress
This hypothesis, also found in research of Pompe and Bilderbeek (2005), refers to the theorem of 'survival of the fittest'. Out of the numerous companies started up in year t = 0, some will go bankrupt in year t = 1, others in t = 2 and so on. The general age of a control sample company will therefore grow, whilst that of a distressed company

will stop. Firm age may be an indication of adequate management, since the company apparently survived whilst others failed. Kor (2003) uses firm age as a control variable.

The following hypotheses refer to the *resource dependence theory*. They focus on the *resource availability* and *resource diversity* of EDs.

$H_{6(a-b)}$: experience on the board is negatively related to financial distress
This hypothesis refers to chapter 7 which tested age as a proxy variable for experience (Kor, 2003). This studie contains tenure as another measure for experience. Age, a measure of lifetime experience and network more than of specific company experience, will be measured as experience measure in *hypothesis 6.a*; tenure, an often used measure (e.g. Hermalin and Weisbach, 1988; Kor, 2003, Boone, Field, Karpoff and Raheja, 2007) which is more specifically company-related, is the experience measure applied in *hypothesis 6.b*.

$H_{7(a-c)}$: diversity is negatively related to financial distress
This hypothesis refers to the diversity issue discussed in chapter 7. There are strong scientific arguments to plea for more diversity in boards, and some results indicate a positive relationship with performance (Carter, Simkins and Simpson, 2003). This study researches three diversity variables i.e. gender (*hypothesis 7.a*), nationality (*hypothesis 7.b*) and non-independence (*hypothesis 7.c*). People are 'non-independent' if they are family (surname) or form a household (address).

There is one *general* hypothesis based on Hansmann (1996).

H_8: governance characteristics differ between the different types of legal persons.
Based on Hansmann's (1996) theory one would expect that the results for a co-operative, since it is the general form of a company, and the BV would be rather similar, whilst those of the non-profit distributing forms would also show a strong similarity.

8.3 DATA

This section describes the collection of the data. It explains the problems met, and decisions taken, during the process. It subsequently discusses the bankruptcy data, the governance data, the financial data and the disclosure data. The sampling method is explained in 8.3.5. The section concludes with a general data analysis in 8.3.6. The focus is on the data for the years t = -1 to t = -4 (t = 0 is the year in which financial distress actually happens).

8.3.1 Bankruptcy data

In this chapter financial distress is equalled to bankruptcy and suspension of payments[8], as no data is available on financially distressed non–bankrupt companies (as there was in chapter 6). The prominent source on *bankruptcies and suspension of payments* in the Netherlands is a central register on the www.rechtspraak.nl site powered by the *Raad voor de Rechtspraak* (RvR; Council for the Judiciary)[9]. The register (called the *Centraal Insolventieregister*; Central Insolvency Register) contains all the bankruptcy–related announcements ordered by the 19 Dutch District Courts (*rechtbank*). It started functioning around June 2000, without legal basis. Up to 2005 the data base, presently kept as Insolvencies Archive on the www.rechtspraak.nl site, was very flexible as one could search for elements in the text by choosing all of the courts or only selected courts, and any given period in time. Due to the protection of privacy as required by the Wet Bescherming Persoonsgegevens (WBP; Personal Data Protection Act), this flexible system was replaced on 1 January 2005 by a less easily accessible system, the present Central Insolvency Register. This system only allows searches on names (exact names and initials for natural persons; for legal persons asterisks and Boolean–operators are allowed), trade register numbers (for legal persons), postal codes (combined with house number) and some specified insolvency characteristics (related to the court's sentence). The system refuses any output of more than 200 items. All these limitations seriously hinder scientific research on this data base.

There are no other databases with detailed information on bankruptcies. After pressing 'bankruptcies', the *Handelsregister* only shows the addresses of so–called bankrupt *active* companies, which the administrator has decided not to close down for the time being. This is a minority of bankruptcies. However, the *Handelsregister* does contain historical information on all companies, also bankrupt and dissolved ones. This information can only be printed and is not electronically exportable. Every February, the *CBS* an aggregate survey of bankruptcies for the past year. This information comes through questionnaires

Table 8.1 Survey of declared bankruptcies by legal form, 2000–2009.

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
institutions	83	94	100	112	127	110	124	119	124	171
companies (excl one-man business), of which	2,538	3,239	3,985	5,123	5,140	4,973	4,104	3,470	3,716	6,824
limited form (NV/BV)	2,284	2,975	3,725	4,709	4,616	4,434	3,645	3,189	3,416	6,318
vof and cv	212	232	227	363	485	495	392	222	235	402
maatschap, Ltd, Inc	42	32	33	51	39	44	67	59	65	104
natural persons, of	1,877	2,501	2,686	3,513	4,082	4,999	4,951	4,363	3,007	3,564
which one-man business	958	997	878	1,151	1,381	1,697	1,713	1,013	795	1,045
total bankruptcies	4,498	5,834	6,771	8,748	9,349	10,082	9,179	7,952	6,847	10,559

Source: CBS and own research

from the District Courts. This aggregate information does not fully correspond with the information collected from the detailed information supplied by the *Centraal Insolventieregister*. Table 8.1 shows the CBS survey of bankruptcies in the period 2001–2009. It shows a sharp rise of the number of bankruptcies in 2009 to above that of 2005. More striking is the number of companies that went bankrupt in 2009: almost twice the number for 2007 and over 30% higher than the 2003 and 2004 figures. The table shows *coöperaties*, *verenigingen* and *stichtingen* on one line as *institutions*. Table 8.2 shows the results of a breakdown of the category *institutions* from table 8.1 in *coöperaties*, *verenigingen* and *stichtingen* and of the limited form in *BV and NV*, based on the author's own research by means of the *Centraal Insolventieregister* and the Insolvencies Archive. The *BV-line* in table 8.2 results from the deduction of the bankruptcies of NVs found in the insolvency registers, and the line *BV and NV* from table 8.1.

Table 8.2 Survey of declared bankruptcies of institutions and BV and NV, 2001–2007.

	2001	2002	2003	2004	2005	2006	2007	total bankrupt	total active 2007
institutions									
co-operatives	8	10	15	16	15	18	9	91	1,850
associations	8	5	3	7	4	3	3	33	5,720
foundations	65	76	83	101	76	103	94	598	17,660
subtotal	81	91	101	124	95	124	106	722	
CBS institutions	94	100	112	127	110	124	119	786	
CBS BV and NV	2,975	3,725	4,709	4,616	4,434	3,645	3,189	27,293	262,742
NV	14	12	11	12	20	11	6	86	
BV	2,961	3,713	4,698	4,604	4,414	3,634	3,183	27,207	

Source: CBS, *Handelsregister*, Santen and de Bos (2006), www.rechtspraak.nl, own research.

Remarkably not all the bankruptcies reported by the CBS could be traced in the insolvency registers. The subtotal for *institutions* in table 8.2, as calculated on the basis of data derived from the *Centraal Insolventieregister* and the Insolvencies Archive, and the CBS figures on institutions differs on average by 8%. This could be due to human errors such as input failures (the symbol ö in the Dutch word *coöperatie* was found in various forms in the Insolvencies Archive), categorization failures (is the bankruptcy of someone trading as a 'limited', the bankruptcy of a Ltd or of a private person), search-formulation failures (the problem of finding the right combination of Boolean operators) and reporting errors to the CBS. The fact that the law does not require an association (contrary to private limited companies, cooperatives and foundations[10]) to have the word 'vereniging' in its name, is another problem. An association can virtually go by any name, and as a consequence it will be impossible to retrieve all the associations from the insolvency registers. It might be best to interpret the difference between the CBS institutions line and the subtotal institutions line as being due to this 'mention of vereniging' problem.

8.3.2 Governance data

Data for non–listed legal persons can be derived from two sources, the *Handelsregister* and REACH. REACH is an electronically available database (ultimately) published by ReedElsevier. It does not contain complete actual as well as historical data on directors for small companies. Therefore the *Handelsregister* has been the source for the governance variables used in this study. It discerns agency theory and resource dependence theory related variables. *Agency theory* related variables concern the organization of the company and the turnover of directors. They are in sequential order of the hypotheses to be tested: DIRECTOR (the number of directors at yearend); DIRLPDM (a dummy variable for the presence of a legal person on the board[11]); NED (the number of non–executive directors); MANAGER (the number of managers outside the board); LEFT and NEW (the number of directors leaving and taking office during the year): DISCLDM (a dummy variable for the timely disclosure of the financial data). The age of the legal person (LP AGE), measured from the date of registration in the register, is considered an agency variable as well in the sense that the institutional memory and established procedures of an older company could be of help in avoiding financial distress. *Resource dependence theory* related variables concern experience and diversity on the board. Both the variables DIR AGE (average age of directors at year–end) and TENURE (average tenure of directors at year–end) are some indication for experience, whilst GENDER (the number of female executive directors), NATIONALITY (the number of non–Dutch executive directors[12]) and DEPENDENT (the number of non–independent directors[13]) give specific information about the sort of person a director is. Data on the education of directors or on membership and shareholders[14] is not available. The data is presented and applied in terms of numbers, as e.g. has been done by Hermalin and Weisbach (1988) and Ruigrok, Peck and Tacheva (2007). Since the incidence of gender, nationality or non–independence is almost always, if at all, one, a dummy variable as in Carter, Simkins and Simpson (2003) would not add additional information and has therefore been omitted. The effect of diversity on the board is measured as in chapter 7. However, the various AVERAGE and DIVERSITY (Blau–indicator) variables showed virtually no significant result. The results are therefore not reported in the tables and the text[15].

8.3.3 Financial data

It appeared to be impossible to construct a full database with financial data from the *Handelsregister* for three reasons. The *first* reason for the lack of financial data is that disclosure of financial data for associations and foundations is not required legally unless they carry one or more businesses with an aggregate turnover of more than €4.4

million[16]. The *second* reason is that legal persons often do not comply with the obligation of disclosure[17]. The *third* reason is that if the *Handelsregister* indicates that financial data has been disclosed, the data is not always available on–line.

An effort has been made to acquire additional information on bankrupt legal persons through research of the District Courts files, through questionnaires (by letter and by email) and through telephonic interviews, but to no avail. The District Court files provide insufficiently standardized and complete information. Every administrator fills in the required report in a different way. These reports seldom contain complete information. This could be due to negligence of the bankrupt company if the data is not available, as well as that of the administrator, who is not always keen to retrieve and fill in all the requested details. The response to questionnaires proved insufficient as well.

Since the disclosure of BVs was relatively high, a financial database was only constructed for this type of legal person. The 179 data, belonging to 100 companies for three years (60%) and retrieved from the *Handelsregister*, do not contain any information on cash flow or result[18].

8.3.4 Disclosure data

Depending on the size, Dutch law requires full or partial disclosure of annual accounts by all BVs and co–operatives. Associations and foundations are exempt, unless they exploit companies with a turnover of €4.4 million or more[19]. Non–disclosure is a criminal offence[20], and in the case of bankruptcy it could lead to personal liability of the directors[21]. In practice though, the disclosure obligation is not well–adhered to, as table 8.3 shows. A mere 57% of the BVs and only 34% of the co–operatives disclosed according to the legal obligations within 13 months after year–end (the consolidated statements in the last column are treated as timely as well). Around 9–10% discloses in the 14th month, which is important because the Hoge Raad has judged a delay of 11 days to be an insignificant omission[22]; others plea for a 14 days'[23] *terme de grâce*. Another 13–16% eventually disclose after the 14th month; whilst 20% of the *BVs* and 41% of the *coöperaties* do not disclose at all.

Table 8.3: survey of disclosure by BVs and coöperaties of the control sample and the financially distressed sample, over the period t =–2 through t =–4 before the distress event.

	number of obligations to disclose	no disclosure		timely		14th month		afterwards		consolidated at a higher level	
BV	250	50	20%	125	50%	24	10%	33	13%	18	7%
co-operative	259	105	41%	87	34%	24	9%	42	16%	1	0%

8.3.5 Sampling method

An analysis of board characteristics of bankrupt companies becomes more interesting if the results are compared with data on similar non-distressed companies. As all the information on distressed as well as control companies had to be retrieved manually from the *Handelsregister* at a certain cost[24], decisions had to be taken on the most efficient approach to this research:

- the number of financially distressed companies to be researched was arbitrarily[25] limited to 50 by type of legal person.
- the distressed *BVs* were randomly chosen from the declared bankruptcies on 24, 25 June and 1 and 2 July 2008. The distressed co-operatives were randomly chosen out of the 91 reported bankrupt *coöperaties* in table 8.2. Only 33 *verenigingen* went bankrupt during 2001–2007, another 6 could be retrieved from 2000 and from 2008, making the total number 39. The distressed *stichtingen* were randomly selected from the 598 reported ones in table 8.2.
- for each company in the distressed group, one similar company from the control group was chosen;
- a similar company means: as far as possible similar in SIC code[26] on a two-digit level and similar in size, measured in number of employees (as financial data was mostly unavailable, these could not be used as size measure). The data on SIC codes and number of employees was furnished by REACH.
- the control group consists of a random sample out of all the non-distressed, at least one-year-old companies[27] available from the *Handelsregister*.

It should be noted that the control group by no means forms a random selection of the sample of non-distressed companies. It is deemed more useful to compare bankrupt companies with similar non-distressed companies (which *are* chosen randomly from the group of non-bankrupt and 'similar' companies), than with a randomly selected sample of non-distressed companies, since size and industry may determine the organization form.

As the bankruptcies under research have been declared over a time span of years – with an exception for the *BVs* – the control sample could only be drawn afterwards. Since the aim of this research is to discover patterns, and the relevant legislation did not change, this procedure does not influence the results, except for one variable: the age of the legal person. This problem has been solved by using the average bankruptcy declaration date for the legal person concerned as the $t = 0$ for the control sample[28].

8.3.6 General data analysis

This section analyses in 8.3.6.1 the numbers of the various variables involved, to get a feel for the dataset. In 8.3.6.2 the industry distribution of the sample is shown.

Table 8.4: the incidence and absence of direction-related count variables in the control and distressed sample of Dutch BVs, coöperaties, verenigingen and stichtingen.

	BV		coöperatie		vereniging		stichting	
	number	average	number	average	number	average	number	average
number of companies	100		100		78		100	
number of observations	350		359		302		350	
incidence of:								
directors	546	1.56	949	2.64	1374	4.55	1040	2.97
directors/legal person	141	0.40	47	0.13	1	0.00	10	0.03
female directors	68	0.19	172	0.48	252	0.83	288	0.82
foreign directors	61	0.17	108	0.30	85	0.28	100	0.29
non-indep. directors	58	0.17	126	0.35	29	0.10	13	0.04
leaving directors	61	0.17	90	0.25	312	1.03	158	0.45
new directors	61	0.17	77	0.21	253	0.84	137	0.39
NEDs	50	0.14	6	0.02	0	0.00	58	0.17
managers	11	0.03	37	0.10	27	0.09	44	0.13
timely disclosure	143	0.57(a)	88	0.34(b)				
absence of:								
directors/legal person	209	0.60	317	0.88	301	1.00	340	0.97
female directors	285	0.81	209	0.58	157	0.52	187	0.53
foreign directors	309	0.88	278	0.77	259	0.86	258	0.81
non-indep. directors	292	0.83	253	0.70	276	0.91	337	0.96
female,foreign,non-indep.	237	0.68	156	0.43	121	0.40	157	0.45
leaving directors	312	0.89	292	0.81	158	0.52	264	0.75
new directors	312	0.89	313	0.87	182	0.60	274	0.78
NEDs	329	0.94	354	0.99	302	1.00	335	0.96
managers	339	0.97	322	0.90	275	0.91	309	0.88
timely disclosure	107	0.43(a)	171	0.66(b)	–	–	–	–
age:								
legal person age		10.39		8.02		27.27		10.44
director age		47.76		42.96		46.32		46.95

(a) out of 250 observations.
(b) out of 259 observations.

8.3.6.1 *Number analysis of the data*

Whilst the results of various analysis techniques of the data will be shown in 8.5, table 8.4 presents the raw data for each legal person. The second line shows the total number of observations available for each legal person since not every legal person existed during the full period t = –1 through t = –4.

The data gives rise to a few remarks:

(a) the *vereniging* shows the highest number of directors, as well as of female, leaving and new directors. Its legal persons are the oldest of the dataset. It also shows the lowest percentage (40%) of 'all white, all male' boards, to be derived from the line '*absence of*: female, foreign, non–indep';

(b) *BVs* show the lowest number of female and foreign directors, and the highest number of 'all white, all male' boards. BV boards are the smallest of all legal persons. BVs also have legal persons on the board most frequently;

(c) *coöperaties* show the highest incidence of non–independent directors, presumably a consequence of the 'man–wife' coöperaties relatively recently established for fiscal reasons as can be interpreted from the 'legal person age' line in the table's last row.

8.3.6.2 *Industry analysis of the data*

Figure 8.1 shows the division of bankruptcies over the various industries. The BIK–codes and number of employees were furnished by REACH. It should be stressed that, as the

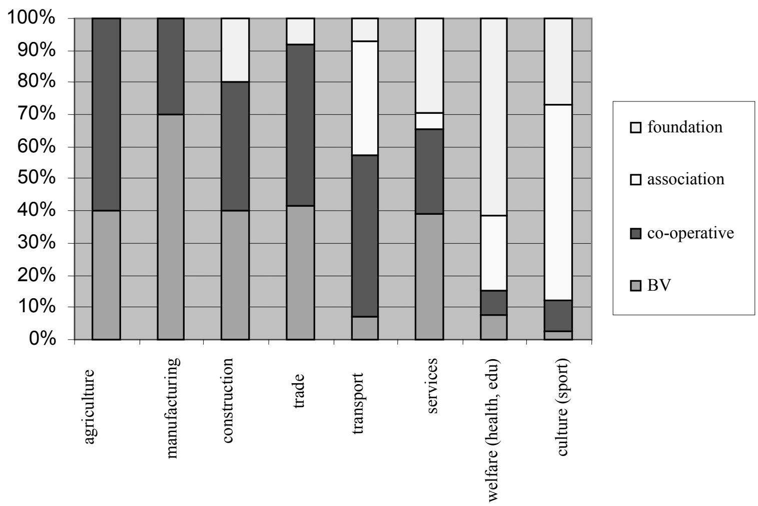

Figure 8.1: an analysis of the industry sectors of the financially distressed sample for the BV, the coöperatie, the vereniging and the stichting.

input of the original data has often been done manually[29], mistakes in the data are possible. Furthermore, questions of classification (of industry for example) bear subjective elements[30]. Since this research is intended to be done on data disclosed to the public in order to make the results comparable and objective, the data has not been changed (let alone evident typing errors). The *Handelsregister* as well as REACH are thus followed rigorously.

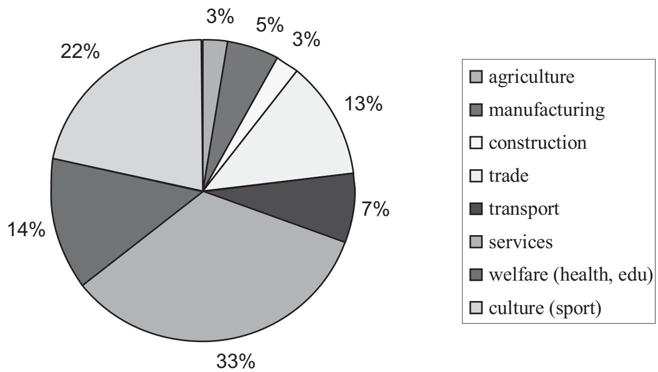

Figure 8.2: an analysis of the industry sectors of the total sample of Dutch BVs, coöperaties, verenigingen and stichtingen.

Figure 8.2 shows a clear emphasis on commercial activities for the BV and the co-operatives; on welfare, especially health and education, related activities for associations; and on cultural, especially sports and specific or general interests promoting, foundations, each as could be expected from the original roots of the legal form. There were not many ICT-related bankrupt companies. In the period under review (2008 for the BV; 2001-2008 for the other legal persons[31]) the highest reported incidence of bankruptcies is in the service sector, which includes ICT, followed by culture, welfare and trade.

8.4 METHOD

The applied methods are the same as in the chapters 6 and 7 and already explained in 6.4. Each section contains the analysis of one type of legal person. The analysis starts with a *correlation* table, calculated through the Spearman-method as most variables are distributed (very) skewed and as some are of an ordinal nature. The *difference between the samples* comes next. Since the control sample is *matched* with the distressed sample in industry and size, the difference between the samples is determined by the non-parametric Wilcoxon test. The null hypothesis in the tests is that both samples do not differ. Finally each section presents a table with the results of a *univariate regression* between the governance variable as explanatory variable and distress. This table shows whether there is a relationship between distress and the variable. This relationship is *not* necessarily a causal relationship.

The results of the analysis of differences and the univariate regression analysis are presented over four panels: the t= −1, t= −2, t= −3, t= −4 panel. This detailed analysis enables detection of patterns for each legal person near financial distress.

A *regression analysis* on the governance data is omitted due to the lack of reliable financial control variables.

Table 8.5: a correlation table (Spearman) of governance variables of Dutch BVs based on the data for t = −1 through t = −4 before the financial distress event occurred.

	DIR	DIR LP	NED	MAN	LEFT	NEW	DISC DM	BV AGE	DIR AGE	TEN	GEND	NAT
DIRECTOR	1											
DIRLPDM	.01	1										
NED	.45**	.06	1									
MANAGER	.04	.05	−.04	1								
LEFT	.07	.13*	.25**	.06	1							
NEW	.20**	.16**	.34**	.01	.77**	1						
DISCLDM	.24**	.00	.07	.00	.12	.13*	1					
BV AGE	.15**	−.14**	.16**	−.10	.07	.12*	.25**	1				
DIR AGE	.15**	−.01	.04	.10	−.08	−.08	.10	.42**	1			
TENURE	−.04	−.18**	−.18**	−.13*	−.34**	−.34**	.06	.59**	.52**	1		
GENDER	.41**	−.05	.02	.02	−.02	−.02	.12	−.13*	−.03	−.06	1	
NATIONALITY	.27**	−.03	.15**	.05	.13*	.16**	.01	.05	.02	−.25**	.05	1
DEPENDENT	.52**	−.08	−.11*	.02	−.11*	−.08	.20**	.03	.11*	.17**	.60**	−.04

** correlation is significant at the 1% level; * correlation is significant at the 5% level.
DIRECTOR number of executive directors (EDs)
DIRLPDM dummy variable being 1 in the case of (one or more) EDs that are legal persons
NED number of non–executive directors (NEDs)
MANAGER number of professional managers outside the executive board (EB)
LEFT number of EDs that left during the year
NEW number of EDs that took office during the year
DISCLDM dummy variable being 1 in the case of timely disclosure in the *Handelsregister*
BV AGE lifetime of the BV
DIR AGE average age of the EDs
TENURE average years of tenure of the EDs
GENDER number of female EDs
NATIONALITY number of non–Dutch EDs
DEPENDENT number of non–independent EDs.

Table 8.6: An analysis of governance variables for the financially distressed sample and the matched pair control sample of Dutch BVs in May 2008, based on panel data for t = –1 through t = –4 before the financial distress event occurred.

	control sample				financially distressed sample				difference
governance variable	number	min (max)	mean (median)	standard deviation	number	min (max)	mean (median)	standard deviation	distribution (|z-value|)
t = –1									
DIRECTOR	50	1	1.72	1.09	50	1	1.30	0.71	(3.03)**
		(7)	(1.50)			(4)	(1)		
DIRLPDM	50		36%		50		54%		(1.80)
NED		0	0.8	0.27		0	0.2	0.14	(1.73)
		(1)	(0)			(1)	(0)		
LEFT	50	0	0.10	0.36	50	0	0.36	0.69	(2.15)*
		(2)	(0)			(3)	(0)		
BV AGE	50	0.73	13.09	10.36	50	0.87	7.96	7.37	(3.16)**
		(37.65)	(10.56)			(30.44)	(5.46)		
DIR AGE	50	34.53	50.33	7.66	50	27.50	45.61	9.57	(2.43)*
		(70.53)	(49.53)			(63.56)	(44.53)		
TENURE	50	0.25	7.78	6.04	50	0.17	4.64	5.14	(2.56)**
		(25.50)	(7.04)			(24.00)	(2.67)		
t = –2									
DIRECTOR	46	1	1.70	0.92	48	1	1.35	0.76	(1.81)
		(5)	(1.50)			(4)	(1)		
DISCLDM	46		70%		48		44%		(2.69)**
BV AGE	46	0.89	13.12	10.16	48	0.46	7.25	7.38	(3.36)**
		(36.65)	(10.09)			(29.44)	(4.60)		
DIR AGE	46	33.53	49.44	7.97	48	26.50	44.60	8.93	(2.42)*
		(69.53)	(48.03)			(62.56)	(42.50)		
TENURE	46	0.25	7.78	6.07	48	0.33	4.39	4.81	(2.72)**
		(24.50)	(7.08)			(23.00)	(3.00)		
t = –3									
DIRECTOR	42	1	1.90	1.56	40	1	1.30	0.61	(2.28)*
		(9)	(2.00)			(3)	(1)		
DIRLPDM	42		29%		40		45%		(1.81)
BV AGE	42	0.96	13.27	9.89	40	0.68	7.50	7.49	(2.66)**
		(35.65)	(10.22)			(28.44)	(4.81)		
TENURE	42	0.50	8.65	6.89	40	0.25	4.75	4.87	(1.89)
		(32.00)	(8.33)			(22.00)	(3.13)		
t = –4									
DISCLDM	40		67%		34		47%		(2.00)*
BV AGE	40	0.50	12.88	9.74	34	1.08	7.65	7.56	(2.41)*
		(34.65)	(9.85)			(27.44)	(4.74)		

***, ** and * indicate statistical significance at a 0.1%, 1% and 5% level, respectively. Results with lower statistical significance than 10% are not reported.

DIRECTOR	number of executive directors (EDs)
DIRLPDM	dummy variable being 1 in the case of (one or more) EDs that are legal persons
NED	number of non-executive directors (NEDs)
LEFT	number of EDs that left during the year
DISCLDM	dummy variable being 1 in the case of timely disclosure in the *Handelsregister*.
BV AGE	lifetime of the BV
DIR AGE	average age of the EDs
TENURE	average years of tenure of the EDs

8.5 RESULTS

This section presents sequentially the results of the data analysis for the private limited company (BV), the co-operative (coöperatie), the association (vereniging) and the foundation (stichting). An analysis of all the legal persons concerned is presented in 8.5.5. The analysis of the financial data available for BVs follows in 8.5.6.

8.5.1 Private limited companies (BV)

The analysis starts with the correlation between the governance variables in table 8.5. The table shows important though not alarming (see 6.4.3) correlations between LEFT and NEW, a rather logical relationship as leaving directors normally should be replaced; between DIRECTOR and DEPENDENT and between DEPENDENT and GENDER, caused by the number of man-wife (or largely: family) BVs ; and between TENURE, BV AGE and AGE DIR, presumably explained by BVs established long ago and still managed by the founder/owner/director. Table 8.6 shows the differences in the variables between the financially distressed and the control sample. From the differences in mean and median and the relatively high standard deviations reported in table 8.6, it is clear that the distribution of the various variables, with the exemption of DIR AGE, is very skewed. The attributes of a normal distribution are thus not valid, and the reported mean has a very limited meaning and should be used cautiously. This goes for all the data reported in this chapter.

Table 8.6 shows that BV AGE is significantly higher for the control sample over all panels at the 5% level. The number of DIRECTORs and TENURE is higher for the control sample and statistically significantly different at the 10% level or better on the panels t= -1, -2 , -3. The age of directors (DIR AGE) is higher in the control sample at the 5% level in t= -1 and -2 and timely disclosure is higher at the 5% level in t= -2 and -4. This means that the control sample generally is a stable firm with a stable and mature board, both in terms of general experience as in experience in the firm, as opposed to the financially distressed sample.

Table 8.7 showing the *univariate relationship* between financial distress and the governance variables of the BV presents similar results as table 8.6. The number of DIRECTORs,

Table 8.7: A univariate logit analysis of governance variables on the control sample and the financially distressed sample of Dutch BVs in May 2008, based on panel data for t = –1 through t = –4 before the financial distress event occurred.
model 1*: DISTRESS* $\approx \alpha + \beta_1$*(variable)*

dependent variable	t = -1	t = -2	t = -3	t = -4
DIRECTOR	–0.63*	–0.52[a]	–0.74*	–0.43
DIRECTOR LEGALPERSON	0.74[a]	0.73[a]	0.72	0.61
NED	–1.45	–0.78	–1.10	–0.98
MANAGER	1.42	–0.04	21.33	21.43
LEFT	1.01*	–0.17	1.20	–0.95
NEW	0.53	–0.17	–0.75	–0.21
TIMELY DISCLOSURE	–	–1.08*	–0.59	–0.88[a]
BV AGE	–0.07**	–0.08**	–0.08**	–0.07*
DIRECTORS' AGE	–0.06**	–0.07**	–0.05[a]	–0.05[a]
TENURE	–0.11**	–0.12**	–0.12**	–0.12*
GENDER	–0.40	–0.19	0.22	0.19
NATIONALITY	0.00	0.34	–0.41	–0.83
DEPENDENT	–0.84	–0.87	–0.65	–0.95

***, ** and * indicate statistical significance at a 0.1%, 1% and 5% level, respectively
[a] signifies significance at a 10% level.
Variables defined below table 8.5.

their AGE and TENURE as well as the BV AGE are the predominant explanatory variables. Some other observations are worth mentioning:

(1) the number of leaving directors (LEFT) is significantly higher for the distressed group at the 5% level at t = –1, which is in line with other studies and chapter 6 which showed a significantly different resignation of directors in situations of near financial distress;

(2) a legal–person–director (DIRLPDM) is, contrary to *hypothesis 2.a,* more often present in the financially distressed sample and is, at the 10% level, statistically significantly connected with financial distress in the t = –1 and t = –2 panel. A suggestion comes up that the distressed subsidiary BV is used by the holding company to bear a huge risk or as a cost centre, but there is no specific proof for that;

(3) table 8.6 presents weak evidence in the t = –1 panel that the presence of NEDs is higher in the control group, although the result is only at the 10% level and the number of NEDs is very small; and finally (4) timely disclosure (DISCLDM) is closely related to the control sample and significantly different in the panels t = –2 and t = –4. Note that the legal obligation is to disclose within 13 months after year–end. Therefore no DISCLDM data is available for t = –1.

Thus, for the *BV* the governance and resource variables statistically significantly and negatively related throughout to *financial distress* are:

- the number of directors
- BV age
- directors' age
- directors' tenure.

8.5.2 Co-operatives (*coöperatie*)

The analysis starts with the correlation between the governance variables in table 8.8. The table shows an important though not alarming (see 6.4.3) significant correlation between LEFT and NEW, a rather logical relationship; between DEPENDENT and GENDER, indicating that most dependents are spouses; and between TENURE and CO-OP AGE, presumably explained by the role of the founder/director.

Table 8.8: a correlation table (Spearman) of governance variables on the full sample of Dutch coöperaties, based on the data for t = −1 through t = −4 before the financial distress event occurred.

	DIR	DIR LP	NED	MAN	LEFT	NEW	DISC DM	AGE	DIR AGE	TENR	GEND	NAT
DIRECTOR	1											
DIRLPDM	−.11*	1										
NED	.15**	−.04	1									
MANAGER	.36**	.05	.35**	1								
LEFT	.13*	−.09	.00	.07	1							
NEW	.30**	−.08	.03	.07	.57**	1						
DISCLDM	.24**	−.05	.18**	.20**	.03	.04	1					
CO-OP AGE	.07	.01	.17**	.20**	.00	.02	.07	1				
DIR AGE	.19**	−.03	.17**	.14**	.03	.00	.23**	.34**	1			
TENURE	.00	.16**	.06	.15**	−.24**	−.26**	.15*	.70**	.35**	1		
GENDER	.11*	−.10	−.05	−.12*	−.17**	−.03	−.03	−.16**	.03	−.05	1	
NATIONALITY	−.22**	−.09	−.01	−.01	.00	.06	−.06	−.11*	−.02	−.20**	.04	1
DEPENDENT	−.07	−.06	−.08	−.14**	−.26**	−.14**	−.03	−.12*	−.05	.01	.60**	.01

** correlation is significant at the 1% level; * correlation is significant at the 5% level; definition of variables below table 8.5.

Table 8.9 shows the differences between the financially distressed and the control sample. Only *z-values* are reported since the variables are skewed. The age of directors (DIR AGE), TENURE and the presence of a MANAGER throughout all panels are statistically significantly higher for the control group at the 10% level or better. The laymen structure of the executive board (EB) of larger co-operatives explains the significance of the presence of professional managers. The number of DIRECTORs and the age of the co-operative (CO-OP AGE) are significantly higher in the control group at the 5% level on t = −1 and −2. The disclosure dummy (DISCLDM) shows that control co-operatives adhere better to their disclosure obligation at the 5% level.

Table 8.9: An analysis of governance variables for the financially distressed sample and the matched pair control sample of Dutch coöperaties from 2001 to 2007, based on panel data for t = –1 through t = –4 before the financial distress event occurred.

governance variable	control sample				financially distressed sample				difference distribution
	number	min (max)	mean (median)	standard deviation	number	min (max)	mean (median)	standard deviation	(|z-value|)
t = -1									
DIRECTOR	50	1	2.92	1.51	50	1	2.16	1.28	(2.86)**
		(8)	(2)			(6)	(2)		
MANAGER	50	0	0.18	0.39	50	0	0		(3.00)**
		(1)	(0)			(0)	(0)		
CO-OP AGE	50	3.00	11.67	17.24	50	0.50	5.59	6.60	(2.70)**
		(85.04)	(5.04)			(46.74)	(4.69)		
DIR AGE	50	22.71	44.71	8.88	50	25.05	42.49	7.98	(1.81)
		(76.71)	(44.71)			(61.30)	(41.43)		
TENURE	50	1.33	7.78	5.55	50	0.25	3.79	2.84	(4.08)***
		(26.33)	(7.33)			(11.58)	(3.42)		
t = -2									
DIRECTOR	50	1	2.92	1.44	44	1	2.32	1.39	(2.19)*
		(7)	(2)			(7)	(2)		
MANAGER	50	0	0.18	0.39	44	0	0		(3.00)**
		(1)	(0)			(0)	(0)		
DISCLDM	50		48%		44		20%		(2.89)**
CO-OP AGE	50	2.00	10.67	17.24	44	0.21	5.23	6.79	(2.07)*
		(84.04)	(4.04)			(45.74)	(4.01)		
DIR AGE	50	21.71	43.93	8.84	44	24.05	41.29	8.39	(3.25)**
		(75.71)	(44.21)			(60.30)	(40.43)		
TENURE	50	0.75	6.92	5.45	44	0.17	3.49	2.70	(3.35)**
		(25.33)	(6.63)			(10.58)	(2.83)		
t = -3									
MANAGER	49	0	0.18	0.39	39	0	0		(2.65)**
		(1)	(0)			(0)	(0)		
DISCLDM	49		37%		39		23%		(1.96)*
DIR AGE	49	20.71	43.93	9.46	39	27.38	40.51	8.30	(3.83)***
		(74.71)	(45.71)			(59.30)	(38.49)		
TENURE	49	0.17	6.52	5.38	39	0.00	3.29	2.97	(2.97)**
		(24.33)	(6.42)			(13.58)	(2.25)		
t = -4									
DIRLPDM	45		11%		32		13%		(2.00)*
MANAGER	45	0	0.20	0.41	32	0	0		(2.24)*
		(1)	(0)			(0)	(0)		
DISCLDM	45		42%		32		25%		(2.40)*
DIR AGE	45	24.71	44.60	8.45	32	26.38	40.89	8.88	(3.79)***
		(73.71)	(45.71)			(58.30)	(38.25)		
TENURE	45	0.00	6.40	5.21	32	0.00	3.21	3.45	(2.93)**
		(23.33)	(5.92)			(17.83)	(2.29)		

***, ** and * indicate statistical significance at a 0.1%, 1% and 5% level, respectively. Results with lower statistical significance than 10% are not reported.

DIRECTOR number of executive directors (EDs)
DIRLPDM dummy variable being 1 in the case of (one or more) EDs that are legal persons
MANAGER number of professional managers outside the management board (EB)
DISCLDM dummy variable being 1 in the case of timely disclosure in the *Handelsregister.*
CO-OP AGE lifetime of the co-operative
DIR AGE average age of the EDs
TENURE average years of tenure of the EDs

The univariate regression results of table 8.10 show clear significant relationships between the number of DIRECTORs, TENURE and DISCLOSURE and distress over all the panels. Note that the legal obligation is to disclose within 13 months after year-end. Therefore no DISCLDM data is available for t = –1. DIRECTORS' AGE and CO-OP AGE are only significantly related in two out of four panels.

Thus, for the *coöperatie* the following governance and resource variables are statistically significantly and negatively related throughout to *financial distress*:

- the number of directors
- timely disclosure
- directors' tenure.

Table 8.10: A univariate logit analysis of governance variables on the control sample and the financially distressed sample of Dutch coöperaties from 2001 to 2007, based on panel data for t = –1 through t = –4 before the financial distress event occurred.
model 1*: DISTRESS* $\approx \alpha + \beta_1$*(variable)*

dependent variable	t = –1	t = –2	t = –3	t = –4
DIRECTOR	–0.41*	–0.32*	–0.30[a]	–0.44*
DIRECTOR LEGALPERSON	0.00	0.14	0.47	0.13
NED	–21.22	–21.09	–21.01	–20.88
MANAGER	–21.40	–21.27	–21.20	–21.08
LEFT	0.52	0.04	–0.10	0.31
NEW	–0.55	–0.31	0.04	–0.22
TIMELY DISCLOSURE	–	–1.44**	–0.94*	–1.17*
COOPERATIE AGE	–0.05[a]	–0.04[a]	–0.04	–0.03
DIRECTORS' AGE	–0.03	–0.04	–0.04[a]	–0.05[a]
TENURE	–0.28***	–0.25**	–0.22**	–0.22**
GENDER	0.17	0.48	0.68	0.28
NATIONALITY	0.44	0.41	0.43	0.26
DEPENDENT	0.21	0.49	0.88[a]	0.63

***, ** and * indicate statistical significance at a 0.1%, 1% and 5% level, respectively
[a] signifies significance at a 10% level.

8.5.3 Associations (*vereniging*)

The analysis starts with the correlation between the governance variables in table 8.11. The table shows an important though not alarming (see 6.4.3) correlation between LEFT and NEW, which is rather logical.

Table 8.11: a correlation table (Spearman) of governance variables on the full sample of Dutch associations, based on the data for t = −1 through t = −4 before the financial distress event occurred.

	DIR	DIR LP	NED	MAN	LEFT	NEW	AGE	DIR AGE	TENR	GEND	NAT
DIRECTOR	1										
DIRLPDM	−.07	1									
NED	.	.	1	.	.	.	.	.	.	.	.
MANAGER	.25**	−.02	.	1							
LEFT	.23**	.10	.	.12*	1						
NEW	.37**	.11	.	.09	.65**	1					
ASSOCIATION AGE	.36**	−.09	.	.04	.15**	.20**	1				
DIR AGE	.24**	.06	.	.10	.12*	.01	.10	1			
TENURE	.06	−.10	.	.08	−.34**	−.42**	.31**	.27**	1		
GENDER	.18**	−.06	.	.05	.10	.09	.18**	.01	−.02	1	
NATIONALITY	−.10	−.02	.	.14*	−.05	.01	−.27**	−.15**	−.21**	−.11	1
DEPENDENT	−.09	−.02	.	−.10	−.02	−.03	−.14*	−.04	.04	.06	.18**

** correlation is significant at the 1% level; * correlation is significant at the 5% level; definition of variables below table 8.5.

Table 8.12 presents the differences between the financially distressed and the control sample and their significance.

TENURE is in table 8.12 the only variable that is statistically significantly different throughout. Tenure is higher in the control sample (at the 1% level). The DIRECTOR variable is significantly higher for the control sample in the t = −1 and t = −2 panel (at the 5% level). The LEFT and NEW variables are significantly higher in the distressed sample (at the 5% level) in the panels t = −1 and −4, indicating more turnover in the distressed group.

Table 8.13 shows whether there is a relationship between the governance variables and financial distress. The TENURE variable is statistically significantly negatively related to financial distress in all the panels just like the DIRECTOR variable in t = −1 and −2. The LEFT and NEW variables prove positively related to financial distress in some panels. A meaningful result is the LEFT difference in t = −1, when obviously directors in distressed associations leave.

Table 8.12: An analysis of governance variables for the control sample and the financially distressed sample of Dutch associations from 2000 to 2008, based on panel data for t = –1 through t = –4 before the financial distress event occurred.

governance variable	control sample				financially distressed sample				difference distribution (|z-value|)
	number	min (max)	mean (median)	standard deviation	number	min (max)	mean (median)	standard deviation	
t = –1 DIRECTOR	39	1	4.77	2.33	38	1	3.53	2.06	(2.51)*
		(10)	(4)			(10)	(3)		
LEFT	39	0	0.74	1.16	38	0	1.55	1.81	(2.37)*
		(4)	(0)			(7)	(1)		
NEW	39	0	0.62	0.99	38	0	1.26	2.22	(1.82)
		(3)	(0)			(9)	(0)		
TENURE	39	0.50	6.86	5.30	38	0.8	4.41	3.37	(2.63)**
		(22.08)	(5.58)			(13.92)	(4.13)		
t = –2 DIRECTOR	39	1	4.90	2.47	38	1	3.84	2.18	(1.99)*
		(11)	(5)			(10)	(4)		
TENURE	39	0.75	6.53	4.99	38	0.17	3.91	2.80	(3.00)**
		(21.08)	(5.75)			(12.92)	(3.25)		
t = –3 TENURE	39	0.67	6.94	4.86	36	0.42	3.56	2.46	(3.33)**
		(20.08)	(5.50)			(11.92)	(3.17)		
t = –4 LEFT	38	0	0.53	0.80	35	0	1.14	1.87	(2.46)*
		(2)	(0)			6	(0)		
NEW	38	0	0.47	0.86	35	0	1.14	1.70	(2.51)*
		(3)	(0)			(6)	(0)		
TENURE	38	1.08	6.82	4.55	35	0.08	3.24	2.33	(3.47)**
		(19.08)	(5.08)			(10.00)	(2.58)		

***, ** and * indicate statistical significance at a 0.1%, 1% and 5% level, respectively. Results with lower statistical significance than 10% are not reported.

DIRECTOR	number of executive directors (EDs)
LEFT	number of EDs that left during the year
NEW	number of EDs that took office during the year
TENURE	average years of tenure of the EDs.

Thus, for the *vereniging* the only governance and resource variable statistically significantly and negatively related throughout to *financial distress* is

- directors' tenure.

Table 8.13: A univariate logit analysis of governance variables for the control sample and the financially distressed sample of Dutch verenigingen from 2000 to 2008, based on panel data for t = –1 through t = –4 before the financial distress event occurred.
model 1*: DISTRESS* $\approx \alpha + \beta_1$*(variable)*

dependent variable	t = –1	t = –2	t = –3	t = –4
DIRECTOR	–0.26*	–0.20[a]	–0.14	–0.13
DIRECTOR LEGALPERSON	21.26	0.00	0.00	0.00
NED	na	na	na	na
MANAGER	–0.97	–0.54	–1.64	–1.64
LEFT	0.37*	0.01	0.17	0.40*
NEW	0.25	–0.09	0.19	0.42*
ASSOCIATION AGE	–0.01	–0.01	–0.01	–0.01
DIRECTORS' AGE	0.03	0.01	0.01	–0.01
TENURE	–0.14*	–0.19*	–0.31**	–0.39**
GENDER	0.07	0.20	–0.20	0.17
NATIONALITY	–0.13	0.08	–0.20	–0.10
DEPENDENT	0.03	0.23	–0.17	–0.17

***, ** and * indicate statistical significance at a 0.1%, 1% and 5% level, respectively
[a] signifies significance at a 10% level
na not available
Variables defined below table 8.5.

8.5.4 Foundations (*stichting*)

The analysis starts with the correlation between the governance variables in table 8.14. The table shows an important though not alarming (see 6.4.3) correlation

Table 8.14: a correlation table (Spearman) of governance variables for the full sample of Dutch foundations, based on the data for t = –1 through t = –4 before the financial distress event occurred.

	DIR	DIR LP	NED	MAN	LEFT	NEW	AGE	DIR AGE	TENR	GEND	NAT
DIRECTOR	1										
DIRLPDM	–.05	1									
NED	.10	–.04	1								
MANAGER	.17**	–.06	.40**	1							
LEFT	.01	–.02	–.02	.03	1						
NEW	.16**	.04	.06	–.01	.63**	1					
FOUNDATION AGE	.22**	–.12*	–.18**	.03	.02	.03	1				
DIR AGE	.07	.04	.07	.15**	–.01	.01	.17**	1			
TENURE	–.02	–.08	–.12*	.03	–.36**	–.34**	.61**	.27**	1		
GENDER	.61**	.05	–.03	.09	.12*	.16**	.18**	–.11*	–.11*	1	
NATIONALITY	.07	–.04	–.03	.05	.06	.08	.04	–.10	–.04	.08	1
DEPENDENT	.01	–.03	–.04	–.07	–.01	.04	–.03	–.05	.03	.15**	–.02

** correlation is significant at the 1% level; * correlation is significant at the 5% level; definition of variables below table 8.5.

Table 8.15: An analysis of governance variables for the financially distressed sample and the matched pair control sample of Dutch foundations from 2001 to 2007, based on panel data for t = –1 through t = –4 before the financial distress event occurred.

	control sample				financially distressed sample				difference
governance variable	number	min (max)	mean (median)	standard deviation	number	min (max)	mean (median)	standard deviation	distribution (|z-value|)
t = -1									
DIRECTOR	50	1	3.38	1.83	50	1	2.52	1.42	(2.74)**
		(9)	(3)			(6)	(2.50)		
FOUNDATION AGE	50	1.00	13.35	16.39	50	0.82	7.81	8.70	(2.56)*
		(89.14)	(7.70)			(37.57)	(4.92)		
TENURE	50	0.25	6.61	5.41	50	0.08	3.15	2.83	(3.83)***
		(25.50)	(5.04)			(11.75)	(2.08)		
GENDER	50	0	0.98	1.08	50	0	0.66	1.12	(2.12)*
		(4)	(1)			(5)	(0)		
t = -2									
DIRECTOR	49	1	3.27	1.85	46	1	2.50	1.64	(2.30)*
		(9)	(3)			(8)	(2)		
LEFT	49	0	0.16	0.66	46	0	0.74	1.20	(3.10)**
		(4)	(0)			(6)	(0)		
FOUNDATION AGE	49	0	12.56	16.49	46	0.21	7.40	8.84	(2.06)*
		(88.14)	(6.74)			(36.57)	(4.55)		
TENURE	49	0.00	6.56	5.18	46	0.08	3.01	2.67	(3.61)***
		(24.50)	(5.67)			(10.75)	(2.17)		
t = -3									
DIRECTOR	45	1	3.24	1.86	40	1	2.88	1.99	(1.81)
		(9)	(3)			(9)	(3)		
FOUNDATION AGE	45	0	12.67	16.76	40	0.27	7.34	9.11	(2.34)*
		(87.14)	(7.65)			(35.57)	(4.47)		
TENURE	45	0.00	6.34	4.97	40	0.00	2.71	2.75	(3.51)***
		(23.50)	(4.75)			(9.75)	(1.79)		
t = -4									
DIRECTOR	41	1	3.20	1.65	29	1	2.69	1.89	(1.85)
		(7)	(3)			(9)	(2)		
FOUNDATION AGE	41	0	12.84	17.12	29	0.51	8.67	9.71	(1.93)
		(86.14)	(8.44)			(34.57)	(4.90)		
LEFT	41	0	0.12	0.33	29	0	0.72	1.25	(2.23)*
		(1)	(0)			(4)	(0)		
TENURE	41	0.08	6.59	4.97	29	0.17	3.00	2.60	(2.70)**
		(22.50)	(5.83)			(8.75)	(2.25)		

***, ** and * indicate statistical significance at a 0.1%, 1% and 5% level, respectively. Results with lower statistical significance than 10% are not reported.

DIRECTOR number of executive directors (EDs)
LEFT number of EDs that left during the year
NEW number of EDs that took office during the year
FOUNDATION AGE lifetime of the foundation
TENURE average years of tenure of the EDs
GENDER number of female EDs.

between LEFT and NEW, a rather logical relationship; between DIRECTORS and GENDER, indicating that the number of female directors grows when the board increases; and between TENURE and the AGE of the foundation, presumably caused by the founder/director.

Table 8.15 shows the differences between the financially distressed and the control sample. TENURE, the number of DIRECTORs and the FOUNDATION AGE are higher in the control sample and statistically significantly different throughout. TENURE at the 1% level, DIRECTORs at a gradually declining level from 1% to 10% and FOUNDATION AGE declines from 5% to 10% in panel t = −4. LEFT, the number of directors leaving, is significantly higher in the distressed group in the panels −2 and −4 at the 5% level. The GENDER variable indicates in the t = −2 panel a statistically significant higher number of women in the control group.

Table 8.16 reports the univariate logit regression results. These reflect the results from table 8.15 although they are somewhat less strong in terms of level of significance.

Table 8.16: A univariate logit analysis of governance variables for the control sample and the financially distressed sample of Dutch stichtingen from 2001 to 2007, based on panel data for t = −1 through t = −4 before the financial distress event occurred.

model 1*: DISTRESS* $\approx \alpha + \beta_1$*(variable)*

dependent variable	t = −1	t = −2	t = −3	t = −4
DIRECTOR	−0.33*	−0.26*	−0.10	−0.17
DIRECTOR LEGALPERSON	0.71	0.78	0.84	21.58
NED	−0.24	−0.15	−0.06	−9.77
MANAGER	−0.29	−0.11	−0.06	0.39
LEFT	0.35	0.88*	0.16	1.09*
NEW	0.37	0.44	0.23	0.39
FOUNDATION AGE	−0.04[a]	−0.04[a]	−0.04[a]	−0.02
DIRECTORS' AGE	−0.01	−0.02	−0.03	−0.02
TENURE	−0.22**	−0.24***	−0.26**	−0.26**
GENDER	−0.90*	−0.30	0.02	−0.04
NATIONALITY	−0.13	0.35	0.33	−0.01
DEPENDENT	0.00	1.21	0.84	0.36

***, ** and * indicate statistical significance at a 0.1%, 1% and 5% level, respectively
[a] signifies significance at a 10% level.

Thus, for the *stichting* the only governance and resource variable statistically significantly and negatively related throughout to *financial distress* is

- directors' tenure.

8.5.5 All the legal persons

This section analyses all the previous results in one table in order to discover common characteristics in the patterns. Table 8.17 presents all the statistically significant univariate regression results of the previous sections. One variable appears in each panel for each legal person: TENURE, remaining significant throughout at the 5% level. The number of DIRECTORs is a statistically significant explanatory variable for all the legal

Table 8.17: A survey of the statistically significant results of the univariate logit analysis of governance variables for the control sample and the financially distressed sample of Dutch BVs, co-operatives, associations and foundations over 2001–2008, based on panel data for t = –1 through t = –4 before the financial distress event occurred.
model 1*: DISTRESS* ≈ $\alpha + \beta_1$*(variable)*

dependent variable	legal person	t = -1	t = -2	t = -3	t = -4
DIRECTOR	BV	–0.63*	–0.52[a]	–0.74*	–0.43
	co-operative	–0.41*	–0.32*	–0.30[a]	–0.44*
	association	–0.26*	–0.20[a]	–0.14	–0.13
	foundation	–0.33*	–0.26*	–0.10	–0.17
DIRECTOR LEGALPERSON	BV	0.74[a]	0.73[a]	0.72	0.61
LEFT	BV	1.01*	–0.17	1.20	–0.95
	association	0.37*	0.01	0.17	0.40*
	foundation	0.35	0.88*	0.16	1.09*
NEW	association	0.25	–0.09	0.19	0.42*
TIMELY DISCLOSURE	BV	–	–1.08*	–0.59	–0.88[a]
	co-operative	–	–1.44**	–0.94*	–1.17*
LEGAL PERSON AGE	BV	–0.07**	–0.08**	–0.08**	–0.07*
	co-operative	–0.05[a]	–0.04[a]	–0.04	–0.03
	foundation	–0.04[a]	–0.04[a]	–0.04[a]	–0.02
DIRECTORS' AGE	BV	–0.06**	–0.07**	–0.05[a]	–0.05[a]
	co-operative	–0.03	–0.04	–0.04[a]	–0.05[a]
TENURE	BV	–0.11**	–0.12**	–0.12**	–0.12*
	co-operative	–0.28***	–0.25**	–0.22**	–0.22**
	association	–0.14*	–0.19*	–0.31**	–0.39**
	foundation	–0.22**	–0.24***	–0.26**	–0.26**
GENDER	foundation	–0.90*	–0.30	0.02	–0.04
DEPENDENT	co-operative	0.21	0.49	0.88[a]	0.63

***, ** and * indicate statistical significance at a 0.1%, 1% and 5% level, respectively
[a] signifies significance at a 10% level.

persons, but not in each panel. Its relevance generally declines over time from the 5% level. DISLOSURE proves significantly different for the BV and the co-operative since only these two have a mandatory disclosure obligation.

For three legal persons the variables AGE LEGAL PERSON (rather predominant) and number of leaving directors (LEFT; in specific panels only) prove significant. The directors' age (DIR AGE) is significant for two legal persons in some panels. New directors (NEW), legal person director (LPDIRDM), GENDER and DEPENDENT are significant in specific panels and only for one legal person.

The 'for-profit' legal forms (BV, co-operative) five times (DIRECTOR, DISCLOSURE, LP AGE, DIRECTOR'S AGE, TENURE) out of 10 show the same significant variables in one or more time frames. The 'nonprofit' forms only show this three times (DIRECTOR, LEFT, TENURE). For one of both 'for-profit' and 'nonprofit' legal forms, only four variables present significant time frames: DIRECTOR, LEFT, LP AGE, TENURE. There is no apparent 'clustering' of variables over both groups. Moreover, an analysis of the collective data per panel for all legal persons has been considered. The risk of generalizing is that one finds statistically significant results for this 'full panel' that do not have any meaning for a specific category of legal persons. Therefore, and because of the differences in size and industry between the samples, such results would in fact be useless. The presentation of table 8.17 keeps the results were they belong, tied to a specific legal person.

8.5.6 Financial data analysis (BV)

The data only permitted the construction of a financial data base for the BV. As all BVs from the sample are small, they did not report figures on turnover, profit or cash flow. Moreover, since disclosure always lags behind and not all companies existed or adhered to their legal obligations during the three years under review (t = -2 though t =-4) only 176 data sets could be retrieved. Table 8.18 presents the results. The CR and QR variables are added to the analysis, as they may be considered a liquidity measure (Ohlson, 1980). The data analysis of table 8.17 leads to the conclusion that the quality of the data is disputable. All variables are very skew.

A minimum leverage of -15 or -17 is imaginable if CE = -1 and TA = 15 or 17, but a mean CR of 10 and a max of over 200 may indicate a negligent filling in of the required form instead of reality. That LNTA does not prove statistically significantly different at the 5% level may not come as a surprise, since another size indicator, the number of employees, is used as a sample variable. The other variables though prove statistically different at the 0.1% level.

Table 8.18: An analysis of financial variables for the control sample and the financially distressed sample of Dutch BVs in May 2008, based on panel data for t = –2 through t = –4 before the financial distress event occurred.

	control sample				financially distressed sample				
financial variable	number	min (max)	mean (median)	standard deviation	number	min (max)	mean (median)	standard deviation	difference distribution (|z-value|)
LNTA	94	1.48	5.99	1.42	81	–0.36	5.47	1.98	(1.78)
		(10.57)	(5.91)			(10.34)	(5.57)		
CETA	94	–15.30	–0.11	1.77	82	–17.86	–0.72	2.41	(4.52)***
		(0.99)	(0.17)			(1.00)	(-0.13)		
CR	91	0	10.11	29.00	83	0	4.79	26.44	(5.03)***
		(217)	(1.70)			(235)	(0.77)		
QR	91	0	9.97	29.03	83	0	4.57	26.47	(5.65)***
		(217)	(1.46)			(235)	(0.53)		

***, ** and * indicate statistical significance at a 0.1%, 1% and 5% level, respectively. Results with lower statistical significance than 10% are not reported.

LNTA the natural logarithm of total assets
CETA common equity divided by total assets
CR current ratio (current assets divided by short–term obligations)
QR quick ratio (current assets less inventories divided by short–term obligations).

A correlation analysis (not reported) has been executed. All correlation coefficients are acceptable, except the r > 0.9 between CR and QR, due to the fact that many BVs do not report inventories (separately). The results of a performed regression analysis are not reported, since no variables proved statistically significant.

8.6 CONCLUSION

This chapter aimed to study the differences in governance characteristics of financially distressed and non–distressed companies in the *BV*, *coöperatie*, *vereniging* and *stichting* form. What do the results say about the hypotheses? They were:

H_1: the number of directors is negatively related to financial distress
$H_{2(a-c)}$: the number of additional control instruments is negatively related to financial distress
H_{2a}: the additional control instrument being a legal person;
H_{2b}: the additional control instrument being a supervisory board;
H_{2c}: the additional control instrument being a manager outside the board.
$H_{3(a-b)}$: board turnover is positively related to financial distress
H_{3a}: measured in terms of leaving directors;
H_{3b}: measured in terms of newly appointed directors.
H_4: overdue disclosure is positively related to financial distress

H_5: the age of the company is negatively related to financial distress
$H_{6(a-b)}$: experience on the board is negatively related to financial distress
H_{6a}: measured in terms of age;
H_{6a}: measured in terms of tenure.
$H_{7(a-c)}$: diversity is negatively related to financial distress,
H_{7a}: measured in terms of female directors;
H_{7b}: measured in terms of directors born outside the Netherlands;
H_{7c}: measured in terms of non-independent directors.
H_8: corporate governance characteristics differ between the different types of legal persons.

The *analysis of differences* between the samples presented in tables 8.6, 8.9, 8.12 and 8.15 showed that for each legal person a number of variables differ statistically significantly at the 10% level or better between the financially distressed sample and the control sample in one or more panels. TENURE in any panel is significantly different (16 out of 16 panels); the number of directors (DIRECTOR: 11 out of 16); the disclosure dummy (DISCLDM: 5 out of 6); firm age (10 out of 16); directors' age (DIR AGE: 6 out of 16) and the number of directors left (LEFT: 5 out of 16) are other prevalent statistically different variables.

The *univariate regression results* from tables 8.7, 8.10, 8.13 and 8.16 summarized in table 8.17 conclude on the hypotheses. Of the *agency-oriented* hypotheses, H_1 on the negative effect of the number of directors on distress cannot be rejected since a higher number of directors decreases the chance of financial distress. The hypotheses on the negative effect of additional control instruments ($H_{2\,(a-c)}$), such as a legal-person-director, a NED or a professional manager, on distress should be rejected since neither a *legal person-director* nor the presence of a *NED* or a *manager* is negatively related to *financial distress*. In fact, for the BV the legal-person-director is positively related to distress.

The positive relation between leaving directors and distress, hypothesis H_{3a}, cannot be rejected. The results show support in five panels for this hypothesis of directors leaving in situations of near financial distress. However, hypothesis H_{3b} on the positive relation between incoming directors and distress should be rejected as only one panel shows a significant explanatory value in newcomers. Since distressed BVs and co-operatives disclose significantly less timely than their control sample equals, H_4 on the positive relation between overdue disclosure and distress cannot be rejected. Finally, age of the legal person may be considered as a sign of good governance since H_5 on the negative effect of the age of a legal person on distress is supported for all legal persons except the vereniging.

The results on the *resource availability* and *resource diversity* hypotheses show that the hypothesized negative effect of experience on distress ($H_{6(a-b)}$) cannot be rejected since tenure is negatively related to financial distress *overall*. Directors' age appears to relate only to the *BV* and the *coöperatie*. $H_{7\ (a-c)}$ on the negative effect of diversity on distress should be rejected. The *diversity* related hypotheses $H_{7(a-c)}$ show few results, either in the form of an analysis of their number or in that of an average (ratio) or diversity (Blau-indicator) approach. Apparently the boards of the legal persons under review did not differ significantly in these respects. The negative relationship between gender and distress (*stichting*) and the positive result between non-independence and distress (*coöperatie*), both in only one panel, are not impressive.

The Hansmann (1996) inspired hypothesis H_8 presuming different values for corporate governance and resource variables between the for-profit and the nonprofit legal forms cannot be rejected based on tables 8.4 and 8.17. Legal persons do appear to differ randomly in governance and resource characteristics between each other. However this result is not statistically supported, since the different samples cannot be compared due to the difference in industry over all the samples.

This is the first systematic research on the effect of governance and resource related variables on the likelihood of financial distress for non-listed legal persons. The research shows first and foremost that the control sample firms have more directors with a longer tenure and better adherence to disclosure requirements. For three out of four legal persons, the control firms are older as well. These findings are irrespective of industry or size. The results fit in with earlier research by Van Amsterdam (2004) and Adriaanse (2005) who stressed the importance of the quality of management. In addition to the financial reports and management information of a specific legal person under research, the above discerned governance and resource variables can be considered tools for qualifying the personal impression of the account manager, auditor or lawyer on the quality of the management. A legal person established some time ago, with a board that is not too small and which has a certain tenure, that adheres visibly to legal obligations is apparently less prone to bankruptcy than its opposite.

Since the sample is small and the control sample method may lead to results that are only relevant for the industry sectors concerned, new research on larger databases, preferably in a European context, is necessary to confirm the relevance of the discerned variables.

The non-rejection of H_8 may indicate the reason of existence for each of the different legal persons. Apparently each of them works within a different corporate governance framework which may be caused by different requirements of the legal person and its environment.

The results confirm the *agency theory* and *resource dependence theory* since (1) a higher number of executive directors i.e. better monitoring; less leaving directors i.e. monitoring output; and timely disclosure i.e. visible bonding prove to be statistically significantly differently distributed *agency* variables between the control and distressed samples of most of the legal persons; (2) longer tenure and older directors i.e. more experience prove to be statistically significantly differently distributed *resource dependence* variables between the control and distressed samples of most of the legal persons; and (3) these variables are significant explanatory variables for financial distress in the univariate analysis.

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ENDNOTES

1 At least in the Netherlands (s 2:53(1) BW); the German co–operative may also be targeted at immaterial needs.

2 s 2:285(1) BW.

3 An alternative is e.g. to appoint all the 'members' as directors or to organize an annual meeting of donors and attribute advisory competences to this meeting.

4 Payment is not forbidden, as it is in the British Charities Act, unless the articles provide for it.

5 No real evidence is published on the matter, and cases started by the OM are all lost. See: Santen and de Bos (2006). See for the legal developments on the issue Annex 2.

6 In this chapter financial distress is equalled to bankruptcy or suspension of payments, as only this data can be retrieved (see further 8.3.1).

7 Distribution means: distribution to members (or related parties). So says s 2:26(3) BW directly and so should s 2:285(3) BW be understood (Van Dijk/ van der Ploeg, 2007). But lower contribution, in order to decrease the accumulated reserves of an association, or payment of directors when general or specific services are rendered, provided that the rates are reasonable, is permitted.

8 All but two legal persons in the distressed sample were eventually declared bankrupt. The two exemptions were associations. Their suspension of payments was relieved after a composition.

9 The RvR is established by law (s 84 *Wet Rechterlijke Organisatie*; Wet RO, Judiciary (Organization) Act) in order to facilitate the administration of justice (s 91 RO). The duty to keep the central bankruptcy register has been assigned to the *Raad voor de Rechtspraak* by an *Algemene maatregel van bestuur* (Amvb; Order in Council) of 24 November 2005.

10 See s 2:27(4.a) BW; s 2:177(2) BW; s 2:54(2) BW; s 2:285(4.a) BW.

11 Permitted by law in s 2:11 BW. Not all legal systems have a similar liberal regime, e.g. in France a directorship by a legal person is forbidden.

12 Foreign is defined as: born outside the Netherlands. The *Handelsregister* contains only information on the place of birth, not on nationality.

13 Non-independent is defined as: the existence of a family relationship in the first or second degree (surname) or a common household (address data).

14 The *Handelsregister* does disclose only if a private limited company has only one shareholder.

15 For each legal person the average variables GENAV (average female), NATAV (average foreign nationality) and DEPAV (average non-independent) and the diversity variables GENDIV (diversity on gender), NATDIV (diversity on nationality) and DEPDIV (diversity in non-independence) were calculated for each time frame. Of these 96 calculations only 5 showed a difference in distribution between the non-distressed and the bankrupt sample at the 10% level (Wilcoxon). Out of these 5 three proved significant, again at the 10% level, in a univariate analysis: GENDIV1 for the stichting (negative sign); DEPAV1 and DEPDIV1 for the BV (negative sign).

16 See s 2:360(3) BW.

17 The obligation of disclosure is in s 2:394-397 BW. The civil sanction to be applied by an interested party is mentioned in s 2:394(7) BW, whilst the criminal sanction, which is not applied very often, is in s 1(4) WED.

18 According to the requirements of s 2:397(7) BW.

19 s 2:360(3), 394-398 BW.

20 s 1 under 4 WED.

21 s 2:138, 248, 53a jo. 50a BW.

22 HR 11 June 1993, NJ 1993, 713 (*Brens q.q./Sarper*); and see s 2:248(2) last sentence BW.

23 The AG under HR 2 February 1996,NJ 1996/406. In this case the HR judged (a) 17 days too late too long to be considered 'an insignificant omission', but (b) a potentially pardonable omission as it is of a 'restricted duration', depending on the arguments to be brought forward by a director.

24 Between €2.50 and €9.00 per company. For companies with a legal person as a director, more data had to be retrieved. The age of the company could only be determined after retrieval.

25 As there are four types of legal persons to be researched, times 50 financially distressed and 50 control (two times 39 for associations), this adds up to 378 printed data sets. In fact a lot more data was retrieved, as it was often impossible to check beforehand whether the retrieved company suited all of the criteria mentioned further on in the text.

26 To be precise: the SIC–code used was the BIK–code (the Bedrijfs Industrie classificatie code of the the *Handelsregister*). From 1 June 2009 this BIK–code has been replaced by the Standaard Bedrijfsindeling (SBI 2008; Standard industrial classification). For the presentation of the results this replacement did not have any consequences.

27 The control group consists of active and non–active companies. A choice for only active companies would have implied a bias, as financially distressed companies could have been active or non–active (this information cannot be retrieved – at least not electronically – after bankruptcy).

28 Obviously, some control sample legal persons were established after this average date. For them, the age is set at the actual number of years in existence.

29 This also applies to most of the data used in this thesis.

30 It is for example unclear why the *Vereniging tegen bekkenproblemen* (association against pelvic problems) is assigned BIK classification 91 (interest) and the *Samen strijden tegen astma* association (fighting asthma together) BIK classification 85 (health). A re–classification on the basis of the name of the association would give an outcome as debatable as the original classification of the *Handelsregister* as found in REACH.

31 The exact periods will be shown in the sections devoted to the specific legal persons.

Chapter

9

Summary, concluding remarks and recommendations

What we should seek to do, then, is to allow the one-man full rein when he is right but hold him in when he is wrong. Of course, we do not know when he is going to be wrong but we can give him full rein until he has built up a socially significant organization and then, whether he will go on being right or not, rein him in. We have to bottle the genie. (Argenti, 1976: 173)

9.1 SUMMARY

This thesis studies *the role of monitoring near financial distress*. The *first* and theoretical part attempts to answer the following questions:

- What is financial distress?
- Which options does a financially distressed company have?
- What is the role of monitoring from an economic perspective?
- What monitoring devices did the legislator put in place?
- Are there any specific requirements for monitoring near financial distress?

Chapter 1 embeds the research question. It starts by analysing the damage society suffers from bankruptcy. In the words of Argenti (1976: 2)

> *corporate collapse has always brought fearful mental pain to proprietors and entrepreneurs and managers and to their families. It has always meant that employees lose their jobs, shareholders lose their savings, creditors lose cash and future business. The customer is deprived of the product. The local community may be plunged into despair.*

A survey of *recovery studies* shows that the recovery rate after bankruptcy for ordinary, non-secured creditors could range between a mere average of 7.5% in the Netherlands and 37.61% or more in the USA. For Dutch society as a whole, non-payment of debt due to bankruptcies of legal persons takes annually as much as 0.39% of annual GDP, let alone the costs of unemployment expenses and lay-offs at suppliers on the negative and efficiency gains on the positive side. A range of studies on the *role of management* e.g. Altman (1968), Argenti (1976), van Amsterdam (2004), Adriaanse (2005), Bollen, Mertens, Meuwissen, Raak and Schelleman (2005), Ooghe and De Prijcker (2008) concludes that management errors are at the root of many of the bankruptcies researched. CBS (2010) reports that mismanagement is a cause of 32% of bankruptcies; problems within the board 4%; and fraud 3%. The other 61% is due to external causes. This thesis focuses on one of the possibilities to diminish these management errors and problems, that is, by monitoring the management. Not, as Jungmann (2006: 473) rightly puts it, that 'members of the supervisory board have a degree of foresight and wisdom that makes them, in any case, superior to the executive directors'. But, he continues, 'an enhanced level of control would reduce the probability of mistakes that occur at the managerial level remaining undetected'. Therefore the research question is

> *What is the role of monitoring near financial distress from an economic and legal perspective?*

Chapter 2 discusses the definition of and possible solutions to financial distress. After dropping some of the non-essential elements of the definition of Gordon (1971) it defines financial distress as *the existence of a non-trivial probability that the legal person will not be able to pay its debt within the terms of payment*. However, for empirical purposes this definition needs to be made operational and for example be confined to bankruptcy. The chapter presents an Ooghe and Waeyaert (2004) and Ooghe and De Prijcker (2008) inspired model for strategically handling financial distress. The model stresses the importance of targeting the restructuring activities at the determining factor of financial distress and not at a symptom. Once the restructuring strategy is set, the actual restructuring form requires a choice between formal and informal reorganization. The options essentially are: (1) formal and voluntary liquidation and reorganization; (2) formal and involuntary liquidation and reorganization; and (3) informal reorganization through a 'work-out'. A 'work-out' is a privately negotiated form of re-contracting in situations of near financial distress which has been developed over the years especially in the UK. A comparison between the formal and informal reorganization routes in section 2.6 clarifies why the work-out solution is so widely applied. Provided that the market decides, by actually supporting the reorganization, that a work-out is the Pareto-optimal solution, the chapter concludes that a 'work-out' is the most efficient solution.

Monitoring is the subject of *chapter 3*. The previous chapters show that whilst management's role is apparently crucial in running a company near financial distress, an attempt to improve the quality of its decisions is worthwhile, since 39% of bankruptcies are due to mismanagement and fraud. Would the presence of monitors contribute to the quality of the management's decisions and decrease this percentage? The chapter subsequently analyses the role of monitoring in the governance of a company. It starts with the basic insight of the *agency theory* that the principal and the agent by definition have a different utility function (Jensen and Meckling, 1976). However, the proper performance of agents in the interests of the principal may severely be hampered by other factors. These are *bounded rationality* (Simon, 1957) i.e. every agent can cope with only a few alternative solutions, and *information asymmetry* i.e. the agent does not share all the relevant information with the principal (Knight, 1921; Akerlof, 1970) which may even result in 'self-interest seeking with guile' (Williamson, 1981). Proper control by the principals of the agent is therefore essential. Principals can be shareholders but also lenders, trade creditors and employees. Control, according to Jensen (1993), is a warning system. The control structure envelops the direction of the company. The control process is executed through monitoring by all the stakeholders from inside and outside the company. *Internal control* mechanisms are the executive board and senior management; the supervisory board or NEDs in a one-tier system; the general meeting of shareholders; and a company secretary, a works council or even the employees, depending on the legal system. *External control* mechanisms are the input and output markets as well as various external monitoring authorities on special issues e.g. formation, tax, disclosure, law and responsible behaviour. The external auditor is the most prominent among them. These control mechanisms create a form of corporate democracy. In point of fact, the party most interested in a well-performing monitoring structure should be management itself. By listening to the various signals, arguments and opinions whilst keeping in mind the specific interests of each monitor, the probability of mistakes will be reduced (Jungmann, 2006) and management's decisions will be improved. Monitoring comes at a cost. As long as the sum of agency costs declines, investments in monitoring are efficient. Thus, managers act sensibly to organize effective and efficient internal and external control mechanisms, adapted to the needs of the company and to be performed by effective monitors.

If this conclusion follows from economic theory, one wonders what the legislator has done with the monitoring concept. *Chapter 4* explores by means of two analytical tools developed by Kraakman (2009), Davies (2010) and Timmerman (2009) the legal mandatory monitoring system of the Netherlands, Germany and the UK of public limited companies, private limited companies, co-operatives, associations and foundations. After a lengthy analysis of mandatory law for these legal persons it concludes that (1) the law is reluctant to apply mandatory monitoring mechanisms and (2) each system finds its own equilibrium adapted to the specific circumstances of the type of legal person under review. Whilst Germany believes in co-determination and a supervisory board if the company employs over 500 people for all for-profit-companies and a strict regulation for the *Aktiengesellschaft (AG)* and *eingetragene Genossenschaft (eG)*, the Dutch system is somewhat more flexible and liberal in the organization of companies. Most flexible is the 1,300 sections counting UK Companies Act 2006 which for the internal organization of for-profit and nonprofit companies relies heavily on the articles each company has to draw up. The CA mentions neither non-executive directors (NEDs) nor any form of formalized labour influence. Consequently one finds in the UK rather strong and elaborated directors' duties and external controlling government agencies, such as the FRC, the FRRP, the FSA, the Bank of England, the Panel on Takeovers and Mergers, the Charities Commission, the CIC Regulator and BIS. Such agencies are less predominant in Germany (financial authorities and the *Bundesländer* for *Stiftungen*) or in the Netherlands (only financial authorities) whilst directors' duties are less developed in these countries than in the UK.

Although chapter 3 concluded with the importance of internal and external monitoring, chapter 4 indicated that in the law the *specialized management* feature as constrained by directors' duties often prevails over the possibility of establishing mandatory internal monitoring mechanisms. Would all this change near financial distress? *Chapter 5* explores the economic and legal approach to this question. It shows that, from an economic point of view, shareholders and directors in situations of near financial distress may develop an overly risky attitude. Therefore creditors have to monitor their position continuously. The law assists the creditors' position by imposing civil and criminal liability to directors personally, as well as the risk of directors disqualification by a court. However, directors often realize the impact of these measures at too late a stage to prevent financial distress.

From the theory explored in chapters 1 to 4, chapter 5 develops a solution for earlier prevention and detection of the distress risk based on the theory of Argenti (1976). In his view it is all about avoiding the key errors in the failure process, i.e. *management* defects, *system* defects or *change* defects. This is subsequently applied to the conceptual failure model of Ooghe and Waeyaert (2004) and Ooghe and De Prijcker (2008), already used in chapters 1 and 2. They discern four conceptual categories ('boxes') of causes of bankruptcy: (1) GENERAL ENVIRONMENT, (2) IMMEDIATE ENVIRONMENT, (3) CORPORATE POLICY, and (4) MANAGEMENT/ENTREPRENEUR. The solution presented in chapter 5 proposes implementation and actual application of tailor–made monitoring around the MANAGEMENT/ENTREPRENEUR box and the CORPORATE POLICY box. Such a tailor–made monitoring structure for *each* legal person appears to form a solid basis in the 'directors' liability pyramid' of figure 9.1 , which was subsequently developed in chapter 5 and 'which presents the various stages of increasing and cumulating directors' liability from a 'healthy' to a 'bankrupt' company. This pyramid idea with 'tailor–made monitoring' at the basis leads to the formulation of a new *bottom–line criterion*. This criterion should apply not only to the legal liability rules in situations of near financial distress but in order to be effective, already beforehand, when the company is still in good shape.

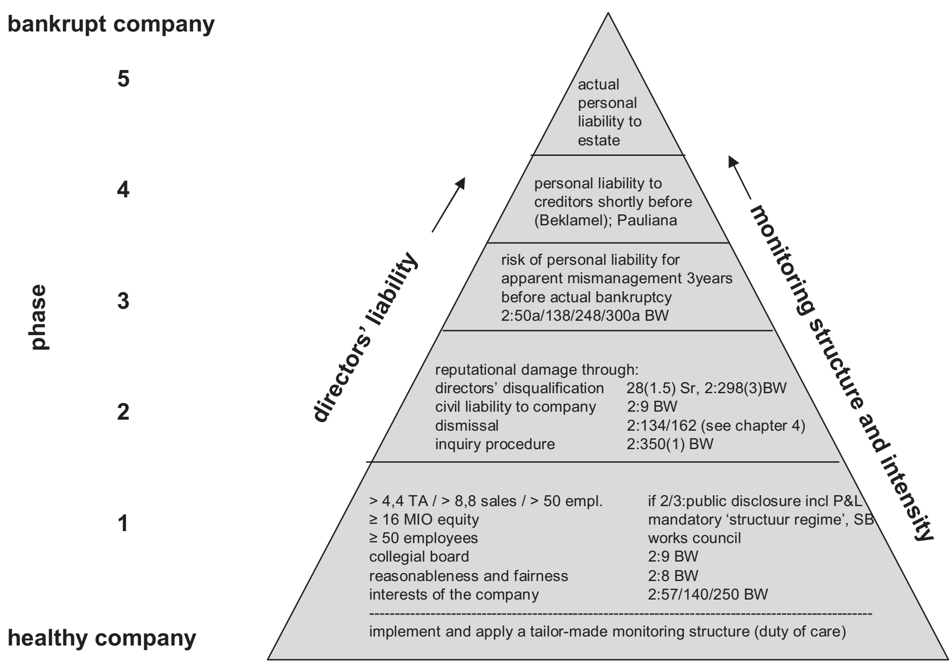

Figure 9.1: a monitoring–based directors' liability pyramid towards bankruptcy in the Netherlands

Derived from economic theory and to be embedded in the duty of care as one of its elements, the criterion reads: *at any rate and in any company directors are obliged to implement and actually apply a monitoring structure tailored to the needs of the company.* Formulated and meant as an element of 'proper management', this obligation fits in with the Dutch corporate governance code and, arguably, through a broad interpretation of Hoge Raad *dicta*[1], may actually already apply to all legal persons by means of s 2:9 BW.

Part 2 is of an empirical nature. Chapters 6 to 8 explore empirically whether elements of the monitoring structure, e.g. the number of directors or their level of education, differ between listed and non–listed financially distressed and 'control' companies; and whether these variables may add to the explanation of financial distress. The hypotheses are based on the agency theory of Jensen and Meckling (1976) and the resource dependence theory of Pfeffer and Salancik (1978).

The empirical research in *chapter 6* on Dutch listed companies from an *agency theory* perspective opens with an analysis of the distribution of *monitoring rights*, *monitoring structure* and *monitoring output* related governance variables. This shows that the typical *non–distressed, control sample company* appears to be a 'structure NV' with five NEDs, a relatively low board turnover and 19% non–independent NEDs on the supervisory board. The *financially distressed* firm is statistically significantly different as regards these aspects. Two years before bankruptcy it is an 'ordinary NV' with four NEDs, a relatively high board turnover and 14% non–independent NEDs on the supervisory board. The average control sample company is larger than the distressed company. The *univariate regression results,* being a check on the one–on–one relationship between financial distress and an explanatory variable, show that (a) a *negative* i.e. opposite and statistically significant relationship exists between financial distress and the regime of a 'structure NV'; a relative high number of NEDs on the board; one or more non–independents on the board two years before bankruptcy; and for the financial variables size, income and cash flow; and (b) a *positive* i.e corresponding and significant relationship exists between financial distress and a relatively high number of directors per unit of the total active; and a relatively high number of leaving directors. In the *multivariate monitoring rights* model 'certification' is the only (and positively significant at the 10% level) explanatory variable for financial distress in the regression with 'bankrupt only' companies. The *monitoring structure* model shows a positive and significant relationship in both regressions between financial distress and a relatively high number of NEDs per unit of the total active. The *monitoring output* model shows a positive and significant relationship in both regressions between financial distress and a relatively high number of leaving directors. Agency–related variables, e.g. the existence of an SB, board size and board turnover, therefore do matter.

Whilst chapter 6 focused on monitoring rights, structure and output, *chapter 7* concentrates on the personal and qualitative characteristics of the monitors involved as well as their *diversity* in distribution on the board. It tests the relevance of the underlying *resource dependence theory* for Dutch listed companies specifically for the relationship between financial distress and age, nationality, gender, education, non-independence, network and workload of the NED. The key question is whether the availability of resources on the supervisory board and whether its diversity in composition influences the likelihood of financial distress. The analysis of distribution reveals that NEDs on the non-distressed, control sample board are: aged 60, 84% Dutch, 97% male, 71% have a university degree, 82% are independent, they have a 4.39 NED position, and a workload[2] of 0.68 FTE. Two years before bankruptcy NEDs on the financially distressed sample are statistically significantly younger, more often foreign, less educated, slightly less independent and they have a smaller network and a higher workload. The *univariate regression results* show a *negative* relationship between financial distress and (1) being an older NED, (2) a better educated NED; or (3) a NED with a larger network; and a *positive* relationship between financial distress and (4) a foreign nationality and (5) a relatively high workload. Similar although not identical results are found for the availability and the diversity of these variables on the board. The *logit regression* for both the *resources availability* model and the *resources diversity* model clearly presents that foreign nationality either as an average (bankrupt sample only) on the board or as a diversity measure (both samples) is a significant and positive explanatory variable for distress. Thus, the availability and diversity of resources on the board in terms of age, nationality, university education, network and workload, are in one way or another significantly related to financial distress.

Listed companies are favourite research subjects for financial economists probably because there is so much information publicly available. *Chapter 8* is on Dutch *non-listed* company forms: the private limited (*BV*), co-operative (*coöperatie*), association (*vereniging*) and foundation (*stichting*). Based on the agency theory and the resource dependence theory *chapter 8* researches the relationship between financial distress and the governance structure of these non-listed legal persons. Data is retrieved from the *Handelsregister* on: the number of executives, NEDs and managers; board turnover; disclosure; company age; directors' age and tenure; gender, nationality and non-independence. The different legal forms show statistically significant differences in distribution of the variables although not always on the same variables. For all or for some of the legal forms involved the *univariate regression results* show a *negative* relationship between financial distress and (a) a relatively high number of directors; (b) a relatively 'older' legal person; (c) a relatively older director; (d) a director with a relatively long tenure, and (e) timely disclosure to the *Handelsregister*. A *positive* relationship exists between financial distress and (f) a relatively high number of leaving directors; and (g) if a BV is a group company. Whether the latter finding is due to the complexity of managing a group of companies or due to the BV being a cost centre of the group could not be detected.

Thus, also in smaller legal persons, governance-related variables differ significantly between a control and a financially distressed sample and quite a few of them are significantly related to financial distress.

9.2 CONCLUDING REMARKS

Based on the literature this thesis shows that in order to improve the quality of management decisions and thus presumably to decrease the incidence of financial distress, each company needs an adequate monitoring structure i.e. a monitoring structure which is tailor-made to the specific requirements of the company. Subsequent empirical evidence indicates elements of importance for the adequacy of the structure. Below, the findings and conclusions are reported for the following six elements: monitoring rights; monitoring structure; monitoring output; monitoring resources; monitoring diversity; and transparency and accountability.

on *monitoring rights* (chapters 3 and 6)
Chapter 3 indicates that on theoretical grounds NEDs are better internal monitors since (a) shareholders often show free-rider behaviour which is at least in the end not accepted on boards; and (b) NEDs have a reputational incentive to avoid and solve problems. From chapter 6 it appeared that weakening shareholders' rights in favour of those of NEDs and strengthening the rights of the SB in the '*structure-NV*' relates significantly to the absence of financial distress. One could conclude that NEDs apparently monitor better than shareholders - that is to say at least under the pre-2005 'structure-regime'.Depriving shareholders of their voting rights through tradable depositary receipts (*certificering*) and having an *Administratiekantoor* voting instead, appears to be a corresponding variable with financial distress in one regression model, but does not show any statistical difference in the variable and univariate analysis. Thus, the 'structure-regime' seems to oppose, and 'certification' may correspond to financial distress.

on *monitoring structure* (chapters 3, 6 and 8)
Each legal person has an internal and an external monitoring structure. The *internal* monitoring structure consists of an executive board and other bodies such as a supervisory board, a secretary, a works council or other bodies established in the articles. For *small* companies, Argenti (1976) argues theoretically and chapter 8 indicates empirically that a one-man board is more bankruptcy-prone than a board with more people. Since in a two-man board one may heavily depend on the other, e.g. the chief financial officer (CFO) appointed by the owner/director/CEO, a separate supervisory board with independent members is theoretically preferable. *Large* companies should normally have NEDs of which the majority is independent. Lipton and Lorsch (1992), Jensen (1993) and Yermack

(1996) argue that one–tier boards should not be too large, i.e. the number of EDs plus NEDs should not exceed 8 or 9 people. Dutch boards do indeed have on average 7 to 8 directors, as the empirical research shows. Moreover, the chapter supports the findings of Klein (1998) that it generally is important to have – provided that they form a definite minority of NEDs – non–independent NEDs on the board 'to contextualize the rich ideas of outside directors' (Harris and Shimizu, 2004). Almost all listed companies are obliged to have a *works council*. This council is in the view of the author an important part of the internal mandatory monitoring structure of the company. Any company with a works council should envisage obtaining the best return from that investment in terms of e.g. improvement of efficiency and labour relations.

The *external* monitoring mechanisms contain a similar challenge. Intuitively a director will not like a critical remark or question from the external auditor, from the AFM, from a court, or from a journalist. However, if the director were able to consider these questions as monitoring activities of the external monitoring mechanisms meant to prevent future reputational or other damage to the company, his attitude might change. The company gains by turning the annoyance into a challenge to improve company return in terms of quality, efficiency and effectiveness of the company processes concerned.

Chapter 4 shows that monitoring provisions in the law are often not mandatory. Since no legal person operates in a vacuum and monitoring may help to prevent mistakes, chapter 5 concludes that the implementation and actual application of a tailor–made monitoring structure in the company forms one of the important elements of a directors' duty of care.

on *monitoring output* (chapters 3 and 6)
The literature, e.g. Gilson (1989) and Gales and Kesner (1994), indicates that directors will leave a company near financial distress either because they are dismissed or because they are leaving the sinking ship. Empirical evidence of chapters 6 and 8 supports these insights. A high number of leaving directors is a warning signal for distress. Anyhow, one should consider planning and forecasting the succession of directors as part of adequate management.

on *monitoring resources* (chapters 7 and 8)
Not only the monitoring structure matters, but also the personal and qualitative characteristics of the monitors involved. Age, nationality, education, network and workload of NEDs prove to be statistically significantly differently distributed resources over the control and the financial distress sample (table 7.13). Chapters 7 showed that older and graduated NEDs with a larger network work positively for the firm, whilst foreign nationality and workload relate positively to financial distress. Company age for 'institutional memory' and experience in terms of directors' tenure and to a lesser extent directors'

age proved to be relevant as well for small companies in staying out of financial distress (table 8.17). Nationality of NEDs is a strong and positive explanatory variable for financial distress of listed companies. These are factors to take into account when selecting a NED. Especially foreigners should have a clear and specific surplus value on the board. Abstract advantages as 'network' and 'know-how' may turn out to be insufficient to outweigh the more formal communication processes due to cultural, language and time constraints, which is often the consequence of the 'internationalization' of the supervisory board.

on *monitoring diversity* (chapters 7 and 8)
The literature, e.g. Carter, Simkins and Simpson (2003), Ruigrok, Peck and Tacheva (2007), holds that diversity is a separate factor in the explanation of the usefulness of NEDs. Indeed the findings of chapter 7 show that diversity in nationality is positively and significantly related to financial distress (table 7.13). A possible explanation can be found in the previous paragraph. Diversity in education is negatively related to financial distress, and so are diversity in non-independence and workload two years before bankruptcy. Since diversity in these factors apparently has some importance, the selection of a new foreign NED is apparently risky, whilst board diversity in education, non-independence and workload is advisable.

on *transparency and accountability* (chapter 8)
In order to diminish the information asymmetry and connected risks such as moral hazard or outright opportunism, as described in chapter 3, chapter 4 showed that the law urges directors of most company forms to inform stakeholders. Separate provisions exist for informing members/shareholders, NEDs, works councils, external auditors, external market supervisors and – through the *Handelsregister* and with some exceptions – the general public. From the results presented in chapter 8 it is clear that distressed firms comply significantly less with disclosure obligations than control firms. Non-disclosure is a warning sign.

The challenge for directors, whether they are entrepreneurs or just agents for shareholders, in any phase of a firm is to organize and facilitate an adequate monitoring structure for their company and to consider these monitors as an opportunity and not as a threat. An opportunity since it provides access to various resources. Not a threat since executive directors remain the management of the company: théy initiate new ideas and generally théy determine the course of action. If it so happens that the law, the articles or resolutions compel them to consult or even convince monitors of the justification of a (proposed) course of action, they should interpret this as an opportunity to re-assess its validity. If they do not succeed in convincing the supervisory board, the bank, or the works council, they should admit that maybe it was not such a good plan after all. Only this attitude will enable them to use effectively the available resources in the various internal and external monitoring mechanisms for the success of the company, that of their stakeholders and eventually their own.

9.3 RECOMMENDATIONS

To mitigate the chance of financial distress the following courses of action are recommended as far as they relate to monitoring, the subject of this thesis:

to the general meeting

- avoid the one–man–rule i.e. one–executive only. If this is the only feasible option, surround this director with a supervisory board or a lighter non–legal based version 'board of advice', or with an experienced auditor or a freelance 'company consultant';
- create a supervisory board or at least a 'board of advice' as soon as a company has a certain size and social impact, for both disciplinary and resource reasons;
- avoid executive boards and supervisory boards that are too large. Check the adequacy of your board size by comparing with similar companies in your industry;
- strengthen the monitoring role of NEDs through the articles or through GM resolutions since this may strengthen the company and avoid financial distress. NEDs by law look after the interests of the company, whilst shareholders primarily look after their own.

to the general meeting and the supervisory board

- have a critical eye on executives who owe their career to the CEO. Realize that the collegial board character implies that executives are – or should be – each others monitors;
- ensure that the majority of the supervisory organ, i.e. two–thirds, consists of truly independent people, which means people who do not, either by formal criteria or by factual circumstances, have ties with the executives. Appoint knowledgeable dependents for the remaining one–third;
- consider many directors leaving as a warning sign for the health of your company. If you do not, others will;
- know that experience (proxied by age), academic education and network on the supervisory board are positively related to the control sample; and that foreign nationality and workload are positively related to financial distress;
- think hard before you diversify your supervisory board in terms of nationality. It complicates communication which could spoil the monitoring effectiveness of the supervisory board.

to the executive board

- every executive director should consider the implementation and actual application of a tailor-made, effective and efficient monitoring structure in the company as an important element of his duty of care;
- consider the works council as a means to promote the success of the company for all stakeholders.

to the supervisory board

- profile your NED vacancy in terms of resources first. Start thinking of suitable candidates afterwards;
- realize that although for NEDs the interests of the company come first by law, they may unconsciously but inevitably serve their own interests as well. This goes for every monitor;
- encourage diversity in education, non-independence and workload on the supervisory board.

to lawyers, notaries, auditors and insolvency practitioners

- urge your client-director to organize an adequate, efficient and effective monitoring structure in the company he is working for;
- urge your client-director to disclose to the *Handelsregister* as soon as possible, since it is a sign of being in control. Discourage the 'strategy' of waiting till the last moment.

to the courts

- whilst judging on the quality of management under s 2:9 and 138/248 BW, take into account the executive's effort in organizing an adequate, efficient and effective monitoring structure in the company he is working for.

to the legislator and the government

- present positive legal stimuli for directors' behaviour in situations of near financial distress. Such as:
    - o the 'silent administrator' presented by the *Commissie Kortmann*
    - o deductibility for tax purposes through box 1 or 2 of privately paid expenses for monitoring or restructuring in situations of (near) financial distress;
- rethink the maximum term of disclosure. At present it is 13 months in the Netherlands, 12 months in Germany and 9 months for a Ltd in the UK[3];
- make a massive effort to improve the disclosure compliance rate. A disclosure control system that automatically reminds non-compliants after the legal maximum disclosure term of 13 months; and produces a fine after 14 months or gives a one month *terme de grâce* if requested (and a fine if the request is not complied with) is efficient[4];

- since EDs are the principal interested parties in a successful audit, assign to NEDs, if available, a more conspicuous and leading role in the audit process, not only in the *NV* but also in the *BV* and the *coöperatie*;
- apply the 'adequate monitoring structure rule' to the *vereniging* and a *stichting* as well instead of the development of new rules and new legal forms;
- commission a study to compare the effectiveness of the British Charity Commission vis–à–vis the absolute lack of a mandatory supervision structure for a *vereniging* or a *stichting* in the Netherlands.

to researchers

- replicate this research for larger and/or European–wide databases;
- pay more attention to the monitoring effect of a works council;
- find out why foreign NEDs in general in the Netherlands appear to be ineffective near financial distress;
- design and test a model for the effectiveness of Dutch two–tier boards in relation to the characteristics of their members.

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ENDNOTES

1 HR 13 July 2007, JOR 2007/178, *Bank of America/ VEB and ABN AMRO Holding* and HR 9 July 2010 LJN: BM0976 (*ASMI/Hermes*)

2 See 7.5.7 and table 7.9. The text of chapter 9 refers to WL1NED.

3 See s 2:394 BW; s 325 HGB; s 442(2) CA. On 10 March 2010 the European Parliament approved a legislative resolution on the proposal for a directive of the European Parliament and of the Council of Ministers amending Council Directive 78/660/EEC. The proposal envisages exempting 'micro–entities' from public disclosure of annual accounts. The implementation of this directive – if it comes to that which depends on the position of the Council – could be an opportunity for the Dutch legislator to rethink the disclosure term as well. The automation of bookkeeping enables the reduction of the term up to even 5 months in Denmark. A shorter term makes the figures and the auditor's statement more valuable (H.J.R. Litjens, 18 March 2010, *Het Financieele Dagblad*, Sneller deponeren jaarrekening nodig, p. 11).

4 S. Eikelenboom and P. Kakebeeke, 25 March 2010, *Het Financieele Dagblad*, Niet–deponeerders harder bestraft, p. 17, reports that of the approximately 90,000 non–disclosure–compliant legal persons, around 550 were effectively given a fine.

ANNEX 1 THE IMPACT OF ALL CONCLUDED DUTCH BANKRUPTCIES

This annex shows the impact of *all* concluded bankruptcies on the Dutch economy, thus including bankruptcies of people and one–man businesses. It belongs to chapter 1, section 1.2. The tables A1.1 to A1.3 below are identical in set–up to the tables 1.1 to 1.3 of chapter 1 of this thesis. The choice to restrict the figures in chapter 1 to those of legal persons originates from the decision made in 1.4 to study legal persons only.

Table A1.1: survey of concluded bankruptcies in the Netherlands 1992–2008 (mln euros)

year	number of concluded bankruptcies	total assets	of which (3) to secured creditors	net assets (3)-(4)	total debt	total dividend paid	calculated recovery rate in % (3)/ (4)+(6)	overall recovery rate (CBS) in %
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
1992	3,447	319.3	197.4	121.9	1,258.4	121.9	21.9	4.4
1994	5,031	287.6	157.9	129.7	1,478.1	129.7	17.6	4.6
1996	5,266	292.9	154.6	138.3	1,437.5	138.3	18.4	4.0
1998	5,098	295.2	105.4	189.9	1,647.0	189.9	16.8	6.4
2000	3,758	277.6	121.2	156.4	1,338.1	156.0	19.0	5.1
2002	3,948	203.4	82.6	120.7	1,247.5	119.3	15.3	4.3
2004	5,939	289.7	77.8	211.9	2,098.7	208.5	13.3	5.1
sub-average	4,641	280.8	128.1	152.7	1,500.8	151.9	17.2	4.9
2006	9,119	820.0	139.0	681.0	3,789.0	680.0	20.9	13.6
2008	7,196	478.0	84.0	394.0	4,021.0	394.0	11.6	5.5
average	5,422	362.6	124.4	238.2	2,035.0	237.5	16.8	6.8

Source: CBS Statline[1]

Table A1.2: composition of total debt of concluded bankruptcies in the Netherlands 1992–2008 (in percentages)

		debt categories (in percentage of total debt)			overall recovery rates by debt category		
year	total debt in mln euros	estate handling	taxes and social security	other debt	estate handling	taxes + social security	other debt
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
1992	1,258.4	6.7	24.4	68.9	83.2	9.6	2.5
1994	1,478.1	5.7	25.7	68.7	78.2	10.4	2.5
1996	1,437.5	7.5	30.5	62.0	79.4	7.9	2.0
1998	1,647.0	7.1	22.1	70.8	78.3	10.1	5.3

1All the figures in these and the following tables are available online from CBS. The author is responsible for the presentation of the figures.

Table A1.2: Continued

		debt categories (in percentage of total debt)			overall recovery rates by debt category		
year	total debt in mln euros	estate handling	taxes and social security	other debt	estate handling	taxes + social security	other debt
2000	1,338.1	8.8	21.4	69.8	79.7	14.4	2.2
2002	1,247.5	7.5	25.5	67.0	75.1	9.7	2.2
2004	2,098.7	7.4	23.6	69.0	70.9	7.4	4.3
sub-average	1,500.8	7.2	24.6	68.1	77.3	9.6	3.2
2006	3,789.0	7.3	24.2	68.4	73.4	8.9	15.2
2008	4,021.0	6.0	22.7	71.3	76.1	6.7	5.2
average	2,035.0	7.0	24.1	68.9	76.2	8.9	6.1

Source: CBS StatLine

Table A1.3: the impact of concluded bankruptcies in the Netherlands, 1992–2008, on the Dutch economy (mln euros)

			total dividend paid					
year	GDP	total debt	in mln euros	% to estate	% to taxes +social security	% to other debt	remaining debt (3)-(4)	remaining debt as % of GDP (t=-2) (5)/(2)
(1)	(2)	(3)	(4)				(5)	(6)
1990	243,561							
1992	266,472	1,258.4	121.9	57.8	24.2	18.0	1,136.5	0.47
1994	287,517	1,478.1	129.7	50.5	30.3	19.2	1,348.4	0.51
1996	319,755	1,437.5	138.3	61.7	25.1	13.2	1,299.2	0.45
1998	362,464	1,647.0	189.9	48.3	19.4	32.3	1,457.1	0.46
2000	417,960	1,338.1	156.0	60.3	26.5	13.2	1,182.1	0.33
2002	465,214	1,247.5	119.3	58.8	25.9	15.3	1,128.2	0.27
2004	491,184	2,098.7	208.5	52.8	17.7	29.5	1,890.2	0.41
sub-average	337,563°	1,500.8	151.9	55.2	23.4	21.3	1,348.9	0.40
2006	534,324	3,789.0	680.0	30.0	12.1	57.9	3,109.0	0.63
2008	595,900	4,021.0	394.0	47.0	15.5	37.5	3,627.0	0.68
average	376,495°	2,035.0	237.5	45.7	18.3	36.0	1,797.5	0.48

Source: CBS StatLine
° in the calculation of the average the last year is omitted due to the time lag assumed in column 6 (see text).

ANNEX 2 PENDING CHANGES IN DUTCH CORPORATE LAW

This annex lists the major changes in Dutch corporate law pending in the legislation process and belongs to chapter 4, section 4.4 on the Dutch legal forms. It contains only proposals submitted to Parliament.

Annex 2.1 31 058 Flexible BV (*Flex BV*)

Official title: Wijziging van Boek 2 van het Burgerlijk Wetboek in verband met de aanpassing van de regeling voor besloten vennootschappen met beperkte aansprakelijkheid (Wet vereenvoudiging en flexibilisering bv-recht)
Status: Pending in Senate (*Eerste Kamer*)
Content: This proposal contains four main issues: (1) deletion of minimum capital requirement and mandatory blocking clause; (2) enhanced freedom in structure and decision; (3) new creditor protection rules; (4) adaptation of conflict rules.

The *minimum capital* requirement is dropped. Shares become freely transferable. Whilst default law (s 2:195(1) new) requires that shares should first be offered to the other shareholders and the articles may restrict the freedom of transfer, a transfer should not be made impossible (s 2:195(5) new). Shareholders do not necessarily have a voting right (s 2:228(5) new). The articles may contain additional liabilities for shareholders (s 2:192 new). In addition, the proposal offers new exit arrangements (s 2:192 and 192a new). Payment in kind on shares is made easier (s 2:204a and 204b new); the restriction on transfer of assets from a shareholder to the company is dropped (former s 2:204c). The *enhanced freedom in structure and decision* shows in the abandonment of the duty to hold an AGM. It may be replaced by a resolution in writing (s 2:218 and 238(1) new). If all shareholders are directors and they have all signed the accounts, adoption of the financial accounts in the AGM is no longer mandatory (s 2:238(3) new). On the contrary, 1% may already require that an EGM be held (s 2:220(1) new). The meeting may be held outside the Netherlands (s 2:226 new). The articles could arrange for the appointment of one or more directors by a specific category of shares (s 2:242(1) and 252(1) new).

Creditor protection regards buying shares, payment on shares and dividend payments. If the board of a BV decides to buy the company's shares, directors are jointly and severally personally liable if the company's capital is less than its mandatory reserves or if the board knew or reasonably should have known that after the transaction the company could not continue to meet its current liabilities (s 2:207 new). The latter also applies to the seller of the shares; compensation is excluded (s 2:207(3) new). Payments on shares of whatever nature (s 2:208(6) new; s 2:216 new) thus including dividends are subject to a similar test. A decision to pay on shares has no effect unless the board has approved it. The board should not approve it if it knew or reasonably should have known that after the payment the company could not continue to meet its current liabilities. If it does, it is jointly and severally liable for the deficit, just like the knowing receiver of the payment to the level of the receipt. The *adaptation of conflict rules* consists of provisions to speed up the procedure and to avoid delaying tactics.

Annex 2.2 31 386 Professional disqualification (*Ontzetting uitoefening beroep*)

Official title: Wijziging van het Wetboek van Strafrecht, Wetboek van Strafvordering en enkele aanverwante wetten in verband met de strafbaarstelling van het deelnemen en meewerken aan training voor terrorisme, uitbreiding van de mogelijkheden tot ontzetting uit het beroep als bijkomende straf en enkele andere wijzigingen
Status: The law, published in Stb. 2009, 245 is not yet in force. The *Eerste Kamer* has required a final say on its implementation (Kamerstukken I 2008/09, 31 386, F).
Content: The law adds an additional penalty to certain specified crimes: the possibility of disqualification for certain professions, e.g. to be a director. The possibility of disqualification as an additional penalty exists in s 28(1.5) Sr for 'cases specified in the law'. This law specifies the penalty for (1) crimes against the public order (131–134, 137c–137g, 147, 194, 205 Sr; these are partly new in this proposal and relate to the prevention of terrorist attacks); (2) financial crimes (235, 349 Sr; 69 AWR; 65 Iw).

Annex 2.3 31 763 Board and supervision (*Bestuur & Toezicht*)

Official title: Wijziging van boek 2 van het Burgerlijk Wetboek in verband met de aanpassing van regels over bestuur en toezicht in naamloze en besloten vennootschappen
Status: Pending in Senate (*Eerste Kamer*)
Content: This proposal is hybrid since it (1) adapts the formulation of the tasks of the executive board of all legal persons; (2) changes the conflict of interests provisions for the NV and BV; (3) enables the establishment of a one–tier board for the NV and BV; (4) introduces a mandatory new contract form with EDs of a listed NV; and (5) formulates requirements on the composition of the board and on its members for the NV, BV and stichting.

The adaptation in the *formulation* of s 2:9 ('liability for mismanagement') and s 2:129/239 BW ('interests of the company prevail') is a codification of case law already mentioned in 4.4.1.3 The *conflict of interests* provision of the new s 2:129(6)/239(6) for EDs and the new s 2:140(5)/250(5) for NEDs replaces s 2:146/256 BW. It provides a duty for the conflicted director to abstain from the decision (process). To the GM it provides a right to decide by default if conflicting interests prevent the board from deciding. The *one–tier board* organized in the new s 2:129a/239a as an alternative direction model essentially maintains the division of tasks between EDs and NEDs as described in the text for the two–tier system. This also applies to the 'structure NV/BV' (s 2:164a/274a new). An exception is the new 2:134(1)/244(3) (suspension of an ED by the one–tier board) In the new s 2:133(3) the law prescribes that the *service contract* of a director (ED and NED in one–tier; ED in two–tier) in a listed NV is a contract sui generis, therewith bypassing the protection rules of regular labour law which inhibit the proper application of the Dutch Code II.1.1 and II.2.8. As to the *personal requirements* of EDs and NEDs, the new s 2: 132a/242a/297a requires that an ED of a large (> 2:397 BW) NV, BV or stichting cannot be a NED of more than two other such legal persons; or only be the chairman of one. A NED of a large (> 2:397 BW) NV, BV or stichting cannot be a NED of more than five such legal persons; a chairmanship counts twice, according to the new s 2:142a/252a/297b. For the large NV and BV only (not for the stichting) the new s 2:166/276 requires 'taking into account as much as possible' a balanced distribution of gender over ED and NED functions, with a minimum of 30% each. If the distribution is not balanced, in the annual report the company should account for its efforts and future plans to achieve it. These gender related provisions remain in force up to 1 January 2016.

Annex 2.4 31 948 Prevention of abuse of legal persons (*Voorkomen en bestrijding misbruik rechtspersonen / vervallen vvgb*).

Official title: Wijziging van onder meer Boek 2 van het Burgerlijk Wetboek en de Wet documentatie vennootschappen in verband met het vervallen van de verklaring van geen bezwaar (vvgb) en het verbeteren en uitbreiden van de controle op rechtspersonen met het oog op de voorkoming en bestrijding van misbruik van rechtspersonen (Wet controle op rechtspersonen)
Status: Law of 7 July 2010, Stbl 2010 280. Not yet in force.
Content: This proposal relates to government clearance ex ante for the NV and the BV.
It partly replaces the external mandatory monitoring by the formation authority on formation of an NV or BV by a continuous *ex post* screening of directors to prevent abuse of legal persons.

The proposal removes all referrals to government clearance in Book 2 BW (see e.g. s 2:4 new; 2:64/175 new; withdrawal of 2:68/179 and 125/235; s 2:72 and 181). The proposal renames the 'Wet documentatie vennootschappen' in the 'Wet controle op rechtspersonen'. In s 4 it enables the establishment of a register with data on the promoters, shareholders, directors, other members with a function in the legal person, its representatives or other people that determine or are able to determine the policy of the legal person. If it is deemed necessary that the network of a person be analysed, it may register parents, children and grandchildren as well.

Annex 2.5 32 014 Change of thresholds (*Wijziging drempelwaarden*)

Official title:Wijziging van de Wet op het financieel toezicht, de Wet giraal effectenverkeer en het Burgerlijk Wetboek naar aanleiding van het advies van de Monitoring Commissie Corporate Governance Code van 30 mei 2007
Status: pending in the House of Representatives (*Tweede Kamer*)

Content: The proposal aims to insert an additional threshold in the Wft of 3% where investors have to disclose their intent with the investment. It increases the level necessary to place an item on the agenda to 3% and removes the present '€ 50 million worth' criterion (s 2:114a new).

Annex 2.6 32512 Adaptation and 'claw back' of bonuses (*Aanpassing en terugvordering bonussen*)

Official title:Wijziging van boek 2 van het Burgerlijk Wetboek en de Wet op het financieel toezicht in verband met de bevoegdheid tot aanpassing en terugvordering van bonussen en winstdelingen van bestuurders en dagelijkse beleidsbepalers en deskundigheidstoetsing van commissarissen
Status: pending in the House of Representatives (*Tweede Kamer*)
Content: The proposal introduces a right for the organ that has determined the salary packages of an ED (s 2:135(3) BW) to adapt the bonus to an equitable level if payment were unacceptable according to the measure of reasonableness and fairness (s 2:135(6) BW new). Moreover, it introduces a 'claw-back' right to the company, to be executed by either the SB or the NEDs in a one-tier system, or a representative appointed by the GM, if the payment has been executed based on wrong information concerning the achievement – in short – of the underlying targets (s 2:135(8) BW new). A special rule is proposed in the case of a take-over (s 2:135(7) BW new). This proposal concerns all NVs as well as cooperative banks and insurance companies (s 2:53a(2) BW new) and banks in BV form (s 2:245(2) BW new).

S 1:111 (new) Wft extends the 'claw back' of bonuses to the senior management of financial companies.

ANNEX 3 STATISTICAL COMMENTS ON THE FINDINGS OF CHAPTER 6

This annex presents the following statistical comments on the findings of chapter 6:

Annex 3.1 Composition of the financial distress and control sample
Annex 3.2 Composition of matched pairs
Annex 3.3 Statistical comments on table 6.12
Annex 3.4 Results on the matched pairs sample (tables 6.12A and 6.14A).

Annex 3.1 Composition of the financial distress and control sample

Table annex 3.1.1: sample of listed Dutch financially distressed companies, 1993–2003

distressed sample									
number	year	company	distress code	SIC	number	year	company	distress code	SIC
1	1993	DAF NV	1	34	27	2001	Ring!Rosa	1	72
2	1993	Holland Sea Search	2	11	28	2001	Management Share	1	72
3	1993	Homburg Holding NV	1	15	29	2001	HES Beheer	2	63
4	1993	Pahlte NV	1	52	30	2001	Kon. Begemann	2	67
5	1993	Rood Testhouse	1	74	31	2001	Pharming Group	1	24
6	1993	Verto NV	1	28	32	2001	Mulderboskoop/ VRG	1	29
6A	1993	Omnium Europe	1	74	33	2002	Landis Group	1	72
6B	1993	UDG/ICA Holding	1	70	34	2002	AFC Ajax	2	92
8	1994	Wolff Handelmij	2	25	35	2002	AINO/Astra	1	72
9	1995	Wyers Beheer NV	1	51	36	2002	CSS Holding	1	72
10	1996	Koninklijke Van Besouw	1	17	37	2002	Emis Euromarketing	1	74
11	1996	Fokker	1	35	38	2002	Laurus	1	52
12	1997	Multihouse NV	1	72	39	2002	Koninklijke Textielgr.	1	17
13	1998	Tulip Computers NV	1	30	40	2002	KPN Qwest	1	64
14	1999	Ceteco Holding NV	1	52	41	2002	TIE Holding	2	72
15	1999	Koppelpoort NV /DNC	2	74	42	2002	UPC	1	64
17	2000	Baan Company NV	1	72	43	2002	Vedior	2	74
18	2000	Atag Group NV	1	29	44	2002	Versatel	1	64
19	2000	Alanheri	2	51	45	2003	Van Heek Tweka	1	18
20	2000	Burgman Heybroek	2	51	46	2003	ASML	2	31
21	2000	Dico	2	36	47	2003	BE Semic	2	31
22	2000	EVC International	2	24	48	2003	Getronics	2	72
23	2000	Scala	2	72	49	2003	Magnus Holdings	2	72
24	2001	AND Int. Publishers	1	72	50	2003	Neways	2	31
25	2001	LCI Technology	1	72	51	2003	Prolion	2	29
26	2001	Toolex International	1	29	52	2003	RTCompany	2	72

Table annex 3.1.2: control sample of listed Dutch companies, 1993–2003

1	1993	Beers	50	87	2001	Delft Instruments	33
2	1993	Borsumy Wehry Kon	51	88	2001	DocData	22
4	1993	EHCO-KLM kleding	17	89	2001	Grontmij	70
5	1993	Gelderse Papiergroep	21	90	2001	HBG	45
6	1993	Gist-Brocades	24	92	2001	ICT Automatisering	72
7	1993	GTI-Holding	51	94	2001	ISPAT	28
8	1993	Hoogovens	27	95	2001	KLM	62
9	1993	Koninklijke Olie	11	96	2001	Kuhne + Heitz	51
10	1993	Krasnapolski	55	97	2001	Nyloplast	25
11	1993	NEDAP	33	98	2001	Nutricia ver bedrijven	15
13	1993	Nedlloyd	61	99	2001	Oce-van der Grinten	30
15	1993	Phoenix Beheer	74	100	2001	Ordina Beheer	72
16	1993	Pie Medical	51	101	2001	OPG	51
17	1993	Sphinx Kon	26	102	2001	Polynorm	29
19	1993	Weweler	34	103	2001	Porceleyne Fles	26
20	1994	Flexovit International	29	105	2002	Accell Group	35
21	1993	Groenendijk Yellowcabine	71	106	2002	Athlon Groep	71
22	1994	Kondor Wessels Groep	45	107	2002	AXA Stenman	28
23	1993	Landre & Glimmerman	51	108	2002	Bever Holding	67
25	1994	Union	35	109	2002	Blydenstein-Willink	17
27	1995	Klene Holding	15	110	2002	BolsWessanen	15
28	1995	Polygram	22	111	2002	Boskalis Westminster	45
29	1996	Giessen-De Noord Van	35	112	2002	Copaco	72
30	1996	Hoek's Machine & Zuurstof	24	113	2002	CVG Gem Bezit	21
31	1996	Kon Beijenkorf Beheer	52	114	2002	DSM	24
32	1996	NKF Holding	31	115	2002	Eriks Holding	51
33	1996	Pirelli Tyre Holding	25	116	2002	Gucci	19
36	1997	Cindu International	24	117	2002	KPN	64
38	1997	OTRA	51	118	2002	Macintosh	52
39	1998	Smit Transformatoren	31	119	2002	Moolen Holding Van d	67
40	1998	Ommeren van	61	120	2002	Naeff	24
41	1998	Welna	25	121	2002	NBM-Amstelland	45
43	1997	Cate Koninklijke ten	17	122	2002	Nedschroef Holding	28
44	1999	Content Beheer	74	123	2002	Nutreco	15
45	1995	CSM	15	124	2002	Philips	31
46	1999	Dorp Groep van	51	125	2002	Randstad Holding	74
47	1999	Frans Maas Groep	60	126	2002	Reesink	51
48	1999	Geveke	51	127	2002	Roto Smeets De Boer	22
49	1999	Hollandia Industriële Mij	63	128	2002	Samas Groep	36

50	1999	IHC Caland	35	129	2002	Schuitema	52
51	1993	NAGRON	70	130	2002	Schuttersveld Holding	25
52	2000	ACF Holding	51	131	2002	Simac Techniek	72
53	2000	Ahold	52	132	2002	Sligro Beheer	51
54	2000	Ahrend Groep	51	133	2002	Smit Internationale	63
55	2000	Akzo	24	134	1993	Stork	29
56	2000	AXXICON	25	135	1993	Telegraaf Holdingmij	22
57	2000	Beter Bed	52	136	2002	TNT Post Groep	64
58	1993	De Drie Electronics	31	137	2002	Unilever	15
59	2000	Draka	31	138	2002	Vendex	52
60	2000	Econosto	51	139	2002	VNU Ver Bez	22
61	2000	Elsevier	22	140	2002	Volker Stevin	45
62	1993	Free Recordshop	52	141	2002	Vredestein	25
63	2000	Gamma Holding	17	142	2003	Wolters Kluwer	22
64	2000	Goudsmit	74	144	2003	Airspray	24
65	2000	Grolsch	15	145	2003	Batenburg Beheer	45
66	2000	Hagemeyer	51	146	2003	Blue Fox Enterprises	72
67	2000	Helvoet Holding	25	147	2003	Ctac	72
68	2000	Heijmans	45	148	2003	DPA Holding	74
69	2000	Holland Colours	24	149	2003	Exact Holding	72
71	2000	Melle , van	15	150	2003	Fugro-McClelland	11
72	2000	Norit	24	151	2003	Gouda Vuurvast Holding	26
73	2000	Ubbink	25	152	2003	Heidemij	45
74	2000	Wegener	22	153	2003	Heineken	15
75	2001	Aalberts Industries	28	154	2003	Hitt	72
76	2001	Amsterdam Options Traders	67	155	2003	Internatio Muller	45
77	2001	Amsterdam Rubber	51	156	2003	Innoconcepts	74
78	2001	ARTU Biologicals	51	158	2003	KNP BT	21
79	2001	ASMI	31	160	2003	McGregor Fashion Groep	52
80	2001	Autombiel-Industrie Rotterdam	50	161	2003	Nedcon Groep	28
81	2001	Ballast Nedam	45	162	2003	Petroplus Int	51
82	2001	Bam Groep	45	163	2003	Pink Roccade	72
83	2001	Brill	22	164	2003	Seagull Holding	72
84	2001	Brunel International	72	165	2003	Twentse Kabel Holdin	28
85	2001	Cap Volmac Groep	74	166	2003	Unit 4	72
				167	2003	Vilenzo International	18

Annex 3.2 Composition of matched pairs

The small number of listed companies in Amsterdam, the lack of comparable companies and the lack of data for the early years hampered the matching process considerably. The SIC code and size were primarily leading; the specific business activities were a secondary criterion; and if this did not lead to a match, then a product match was sought (DAF and Hoogovens having steel as a connecting factor; Ajax and Gucci have leisure). Two years' difference for the data of the matched companies was accepted. Table annex 3.2. presents the result which as regards quite a few choices is undoubtedly arbitrary.

Table annex 3.2: matched pairs of listed Dutch financially distressed and control companies, 1993–2003

distressed sample					control sample			
number	year	company	distress code	SIC	number	year	company	SIC
1	1993	DAF NV	1	34	8	1993	Hoogovens	27
2	1993	Holland Sea Search	2	11	9	1993	Koninklijke Olie	11
3	1993	Homburg Holding NV	1	15	27	1995	Klene Holding	15
4	1993	Pahlte NV	1	52	4	1993	EHCO-KLM kleding	17
5	1993	Rood Testhouse	1	74	58	1993	De Drie Electronics	31
6	1993	Verto NV	1	28	5	1993	Gelderse Papiergroep	21
6A	1993	Omnium Europe	1	74	15	1993	Phoenix Beheer	74
6B	1993	UDG/ICA Holding	1	70	10	1993	Krasnapolski	55
8	1994	Wolff Handelmij	2	25	20	1994	Flexovit Internation	29
9	1995	Wyers Beheer NV	1	51	2	1993	Borsumy Wehry Kon	51
10	1996	Koninklijke Van Besouw	1	17	43	1997	Cate Koninklijke ten	17
11	1996	Fokker	1	35	25	1994	Union	35
12	1997	Multihouse NV	1	72	38	1997	OTRA	51
13	1998	Tulip Computers NV	1	30	39	1998	Smit Transformatoren	31
14	1999	Ceteco Holding NV	1	52	53	2000	Ahold	52
15	1999	Koppelpoort NV /DNC	2	74	44	1999	Content Beheer	74
17	2000	Baan Company NV	1	72	85	2001	Cap Volmac Groep	74
18	2000	Atag Group NV	1	29	75	2001	Aalberts Industries	28
19	2000	Alanheri	2	51	48	1999	Geveke	51
20	2000	Burgman Heybroek	2	51	46	1999	Dorp Groep van	51
21	2000	Dico	2	36	57	2000	Beter Bed	52
22	2000	EVC International	2	24	55	2000	Akzo	24
23	2000	Scala	2	72	92	2001	ICT Automatisering	72
24	2001	AND Int. Publishers	1	72	131	2002	Simac Techniek	72
25	2001	LCI Technology	1	72	100	2001	Ordina Beheer	72
26	2001	Toolex International	1	29	102	2001	Polynorm	29

27	2001	Ring!Rosa	1	72	84	2001	Brunel International	72
28	2001	Management Share NV	1	72	88	2001	DocData	22
29	2001	HES Beheer	2	63	95	2001	KLM	62
30	2001	Begemann Koninklijke	2	67	76	2001	Amsterdam Options AOT	67
31	2001	Pharming Group	1	24	72	2000	Norit	24
32	2001	Mulderboskoop NV/ VRG	1	29	107	2002	AXA Stenman	28
33	2002	Landis Group	1	72	163	2003	Pink Roccade	72
34	2002	AFC Ajax	2	92	116	2002	Gucci	19
35	2002	AINO/Astra	1	72	146	2003	Blue Fox Enterprises	72
36	2002	CSS Holding	1	72	154	2003	Hitt	72
37	2002	Emis Euromarketing	1	74	147	2003	Ctac	72
38	2002	Laurus	1	52	129	2002	Schuitema	52
39	2002	Koninklijke Textielgroep	1	17	130	2002	Schuttersveld Holding	25
40	2002	KPN Qwest	1	64	117	2002	KPN	64
41	2002	TIE Holding	2	72	166	2003	Unit 4	72
42	2002	UPC	1	64	136	2002	TNT Post Groep	64
43	2002	Vedior	2	74	125	2002	Randstad Holding	74
44	2002	Versatel	1	64	145	2003	Batenburg Beheer	45
45	2003	Van Heek Tweka	1	18	109	2002	Blydenstein-Willink	17
46	2003	ASML	2	31	79	2001	ASMI	31
47	2003	BE Semic	2	31	124	2002	Philips	31
48	2003	Getronics	2	72	155	2003	Internatio Muller	45
49	2003	Magnus Holdings	2	72	164	2003	Seagull HoldingNV	72
50	2003	Neways	2	31	165	2003	Twentse Kabel Holding	28
51	2003	Prolion	2	29	161	2003	Nedcon Groep	28
52	2003	RTCompany	2	72	156	2003	Innoconcepts	74

Annex 3.3 Statistical comments on table 6.12

- The number of observations is 201 containing 52 distressed firms.
- R^2 is in linear regression the coefficient of determination i.e. the percentage of variance in Y explained by X. In logit analysis this concept cannot be applied. Nagelkerke R^2 originates from the desire to generalize the definition of R^2 to more general models, for which the concept of residual variance cannot be easily defined, and maximum likelihood is the criterion of fit (Nagelkerke, 1991). Thus the Nagelkerke R^2 is a measure for the goodness of fit of a model.
- All models perform statistically significantly better than a distribution of all observations to the control category (expressed by χ^2) at the 0.1% level.
- The Type I error figure in the table is expressed as the number of False Positives i.e. control companies classified as distressed, as a percentage of all control companies. This is the opposite number of what is commonly called the *specificity* (1–Type I error)

of a test, which is the likelihood of correct prediction of the control sample. The Type II error figure in the tables is expressed as the number of False Negatives i.e. distressed companies classified as control, as a percentage of all distressed companies. This is the opposite number of what is commonly called the *sensitivity* (1– Type II error) of a test, which is the likelihood of correct prediction of the distressed sample.

- The cut–off point applied in the tests determines whether a calculated test value falls in one category or the other. In economic terms: in the standard model a company is predicted as a financially distressed company by the model if the likelihood of financial distress is estimated to be 50% or higher (cut–off point 0.5). However, if one were to use such a model as a tool to determine credit ratings, a lower cut–off value may be more appropriate, so that a company that is predicted to have e.g. a 30% likelihood of becoming financially distressed is also not given a loan. By varying the cut–off point, the prediction results may thus change completely. Table 6.12 therefore presents the Type I and Type II error not only for the standard 0.5 cut–off point but also for a 0.1 cut–off point, thus implying a high quantity of potential risk firms in the 'predicted distress' group. The chance of missing a distressed company in the prediction will therefore decrease, and thus the Type II error will decline. This takes its toll in a deteriorating Type I error; logically some firms in the 0.1 to 0.5 range are healthy and are now erroneously classified as distressed (Type I error).
- The figure Annex 3.1 is known as an ROC plot (Receiver Operating Characteristic). The ROC stems from the signal theory and is applied in e.g. medical research (Altman and Bland, 1994B).

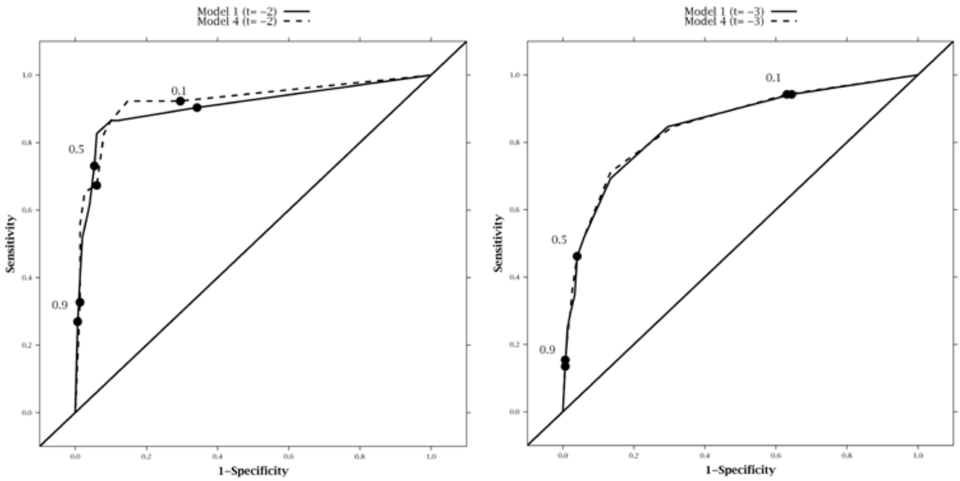

Figure Annex 3.1: ROC for model 1 and model 4 for t = –2 and t = –3

The figures show that by reducing the cut–off values the sensitivity initially grows faster (1–specificity) i.e. than the specificity declines, up to a certain cut–off point. The test results are optimal where the distance between the diagonal and the plotted line is largest: there, the distance between a stochastical result and the test result is maximal[1]. Model 4 appears superior, at least for t = –2, to model 1. Note that maximizing the specificity i.e. minimising (1–specificity) reduces the Type I error; and maximizing the sensitivity reduces the Type II error. Note further that the actual Type I and Type II errors depend on the prevalence of financial distress (Altman and Bland, 1994A) and are thus by no means figures one can compare between different samples unless their distribution is equal.

Annex 3.4 Results on the matched pairs sample (tables 6.12A and 6.14A)

Provide the logit analysis results for the same models as defined in table 6.12 and 6.14 respectively, but now performed on the matched pair sample. Industry classification is lacking since the sample is matched.

A comparison of table Annex 3.4.1 and table 6.12 shows:

- for t = –2:
  - model 1: the same variables are significant as in 6.12
  - model 2: idem
  - model 3: SBLNTA significance at the 10% level not observed; otherwise the same variables are significant
  - model 4: the same variables are significant as in 6.12.
- for t = –3:
  - the significance of CASHVV at the 10% level as reported in 6.12 for the models 2, 3 and 4 is not observed here.

Or: DEB, the number of leaving EDs in t = –2 proves the only significant governance variable of the models in the matched pairs analysis. The ‘complete’ analysis additionally shows in t = –2 a significance of the size of the SB (SBLNTA) at the 10% level.

A matched pairs analysis of *bankrupt–only* companies follows in table Annex 3.4.2. A comparison with the results of table 6.14 for the ‘complete’ control sample shows:

- for t = –2:
  - model 1: LNTA and CETA remain significant, NITA is no longer significant.
  - model 2: financial variables are equally significant. Of the governance variables, STRUCTURED appears significant at the 10% level and certification disappears.

1Or as Altman and Bland (1994B, p.188) put it: ‘a test that is completely useless would give a straight line from the bottom left corner to the top right corner.’ The diagonal represents the equality between sensitivity (TP/(TP+FN) and (1 – specificity) or (FP/(FP+TN). Or in words: the percentage of bankrupt firms rightly predicted by the model is equal to the percentage of falsely predicted bankrupt firms (from the control group). Note: TP = True Positive, FP = false positive, TN = True negative and FN = false negative.

- o model 3: the same variables are significant as in 6.14
- o model 4: the same variables are significant as in 6.14.
- for t= −3 :
  - o in the matched version STRUCTURED is the (only) significant variable, whilst in 6.14 LNTA (in 3 out of 4 models), CERTIFICATION and SBLNTA proved significant.

Table Annex 3.4.1: A logit analysis of the financial control, and agency theory related variables for the matched pairs of listed Dutch financially distressed and control companies from 1993 to 2003, based on panel data for t =−2 and t = −3 before the financial distress event occurred ('table 6.12A')

model 1: $DISTRESS \approx \alpha + \beta_1 LNTA + \beta_2 CETA + \beta_3 NITA + \beta_4 CASHVV + \beta_5 industry + \varepsilon$
model 2: $DISTRESS \approx \alpha + \beta_1 LNTA + \beta_2 CETA + \beta_3 NITA + \beta_4 CASHVV + \beta_5 industry + \beta_6 STRUCTURED + \beta_7 CERTIFICATION + \varepsilon$
model 3: $DISTRESS \approx \alpha + \beta_1 LNTA + \beta_2 CETA + \beta_3 NITA + \beta_4 CASHVV + \beta_5 industry + \beta_8 EBRATIO + \beta_9 SBLNTA + \beta_{10} DEPDM + \beta_{11} AUDDM + \varepsilon$
model 4: $DISTRESS \approx \alpha + \beta_1 LNTA + \beta_2 CETA + \beta_3 NITA + \beta_4 CASHVV + \beta_5 industry + \beta_{12} DEB + \varepsilon$

	exp. sign[1]	*t =-2*				*t =-3*			
		model 1	model 2	model 3	model 4	model 1	model 2	model 3	model 4
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
financial variables LNTA	–	−0.34*	−0.33*	−0.32[a]	−0.48**	−0.18	−0.17	−0.13	−0.19[a]
CETA	–	−1.72	−1.64	−2.13	−1.75	2.76	3.04	2.71	2.71
NITA	–	−16.83**	−17.39**	−18.94**	−14.67**	−2.56	−1.08	−3.61	−2.25
CASHVV	–	−0.80	−0.62	−0.06	−2.86	−5.05	−5.57	−5.01	−5.06
agency variables STRUCTURED	–		−0.76				−0.74		
CERTIFICATION	–		0.80				0.89		
SBLNTA	+			1.23				0.75	
EBRATIO	+			3.37				2.12	
DEPDM	–			−0.17				−0.17	
AUDDM	+			−0.50				0.03	
DEB	+				0.75*				0.15
constant		2.61*	2.75*	0.34	3.09**	0.82	0.87	−0.79	0.82
statistics number of observations		104	104	104	104	104	104	104	104
Nagelkerke R^2		0.51	0.53	0.53	0.65	0.27	0.32	0.29	0.43
LR statistics (χ^2)		49.70***	53.09***	91.63***	116.37***	23.47***	28.04***	25.03***	69.16***
Type I error (cut-off 0.5)		0.15	0.17	0.13	0.17	0.23	0.23	0.21	0.25
Type II error (cut-off 0.5)		0.21	0.21	0.21	0.17	0.35	0.27	0.31	0.35

***, ** and * indicate statistical significance at a 0.1%, 1% and 5% level, respectively.
[a] indicates statistical significance at a 10% level.
[1] expected sign based on the analyses of distribution in chapter 6 (tables 6.3 – 6.10).
Distress = ln (p / (1−p)). Other variables defined in table 6.11.

Table Annex 3.4.2: A logit analysis of the financial control, and agency theory related variables for the matched pairs of control and bankrupt listed Dutch companies from 1993 to 2003, based on panel data for t = –2 and t = –3 before bankruptcy occurred ('table 6.14A')
model 1: $DISTRESS \approx \alpha + \beta_1 LNTA + \beta_2 CETA + \beta_3 NITA + \beta_4 CASHVV + \beta_5 industry + \varepsilon$
model 2: $DISTRESS \approx \alpha + \beta_1 LNTA + \beta_2 CETA + \beta_3 NITA + \beta_4 CASHVV + \beta_5 industry + \beta_6 STRUCTURED + \beta_7 CERTIFICATION + \varepsilon$
model 3: $DISTRESS \approx \alpha + \beta_1 LNTA + \beta_2 CETA + \beta_3 NITA + \beta_4 CASHVV + \beta_5 industry + \beta_8 EBRATIO + \beta_9 SBLNTA + \beta_{10} DEPDM + \beta_{11} AUDDM + \varepsilon$
model 4: $DISTRESS \approx \alpha + \beta_1 LNTA + \beta_2 CETA + \beta_3 NITA + \beta_4 CASHVV + \beta_5 industry + \beta_{12} DEB + \varepsilon$

	exp. sign[1]	t =-2				t =-3			
		model 1	model 2	model 3	model 4	model 1	model 2	model 3	model 4
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
financial variables LNTA	–	–0.36*	–0.34[a]	–0.43*	–0.52*	–0.18	–0.15	–0.13	–0.18
CETA	–	–3.65[a]	–3.87[a]	–5.87*	–4.11[a]	–0.57	–0.39	–1.01	–0.53
NITA	–	–6.11	–7.00	–7.22	–4.96	2.62	–3.41	–2.59	–2.90
CASHVV	–	–2.61	–2.07	–2.61	–4.30	–6.00	–5.82	–6.56	–6.08
agency variables STRUCTURED	–		–1.32[a]				–1.13[a]		
CERTIFICATION	–		1.02				1.24		
SBLNTA	+			3.37*				1.50	
EBRATIO	+			5.10				1.40	
DEPDM	–			0.03				–0.25	
AUDDM	+			–1.19				–0.23	
DEB	+				0.70[a]				0.08
constant		3.36*	3.72*	–0.52	4.03*	1.78[a]	1.87[a]	–0.04	1.73
statistics number of observations		64	64	64	64	64	64	64	64
Nagelkerke R^2		0.41	0.49	0.52	0.47	0.23	0.33	0.27	0.23
LR statistics (χ^2)		23.62***	28.99***	31.90***	27.89***	12.19*	17.92**	14.33[a]	12.24*
Type I error (cut-off 0.5)		0.28	0.22	0.22	0.05	0.25	0.28	0.31	0.22
Type II error (cut-off 0.5)		0.25	0.28	0.31	0.41	0.22	0.31	0.22	0.22

***, ** and * indicate statistical significance at a 0.1%, 1% and 5% level, respectively.
[a] indicates statistical significance at a 10% level.
[1] expected sign based on the analyses of distribution for the full distressed sample in chapter 6 (tables 6.3 – 6.10).
Variables defined in table 6.11.

Or: STRUCTURED, which implies that having an SB with mandatory competences appears to be a significant governance variable at the 10% level on both panels instead of CERTIFICATION. The size of the SB (SBLNTA) is only significant in the t = –2 panel.

Whilst the smaller samples as a result of matching result in lower LR-statistics and R^2 values, it cannot be said that the results differ largely with the results for the 'complete' control sample. For the regressions with agency variables SBLNTA, DEB, STRUCTURED and CERTIFICATION appear to be the relevant variables.

BIBLIOGRAPHY TO ANNEX 3

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ANNEX 4 STATISTICAL COMMENTS ON THE FINDINGS OF CHAPTER 7

This annex presents the following statistical comments on the findings of chapter 7:
Annex 4.1 Statistical comments on table 7.14
Annex 4.2 Statistical comments on table 7.16
Annex 4.3 Results on the matched pairs sample (tables 7.14A and 7.16A).

Annex 4.1 Statistical comments on table 7.14

- The number of observations is 201 containing 52 distressed firms.
- The Nagelkerke R^2, a measure for the goodness of fit of a model, proves negligible.
- All models perform statistically significantly better than a distribution of all observations to the control category (expressed by χ^2) at the 0.1% level.
- The Type II error figure in the table expresses the number of False Negatives i.e. distressed companies classified as a control company, as a percentage of all distressed companies. If this is the mistake bankers want to avoid, then the last line of table 7.14 presents good news. The low cut–off of 0.1 brings the type II error down to 10% and is subsequently lowered in model 3 (t = –2) to 6% and in model 2 (t = –3) to 4%. This implies that 96% of the distressed companies in the latter case are correctly predicted.

Figure Annex 4.1 shows that the ROC for model 5 gives slightly better results than for model 1.

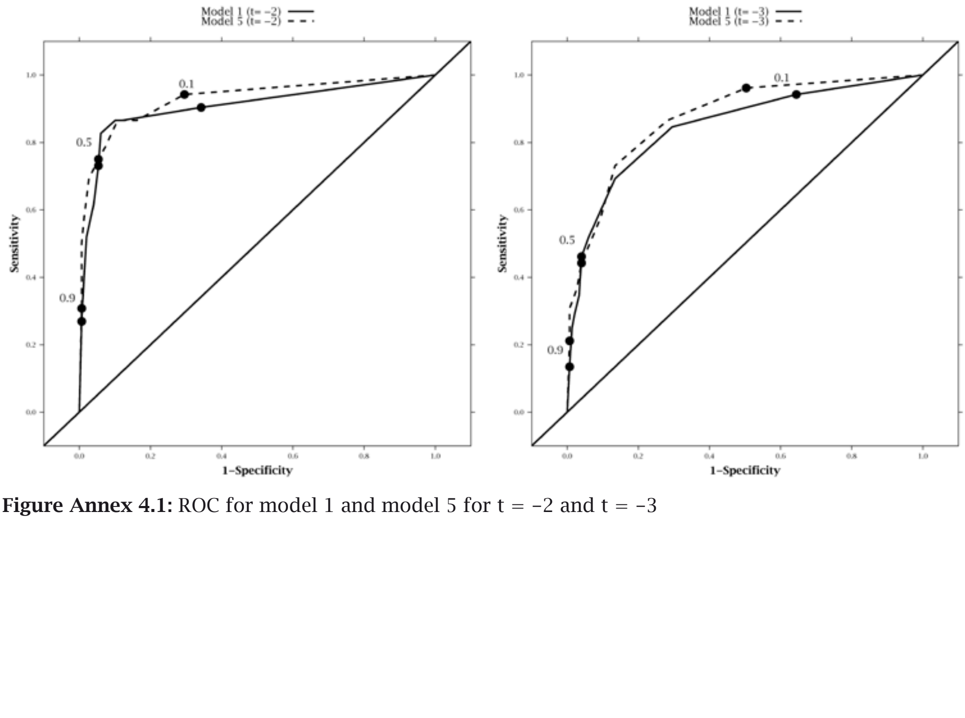

Figure Annex 4.1: ROC for model 1 and model 5 for t = –2 and t = –3

Table Annex 4.2.1: A logit analysis of the financial control, resource dependence and diversity related variables for the matched pairs of control and financially distressed listed Dutch companies from 1993 to 2003, based on panel data for t =–2 and t = –3 before the financial distress event occurred ('table 7.14A').
model 1: $DISTRESS \approx \alpha + \beta_1 LNTA + \beta_2 CETA + \beta_3 NITA + \beta_4 CASHVV + \beta_5 industry + \varepsilon$
model 5: $DISTRESS \approx \alpha + \beta_1 LNTA + \beta_2 CETA + \beta_3 NITA + \beta_4 CASHVV + \beta_5 industry + \beta_6 AGEAV + \beta_7 GENAV + \beta_8 NATAV + {}_9 GRADEAV + \beta_{10} DEPAV + \beta_{11} NETAV + \beta_{12} WL1AV + \varepsilon$
model 6: $DISTRESS \approx \alpha + \beta_1 LNTA + \beta_2 CETA + \beta_3 NITA + \beta_4 CASHVV + \beta_5 industry + \beta_{13} AGEDIV + \beta_{14} GENDIV + \beta_{15} NATDIV + \beta_{16} GRADEDIV + \beta_{17} DEPDIV + \beta_{18} NETDIV + \beta_{19} WL1DIV + \varepsilon$

	exp. sign[1]	*t =-2*			*t =-3*		
		model 1	model 5	model 6	model 1	model 5	model 6
(1)	(2)	(3)	(4) - AV	(5) - DIV	(6)	(7) - AV	(8) - DIV
financial variables							
LNTA	–	–0.34*	–0.43*	–0.54**	–0.18	–0.24	–0.36*
CETA	–	–1.72	–2.69	–1.81	2.76	3.37	2.72
NITA	–	–16.83**	–16.97**	–15.35*	–2.56	–3.52	–4.20
CASHVV	–	–0.80	–1.39	–1.64	–5.05	–5.90[a]	–3.96
resource variables							
AGE	–/+		0.05	–0.05		–0.05	–0.03
NATIONALITY	+/+		1.70	3.26[a]		2.39	4.05**
GENDER			0.65	0.86		4.52	4.03
EDUCATION	–/–		0.13	–0.31		–0.85	–0.67
NON-INDEPENDENT	–/–		–0.81	–0.94		–1.97	–1.31
NETWORK	–/–		–0.07	0.15		0.04	0.14
WORKLOAD	+/–		2.63[a]	–2.99		1.93	–1.08
constant		2.61*	–1.01	4.82**	0.82	2.65	1.78
statistics							
number of observations		104	104	104	104	104	104
Nagelkerke R^2		0.51	0.55	0.56	0.27	0.41	0.38
LR statistics (χ^2)		49.70***	54.87***	56.75***	23.47***	37.92***	34.86***
Type I error (cut-off 0.5)		0.15	0.15	0.15	0.23	0.25	0.21
Type II error (cut-off 0.5)		0.21	0.17	0.21	0.35	0.31	0.25

***, ** and * indicate statistical significance at a 0.1%, 1% and 5% level, respectively.
[a] indicates statistical significance at a 10% level.
[1] expected sign based on the difference in mean in the tables 7.2 – 7.9 in chapter 7.
DISTRESS = ln (p / (1–p))
AV = average value of the resource on the supervisory board (SB)
DIV = diversity of the resource on the board (Blau–indicator or standard deviation)
Variables defined below tables 7.2–7.9 and 7.11 in chapter 7.

Annex 4.2 Statistical comments on table 7.16

If it were important to avoid Type II errors, i.e. classifying bankrupt companies as 'healthy', then model 5 (the resources availability model) adds to the prediction since it lowers the Type II error (cut off value 0.1) from 16% to 6% in t = –2. In the t = –3 panel the Type II error is 3% for the basic model and just 6% for the models 5 and 6. Lowering the cut–off value to 0.1 seems the right thing to do.

Table Annex 4.2.2: A logit analysis of the financial control, resource dependence and diversity related variables for the matched pairs of control and bankrupt listed Dutch companies from 1993 to 2003, based on panel data for t =–2 and t = –3 before bankruptcy occurred ('table 7.16A').
model 1: $DISTRESS \approx \alpha + \beta_1 LNTA + \beta_2 CETA + \beta_3 NITA + \beta_4 CASHVV + \beta_5 industry + \varepsilon$
model 5: $DISTRESS \approx \alpha + \beta_1 LNTA + \beta_2 CETA + \beta_3 NITA + \beta_4 CASHVV + \beta_5 industry + \beta_6 AGEAV + \beta_7 GENAV + \beta_8 NATAV + \beta_9 GRADEAV + \beta_{10} DEPAV + \beta_{11} NETAV + \beta_{12} WL1AV + \varepsilon$
model 6: $DISTRESS \approx \alpha + \beta_1 LNTA + \beta_2 CETA + \beta_3 NITA + \beta_4 CASHVV + \beta_5 industry + \beta_{13} AGEDIV + \beta_{14} GENDIV + \beta_{15} NATDIV + \beta_{16} GRADEDIV + \beta_{17} DEPDIV + \beta_{18} NETDIV + \beta_{19} WL1DIV + \varepsilon$

	exp. sign[1]	t =-2 model 1	model 5	model 6	t =-3 model 1	model 5	model 6
(1)	(2)	(3)	(4) - AV	(5) - DIV	(6)	(7) - AV	(8) - DIV
financial variables							
LNTA	–	–0.36*	–0.56*	–0.98**	–0.18	–0.36	–0.48*
CETA	–	–3.65ª	–5.02ª	–6.93*	–0.57	–0.28	–1.20
NITA	–	–6.11	–5.85	–5.36	2.62	–0.81	–1.48
CASHVV	–	–2.61	–1.72	–2.73	–6.00	–4.25	–4.76
resource variables							
AGE	–/+		–0.07	–0.06		–0.16	0.08
NATIONALITY	+/+		5.16*	6.24*		5.75*	5.09*
GENDER			1.59	1.19		4.65	3.61
EDUCATION	–/–		1.59	1.01		–0.05	0.79
NON-INDEPENDENT	–/–		–2.05	–2.10		–3.71*	–2.13
NETWORK	–/–		0.12	0.31		0.26	0.14
WORKLOAD	+/–		1.44	–4.86ª		1.11	–1.46
constant		3.36*	5.37	7.97**	1.78ª	9.61	1.30
statistics							
number of observations		64	64	64	64	64	64
Nagelkerke R^2		0.41	0.53	0.55	0.23	0.48	0.40
LR statistics (χ^2)		23.62***	32.18***	34.01***	12.19*	28.50***	22.96*
Type I error (cut-off 0.5)		0.28	0.28	0.22	0.25	0.25	0.31
Type II error (cut-off 0.5)		0.25	0.28	0.22	0.22	0.28	0.31

***, ** and * indicate statistical significance at a 0.1%, 1% and 5% level, respectively.
ª indicates statistical significance at a 10% level.
[1] Expected sign based on the analysis of difference in mean in the tables 7.2 – 7.9 in chapter 7.
Distress = ln (p / (1 – p)).
Variables defined below tables 7.2 – 7.9, 7.11 in chapter 7.

Annex 4.3 Results on the matched pairs sample (tables 7.14A and 7.16A)

Provide the logit analysis results for the same models as defined in table 7.14 and 7.16 respectively, but now performed on the matched pair sample. Industry classification is lacking since the sample is matched.

A comparison of table Annex 4.2.1 and table 7.14 shows:

- for t = −2:
  - o model 1: the same variables are significant as in 7.14
  - o model 5: idem
  - o model 6: idem.
- for t = −3:
  - o model 1: as in 7.14, no variables significant
  - o model 5: CASHVV significant at the 10% level instead of CETA; no resource variable significant whilst NON–INDEPENDENT was in 7.14;
  - o model 6: no CASHVV significance, otherwise the same variables are significant as in 7.14.

Or: DIVNAT, the diversity in nationality of the SB, proves significant in both panels, just as in 7.14. WORKLOAD is significant in t = −2 in model 5. NON–INDEPENDENCE disap–pears as a significant variable.

A matched pairs analysis of *bankrupt–only* companies follows in table Annex 4.2.2. A comparison with the results of table 7.16 for the 'complete' control sample shows:

- for t = −2:
  - o model 1: no NITA significance at the 10% level as in 7.16; otherwise the same
  - o model 5: idem
  - o model 6: idem.
- for t = −3:
  - o model 1: no LNTA significance as in 7.16; no significant variables
  - o model 5: no LNTA significance as in 7.16; NON–INDEPENDENT shows significance in t =−3 at the 5% level; otherwise the same
  - o model 6: the same variables are significant as in 7.16.

Or, the nationality variables AVNAT and DIVNAT remain significant in all models, as in 7.16. Financial variables are somewhat less significant. NON–INDEPENDENCE (model 5) and WORKLOAD (model 6) appear significant in one out of four specifications.

Thus, the matched pairs approach essentially confirms the 'complete' control sample results.

SAMENVATTING (SUMMARY IN DUTCH)

Dit proefschrift gaat over de rol van ‘monitoring’ bij financiële nood van organisaties in de private sector. Dat zijn vaak bedrijven, maar ook verenigingen en stichtingen zijn in het onderzoek betrokken. De termen organisaties, bedrijven en ondernemingen worden hier door elkaar gebruikt. ‘Monitoring’ is het houden van toezicht in brede zin. Dat toezicht kan ook het geven van advies, een waarschuwing of de goedkeuring van een besluit met zich brengen. Vandaar dat wordt vastgehouden aan het gebruik van ‘monitoring’. Het eerste en theoretische deel zoekt een antwoord op de volgende vragen:

- Wat verstaan we onder financiële nood?
- Welke mogelijkheden heeft een organisatie in financiële nood?
- Wat is de economische betekenis van ‘monitoring’?
- Welke monitoring mechanismen heeft de wetgever verplicht gesteld?
- Zijn er speciale eisen aan toezicht bij financiële nood?

Hoofdstuk 1 beschrijft de onderzoeksvraag. Het begint met de analyse van de schade die de maatschappij lijdt van faillissementen. Die is aanzienlijk. Op *micro* niveau raakt het ondernemers, managers en werknemers en hun gezinnen hard. Aandeelhouders maken verlies op hun belegging, crediteuren moeten afschrijven en raken hun klanten kwijt. De klant kan zijn produkt niet meer kopen. Een faillissement kan het welzijn van een hele streek beïnvloeden (Argenti, 1976:2). Op *macro* niveau blijkt op basis van gegevens van het CBS dat crediteuren die geen zekerheden hebben in Nederland gemiddeld genomen slechts 7,5% van de hoofdsom kunnen incasseren. De jaarlijkse schade veroorzaakt door vanwege faillissementen van organisaties niet betaalde schulden is gemiddeld vanaf 1992 0,39% van het Bruto Binnenlands Product. De kosten van werkloosheid van werknemers na de opzeggingstermijn en ontslagen en onderbezettingsverliezen bij leveranciers zijn daar niet bij gerekend. Aan de andere kant is efficiencywinst ook niet uitgesloten, doordat mensen na een faillissement in een andere organisatie meer toegevoegde waarde kunnen hebben.

Altman (1968), Argenti (1976), van Amsterdam (2004), Adriaanse (2005), Bollen, Mertens, Meuwissen, Raak en Schelleman (2005), Ooghe and De Prijcker (2008) concluderen dat managementfouten de belangrijkste oorzaak zijn van faillissementen. Uit gegevens van het CBS blijkt dat mismanagement in 32% van de gevallen de oorzaak van faillissement is, problemen binnen de directie in 4% en fraude in 3% van de gevallen. De overige 61% van de faillissementen wordt veroorzaakt door externe factoren. Sommigen denken dat dat percentage veel lager is: een goede ondernemer kan zijn onderneming ook door zwaar weer laveren. Hoe dit ook zij, dit proefschrift richt zich op één van de mogelijkheden om managementfouten en problemen in het bestuur te voorkomen, namelijk door het ‘monitoren’ van het bestuur van de organisatie. Onder het ‘bestuur’ vallen de senior-managers en de directieleden. Niet dat, in de woorden van Jungmann (2006: 473), toezichthouders beter zijn in het voorspellen van de toekomst of wijzer zijn dan het bestuur. Maar het is goed denkbaar dat meer controle de kans vermindert op fouten die op het niveau van het bestuur niet gesignaleerd worden.

Daarom is de onderzoeksvraag

Wat is de rol van 'monitoring' in geval van financiële nood van een organisatie vanuit economisch en juridisch perspectief?

Hoofdstuk 2 bespreekt de definitie en de mogelijke oplossingen van financiële nood. Op basis van de definitie van Gordon (1971) is een organisatie in financiële nood als er een niet–onbeduidende kans is dat de organisatie niet in staat zal zijn om binnen de normale betalingstermijn aan haar betalingsverplichtingen te voldoen. Voor empirisch onderzoek moet deze definitie worden aangepast. Vaak wordt – en zo ook in dit proefschrift – het onderzoek beperkt tot faillissement. Dit hoofdstuk presenteert een op van Ooghe and Waeyaert (2004) and Ooghe and De Prijcker (2008) gebaseerd model over de strategische benadering van een organisatie in financiële nood. Dit model maakt duidelijk dat herstructureringsactiviteiten op de oorzaak van de financiële nood moeten worden gericht en niet op een symptoom. Als de strategie voor de herstructurering vaststaat moet worden gekozen voor de vorm van reorganisatie. Dat kan zijn (1) een formele en vrijwillige liquidatie of reorganisatie; (2) een formele en onvrijwillige reorganisatie; en (3) een informele reorganisatie via een 'work–out'. Een formele reorganisatie is gebaseerd op de wet en kan in de Nederlandse situatie een liquidatie of ontbinding zijn of een faillissement. In de informele reorganisatie wordt de financiële nood opgelost door contracten opnieuw te onderhandelen om zodoende te komen tot verplichtingen die binnen de mogelijkheden wel kunnen worden nagekomen. De 'work–out' is in de Verenigd Koninkrijk een veel toegepaste, en ook enigszins geregelde techniek. Ook in Nederland vinden veel informele reorganisaties plaats. Anders dan in het Verenigd Koninkrijk is er echter geen regelgevend kader voor. Een vergelijking van de economische en juridische voor– en nadelen van de formele en de informele reorganisatie in sectie 2.6 laat zien waarom de 'work–out' oplossing zo vaak wordt toegepast. Mits de markt de reorganisatie ondersteunt en de 'work–out' dus een Pareto–optimale oplossing is, blijkt de 'work–out' de meest efficiënte oplossing.

'Monitoring' is het onderwerp van *hoofdstuk 3*. De vorige hoofdstukken hebben laten zien dat het een poging waard is om de kwaliteit van managementbeslissingen te verbeteren, aangezien 39% van de faillissementen wordt veroorzaakt door mismanagement en fraude. Zou de aanwezigheid van 'monitors' bijdragen aan de kwaliteit van de managementbeslissingen en zou zo het aantal faillissementen kunnen dalen? Het hoofdstuk analyseert de rol van 'monitoring' tegen de achtergrond van het maatschappelijk krachtenveld waarbinnen de organisatie functioneert.

Het begint met het basale inzicht van de *agency* (agentschaps–) theorie namelijk dat de principaal (in eerste instantie: de aandeelhouder) en de agent (de bestuurder) per definitie een verschillende nutsfunctie hebben (Jensen and Meckling, 1976). Principalen kunnen aandeelhouders zijn, maar ook banken, handelscrediteuren of werknemers. Ieder van deze partijen geeft de bestuurder, de agent, soms het recht en in ieder geval het vertrouwen om te handelen en daarbij op zijn minst ook zijn belang in het oog te houden. Een perfecte stroomlijning van belangen tussen agent en principaal wordt gehinderd door beperkte rationaliteit en informatie asymmetrie. Beperkte rationaliteit *(bounded rationality)* wil zeggen dat een agent slechts enkele uit de veelheid van alternatieve oplossingen kan overzien en uitwerken. Informatie–asymmetrie (*information asymmetry*) wil zeggen dat de agent niet alle belangrijke informatie deelt met de principaal (Knight, 1921; Akerlof, 1970). Dat kan voortkomen uit gemakzucht of nonchalance, maar ook uit door eigenbelang gestuurd opportunisme of bewust bedrog (Williamson, 1981). Een goede controle van de agent door de principaal is daarom essentieel. Controle is volgens Jensen (1993) een alarmsysteem. De controle structuur omhult het bestuur van de organisatie. Het controleproces bestaat uit 'monitoring' door alle binnen en buiten de organisatie betrokken partijen (*stakeholders*). *Interne controle mechanismen* zijn de raad van bestuur (directie) en het senior management; de raad van commissarissen of de niet–uitvoerend bestuurder in het een–laagse (*one–tier*) bestuurssysteem; de aandeelhouders en de vergadering van aandeelhouders; de secretaris van de onderneming, een ondernemingsraad (OR) of zelfs de werknemers, afhankelijk van het rechtssysteem. *Externe controle mechanismen* zijn de in– en outputmarkten (arbeid, kapitaal, leveranciers, afnemers), maar ook verschillende externe autoriteiten. Dit begint met de formatie–autoriteit, die met de oprichting van de organisatie is belast. Andere externe mechanismen zijn de externe accountant en de belasting–, publicatie–, financiële markten– en juridische autoriteit. Tenslotte zijn er vakbonden, belangengroepen, media, overheidsorganisaties en klokkenluiders. Deze controlemechanismen vormen tezamen een soort 'organisatiedemocratie'.

In feite is een goede monitoringstructuur primair in het belang van het management zelf. Door te luisteren naar verschillende signalen, argumenten en meningen en de specifieke belangen van iedere monitor goed voor ogen te houden zal de kans op fouten worden verkleind (Jungmann, 2006) en zal het management tot betere beslissingen komen.

Een *agency*–relatie brengt kosten met zich mee: (1) er moet 'monitoring' van de agent plaatsvinden, (2) agenten moeten zich binden aan allerlei afspraken met de organisatie, en (3) agenten nemen vaak, vanuit de principaal gezien, sub–optimale beslissingen. Investeringen in 'monitoring' zijn efficiënt zolang het totaal van de met de *agency* relatie samenhangende kosten erdoor vermindert, hetgeen meestal betekent dat de kans op sub–optimale beslissingen erdoor moet worden verkleind. Het is dus niet alleen in het belang van de organisatie maar ook in dat van managers zelf om een effectieve en efficiënte interne en externe controlestructuur te organiseren, aangepast aan de behoefte van de onderneming en uitgevoerd door effectieve monitors.

Als deze conclusie kan worden getrokken uit de economische theorie, is de vraag wat het recht heeft gedaan met het concept 'monitoring'. *Hoofdstuk 4* beschrijft met behulp van twee door Kraakman (2009) en Davies (2010) enerzijds en Timmerman (2009) anderzijds ontwikkelde analysemethoden de monitoringsystemen in Nederland, Duitsland en het Verenigd Koninkrijk voor de NV, BV, coöperatie, vereniging en stichting en daarop lijkende rechtspersonen. Na een uitgebreide analyse van de dwingende rechten van monitors in de verschillende rechtspersonen is de conclusie dat (1) de wet afkerig is van het toepassen van verplichte monitoringmechanismen en (2) elk rechtssysteem zijn eigen evenwicht vindt aangepast aan de specifieke omstandigheden van de rechtspersoon. Terwijl Duitsland gelooft in de 'meebeslissingsstructuur' en een raad van commissarissen verplicht stelt voor op winst gerichte ondernemingen met meer dan 500 werknemers evenals een sterke regulering voor de *Aktiengesellschaft (AG)* en de *eingetragene Genossenschaft (eG)*, is het Nederlandse systeem wat flexibeler en vrijer. Het meest flexibel is de 1300 bepalingen tellende UK Companies Act 2006 die voor de interne organisatie van profit- en non-profit ondernemingen zwaar rust op de statuten die elke onderneming moet opstellen. De Engelse wet noemt noch commissarissen (in de Engelse context van het één-laags bestuurssysteem heten die daar: niet uitvoerende directeuren) noch een vorm van geformaliseerde invloed van werknemers zoals de OR. De keerzijde is dat het Verenigd Koninkrijk strenge en in detail uitgewerkte plichten kent voor bestuurders en machtiger overheidsorganen voor externe controle zoals bijvoorbeeld de FRC, de FFRP, de FSA, de Bank of England, de Panel on Takeovers and Mergers, de Charities Commission, de CIC Regulator and BIS. Overheidsorganen zijn minder dominant aanwezig in Duitsland (uitgezonderd de *Bundesländer* voor *Stiftungen*) of in Nederland, terwijl de plichten van bestuurders daar weer minder ontwikkeld zijn dan in het Verenigd Koninkrijk.

Hoewel hoofdstuk 3 afsluit met het belang van interne en externe monitoring, laat hoofdstuk 4 zien dat in het recht niet de 'monitoring' centraal staat maar de inperking van de vrijheid van bestuurders door het opleggen van plichten. Zou dit anders worden in het geval van financiële nood van de organisatie? Op die vraag zoekt hoofdstuk 5 via een economische en juridische benadering een antwoord. Economen laten zien dat aandeelhouders en bestuurders bij financiële nood een overdreven riskant gedrag ('gok-gedrag') kunnen vertonen. Crediteuren zullen hun eigen positie daarom voortdurend moeten monitoren. Het recht ondersteunt de positie van de crediteuren door bestuurders persoonlijk aansprakelijk te stellen als zij zich onrechtmatig jegens crediteuren gedragen. Ook zijn strafrechtelijke sancties mogelijk en in bepaalde gevallen kan een bestuurder een 'bestuursverbod' krijgen. Echter, bestuurders realiseren zich vaak pas de consequenties van deze maatregelen als het te laat is en een faillissement onafwendbaar. Vanuit de theorie in de hoofdstukken 1 tot en met 4 wordt in hoofdstuk 5 op basis van het werk van Argenti (1976, 1986 A; 1986 B) een oplossing ontwikkeld voor het voorkomen of eerder ontdekken van de kans op financiële nood. De primaire fouten die tot een faillissement kunnen leiden moeten worden vermeden: *managementfouten* (de almachtige CEO), *sy-*

steemfouten (geen goed overzicht over de organisatie) of *veranderfouten* (niet reageren op veranderingen in de omgeving van de organisatie). Deze stelling wordt vervolgens toegepast op het model uit hoofdstuk 1 en 2 dat op basis van Ooghe en Waeyaert (2004) en Ooghe en De Prijcker (2008) is ontwikkeld. Dit model onderscheidt vier categorieën (boxen) van oorzaken van faillissement: (1) de algemene maatschappelijke omgeving, (2) de directe bedrijfsomgeving, (3) het beleid van de onderneming en (4) de ondernemer. De oplossing die hoofdstuk 5 presenteert heeft ten doel om de 'monitoring' rond de laatste twee boxen, namelijk het beleid van de onderneming en de ondernemer, te verbeteren door de bestuurder te verplichten een op maat gemaakte monitoringstructuur in te voeren en te laten werken. Deze verplichting lijkt een solide basis te vormen van de aansprakelijkheids- en monitoring piramide (figuur 9.1), die in hoofdstuk 5 ontwikkeld is en die de verschillende stadia van cumulerende aansprakelijkheid van bestuurders laat zien op de weg van een gezonde onderneming naar een failliete onderneming.

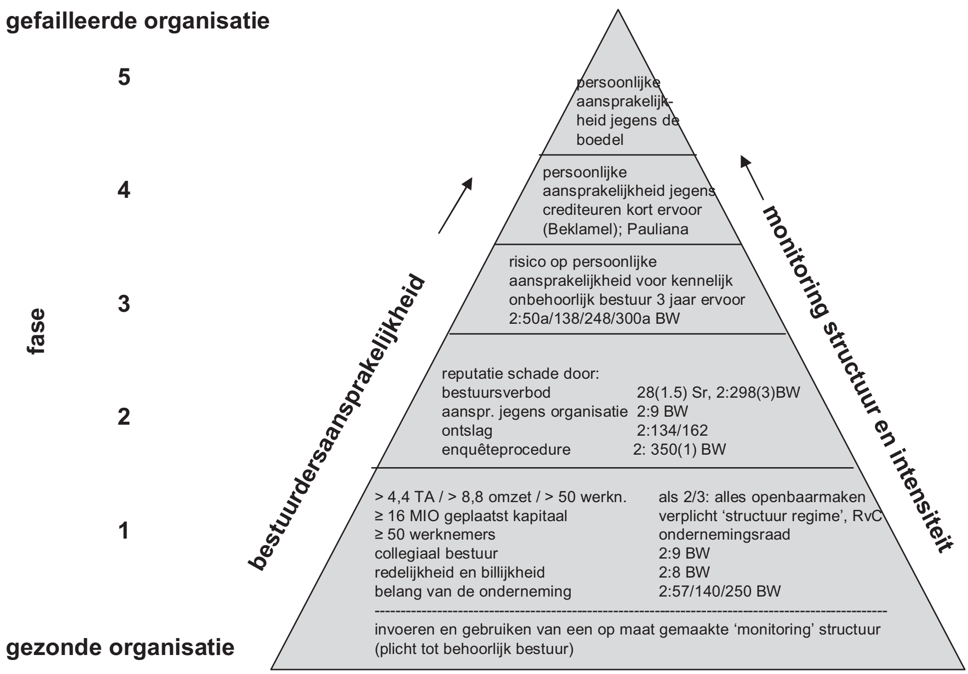

Figure 9.1: Een op monitoring gefundeerde aansprakelijkheids piramide van bestuurders in Nederland

De uit de economische theorie voortkomende en in deze piramide opgenomen gedachte leidt tot de formulering van een nieuwe aan 'behoorlijk bestuur' te stellen eis namelijk dat *in elk geval en in elke organisatie de bestuurder verplicht is om een monitoringstructuur in* *te voeren en te laten werken die is aangepast aan de behoeften van de onderneming.* Deze verplichting past in de Nederlandse *corporate governance* code en is, zo valt onder meer op grond van een brede interpretatie van Hoge Raad–*dicta* te verdedigen, via artikel 2:9 BW van toepassing op alle rechtspersonen.

Het tweede gedeelte van het proefschrift is van empirische aard. De hoofdstukken 6 tot en met 8 onderzoeken of bepaalde elementen van de monitoringstructuur zoals het aantal bestuurders of hun opleiding, verschillen tussen beursgenoteerde ondernemingen in financiële nood en een controlegroep; en of deze variabelen iets kunnen toevoegen aan de verklaring van deze financiële nood. De geformuleerde hypothesen zijn gebaseerd op de *agency* theorie van Jensen en Meckling (1976) en de *resource dependence* (kwaliteitafhankelijkheids–) theorie van Pfeffer en Salancik (1978).

Het empirisch onderzoek in *hoofdstuk 6* bij Nederlandse beursgenoteerde ondernemingen is opgezet vanuit de *agency* theorie en analyseert verschillen tussen en invloed van de *monitoring rechten* (verdeling tussen aandeelhouders en commissarissen), de *monitoring structuur* (grootte en onafhankelijkheid Raad van Commissarissen) en de *monitoring output* (vertrek van bestuurders en commissarissen). Uit het onderzoek blijkt dat de exemplarische 'gezonde' onderneming uit de controlegroep een structuur–NV is met 5 commissarissen, relatief weinig vertrekkende bestuurders en commissarissen en 19% niet–onafhankelijke commissarissen. De in financiële nood verkerende onderneming verschilt statistisch significant op deze variabelen. Twee jaar voor faillissement is dit een gewone NV met vier commissarissen, relatief veel vertrekkende bestuurders en commissarissen en 14% niet–onafhankelijke commissarissen. De gemiddelde onderneming in de controle groep is groter dan de onderneming in financiële nood. De resultaten van de *univariate regressie* – die het rechtstreekse verband tussen financiële nood en een verklarende variabele onderzoekt – tonen aan dat (a) er een *negatief* dat wil zeggen: tegengesteld, en statistisch significant verband bestaat tussen financiële nood en het zijn van een structuur NV; het hebben van een relatief groot aantal commissarissen; of van één of meer niet–onafhankelijke commissarissen twee jaar voor faillissement; en de grootte van de onderneming, inkomen en cash flow. En verder (b) een *positief*, dat wil zeggen samenhangend, en statistisch significant verband tussen financiële nood en een relatief (per eenheid actief) hoog aantal bestuurders en commissarissen; en een relatief groot aantal vertrekkende bestuurders en commissarissen.

In de *multivariate* analyse blijkt van de *monitoring rechten* alleen certificering een positief verklarende, statistisch significante variabele voor financiële nood (althans voor de groep failliete bedrijven). Het *monitoring structuur* model toont een positief, statistisch significant verband tussen financiële nood en een relatief (per eenheid actief) hoog aantal commissarissen. Het *monitoring output* model toont een positief en statistisch significant verband tussen financiële nood en een relatief groot aantal vertrekkende bestuursleden. *Agency*–gerelateerde variabelen zoals de verdeling van zeggenschapsrechten, de grootte van de raad van commissarissen en bestuurs– en commissaris wisselingen blijken in de nabijheid van financiële nood inderdaad van belang te zijn.

Terwijl hoofdstuk 6 zich richt op de monitoring rechten, –structuur en –output, concentreert *hoofdstuk 7* zich op de persoonlijke en kwalitatieve kenmerken van commissarissen en op de diversiteit van die kenmerken in de raad van commissarissen. Gebaseerd op de *resource dependence* theorie onderzoekt het hoofdstuk of voor commissarissen bij Nederlandse beursgenoteerde ondernemingen in financiële nood kenmerken als leeftijd, nationaliteit, geslacht, opleiding, onafhankelijkheid, netwerk en werklast verschillen met die in andere ondernemingen; en of deze verschillen ook aan de verklaring van de financiële nood zouden kunnen bijdragen. Het profiel van commissarissen in de controlegroep is: gemiddeld 60 jaar, 84% is Nederlander, 97% man, 71% heeft een universitaire opleiding, 82% is onafhankelijk van de onderneming, met een gemiddeld aantal van 4,39 commissaris–posities en een werklast van 0,68 fte. Twee jaar voor faillissement zijn commissarissen in de groep met financiële nood statistisch significant jonger, vaker buitenlander, minder hoog opgeleid, enigszins minder onafhankelijk, ze hebben een kleiner netwerk in termen van commissarisposities en een grotere werklast. De *univariate* regressieanalyse toont een negatief verband tussen financiële nood en (1) een oudere commissaris, (2) een hoger opgeleide commissaris, of (3) een commissaris met een groter netwerk. Er is een positief verband tussen financiële nood en (4) een niet–Nederlandse nationaliteit en (5) een relatief hoge werklast. Voor de aanwezigheid en diversiteit van deze kenmerken in de raad van commissarissen zijn de resultaten soortgelijk.

De *multivariate* logit regressie analyse voor zowel het kwaliteitbeschikbaarheidsmodel (*resource availability model*) als het kwaliteitdiversiteitsmodel (*resource diversity model*) laat zien dat niet–Nederlandse commissarissen positief en statistisch significant met financiële nood samenhangen.

De beschikbaarheid en diversiteit van kwaliteitskenmerken in de raad van commissarissen zoals leeftijd, nationaliteit, universitaire opleiding, netwerk en werklast blijken inderdaad gerelateerd aan het voorkomen van financiële nood.

Beursgenoteerde ondernemingen zijn favoriete onderzoeksobjecten voor economen, waarschijnlijk omdat er zo veel informatie openbaar beschikbaar is. *Hoofdstuk 8* richt zich op niet beursgenoteerde Nederlandse ondernemingen: de BV, de coöperatie, de vereniging en de stichting. Met de *agency* theorie en de *resource dependence* theorie als basis onderzoekt dit hoofdstuk het verband tussen financiële nood en de *governance* structuur van deze rechtspersonen. De onderzochte data, gehaald uit het handelsregister, zijn: het aantal directeuren, commissarissen en managers; bestuurs– en commissariswisselingen; het al dan niet deponeren bij het Handelsregister; de ouderdom van de onderneming; de leeftijd van de directie en hoe lang ze bij de organisatie werken; geslacht, nationaliteit en onafhankelijkheid. De verschillende rechtspersonen tonen statistisch significante verschillen in verdeling van de variabelen tussen de controle groep en de in financiële nood verkerende groep, hoewel het niet altijd dezelfde variabelen betreft. Voor alle of voor sommige betrokken rechtspersonen tonen de resultaten van de *univariate* regressie een negatief verband tussen financiële nood en (a) een relatief groot aantal directieleden, (b) een relatief oudere rechtspersoon, (c) een relatief oudere directie, (d) een directeur die langer in functie is, en (e) het tijdig deponeren van de jaarrekening in het Handelsregister. Er is een positief en significant verband tussen financiële nood en (f) een groot aantal vertrekkende bestuursleden, en (g) het onderdeel zijn van een groep van ondernemingen. Of dit laatste het gevolg is van de complexiteit van een groep ondernemingen of van een organisatiestructuur waarin een rechtspersoon als kostenplaats fungeert, kon niet worden onderzocht.

Ook in andere organisaties dan beursgenoteerde NVs verschillen *governance* gerelateerde variabelen inderdaad statistisch significant tussen een controle groep en een groep met ondernemingen in financiële nood. Een behoorlijk aantal van deze variabelen is statistisch significant gerelateerd aan financiële nood.

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Bernard P.A. Santen (1954, Heemstede, the Netherlands) studied (civil)law and (macro) economics at Groningen University and graduated cum–laude. He worked for Dow Chemical Netherlands B.V. as an accountant and for the United Nations Development Programme (UNDP) as a liaison–officer in Islamabad (Pakistan). From 1985 to 2006 he has been a lawyer, specialized in labour law and bankruptcy law. He also acted as a non–executive director in a *BV* and a *Woningstichting*, and as a director of a private *stichting*. From 2004 onwards he serves as an assistant professor in the department of Accounting of the Erasmus School of Law part–time. He teaches Financial law and accounting to bachelor and master students and financial economics to administrators. Bernard presented research on the EAA congresses of Prague (2003) and Lisbon (2007) and has published in international and Dutch journals and books on 'monitoring' and related subjects.