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Independent Directors as corporate governance instruments

*A critical and comparative analysis of their role and
implications in the US system*

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I. Introduction

In the past fifty years, problems relating to corporate governance efficiency, leading to the numerous and wide-spread corporate fraud scandals in the early 2000's, had regulators doubting about the effective role of corporate governance rules. The problem, according to the regulators, was to be insinuated into the lack of an adequate monitoring system into the management boards of companies, thus allowing managers to act opportunistically, enhancing the first agency problem, which affects the relationship between the company's shareholders and the company's managers.

Considering that the issue is that managers tend to pursue their own gain instead of the company's best interest in many opportunities, a solution had to be sought in order to force managers to place the company's and shareholders' interest ahead of their own. This solution has been found in the introduction of Independent Directors, who are expected, because of their independence, to prevent management misconduct and ensure minority shareholders' interest as well as the general interest of the corporation.

This paper attempts to analyse the role and the impact of Independent Directors in the various areas of corporate governance.

In the first chapter, a general and introductory elaboration has been developed as to what exactly contributes to the formation of the three corporate agency problems and to how, among the different jurisdictions, such problems have been dealt with. Consequently, the abovementioned second agency problem has been closely analysed both in regards of its roots in the corporation and in regards of the history of the rise of the Independent Directors as well, starting from the jurisdiction considered to be the birthplace of this concept: the United States.

The prerogative of Independent Directors is, of course, their independence. In fact, the entire concept of Independent Directors as gatekeepers of the company's interest, is based upon the consideration that they must not have any type of relationship with management and are thus truly independent. The second chapter addresses and compares the concept of independence as defined by the various regulatory instruments among jurisdictions. Furthermore, the first problems relating to the figure of Independent Directors will be analysed in regards of the contrasting definitions among countries and their lack of appropriate powers to perform their role, in particular regarding the issue of the information deficit.

The third chapter focuses on the role and the implications of Independent Directors into specific corporate operations. In some of these transactions carried out by companies, Independent Directors have a defined function, sometimes thoroughly provided for by the law. However, this chapter deals as well with aspects of corporate operations in which the role of Independent Directors is not fully designed yet, thus proposing solutions and points of view.

One of the most interesting and debated aspects of the role of Independent and Outside Directors is their liability regime. This is because they do not perform the same functions carried out by executive directors and thus do not have the same responsibilities towards the company and the shareholders. Nevertheless, they do have duties towards the company that, as it is discussed in chapter four, sometimes have led to the affirmation of the liability of Independent Directors by courts. Moreover, the presence and the approval by Independent Directors of certain corporate transactions, as for example self-dealing transactions, have the important consequence of shifting the burden of proof of the fairness of the debated transaction from the company to the plaintiff. This last statement clearly represents the importance that corporate governance attributes to the role of Independent Directors.

Finally, the fifth chapter analyses the various possible shareholders remedies in the event of breaches of fiduciary duties by corporate directors, comparing the private approach of enforcement to the public approach and furthermore defining the differences between derivative suits and direct suits. The chapter will also briefly discuss and evaluate the actual effective deterrence effect of shareholders litigation, in light of the various directors' protective measures put in place by corporations, such as director and officer (D&O) insurance policies.

CHAPTER 1

Independent Directors as a response to monitoring needs

1. Agency problems of the corporation and legal strategies

Corporate law serves several functions: first, it establishes the structure of the corporation and sets ancillary housekeeping rules necessary for that structure to function, secondly and most importantly for our analysis, it controls conflicts of interests among corporate constituencies, both corporate “insiders” such as controlling shareholders and directors, and corporate “outsiders” such as creditors and minority shareholders. These conflicts are referred to as “agency problems”, an economic term which describes the problem arising when the benefit of one party, the “principal”, depends upon actions taken by another party, the “agent”. The problem here, lies in motivating and ensuring that any action taken by the agent is taken in the principal’s interest rather than in the exclusive and personal agent’s interest. Infact, because the agent has generally and inevitably more information about the relevant facts of the operations performed than does the principal, the former has an incentive to act opportunistically, as the principal cannot easily inform himself about the agent’s performance, ensure its consistency with the agent’s promise and make sure that there isn’t any opportunistic behaviour put in place by the agent.

Generally, three types of agency problems arise in business corporations: the first one involves the shareholders and its managers, who must always have in mind and act in view of the shareholders’ interest rather than pursuing their own personal and economic interest. The second agency problem involves majority shareholders, who control the company, and minority or non-controlling shareholders. The problem here lies in assuring that the latter are not expropriated by the former. Finally, the third and last agency problem involves

the firm itself and third parties such as creditors, employees and customers. This third agency problem deals with assuring that the company does not behave opportunistically towards these third parties, by exploiting employees or misleading customers.

Law plays an important role in attempting to solve agency problems and thus reducing agency costs. Legal strategies coping with agency problems can be divided into two categories: regulatory strategies and governance strategies. Regulatory strategies are prescriptive and aim at dictating substantive terms governing the agent-principal relationship, constraining the agent directly. Governance strategies, by contrast, aim at strengthening the principal's control over their agents' behaviour¹.

There are significant differences across jurisdictions in the legal strategies employed to regulate corporate decisions: there is often a correlation between the share ownership structure and the types of legal strategies relied upon to deal with agency problems across the various jurisdictions. In particular, when the ownership of shares is concentrated in the hands of few shareholders, it is possible to rely on governance strategies, which are not costly because of the ease of coordination between shareholders. Conversely, in countries characterized by a dispersed ownership structure, governance strategies are not as effective, and regulatory instruments will be necessary.

The United States is commonly compared to other jurisdictions in Continental Europe, by emphasizing their finance characteristics. In the United States, capital is often supplied by debt financing offered by banks and other institutional investors while equity is financed by public investors. In Continental Europe, capital has historically been financed by banking institutions that offered both debt and equity financing, as a consequence, ownership of companies tended to be fragmented in Anglo-Saxon countries and concentrated in Continental Europe.

¹ J. Armour, H. Hansmann, R. Kraakman, "Agency problems, legal strategies and enforcement", *Harvard John M. Olin Center for Law, Economics, and Business, Discussion Paper No. 644, 7/2009*

Corporate governance regimes in these countries differed substantially as a result of this fragmentation or concentration; United States managers had to focus on shareholders' interest through a complex system of checks and balance, while European companies were to operate not by putting shareholders first, but by assuring that the boards were always acting in the best interest of every constituency of the corporation. Dispersed ownership may cause some problems from the corporate governance point of view, as it may be difficult for many small shareholders to acquire information on the management of the company and its operations, meaning that the principal-agent problem may arise and the company's performance could be negatively affected. On the other hand, concentrated ownership makes it more likely for large shareholders to be genuinely interested in the long-term growth and performance of the company and may be able to solve the principal-agent problem by closely monitoring the firm's management. Concentrated structures also bring their inconveniences: dominant shareholders can exercise control at the expense of minority shareholders who are not properly protected. Furthermore, concentrated and complex structures can undermine the firm's transparency and disclosure regimes, causing problems for both the investors and the wider public. In this dilemma between diffuse and concentrated ownership, the goal should be to maximize the benefits of both structures, and this is why we need to encourage the creation of effective governance systems².

While there is a consensus on certain broad issues in the field of corporate governance, there is no consensus about which corporate governance system is best, as there are no formalized or generally accepted criteria for determining if a particular system of corporate governance is efficient or not. However, there are some empirical methods that can be used to measure the effectiveness of a certain corporate governance system: investors who are confident that a particular system provides a good level of protection against managerial self-

² M. Ventoruzzo, P. Conac, G. Goto, S. Mock, M. Notari, A. Reisberg, *"Comparative Corporate Law"*, West Academic Press, 2015

interest will be more inclined to make investments, in this sense a system of corporate governance can be said to contribute to the overall success or failure of a particular economy. Also, if a corporate governance system is functioning well, as a consequence public markets for capital will function as well and firms will want to go public to obtain a low-cost funding of the project. Therefore, if in a particular jurisdiction there is a large number of companies that are eligible to go public, but refrain from doing so, this indicates the non-effectiveness of the corporate governance system.

The law addresses the shareholder-manager agency problem through various methods, one of the most effective is the appointment strategy, by which shareholders exercise an indirect but at the same time very strong influence in the firm by appointing and removing directors from the management board.

Another type of legal strategy aims at solving the problem not by enhancing powers of shareholders but by enhancing incentives for the agents, the managers, to not act opportunistically. These are the so-called incentives strategies.

1.2 Independent Directors: the Trusteeship Strategy

The principal incentive strategy is the “Trusteeship Strategy”.

The Trusteeship Strategy works on the basis of assumptions that differ from those elaborated across all other types of incentive strategies. In fact, the goal of the trusteeship strategy is to actually eliminate *ex-ante* any possible conflict of interest between the principal and the agent, by removing the potential gain that the agent might derive from dis-serving the principal. This is done by removing monetary incentives for the agent, in our case the manager, to behave opportunistically. By removing the financial stimulus, the manager will act in light of other elements, such as conscience and personal reputation.

The most common example of such strategy is the role of the independent directors who do not have financial ties, or ties of other nature depending on the jurisdiction, with management and thus, according to the rationale of the trusteeship strategy, should be guided by reputation and conscience in performing their function. The same concept applies for external auditors, who are treated as trustees in regards of the approval of certain documents, such as the company's financial statements and other documents through which the conduct of management can be verified³.

It follows that the addition of "independent directors" to the management board does not only attempt to solve the shareholder-manager agency problem but also potential agency problems involving minority shareholders and non-shareholder corporate constituencies.

In short words, independent directors are board members who are not strongly tied by financial incentives to any of the corporate's constituencies but are motivated by ethical and reputational concerns. The United States is the birthplace of this form of trusteeship strategy, both case law and substantial rules encourage independent and non-executive directors to be a part of the board. In particular, the U.S Exchange rules require that company boards include a majority of independent directors and the U.S Sarbanes-Oxley Act requires public companies to be equipped with wholly independent audit committees with the power and duty to select outside auditors.

In Europe, by contrast, independent directors are promoted through the less compulsory codes of best practices.

Independent directors are considered to be a key element of good governance: while in the States they are considered to be monitors of management. Across EU jurisdictions with concentrated ownership structures, they are seen as protectors of minority shareholders and non-corporate constituencies. As a result of these different views, independent directors are potentially effective for treating all agency problems, but at the same time not exclusively dedicated to

³ J. Armour, H. Hansmann, R. Kraakman, *op.cit.* see note 1

treating any. However, independent directors also have their downside: there is an inevitable compromise between a director's independence and his knowledge about the company, which might be poor, specifically as a collateral result of his independence from the company.

Since both the trusteeship and the appointment strategy operate through the board, their effectiveness depend on the board's powers and capabilities. In the last 30 years, corporate governance reforms have tried to enhance board's efficiency, which has been said to be directly linked to a range of so called 'best practices', some of them are board size, independence from management, committees structures.

All EU jurisdictions have adopted corporate governance codes, which are soft law tools containing guidelines for listed companies that address a variety of corporate factors such as composition and structure, and are drafted by a regulatory authority. As soft law regulation, the aforementioned codes do not legally bind companies but they only provide for guidelines that companies have the freedom to follow or not, according to the 'comply or explain' mechanism.

National codes of best practices are in place outside of the EU as well, but not in the United States. In the United States, corporate issues have been dealt with substantial laws rather than with soft law. Federal law, listing rules and case law of the Delaware courts have forced American companies to comply with most of the best practices embodied in the European codes of best practices and recommendations way before the adoption of these codes in the EU. As a matter of fact, independent directors were forming the majority of most US boards since the 1970s, the NYSE required listed companies to appoint audit committees composed by independent directors and both Delaware courts and U.S federal tax law were, in the last decades, encouraging publicly traded companies to increase the number and tasks of independent directors⁴.

⁴ R. Kraakman, J. Armour, P. Davis, L. Enriques, H. Hansmann, G. Hertig, K. Hopt, H. Kanda, E. Rock, *The Anatomy of Corporate Law. A Comparative and Functional Approach*, Oxford University Press, New York, 2009 (2nd edition) pp.64-68

In the last thirty years, American corporate governance has come to support the introduction of independent directors as an effective tool for safeguarding the interests of both shareholders and other corporate constituencies. As stated earlier, State law, federal legislation and stock exchange listing rules (NYSE) rely on independent directors to serve as watchdogs to management.

In order to fully understand the importance of independent directors in modern corporate governance, it is useful to analyse the various functions carried out by the board of directors. In large companies, boards of directors do not direct the day-to-day management of the corporation but resort to delegated management instead: they appoint a CEO and other executives who will take care of the company's strategy, its implementation and its day-to-day operations.

Having clarified that, we can start analysing the board's first function, which is the monitoring of the company's management, on behalf of the shareholders. For this purpose, the board appoints a CEO and other executives whose operations and transactions with and on behalf of the company will always be under the board's revision and reviewing. The board also fulfils other monitoring activities such as financial reporting and disclosures, in order to ensure the company's general compliance with the law.

Secondly, the board plays a role in the development of the company's business strategy by supplementing management in the elaboration of the strategic objectives of the company.

Thirdly, the board also performs an important role by serving as a bridge between the corporation and other actors such as the various stakeholders, the government and the legal and financial communities. The board performs this task by exchanging information with those actors, this also serves as a mean to maintain the contentment of every party involved in the company's business operations.

1.3 The Rise of Independent Directors in the United States and in Europe

The American corporate governance system emphasizes the board's monitoring role, the board therefore has the main function to monitor management. The rise of the board's monitoring function can be traced back to the 1970s, and linked to two particular events that occurred around that time: the collapse of the major railway company Penn Central in 1970 and an academic publication titled "*The Structure of the Corporation*" by Melvin Eisenberg, published in 1976⁵. The author stressed the view of a company's board as the monitoring device of the company, with the power to appoint, remove and monitor the members of the chief executive's office. This task, in Eisenberg's view, could only be performed by the board while being truly independent from the company and at the same time being in a position that could enable the board to obtain all information necessary for its monitoring function. This vision of the board as a monitoring body is exactly what had not been done in the past and is the reason why the book published by Eisenberg had such a revolutionary and influential effect in the corporate world.

The collapse of Penn Central is considered important for the development of the concept of independent directors because of the reason behind that collapse: the company's directors did not know about the financial troubles that the company was going through and, most importantly, did not put any effort into trying to gather information about the financial situation of the company they were managing. In particular, despite the financial problems of the company, Penn Central was still paying attractive dividends to its shareholders by borrowing the amount necessary for such payments from local banks. The shareholders were therefore led to believe that the company was going through an optimal business phase. In reality, the company was, through the payments of (non-existent)

⁵ M. A. Eisenberg, "*The Structure of the Corporation: A Legal Analysis*", Boston: Little, Brown & Co, 1976

dividends, dissimulating its real situation, which was actually close to bankruptcy⁶. Moreover, Penn Central was at the centre of a corporate governance scandal also because on top of its disguised bankruptcy, several corrupt payments were made by the company's management together with other prominent public corporations, giving rise to the Watergate scandal, which shed light on the numerous illegal contributions to the Nixon campaign⁷.

All of these unlawful events brought the general public and the regulators to believe that such misconducts could have been prevented and avoided if there was an adequate monitoring system to watch over management. This belief, of course led to the change of corporate governance rules, including the addition of independent directors onto corporate boards.

In order to have a stronger evidence of the structural changes of the board in regards of its functions and of the rise of independent directors as an effective mean to control executives, we can have a look at the case law of the Delaware courts and notice their approach towards the wave of hostile take-overs that took place in the 1990s. During this time, the Delaware courts were paying major attention to the composition of boards and to the decision-making process which was, of course, influenced by the actual composition of the board. It is during the 1980s and 1990s that, through court decisions, the protective function of independent directors and of the monitoring function of the board started to become clear and undisputed. Infact, Delaware courts established the practice of looking only at the decision-making process and not at the substance of decisions taken by the board: when it was clear, in a take-over situation, that the board in question was composed by an adequate number of independent directors and that the judgements were executed, at least formally, independently, the board was

⁶ Foreword of H. O. Staggers, Chairman of the Special Subcommittee on investigations, Committee on Interstate and Foreign Commerce, in *"The Financial Collapse of The Penn Central Company"*, Staff Report of the Securities and Exchange Commission to the Special Subcommittee on Investigations, August 1972

⁷ S. M. Bainbridge, *"Corporate Governance after the Financial Crisis"*, Oxford University Press, 2012

then able to “just say no” to a hostile take-over bid, even if the bid would favour the target company’s shareholders, without having to face any liability.⁸

This is the reason behind the corporate reforms that have tried to confirm this tendency by adopting further means to control management, like the introduction of audit committees, responsible for auditing and internal accounting control, as well as a remuneration committee that periodically reviews executive compensation as a mean to always keep track of the fulfilment of executives’ duties towards the company.

The monitoring model assigns, as one may deduce, a crucial role to independent directors because of their lack of any kind of business or economic ties with the company and its management. They are in an ideal position to monitor the CEO and other executives and, when necessary, to what is in their powers to protect the interests of shareholders and of the corporation as a whole.

As a consequence, corporate governance rules have given increasing importance and recognition to the role of independent directors, as they are in fact considered “the cornerstone of the monitoring model”.

The importance of independent directors for a good governance is reflected in federal legislation, modern jurisprudence and most importantly, in stock exchange listing rules.

The Enron case is considered to be the most important example of corporate governance failure in modern corporate history, and it led to the creation of the Sarbanes-Oxley Act by Congress in 2002.

The auditors of Enron were found guilty of misconduct in regards of the company’s shareholders as they collaborated with the company’s executives to artificially inflate Enron’s share price for a considerable amount of time, which inevitably led to the collapse of the company’s stock market price, resulting in heavy losses by investors.

The central provision of the Act is the requirement of independent auditors within a corporation and the direct responsibility of audit committees for the oversight of the performance and actual independence of the independent auditor⁹.

The corporate governance reforms enacted from 1990 to modern days are proof of the increasing attention paid by corporate law towards independent directors as fundamental figures in the boards of publicly listed companies. The New York Stock Exchange (NYSE) and NASDAQ have both adopted listing rules requiring companies to have a majority of independent directors on their board¹⁰. By analysing both NYSE and Nasdaq rules, we can interestingly notice that there is a difference in regards of the evidence of independence, as the NYSE rules require a positive finding of independence while Nasdaq rules provide that anyone not employed by the company is automatically deemed to be independent, unless found otherwise by the board. Also, Nasdaq rules provide independent directors with more powers than what is determined by NYSE rules, as NYSE-listed companies are bound to have their directors- compensation decided by a majority of independent directors or by a compensation committee composed solely by independent directors, similarly to what is laid down in regards of board nominations.

However, unlike what is required by Nasdaq rules, in NYSE-listed companies the board as a whole can override decisions of a majority of independent directors in matters of compensation and nomination.¹¹

It is then clear, especially after the 2002 reforms, that not only the courts of Delaware, but the listing authorities and the federal government as well believe

⁹ J. Armour, J. A. McCahery, *After Enron: Improving Corporate Law and Modernizing Securities Regulation in Europe and the US*, Amsterdam Center for Law & Economics, Working Paper No. 2006-7

¹⁰ H. Baum, "The Rise of the Independent Director: a Historical and Comparative Perspective", *Max Planck Institute for Comparative and International Private Law*, Research Paper No. 16/20

¹¹ D. C. Clarke, "Three Concepts of the Independent Director", *Delaware Journal of Corporate Law*, 2007, p. 90

that independent directors who owe their allegiances to the corporation and its stockholders are valuable for the investors and for the wider public, as a guarantee against a potential mismanagement of the company by the executives.¹²

The concept of independent directors, that became popular in the U.S in the 1970s, was brought to Europe through the United Kingdom, whose public companies' boards were composed of a majority of independent directors in the 2000s.

Looking back at the evolution of the presence of independent directors in UK boards, it is interesting to notice some differences between the institutional and regulatory setup of the UK and the US jurisdictions. Britain has a more “shareholder-centric” approach, as shareholders are more powerful than they are in the US, they have the power to propose directors for appointment and to remove serving directors.

However the main difference can be identified in the regulatory approach to corporate governance. In the US, mandatory law is enacted via federal securities legislation and by company law of the several individual states while in Britain much more attention is paid to rules enacted by statutory bodies, instead of legal rules. The principal piece of regulation on corporate governance is the UK Corporate Governance Code that applies and enforces the independent monitoring board model and lays down rules on board composition.

Differently from the US approach, the UK Corporate Governance Code applies the “comply or explain” mechanism and therefore companies may not conform to the rules set by it, with the only obligation of providing an explanation for not doing so.

The European Union was influenced by what was happening in the UK and the first piece of regulation on the matter of non-executive directors was enacted by

¹² D. Marchesani, “*The Concept of Autonomy and the Independent Director of Public Corporations*”, *Berkeley Business Law Journal*, Article 5, Volume 2 Issue 2, 2005 pp. 321-325

the European Commission in 2005, in the form of a non-binding Recommendation. The Recommendation followed what was already in force in the UK through the UK Corporate Governance Code by recommending a composition of companies' boards that would take into account and require an adequate balance between executives and non-executives, in order to prevent small groups of individuals to dominate the decision-making process.

The Recommendation was, again, non-binding but in 2014 a Directive was enacted by the European Commission, which set more stringent requirements in respect of the 2005 Recommendation, by providing a mandatory majority of independent directors for audit committees of public-interest companies¹³.

The 2005 Recommendation, even though chronologically subsequent to the American response to corporate scandals and crisis that occurred in the 1970s (Penn Central, Watergate) with federal legislation and significant judgements by the Delaware courts, had the same legislative goal, which was to respond and find a solution to some of the corporate fraud scandals that occurred in Europe at the start of the 21st century, along with the general goal of strengthening the European Internal Market and business efficiency.

In particular, the most important corporate European scandals were the Parmalat case¹⁴ and the Ahold¹⁵ case. The former scandal highlighted the inherent unsuitability and danger of concentrating the functions of chief executive and chairman of the board in the hands of the same individual, while the latter case highlighted the inefficiency of supervisory boards, as it demonstrated that the mere separation of executive and supervisory by simply creating a supervisory board, is not per se sufficient to prevent abuses.

The scandals and failures of the European corporate governance which was widespread in the Old Continent throughout the end of the 20th century, brought the European Commission to the realization that boards do not exercise an

¹³ H. Baum, *op. cit.*

¹⁴ Italian dairy group, December 2003

¹⁵ Retailer in the US and Europe, 2000-2005

efficient and proper monitoring of management when they are staffed either with people who have direct links to the management or by people who do not possess the sufficient expertise to perform the monitoring function. As a consequence, independence is particularly crucial in areas in which conflicts of interests between shareholders and managers are likely to occur, these areas are, among others, the appointing of managers, the determination of managers' remuneration and the audit of the company's performance, which is a reflection of the managers' performance.

As stated earlier, the enforceability of the standards set by the Recommendation is rather weak considering the "comply or explain" principle, but the Recommendation can reasonably be considered a partial success because, by now, all Member States require or recommend the presence of independent directors in boards or supervisory boards. However, the main problem regards the unclear definition of "independence", as a different meaning of independence among Member States inevitably makes standards uneven and the goal of reaching a convergence of corporate governance rules among all the Member States of the EU is less likely to be accomplished.

Even though one of the main objectives of the Recommendation was to ensure that the requirement of the presence of independent directors in areas in which conflicts of interests between shareholders and managers is very frequent is always complied with, the Report found that this standard has not been followed by many of the Member States, that do not require nor recommend the presence of independent directors in audit and remuneration committees. Without the "interference" of independent directors in remuneration and audit committees, executives may still have significant control over the company by setting their own salary and by not allowing other people, specifically independent non-executives, to audit the company's performance. The negative effects of this practice to the shareholders and the company as a whole are evident.

As regards the actual implementation of the Recommendation's principles about independent directors in the various Member States, as a result of their non-

binding nature, they have been adopted as part of the Member States' corporate governance codes. The codes usually provide the publication of an annual corporate governance statement by listed companies stating whether they comply with the rules set by the national corporate governance code or explain the reasons why they don't comply with it.

One must bear in mind that the success of the corporate governance codes and the "comply or explain" principle that comes with them depends mostly on the quality and reliability of the information provided in the annual corporate governance statements published by listed companies, in order to allow investors to make informed decisions and therefore contribute to a better and more secure investment market¹⁶.

1.4 Are independent directors the answer to both American and European governance problems?

One may wonder if the corporate governance scandals that occurred in the United States starting from the 1970s were inevitably going to influence the European corporate governance system, which is, except for the UK, based on concentrated ownership rather than on the dispersed ownership model, which is by contrast the standard in both the United States and the United Kingdom. At first, the fact that Europe applies the "insider" model, by which shares are concentrated in the hands of blockholders, as opposed to the American "outsider" model, instilled the idea that the European model was indeed more apt to prevent corporate fraud scandals and protect investors, as there is less danger of managers acting opportunistically because blockholders themselves are in a

¹⁶ Report of the European Commission on the application by Member States of the EU of the Commission Recommendation on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board, Brussels 2007

better position to control managers, with a consequential reduction of the need of regulation to hold managers accountable towards shareholders.

However, a simple look at the significant cases that brought both continents to the realization of the need for corporate reforms, makes it clear that there were similarities between them: in both the Enron and Parmalat scandals there were executives who acted opportunistically by manipulating the company's assets, both scandals clearly showed loopholes in the audit mechanism, which strongly contributed to both companies' collapse and lastly, they brought attention to the way the stock market prices securities and its inefficiency to protect the wider public of investors.

Despite these commonalities, there were also important differences that highlight the difference between the European and the Anglo-American corporate governance tradition, which therefore will always render the two systems impossible to be governed by a single set of regulations.

The first difference between the Enron and the Parmalat scandal is the form of misconduct at the core of both cases: even though they both dealt with accounting misrepresentation, in an outsider system it is more common for executives to push for inflations of stock prices while in insider systems it is more common that corporate assets are diverged in the hands of blockholders, both types of executives' misconduct occurred in the scandals.

A further distinction between systems regards the modality of regulation and enforcement of rules governing corporations and its constituencies. While in Italy there were more stringent substantive rules regarding auditors' liability, they were still not sufficient to prevent the Parmalat scandal, this is mainly due to the weak enforcement procedures which were, at the time, existent in Italy. Italy, in fact, relies heavily on public enforcement of substantive rules, neglecting other types of enforcement that might work better in the corporate worlds, such as private class actions. The US system conversely entrusts much of corporate law enforcement to private enforcement, through shareholders' class action.

As a conclusion, even though auditor failure was at the heart of both scandals, the difference between these two corporate governance structures should make us assume that corporate reforms, which are enacted to prevent and solve problems that are characteristics of outsider governance regimes, such as the Anglo-American one, are not automatically valid for insider systems. Therefore, one could really wonder whether the staffing of boards and committees with independent directors, which is a concept that, as we analysed, was born in the United States, is appropriate and valid for the European corporate world as well¹⁷.

¹⁷ J. Armour, J. A. McCahery. *op.cit.*, pp. 9-11

CHAPTER 2

Structure and role of the Independent Director

2. Differences among jurisdictions on the concept of independence

As we have seen in Chapter 1, during the past decades, independent directors have been seen as an essential instrument to improve the monitoring role of the board and the overall efficiency of the company, even though criticism of the actual impact of independent directors on the company's efficiency, transparency and overall performance is common and has been the subject of various literary works.

However, the alleged failure of independent directors in their primary function of watchdogs over management may be attributed to a lack of appropriate incentives, expertise or information within the company. A further element that might undermine the performance of their monitoring task is the often incomplete definition of "independence".

The requirements for directors' independence vary greatly among jurisdictions and usually provide for unclear criteria and requirements.

International bodies have made some attempts to formulate a general definition of independence in order to combine the different approaches across jurisdictions. One of these international bodies is the Basel Committee, which affirmed that the "key characteristic of independence is the ability to exercise objective, independent judgment after fair consideration of all relevant information and views without undue influence from executives or from inappropriate external parties or interests"¹⁸.

¹⁸ Basel Committee on Banking Supervision, Principles for Enhancing Corporate Governance (2010), para 38

National regulations have chosen different approaches to define independence, some jurisdictions try to set independence requirements by laying down a negative catalogue of criteria that describes instances in which the independence criterion is not met. The UK Corporate Governance Code and the NYSE Listed Company Manual have followed this approach.

Other jurisdictions, by contrast, have decided to define the independence requirements in a more detailed and complex way, which is not always a market-smart choice of regulation, as the complexity of the requirements might render those requirements difficult to apply.

The Danish Corporate Governance Code, for example, prohibits the appointment of a person as an independent director by the general meeting if that person is, among other strict and detailed requirements¹⁹, an employee of the company or has been member of the executive board, a senior staff member, a subsidiary undertaking or an associate, if he represents the interests of a controlling shareholder, if he has had significant business relations with the company, if he is a subsidiary undertaking or an associate, within the past year.

At the European Union level, the approach towards the definition of the independence requirement differs from the one elaborated in several European national corporate governance codes, as for example, the aforementioned Danish corporate governance code.

Accordingly, the 2005 EU Recommendation on the role of non-executive directors wisely recognizes that “it is not possible to list comprehensively all threats to director’s independence; the relationships or circumstances which may appear relevant to its determination may vary to a certain extent across Member States and companies, and best practices in this respect may evolve over time”.

¹⁹ Danish Committee on Corporate Governance Recommendations for corporate governance of 2013, as revised by November 2014

But more than the diversity of the regulatory style of drafting instruments on the matter of directors' independence, it is important to look at the substantial differences among the various pieces of regulation on the matter.

For example, not every list of independence requirements mentions independence from controlling shareholders: it is mentioned in the UK corporate governance code but not in its US counterpart. Moreover, the situation of employee representation on the board differs among jurisdictions: the most significant difference can be observed in respect to Germany, because of its co-determination regime.

One of the most important divergences regards the decision, in each country, of who actually has the task to determine if the members of the board of a particular company fulfil the independence requirements set by the national corporate governance code.

While the United States approach determines that it is the NYSE that will have to scrutinize the requirements and decide whether a proposed board member can be considered independent, the EU Recommendation as well as other jurisdictions apply a different system, providing that it is for the board itself to determine whether directors fulfil the independence criteria. The UK Corporate Governance Code, for example, states that the board determines whether each directors is independent in character and judgement²⁰.

More importantly, the United States put in place a mandatory type of regulation towards the issue (federal and state law), while the EU Recommendation operates under the “comply or explain” principle.

²⁰ UK Corporate Governance Code section B.1.1: “The board should identify in the annual report each non-executive director it considers to be independent. The board should determine whether the director is independent in character and judgement and whether there are relationships or circumstances which are likely to affect, or could appear to affect, the director’s judgement. The board should state its reasons if it determines that a director is independent notwithstanding the existence of relationships or circumstances which may appear relevant to its determination, including ... “

Just by giving a quick look at the regulatory and legislative approach of the Western countries' (United States, EU as an institution and the individual Member States) we can notice divergences on the matter of independent directors.

The differences in the determination of the actual meaning of independence among jurisdictions is not *per se* a counterproductive or a negative thing.

This is, in fact, a natural consequence of the fact that every country has a different ownership structure and a different economy, therefore a truly functional perspective on board independence should take into account and consider the specific needs of the particular jurisdiction, which arise from the type of shareholder structure existent in the country.

The basic agency problem in concentrated ownership systems is the conflict between controlling shareholders and minority shareholders, thus, in these jurisdictions, independent directors are used as a tool to mitigate the shareholders conflict and, in order for independent directors to perform this task, it comes naturally that one of the requirements for independence should be independence from the controlling shareholder.

By contrast, in dispersed ownership structures, as for example the United States, the shareholder contrast is much less significant than in concentrated ownership structures and therefore, including independence from controlling shareholders in the independence catalogue is irrelevant, if not counterproductive.

Every jurisdiction has its own needs, which are strongly dependant on the shareholder structure, industry structure and regulatory objectives.

It follows that there is no universal definition of independence and any attempt to harmonise the concept of independence and the consequential legal implications is more harmful rather than helpful for the general goal of board efficiency²¹.

²¹ W.G. Ringe, "Independent Directors: After the Crisis", *Legal Research Paper Series, Paper No. 72/2013*, University of Oxford, July 2013

2.2 Independence requirements in the United States and in Italy

As part of the monitoring mechanism, the introduction of independent directors in a company's board of directors serves the purpose of supervising management and thus maximise shareholder's interest.

Under the United States system, which is where the entire concept of directors' independence originated at the start of the 1970s, there are both federal and state law requirements on independent directors.

However, the Sarbanes-Oxley Act of 2002 has changed the boundaries of the competence between federal securities law and state law on independent directors.

This is because, as a result of multiple corporate scandals that shocked the American corporate world, federal laws now impose higher standards and criteria for directors' independence²².

In particular, the NYSE and Nasdaq listing standards provide for strict requirements applicable to boards of directors of companies that have equity securities listed on the New York Stock Exchange or on the Nasdaq Stock Market.

First of all, both NYSE and Nasdaq listing standards state that boards of directors of listed companies must comprise a majority of independent directors²³.

This rule is supported by the consideration that the more independent is a director's judgement, the more efficient the overall board will be. Consequently, requiring a majority of independent directors will increase the quality of board oversight and reduce potential conflicts of interests, which are damaging for the company.

²² J. Zhao, "Comparative Study of U.S and German Corporate Governance: Suggestions on the relationship between independent directors and the supervisory board of listed companies in China", *Michigan State Journal of International Law*, Vol 18:3, 2010, p. 497

²³ Rule 4200 of Nasdaq Listing Rules and Section 303.A.01 of NYSE Listed Company Manual

NYSE listing rules determine a director's independence by using a negative test, stating that:

- (a)** (i) No director qualifies as "independent" unless the board of directors affirmatively determines that the director has no material relationship with the listed company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the company).
- (ii) In addition, in affirmatively determining the independence of any director who will serve on the compensation committee of the listed company's board of directors, the board of directors must consider all factors specifically relevant to determining whether a director has a relationship to the listed company which is material to that director's ability to be independent from management in connection with the duties of a compensation committee member, including, but not limited to:

 - (A) the source of compensation of such director, including any consulting, advisory or other compensatory fee paid by the listed company to such director; and
 - (B) whether such director is affiliated with the listed company, a subsidiary of the listed company or an affiliate of a subsidiary of the listed company.
- (b)** In addition, a director is not independent if:

 - (i)** The director is, or has been within the last three years, an employee of the listed company, or an immediate family member is, or has been within the last three years, an executive officer, 1 of the listed company.
 - (ii)** The director has received, or has an immediate family member who has received, during any twelve-month period within the last three years, more than \$120,000 in direct compensation from the listed company, other than director and

committee fees and pension or other forms of deferred compensation for prior service (provided such compensation is not contingent in any way on continued service).

(iii) (A) The director is a current partner or employee of a firm that is the listed company's internal or external auditor; (B) the director has an immediate family member who is a current partner of such a firm; (C) the director has an immediate family member who is a current employee of such a firm and personally works on the listed company's audit; or (D) the director or an immediate family member was within the last three years a partner or employee of such a firm and personally worked on the listed company's audit within that time.

(iv) The director or an immediate family member is, or has been with the last three years, employed as an executive officer of another company where any of the listed company's present executive officers at the same time serves or served on that company's compensation committee.

(v) The director is a current employee, or an immediate family member is a current executive officer, of a company that has made payments to, or received payments from, the listed company for property or services in an amount which, in any of the last three fiscal years, exceeds the greater of \$1 million, or 2% of such other company's consolidated gross revenues.

The New York Stock Exchange listing rules entrusts the board of directors with the task of the determination of a director's independence, as it must ensure that the director does not have any "material relationship with the listed company".

The test is deliberately drafted by the NYSE in a broad way, on the basis that it would be impossible to anticipate or explicitly provide for all instances of actual or potential conflicts of interests. The board therefore has to consider all relevant

facts and circumstances before positively concluding for the director's independence. The board should decide on the issue by considering not only the director's standpoint but also the viewpoint of other companies or organizations with which the director has connections²⁴.

The key concern under the NYSE listing rules regarding board independence is independence from management, not ownership, therefore eventual large share ownership by a director does not preclude the fulfilment of the independence requirement. Furthermore, when considering the existence of "material relationships", the board should take into account not only industrial or commercial links, but extend the exam to any banking, consulting, legal or familial relationships. The NYSE elaborated a broader definition of "immediate family member" in respect of that formulated by the Sarbanes-Oxley Act, including not only the spouse, children and stepchildren sharing the director's home, but also siblings, mothers and fathers-in-law, sons and daughters-in-law. Each determination of independence regarding board directors must be disclosed by the company in the company's annual proxy statement²⁵.

Regarding the Nasdaq listing rules, the Preamble to the Corporate Governance Requirements states that companies listed under Nasdaq rules must not only comply with quantitative requirements regarding the company's size and financial details, but must comply with the qualitative requirements as well. Qualitative requirements deal with rules regarding the company's board of directors, audit committees, the oversight of directors' compensation by independent directors and other company matters.

²⁴ NYSE Listed Company Manual, Section 3 Corporate Responsibility, available at http://nysemanual.nyse.com/lcm/sections/lcm-sections/chp_1_4/default.asp

²⁵ Shearman and Sterling, memorandum on NYSE *Revises Proposals on Directors Independence, April 2013*, available at http://www.shearman.com/~media/Files/NewsInsights/Publications/2003/04/NYSE-Revises-Proposals-on-Director-Independence/Files/Download-PDF--NYSE-Revises-Proposals-on-Director_/FileAttachment/CM_0403.pdf

Rule 5605 of the Nasdaq listing standards, regarding Board of Directors and Committees, states that:

The following persons shall not be considered independent:

(A) a director who is, or at any time during the past three years was, employed by the Company;

(B) a director who accepted or who has a Family Member who accepted any compensation from the Company in excess of \$120,000 during any period of twelve consecutive months within the three years preceding the determination of independence, other than the following:

(i) compensation for board or board committee service;

(ii) compensation paid to a Family Member who is an employee (other than an Executive Officer) of the Company; or

(iii) benefits under a tax-qualified retirement plan, or non-discretionary compensation.

Provided, however, that in addition to the requirements contained in this paragraph (B), audit committee members are also subject to additional, more stringent requirements under Rule 5605(c)(2).

(C) a director who is a Family Member of an individual who is, or at any time during the past three years was, employed by the Company as an Executive Officer;

(D) a director who is, or has a Family Member who is, a partner in, or a controlling Shareholder or an Executive Officer of, any organization to which the Company made, or from which the Company received, payments for property or services in the current or any of the past three fiscal years that exceed 5% of the

recipient's consolidated gross revenues for that year, or \$200,000, whichever is more, other than the following:

- (i) payments arising solely from investments in the Company's securities; or
- (ii) payments under non-discretionary charitable contribution matching programs.

(E) a director of the Company who is, or has a Family Member who is, employed as an Executive Officer of another entity where at any time during the past three years any of the Executive Officers of the Company serve on the compensation committee of such other entity; or

(F) a director who is, or has a Family Member who is, a current partner of the Company's outside auditor, or was a partner or employee of the Company's outside auditor who worked on the Company's audit at any time during any of the past three years.

(G) in the case of an investment company, in lieu of paragraphs (A)-(F), a director who is an "interested person" of the Company as defined in Section 2(a)(19) of the Investment Company Act of 1940, other than in his or her capacity as a member of the board of directors or any board committee.

Under Nasdaq listing requirements, the board of directors of listed companies has the duty to positively affirm a director's independence by determining that none of the relationships listed in Rule 5605(a)(2) exist, in each individual case.

Furthermore, similarly to the NYSE listing rules, the Nasdaq rules explicitly state that Nasdaq does not consider stock ownership of the company to be an element of conflict of interest that could undermine the director's independence, and

therefore the non-ownership of significant company stocks by the director is not listed in the catalogue of independence requirements²⁶.

As regards the precise definition of “independent” under US law, each piece of federal regulation has its own definition of independence.

Under the Sarbanes-Oxley Act, which does not directly deal with the role and function of independent directors in general terms, but only mentions them in relation to audit committees, which must, under the 2002 Act, be exclusively comprised of independent directors, an independent director is defined as one who has not accepted any compensation by the company, other than as a director, and is not an “affiliated person” of the company or any subsidiary²⁷.

Nasdaq Listing Standards define an independent director in Rule 4200 by stating that an independent director is a person other than the executive officer, employee of the company or any other person having a relationship which, in the opinion of the board of directors, would interfere with the exercise of an independent judgement in carrying out the responsibilities and duties of a director. The aforementioned rule goes on, as we have described in the preceding pages, by listing specific instances by which a person should not be considered independent by the board.

The New York Stock Exchange Listed Companies Manual doesn’t provide for an individual definition of independent director other than by listing the independence standards mentioned in the preceding pages, which essentially state that the board has to ensure that the director does not have any “material relationship” with the company.

²⁶ Rule 5602, Corporate Governance Requirements, Nasdaq Listing rules, available at http://nasdaq.cchwallstreet.com/nasdaq/main/nasdaq-equityrules/chp_1_1/chp_1_1_4/chp_1_1_4_3/chp_1_1_4_3_8/default.asp

²⁷ Section 301 of the Sarbanes-Oxley Act of 2002

The current conception of director independence, however, falls short of effectively considering every relation that could undermine director independence.

As proof of this statement, it is sufficient to look at the recent corporate scandals, to understand that the independence criteria considered by the law is not always able to acknowledge every possible tie with the company, and, even when directors were considered independent because of the lack of employment or business relationships with the company, they still received some sort of compensation from the company or entertained some other type of relation with the company.

This is why reforms have focused on the goal of strengthening the definition of independence.

The majority of the reforms only consider financial ties with the company: the Sarbanes-Oxley Act states that a person shall not be considered independent if he or she receives any kind of compensation from the company.

Nasdaq and NYSE's definition also focus, as we have seen, on excluding any person who has financial relationship with the company. Along the same line, Delaware courts have also failed to set up a definition of independence without focusing exclusively on financial ties.

No legislation or court decision refers to social or professional connections as situations in which independence is certainly undermined. Federal laws, in fact, only consider familial relationships, not social or professional relationships, as potential threats to independence.

However, after the 2002 corporate scandals, Delaware courts started to consider social ties in the independence inquiry as well. In particular, lower Delaware courts positively considered social ties to potentially impact independence.

This happened in the Martha Stewart case²⁸, in which, however, the court affirmed that a mere friendship relation does not amount to bias in the decision-

²⁸ Beam ex rel Martha Stewart Living Omnimedia, Inc v Stewart (2004)

making process: the court stated that “to render a director unable to consider demand, a relationship must be of a bias-producing nature.. Allegations of mere personal friendship or a mere outside business relationship, standing alone, are insufficient to raise a reasonable doubt about a director’s independence.. some professional or personal friendships, which may border or even exceed familial loyalty and closeness may raise a reasonable doubt whether a director can appropriately consider demand. ... not all friendships, or even most of them, rise to this level”.

Delaware courts, therefore, did not establish a new threshold of professional or social relationships above which independence is considered to be lacking, but decided to apply a case-by-case approach. The Delaware courts presumed directors independence and set a demanding standard to refute such independence.

This standard did not exclusively take into consideration financial ties, as it did in the past, but considered social or professional relationships sufficient to potentially rebut independence.

We can find this specific court approach in two different cases: *In re Oracle Derivative Litigation* (2003) and *Biondi v Scrushy* (2003).

In the former case, the court found that independence was lacking among some members of the special litigation committee because some directors had ties with Stanford University.

In the latter case, the court doubted and questioned the independence of two members of the special litigation committee because of their ties with the defendant director.²⁹

However, recent decisions have shown that directors’ social or professional ties still play a minimal role in determining independence. On this matter, the Delaware Supreme Court affirmed that evidence regarding social, business or

²⁹ P.M. Vasudev, S. Watson, “Corporate Governance after the Financial Crisis” , Edward Elgar Publishing, 2012, p.224

professional relationships are normally insufficient to undermine a director's independence.

Nevertheless, it is expected that cases concerning directors independence linked to professional or social ties will continue to develop in Delaware case law.

A further reason why independence is still not always considered, by the law or by courts, to be impaired by professional or social relationships, is the impact of any possible wrongdoing on the directors' reputation. In fact, it is unlikely that directors would subordinate their professional, business or ethical reputation to a friendship relation, and would, as a result, alter their business decisions depending on their social ties with business associates.

This presumption, however, can be rebutted by three different considerations. First, empirical evidence shows that when directors have acted depending on their social or professional ties with board members or other directors, they did not suffer any business or reputational damage. On the contrary, some directors have continued to be hired by companies as board members, even after the public was informed of their participation in corporate frauds.

Furthermore, cultivating those professional ties may actually produce the opposite effect, and benefit directors. Very often, remaining in a company's board depends upon one's social and professional connections. This leads directors to comply with managerial policies and not question them as often as they should, in order not to damage the professional and social connections built with management over time.

Apart from empirical evidence, social studies have also conducted research on the matter. Social science studies have shown that social ties have a strong impact on one's behaviour and can unconsciously influence decisions.

In fact, some Delaware judges have admitted that not considering social relationships as potential threats to independence equates to ignoring the social nature of humans³⁰. Moreover, some corporate governance findings have found

³⁰ In *Oracle*, the Court of Chancery of Delaware stated:

Nor should our law ignore the social nature of humans. To be direct, corporate

that social ties are likely to reduce the ability to make an objective business decision. This is a problem in company boards, as social ties also reduce the ability to impartially assess and judge each other's actions.

In light of those findings, Delaware courts had the opportunity to make a change in respect of its precedents and satisfy the public outcry for corporate reforms in the aftermath of corporate scandals, by starting to take into consideration social ties in the inquiry for independence.

However this did not happen, meaning that there is an even lower probability that social ties will be considered in the future, as not even the public pressure for corporate reforms of the early 2000's, has been sufficient to change the courts' approach to social ties.

The courts' constant hesitation to consider social ties as an actual threat to independence could be linked to the fact that it is very rare to find directors who do not have any personal or professional ties with other directors prior to board service. Therefore, if those relationships were to be considered a problem for the determination of independence, it would significantly complicate the ability to view any director as independent, and the entire system of independent directors and their monitoring function would be put at crisis.³¹

Additionally, the central issue that one should bear in mind when dealing with independence requirements in the United States, is that each US state has its own company law, which applies to companies incorporated in that state.

directors are generally the sort of people deeply enmeshed in social institutions. Such institutions have norms, expectations that, explicitly and implicitly, influence and channel the behavior of those who participate in their operation. . . . In being appropriately sensitive to this factor, our law cannot assume—absent some proof of that point—that corporate directors are, as a general matter, persons of unusual social bravery, who operate heedless to the inhibitions that social norms generate for ordinary folk.

³¹ L.M. Fairfax, "The Uneasy Case For the Inside Director", Iowa Law Review, 2010

As a result, other than federal laws (Stock Exchange rules and Sarbanes-Oxley Act) dealing with independent directors, companies must also take into consideration state law.

Thus, what might be considered independent under Nasdaq listing rules, might by contrast not be considered independent under, for example, Delaware law.

In particular, Delaware courts have defined the independence requirement to be satisfied when “a director's decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences.”³²

However, the decision of a company’s board of directors regarding the independence of a director under the stock exchange listing rules, inevitably influences the potential consideration of the independence requirement by state courts, in the application of state law.

In fact, in the *Sandys v. Pincus* judgement of the Delaware Supreme Court, the judge affirmed that “the Delaware independence standard is context specific and does not perfectly marry with the standards of the stock exchanges in all cases,” it nevertheless “creates cognitive dissonance” to presume that directors are independent when their “own colleagues will not accord them the appellation of independence[.]”³³

2.3 Independence requirements and definitions in Italy

The belief that independent directors are essential to ensure the performance of the board’s monitoring function, and to protect shareholders from mismanagement and opportunistic behaviours carried out by managers is part of the corporate governance tradition not only in the United States, but in Europe as well.

³² Aronson v. Lewis, 473 A.2d 805, 816 (Del. 1984)

³³ Chief Justice Strine, *Sandys v. Pincus*, No. 157, 2016 (Del. Dec. 5, 2016)

The European regulatory approach regarding the role of independent directors, is, as we know, different from the American one.

Both the European Union and the individual European Member States chose to regulate the matter through non-binding instruments. In practice, all existing corporate governance codes and guidelines contain references to independent directors and their role in companies' boards, each instrument, however, contains a different definition of independence.

At the EU level, we have already mentioned in Chapter 1 the European Commission Recommendation of 2005 on the role of non-executive and supervisory directors. The Recommendation follows the idea that independent directors have a significant role in both dispersed and concentrated ownership structures and, as a consequence, entrusts them with various functions in key areas of the company's business, notably in areas which are sensitive to conflicts of interests. It additionally contains minimum standards requirements for the commitment, independence and qualifications of non-executive and supervisory directors³⁴.

In Italy, the Committee for Corporate Governance adopted the Corporate Governance Code which sets principles and rules aiming at enhancing companies' performance, according to several recommendations made on the EU level, including the 2005 EC Recommendation.

Compliance with the Code by Italian listed companies is voluntary, in line with the comply or explain principle.

Art. 2 of the Code provides that the board of directors must be made up of executive and non-executive directors. Moreover, the competence, authority and time availability of non-executive directors shall be as such as to ensure that their judgement may have a significant impact on the board's decisions.

Art. 3 specifies that "an adequate number of non-executive directors must be independent, in the sense that they do not maintain, directly or indirectly or on

³⁴ P. Santella, G. Paone, C. Drago, *"How Independent are Independent Directors? The case of Italy"*, Giuffrè Editore, March 2006

behalf of third parties, nor have recently maintained any business relationships with the issuer or persons linked to the issuer, of such a significance as to influence their autonomous judgement.”

It is the board of directors that will have to assess the directors’ independence after the appointment, and then continue to evaluate the director’s independence on a yearly basis. The Code furthermore states that the results of the board’s determinations must be communicated to the market.

As regards the criteria for independence, Art. 3 leaves the determination of the independence requirement to the board of directors, specifying that the board will have to focus, in performing the independence test, more on the substance rather than on the form of the relationships attributable to the director.

Moreover, Art. 3 lists a series of instances, which are to be considered merely as examples and not exhaustive, in which a director does not appear to be independent.

In particular, independence has to be excluded:

a) if he/she controls, directly or indirectly, the issuer also through subsidiaries, trustees or third parties, or is able to exercise a dominant influence over the issuer, or participates in a shareholders’ agreement through which one or more persons can exercise a control or dominant influence over the issuer;

b) if he/she is, or has been in the preceding three fiscal years, a significant representative of the issuer, of a subsidiary having strategic relevance or of a company under common control with the issuer, or of a company or entity controlling the issuer or able to exercise over the same a considerable influence, also jointly with others through a shareholders’ agreement;

c) if he/she has, or had in the preceding fiscal year, directly or indirectly (e.g. through subsidiaries or companies of which he is a significant representative, or in the capacity as partner of a professional firm or of a consulting company) a significant commercial, financial or professional relationship:

- with the issuer, one of its subsidiaries, or any of its significant representatives;

- with a subject who, also jointly with others through a shareholders' agreement, controls the issuer, or – in case of a company or an entity – with the relevant significant representatives; or is, or has been in the preceding three fiscal years, an employee of the above-mentioned subjects;

d) if he/she receives, or has received in the preceding three fiscal years, from the issuer or a subsidiary or holding company of the issuer, a significant additional remuneration (compared to the “fixed” remuneration of nonexecutive director of the issuer and to remuneration of the membership in the committees that are recommended by the Code) also in the form of participation in incentive plans linked to the company's performance, including stock option plans;

e) if he/she was a director of the issuer for more than nine years in the last twelve years;

f) if he/she is vested with the executive director office in another company in which an executive director of the issuer holds the office of director;

g) if he/she is shareholder or quota holder or director of a legal entity belonging to the same network as the company appointed for the auditing of the issuer;

h) if he/she is a close relative of a person who is in any of the positions listed in the above paragraphs.

The Italian Corporate Governance Code furthermore states that the adequate number of independent directors should be determined on the basis of the size of the board and the activity performed by the company.

After the appointment of a director who qualifies himself as independent, upon the occurrence of events affecting the independence requirement and at least once a year, the board has the duty to evaluate the relations which could jeopardize the independence of judgement of the directors and notify the results of such evaluation.

What needs to be noted is that the list of criteria mentioned in Art. 3 does not bind the board of directors in the evaluation of independence, as other types of criteria, additional or different in whole or in part, may be taken into

consideration by the board, as long as the market is always informed regarding the reasons of the board's determination on the directors' independence.

In fact, commercial, professional or financial relations tying the director to the issuer or any other subject linked to the issuer, and that are therefore to be considered as relationships that exclude the fulfilment of the independence requirement, are not precisely set out in the Code, leaving their evaluation to the board's discretion. Even the evaluation of familial relationships are left to the board's discretion.

The Code requires that companies make sure that every quantitative or qualitative criteria eventually used by the board of directors to evaluate the director's independence, is disclosed to the market.

It is furthermore specified that the board of statutory auditors, in performing their function of supervising over the correct application of the corporate governance rules, has the task of verifying the correct application of the independence requirements by the board of directors. The board of statutory auditors is also demanded to verify that the assessment procedure of the independence requirements has been conducted by the board in an appropriate way.

Considering the non-exhaustive nor mandatory nature of the relationships set out in the criteria, the board may take into consideration other instances of situations and ties that could undermine independence.

Representatives of companies controlling the issuer, provided that it is a significant control exercised by that company, are usually considered to not be independent because of their professional ties with the controlling company, but, under the Code, the board of directors is always required to make a substantial evaluation on the matter and not only consider the formal appearance of a director's independence: the assessment of independence of a representative of a controlling company will be therefore be made on the basis of the actual role exercised by the party concerned in the controlling company.

If he has been appointed in the controlling company because of his "*super partes*" position, it will then be possible for the issuer's board of directors to

consider him as fulfilling the independence requirements. If, by contrast, the role covered in the controlling company is significant, because he participates in the determination of the company's strategy or plays a guiding role within the management of the company, it will be less likely for the board of directors of the issuer to appoint him as an independent director, because of his lack of independence.

As regards company's shares, the direct or indirect ownership of a certain amount of the company's stock, even though not sufficient to allocate the control or a dominant influence of the company to the director, can be considered as an event capable of jeopardizing a director's independence when the acquisition of stock company had not been subjected to shareholders' agreement³⁵.

This is an important difference in respect of the US corporate governance instruments, as under both Nasdaq and NYSE rules, the ownership of a significant amount of the company's shares is not *per se* considered as a threat to directors' independence. This different view is due to the significant divergences between the Italian and the American ownership structures, as the latter is characterized by dispersed shareholders, rendering the ownership of significant company shares by a director an irrelevant issue.

2.4 Evolution of the definition of independence and the board responsibility in the assessment of independence

Rules and definitions on the matter of directors' independence do not always easily achieve the goal of ensuring independence, having failed to identify every director's professional and personal tie which could undermine independence.

In recent years, an effort has been made by regulatory bodies such as the Securities and Exchange Committee, to take into consideration, when setting

³⁵ Borsa Italiana S.P.A, Comitato per la Corporate Governance, *Corporate Governance Code*, July 2014

independence requirements, more precise provisions regarding the remuneration committee. The SEC required stock exchanges to consider further ties that could potentially endanger the director's independence, such as "personal or business relationships between members of the compensation committee and the listed issuer's executive officers".

The NYSE was already entrusting the board of directors with the task of determining whether the director has "material relationships" such as to undermine his independence but did not go as far as the SEC was suggesting, as the NYSE recalls the difficulty of defining and taking into consideration every factor and circumstance, thus providing the board of directors with the duty of considering every "relevant fact and circumstance", such as professional, business or charitable and familial relationships.

Therefore, the board of directors has the responsibility, under the NYSE listing rules, to evaluate a broad and undefined spectrum of criteria for independence, as, other than the requirements objectively formulated by Section 303 of the NYSE Listed Companies Manual, it has the duty to consider every potential relevant factor for independence.

Some commentators were critical of the regulatory approach taken by the NYSE, requiring more clarification on the actual meaning of "relevant factors". However, the NYSE retains that the independence standards defined by the so called "bright-line" test are sufficient to enable the board of directors to scrutinize every potentially relevant relation and more importantly, the NYSE further states that Section 303A.02(a) of the Listed Companies Manual already imposes to the board of directors to examine and take into consideration every tie, not comprised in the "bright-line" test and that could be potentially relevant.

The request made from the SEC to further specify independence criteria which would also acknowledge personal relationships, has been complied with by the NYSE by providing that "the board must consider all factors specifically relevant to determining whether a director has a relationship to the listed company which is material to that director's ability to be independent from

management in connection with the duties of a compensation committee member”.

However, the need to put in place more detailed requirements for independence has been satisfied in regards of audit committees and remuneration committees, in relation to which both NYSE and Nasdaq listing standards enacted more stringent independence requirements, compared to those applying to independent directors of the management board.

It is precisely in regards to remuneration committees that a reference to “personal relations” has been made by the SEC and consequently by the NYSE and Nasdaq.

Remuneration committees do not have the legal obligation to select compensation consultants or other advisers that are “independent”, but, if they do, they have to inform the market on the evaluation of the consultants’ independence, which has to be performed on the basis of six factors. One of these factor is namely the absence of “any business or personal relationship of the adviser with a member of the compensation committee”³⁶.

This analysis shows that the US approach is coming closer to finally develop a precise and complete catalogue of factors which may undermine directors’ independence, even though it could be said that the consideration of personal relations may also fall within the general spectrum of facts and circumstances

³⁶ Compensation adviser independence assessment: Although compensation committees are not required to select compensation consultants, legal counsel or other advisers that are “independent,” the NYSE’s new listing standard provides that they must, in making their selections, take into account the following six factors (which are identical to those enumerated in SEC rules), which bear upon independence: o the provision of other services to the listed company by the adviser’s employer; o the amount of fees received from the listed company by the adviser’s employer, as a percentage of the total revenue of the employer; o the policies and procedures of the adviser’s employer that are designed to prevent conflicts of interest; o any business or personal relationship of the adviser with a member of the compensation committee; o any stock of the listed company owned by the adviser; and of any business or personal relationship of the adviser or the adviser’s employer with an executive officer of the listed company.

that the board must consider when evaluating the independence of a specific director, pursuant to Section 303 of the Listed Companies Manual³⁷.

The loopholes which inevitably derive from the lack of complete regulation and precise definition of the independence criteria can lead to the appointment of directors who are not really independent, with a series of consequences in case of litigation or company decisions requiring the consent of independent directors like, in the case of US law, decisions regarding the company's bankruptcy.

In fact, one of the key element in the bankruptcy structure under American federal law, is the independent director, as his consent is necessary to file a voluntary bankruptcy proceeding.

In *In re Kingston Square Associates*, 214 B.R. 713 (Bankr. S.D.N.Y., 1997), the matter involved an independent director's veto right on the bankruptcy proceeding: in order to circumvent the independent director's veto right, the debtor's principal decided to address a law firm in order to solicit creditors to file involuntary petitions for bankruptcy, pursuant to chapter 11 of the U.S Bankruptcy Code. The owner³⁸ of the involved entities requested the court to dismiss the filings, claiming an obvious orchestration of the involuntary filings by the creditors and claiming that the purpose was to circumvent the independent director's veto right, resulting in a behaviour that could be defined collusive and in a *prima facie* bad faith.

The court however, did not dismiss the filings, even though the debtor's principal's deceitful purpose was quite evident, on the basis of the lack of independence of the independent director. In fact, the independent director was a former lawyer who worked for investment companies, including Donaldson, Lufkin & Jenrette Securities Corporation (DLJ) whose wholly owned subsidiaries financed many of the entities involved in the involuntary

³⁷ Effective Governance Outlook (EGO) "*Il punto sugli amministratori indipendenti*", January 2015, available at: <http://www.nedcommunity.com/Contents/Documents/EGO%20n%203%20gennaio%202015.pdf>

³⁸ Morton L. Ginsberg

proceedings, and he was also a consultant for several DLJ transactions. Furthermore, the independent director was not honouring his fiduciary duties in respect of the company, as he was completely uninvolved in the activities of the debtors, until the board actually called a meeting to discuss the debtors financial woes.

As a consequence of the impossibility for the court to positively affirm the independence of the director, whose vote was necessary for the filing of the voluntary petition for bankruptcy, the court found that there were not enough grounds for dismissal of the involuntary filings by the debtors.

The court motivated its decision by supporting the debtors' position that it would be ineffective to follow corporate formalities and request the board to file a voluntary petition, for which an unanimous board vote is required, including the independent director's vote.

This case can be thus considered as a reaction to situations in which the independence requirements for independent director are not, in reality, fulfilled³⁹.

All of these considerations on the effects and consequences of appointing as independent director a director who is not really independent, should raise the concern of determining a potential responsibility of the board, whose task is, under both American and Italian law, to positively affirm and ensure the director's independence, by scrutinizing independence criteria set by the law and every other potential non-independent relationship attributable to the director.

In Italy, an potential board responsibility in cases of non-independent directors is much more regulated than in the United States.

In particular, Art. 2 of D.P.R 28/12/2000 n. 445 (*Testo Unico delle disposizioni legislative e regolamentari in materia di documentazione amministrativa*) provides that, if the company agrees so, the director can self-certify with a statement *in lieu* (*dichiarazione sostitutiva*) the fulfilment of the requirements for

³⁹ S. A. Gussett, "A Not-so-independent Independent Director in a Bankruptcy Remote Structure", American Bankruptcy Institute, March 1998

his appointment, including the independence requirement. Statements in lieu are considered, under Italian law, as declarations made to a public official (Art. 76 of the D.P.R.), and therefore any false statement *in lieu* results in the criminal liability of the author.

However, even though Italian law expressly states the criminal liability of the director in case he was not truthful regarding the independence requirement, the company's board responsibility is not excluded. This is clearly stated by the *Disposizioni di Vigilanza per gli Intermediari Finanziari*⁴⁰ which provides that companies allowing directors to recourse to statements in lieu, have the responsibility to perform checks and controls over the self-certification statements, in order to scrutinize the truthfulness of those statements.

This procedure is not only provided by the aforementioned regulation but by the Italian Civil Code, the Italian Corporate Governance Code and other national pieces of regulation as well.

In particular, Art. 2392 of the Italian Civil Code includes among directors' duties the duty to comply with the law provisions and the company's statute with the due care and diligence required by the nature of the specific task. Therefore, if the directors only proceeded to approve the statements in lieu provided by the independent directors without dedicating a careful look and without performing the verification of the actual fulfilment of the requirements, this would clearly constitute a breach of their duty to act with due care and diligence, required by the civil code.

Most importantly, the Italian Corporate Governance Code as well entrusts the board of directors with the task of evaluating the existence and the continuity of the independence requirements of the directors who qualified themselves as

⁴⁰ "Gli intermediari che intendano consentire ai propri esponenti di avvalersi della possibilità di ricorrere alle dichiarazioni sostitutive **dovranno porsi in condizione di poter effettuare controlli sulle dichiarazioni ricevute**", Disposizioni di vigilanza per gli Intermediari Finanziari, (Titolo II, capitolo 2, allegato B, pagina 10, ultimo cpv), 2014

independent⁴¹. This verification can be based other than on objective circumstances, on different evaluation criteria, in whole or in part, adopted by the board of directors, such as information provided by the single parties concerned or, however, at disposal of the company.

Moreover, the *Disposizioni di Vigilanza di Banca d'Italia* provides that the board of directors cannot accept statements in lieu if the board itself is not able to verify those statements and further specifies that, if the board considers itself to be able to perform the required verifications, these must be appropriate and consistent with the goal of ensuring the truthfulness of the statements.

However, we can unfortunately observe a significant area of malpractice by which the mere receipt of the declaration by the board is often considered as an appropriate verification of the requirements, without having to conduct further inspections. Actually, pursuant to the aforementioned regulations, the board of directors should always proceed to attempt to verify the legal requirements regarding independent directors, and should do so by trying to collect documents certifying the truthfulness of the independent director's declarations. This could be done effectively if the board approved *ex ante* a precise and complete verification procedure, also by defining quantitative criteria for the collection of such information.

Special information rules bind listed companies and both listed and non-listed financial intermediaries, as they have a communication duty towards the market and towards supervisory authorities⁴². Supervisory authorities have thus the right to have access to information in view of the general goal to ensure the protection of the market and with the intent of protecting the general interest, which has a constitutional character. Therefore, the efficient verification of the market on the basis of the information collected and provided to the supervisory authorities

⁴¹ Art. 3.C.4.

⁴² (RE art. 144-*novies*, Codice di Autodisciplina paragrafo 3.C.4., TUB art. 51 e art. 108, TUF in vari articoli tra i quali, 8, 74, 76, 82, 115).

depends on the truthfulness and reliability of that information. It is then very important, in order to ensure the entire efficiency of the task performed by the supervisory authorities, that the Italian legislation puts in place appropriate sanctions in case of violations by the supervised entities.

The legal consequences of a communication containing a false declaration regarding the fulfilment of the legal requirements of independent directors depend on the addressee of such declaration.

A false communication to the market could be considered as a market manipulation pursuant to Art. 185 of the TUF⁴³, provided that a communication is considered to be directed to the market when it addresses an indefinite number of people.

By contrast, communications to supervisory authorities are regulated by specific texts (Art. 144 TUB⁴⁴, Art. 185 TUF), which provide that the false certification of the independence requirement, subsequently communicated to the supervisory authorities, results in the application of sanctions towards the board of directors.

As regards the distribution of liability among members of the board of directors for such false statements and communications, case law has clarified that, even when it would be materially possible to assess and graduate the liability of each member in reason of the role concretely executed in the situation, liability will still be attributed to the board of directors as a whole, as it is not practically possible for any of the members of the board of directors, including non-executives, to invoke ignorance on the matter, unless he or she provides evidence of deceit by the other members of the board⁴⁵.

In conclusion, it is hard to practically define the degree of inspection to be performed by the board of directors in order for the verification procedure of the independence requirement to be considered “appropriate”, in order to avoid any

⁴³ Testo unico delle disposizioni in materia di intermediazione finanziaria

⁴⁴ Testo Unico Bancario

⁴⁵ Tribunale di Roma, sez. V pen., 2/11/04 n. 23093; Tribunale di Cosenza 15/11/04; Corte Appello Catanzaro 14/01-04/04/08 n. 73

kind of liability in the event that the independence requirement is not really fulfilled.

The board of directors does not dispose of investigation instruments that could allow it to violate privacy so as to collect information and therefore, cannot conduct investigation without the consent and collaboration of the director concerned. The verification procedure approved by the board should allow the director concerned to provide the board with functional information needed to verify his independence, when so requested by the board, but also provide to the board, without the need for the board to request such information, any piece of information considered necessary in view of the said goal, which is the verification of independence.

The information collected by the board, whether requested by the board or autonomously provided by the director, has to be scrutinized and evaluated by the board with due diligence, and the board must eventually conducting further verifications in case of incertitude over some of the elements of the independence requirements, or if the independent director does not collaborate or is reticent⁴⁶.

2.5 Functions of Independent Directors

To properly identify the functions of independent directors, we must first acknowledge the different terms used by the various jurisdictions to describe independent directors.

Some corporate governance norms speak of directors who are “non-interested”⁴⁷, “independent”⁴⁸, “non-executive”⁴⁹, “non-employee”⁵⁰, “outside”⁵¹ or “disinterested”⁵² directors.

⁴⁶ *Op.cit*, see footnote 30

⁴⁷ See Investment Company Act (ICA) (codified in relevant part at 15 U.S.C. § 80a-2(a)(19) (2000)).

⁴⁸ See Securities Exchange Act of 1934 (SEA) § 10A (codified at 15 U.S.C. § 78j-

As a consequence, each of these terms is defined differently and implies a different function for the director it describes, even though they are often treated as being the same person and, rules thought for one type of director apply to the other types as well, as they are practically considered to cover the same corporate role.

In order to be able to refer to every possible declination of independent directors, we may use the generic term of “non-management” director, because this term encompasses the main element that all the above terms have in common: independence from management.

The role of the non-management director can be analysed by first considering and identifying whether the NMD is perceived as an implementation of external regulation, or as a substitute to it.

Under American law, the NMD is perceived as being a substitute of external regulation, as a solution to the danger of legislation and courts decisions to become too involved with corporate decisions. In fact, in Delaware, a rule that might be considered obvious, like the one imposing that every transaction between the company and the director has to be performed under conditions that are fair to the company, is not imposed by Delaware law, which does not legally require the fairness of the transaction between the company and the director, as

1(i)(3)(B) (2002)). The provision in question comes from Section 301 of the Sarbanes-Oxley Act of 2002 (SOA). Sarbanes-Oxley Act of 2002 § 301 (codified at 15 U.S.C. § 78j-1(m)(3)(A) (2002)).

⁴⁹ See FINANCIAL REPORTING COUNCIL, LONDON STOCK EXCHANGE, REPORT OF THE COMMITTEE ON THE FINANCIAL ASPECTS OF CORPORATE GOVERNANCE ¶ 4.1 (Gee & Co., Ltd. 1992), available at http://www.ecgi.org/codes/code.php?code_id=132 [hereinafter CADBURY REPORT].

⁵⁰ See Rule 16b-3 under the Securities Exchange Act promulgated by the Securities and Exchange Commission (SEC) (codified at C.F.R. § 240.16b-3(b)(3)(i) (2005)).

⁵¹ See COMMERCIAL CODE OF JAPAN, art. 188(2)(7.2) (2002) (using the term *shagai torishimariyaku*—literally, "director from outside the company").

⁵² See, e.g., DEL. CODE ANN. tit. 8, § 144 (2001); MODEL BUS. CORP. ACT § 8.31(a)(iii) (2005) (requiring director independence).

long as the company in question has a board comprised of a majority of independent directors and as long as these independent directors have, after full disclosure by the board, approved the transaction in question.

An important way in which NMDs help improving corporate functioning from the inside is as monitor of related-party transactions, as the danger of conflicts of interests is very high in these types of transactions.

Sometimes NMDs are considered to be protectors of minority shareholders against the voting power of larger shareholders who might, because of their large ownership of the company, have a dominant power over the selection of directors and managers, and therefore use their significant voting power at the expense of minority shareholders.

Sometimes, NMDs are used as board's consultants, but if this was their function, it would be hard to understand the reason why they need to fulfil all those thoroughly defined independence criteria.

In the United States, independent directors have been introduced to solve the main agency problem of managerial domination of the board. This is based on the idea of a corporation in which powerful managers exploit dispersed shareholders⁵³, this explains why American corporate law does not generally prohibit the ownership of the company's stock by independent directors.

The most common form of non-management director is the independent director, who serves the primary function of checking on management, in the interest of shareholders. In fact, they can only perform the monitoring function over management effectively if they are independent from management⁵⁴.

Therefore, the supervision function is the first and most basic function of independent directors. The main goal is to ensure that the manager's behaviour is compliant with the general interest of the company and does not harm shareholders or stakeholders.

⁵³ Berle and Means corporation model

⁵⁴ D.C. Clarke, *op.cit.*

As a result of this primary function, jurisdictions assign the aforementioned monitoring functions to independent directors in areas in which conflicts of interests have high probabilities of happening. In particular, jurisdictions often provide for independent directors to be part of board committees, which are different depending on the country.

One of the most important committees is the audit committee, which is often mandatory by law or recommended by national corporate governance codes.

Independent directors of course have a major role in audit committees. Their presence in audit committees renders possible a significant flow of information, which is essential for independent directors to properly perform their monitoring function.

Moreover, audit committees have access to company's documents and reports, which are useful to verify the company's compliance with accounting standards and verify the truthfulness of the company's financial statements.

Independent directors cover a further important task within audit committees, which is the appointment of outside auditors, overcoming the problem of shareholders opportunistically selecting and removing auditors.

Although audit committees are present in almost every jurisdiction, their composition and the roles assigned to independent directors within the committees vary among the different countries.

Under American corporate law, independent directors have a very important role in audit committees. The Sarbanes-Oxley Act (SOX) assigns to audit committees a major role within the corporation. In particular, the audit committee has the task to oversee whether financial statements and records, which have to be prepared by the board, are effectively prepared, audited and communicated to investors. Furthermore, audit committees must ensure that financial statements are accurate and truthfully represent the financial situation of the company.

The SOX provides that audit committees have to be comprised exclusively of independent directors and specifies that they may not receive any direct or

indirect payment from the corporation or its subsidiaries, other than remuneration for their services as directors.

Interestingly for our analysis, the SEC expands the definition of independence when relating to independent directors being members of audit committees, further requiring that the director is not an “affiliated person⁵⁵” of the company or its subsidiaries.

Under the SOX, audit committees must perform a variety of functions. These activities include the performance of financial disclosure duties, controlling the company’s relationship with the auditor and establishing company’s key policies. Regarding the second function, the SOX restructured the previous provision regarding the relationship between the company and the auditor, who was, in the past, hired by the management. Under the new SOX rules, the outside auditor is now appointed by the audit committee, who is also responsible for the elements of that engagement, including the auditor’s independence, which has to be periodically ensured by the audit committee. The SOX then proceeds to list, in a very self-explanatory way, the various functions of the audit committee.

To prevent and detect fraud, in light of the audit committee’s financial oversight over the company, the committee must establish procedures for the confidential submission of complaints by employees, regarding auditing or accounting matters (Whistle-blower policies). Under the SOX, audit committees also have the task of reviewing ethic codes, company’s risk assessment and risk management policies.

Nasdaq listed companies must conduct, through their audit committees, appropriate reviews, on a periodical and ongoing basis, of all related party transactions, in order to keep track of every potential conflict of interest situation. The definition and the procedures established by law regarding related party transactions will be further discussed in Chapter 3.

⁵⁵ Under SEC’s rules, an affiliate of a company is “a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the company”.

Audit committees play a very important role in disclosure matters, the law either sets the obligation for audit committees to disclose their activities or provides audit committees with the task of reviewing activities performed by the management. In particular, the audit committee must provide its annual report in the company's proxy statement, covering its verification of the company's financial statement prepared by management⁵⁶.

Other than in the audit committees, independent directors cover a specific function in two other committees, the Remuneration Committee and the Nomination Committee.

The former committee's main function is to make independent recommendations to the board of directors regarding directors' and other executives' remuneration. Under the SOX, both the remuneration and the nomination committees are comprised exclusively of independent directors.

The nomination committee is in charge of identifying potential appointments of the members of the board of directors, by determining whether they are qualified to become members of the board and, eventually by recommending such individuals for appointment to the board of directors.

In order to determine whether an individual is qualified to become part of the board of directors, the nomination committee will take into consideration every criteria laid down by the Nasdaq listing standards and other factors such as age, expertise, skills, experience and integrity.

Independent directors have a significant role to play in remuneration and nomination committees in Continental Europe as well.

Following the Commission's Recommendation, nomination and compensation committees are recommended by corporate governance codes, except for Belgium, in which these committees are mandatory by law.

⁵⁶ B.F. Dravis, *"The role of Independent Directors after Sarbanes-Oxley"*, Chicago: American Bar Association, 2007

The number of independent directors varies among countries: some provide for a majority of independent directors while others require at least one independent director to be comprised in the committees.

Independent directors play an important role in remuneration committees when a conflict of interest may arise. They might, for example, disapprove the remuneration of an owner-manager that includes equity-based incentives on the basis that the manager is already incentivized through its stock ownership in the company.

As we can interpret by looking at the rise and evolution of the independent directors since the 1970s, their main function is to serve as watchdogs to management. The areas in which management is more likely to behave opportunistically are the areas in which there are potential conflicts of interests. The important role that independent directors have in monitoring conflicts of interest are evidence of the great expectations that corporate law puts on the figure of independent directors.

By looking at the evolution of the American approach towards conflict of interest transactions, we can notice how both courts and legislative instruments changed their perspective towards the problem.

In 1880, in the United States the general rule was that any contract between a director and his company was considered voidable at the instance of the company or its shareholders, without regard to the fairness or unfairness of the transaction, without even focusing the attention on whether independent directors approved the transaction in question.

Back then, the skepticism over self-dealing transactions was coming from the consideration that the company and its shareholders are entitled to the impartial judgement of all its directors.

However, because conflicts of interests are inevitably part of the commercial world, both courts and laws learned to apply a less stringent approach to self-dealing transactions and, by 1910, the general rule in the United States was that a

contract between a director and his corporation was valid if approved by a majority of independent directors and was found to not be unfair or fraudulent by the court, if challenged.

If we now look at the modern regulation of conflict of interests transactions, we can notice that in a very short time the law has moved from prohibiting conflicts of interest transaction *tout court* to an approach in which conflicts of interests are not prohibited, but must, instead, be managed. Central to this development is the role of the independent director.

The amendments made in 1989 to the Model Business Corporation Act had the intent to provide a bright-line test to identify what is a director conflict of interest transaction, and, if the test is passed, to provide a safe harbour to prevent the challenge of the transaction in question, provided that the bright-line conditions are satisfied. The statute provides that “a director’s conflicting interest transaction may not be enjoined, set aside or give rise to an award of damages or other sanctions”⁵⁷ if the approval procedure set by the statute has been complied with.

As previously stated, the independent director’s primary function is to monitor managers, focusing on preventing managers to abuse their authority and engage in self-dealing transactions, which can be harmful for the company. This monitoring function implies a variety of tasks: independent directors closely examine conflict of interest transactions, in order to ensure that they benefit the corporation, they also have the task of detecting and preventing fraud, because their monitoring activities will likely decrease managers’ ability or intent to commit wrongdoings towards the corporation. Moreover, their presence in both remuneration and audit committees lowers the danger of managerial abuse. By exercising functions within the remuneration committee, independent directors can ensure that directors’ compensation is not inappropriate, and therefore indirectly encourage managers to act in line with the company’s interests.

⁵⁷ Model Business Corporation Act Ann. Par. 8.61(b).

The presence of independent directors also reduces the risk of incomplete or distorted disclosure of information by managers, because they know that the independent directors will scrutinize the information received.

A conflict of interest transaction occurs when the transaction in question benefits a director or an officer, but does not equally benefit the other constituencies of the corporation. These transactions are inherently dangerous because the corporate actor will not be able to “exercise his independent judgement without being influenced by the personal consequences resulting from the decision”⁵⁸. Given the risk of self-dealing associated with these kind of transactions, as we have seen earlier, conflict of interest transactions were historically voidable by shareholders.

The courts’ approach towards conflict of interest transactions, however, changed on the assumption that some of these transactions may as well benefit the corporation, and as a consequence, the voidability rule was replaced by the requirement of a review of the transaction for it to be valid.

This requirement review is known as the “entire fairness” standard, whose application tends to ensure that the transaction in question is fair to the company. However, the high regard that courts have towards independent directors can be seen in situations of conflicts of interests transactions, as when such a transaction is approved by independent directors, courts reinstate the review under the business judgement rule, which is a less rigorous standard than the entire fairness standard. Independent directors therefore enable courts to act less rigidly when discussing self-dealing transactions, despite the risk of misconducts⁵⁹.

Along the duty of care and the duty of loyalty, a third director’s duty that has emerged in American corporate law in the last decades is the duty of disclosure.

The duty of disclosure has been required for public companies by securities law and entails a duty to disclose to shareholders in two cases: when shareholders are

⁵⁸ *Rales*, 634 A.2d at 936

⁵⁹ L.M. Fairfax, *op.cit.*

called to vote on a certain matter and when the company engages in a conflict of interest transaction. More importantly for our analysis, the duty of disclosure plays an essential part in preventing conflict of interests transactions.

Regarding the first case, the reason behind the duty to disclose is evident: the shareholder needs every available information in the hands of management in order to vote on the matter in an informed and fair way.

In conflicts of interests transactions, the duty to disclose derives from a two-fold reasoning: it eventually gives shareholders the possibility to sue, claiming a violation of the duty of loyalty, and secondly, it can prevent the conflict of interest transaction to be completed, by disclosing alone.

The problem, which is still unsolved today, is to determine which remedy to impose for a violation of the duty of disclosure. If the lack of complete disclosure is discovered early enough, it could be corrected with additional disclosure but, if the transaction has already been completed without letting the shareholders vote on the matter with a full knowledge of the terms of the transaction at stake, the remedy is not easy to find. This derives from the assumption that it is impossible to affirm with total certainty that the company's vote would have been different if full disclosure had been complied with.

2.6 Information obligations towards independent directors and the information deficit

In order for independent directors to be able to play their monitoring role, information accuracy is essential. However, informational asymmetries are very common in the corporate environment, affecting the entire monitoring function, which relies on independent directors.

The fact that independent directors are substantially company outsiders, and are therefore not engaged in the company's day to day management, means that they will necessarily need information from other insiders about the company's

activities. As a consequence, independent directors paradoxically depend on insiders, who have to supply information to independent directors, in order for them to effectively monitor management.

The problem here lies in the fact that independent directors do not have the tools to verify the accuracy of the information provided to them by insiders, who could manipulate or provide incomplete information. This results in the performance of a less efficient monitoring role by independent directors.

One of the main corporate response to such problem is the reliance on the role of “gatekeepers”, such as accountants or advisors.

These gatekeepers are considered to be an eventual solution to the information asymmetry problem as they provide independent directors with a different and more objective source of information, and therefore not dependant on insiders’ information, or eventually control and verify the accuracy of the information provided by company insiders.

However, gatekeepers carry their partial independence problems as well, as they are subject to conflicts of interests too that could lead them to manipulate information provided or verified for independent directors in order for them to have some kind of benefit from company insiders. Moreover, even when there is no potential conflict of interest, they are still dependant on insiders to supply information to them, not solving the supremacy of insiders in the information area. In fact, the unreliability of gatekeepers is at the centre of many corporate scandals. Many of the failures that have been blamed on the inefficiency of independent directors are actually to be considered in the light of gatekeepers inefficiency and unreliability. This is due to the fact that independent directors don’t have the instruments to ensure the impartiality of gatekeepers or to ensure the integrity and truthfulness of financial and other company reports without the assistance of gatekeepers.

Gatekeepers are not the only solution to the information deficit: another solution is the public disclosure of corporate information.

Public disclosure aims at ensuring that independent directors do not rely entirely on the information provided by corporate insiders, but can instead rely on the law, which binds companies to disclose certain information, and eventually rely on the law to prevent manipulation of the publicly disclosed information, by establishing sanctions in the event of non-compliance with the law.

In the States, the SEC has tried to resort to public disclosure through rules compelling companies to publish certain information, in order to solve the information and transparency problem, by requiring better and more accurate disclosure in the areas in which conflicts of interests are more likely to happen.

As a result of the disclosure regime imposed by the SEC and other laws, the entire stock market is more informed, which means that the conditions for a more transparent and efficient investment market are further enhanced⁶⁰.

As mentioned earlier, the SEC has assigned to independent directors a role as securities monitor.

According to the SEC, directors should review, prepare and draft company statements. When not directly involved in the preparation of statements, they have to be sufficiently active to question and correct inadequate or false company statements. The important role that the SEC entrusts to independent directors can be deduced by the fact that it stated that directors who are not “reasonably well informed . . . [do] not provide the shareholders with any significant protection in fact.”⁶¹

The securities monitor role however brings responsibilities as well, especially when it provides the duty for independent directors to draft or sign statements, as it is also required that directors accept the “responsibility affirmatively to keep themselves informed of developments within the company and to seek out the nature of corporate disclosures to determine if adequate disclosures are being

⁶⁰ L.M. Fairfax, *op.cit.*

⁶¹ See Report of Investigation in the Matter of Stirling Homex Corporation Relating to Activities of the Board of Directors of Stirling Homex Corporation, Exchange Act Release No. 11516 (July 2, 1975), SEC Docket at 300

made.”⁶². Independent directors therefore serve the function of monitors over securities, verifying that management complies with their obligation to disclose information to investors.

If independent directors need some information that has not been voluntarily disclosed to them by the directors, their role as securities monitors requires them to bypass the officers and proceed to look for information by questioning employees or legal counsels, whenever they need disclosure for a specific situation or need to fact-check the information provided by officers.

Their monitoring role requires them to be always in touch with the development of the company’s operations, so as to always have regular and sufficient information about the company’s affairs. They need to have a firm grasp of the accounting practices and other business related operations, as it would not, otherwise, be possible for independent directors to express a reliable judgement on the integrity of corporate officers. Even when independent directors may rely on the help of independent accountants, they still need to be familiar with accounting standards and practices, so as to additionally verify the accountants’ potential conflicts and misconduct.

As we can easily notice from the Security and Exchange Commission provisions, independent directors are called to perform their task not only from a formal standpoint, but they must comply with their monitoring duties in a substantial way. This means that even when independent directors have received the requested corporate information from insiders, and therefore have technically performed their monitoring function, the Commission specified that whenever the information provided is superficial, independent directors have an additional duty to further inquire on the matter and ensure themselves that the information is accurate. In particular, directors who “review, approve, or sign their company’s proxy statements or periodic reports must take steps to ensure the

⁶² See National Telephone Release

accuracy and completeness of the statements contained therein, especially as they concern those matters within their particular knowledge or expertise.”

When independent directors have the knowledge of violations or potential violations, they must take immediate action in order to protect the investors. Their monitoring role is therefore satisfied, according to the SEC, only when they substantially comply with their duties, even when this would mean that directors may have to “move aggressively to fulfil their responsibilities to oversee the conduct and performance of management and to ensure that the company’s public statements are candid and complete.”⁶³

These considerations lead us to conclude that independent directors should be active directors, their monitoring role requires them to ask questions and keep inquiring until certainty on a certain matter is reached. Passively approving information provided by insiders does not equate to the effective performance of their role and should therefore be considered as a monitoring failure.

Evidence of the need for independent directors to substantially perform their monitoring function can be found in a SEC Exchange Act report on the National Telephone Co. case, in which the Commission investigated on the role of independent directors and their actions, and furthermore issued a report⁶⁴ on this matter.

National was a company that designed, installed and leased telephone equipment systems for commercial customers. National’s operations were brought forward through independent financing but, prior to the problematic disclosure, the company was running out of cash. The result of this lack of cash was a “clash” between the company’s actual financial situation and its public appearance, resulting in a contradiction between reality and investors’ knowledge.

⁶³ See Cooper Release

⁶⁴ Report of Investigation in the Matter of National Telephone Co., Inc., Relating to Activities of the Independent Directors of National Telephone Co., Inc., Exchange Act Release No. 14380 (16th January 1978) (issuing a report pursuant to section 21(a) of the Exchange Act).

The company, for example, disclosed false information about their cash availability in their Annual report and did not, subsequently, inform the shareholders about the fact that the banks with which the company had credit arrangements, cut off the company's financing.

National's directors, which were seven at the time of the fraud, and were composed of only one insider, did question the management on the company's situation. According to SEC, they received copies of press releases and shareholders letters but did not perform their monitoring function by playing a role in approving them. The Commission harshly criticized the fact that directors did not further investigate on the disclosed statements to shareholders and did not insist on the disclosure of more truthful statements. The directors' behaviour in this case can be described as a passive behaviour, which is precisely the kind of directors' conduct that the SEC explicitly considered wrongful.

Even when it was clearer that the company's financial situation was collapsing, the Commission noted that the directors "did nothing to determine the status of the company's incipient obligation . . . to cease entering new leases or the company's consequent disclosure responsibilities."⁶⁵

Furthermore, the audit committee, composed of independent directors did not meet and the directors ignored independent reports on the company's financial situation.

The reason behind the Commission's criticism of the directors' action, even though they were not actively drafting or participating in the drafting of any of the statements, derives from the consideration that the directors entirely failed to monitor not only the financial situation of the company, but they failed to monitor the company's public statements as well. They therefore failed to fulfil their monitoring function.

The Commission stated that "the independent directors knew about National's need for independent capital, its cash squeeze in the fall of 1974, its acceptance

⁶⁵ National Telephone Release

of severe restrictions on its operations in the Credit Agreement closed in December 1974, and its obligation to cease making new leases if new financing could not be obtained within the immediate future. They also knew of the highly optimistic nature of the company's public communications".

The independent directors' justifications for their actions were based on the management's action as they argued that they were relying on management to make appropriate disclosure on the company's situation and on independent counsel.

The Commission did not accept the directors' justifications as it insisted on the duty of independent directors to review, vet and correct the company's disclosed statements. This affirmation by the Commission further solidifies its approach to independent directors' role: they cannot be passive, they are "expected to maintain a general familiarity with their company's communications with the public.", and must "compare such communications with what they know to be the facts.", when they discover that the information provided to them and facts do not match up, they are expected to act "as stewards for the company, [with ensuring] that appropriate revisions or additions be made."

Moreover, the Commission stated that independent directors need to establish proper and regularized procedures to ensure proper disclosure from corporate insiders.

The monitoring role of independent directors is particularly important in the context of public offerings, as the risk of insider trading is very high.

The role of independent directors in this context is to reduce the information asymmetry between the issuer and the potential purchasers. The issuer is, in fact, inevitably in possession of information not known to the general public.

As it is clear from the SEC's attitude in the National Telephone Release, it is in the Commission's intent to extend the monitoring role of independent directors from the offering context to every other corporate context.

Officers should therefore never be completely trusted by independent directors, instead, every information provided by them has to be scrutinized and tested, in order to always ensure its accuracy.⁶⁶

However, a regime in which independent directors have to rely on the company's stock price to measure the company's success and the overall financial situation is inherently flawed. This is because many times stock price does not reflect the reality of the company's financial situation. As evidence of the inefficiency of relying on the disclosure regime to prevent corporate frauds through independent directors' monitoring function, is the fact that often, directors' remuneration is stock-based. This leads to an obvious conflict of interest when independent directors have to verify the accuracy of the stock price: there is a risk that independent directors will behave opportunistically and cooperate with insiders to manipulate the company's stock price.

The utility of the disclosure regime to fight independent directors' information asymmetry can be therefore doubted because of its functioning structure.

In order for the disclosure regime to solve independent directors' informational disadvantage, the regime must provide accurate information. However, the accuracy of the information depends upon the independent directors' ability to verify the truthfulness and accuracy of such information. As a result, the efficiency of one regime, the disclosure regime, depends on the efficiency of another regime, the monitoring function of independent directors.

This reasoning highlights the inherent flaws of the public disclosure regime.

Other than the securities monitors function that the law itself, through the Security and Exchange Commission, entrusts to independent directors, there is a further "natural" reason behind the watchdog role that corporate law in general assigns to independent directors.

⁶⁶ H.A. Sale, "Independent Directors as Securities Monitors", University of Iowa Legal Studies Research Paper Number 05-38, University of Iowa College of Law, July 2006

This derives from the logical reasoning that, given the fact that independent directors are not full-time employees of the company, that they are excluded from its day-to-day management and are appointed by the company because of their personal qualities, in particular because of their independence, they have a higher risk of damaging their personal reputation, and are therefore more inclined to provide voluntary disclosure of information to the public, in order to protect shareholders against eventual opportunistic behaviours of the managers.

Namely because of the independent directors' limited involvement in the company, they will tend to minimize the risk attached to the mismanagement of the company by its managers and will, more often and more easily than company insiders, reduce their exposure risk by always trying to provide the necessary information to the public.

This behavioural assumption is deduced from the inherent qualities and characteristics of independent directors: the independent director's interest to protect his reputation is a guarantee against managers' misconduct. It is important for them, in order to protect their reputation, not only to actually control managers and their actions, but also to let the investors market know that they are really performing their monitoring function. By insisting on voluntary disclosure, independent directors reach the goal of informing the market about the substantial performance of the monitoring duty, and also serves to prevent an eventual responsibility for lack of monitoring, in the event of a firm failure or litigation for frauds. All this plays a function in protecting their reputation, which is the main reason why they have been appointed as independent directors⁶⁷.

However, the reputation rationale is not always enough for independent directors to always disclose information they entered in contact with or to further investigate in cases of potential manager misconduct.

⁶⁷ S. Lim, Z. Matolcsy, D. Chow, *"The Association between Board Composition and Different Types of Voluntary Disclosure"*, University of Technology, Sydney, 2007

Furthermore, the information asymmetry between independent directors and company insiders, such as managers, is almost impossible to completely eliminate because it is a natural consequence of the independence requirement of independent directors.

Because the main reason for appointing independent directors is the need to solve the agency problem, deriving from the conflicts of interests between managers and company shareholders, it is therefore important to establish possible solutions to solve the information gap problem.

Three elements have been considered to be potentially adequate to reduce the informational deficit of independent directors and, as a consequence, adequate to enhance the effectiveness of their role, these elements are: expertise, social ties at the board level and board structure.

A correlation between industry expertise and board effectiveness has received some empirical support. However, the independence criteria laid down by most jurisdictions do not comprise the requirement of industry expertise.

Regarding board structure, the possibility that some jurisdictions give to company to freely choose board structure, in particular between one or two-tier board structures, has different effects on independent directors. Choosing the two-tier board structure enhances the monitoring role but also enlarges the informational gap.

As regards the third element, which is the existence of social ties between the independent directors and other board members, this often serves the function of filling the informational gap.

Actually, informal social connections between independent directors and company executives may have a two-fold effect. On the one hand, it certainly fills the informational gap because it favours a climate of mutual trust that benefits information sharing between managers and independent directors but, on the other hand, it may also have the opposite effect of limiting the independent director's motivation and willingness to verify the executives' actions and, eventually, sanction them.

This last consideration goes back and explains the Delaware courts' attempts, addressed in paragraph 2.2, to affirm that social ties among directors and members of the board are to be considered as possible threats to directors' independence.

CHAPTER 3

Corporate Transactions and the implications of the presence of Independent Directors

3. Dividends pay outs and Independent Directors post Sarbanes-Oxley Act

Dividends pay-outs are considered one of the various methods that can be used by managers to mitigate agency conflicts of interests within the company, as they reduce agency costs mainly for two reasons.

The first reason is that it limits the amount of free cash flow, which could be misused by managers and insiders to finance their own business projects, at the expense of shareholders. The second reason is that dividends tend to expose the company to more frequent inspections by the capital markets.

It is interesting to compare dividend pay-out, which is, as we have previously stated, a mechanism used to reduce agency costs, to another mechanism which has the same goal, which is the requirement of independent directors within company boards. In particular, it is interesting to define whether they are complements or substitutes mechanisms in reducing agency costs.

First of all, it is important to explain what dividends pay-outs are and what is their function within the company. The dividend pay-out ratio is the percentage of the company's net income which is given and distributed among shareholders, in the form of dividends. They are relevant because it gives an insight to investors regarding the company's dividend policy: a high pay-out ratio is suggesting that the company is paying shareholders more than it could comfortably afford, in fact, extremely high pay-outs are rarely sustainable and it

is often the hint that the company is paying more than it earns, usually leading to a dividends cut in the future.

Dividend pay-out ratios can be influenced by a multiplicity of factors: accounting methods might lead to different earning per share, thus establishing different pay-out ratios. Furthermore, the type of business also influences the dividend ratio, as fast-growing companies are more likely to re-invest its earnings into the company, in order to grow the business. This leads these fast-growing companies to distribute low or close to zero dividend pay-out ratios. By contrast, larger and over time well-established companies usually return a higher percentage of company earnings to shareholders.

Dividend pay-out ratios also depend on the industry in which they are distributed. These differences must be always taken into account when using dividend pay-out ratios to financially compare companies⁶⁸.

Determining the company's dividend pay-out policy is one of the most important decisions taken by the board. The board has to decide whether, when and how much cash the company decides to return to shareholders in the form of dividends and therefore decide to not re-invest in the company or in share repurchases, debt reduction or other types of actions that could be using the company's free cash flow.

This decision not only influences the entire company's financial situation, but also has an influence on the type of investors it will attract in the future.

The payment of dividends by a company is, in finance, very much linked to its reputation, as the worth of a company is tied to its possibility to pay dividends to its shareholders; otherwise, of course, there would be no return benefit for the shareholder following the investment of its personal capital in the company.

Even when dividends are not being distributed, there is always at least, the shareholders' expectation of payment of future dividends by the company.

⁶⁸ <http://www.investinganswers.com/financial-dictionary/ratio-analysis/dividend-payout-ratio-1234>

For example, Microsoft did not give any cash back to its shareholders for a very long time, and its stock price kept rising over the years as a result of the investors' guess regarding the value of those future dividends. It was indeed the promise of future pay-outs that kept the company's stock rising.

Given the importance of the distribution of dividend pay-outs in the market, the board has to be very careful when assessing and determining the dividends policy to adopt.

Several considerations have to be carried out by the board: the eventual profit of reinvestments of the surplus cash flow, whether it is responsible for the company to pay out dividends or whether it would be wiser to build and maintain cash reserves to absorb eventual losses or economic instability, tax impositions in the specific time of consideration, compare its dividend policy to those adopted by other companies, in order to attract investors with higher dividend pays than those offered by its competitors.

An interesting difference can be noted as regards dividend pay-outs in English companies and those distributed by companies in the United States.

In the UK, companies tend to distribute dividends on a yearly basis and on the basis of an economic forecast typical of private businesses, thus creating volatility in the dividend rates of many companies.

In the United States, by contrast, the main concern of companies as regards dividend pay-outs to shareholders, is to ensure constant payments to investors, enabling them to constantly rely upon that income. American companies do so by distributing smooth dividends to shareholders, even during productive years, so as to always build reserves and eventually increasing dividends per share at a slower rate⁶⁹.

After having analysed the function of dividend pay-outs, it is interesting to look at the existing relation between dividends and the corporate governance structure,

⁶⁹ *Determining a Company's Dividend Payout Policy*, available at <https://www.thebalance.com/determining-a-company-s-dividend-payout-policy-356100>

in particular after the obligation, imposed by the SOX, to compose boards of a majority of independent directors.

The relation between dividend pay-out policies and measures of governance such as the presence of independent directors or board composition was significant before the enactment of the Sarbanes-Oxley Act, while the situation changed after its enactment, causing the aforementioned relation to change.

While before the SOX shareholders' rights, the proportion of independent directors, board size and managerial ownership proportion were of significance in respect of a company's dividend policy, the Act reduced their significance, because investors choose to rely more on the regulatory effect of the Sarbanes-Oxley Act rather than on corporate governance techniques to ensure that managers operate the company in its best interest.

The Sarbanes-Oxley Act provided for the much needed transparency, via the provision of independent audit committees. As a consequence, investors do not rely on the proportion of external directors anymore, but rely on the law's protection instead, provided by the 2002 federal Act.

In order to prove the different attitude of investors and companies towards the dividends policy before and after the enactment of the SOX, we will compare companies that chose to apply measures regarding independent directors and full independent committees before they became mandatory, as a result of the 2002 Act, to companies that put in place the aforementioned measures only after it was imposed by Sarbanes-Oxley.

As noted early in the chapter, the manner in which public companies handle their free cash flow has been an issue for decades, because it is very easy to give rise to conflicts of interests between members of management as regards the use of free cash flow, which should be used in the sole interest of shareholders, and not in the manager's own benefit.

It is the board of directors that is in charge of decisions regarding dividend pay-outs and, as a result of the many corporate scandals in the early 2000's, the legal

answer to this could reasonably have been to reduce the portion of free cash flow available to management.

As we know, the SOX has imposed many different new requirements on publicly traded firms, and, while some of them already had similar measures in place for the same goal of reducing agency costs and enhancing transparency, others had to restructure their whole corporate governance system and put in place the SOX new requirements from scratch. As a consequence of this, the effect of the SOX on those companies was different, especially as regards the dividend policy.

In particular, it can be noted that there is a positive relationship between increases in dividends paid and changes in board composition when those changes, as for example the imposition of the presence of independent directors, have been imposed by law, and were not pre-adopted by the companies.

Under the SOX, and under the stock exchange listing requirements as well, the powers of independent directors over management are strengthened, through the requirements for greater independence in board composition. Already before the enactment of the SOX, dividend payments were considered an effective tool to measure managerial responsiveness to shareholders' interest, and this function has remained the same after the implementation of the Sarbanes-Oxley Act as well.

It is therefore interesting to determine whether the requirements imposed by the 2002 Act, in particular the obligation to appoint independent directors in board committees, have had a positive impact on management responsiveness to shareholders' interest, and whether this greater responsiveness can be evidenced by the dividend policy adopted, in terms of cash returned to shareholders.

Because dividend policies are determined by the board of directors, these policies are inevitably and inextricably linked with the management's representation of its financial situation and eventual business plans, submitted to the board for revision and/or adoption. Therefore, dividends policies adopted by the board cannot be set or considered separately from the range of possible corporate actions that are being considered by management and that could be developed

into actual business choices and actions, because, of course, those actions will need the company's cash in order to be put in place.

Even though in modern corporate governance the board of directors is expected to act in the shareholders' interest, as it is designed to allow the separation of management and control in respect of the company's most important decisions⁷⁰, several empirical studies show that this mechanism has proven to be inadequate, as very often the task of fiscal supervision and decision-making verification entrusted to the board did not meet the very much hoped result, and led to some major corporate governance failures.

This could be also be linked to the many problems attached to the independence requirement already discussed in Chapter 2, as the absence of any employment relationship between the director and the issuer, as a guarantee for director's independence, does not always ensure independence and, very often these directors might find themselves absorbed by management, and therefore naturally failing their monitoring function.

Through the SOX and the stock exchanges requirements, the US has seen an increase in the use of independent directors.

Having a majority of independent directors in the board, as imposed by both exchanges, helps assure that the board decision will be guided by shareholders' interest, represented by independent directors. The presence of independent audit committees ensures the board's awareness of the company's actual financial position.

By comparing companies which pre-adopted the independence directors requirements before the implementation of the SOX to those that only did so after, it can be affirmed that, looking at data from years prior to the 2002 Act (1993, 1995, 1998, 2000 and 2002), lower levels of shareholder rights were associated with higher dividend pay-outs⁷¹. The greater level of dividends distributed when shareholder rights are low can be explained with the intention to

⁷⁰ Fama and Jensen (1983)

⁷¹ Jiraporn and Ning (2006)

make the payment of high dividends the “counterbalance” to low shareholder rights, with a view to render the lack of those rights more tolerable in the eyes of the shareholders⁷².

As we know, SOX has significantly impacted the way investors and the market in general react to a company’s governance practices. With the enhanced transparency requirements and general strengthened company’s financial knowledge imposed by the SOX, it could be said that the need for dividends as a mechanism to demonstrate the company’s credibility and responsiveness to shareholders’ interest should be found to be reduced.

The substitution effect of dividends pay-outs as an alternative tool to external governance, is stronger prior to the SOX, when companies had an even stronger need to use dividends as proof of their good reputation.

The researches carried out by Jiraporn and Ning show that the impact of corporate governance on dividends is positive and significant and, as shareholders rights get weaker, companies tend to pay higher dividends. This is consistent with the substitution effect of dividends pay-outs, as a reaction to the management’s inability to control the company.

It follows that greater board presentation by independent directors tends to further increase the distribution of cash dividends.

However, the relationship between dividends policy and the governance mechanism represented by the introduction of independent directors is affected by the Sarbanes-Oxley Act. While this relation is significant in relation to dividend pay-outs before 2002, which is the year of implementation of the SOX, it changes direction and becomes statistically insignificant in relation to dividends, following the passing into law of the 2002 Act.

This means that the proportion of independent directors no longer influences companies’ dividends policies, due to the fact that the SOX significantly increased the level of board oversight and management monitoring through the

⁷² T.G. Coville, G. Kleinman, *“Independent Directors and Dividend Payouts In the post Sarbanes-Oxley Era”*, in *“Sustainability and Governance”*, edited by C.R. Lehman, 2015

provision of independent audit committees. This level of accountability, imposed by the SOX, has had the effect of reducing the importance of independent directors in regards of decisions implying the determination of the optimal dividend pay-out.

This change, following the external regulatory interference of the Sarbanes-Oxley Act, implies that investors, who were, previously to the enactment of the SOX, demanding compensation for the limited control in a company through distribution of high dividend pay-outs, seem to rely more on the Sarbanes-Oxley Act rather than on the dividends mechanism to exercise an internal control and force managers to manage the company in its best interest.

This is certainly due to the greater transparency requirements imposed by the Sarbanes-Oxley Act, which also raise managers' accountability and reduces their motivation to act in their selfish interests and mismanage the company⁷³.

3.2 The proposed role for Independent Directors in corporate control transactions

The role of independent directors in take-overs has been particularly significant in relation to banks take-overs, which have been very numerous in the United States in the years between 1990 and 1998⁷⁴, leading the total amount of operating banks in the United States to drop by 30% as a result of take-overs in the last decade of the 20th century.

The take-over market is influenced by a variety of factors, board composition and the presence of independent directors can be considered to be among some of them.

⁷³ M. Bertus, J.S. Jahera Jr, K. Yost, *"Sarbanes-Oxley, Corporate Governance, And Strategic Dividend Decisions"*, Auburn University, USA

⁷⁴ Between 1990 and 1998, the number of bank mergers and acquisitions were of 510 per year, compared to 345 per year in the years between 1980-1989.

Independent directors are meant to protect shareholders' interest because, of course, they tend to be seen by corporate law as mitigators of the management/shareholder agency problem.

It follows that as a result of this protective task, in merger and take-over transactions it is reasonable to expect from them to make decisions more consistently meeting the shareholders' interest and, therefore play a monitoring role in merger transactions as well.

Shareholder's interests are satisfied when, among other things, their economic interest is taken into consideration. It follows that in some instances, shareholders' interest equates shareholder-wealth maximization. This means that, in relation to mergers, merger prices will be expected to be higher when the target companies have a greater proportion of independent or outside directors, in respect to companies who have a fewer percentage of outsiders.

It has in fact been found that non-financial companies that are targets of tender offers, get an initial tender offer premium and shareholder gains when the board is independent⁷⁵.

Other than board independence, corporate governance literature finds other factors as possible influences on the take-over market, these factors are board size and equity ownership by directors or other insiders.

The regulatory environment in which mergers are carried out is also very important. Important changes were brought by the Riegle-Neal Act, affecting the bid premiums offered by acquiring banks and the overall take-over and merger decisions in the United States banking industry.

Going back to the relation between mergers and independent directors, Cotter, Shivdasani and Zenner tend to define a board as being independent when independent directors comprise more than fifty percent of the board.

⁷⁵ Cotter, Shivdasani and Zenner (1977)

However, in average, banks tend to have more than fifty percent of independent directors in their boards and the larger a bank is, the greater will be the number of independent directors within its board.

The empirical study⁷⁶ conducted by Brewer, Jackson and Jagtiani, based on 187 bank mergers carried out in the last decade of the last century, shows that both the regulatory environment and internal factors such as the presence of independent directors had a significant impact on bank merger activities and on the related merger prices as well. Therefore, there certainly is a correlation between independent boards and a greater shareholders wealth, when those independent directors are part of the target company's board⁷⁷.

The general duties binding directors in take-over attempts are the duty to act in good faith, the duty of care, the duty of loyalty and a general duty to act in what directors genuinely believe to be in the best interest of the company and its constituencies.

Negotiated acquisitions such as take-overs and mergers raise complex issues that are not always thoroughly considered and regulated by the law or by the courts.

Corporate statutes assign corporate directors a major role in merger and take-over transactions, both when they are part of the target company and when they are part of the acquiring company, as they must negotiate the terms of the transaction. However, there is a difference between directors of the target and of the acquiring company in respect of the decision-making procedure regarding the merger proposal.

In fact, while directors of the target company have the power to unilaterally reject a merger proposal, they must instead obtain shareholder approval in the event they wished to initiate the merger transaction. This power held by target

⁷⁶ The study was conducted on the basis of data obtained from the Security Data Corporation (SDC), all bank mergers and acquisitions took place between 1990 to mid-1998.

⁷⁷ E. Brewer III, W.E. Jackson III, J.A. Jagtiani, *"Impact of Independent Directors and the Regulatory Environment on Bank Merger Prices: Evidence from Takeover Activity in the 1990s"*, Federal Reserve Bank of Chicago, 2000

directors in regards of the possibility to unilaterally reject a merger proposal brings to light potential conflict of interests issues between the directors and the target shareholders.

This conflicts of interests are due to the consideration that when a merger is effectively carried out, it leads to the disappearance of the former target company, meaning that the target directors will lose their job in the company and the control arising from it. Most importantly, in light of these potential negative effects for target directors, the directors of the acquiring company might take advantage of those concerns and proceed to offer target directors employment contracts or other type of lucrative offers, in order to secure the target directors' cooperation in the merger proposal. As a consequence of this mechanism, the directors of the merger company might be tempted to make a decision on the merger by considering their own interests, thus ignoring the company's best interest and breaching their fiduciary duties.

Some monitor mechanisms have been put in place in order to police target directors' actions more effectively than what has been done by judicial review under alleged breaches of the fiduciary duty standards of loyalty and care, which are very difficult to consistently attack before a court.

These monitors are the shareholders' vote, that will police both the motives and the opportunity of the board's resolution regarding the merger; the market, which affects the merger proposal in an indirect way, by providing to the target companies alternate competing merger proposals or tender offers.

As stated earlier, the courts have been an ineffective monitor of the directors' compliance with their fiduciary duties.

Going back to the conflicts of interests inherently existent in merger transactions, the rules have changed in respect of what was provided in the past, by assigning more powers to directors: modern statutes provide that a majority or a supermajority is required, differently from the former unanimity requirement.

Secondly, even though directors must provide to shareholders a resolution recommending the merger, they can negotiate the terms and conditions of the

transaction with the potential merger partner even before shareholders are informed of the merger proposal.

Therefore, it is safe to say that in regards to merger transaction, shareholders and directors do not have equal powers, the latter not only have a more predominant and formal role in the overall operation, but also play the central and decisive role in a very important aspect of the merger proposal: the reject of the proposal.

Directors can, as mentioned earlier, unilaterally decide on an eventual rejection of the offer, without the need to ask for shareholder input.

However, given the complexity of modern day merger operations and the inability of shareholders, as a large and disparate group, to evaluate the merger proposal from an adequately technical point of view, the question is not whether the major role played by target directors should be eliminated, but whether the monitoring systems watching over directors are working efficiently. Those mechanisms should take into account not only the loyalty of the directors, but the appropriateness of the recommendation's content as well.

The inappropriateness of the reliance on courts' decisions to monitor the behaviours of directors in complex transactions such as those of take-overs and mergers is linked to the application of the business judgement rule in those contexts. In fact, the courts test directors' decisions on the basis of an examination carried out in order to establish whether they have complied with their fiduciary duties, namely the duty of loyalty and the duty of care, which are embodied into the business judgement rule. This examination however, is limited to the decision-making process, and does not extend to their final decision. As a consequence, if directors seem to have complied with their fiduciary duties towards the company during the decision-making process, they will not be considered to have breached any of their duties, regardless of the actual content and fairness of the ultimate decision.

This means that, in court, plaintiffs will have to overturn the business judgement rule presumption, and demonstrate that directors did not really fulfil their duty of loyalty and care towards the company and the shareholders.

It then comes naturally to doubt the effectiveness of courts decisions as an instrument to monitor directors in corporate control transactions, given the inevitable conflicts of interests that these operations carry with them. The conflict of interest arising from the potential rejection of a merger offer by directors only because of their fear to lose their job and their position of prestige on the one hand, and the potential incentives proposed by the bidders in order to secure the target directors' cooperation in the transaction on the other hand, makes it very difficult to believe that the presumption of a just and loyal behaviour embodied in the business judgement rule could be applied by courts in merger transactions.

By analysing the courts' approaches and judgements about the potential liability of the target directors, we can notice some differences among the various judgments. First of all, case law delivers to us a larger number of judgements on hostile tender offers rather than cases involving the mere rejection of a merger offer by target directors. However, these two situations can be considered as being analogous, as both raise inherent conflicts of interests for target directors. Regarding hostile offers, the target directors tend to put in place defensive tactics such as the poison pill, which are not always benefitting the company. Therefore, in both mergers and tender offers target directors are brought before the decision of whether they should allow a transfer of control. In the first case, directors have the statutory power to allow that transfer by recommending the merger, while in the second case, they might block the transfer. This consideration leads to the affirmation that both transactions carry with them conflicts of interests. These conflicts should therefore not be ignored by the courts, and, the logical expansion to this reasoning is that the business judgement rule, which is a powerful presumption, should not be applied by courts to situations that are inherently and inevitably flawed by conflicts of interests.

However, the courts took the opposite approach and traditionally decided that precisely because conflict of interest are inherent in corporate control operations, plaintiffs must prove something more than the sole directors' desire to remain in

control of the company in order to push the courts to rebut the business judgement rule presumption. Moreover, on the basis of this reasoning, courts have decided that plaintiffs should not only bear the initial burden of proof, but must demonstrate additional criteria as well, such as the inappropriateness, from a business standpoint, of any defensive tactic put in place by the target directors, or the fact that directors have acted in bad faith, fraud, or have engaged in self-dealing transactions for their own sake.

Because these judicial standards are very hard to satisfy, especially for plaintiffs, who do not easily have access to the information needed to prove these standards, many scholars and judges have criticized the courts' effectiveness in their monitoring role over target directors.

As mentioned earlier, the judicial approach also depends on the specific US state, in fact, the Delaware Supreme Court has agreed that the application of the business judgement rule to mergers and take-over transactions does not guarantee a proper monitoring of the target directors' loyalty. The Supreme Court went as far as to establish a test⁷⁸ in order to confirm or not confirm the directors' compliance with their fiduciary duties.

The appropriateness of the application of the business judgement rule in corporate control transactions was discussed by the court in the *Unocal Corporation v. Mesa Petroleum Co.*⁷⁹ case. The court affirmed its view by stating that "the omnipresent spectre that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders, there is an enhanced duty which calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred."⁸⁰

As a result of this change of approach, the test ideated by the Delaware Supreme Court transfers the burden of proof from the plaintiff to the target directors.

⁷⁸ The *Unocal* test

⁷⁹ *Unocal Corporation v Mesa Petroleum Co.* (Delaware 1985)

⁸⁰ 493 A.2d at 946 (Delaware 1985)

According to the test, directors have to prove the reasonableness of their actions in the event that they put in place defensive tactics in order to block the tender offer, by demonstrating that 1) the board acted in good faith and had reasons to believe that the takeover offer presented danger to the corporation and its policies, 2) that the defensive tactic actually applied was proportional to the danger presented by the tender offer. If the board demonstrates both test requirements, the burden of proof will then shift from the board back to the plaintiff, who will then have to prove that "by a preponderance of the evidence that the directors' decisions were primarily based on perpetuating themselves in office, or some other breach of fiduciary duty such as fraud, overreaching, lack of good faith, or being uninformed.. "⁸¹.

The Unocal test developed by the court can be, at first sight, considered as an important achievement for target shareholders, who are far more protected by the burden of proof laying on target directors than they were by the business judgement rule.

In this respect, the Delaware Court affirmed that the Unocal test developed a "more flexible, intermediate form of judicial review"⁸² between that represented by the evaluation of the fairness of the board's decision, and the one relying on the total deference to the target board's decision, required by the business judgement rule. This is true if we consider that the new test requires target directors to prove three components: good faith, a danger for the corporation and a reasonable investigation conducted by them. The first two components imply director's loyalty and therefore the potential compliance with their duty of loyalty, while the last one is a reference to the correct exercise of the duty of care.

However, looking more closely, it can be concluded that this test developed by the court is only superficially more protective of the target shareholders interest than the business judgement rule is, as the first two requirements can hardly be

⁸¹ Unocal, 493 A.2d at 958 (Del. 1985)

⁸² AC Acquisitions corporation v. Anderson, Clayton & Co. 519 A.2d 103 (Delaware Chamber 1986)

considered as being guarantees of directors' loyalty. Regarding the element of the danger for the corporation and its policies, that is actually a "non-requirement" or rather an insignificant one, because the directors will always be able to find at least one conflict between one of the company's policies and the bidder.

The good faith requirement is not very effective either, as it simply requires directors to genuinely believe that a danger to corporate policies exists. The vagueness of both components of the test's first prong allows target directors to easily demonstrate what is required for them to get freed of the burden of proof. The second prong requires that the defensive tactic is reasonable in respect of the danger envisaged by the company as a result of the take-over. This requirements, however, implies that it will be the court's task to judge on the reasonableness of the decision taken by the target directors. Courts however do not easily engage in reviewing substantive business decisions, leaving, as a consequence, a significant discretion and latitude to directors as what is considered "reasonable" within the take-over transaction and, as a consequence only invalidating decisions which are blatantly unreasonable.

The fact that the majority of target directors' decisions regarding the employment of defensive tactic have been upheld by the courts, when accompanied by evidence of due care by the directors, can be used as evidence of the ineffectiveness of the Unocal test.

A further consideration that serves the purpose of supporting the idea of the ineffectiveness of the Unocal test relates to the points that have to be proven by the plaintiffs once the target directors have, through the Unocal test, demonstrated the reasonableness of their decision.

In fact, once the burden of proof has, as a consequence of the satisfaction of the Unocal's requirements by target directors, shifted to the plaintiff, they have to prove that the directors were either 1) lacking good faith, 2) lacking adequate information regarding the transaction; 3) motivated by the primary motive of perpetuating themselves in office; 4) fraudulent; or 5) overreaching.

The first two of these components, which are good faith and the lack of adequate information by directors, are actually what has been negatively proven by the target directors and what has permitted the shift of the burden of proof to the plaintiffs. Therefore the first two requirements cannot be reasonably proven by the plaintiffs. Similarly, the third criterion cannot be easily proven by the plaintiffs because at this point the court will have already accepted the directors' argument regarding the presence of a potential danger for corporate policies.

As a result, only the last two requirements are to be considered useful for plaintiffs to prove their point, after the directors have met their burden of proof.

These last two criteria- the fraudulent nature of the directors actions or their overreaching nature- match the traditional requirements which were comprising the burden of proof bearing on the plaintiffs in corporate control cases.

In conclusion, even though the Delaware Supreme Court has acknowledged that corporate control transactions such as hostile take-overs and mergers inherently comprise a conflict of interest situation for target directors, and has required directors to provide evidence that the decisions regarding the transaction have been taken for professional and corporate reasons rather than for personal ones, the test developed by the Court is too vague and in practice inefficient.

In fact, the only substantive component of the Unocal test is the obligation for target directors to prove that they have complied with their duty of care. This duty, however, can be conveniently satisfied by dedicating enough time and attention to the decision-making process. Nonetheless, providing enough time and attention to a certain decision does not equate to successfully emptying that decision from any potential conflict, and therefore may anyhow lead to a decision matured and taken in bad faith.

What is really at stake in corporate control operations is not the target directors' care, but their loyalty. By providing for such requirements, the Unocal test and consequently the courts have not been able to appropriately protect target shareholders and their interests. Thus, judicial review is ineffective in its monitoring function. Furthermore, given the similarities between hostile take-

overs and mergers, the same judicial approach can be expected to be applied in cases where the target directors have unilaterally rejected a merger offer.

In fact, the Delaware courts have very often tolerated the implementation of defensive tactics by the target directors. The practice of using defensive tactics in order to avoid a merger or a take-over indirectly weakens the monitoring activity of the market in respect of target directors behaviours.

There is an important difference of regulation of merger approvals and merger rejections: corporate statutes provide that any merger transaction, in order to be approved, has to pass by shareholders vote who will therefore have a veto power in the event that the target directors have made a merger recommendation that seems unwise or motivated by personal interests.

By contrast, target directors can reject a merger offer without giving shareholders the opportunity to vote on the transaction. As a consequence, not only the merger transaction will be much more exposed to unfair behaviours by directors because of the inherent conflict of interest, but it will also weaken the monitoring function exercised by the market. This happens because if directors have the unilateral power to reject the merger, the market will not have the opportunity to provide the target shareholders with alternative competing merger bids or tender offers.

The rejection of a merger offer by target directors would not be a problem if there was an effective monitoring entity or mechanism that would ensure that directors made the rejection decision by complying with their fiduciary duties but, as stated earlier, the Delaware courts have not been an efficient monitor in this respect. Moreover, the tendency of the same courts to tolerate defensive tactics implanted by target shareholders goes even more against the target shareholders interest. The courts have, quite ironically, increased directors' power in corporate control transactions, especially in cases of rejection of a merger offer, because of the statutory provision enabling directors to decide on the transaction, by rejecting it, without the involvement of shareholders. The Delaware court went as far as stating that "the function of the court is not to

define the terms of the negotiation in advance or even to suggest further negotiation if, in the board's judgement, further negotiations with either party are not in the interests of shareholders"⁸³. This statement by the Court gives the idea that the rejection of a merger by the target directors has to be considered as an ordinary business decision, giving directors a very wide latitude in making these kinds of decisions, in a context in which, as demonstrated, is lacking an effective monitoring mechanism.

As mentioned earlier, the significant freedom left to target directors to decide on corporate control mergers by unilaterally rejecting them or by implementing defensive tactics and tolerated by the courts, makes the other monitoring mechanism, the market, quite ineffective. If the market is meant to monitor over directors by offering alternative competitive bids to shareholders, the enactment of defensive tactics by the target directors will make it impossible for other bidders to enter into contact with the target shareholders, leading the entire mechanism to fail.

Courts, in conclusion, are an ineffective tool in watching over shareholders interest by second-guessing directors' decisions in corporate control transactions, not only because of the establishment of empty requirements in order for directors to prove the absence of any conflict of interest as explained earlier in the paragraph, but also because of their tendency to accept tender offer defensive tactics quite easily, without conducting a proper and thorough control to ensure the target directors loyalty towards the company's interest.

We can therefore conclude that the structural monitor over directors' loyalty does not work because there is no efficient verification of their good faith and loyalty when making decisions, and the market monitor does not work either, as a consequence of the court's approach in over-tolerating defensive tactics, which block any market intervention in the considered corporate control transaction.

⁸³ MacAndrews & Forbes Holdings v. Revlon, Inc. 501 A.2d 1239, 1251 (Delaware Chamber 1985)

When looking for a solution to this problem, one has to bear in mind that management, and therefore the target directors, is the only body who is capable of making business decisions in regards of corporate control transactions, because of their expertise and knowledge of the company but, the central issue is that, namely because of the significant powers and economic profits at stake, directors must deal with an inherent conflict of interest.

The only solution to this complex issue seems to be the exclusive employment of independent directors to make decisions on corporate control operations.

The target independent directors will have the task to deliberate, negotiate, accept or reject merger proposals. The decisions should be taken by the majority of independent directors.

Independence in this case should be measured with the absence of any economic interest in the merger or any familial relationship with a corporate non independent insider. This rule would protect shareholders interest in a corporate environment in which, given the statutory provisions and the judicial attitude, they seem to be negatively affected by the inevitable conflict of interest borne by target shareholders. This rule involving independent directors would satisfy the need for a well-thought business decision, which can only be made by persons having expertise in the business field, in this case independent directors, without the participation of those directors who have an actual or potential conflict of interest. Independent directors can negotiate with the bidders, because of their experience and technical knowledge, without the involvement of any conflict of interest from their part, because of their independence.

Interestingly, both corporate statues and court judgements have encouraged the use of independent directors as a way of monitoring over conflict of interests transactions.

Regarding corporate statutes, the Delaware Code states that a conflict of interest transaction is not void nor voidable solely for this reason, if the conflict is

disclosed to the board of directors and approved by a majority of disinterested directors, even if the disinterested directors are less than the quorum⁸⁴.

Case law has also played a significant role in enhancing independent directors' vote in merger transactions: in *Unocal v. Mesa Petroleum*, the Delaware court stated that the target directors' burden to prove their good faith and loyalty in the employment of a defensive tactic was materially strengthened by the fact that the defensive tactic had been previously approved by a board comprised of a majority of outside directors, who, in the *Unocal* case, had separately met with some of the company's advisors and unanimously agreed to approve the adoption of the tender offer defensive tactic. The court, by facilitating the target director's burden of proof because of the previous approval by outside directors, has indirectly, or quite directly, recognized the important monitoring function of independent directors in corporate control transactions.

Another example of the importance given to independent directors by the Delaware court can be found in the *Weinberger v. UOP, Inc.* case, which involved a parent-subsidary cash-out merger. The court, in this case stated that the majority shareholder failed to appropriately consider the minority shareholders of the subsidiary and, additionally, suggested that the situation would have been much different if the subsidiary had appointed a negotiating committee comprised of outside directors, in order to deal and negotiate the entire operation, further enhancing the potential role of independent directors, in this case to alleviate the inherent conflict of interest in parent-subsidary merger terms and conditions.

However, the use of independent directors and independent committees to fight directors conflict of interests in corporate control transactions, raises the same concerns that are present wherever independent directors are put in place to contrast opportunistic behaviours: it is crucial that they are really independent.

⁸⁴ Delaware Code Title 8 § 144(a)(1) Interested directors; quorum.

Shareholders representation by independent directors is a viable and effective solution only if the directors are substantially independent, not only formally.

While the typical remarks that have been made in the corporate world in regards of the ineffectiveness of independent directors make valid points, they do not have the same effect if put in respect of acquisitions operations such as mergers and take-overs.

In particular, the use of independent directors as a monitoring tool over management is heavily criticised because these same directors, who are supposed to have a watchdog function over insiders, are actually selected and appointed by the same management body who is supposed to be the recipient of that monitoring activity. This might push independent directors to not be entirely objective about the actions of management, in order to obtain further benefits, of economic or employment nature, from inside directors.

These concerns, however, do not apply in the acquisition context because what is at stake in corporate control transactions is not the management's actions, but the merger proposal itself.

In fact, what independent directors are called to perform in merger transactions, is not the ex-post supervision of actions executed by management, but it will be the taking into consideration and the negotiation of merger proposals. Furthermore, this will be an easier task for them because they will only have to deal with one acquisition proposal at a time, instead of having the burdensome duty of supervising the general performance of management.

By providing independent directors with the function of dealing with corporate control transactions, and entrusting to them the decision-making process, the issue of directors' loyalty in merger transactions could be solved, and it would also indirectly and positively affect the monitoring function of the market.

This solution is particularly optimal in merger rejection cases because the structural monitor, which is the need for shareholders vote and therefore approval, is not operative in these cases.

By completely excluding inside directors from the decision-making process related to mergers, and assigning this task exclusively to independent directors, some problems may nevertheless arise. These problems are linked to the inevitable information gap which characterizes independent directors, discussed in the previous chapter. Insiders certainly know more about the corporation than outsiders do, and, if the former are not able to provide any kind of input on the operation, the operation itself might not meet the best interest of the company because of eventual miscalculations due to the lack of company knowledge from the part of independent directors.

This information problem can however be easily solved by relying on some form of expert recommendation on the transaction, provided by external experts or, if that, by relying on recommendations made by the management itself, allowing independent directors to make informed and business-wise choices⁸⁵.

If provisions regarding the role of independent directors in corporate control transactions do not get enacted, it implicitly means that the entire system is flawed and destined to inefficiency. This is because every statute that regulates conflict of interest transactions places the burden of proof of the fairness of the operation upon directors. Considering that the situation of a directors conflict of interest arising from corporate control transactions has been explicitly recognized by both statutory law and case law (Delaware courts), it follows that if they are not called by law or by the court to prove the fairness of the merger transaction, in case it has been unilaterally rejected or blocked by defensive tactics, it automatically contradicts and empties of value every statute provision generally binding directors to prove the fairness of conflict of interest transactions.

⁸⁵ J.J. Johnson, M. Siegel, *“Corporate Mergers: Redefining the Role of Target Directors”*, University of Pennsylvania Law Review, 1987

3.3 Transactions with related parties

Related party transactions are transactions between the company and a “related” party, which is a term used to comprise several company insiders who have an influence over corporate decisions and may, due to this influence, have a possibility to negotiate and secure better terms for themselves regarding the transaction, possibly emptying the deal from any kind of economic benefit for the company. The fact that these parties already have a role into the corporate decision-making processes, and therefore have a certain degree of power inside the corporation, will allow them to seize better opportunities from the transaction, compared to what they would be able to gain from it if they had to follow the operation from an ordinary shareholder’s point of view.

Related party transactions are, for this reason, a very effective instrument to divert value from a company by those in control, which, depending on the ownership structure, might be dominant shareholders or, when ownership is sufficiently dispersed, managers.

The reason why transactions with related parties are effective instruments to detract value from the company, and therefore bring many concerns regarding the fairness of their terms and consequences, is because these transactions are in general legitimate business transactions: company value is not given away for free, something is in fact given in return for that value. It is therefore a legitimate business transaction.

However, the problem lies in ensuring that what has been exchanged in the related party transaction is fair, and in making sure that what the company receives in exchange of what has been given away is, at least, worth the same as the latter.

Considering that the other party of the transaction is someone who has a significant influence in the company as well, it is not hard to fathom the idea that the related party might have diverted the company’s business decision in a way as to meet his own personal economic interests.

In order to determine whether the transaction is fair from the company's viewpoint, it is necessary to assess the merits of the transactions by considering the interests of the company, such assessment becomes very complex when it is done by third parties, who do not have a complete understanding of the corporation's business choices and needs. This task will be even more complex if performed by a court, as a court will certainly not have the expertise or knowledge necessary to understand and analyse certain business strategies, which might be at the heart of the related party transaction and therefore give a purpose to the entire transaction.

Because of the abovementioned complications, related party transactions are specifically regulated around the world, and some jurisdictions have provided for specific rules to address them, in order to free these transactions from eventual bias coming from the related party.

Transactions with related parties are very common in every jurisdiction, and both the United States and European countries have tried to put in place techniques to avoid these transactions to be of damage to the company.

For example, in the UK, procedural steps have to be closely followed when a related party transaction is in place. More specifically, the UKLA⁸⁶ Listing Rules have imposed some safeguards which require specific disclosure from companies with a premium listing whenever they are to engage in a transaction with related parties and the transaction in question is to be considered substantial. Specifically, whenever a certain transaction reaches a certain size, it will not have to be considered to be part of the "ordinary course of business" and requires certain safeguards such as (1) full disclosure before their finalization, in the form of a circular to be sent to shareholders, (2) a statement by the board stating that the transaction is fair and reasonable and that the directors have been so advised by a sponsor, (3) approval by the shareholders meeting, which further has to

⁸⁶ UK Listing Authority (UKLA)

ensure that the related party does not vote in the approval resolution, and neither do its associates⁸⁷.⁸⁸

The European Commission has also issued a proposal in order to supplement the Shareholders Directive by harmonizing the rules on related party transactions throughout the EU Member States, its main proposed strategies are ad hoc disclosures and approval by shareholders meeting⁸⁹.

In order to correctly identify the possible efficient legal strategies to avoid related party transactions to only serve as a tool for opportunistic behaviours by corporate insiders, we should first analyse the reasons behind the very common and spread out use of these transactions as a way of depriving the companies from their value.

Very often, countries, but more specifically their governments, do not perform a very good job at being business-friendly and as a result, they create a hostile environment for companies, who will not be able to develop their business without having to face several difficulties, most of them coming from business-hostile laws. In addition to laws, obstacles to the company's business might also derive from courts, which are often slow and do not have a precise case law or organic judiciary position on corporate issues, making the court's remedy unpredictable and therefore not a reliable solution for companies.

This will push the companies to try to differentiate their business, by investing into different companies as a way of keeping their value and not lose it as a consequence of the weaknesses and regulatory failures of the institutional framework. By securing its value into other companies, which will be owned by

⁸⁷ UKLA Listing Rules, *Chapter 11 "Related party transactions: premium listing", Section 11.1.7*

⁸⁸ These rules have been further strengthened and apply in addition to the Companies Act 2006 obligations for conflicted and shadow directors and are complemented by periodic disclosure requirements on related party transactions in accordance with International Financing Reporting Standards.

⁸⁹ European Commission, Proposal for a Directive of the European Parliament and of the Council amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement and Directive 2013/34/EU as regards certain elements of the corporate governance statement

the original company but will still be legally considered “third parties” or by entering into transactions with the company’s owner himself, the company will have pursued the goal of minimizing the risk of having its value seized or expropriated by the government or by creditors.

As a result of the often fragmented and hostile institutional framework, it is more convenient for companies to be structured as a group of connected, but formally and legally separated entities, typically with a holding company in charge of financial operations and many other operating subsidiaries. Once this kind of company structure becomes the norm, transactions with related parties will comprise the majority of transactions operated by the company and thus become the norm as well. In fact, when the company has this group structure, it will be even more complex for external third parties to find related party transactions suspicious, making it very easy for these kind of companies to get away with such transactions.

Even when countries do not possess the aforementioned business unfriendly features, related party transactions are still viewed as the perfect tool to move the company’s value elsewhere, first, because they are legally considered as legitimate business transactions, and second, they are not taxed as corporate distributions, because they are not considered to be a form of distribution among the company itself, unless proven otherwise by third parties such as courts or other persons put in place by the law to specifically overview related party transactions.

It is worth mentioning that transactions with related parties may also bring benefit to the company, thus creating value for every party involved. This happens because usually transactions with external parties bear higher costs for the company, as information obligations for both sides is more costly.

This further consideration makes it harder for third parties to assess in a complete manner whether the transaction is fair or not, because many aspects of the transaction must be considered in order to exclude without any doubt that the

transaction in question does not benefit the company and therefore has been concluded for the related party's own personal interest.

Whether this third controlling party is the company's minority shareholders, the company's audit committee, financial analysts, independent directors or the public in general, will not only have the task of evaluating whether the transaction is being concluded on fair terms, but also have the task to try to understand if it would be possible for the company to gain greater value if the transaction were to be carried out with a third party, who would offer a higher price than that settled in the related party transaction.

All of this analysis would entail the calculation of the costs that the company bears when operating with a related party, and compare those to the costs that would arise if another external buyer were to be considered for the transaction.

A theory could be brought forward to our consideration, and this theory relies on the eventual justification of related party transactions by minority shareholders, who could, in a way, accept the private benefits that dominant shareholders may derive from such transactions, as a way of counterbalancing the entrepreneurial contribution of dominant shareholders to the company. In short, minority shareholders could just accept the fulfilment of the dominant shareholders' or managers' personal interests, in so far as this is compensated by their contribution to the company, which results in the profit of minority shareholders, if the company is well-run and dividends or assets are distributed.

Even if we accept this theory, the evaluation of the fairness of a related party transaction would still be complex as private benefits extraction is hard to verify by a court or a third party, this is because dominant shareholders would never be truthful in disclosing the amount of value they are extracting from the company, thus making it impossible to verify the correct counterbalance of "gives" and "takes" by controlling shareholders or managers.

No legal regimes explicitly take into consideration this "give and take" view of private benefit extraction but anti-tunnelling provisions are wide-spread around the world. Tunnelling can be defined as an illegal practice in which a dominant

or controlling shareholder or a corporate insider such as a director targets company assets or future business opportunities to himself, for his own personal gain.

Therefore, related party transactions are, if conducted unfairly, an example of tunnelling, and many jurisdictions provide for specific regulation addressing related party transactions as such. Regulations address transactions with related parties as such, without dealing with the issue in more general terms through provisions regarding tunnelling or conflict of interest transactions, because related party transactions have some distinctive features which differentiate them from other conflict operations. These particular features can be identified by looking at the definition of such transactions.

According to the International Financial Reporting Standards, a related party transaction is “a transfer of resources, services or obligations between a [corporation] and a related party, regardless of whether a price is charged.”^{90,91}

The key component of this definition is the term “between” and therefore, no related party transaction exists if the company is not a party to it. Thus, many transactions which might potentially be considered as tunnelling, do not qualify as related party transactions because they do not directly involve the company. These transactions are, among others, internal tender offers, by which a controlling shareholder intends to purchase all the shares he does not yet own and take the company; and insider trading instances, which relate to the purchase of shares on the basis of inside information, not known to the public.

Another qualification requirement, according to the International Accounting Standard 24, is the involvement of “resources” into the transaction, thus when the transfer of value happens to transfer something different than a resource, the transaction is not to be considered as a related party transaction.

⁹⁰ International Accounting Standard 24.

⁹¹ International Financial Reporting Standards were previously known as International Accounting Standards. Those adopted prior to renaming, kept their original name.

The differentiated regulatory treatment that related party transactions experience is therefore justified. However, the downside of this regulatory approach is that the dominant shareholder or director, when deciding on the technique to perform to expropriate value from the company, will be able to choose the less stringent regulated one. If, then, the law prescribes that the rigorous provisions on related party transactions have to be complied with when the company engages in a parent-subsidary merger, the controlling shareholder will logically choose to initiate a tender offer followed by a squeeze-out instead, as much looser rules apply to the latter operation. Nevertheless, it is important to provide for a different regulatory framework for related party transactions and to not consider them as comprised within the more general term of “conflict of interest” transactions, as it is more difficult to individuate a transaction flawed by a conflict of interest, as it often left to a subjective consideration rather than an objective evaluation.

Turning to legal strategies against corrupt related party transactions, it is important to set up a framework that is still able to take into consideration not only the risk of opportunistic behaviours and thus try to minimize that risk, but to consider the possible value-creating element of the transaction in question as well.

The different legal techniques put in place by some jurisdictions are prohibitions, procedural safeguards, external independent advice and disclosure requirements.

The most basic strategy to deal with the problems arising out of related party transactions is to simply prohibit them as such. But, as it is easily understandable, this would also take away the one good thing that might come out from such transactions for minority shareholder, which is the value-creating feature.

The procedural safeguards technique is a less extreme solution to the issue of transactions with related parties compared to the prohibition technique. These safeguards lay down rules regarding the practical process of entering such transactions, providing for rules on how to initiate and further conduct them.

Some of these procedural standards apply to related party transactions as such, as in the case of Italy, or differentiate on the basis of the identity of the related party, depending on whether it is a director or a controlling shareholder, this is the case of Belgium.

The most important safeguards, which are worthy of being mentioned here, are the approval by independent shareholders and approval by independent directors. Many jurisdictions support the idea that the most effective legal technique is the requirement of a shareholders' approval, and ensuring that the interested related party does not vote on the resolution. The approval resolution must be the result of actual and truthful votes by shareholders and must be voted on by the meeting after the shareholders have been thoroughly informed on the transaction, having had full disclosure of the relevant material about the related party transaction by the controlling shareholders or the directors.

However, the requirement of approval by the majority of shareholders does not always ensure the exclusive pursuit of the company's benefit, as sometimes shareholders will not approve the conclusion of a fair related party transaction, in the sense of a transaction in the best interest of the company. This might happen when shareholders' knowledge is flawed, which will make them incorrectly evaluate the worth of the asset to be sold or acquired by the corporation. Furthermore, the costs that arise from the need to obtain shareholders' approval, would sometimes make the transaction less convenient than it would be if all these procedural requirements were not to be applied, including the downside coming from the longer time to be spent on the single transaction, alongside the publicity needed to conclude the operation, such as informative statements on the transaction, to be sent to shareholders before the meeting is held.

All these considerations make us lean towards the other instance of procedural rule, which relies on independent directors evaluation, and which brings us to the heart of our analysis on related party transactions.

The intensity of the involvement of independent directors into related party transactions is different among jurisdictions. Belgium limits it to intra-group

transactions while the United States, through Delaware case law, only recommends it, however differentiating the requirements depending on whether the related party is a director or a controlling shareholder.⁹²

In the case of Italy, independent directors' mark in such transactions is required. First, the Italian Corporate Governance Code recommends the audit committee to lay down the rules for the approval and the performance of related party transactions, which have to be, according to the Code, approved after the audit committee's opinion and/or with the assistance of independent experts⁹³.

In 2005, following some corporate scandals (Parmalat, Cirio), the Italian Code was amended and a new provision on related party transaction was introduced, which requires listed companies to comply with the Consob requirements, issued regarding such transactions. The Consob had, in fact, strengthened procedural requirements attached to related party transactions and provided for a more comprehensive disclosure framework.

The stringency of these rules is graduated depending on the materiality of the transaction, which is the size of the transaction related to that of the company⁹⁴.

Disclosure, which is the main tool used by the Consob regulation, is more or less demanding depending on the materiality of the transaction, which is to be evaluated case by case.

Either of two procedures has to be followed for the approval of the related party transaction. When the transaction in question is below the threshold of materiality, the approval must pass through the advice of a committee of unrelated directors, with a majority of independent directors, regarding the substantial fairness of the transaction. However, the committee's opinion does

⁹² L. Enriques, *"Related Party Transactions: Policy Options and Real-World Challenges (With a Critique of the European Commission Proposal)"*, European Corporate Governance Institute, Working Paper n. 267/2014, October 2014

⁹³ Codice di autodisciplina, 9.C.1.

⁹⁴ The size of the transaction can be evaluated on the basis of three ratios, the most relevant one is the ratio between the transaction's consideration and the listed company's market capitalization.

not bind the body responsible to approve the transaction, whether it is the CEO or the general board of directors. Therefore, even if the committee's opinion did not support the conclusion of the transaction, it can still be performed, with the only consequence of the obligation to disclose the transaction in question in the quarterly report.

Independent directors' role is much more significant when the transaction is considered material. Independent directors must be involved in the transaction even prior to its conclusion, they have to participate in the negotiations and therefore must receive an adequate information from the executive directors, and eventually share their point of view. Secondly but most importantly, the committee of independent directors has a veto power over the related party transaction. It follows that the board of directors will not be able to close the transaction without the relevant independent directors' favourable opinion.

However, the Consob regulation still provides for significant opt-outs possibilities for companies, allowing them to better adapt the related party transaction provisions to the specific company environment, by for example giving more powers to shareholders and eventually permit the related party transaction even when a negative advice is given by independent directors, provided that a majority of unrelated shareholders approve it⁹⁵.

Turning the analysis to the United States, the SEC has, in 2006, amended and strengthened the disclosure requirements for related party transactions.

It is required that any transaction over \$120,000 in which the company is a party, or with any related person who has an indirect or direct material interest, must be disclosed. Regarding the definition of "related person" according to the SEC, the term encompasses directors, executive officers, five percent shareholders and their immediate family members, including stepchildren and those living in the same household.

⁹⁵ M. Bianchi, A. Ciavarella, L. Enriques, V. Novembre, R. Signoretti, *"Regulation and self-regulation of related party transactions in Italy"*, Consob, January 2014

Regarding the approval of the related party transaction, US rules are less precise than the ones laid down by the Italian regulatory body. The NYSE Listing Company Manual provides that “Each related party transaction is to be reviewed and evaluated by an appropriate group within the listed company involved”⁹⁶, without however specifying which body is compelled to perform this task. The provision continues by advising that the body responsible for such approval should be the Audit Committee or another comparable body.

Given the well-known risks arising out of related party transactions, it is advisable, both under the Exchanges rules and Delaware case law, to turn to special committees as a way of minimizing not only opportunistic behaviours, but possible director liability as well. The implications of the use of a special committee in the approval of related party transactions and conflict of interest transactions in general, has a procedural consequence on the burden of proof, which, in this case, shifts from the parties defending the transaction to the plaintiffs, who will have to demonstrate that the transaction is not fair. The shifting of the burden of proof applies when the transaction in question is subjected to the entire fairness standard by the court, which will be further discussed in Chapter 4.

Another interesting topic related to independent directors within the regulatory area of related party transactions, is the event in which the related party is actually an independent director.

Both NYSE and Nasdaq rules have explicitly configured and regulated such situation. First and foremost, it is important for companies that are engaging themselves in such a transaction, to ensure that the director in question is really independent. In order to determine that, both the Exchanges laid down a bright line test which excludes some types of transactions from being considered as carried out with independent directors: the NYSE states that a director does not qualify as independent if the transaction in which he is participating is worth

⁹⁶ Section 314.00 of the NYSE Listed Company Manual

more than \$1 million or two percent of the other company's gross revenues. Nasdaq, on the other hand, establishes the line at \$200,000 or five percent of the other company's gross revenues.

When the related party satisfies the independence requirement, the transaction will not be considered as a related party transaction, and therefore it will be comprised in the exempt transactions that can be either be exempted by the law or by the company's statements, within certain limits set by law. When transactions are exempt, they will not be subject to the rules and safeguards provided by law. Even though the exclusion of transactions with independent directors from the application of the regulation on related party transaction is not provided by law, some companies have borrowed, for this intention, the independence listing standards of NYSE and Nasdaq and have set up exempt policies which exclude, for this matter, commercial transactions with any entity where the related person is not employed in an executive position, using the same thresholds which are used in the listing standards.

De facto, this will mean that when a director is to be considered independent, he will be able to enter into a transaction with the company without the burden of the application of the related party transactions regime.

As a consequence, the rules laid down in the listing standards will then be useful not only to determine director independence, but also as an additional lens through which a transaction can be inspected, and eventually preclude the application of the safeguards and disclosure requirements set down for related party transactions⁹⁷.

As we have seen, independent directors involvement varies in intensity. The weakest involvement is that provided by Belgian laws and that, however only limited to smaller transactions, in Italy, in which independent directors are only required to express an opinion, which is nonetheless non-binding. This will give the dominant shareholder the opportunity to participate in the decision making

⁹⁷ N. Chiu, R. Truesdell, "Disclosure and Approval of Related Party Transactions: Examining the Revised Regulations", The Corporate Governance Advisor, Volume 17 Number 3, June 2009

process without any particular dependency on other people's decisions in regards of the performance of the transaction.

Involvement is stronger when the approval of the transaction has to be given not only by the board, but also by a majority of independent directors. If independent directors have a veto power, this will mean that the conclusion of the transaction will depend on their favourable vote and, therefore, the related party involved will not be able to pursue his own interest in spite of the company's benefit.

However, as mentioned earlier in this chapter, the strongest form of involvement is that developed by Delaware case law, which supports the use of "independent negotiating committees" (or special committee), these committees will be fully involved in the negotiation of the transaction and will therefore have better information, thus reducing the cost of the overall transaction and enhancing the probability of the efficiency of the committee's decision on the transaction, which is more likely to be meeting the interest of the company⁹⁸.

The European Union is well-aware of the challenges linked to transactions with related parties and, in 2014, the EU has issued a proposal⁹⁹ to amend the Shareholders Directive in order to further regulate such transactions. The basis of such proposal is the belief that shareholders do not have a sufficient power in transactions with related parties, this is due to the lack of information and the lack of effective tools to eventually oppose transactions, in the event in which they appear as abusive. The proposal in question establishes three different regimes depending on the size of the transaction: if the related party transaction represents less than one percent of the company's assets, it is left unregulated; if the transaction constitutes more than one percent of the company's assets, companies will then be obliged to publicly announce such transaction whereas if the transaction is worth more than five percent of the company's assets, the related party will not be allowed to vote.

⁹⁸ M. Bianchi, A. Ciavarella, L. Enriques, V. Novembre, R. Signoretti, *op. cit.*

⁹⁹ See note 86

Furthermore, the proposal leaves to the Member States the task of laying down the sanctions in the event of non-compliance with the national rules adopted in accordance with the Directive.

The proposed rules however do not appear to be very effective, this is due to the fact that they are under-inclusive, as they tend to exclude many transactions from the application of the Directive and, also, they provide for very weak safeguards.

The amendments to the Shareholders Directive, which is currently in its final stage, has been heavily criticised as it focuses on disinterested shareholders, by attributing to them a veto power for related party transactions, in an attempt to solve the agency problem between majority and minority shareholders.

However, it is well-known that decisions taken by minority shareholders do not always meet the company's best interest because of the lack of information and their possible apathy towards the decisions regarding the management of the company. Furthermore, they might be considered as possible tools for leverage by opportunistic activist hedge funds, who may use strategies to pursue their own interests.

The root of this criticism is then, easily understandable. The efficiency of the strategy relying on minority shareholders approval is doubtful¹⁰⁰ and a solution closer to that laid down in the United States, which provides for the possibility of boards to delegate the negotiation and conduct of the transaction to special committees, seems more appropriate to solve the risks of opportunistic behaviours in related party transactions, all by still making sure that the decision is informed and is not influenced by other parties, which is likely to happen when minority shareholders are in charge of the approval¹⁰¹.

¹⁰⁰ European Institutions have responded to this criticism by stating that Member States still have the option of opting for board approval instead of a majority of the minority shareholders vote, which allows the Directive of being more adjustable to the different legal and economic framework of the European Member States

¹⁰¹ A. Tarde, *"The Upcoming European Regime on Related Party Transactions in Light of Agency Theory"*, 5 April 2017, available at www.law.ox.ac.uk

3.4 Non-Compete Clauses

In the United States, many contracts include a “non-compete” covenant, which is a clause inserted to protect certain interests of the employer. In fact, the non-compete clause prohibits the employee to enter into a competition with the employer. Such covenants are very necessary in these types of principal-agent relationships as the employee, in this case, will be often exposed to confidential information and information about business strategies or intentions, making it important for the employer to ensure that such information will not be disclosed or used against him during or after the employment relationship terminates.

The insertion of such covenants in an employment contract, however, may turn in disfavour of the employee when the non-compete clauses are too broadly formulated. It is important that the clause is reasonable, such reasonableness can be determined by considering several factors, including the duration of the restriction, geographical limitations and the nature of the restricted activity.

More importantly, in order to determine whether a non-compete clause can be enforced, courts tend to ensure that a legitimate business interest is present, and that the clause in question was meant to protect such legitimate interest.

Given that the enforcement of non-compete clauses is governed by contract law, and considering that each US state has its own contract law, such enforcement will vary among states and their dominant case law.

The most general specification of non-competes is the limitation, for the employee, to compete against the former employer. However, some US courts refuse to interpret the limitation of competition as what regards an ordinary competition, which does not create any form of unfairness towards the employer and instead, support the idea that the competition prohibited by the covenants in question, is solely “unfair” competition. Actions that might be considered as

unfair competition are the use, by the former employee, of business opportunities or advantages gained during the previous employment situation.

Trade secrets, customer contracts and confidential information are always considered by courts as being legitimate business interests and therefore will be protected by non-compete clauses, which means that in the event that the former employee violates such legitimate interests, he will most certainly incur into liability.

Regarding the limits of non-competes, they are restricted to a certain period of time. Some States, such as Oregon and Louisiana, put a precise limit to the maximum duration of a non-compete clause, providing that these clauses can be effective only up to two years after the termination of the employment contract.

The limitation can only extend to a certain geographical area, which must be appropriate, but is not precisely determined as in the case of the duration. Geographical restrictions may be considered differently appropriate depending on the area in question: where there is a high population density, the consideration of what is considered to be an appropriate restriction may be different than in the case of geographical areas in which population is not much developed and thus there are less job opportunities.

A second analysis that has to be considered by the court in order to establish if the clause is reasonable, is whether it is injurious to the public. This aspect however, is not often taken into consideration by courts.

Regarding the burden of proof, most states will require the employer to prove the reasonableness of the clause. If the party bearing the burden of proof successfully proves the unreasonableness of the non-compete clause, the consequences of such finding are different depending on the court's approach.

While some states' judiciary are less lenient to keep the validity of the clause if its unreasonableness is proved, by simply declaring it void and unenforceable, some other states' courts follow a more employer-favourable approach and apply the "blue pencil doctrine" by which only the unreasonable part of the covenant

will be declared void and unenforceable, while the rest will be considered to be applicable, provided that the clause in question can be subjected to a division.

The courts that follow the blue print doctrine will not add anything to the wording of the clause. However, an intervention on the formulation of the clause carried out by the court in order to render the non-compete reasonable is still considered acceptable, even though a con of the re-wording of non-competes is the possibility that it might de-incentivize employers to draft the clauses in a precise way, and give them a convenient ground to word them in a broad manner, instead.

If the relevant court finally determines that the non-compete clause is reasonable and that the former employee violated the obligations arising out of it, remedies have to be established in order for the employer to be compensated for the damage that the former employee's actions have brought to the employer's company. The remedies that the employer may seek are either a monetary compensation, or simply an equitable remedy as an injunction towards the former employee, barring him from completing the business action or, in general, the behaviour in violation of the non-compete provision. However, damages are more often ordered by courts rather than injunctions because the latter are more restrictive of a person's ability to make a living and sustain himself, and therefore are less likely to be ordered by courts¹⁰².

After having analysed the general regime applicable to non-compete clauses in the United States, the attention is now shifted on establishing whether non-competes can be applicable to independent directors. In order to determine that, the question lies on whether independent directors can be considered as "independent contractors".

In fact, the applicability of non-compete clauses to independent contractors has been discussed by scholars in the area of employment law for a significant period

¹⁰² J. P. Kesan, C. M. Hayes, *"The Law and Policy of Non-Compete Clauses in the United States and their Implications"*, in *"Comparative Business Innovation: A Legal Balancing Act"*, Edward Elgar Publishing, 2013

of time. It is clear that the fundamental reason behind non-compete covenants is the underlying employer-employee relationship, as a way for the employer to protect his business against actions that the employee, once the employment relationship terminates, might carry out by taking advantage of the information, expertise or clients he might have acquired during his previous employment.

The law considers, by implementing and in some cases enforcing non-compete clauses, that it is reasonable for the employer to require this kind of protection, because the employee, namely as a result of his employee position, will necessarily come into contact with a significant amount of information, whether it is client-based information or know-how expertise which will be transferred from the employer to the employee.

A logical consequence of this consideration is that, when such employer-employee relationship cannot be considered to be fulfilled, the protection provided by non-compete clauses should not be needed by the employer because, if the person working for him does not legally qualify as an employee, it means that most probably he will not be exposed to the same amount of confidential information or expertise and will then not be able to potentially use that against the employer and at his own advantage. This is the fundamental consideration behind the non-applicability regime of non-compete clauses to independent contractors, who, as such, do not qualify as employees.

However, even though it is clear that independent contractors are not employees, sometimes the law, more specifically courts, have allowed the employer to bind independent contractors with non-compete clauses. The law governing such clauses is state specific, and therefore their applicability or enforceability depends on the state in which such protection is demanded.

For example, the courts of Tennessee¹⁰³ have affirmed that compete-clauses may possibly be applied to independent contractors, provided that they are reasonable, which is to be assessed under the legitimate business interest consideration, the

¹⁰³ Baker v. Hooper, 1998 WL 608285 (Tenn. Ct. App. 1998)

public interest factor and also on focusing on the economic consequences of such restrictions for the independent contractor. But, again, Tennessee courts will allow the enforceability of non-compete covenants to independent contractors only when there is a risk of unfair competition, that might arise out of a situation in which the independent contractor had access to confidential information or relevant client information¹⁰⁴. So, by assessing the existence of the legitimate business interest on the fact that the independent contractor had access to this kind of information, which are typical of an employee level position, it implicitly affirms that such protection is only needed when the other party is an employee, or at least is exposed to the same risky information employees are.

In conclusion, when the independent contractor agreement is sufficiently similar to an employment relationship, in terms of exposure to sensitive information, the applicability of the non-compete clause seems more reasonable and is more likely to be enforced by courts. This reasoning was also upheld by the Pennsylvania Supreme Court in the *Fitness Essentials*¹⁰⁵ litigation case, in which an independent contractor was bound by a non-compete clause which prohibited the solicitation of clients for a period of two years after the termination of the contract. The court supported the application of the covenant upon consideration that there had been previous cases in which non-compete covenants were considered applicable even outside of the typical employer-employee relationship and that, in the specific case, the relationship between the independent contractor and Fitness Essentials, LLC (a company operating in the physical fitness training business) was analogous to that of an employment relationship.

Going back to the question of whether independent directors are to be considered as independent contractors and therefore are not meant to be bound by non-compete clauses in their relationship with the company, it must be considered

¹⁰⁴ C. Dowsley, "Are Non-Compete Agreements Binding on Independent Contractors?", *Litigation & Dispute Resolution*, Thompson Burton PLLC

¹⁰⁵ *Fitness Essentials, LLC v. PICS*, case no. 15-0898 (Pa. Super. June 2, 2015)

that outside or independent directors are, predominantly, treated as independent contractors.

By contrast, officers and executives of the company are treated as employees and are very often subjected to non-compete covenants because of the confidential information and information advantages they take from their central and managing position in the corporation.

Non-compete clauses are less widely-spread in the case of Italy. Non-compete covenants are provided by art. 2125 of the Italian Civil Code which states, among other requirements, that the validity of non-compete clauses must be limited to the five years following the termination of the contract, for directors, and to three years in other cases.

More specifically, art. 2390 of the Italian Civil Code provides that directors are bound to refrain from conducting a business in competition with the employer company and are also barred from serving as directors in other concurrent companies. The corporate constituencies which are subject to the restrictive covenant under Italian law are directors in general, without any differentiation between executive directors or other members of the board.

To date, Italian case law has not yet considered the application of such prohibition to independent directors, but the relevant case law seems to be leaning towards the applicability of non-compete clauses whenever the subject *de facto* manages the company, whether or not there has been a formal appointment. It follows that non-compete covenant may also apply to de facto directors, which, according to the recent Italian doctrine, should be qualified as “general directors” whenever they manage the company without any formal appointment¹⁰⁶.

In conclusion, shifting the focus from the legal regime of non-compete clauses towards a more general consideration of the usefulness, in business terms, of such covenants, it is interesting to challenge the possibility of prohibiting non-

¹⁰⁶ A. Colombo, “Il Divieto di concorrenza ed il conflitto di interesse dell’amministratore”, 2012

competes, as sometimes they might be more of a burden for technology development rather than an effective business habit.

This is especially true in the case of the technology industry, while the rationale of non-compete clauses is more easily defensible when applied to company directors as, in the latter case, different considerations are at stake.

The US state of California has a policy of prohibition of non-compete clauses, and, by looking at the great success of technology companies in that area, it might seem that the prohibition of non-compete covenants might have been a smart and business-friendly regulatory choice¹⁰⁷.

3.5 The Corporate Opportunity doctrine and its development

The corporate opportunity doctrine is, traditionally, a common law doctrine which arises out of one of the most fundamental directors' duties: the duty of loyalty.

The duty of loyalty has been the backbone of corporate law in the Anglo-American world for nearly two centuries, regarded as the duty that could potentially solve any intra-firm agency cost. Binding on corporate managers, the duty of loyalty is the starting point through which conflicts of interests originating from within the company can be analysed and eventually give rise to managers' liability. The duty of loyalty imposes on company directors to subordinate their own personal interest to the company's, and this is why courts have always considered this specific fiduciary duty to be the main lens through which any suspect transaction involving the company's directors can be assessed and evaluated.

The corporate opportunity doctrine limits the ability of some corporate constituencies to individually pursue business opportunities, requiring that any

¹⁰⁷ J.P. Kesan, C. M. Hayes, *op.cit.*

business prospect must be first offered to the company. This obligation will certainly lead to conflictual situations in the event that two companies share the same directors or officers, as well as in situations of infra-group transactions, more specifically in parent-subsiary contexts.

Interestingly, the corporate opportunity doctrine does not apply to every constituency of the company such as employees or other stakeholders, but its scope is limited to corporate directors and officers, even though some exceptions may be observed in American case law¹⁰⁸.

After all, the restrictive application of such doctrine is logical and appropriate, as such directors are called to cover a gatekeeper role, they are the ones who assess business opportunities for the company, evaluate and create business strategies and determine the next strategic moves of the company, by always keeping in mind what is best for the company. It is thus clever to impose the corporate opportunity doctrine on directors, as they are the ones who come in close contact with opportunities that might, sometimes, meet both the company's and the individual director's personal interest, thus giving rise to a conflict of interest. But, complying with the doctrine, the director should always put the company's interest ahead of his own.

The fact that independent directors, or more generally, non-executive directors are skilled and experienced individuals who, for this reason, are called to sit on the boards of companies, naturally leads to the fact that very often they act as independent directors for more than one company, thus creating a fertile ground for corporate opportunities situations, which will be however dealt later in this paragraph.

Considering that, when managing a company, a director might come across multiple business opportunities and potentially lucrative projects, the first step is to establish whether the disputed project is, in fact, a corporate opportunity.

¹⁰⁸ In *A. Teixeira & Co. v. Teixeira*, 699A.2d 1383, 1387 (R.I. 1997) the corporate opportunity has been applied to a shareholder not strictly affiliated with management, if the shareholder nevertheless participates in an active way in management decisions.

This is therefore the first consideration that a court should make when dealing with alleged cases of corporate opportunities.

Courts have, in the United States, applied several different tests for such purpose. One of the most perpetuated test lies on the “interest” or “expectancy” of the company¹⁰⁹: a new business prospect might qualify as a corporate opportunity if the company has a commercial interest or commercial expectancy in such opportunity. However, the terms of interest and expectancy have a precise legal difference: the company has an interest in the corporate opportunity if the company has an actual contractual right over the disputed business project; while there is an expectancy when, given the current state of the company’s business, it is likely that the business project in question might develop into concrete contractual rights for the company in the future.

This test, however, has been criticised as being too under-inclusive, as it only applies to projects which are relatively already known by the company and on which the company’s claim must be already mature, thus excluding business “opportunities” in their strict literal sense.

A second test that is used by courts is the “line-of-business” test, by which a new business prospect is deemed to be considered a corporate opportunity if it is in line with the company’s business. More specifically, it means that it encompasses every project that, considering the company’s expertise, talents and assets, might potentially and reasonably be pursued by the company, whether it is in the exact same period of time in which such project has come across directors, or whether it is in the reasonable future.

Delaware courts have been crucial in the definition of such test, the most-used definition of the line-of-business test is the one formulated in the Delaware case of *Guth v. Loft, Inc.* in which the test has been articulated as follows, “where a corporation is engaged in a certain business, and an opportunity is presented to it embracing an activity as to which it has fundamental knowledge, practical

¹⁰⁹ “The interest and expectancy test”

experience and ability to pursue, which, logically and naturally, is adaptable to its business having regard for its financial position, and is one that is consonant with its reasonable needs and aspirations for expansion, it may be properly said that the opportunity is in the line of the corporation's business.¹¹⁰

This test is embraced by many jurisdictions because, differently from the previous test, it is able to include more business projects and thus responds more to the concept of corporate opportunities. The *Guth v. Loft* decision goes farther than any other decisions on the doctrine of corporate opportunity as it is applicable whenever there is an opportunity to expand the existent business. This last peculiarity defines the difference with the interest and expectancy test, which only qualifies an opportunity as falling under the corporate opportunity doctrine when it is essential to the current business of the company and therefore, excluding any other commercial prospect that does not have a concrete and close relation to the company's immediate needs and current interests.

However, the fact that this test includes many prospects of business might be regarded as being, maybe, over-inclusive and too general, leading to a possible unpredictability and uncertainty of judgements.

A third, but less common test to individuate corporate opportunities is the "fairness" test, which considers a business opportunity as being a corporate opportunity if its eventual appropriation by the director would not fulfil "ethical standards of what is fair and equitable [to the corporation in] particular sets of facts."¹¹¹

The main problem that courts encounter when using this test, is the challenge of finding a precise restriction of what is fair to the corporation. Some scholars have in fact argued that a definition of fairness is closer to procedural requirements rather than substantive ones¹¹².

¹¹⁰ *Guth v. Loft, Inc.* 5 A.2d 503, 514 (Delaware 1939)

¹¹¹ *Durfee v. Durfee & Canning, Inc.*, 80 N.E.2d 522, 529 (Mass. 1948) (citing Henry Winthrop Ballantine, *Ballantine on Corporations* 204-05 (rev. ed. 1946))

¹¹² See Lawrence E. Mitchell, *Fairness and trust in Corporate Law*, 43 DUKE L.J. 425, 426-29 (1993)

As is prescribed in most cases of conflict of interest transactions, the legal tool used for corporate opportunities is the duty to disclose to the company.

In fact, the director who comes across a corporate opportunity might choose two different paths: he might simply abstain from appropriating such opportunity, or might decide to disclose it to the company, hoping for a reject, so as to be allowed to actually appropriate the business opportunity without being liable of having breached a fiduciary duty.

The disclosure of the business project must include the essential properties of the project along with the elements of the director's personal interest. It is important, for the sake of the decision's validity, that directors provide a full disclosure of all relevant details of the project.

If the corporation, following the disclosure, decides to reject the opportunity, only then the director will be entitled to individually pursue the corporate opportunity. The rejection procedure is very similar to that followed in other conflict of interests contexts, as it requires the approval by either an affirmative vote of disinterested directors or an affirmative vote by disinterested shareholders. American case law shows that the remedies for a breach of the duties attached to the corporate opportunity doctrine may be legal or equitable. It is however more common for courts to order an equitable remedy, such as a constructive trust on the disputed business project appropriated by the director, which has the consequence of de facto emptying all of the director's profits eventually arising out of the disputed corporate opportunity.

Regarding the bad faith or good faith with which the director decided to deal with the disputed project, courts tend to not pay much attention to it even though it has been more likely for courts to add punitive damages on top of the constructive trust, which is the default remedy, in cases in which the breach arose out of the non-compliance with the disclosure requirements, rather than in cases in which the breach identified with the lack of the consideration of the absence of

the company's refusal, provided that the disclosure duty had been complied with.¹¹³

As mentioned earlier, the corporate opportunity doctrine is a legal doctrine originating from an Anglo-American corporate point of view. It is thus interesting to compare the two different ways through which the United States and the UK decided to regulate the matter. As we have seen, the US does not *a priori* prohibit corporate opportunities but rather focus on identifying the owner of the corporate opportunity and later binds him to disclose such opportunity to the board or to the shareholders.

The UK, by contrast, follows a different approach, which focuses on the avoiding of conflict of interests. The English regulatory choice of corporate opportunities has been defined as the "status approach" as opposed to the "ownership" approach typical of the United States, which focuses, as we have seen, on establishing whether the corporate opportunity belongs to the corporation because it is in line with the business, or if it fulfils the company's interest or expectancy. The reason why the legal approaches towards the same corporate issue have developed differently in these two common law countries are due to the different ways of enforcement of corporate law.

In the United States, enforcement of directors fiduciary duties is left to the courts, that perform an ex-post verification of compliance with such duties while in the UK such enforcement relies on the ex-ante monitoring performed by independent or outside directors.

This discrepancy between regulatory systems also influences the different importance and consideration of independent directors, or more generally non-executive directors, which is given in the jurisdictions in question. In the UK, non-executive directors who sit on the board are bound by the same core duties that are binding on executive directors, yet with some differentiations based on

¹¹³ E. Talley, M. Hasmail, "The Corporate Opportunity Doctrine", USC Gould School of Law, February 2001

the different tasks that are being performed by them and the distinction of their level of knowledge, skills or experience.

Hence, independent directors are able to have a clear understanding of their duties by looking at the company law of the country in which they perform their activity, but in both the UK and the US there is still uncertainty as to what regards the duties of independent directors in situations of corporate opportunities.

This is possibly a very sensitive issue for independent directors because, as mentioned earlier in the paragraph, they are appointed specifically because of their expertise or other special skills, and therefore are subject to being appointed in multiple companies to perform their monitoring role over management or to provide different business services of other nature, because of their expertise.

Namely because of the fact that they might sit on the boards of more than one company, they might as well come across many different business prospects, and, given the lack of regulation, it is difficult to precisely discover what the law requires them to do in such situations.

Multiple directorship is not per se considered negatively, but rather the opposite, as it is encouraged by the UK Corporate Governance Code¹¹⁴. The UK Companies Act of 2006 reformulated the original Section 175 regarding the duty to avoid conflicts and introduced new procedures in order to allow directors to authorise potential conflicts of other directors. In the case of multiple directorships, it is not always easy for a director to understand whether there is a possible conflict between his personal interest and the interest of the company. Section 175 therefore requires that a director may not engage himself in a situation if there is a foreseeable conflict of interest, and, if such conflict of interest does exist, the director will need the authorization of the other directors¹¹⁵. Once the separate capacity has been disclosed and authorised, it will

¹¹⁴ The UK Corporate Governance Code states that non-executive directors must disclose their “other significant commitments”.

¹¹⁵ The Solicitor-General said: ‘If a person cannot possibly foresee a situation, it cannot be reasonably regarded as being likely to give rise to a conflict of interest. On the other hand, if they can foresee it, the

then be a task of the court to establish whether the exploitation of a particular opportunity can be considered a breach of duty.

If a corporate opportunity situation arises as a result of the director's multiple directorships, the courts' analysis of the non-executive director's duty will be each time different depending on the actual capacities he holds in the different companies and might lead to the conclusion that the opportunity should have been offered to the company because he was acting in his capacity of director or to the conclusion that the director did not owe any duty to either of the companies and therefore was free to personally exploit the opportunity he came across, because in that moment he was not acting in his director capacity.

The same could be applied in a situation of corporate opportunities arising from the only fact that independent directors are sitting on the boards of two different companies. In particular, it will be easier for courts to state that there is no conflict of interest if the companies have two completely different lines of business.

But again, the very nature of non-executive directors is likely to expose them to situations of potential conflict, as they might have been appointed for the sole purpose of finding other investment opportunities or for having outside interests, considered as an asset to the company.

It follows that almost every opportunity discovered by non-executive directors can give rise to a situation of conflict of interest. However, section 175(4)(b) of the UK Corporate Governance Code provides that the duty to avoid conflicts of interests is complied with if the matter has been authorised by the directors. As often provided by most jurisdictions when dealing with the matter of conflicts of interests, Section 175(6) provides that interested directors cannot participate in the directors' meeting on the approval of the corporate opportunity and votes can be cast by disinterested directors only. If approval is granted, the director will

director or members of the company should be able to make an informed decision about whether it is an acceptable conflict of interest or whether the matter should be dealt with in accordance with applicable provisions under the company's constitution.'

be allowed to appropriate himself of the corporate opportunity, without being liable of a breach of Section 175. Clearly, approval by the disinterested directors should be preceded by a full and precise disclosure of the characteristics of the corporate opportunity. If the interested director fails to comply with such requirement, courts may invalidate the approval granted by disinterested directors on the ground that the decision was not given on a fully informed basis¹¹⁶.

Returning to the United States, Delaware case law and state law are the main reference for the corporate opportunity doctrine. In 2000, Delaware departed from its traditional position on corporate opportunities and enabled the amendment of statutes to allow companies to waive the corporate opportunity doctrine and several other states later followed this same movement, initiated by the state of Delaware. This regulatory decision is not completely illogical, even if it may seem like it at first look. In fact, by analysing the effects of the duties attached to the corporate opportunity doctrine, it can be observed that these obligations impeded company's ability to operate efficiently, having negative consequences on the raising of capital and the formation of good investment bases.

Prior to the 2000 amendment of Delaware law, it was not possible for corporations to ex-ante opt out of the corporate opportunities doctrine, but it was only permitted for boards to reject a corporate opportunity ex-post, meaning after it had already arisen.

Even though Delaware statutes did not explicitly permit a waiver of the corporate opportunity doctrine, it did not explicitly prohibit such practice either.

It is only in 2000 that the Delaware Assembly amended the state's statutes and added a subsection to § 122 of the Delaware General Corporation Law (DGCL), explicitly permitting waivers of the corporate opportunity doctrine. This new subsection provides that a Delaware company has the power to "renounce, in its

¹¹⁶ S. Witney, *"Corporate opportunities law and the non-executive director"*, Journal of Corporate Law Studies, 2016

certificate of incorporation or by action of its board of directors, any interest or expectancy of the corporation in, or in being offered an opportunity to participate in, specified business opportunities or specified classes or categories of business opportunities that are presented to the corporation or one or more of its officers, directors or stockholders.¹¹⁷”

This waiver will then allow the company to determine in advance “whether a specified business opportunity or class or category of business opportunities is a corporate opportunity of the corporation rather than to address such opportunities as they arise”¹¹⁸.

Under Delaware law, the corporate opportunity waiver must be specific, it must identify the categories of business included in the waiver and cannot be defined by a “blank” waiver, as for example one that simply waives all corporate opportunities, without further specifications. It has to be born in mind that, even though paragraph 122 of the DGCL allows the adoption of waivers of corporate opportunities doctrine, such decision cannot be unilaterally taken by the board but, just as the rejection of a business opportunity, it is subject to traditional fiduciary principles. Thus, the waiver must be approved by conventional means such as a vote of disinterested directors or shareholders. Failure to comply with this procedure will enable the Delaware courts to possibly subject the waiver clause to the entire fairness standard¹¹⁹.

The serious enforcement of the corporate opportunity doctrine by courts may have reached a stage in which its costs exceed its benefits, thus creating a reason for companies to opt out of the corporate opportunity doctrine. In particular, the doctrine creates the most problems when an individual, mostly in the case of independent or non-executive directors, sits on the boards of multiple companies in the same industry, thus rendering almost impossible for the director to avoid

¹¹⁷ Section 17 of paragraph 122 of the Delaware General Corporation Law

¹¹⁸ Legislative synopsis which accompanied the amendment

¹¹⁹ G. Rauterberg, E. Talley, *“Contracting Out of the Fiduciary Duty of Loyalty: An Empirical Analysis of Corporate Opportunity Waivers”*, Columbia Law Review, 2017

conflicts of interests identifying as corporate opportunities, specifically because of the tasks he is supposed to perform as a result of his multiple directorships.

In spite of the fact that the corporate opportunity doctrine is traditionally an Anglo-American legal concept and has, as we have seen, mainly developed in the UK and in the US, the regulation of the doctrine has spread out to the other corporate advanced jurisdictions as well. In the case of Italy, the Italian legislator has, in 2003, amended art. 2391 of the Italian Civil Code, providing for a more general duty bearing on directors in relation to transactions in which they have an interest. In particular, the original formulation of the article bound directors to disclose any interest they had in a certain transaction if such interest was in conflict with the company's interest. Following the 2003 reform, it is significant to mention that the title of the article has been amended from "conflicts of directors" to "interests of the directors". The change of title symbolizes the change of approach of the Italian legislator towards risky transactions within corporations and involving the company's directors. While before the reform, the director had the duty to disclose his interest in a specific transaction only if that interest was in contrast with the company's, the new wording of art. 2391 imposes the disclosure of the director's interest regardless of a situation of conflict with the company. Whenever the director has an interest in regards of a transaction which is to be operated by the company, such interest must be disclosed to the board of directors or to the shareholders' meeting if the interested director is a sole director.

CHAPTER 4

The liability of the Independent Director

4. Evolution of the duty to monitor and the personal liability of Independent Directors

As we know, the NYSE and Nasdaq Stock Exchanges rules require companies to have a majority of independent directors on their boards for the purpose of maximizing investors' confidence and shareholder value, by overseeing management and prevent conflicts of interests within the company. It is clear, from the task that the Exchanges attribute to independent directors, that they are the recipients of a significant amount of trust given by the legal system in regards of their duty to monitor.

In short, the legal system expects independent directors to possess specific ethical traits such as judgement, experience, integrity and wisdom in order for them to properly perform the several duties they are called to serve, which might be the protection of shareholders' interest, the mediation of conflicts of interests between management and shareholders and other conflict-sensitive areas, such as executive compensation. Certainly, these tasks are far from being easily performable and very often independent directors will find themselves as being "victims" of managers, trapped in the many corporate conflictual dynamics, and thus becoming unable to perform their duties.

If regulators want the concept of independent directors as instruments to ensure the efficiency and the transparency of corporate boards to be considered valid, a legal framework of the liability of independent directors should be defined.

The board's duty to monitor, entrusted to independent directors, is designed to prevent any harm to the company. When the board fails to effectively monitor

over management's action and a damage is brought to the corporation, the duty to monitor can be considered to be breached.

However, the secret of an efficient performance of the duty to monitor is to find the right balance between the situations that should receive board's attention, monitoring and intervention from those that don't, otherwise there is the risk that the board becomes risk-averse. This could harm shareholders because, as a result of their inherent risk, boards may reject business-enhancing opportunities for the company.

This consideration has prevented Delaware courts to establish an overly-inclusive regime of directors' liability in regards of the duty to monitor.

The current standard for the violation of the duty to monitor that might expose directors to liability, is the situation in which they fail to intervene in the face of explicitly dangerous situations (*red flags*) or when their inaction leads to legal violations. The limits of directors' liability in response of violations of the duty to monitor have been defined by the Delaware courts throughout three specific cases.

The evolution of the case law regarding the board's duty to monitor can be viewed as a mirror of the changes of approach and solutions given by corporate law over time, that has led to the recent mandatory introduction of independent directors on corporate boards to specifically perform the monitoring function.

The first one is the *Graham v. Allis-Chalmers Manufacturing Co.*¹²⁰ case, in which however, the court limits directors' liability only to situations presenting obvious signs of danger, excluding the existence of a general duty to monitor binding the board to investigate any possible wrongdoing within the corporation. The reasoning of the court in this case identifies a very restrictive definition of the duty to monitor, which is however in line with the judgement's year of issuance, being a case dating 1963.

¹²⁰ *Graham v. Allis-Chalmers Mfg.* 188 A.2d 125, 130 (Del. 1963)

The duty to monitor has went through a reconsideration by the Delaware court in the *Caremark*¹²¹ case. This case is so important in regards of the definition of the duty to monitor that monitor claims are often referred to as “Caremark claims”. In fact, the court has completely changed the approach sustained in the *Graham* judgement and affirmed instead that the boards have a duty to “attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists, and that failure to do so under some circumstances may, in theory at least, render a director liable for losses caused by non-compliance with applicable legal standards.” Prior to *Caremark*, Delaware courts were expecting board involvement only in cases of “red flag” situations, such as for example evident self-dealing transactions. This approach had developed from the *Graham* judgement discussed earlier.

Following the *Caremark* judgement, Delaware courts significantly changed approach regarding the board’s duty to monitor and established the duty for the board to ensure the adequacy of its information-reporting system and internal control in general.

This generous definition of the duty to monitor however did not last much, as the Delaware courts decided, in the *Stone v. Ritter* case, ten years later to the *Caremark* case, to consider the duty to monitor as part of the duty of loyalty and good faith.

By re-categorizing the duty to monitor and comprising it into the more general duty of loyalty, courts rendered more difficult for plaintiffs to prove an eventual breach of the monitoring duty. Additionally, the Delaware Supreme Court reformulated the previously established *Caremark* standard by creating a two-part test in order to determine whether personal liability can be affirmed in the so called “Caremark claims”. The court stated that liability stems from (1) “utterly failing to implement any reporting or information system or controls”, or (2) if “having implemented such systems and controls, consciously failing to monitor

¹²¹ *Caremark*, 698 A.2d (Del. Ch. 1996)

or oversee its operations”¹²². As a result of such test, it seems like a breach of the duty to monitor can only be established if the directors knew that they were not complying with their fiduciary duties, meaning that plaintiffs must prove that directors had an “actual or constructive knowledge”¹²³ that their behaviour was illegal. Following the Stone case, Delaware courts have considered further duty to monitor cases as motions to dismiss, specifically because of the inability of plaintiffs to prove sufficient facts to meet the scienter requirement.

As a result of the aforementioned test, even after a red flag situation is identified, the board’s liability does not automatically stem from the failure to act on the red flag, but only if that failure to act is due to a conscious decision. However, the lack of reaction from the board to a red flag situation might even be considered as a business decision and, as such, be subjected to the business judgement rule by the court.

This means that only when the failure to act is due to omission or inattention from the board that a claim can be made regarding the board’s violation of the duty to monitor. In conclusion, a successful claim of breach of the duty to monitor can only rely on cases in which the business judgement rule protection does not apply because, for example, the board did not make any decision regarding the dangerous situation and therefore no decision must be evaluated by the court through the lens of the business judgement rule.

When these requirements of non-intervention by the board, stemming from inattention or omission, are satisfied, plaintiffs will then have a chance to bring the claim towards a court without the risk of being dismissed *prima facie* because their claim cannot be qualified as a violation of the duty to monitor, as it does not satisfy the two-fold test. However, plaintiffs will still have to face the problem of avoiding being dismissed as a result of not having sufficient facts to prove that the board consciously failed to react. Thus, the scienter requirement is not easily applicable if the duty in question is breached only when the board fails to

¹²² Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006)

¹²³ Wood, 953 A.2d at 141

deliberate, as it is hard to prove knowledge of a decision if the decision has not, in reality, been taken.

As it is easily understandable from the precedent considerations, it has been more common, after the Stone case, for courts to not actually debate on the merits of a duty to monitor, as most of the judgements post-Stone case focused on whether the scienter requirement had been satisfied by the plaintiff. In most of the cases, the plaintiffs have encountered difficulties in demonstrating scienter.

For example, in the *Desimone v. Barrows* case, which dealt with a shareholders derivative action against a company's directors, who allowed the backdating of stock options. The plaintiff claimed that the allowance of the backdated stock options was showing the lack of the board's duty to monitor the company's compliance with the relevant laws.

The judge stated that in order to establish a breach of the duty to monitor, it was required that the plaintiff proved both that the board, in that case, knew of the inadequacy of the internal control and additionally, that it chose to ignore such inadequacy. The plaintiff could not do so, and only brought before the court an internal memorandum about the backdating activities which did not prove, in the judge's eyes, that the board actually knew the content of that memorandum.

The same restrictive definition of the duty to monitor was applied by the court in another case, *Wood v. Baum*. This time, the plaintiff lamented a breach of the duty to monitor by the board because of the inadequacy of both accounting and financial reporting controls. The plaintiff attempted to support its claim by affirming that the directors had actual knowledge of such inadequacy because they approved transactions which were then considered inappropriate or even publicly signed documents which contained misstatements. The judge however, rejected the plaintiff's argument because such accusations were only proof of the fact that directors had the chance to find out about the wrongdoings and mistakes contained in the documents or transactions they approved, but they cannot concretely prove that directors knew or consciously participated in the illegal acts.

Another important and recent case, further consolidating this same restrictive enforcement of the duty to monitor, is the *Citigroup* case. In this case, the court founded its inability to affirm the board's liability on the basis of the fact that, according to the court, it would have the effect of invading the management's business judgement rule. More specifically, the *Citigroup* case dealt with the management of business risk: the shareholders of the company brought a derivative action against the directors because, from the shareholders point of view, the board failed to properly manage the company's risks and ignored several signs of danger for the company. The judge did not support the plaintiff's claim and stated that extending the duty to monitor to the monitoring of business risks would interfere with the board's business judgement. This is because the core of the board's business judgement is the dealing with business decisions that might, specifically because of their business nature, benefit or harm the corporation. It is thus exactly the board's task to evaluate opportunities, and, relying on its judgement, decide to take or reject these opportunities. If the duty to monitor were to be expanded to the monitoring of business risks, this would result in the "mutilation" of the board's very nature.

In the *Citigroup* case, the judge supported the rejection of the plaintiff's claim on the basis of a further consideration, also concerning the interference with the business judgement rule. In particular, the court stated that the board cannot be considered liable for making business decisions that are later found to have been unwise. If the board's liability could stem from such decisions, it would mean that the courts, in order to judge on the violation of the duty to monitor, would have to evaluate and second-guess the board's business decision, clearly interfering with the director's business judgement. This would equate to the emptying of the purpose of the business judgement rule that the judge defined in the *Citigroup* case as having the objective of allowing managers and directors

“to pursue risky transactions without the spectre of being held personally liable if those decisions turn out poorly.¹²⁴”

The judgement of the Delaware court in the *Citigroup* case is not entirely consistent with that given in regards of the *Caremark* case. The inconsistency derives from the fact that in the *Caremark* case, the duty to monitor has been considered to pertain to “omissions” or “inaction” of the board, thus not regarding decisions of the board. On the contrary, in the *Citigroup* case, the court focused on the decisions actually taken by the board, and decided to protect such decisions under the business judgement rule. In reality, what was lamented by the shareholders is the lack of monitoring after the approval of such decisions, not the inappropriateness of the board’s decisions *per se*. If the judge would have considered the case from this point of view, which is the absence of any board decision in regards of the development of the investment decision, the board’s behaviour could have been considered as comprised in the duty to monitor regime and eventually led to the affirmation of the board’s liability for the breach of the duty to monitor.

As we can see from the analysis of the abovementioned cases, the Delaware courts have not been able to deal with risk management and the deriving liability of the board in a precise and balanced manner, as it is not easy, as we can note from the recurrent interference with the business judgement rule, to find a compromise between encouraging directors to take business risks in order to make the company grow, and at the same time asking for supervision and control by the board, in order to ensure that such risks are well-thought and that they are taken in an appropriate way¹²⁵.

The restrictive application of the duty to monitor still to this day applied by the Delaware courts is not an appropriate judiciary response to the numerous and frequent corporate governance scandals. Even though corporate law has decided to face the problems arising from the lack of good internal supervision with the

¹²⁴ *Citigroup Inc Shareholders Derivative Litigation*, 964 A.2d 106, 125 (Del. Ch. 2008)

¹²⁵ E. J. Pan, “A Board’s Duty to Monitor”, *New York Law School Review*, Volume 54, 2009

introduction of independent directors, such technique is destined to be declared as inefficient if clear definitions and applications of the duty to monitor, binding on independent directors, are not developed by the law or by the relevant case law.

It is evident that the duty to monitor should be strengthened. However, it is clear that such enhancement, in order to be effective, should also be accompanied by the establishment of a personal liability for directors, in particular for independent directors, whose main function is to monitor the company's transactions. The duty to monitor may be intensified by providing that boards must monitor business risks and conduct follow-ups and verifications of the business decisions taken by directors.

A stronger duty to monitor would however raise several concerns, some of them can be refuted while others can be considered to be appropriate, but the benefits that the company might take from the enhancing of the duty to monitor are, reasonably, exceeding the costs that might, on the other hand, derive from such enhancement.

A first concern, which has already been discussed in the *Citigroup* case, is the risk that a duty to monitor defined in such terms would put judges in the position of second-guessing the board's business decisions, interfering with the business judgement rule. But this concern is the result of an erroneous understanding of the duty to monitor, in its enhanced version: such duty only applies when the board failed to keep itself informed of the potential risks that the company is facing. As a result of this, boards will keep their business judgement protection even in the scenario of a strengthened duty to monitor, as, again, such enhancement focuses on the board's follow-up activities and on the consequent possible prevention of damage to the company, not on the content of the board's business decision.

A second concern is that a more solid duty to monitor could have the unwanted effect of inhibiting risk-taking activities by the boards, which results in lower opportunities for the company to grow its business. But again, by giving a closer

look to this concern, it can be concluded that in reality boards still have total freedom in deciding the degree of risk they want the company to assume. The duty to disclose does not apply to the intrinsic content of the board's decision, but to the following supervision activities.

As previously indicated, efficient duty to monitor must be accompanied by a potential personal liability for directors who, eventually, fail to comply with such duty.

Nonetheless, it is very rare for courts to affirm out-of-pocket liability for outside directors. This circumstance might overshadow any proposal of enhancement of fiduciary duties because, as mentioned, directors will almost always succeed in avoiding personal liability. The reason why the personal liability of outside directors is so rarely affirmed in courts is to prevent such directors to purposely not sit on the boards because of the risk of being held personally liable for their actions or inactions. In fact, the law puts in place several mechanisms to shield directors from personal liability. In particular, Delaware state law offers, through Section 102(b)(7) of the DGCL, the possibility for companies to exculpate directors' liability for duty of care violations. Furthermore, Section 145 allows companies to cover for their directors insurance and to indemnify their board members for all legal expenses for litigation or settlements.

The law does not put a limit on the insurance coverage, and considering that all damages or settlement payments deriving from any claim against the director regarding his duty to monitor, except for cases in which the director's behaviour identifies as deliberate fraud, are covered by the insurance paid by the company, outside directors are not worried about having their personal wealth deprived by court judgements.

In particular, according to a study carried out by Black, Cheffins and Klausner in 2006, only two judgements issued in that year ordered out-of-pocket payments for outside directors. The risk of personal payments by outside directors only rises when the company goes bankrupt and therefore is not able to indemnify the outside directors' legal expenses. In reality, it is also rare for inside directors to

be obliged to personally pay for their violations, as usually they are well-covered by D&O insurances offered by the company itself.

In conclusion, the purpose of imposing on boards a more stringent definition and application of the duty to monitor loses its value if that duty is not followed, in courts, by the affirmation of directors' personal liability. In such circumstances, an enhanced fiduciary duty will only have the effect of an increase of lawsuits that the company itself, not the directors, will have to bear, negatively affecting the company's capital.

Nonetheless, out-of-pocket payments are not the sole motivation that would push outside directors to put in place a more solid compliance with their duty to monitor. In fact, if such duty is breached, directors will still be sued and will have to sacrifice their personal time to participate in legal proceedings. But the most important cost that will have to be borne by outside directors is the negative effect of lawsuits on their reputation as, as we know, very often outside directors get appointed by companies because of their acknowledged ethical standards. Being sued will also lower the chances of being re-elected at the next board election, other than increasing the chances of being sued additional times, because of the bad reputation.

In conclusion, independent directors must take into consideration other than personal liability resulting in out-of-pockets payments, reputational costs as well. All these considerations might put in place a mechanism that will result, at last, in meaningful changes in how boards fulfil their duty to monitor: if the duty to monitor is actively enhanced, independent directors will be less lenient in engaging in wrongful actions or omissions resulting in a breach of the duty to monitor, which will in turn lower the number of lawsuits towards them and maintain the independent director's good reputation. Boards will tend to only appoint directors who have proven to have good reputation and this will, as a consequence, result in lower insurance costs for the company as a whole.

The duty to monitor is thus a very valuable and powerful tool to enhance the board's, and consequently the company's, overall performance¹²⁶.

4.1 The duty of good faith and the exculpatory regime

The Delaware courts have not been conclusive as whether the duty of good faith is an autonomous duty, separated from the other fiduciary duties of care and loyalty, or whether it must be considered as a constitutive element of the duty of loyalty.

The DGCL uses the term good faith as a term defining the subjective state of mind in which directors must reason when taking decisions affecting the company.

Section 144 of the DGCL deals with one of the corporate operations that require the most duties for directors: transactions between the company and members of the board. The formulation of the provisions comprised in this section is a further confirmation of the overcoming of the past consideration of such transactions, which could be declared void at the instance of any objective shareholder.

In fact, the statute affirms that interested transactions are not voidable solely for their interested nature if the material facts related to the director's interest or relationship are disclosed to the board or to the committee, and such bodies authorize, in good faith, the completion of the transaction with a vote by the majority of the disinterested directors. The statute also takes into consideration the case in which the company statute provides that interested transactions must be approved by a vote of the majority of shareholders, specifying that, in this case, the transaction is not voidable ex-post if the shareholders have approved it in good faith.

¹²⁶ E. J. Pan, *"Rethinking the Board's Duty to Monitor: A Critical Assessment of the Delaware Doctrine"*, Florida State University Law Review, Volume 38, Issue 2, 2011

It is clear that the use of good faith in this sense does not establish a new duty but it is the subjective specification of the duty of loyalty. Therefore, there is no loyalty without good faith.

In particular, the presence of the good faith requirement in a director's actions is essential for the valid application of the exculpatory clauses or eligibility for indemnification. This is provided for in Section 145 of the DGCL which subordinates the application of indemnifications to the circumstance that the board finds that the director seeking indemnification has acted in good faith, reasonably believing that his actions were not opposed to the best interests of the corporation. It follows that, according to the mentioned provision, courts have the possibility to approve indemnification to the director who has been proven to be liable to the corporation, provided that the director acted in good faith.

This logically means that, considering that good faith is a fundamental element of the duty of loyalty, the abovementioned provision can only be applied to cases of alleged breaches of the duty of care, not to those claiming a violation of the duty of loyalty.

In order to have a more complete understanding of the duties bearing on directors whose breach would likely result in their liability and those that are likely to be protected by the company's statute provisions, we must look at Section 102(b)(7) of the DGCL which enables corporations to provide for limitations of the personal liability of directors resulting from monetary damages for breaches of fiduciary duties. Thus, this provision allows companies to establish the so called "exculpatory clauses", which play a very significant role in court's judgements in regards of the finding of directors' liability. In fact, very often courts find room to protect company directors from personal liability by reconnecting their actions into one of the exculpatory circumstances.

Section 102(b)(7) restricts the freedom of companies in limiting their directors' liability for breaches of fiduciary duties, providing that such liability cannot be excluded when: (i) For any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or

which involve intentional misconduct or a knowing violation of law; (iii) under § 174 of this title¹²⁷; or (iv) for any transaction from which the director derived an improper personal benefit¹²⁸.

The provision does not limit the company in exculpating the duty of care, therefore it can be used to permit exculpation of negligence and gross negligence. On the contrary, the restrictions clearly mention acts not conducted in good faith. It follows that under Delaware corporate law, bad faith is not exculpable while breaches of the duty of care, even when identifying as negligent conducts, can be exculpated and therefore not result in directors' liability.

In order to precisely set boundaries between acts of bad faith and acts merely amounting to negligence (which would result in breaches of the duty of care), it is important to determine the exact content of the duty of loyalty and to understand the role played by good faith in the loyalty requirement.

A breach of the duty of loyalty occurs when a director pursues his own personal benefit and does not avoid situations of possible conflicts of interests. The Delaware Supreme Court finds that when the director's personal benefit is absent, it will be hard to claim a breach of the duty of loyalty, and the situation would more likely fall into a possible violation of the duty of care standard.

However, when the claim regards actions perpetuated by the directors in bad faith, even when there is no personal benefit, the presence of bad faith will eliminate the protection from both the presumption of business judgement and statutory exculpations.

An interesting case that would allow us to better comprehend the dynamics between the business judgement presumption, which is based upon good faith, and the other duties whose violation could lead to liability, is the *Walt Disney Company Derivative Litigation* ("Disney III"). The Chancery Court in this case

¹²⁷ Paragraph 174 of the DGCL provides for the liability of directors for unlawful payment or dividend or unlawful stock purchase or redemption.

¹²⁸ L. Strine, L. Hamermesh, R. F. Balotti, J. Gorris, "Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law", *The Georgetown Law Journal*, February 2009

found that the liability of directors could not be affirmed because their behaviour could not be qualified as being more than ordinary negligence. As it is known, directors' actions are protected by the presumption of business judgement, whose fundamental element is the requirement of good faith when, of course, such actions are being carried out. In *Disney III*, the presumption of good faith was not rebutted, meaning that the ordinary negligence exhibited by directors was protected by the business judgement rule and therefore not appropriate to create liability.

If the business judgement rule could not have been applied in this judgement because, for example, a decision had not been taken by the directors, it would have been easier to affirm the directors' bad faith and consequent liability because in the case in which there is decision and therefore the business judgement rule is applicable, good faith is presumed, rendering difficult for the plaintiff to rebut that presumption and claim liability on the basis of an ordinary negligence¹²⁹.

Exculpatory clauses are a very important tool for the protection of independent directors, as it has been proven by a recent judgement from the Delaware Supreme Court, the *Cornerstone* case.

In such judgement, the Court has affirmed that, in order to avoid the effect of demotivating independent directors to sit on company boards because of the risk of litigation and eventually liability, a plaintiff seeking only monetary damages must present to the court non-exculpated claims against independent directors in order to survive a motion to dismiss, regardless of the standard used to review the board's conduct: whether that is the business judgement rule or the entire fairness standard.

In order to fully understand the effect of such judgement on the liability of independent directors, it is useful to first analyse the concept of the entire fairness standard.

¹²⁹ C. G. Bishop, "A Good Faith Revival of Duty of Care Liability In Business Organization Law", Research Paper 07-02, Suffolk University Law School, January 2007

The entire fairness standard is a standard of review applicable to interested transactions, which are transactions that see controlling shareholders or directors on both sides of the deal. Under Delaware law, when the interested transaction is being challenged by shareholders who claim the liability of the controlling shareholder or the interested director, it is upon the interested directors to prove the entire fairness of the transaction, which is based on two premises: fair dealing and fair price. Conversely, when shareholders direct the claim towards disinterested directors such as independent directors, who are involved in the interested transaction only through their monitoring or approval-giving role and therefore have no financial interest in the transaction, they must claim non-exculpated actions as the basis for their lawsuit. Otherwise, it is very likely that the court will order a motion to dismiss the claims against the independent directors.

While the standard of review in regards of transactions not involving company insiders is the business judgement rule, which can lead to a successful claim if the plaintiff successfully rebuts the business judgement presumption, such standard is different when the lawsuit involves self-dealing transactions, regarding the company on one hand and a corporate insider, whether that is a director or a controlling shareholder, on the other hand.

In particular, in self-dealing transactions the standard of review which will be applied by the courts is the entire fairness standard that, as mentioned earlier, places the burden of proof on the defendant, who will have to provide evidence that the transaction in question has been performed in a fair way.

It follows that when self-dealing transactions are the object of the shareholders' claim, it will be less likely that the defendant will obtain a motion to dismiss by the court. This is because the core of the claim presented by the shareholders is the conflict of interest bearing on the entire board, which is enough to rebut the business judgement presumption. However, the Delaware court has affirmed in *Freeport-McMoran Sulphur, Inc.* that under Delaware law, when a transaction is negotiated and approved by independent directors and then approved by the

stockholders of the company, the transaction is reviewed under the business judgement standard. In such situations, the plaintiffs would have to attack the independent director's actual independence in order to render the transaction reviewable under the entire fairness standard¹³⁰.

This is why, when a corporation intends to perform a self-dealing transaction, special negotiating committees comprised of independent and disinterested directors are being formed. Such committees will have the task of approving the transaction. The delegation of the approval of self-dealing transactions to special negotiating committees has the effect, in court, of shifting the burden of proof from the company's managers to the plaintiff who claims the unfairness of the approved transaction. Even though the transaction approved by the special committee can still be scrutinized by the court and, therefore it does not have the effect of completely excluding any possible unfairness, it still produces a very important procedural consequence, as the burden of proof in regards the unfairness of the transaction cannot be easily satisfied by the plaintiffs¹³¹.

From the abovementioned considerations, we can conclude that the presence of independent directors on a company's board and their role in the approval of self-dealing transaction is crucial for the determination of the transaction's review standard or, when special negotiating committees are formed, it has a crucial effect on the procedural rules to be followed.

In conclusion, the entire fairness standard doctrine is applicable when the business judgement standard is rebutted, by proving the conflict of interests of those involved in the transaction or by actually proving the breach of fiduciary duties. The entire fairness standard will have the effect of shifting the burden of proof of the unfairness of the transaction from the plaintiffs to the company, who

¹³⁰ L. H. Lazarus, "Standards of Review in Conflict Transactions: An Examination of Decisions Rendered on Motions to Dismiss", Delaware Journal of Corporate Law, 2009

¹³¹ M. D. Gerstein, B. C. Faris, "Special Negotiating Committees. If, When; Who and How- A Guide for The General Counsel", Latham&Watkins LLP, January 2012

will need to adequately demonstrate that the process and the price applied to the transaction were both fair.

(i) *The Cornerstone case*

Having clarified the meaning and the origins of the entire fairness standard, it is now easier to fully comprehend the implications of the *Cornerstone* judgement, issued by the Delaware Supreme Court.

The judgement deals with two appeals that turned on the same legal question and therefore were addressed by the same judgement.

The case was submitted to the Supreme Court by the Court of Chancery, that in both cases had rejected the defendants' motions to dismiss on the basis of the Supreme Court's precedent, that denied motions to dismiss regardless of the exculpatory clauses comprised in the company's statute. Moreover, the Supreme Court precedent sustained the idea that even where plaintiffs could not present to the court non-exculpated claims, all directors, including independent directors were to remain defendants until the end of litigation, provided that the transaction in question is subject to the entire fairness standard.

The Supreme Court, in the *Cornerstone* case, departed from its previous precedent and established a differentiation between interested directors and independent directors. In particular, when independent directors are protected by one or more of the exculpatory provisions contained in the company's statute, plaintiffs are required to plead non-exculpated claims against them, otherwise independent directors will have the right to see their claim dismissed by the court. Contrary to what was sustained by the plaintiffs, the Court further established that the rule by which plaintiffs must plead non-exculpated claims against the independent directors applies regardless of the standard of review of the transaction. In fact, the plaintiffs' argument was that the independent

directors' motion to dismiss could be overcome solely by the consideration that the transaction had to be reviewed on the basis of the entire fairness standard.

Only when plaintiffs prove that the independent directors acted in bad faith, put their own interest ahead of that of shareholders' or acted pursuant to the interest of a party from whom they could not be presumed to act independently, it will then be more probable for plaintiffs to survive an independent director's motion to dismiss. The circumstances above listed coincide with the restrictions of the exculpation regime provided by Section 102(b)(7) of the Delaware Corporate Governance Code.

It follows that plaintiffs cannot solely rely on the entire fairness standard review to include every director, regardless of their interest situation, into litigation.

Of course, the pleading of facts supporting the application of the entire fairness standard to the transaction instead of the business judgement presumption is still very important for the plaintiffs as it will most likely allow them to survive a motion to dismiss brought forward by the interested directors. The application of the entire fairness standard can eventually lead to the finding of liability for a breach of the duty of loyalty in regards of interested directors but, again, it will not relieve plaintiffs from the obligation to plead non-exculpated claims in regards of parties who did not have a financial interest in the transaction, such as the independent directors.

As a result of the entire fairness review, interested directors can be found liable of a breach of the duty of loyalty as a result of the unfairness of the transaction regardless of their state of mind during the transaction, whether it was good faith or bad faith. This is because the business judgement rule is not applicable in cases of evident conflicts of interests, with the consequent effect of placing the transaction under the entire fairness standard.

The Court has thus established that every director has the right to be considered individually when the claim is directed towards the board as a whole. The role played by the directors in the board has therefore a legal value and independent directors in particular are presumed to be faithful to their fiduciary duties that can

only be doubted by the court if the plaintiffs are able to support their demand with non-exculpated claims towards independent directors.

The court goes further with its reasoning and states that if the court were to accept the plaintiffs' approach, it would harm the category of stockholders rather than benefit them, other than being inconsistent with the foundations of Delaware law. In fact, Delaware law attributes to independent directors the power to negotiate conflicted transactions and possibly, as a result of that negotiation, give a negative opinion to controlling shareholders in respect of the conflicted transaction.

For decades, the presence of independent directors in interested transaction was considered a guarantee for the interests of minority shareholders. Thus, when approval of the transaction is subjected to the favourable vote of a special committee, very often these transactions are presumed to have been concluded on a fair price. Given this generational approach towards independent directors and their role in respect of conflicted transactions, it would be counter-productive to establish the same judiciary path of liability-founding for both interested and independent directors. This would cause more incentives for independent directors to decline serving as members of special committees or to reject interested transactions, even when based on fair terms, only to avoid being sued by shareholders who wish to challenge the transaction. This would also serve against the exculpatory provisions of Section 102(b)(7), as such provisions were adopted to prevent directors to decline strategic business decisions for the sole purpose of avoiding being held liable by a court. This regulatory objective was very clearly explained by the court in the *Malpiede*¹³² case, in which the judge clarified that "Section 102(b)(7) was adopted by the Delaware General Assembly in 1986 following a directors and officers insurance liability crisis and the 1985 Delaware Supreme Court decision in *Smith v. Van Gorkom*."¹³³

¹³² *Malpiede v. Townson*, 780 A.2d 1075, 1094 (Del. 2001)

¹³³ 780 A.2d 1075, 1095 (Del. 2001) (citing *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985)).

The abovementioned crisis was the hint that one of its consequences could have been the unwillingness of directors to make any kind of business decisions that would benefit shareholders, if such decisions could cause them to be held liable towards the shareholders or the corporation. It follows that the purpose of Section 102(b)(7) was to “free up directors to take business risks without worrying about negligence lawsuits.”

If the Delaware courts established that all directors must remain defendants in case of litigation regarding a transaction with an interested party, it would equate to render the provision of Section 102 less valuable and empty its regulatory purpose.

It stems directly from the intent of Section 102(b)(7) that when plaintiffs do not support the claim with facts the alleged breach of the duty of loyalty by independent directors, that such claim must be dismissed, to protect the role and functions of independent directors in conflicted transactions.

As a result of these considerations, the Delaware Supreme Court reversed the judgement of the Court of Chancery that had previously denied the independent directors’ motion to dismiss the plaintiffs’ claim, and invested the Court to determine if the plaintiffs satisfied the requirement of pleading sufficient facts to support a non-exculpated breach of the independent directors’ fiduciary duties¹³⁴.

This judgement is significant for the liability regime of independent directors, as it finally clarifies a distinction between the liabilities of non-independent and independent directors, recognizing the differences of functions and therefore of responsibilities in case of breach of fiduciary duties, which depend on the actual role played by the single director in the debated transaction.

Moreover, the judgement was very important because it helped clarify the uncertainty that was arising very often in corporate litigation and clarified that independent directors will not lose their benefit of the company statute’s

¹³⁴ Cornerstone Therapeutics Inc. Stockholder Litig., Case 8922, (Del.Ch.)

exculpatory provisions, even when the debated transaction involves a controlling shareholder or another interested director.

Regardless of the standard of review applied to the transaction, the protection granted by Section 102 will be applicable at the motion to dismiss stage, unless, of course, the plaintiff has sufficient facts to prove an independent director's behaviour that goes further than the justifications provided by the exculpatory regime. For example, plaintiffs would have to provide evidence that the independent director breached his duty of loyalty or acted in bad faith, all actions that are unable to be comprised into the exculpatory regime. However, it is very difficult for plaintiffs, who did not closely participate in the debated transaction, to prove such violations.

One year before the *Cornerstone* judgement, in 2013, the Delaware courts refused to dismiss a motion regarding a breach of fiduciary duties towards the independent directors of the company sued in the *Puda Coal, Inc.* case¹³⁵.

The company's stockholders sued the independent directors because they failed to discover the unauthorized sale of company assets situated in China by the company's chairman.

The judge stated that the specific fiduciary duty that was at stake in this case is the duty of loyalty which, differently from the duty of care, if found violated may cause personal liability for the independent director, with the consequent absence of indemnification from the company.

However, this case is somewhat extreme because it deals with assets situated outside of the company's incorporation country and therefore, require an enhanced attention from the part of independent directors who should have, as the judge affirmed in the judgement, put in place additional controls in respect of those that would have been applied if the assets were situated into the country.

¹³⁵ Puda Coal, Inc. Stockholders Litigation, C.A. No. 6476-CS (Del. Ch. Feb 6, 2013)

The judge made it very clear that the behaviour of the independent directors in this case was to be comprised into the duty of loyalty, and not into the duty of care in the sense of a negligent behaviour. In particular, the judge made this clear by stating that “Independent directors who step into these situations involving essentially the fiduciary oversight of assets in other parts of the world have a duty not to be dummy directors. I’m not mixing up care in the sense of negligence with loyalty here, in the sense of our duty of loyalty. I’m talking about the loyalty issue of understanding that if assets are in Russia, if they’re in Nigeria, if they’re in the Middle East, if they’re in China, that you’re not going to be able to sit in your home in the U.S. and do a conference call four times a year and discharge your duty of loyalty. That won’t cut it.”

The judge further stressed that the reason why companies appoint independent directors is for their monitoring function, therefore in this case such directors should have, once again, put more effort in understanding and reviewing the situation of the company’s assets situated in another country, even more if this foreign country is a country like China, with significant linguistic, ethical and regulatory differences.

On the basis of the fact that the monitoring function implied in this particular case the control over assets that were harder to effectively monitor, and such enhanced control was not put in practice by the independent directors, it can be concluded that there was no good faith effort in the monitoring task. Another consideration that strengthens the breach of the fiduciary duties is, in the judge’s eyes, the fact that independent directors resigned as soon as they found out about the illicit activities put in place by the company’s chairman.

This, according to the judge, can be well considered as a breach of the fiduciary duties that directors have towards the company and its stockholders’ interest.

Even though, as stated earlier, this case involves extreme circumstances and facts, and therefore could be considered as a precedent only when a lawsuit concerns operations or company assets situated in foreign countries, the vision of

independent directors, their functions and responsibilities and in general, board responsibilities may need a major revision by Delaware law if such approach develops to be established case law and become an applicable Delaware standard.

In particular, the judge focused on the linguistic and cultural differences as a matter to be considered in order to precisely set the responsibilities of the independent directors, who had to, because of such differences, enhance their control.

Maybe in the future such details will become circumstances to be scrutinized by the courts in order to establish directors' liabilities, setting further standards in the analysis of the behaviour of corporate directors¹³⁶.

4.3 Sanctions for Independent Directors

The Securities and Exchange Commission has, in recent years, charged independent directors for corporate fraud actions in several cases.

This provides an important insight on how the SEC expects independent directors to react when there is evidence of management misconduct. It is interesting to note that the SEC did not consider harm to shareholders as being a fundamental predicate for enforcement actions against independent directors.

The reason behind this strict enforcement attitude has been explained by the SEC Chair Mary Jo White who states that the strategy is to legally pursue and eventually enforce any violation of securities law, because even the smallest violations are a sign of negligence towards regulations and, as such, should be punished in order to prevent the commission of bigger crimes.

¹³⁶ K. M. LaCroix, "Delaware Chancery Court: A Sweeping Vision of Outside Directors' Foreign Operations Oversight Responsibilities?", The D&O Diary, February 2013

The sanctions applied to independent directors by the SEC also serve the purpose of making clear the SEC's views about the duties of independent directors which, for decades, considered that the primary duty for outside directors was to gain familiarity with the company's public disclosure and accounting practices, in order to better perform their monitoring role¹³⁷. However, these views had never been quite enforced by the SEC before the corporate scandals of the early 2000's, as independent directors were never prosecuted for failing to activate themselves in regards of their monitoring duty and the enforcement actions were concentrated on punishing affirmative bad actions committed by independent directors.

The first case in which the SEC considered independent directors liable for not taking action in the presence of red flag situations occurred in 2003, where an outside director was sued for financial fraud, as he failed to review the management's accounting situation over a transaction, even though there was an evident disagreement on the issue between managers and the company's auditors. This was the first case, in the history of SEC's enforcement actions, that an outside directors was held liable for not taking action, rather than for affirmatively committing an unlawful action.

Following 2003, further actions were brought forward against independent directors for similar reasons. The most significant one is the case involving DHB Industries Inc.¹³⁸, in which three independent directors, who were part of the audit committee, were found liable for the company's securities law violations as a result of their negligent behaviour. In fact, the three former independent directors did not take any action towards several red flags that were an obvious sign of fraud. The independent directors' inertia facilitated the actions of management in the filing of materially false and misleading documents.

¹³⁷ L. A. Copenhefer, R. Joseph, *"Independent Directors: in the SEC's crosshairs?"*, Learning Curve, May 2016

¹³⁸ SEC v DHB Industries Inc. n/k/a Point Blank Solutions Inc., filed February 28, 2011

The SEC clearly blamed part of the management's success in the commission of frauds on the independent directors' behaviour by stating, in the judgement, that the directors failed to "to carry out their responsibilities as 'independent' directors and Audit and Compensation [] Committee members" as a result of them being "willfully blind to numerous red flags signaling accounting fraud, reporting violations and misappropriation at DHB. Instead, as the fraud swirled around them, they ignored the obvious and merely rubberstamped the decisions of DHB's senior management while making substantial sums from sales of DHB's securities."

The SEC's complaint also mentions that the actual independence of the independent directors was compromised by the long-time friendship relationship with the CEO of the company other than business relationships that each of the independent director entertained with the CEO, clearly influencing their impartiality and independence. Moreover, the CEO was granting the independent directors lucrative stock warrants, practice that goes against the concept of independence.

The SEC has sued independent directors for other violations as well. In particular, independent directors have been sanctioned for having misvalued securities. In fact, of all the enforcement actions towards independent directors by the SEC, the misevaluation of securities represent the greatest enforcement risk because five of the nine enforcement orders involved misvalued securities.

Regarding the actual sanctions that were applied to independent directors as a result of the SEC enforcement actions, many of the sanctions dealt with cease and desist orders and the application of monetary civil penalties, along with, sometimes, a multiple years bar from serving as independent directors¹³⁹.

As it can be concluded by analysing the various enforcement actions brought forward by the commission, its intention is not to consistently second-guess directors' actions, but to avoid violations of securities law resulting from

¹³⁹ Reed Smith Client Alerts, "Fair Valuation and Mutual Funds Directors: History of enforcement Actions Against Independent Directors", June 2014

omissive behaviours from the part of independent directors, who are those that should actually always keep an attentive eye towards any red flag sign and eventually take action to prevent any misconduct from management.

The SEC has decided to prosecute independent directors who do not consistently perform their preventive monitoring function in order to hold them responsible for actions that are facilitated by their omissive behaviour and that could have been prevented if the independent directors correctly performed their monitoring duties.

This means that, if independent directors want to avoid being held liable for their inactions, they should first thoroughly consider whether they have sufficient time to serve on a company's board as an independent director in order to regularly check for the appropriateness of the company's internal controls and accounting procedures, other than making sure that the components of the other committees are all skilled and experienced, in order to prevent that possible mistakes committed by other board members may fall on independent directors.

Furthermore, independent directors should also inform themselves about the D&O insurance programs offered by the company, in order to protect themselves from eventual future enforcement actions against them, considering the wide spectrum of actions that the SEC found as being the root for the liability of independent directors.

Indemnification policies and statute provisions about exculpation instances are also to be scrutinised by independent directors in order to fully evaluate the convenience of accepting the appointment as independent directors.¹⁴⁰

4.4 The criminal liability of Independent and Non-Executive Directors in Italy

¹⁴⁰ M. Tonello, "SEC Enforcement Actions Against Outside Directors Offer Reminder for Boards", Harvard Law School Forum on Corporate Governance and Financial Regulation, July 2011

Independent directors are an important corporate role in Italy as well and serve, as we know, to protect the interests of minority shareholders and the other stockholders.

Italy has a significant case law in regards of the criminal liability of non-executive directors, specifically in the matter of bankruptcy crimes, which in most cases results in the application of precautionary measures, both personal and patrimonial.

The affirmation of a criminal liability in the context of corporate operations is quite difficult because decisions are taken collectively, by the board. It follows that the single decision or behaviour adopted by a single board member is reflected in the board's decision as a whole. Thus, in the case of a lawsuit against a board decision that the shareholders consider unfair or taken in violation of directors' duties, the judge must assume the hard task of trying to separate the behaviours of the single board members and establish whether criminal liability arises for some of them.

The "reato collegiale", elaborated by the Italian doctrine in respect of crimes committed by a unitary body, have the peculiarity of referring to decisions that are taken by a single body and therefore result in a single and unitary measure.

The legal structure of these crimes identifies the liability of the body's members into their qualification of "body members" rather than into the characteristics of the crime *per se*.

However, the affirmation of a criminal liability in this sense, as existing only as a result of the participation in a certain body, carries the risk of leading to an incorrect application of the principle of fault, and therefore to an incorrect affirmation of a criminal liability. This is because it would render almost impossible for the judge to evaluate the single responsibilities of the members of the body.

The application of this concept to corporate boards is significantly inappropriate because, other than the consideration that it does not permit to correctly establish

the liability of each member, board members may have different functions within the board and therefore have a different impact on the decisions taken by such board. In this respect, the diverse functions performed by executive and non-executives, independent directors sustain the thesis of the necessary differentiation of liability among board members.

Decisions are, in practice, thought and rendered by the executive directors, while the directors who do not have any executive delegation such as independent directors mostly perform an advisory function. Those directors, in most of the cases, do not have sufficient knowledge to evaluate the scope and consequences of the act or decision object of the approval. Very often they base their knowledge upon opinions and documents that are provided by management before the approval meeting. It follows that important corporate acts such as budget approval, loans for financial operations, and merger transactions, are usually approved by board members on the basis of poor or insufficient knowledge, and acquired little time before the approval meeting.

This means that it may occur that the favourable or non-favourable vote rendered by the various board members depends, in reality, on the personal or professional relationship with the executive directors. Obviously, this has a consistent consequence on the psychological aspect of the decisions taken and thus of the personal liability, in the event that the board decision is the object of claims of unlawfulness by shareholders, if decide to turn to litigation.

The issue then is to determine the extension of the potential criminal liability stemming from the independent director's behaviour, consisting in a negligent attitude towards the act that has to be approved, as he does not collect the sufficient information necessary to cast a well-informed vote on the corporate act. The determination of such extension depends on the relevance and scope of the actual task attributed to each board member. In particular, case law differentiates between two factors: (1) whether the directors cover the functions

of “guarantors” of the company’s interest and (2) the existence of bad faith in the negligent behaviour performed by the directors.

Case law tends to individuate an “improper omissive conduct” (*fattispecie omissiva impropria di natura dolosa*) in the actions of an independent director who does not impede the commission of unlawful acts by the entity that he is supposed to monitor. However, such an approach would have the unwanted effect of significantly enlarging the threshold of liability in the environment of board activities.

The setting of Italian case law in the area of corporate crimes can be summarised into the following reasoning: it is established that independent directors perform a “guarantor” function, according to the obligations stemming from the articles 2392¹⁴¹ and 2403¹⁴² of the Italian Civil Code, the behaviour of the independent director who the non-executive director who, as a result of negligence, allows directors to commit illicit activities, can be qualified as eventual wilful default (*dolo eventuale*).

141 Art. 2392 “Responsabilità verso la società”:- [1] Gli amministratori devono adempiere i doveri ad essi imposti dalla legge e dallo statuto con la diligenza richiesta dalla natura dell'incarico e dalle loro specifiche competenze. (2) Essi sono solidalmente responsabili verso la società (3) dei danni derivanti dall'inosservanza di tali doveri, a meno che si tratti di attribuzioni proprie del comitato esecutivo o di funzioni in concreto attribuite ad uno o più amministratori.- [2] In ogni caso gli amministratori, fermo quanto disposto dal comma terzo dell'articolo 2381, sono solidalmente responsabili se, essendo a conoscenza di fatti pregiudizievoli, non hanno fatto quanto potevano per impedirne il compimento o eliminarne o attenuarne le conseguenze dannose.- [3] La responsabilità per gli atti o le omissioni degli amministratori non si estende a quello tra essi che, essendo immune da colpa, abbia fatto annotare senza ritardo il suo dissenso nel libro delle adunanze e delle deliberazioni del consiglio, dandone immediata notizia per iscritto al presidente del collegio sindacale.

142 Art. 2403: “Doveri del collegio sindacale”: - [1] Il collegio sindacale vigila sull'osservanza della legge e dello statuto, sul rispetto dei principi di corretta amministrazione ed in particolare sull'adeguatezza dell'assetto organizzativo, amministrativo e contabile adottato dalla società sul suo concreto funzionamento. (2)- [2] Esercita inoltre il controllo contabile nel caso previsto dall'articolo 2409-bis, terzo comma. (3)

The position of the Italian Supreme Court¹⁴³ on this matter is very significant, as it identifies the foundation of the “guarantor” role of directors in art. 2392 and further states that directors must prevent harmful acts not only in respect of the company, but towards creditors, shareholders and third parties as well. In the event that the director does not honour his guarantor function, he might be held liable, ex art. 40, for not having acted to prevent the commission of bankruptcy crimes by the other directors.

The Supreme Court further affirmed this approach in a recent judgement¹⁴⁴, which dealt with independent directors who had accepted their appointment in the company for the sole purpose of giving prestige to the company’s board. The Court re-affirmed the obligation stemming from art. 2392, that provides for a residual liability for directors in respect of wrongful acts committed towards the company as a whole, towards third parties or creditors.

However, the demarcation of the non-executive directors’ responsibilities in such manner, may result in unfair judgements because very often, they do not have the practical powers to effectively prevent the commission of wrongdoings. In fact, the consideration that the foundation of such liability is a civil code attributes to such liability a mere patrimonial nature.

Furthermore, additional critics derive from the qualification of the subjective element as “*dolo eventuale*” as, in most cases, directors solely have the representation of the unlawful event, circumstance that does not fulfil the legal requirements of *dolo eventuale*.

More specifically, the Supreme Court finds the requirements for the affirmation of the directors’ wilful default into the diligence obligations, which are actually typical elements of fault rather than those of wilful default, and into the knowledge of dangerous events that might qualify as unlawful acts, through the so-called red flag situations (*campanelli d’allarme*), which have also been

¹⁴³ Cass. Sez. V, 27.5.96, in *Riv. trim. dir. pen. ec.* 1996

¹⁴⁴ Cass. Sez. V, 24.5.2006 in *Riv. trim. dir. pen. ec.*, 2007

previously discussed in the analysis of the Delaware courts' approach towards the liability of independent directors.

The Court specified this reasoning by further stating that the existence of wilful default stems by the mere fact that the independent director could potentially know about the red flag situation.

The circumstance that the independent director may have performed certain tasks in the company and thus had a consistent knowledge of the group's dynamics, may be considered by the courts as an opportunity for the director to know about potential unlawful acts and, in the event that crimes have been actually committed by other directors in such setting, the independent director's liability might be found by the court.

Considered that the existence of liability for a non-executive or independent director depends on his ability to acquire appropriate information, on the fact that information was provided to him and on the basis of the actual use that was made by that director of that information; it follows that, because the independent director regularly sits on advisory boards, remuneration committees or audit committees, the chances that he might come across such useful information are more consistent in respect of those of the non-executive director, who does not usually sit on these specific committees. However, independent directors very seldom have actual powers to prevent or stop corporate insiders to pursue unlawful transactions¹⁴⁵.

It follows that the Italian judiciary attitude towards liabilities of non-executive members of company boards could be considered as being unfair and thus pursuing political goals rather than rendering fair judgements.

¹⁴⁵ L. Gaspari, " *Sulla responsabilità dell'amministratore indipendente quale componente in un comitato consultivo*", in *La responsabilità degli amministratori indipendenti*, Nedcommunity, 2006

In fact, the substantial function attributed to independent directors, considered as guarantors of the company's interest, is not followed by the vesting of practical powers to impede the commission of crimes by the other company directors¹⁴⁶.

In a more recent judgement¹⁴⁷, the Italian Supreme Court may have considered the abovementioned critics and has rendered a judgement that partially departs from the previously mentioned considerations. The court has affirmed that the non-executive director cannot be considered liable for the conduct assumed by the other directors, except when he breaches his obligation to always act informed. It follows that it is essential for the non-executive director to require information about the acts performed by the other directors and on the basis of such information, decide his conduct.

On the contrary, if he does not comply with such information duty, he might be liable together with the wrongdoers.

4.5 De facto directors and their duties towards the corporation

The United States do not provide for explicit provisions or regulations regarding the so-called “*de facto* directors” or “shadow directors”.

Conversely, the UK's Companies Act 2006 provides for a very comprehensive definition of a director, affirming that it includes “any person occupying the position of a director, by whatever name called”. Under UK law, there are three different categories of directors, comprising *de jure* directors, shadow directors and *de facto* directors.

Some uncertainty persists in regards of the exact difference between shadow and *de facto* directors.

¹⁴⁶ F. FogliaManzillo, “*Amministratori non delegati, responsabilità penale da mera posizione nelle fattispecie di bancarotta ed applicazione di misure cautelari*”, *Diritto Penale dell'Impresa*, February 2013

¹⁴⁷ Cass. Sez. I, 31.8.2016 n. 17441

We are going to first analyse the role and implications of shadow directors.

A shadow director is considered by the law as a person "in accordance with whose directions or instructions the directors of the company are accustomed to act.". Such persons may be both individual persons or companies. Section 251 of the Companies act provides for certain exceptions to the abovementioned definition¹⁴⁸.

It is therefore easy for parties such as majority shareholders, consultants and advisors to be considered as de facto or shadow directors. Such definition makes holding companies a perfect example of what could be considered as shadow director. In fact, the subsidiary is accustomed to act pursuing to the instructions given by the holding company, in particular from its board. The capacity of the holding company as shadow director can be affirmed only if it establishes more than the mere subsidiary's business policy. Moreover, the individual directors members of the holding company's board are not considered individually liable for the instructions given to the subsidiary, unless such directors go as far as

148 Section 251 of the UK Companies Act 2006: "Shadow director": (1) *In the Companies Acts "shadow director", in relation to a company, means a person in accordance with whose directions or instructions the directors of the company are accustomed to act.*

(2) *A person is not to be regarded as a shadow director by reason only that the directors act*

(a) on advice given by that person in a professional capacity;

(b) in accordance with instructions, a direction, guidance or advice given by that person in the exercise of a function conferred by or under an enactment;

(c) in accordance with guidance or advice given by that person in that person's capacity as a Minister of the Crown (within the meaning of the Ministers of the Crown Act 1975)]

(3) *A body corporate is not to be regarded as a shadow director of any of its subsidiary companies for the purposes of—*

Chapter 2 (general duties of directors),

Chapter 4 (transactions requiring members' approval), or

Chapter 6 (contract with sole member who is also a director),

by reason only that the directors of the subsidiary are accustomed to act in accordance with its directions or instructions.

providing personal instructions, and therefore not representing the whole board's decisions. The single director should thus always make sure that the instructions are approved by the board in order to avoid being held personally liable.

Regarding the possibility for the company's advisers to be qualified by the law as shadow directors, it is important to first note that the Companies Act clarifies that a person's instructions may not be considered as the foundation for the qualification as a shadow director if such instructions are given in a professional capacity. It follows that if the adviser provides the company with instructions that go beyond his professional capacity, and such advice is followed by the company, the courts may still consider the adviser as a shadow director.

Sometimes banks could find themselves in the position of being considered shadow directors. This might occur when the company is bound to follow the bank's instructions regarding the managing of the company's capital as a result of the company's financial difficulties. The more the bank is involved, through for example the imposition of a bank's nominee director in the company's board, the more there is the risk of being deemed a shadow director. However, except extreme cases as the presence of a bank's nominee director on the company's board, as long as the bank's or lender's instructions are limited to the restrictions which are necessary to continue with the provision of the bank's facilities and loans, there is no such risk.

By looking at the statutory provision, the focus is put on the expression "accustomed to act", as the essential element of a shadow director-company relationship. Usually, in order for that requirement to be satisfied it is usually prescribed that the company's board must have followed the instructions on several occasions. However this is not always that case, as courts might consider that a single instruction, followed by the board, was so consistent and material to the company's business that the party providing for such instructions should undoubtedly be qualified as a shadow director.

The provision further accentuates the nature of the instructions, which must assume the form of instructions or directions rather than the form of

recommendations or advices. This is a matter that should be evaluated by the courts on a case by case basis, in light of all the facts. What matters, for the courts' analysis, is the substantial nature of those communications, thus simply classifying the communication with a different label will not exclude its qualification as "instruction" if the board actually is obliged to act accordingly.

Furthermore, the shadow director role does not require the company's board to be completely dependent on the shadow director's instructions, as it is enough that the company is accustomed to act in accordance with the directions given by the shadow director, who, moreover, might as well acknowledge his position, conversely from the *de facto* director.

Turning the analysis to *de facto* directors, these are persons who act as directors but have not been formally appointed. This might happen in two circumstances: when a person has agreed on his appointment as a company's director but, for some reasons, perhaps linked to the lack of some requirements stated in the articles of association in regards of directors requirements, the appointment is defective; or when a person has not been appointed as director but carries out activities that should only be performed by board members.

The courts have identified several situations that might suggest the presence of a *de facto* director such as the fact that the person in question is the only person in charge of a certain company department or the fact that the person in question negotiates with third parties on behalf of the company.

One of the most significant problems arising out of the question of shadow and *de facto* directors pertain to the definition of their duties towards the company.

The matter is easily solved in regards of *de facto* directors as they fall under the general definition of "director" provided for in Section 250 of the 2006 Companies Act.

It follows that *de facto* directors will be bound by the same fiduciary duties and legal obligations provided for by state law and by the specific company statute. This means that even if not formally appointed, the *de facto* director is still considered liable for breaches of fiduciary duties. The only legal issue regarding

de facto directors and that brings legal uncertainty regards the exact identification of de facto directors, a matter that, as mentioned earlier, is left to the courts' considerations.

While, as explained, de facto directors owe to the corporation the same duties that are owed by directors, the problem lies in understanding which duties apply to shadow directors. While the Companies Act expressly states that shadow directors will be considered liable in the same manner as the other directors in some specific areas, such as wrongful trading and conflict of interest transactions, it has not always been clear whether they also owe fiduciary duties to the company and whether they are to be held liable for eventual breaches of such duties.

This issue was dealt with by the High Court in 2013¹⁴⁹, which affirmed that shadow directors owe fiduciary duties to the company at least in regards of the directions or instructions given to the company's board. More specifically, the court mentioned the duty of loyalty.

As a result of this judgement, persons being involved with a company's affairs should be careful in not performing actions that might include them in the definition of shadow directors, without them being aware of such potential qualification and consequently being held liable for the consequences of the actions performed by the board according to that person's directions¹⁵⁰.

De facto directors are regulated by Italian law as well.

Under Italian law, de facto directors have managerial functions such as the power to take decisions in the name and on behalf of the company, without, however, being formally appointed through a company's resolution. In particular, the invalidity of the appointment may derive both from an invalid resolution or from a non-existing resolution. Non-existing resolutions are those resolutions which

¹⁴⁹ Vivendi SA and anor v Ricards ad anor, 2013

¹⁵⁰ J. Blossfeldt, "Shadow directors and de facto directors – do they owe duties of care?", Foxwilliam news, May 2015

lack one of the legal elements required by law in order for the resolution to produce legal effects. The invalidity may derive from the fact that the resolution has been passed by a body that lacked the power to act in such respect, when the required quorum was not reached, when the shareholders' meeting was called by a non-legitimized body, when votes were not properly casted and so on. Such cases have been developed by case law.

The adoption of non-existing resolutions have a domino effect into the company as they produce the invalidity of every resolution or shareholders' meeting eventually called by the de facto director, as a result of the irregularity of his appointment resolution.

As regards the duties binding the de facto director under Italian criminal law, de facto directors are subject to the same duties and prohibitions binding on rightful directors. If they were to be exonerated from such prohibitions, this would equate to affirming that the invalidity of their appointment excludes their criminal liability, placing them in an unjust advantageous position in respect of the rightfully appointed directors. It follows that the company can take actions against both rightful and de facto directors for corporate criminal crimes such as bankruptcy crimes, without, however, the need for a shareholders' meeting resolution in regards of actions against the de facto director.

The same reason provided for the subjection of de facto directors to criminal prohibitions has been carried out by some Italian case law and literature in respect of civil liability. In fact, if de facto directors were not to be considered liable for negligent or wilful mismanagement of the company as rightful directors are, this would, again, create an unjust protectionist attitude towards de facto directors and thus disadvantaging creditors and third parties who might have been damaged by the actions of de facto directors.

Rightful directors are bound by art. 2392 of the Italian civil code which prescribes that directors must fulfil their fiduciary duties towards the company with diligence and are jointly liable for any damage caused to the company. However, rightful directors' decisions are protected by the business judgement

rule, thus not subject to the scrutiny of the courts. It follows that the plaintiffs must prove to the judge, in the event of a lawsuit against the rightful directors, the wilful default or gross negligence of the directors' actions, while the latter are called by law to counter-prove the fairness of their actions.

In regards of de facto directors, it has been for long discussed whether it is appropriate to bind them by the same liability regime prescribed by articles 2392-2394 of the Civil Code. Some legal scholars have sustained the applicability of such liability regime to de facto directors by assimilating them to general directors (*direttori generali*, art. 2396) or by stating that the liability regime provided by the Civil Code is to be applied to every case of managerial activity, regardless of the presence of a formal appointment of the individual performing such managerial role. However, the dominant approach is to exclude the subjection of de facto directors to the same liability regime prescribed for rightful directors, thus affirming that the sole exercise of managerial functions, without a formal appointment, are not sufficient to bind de facto directors by the same duties to which rightful directors are subjected¹⁵¹.

The abovementioned theory of subjecting de facto directors to the same civil liability prescribed for rightful directors because the same happens in regards of criminal liability is incorrect and does not take into consideration the fact that criminal liability regimes and civil liability regimes pursue different objectives: criminal prosecution is done in light of the public interest and, therefore, is based on different considerations and needs.

Moreover, the fact that Italian law considers the liability of the *falsus procurator* as being tortious is an indirect denial of the opinion by which de facto directors should be subjected to the same civil liability as rightfully appointed directors.

It follows that while shareholders necessarily need a shareholders' meeting resolution to act against the rightful director, because of the presumption of good faith of the director's behaviour, the situation is different in respect of de facto

¹⁵¹ G. F. Campobasso, "Diritto delle Società", UTET (8° edizione), 2012

directors. Shareholders can in fact act individually against de facto directors, thus not needing the shareholders' meeting resolution¹⁵².

¹⁵² G. Valcavi, *“Sulle responsabilità degli amministratori di fatto verso le società e i soci”*, *Scritti di Diritto Civile*

CHAPTER 5

Enforcement of substantive rules – Shareholders Litigation

5. Public enforcement vs Private enforcement

An essential element for the efficiency of independent directors and, in general, for the efficiency of gatekeepers, is the actual enforcement of substantive rules. In the last decades, as a result of the several corporate scandals that have interested not only the United States but Europe as well, much effort has been put to formulate more elaborate and complete corporate governance rules. Codes of conduct have been adopted in almost every country with developed market economies and companies everywhere have tried to adhere to corporate governance recommendations issued by governments and regulatory authorities. However, part of the blame for the only partial success of these enhanced corporate governance strategies is to be given to the weak enforcement actions of such rules.

The main distinction among enforcement mechanisms is that between private and public enforcement. When enforcement actions are public, it is the government that acts as the prosecutor and the whole final enforcement system is provided by the government. Conversely, private enforcement is carried out by private agents who prosecute the wrongdoers and use the framework provided by law, which is the courts system, to obtain a judgement and eventually compensation.

Private and public enforcement are inter-connected, this is because the effectiveness of private lawsuits really depends on the actual efficiency of

public mechanisms such as the court system, the sanctions regime and other litigation consequences that depend on the government.

While public enforcement is less costly than private action, sometimes it could be less effective because individuals tend to have more information and incentives, as they usually are the ones who have been directly damaged by the addressees of the lawsuit¹⁵³.

In the United States, which is one of the most developed stock markets, lawsuits against corporate directors for alleged breaches of fiduciary duties are very rare and most importantly, the majority of lawsuits do not get to a final judgement as they are frequently dismissed, as we have discussed in the previous chapter relating to the liability of directors.

Legal literature has for long discussed about the perks of private enforcement in respect of public enforcement mechanisms and some sustain the so-called “private enforcement primacy” view, which stands on the idea that private agents have better incentives to carry out actions against company directors than public agencies do. However, other views rely on a “multiple mechanisms” approach and state that private enforcement is useful but not essential to fight manager misconduct, and that all enforcement strategies as for example those brought by securities regulators, stock exchanges rules and the scrutiny of transactions by intermediaries can all contribute, along with shareholders exercise of their rights, to fight against the mismanagement of corporations.

The role of private enforcement or other enforcement mechanisms depends on various factors that differ among countries. In particular, these factors include rules of civil procedure, the duties imposed on directors and procedural rules governing the process for shareholders litigation. By considering all these factors, it is easy to understand why private actions are fairly common in the United States, as numerous rules of civil procedure turn out to be more

¹⁵³ E. Berglof, S. Claessens, “*Corporate Governance and Enforcement*”, World Bank Policy Research Working Paper 3409, September 2004

favourable to plaintiffs and therefore, it is more convenient for them to turn to private litigation against unloyal or negligent directors.

These factors include the regime established in regards of legal expenses, that provides that in the event of a successful claim against the corporation, the latter will pay the legal expenses suffered by the shareholders, otherwise each party pays for their own legal fees. Moreover, shareholders can bring a direct action against directors if a direct harm has been caused to shareholders: the possibility for shareholders to bring direct actions is a big achievement for shareholders because it allows them to get directly compensated if the directors have been found liable by the court, instead of waiting to receive compensation through the company's assets, as it is the company who gets compensated in cases of derivative suits against the directors.

Many of the shareholders lawsuits involve take-overs because even though the law clearly states that directors owe duties of loyalty and care to the company, the duties of disclosure and enhanced care when a take-over is at stake are not clearly defined by the law. It follows that self-dealing transactions and conflict of interest transactions are dealt with by the courts as involving the duty of loyalty. This, of course, enhances potential litigation.

Furthermore, when in the United States directors may have breached their fiduciary duties, shareholders are usually able to commence litigation against directors in the form of a direct action if the harm is caused directly to shareholders or in the form of a derivative suit if it is the corporation that has been principally being damaged. The easiness with which US shareholders are able to resort to litigation against directors is not always reached in other countries, it follows that in countries where shareholders are not encouraged, through the enactment of lenient procedural rules, to sue directors, it is more likely that corporate issues are dealt with by public enforcement mechanisms instead of private actions.

For example, in the United Kingdom direct actions are not available for shareholders and derivative suits are regulated in a way¹⁵⁴ which makes it very hard for the suit to follow its course and reach a judgement.

According to a research carried out by J. Armour, B. Black, B. Cheffins and R. Nolan on the rate of litigation involving corporate directors of US publicly held companies as defendants, in the state of Delaware, it is interesting to notice, as it has also been anticipated in the previous chapter, that there is a significant gap between the lawsuits that were actually filed and those that contain a judicial decision¹⁵⁵. This happens because many of these cases get dismissed upon a motion to dismiss requested by the directors and, also, many cases sit with no action, where neither the plaintiffs pursue the case nor the directors seek for dismissal.

By looking at the various lawsuits involving directors as defendants, the primary target are insider directors for alleged misconducts and sometimes outside directors for failing to respond appropriately to the insiders' behaviour. Statistically, it is more likely that courts dismiss the claim upon a request from the defendants or decide to proceed with a summary judgement. Also, it is very uncommon for directors to have to perform out-of-pocket payments because of the many protections that the company provides for its directors, including D&O insurance, exculpatory provisions contained in Section 102(b)(7) of the DCGL and more in general, the business judgement rule. All of these protective devices have been discussed in the previous chapter regarding directors' liability.

¹⁵⁴ In the UK, the company is the only plaintiff in a suit alleging a breach of a duty, the board will control every decision about litigation. However, this regime is bound to change with the introduction of the Companies Act 2006 pt.11 which should make derivative suits easier.

¹⁵⁵ Thompson and Thomas, in *"Delaware Class Action"* 2004, found that in the year between 1999 and 2000, 150 cases were filed in the state of Delaware involving claims for breach of fiduciary duties, but only 20 decisions were actually issued by Delaware courts.

Even after the considerations about the various protective tools enacted by corporations to shield their directors from personal liability, it is still more likely that lawsuits are brought before a US court rather than before an UK court because of the more lenient US procedural rules, that encourage shareholders to engage in litigation whenever they claim breaches of fiduciary duties from the part of directors. However, the potential inefficiency of private actions, resulting from the fact that half of these lawsuits get dismissed before getting to an actual trial, may be the basis for starting to consider other mechanisms of enforcement besides private litigation, such as public enforcement or extra-legal substitutes¹⁵⁶.

Public enforcement refers to legal actions brought by organs of the state. These include not only local prosecutors but national regulatory authorities such as the SEC as well, which as seen in the previous chapter, has often intervened to sanction independent directors for their breach of the duty to monitor.

Stock Exchanges authorities such as the Nasdaq and NYSE are considered as public enforcers too, as they might act *ex-ante* by requiring compliance with their rules or *ex-post* by applying sanctions in the event of non-compliance¹⁵⁷.

Public enforcement carried out by the SEC can disqualify directors if they are found liable and therefore bar them from sitting on the board of publicly held companies. The SEC is the principal governmental body charged with the duty of monitoring and enforcing federal securities laws, and several enforcement powers are conferred to the Commission such as the power to initiate litigation against directors who violated securities law provisions, eventually disqualify liable directors and impose sanctions and administrative fines.

¹⁵⁶ J. Armour, B. Black, B. Cheffins, R. Nolan, "Private Enforcement of Corporate Law: An Empirical Comparison of the United Kingdom and the United States", Volume 6, Issue 4, 687-722, Journal of Empirical Law Studies, December 2009

¹⁵⁷ See note 1, J. Armour, H. Hansmann, R. Kraakman, *op. cit.*

Despite the large authority conferred upon the Commission, the SEC still considers private enforcement as an essential mechanisms in order to fully achieve compliance with the federal securities and disclosure law.

The SEC is the primary enforcer of federal provisions regarding disclosure requirements in the event of related party transactions. It does so by a variety of techniques, with both ex-ante rules which have to be complied with by companies with registered securities and ex-post measures such as the revocation of the registration of the issuer's security. Moreover, the Commission can impose fines and seek injunctive relief or, in extreme cases, refer to the Department of Justice for criminal prosecution.

Regarding the importance of private agents along with the SEC's federal powers to ensure the compliance with federal disclosure and securities law, investors can bring class actions against directors who have produced false or misleading information about related party transactions, thus causing a damage to the company's shareholder.

Moreover, along with securities law, take-overs are regulated by state law fiduciary disclosure duties and by specific disclosure requirements that federal law prescribes for tender offers and mergers. In regards of such rules, their enforcement is typically handled by shareholders through class actions.

It is namely in these specific roles that private actions play that we can notice the inter-connectivity between private and public enforcement. In fact, even though such provisions are enacted by national authorities such as the SEC and the Exchanges, and can also be enforced by these agents, it is nevertheless more likely that shareholders bring actions against directors in force of such rules, by way of private lawsuits¹⁵⁸.

Particularly in the United States, and differently from other jurisdictions in which substantive rules tend to be more intensely enacted and provide for a more precise legal framework, private enforcement may have took the role of

¹⁵⁸ OECD (2013), *Supervision and Enforcement in Corporate Governance*, Corporate Governance, OECD Publishing

compensating for such weak substantive protection and thus produce a shareholder-friendly result in courts. The main area in which a lack of substantive regulation, leading to a higher percentage of litigation, can be observed is the take-over regime. In fact, take-overs are not organically regulated by federal legislation and thus shareholders must rely on courts' judgement in the event that directors do not honour their fiduciary duties. Conversely, in the UK take-overs are comprehensively regulated by the Take-over Panel, this, of course lowers the likeliness of litigation because duties and obligations of the board are already thoroughly regulated by the law.

It can be concluded that the rate of public and private enforcement depends on a variety of factors which differ from jurisdiction to jurisdiction and, most importantly, there is a significant interdependency between governmental actions such as legislation and enforcement by national authorities and private enforcement as such.

The belief of the close connection between private and public enforcement can be further strengthened by considering that when attempting to prevent frauds, non-monetary fines such as imprisonment ordered by a court, are necessary because the level of benefit that a director or insider may derive from committing a fraud is so high that sometimes it could, monetary speaking, be worth the risk of being sued and potentially ordered to pay damages. Moreover, from a prevention standpoint, mandatory disclosure is also needed to avoid frauds. These mandatory disclosure provisions can only be verified by a public enforcer, through a private action carried out by shareholders.

In an ideal world, public enforcers would be the perfect agents to investigate and punish corporate wrongdoings because of the presumed larger access to information and investigation tools, that are significantly reduced for private agents, and for the financial resources needed to bring lawsuits to a conclusion. However, this does not reflect the reality as very often it is the private agents who have more access to the information needed to investigate a certain case, because of their involvement in the debated transaction and, most importantly

have more incentives to legally pursue directors who have caused harm to the corporation. It is therefore necessary to ensure to shareholders the access to litigation.

The point is then, not to pick which type of enforcement, private or public, better suits the political and regulatory goals of corporate governance, but it is the research of an optimal balance between these enforcement mechanisms as it is clear that they both serve a purpose in the development of the market.

It is essential at this point, to set up effective coordination systems between the roles of legislation and litigation, taking into extensive consideration the role that private enforcers play in the latter¹⁵⁹.

5.1 Shareholders actions against management misconduct

The qualification of “shareholder” of a company derives, as we know, from the ownership of shares in the corporation. When a person assumes such qualification, several rights stem from it.

When these rights are breached by those in charge of management, shareholders have the right to obtain compensation. Such compensation and the procedure that shareholders need to follow depend on the type of fiduciary duty that is substantially being violated by management.

In particular, shareholders have the right, among others, to inspect the company’s books and records. If, for example, such right is denied to a shareholder, he may sue the corporation through a “direct action” because the denial of his right to inspect the company’s books caused him a direct harm. Direct actions give shareholders the right, if successful, to obtain personal relief.

¹⁵⁹ G. Ferrarini, P. Giudici, *“Financial Scandals and the Role of Private Enforcement: The Parmalat case”*, Law Working Paper n° 40/2005, ECGI, May 2005

If, by contrast, the managers perform an action that harms the corporation as a whole instead of a single or more individual shareholders, it is the corporation that is directly damaged while the shareholders only suffer an indirect harm deriving from the reduction of the company's assets if, for example, the misconduct of managers involve the unlawful appropriation of corporate assets.

The corporation may sue the directors and obtain recovery of the misappropriated assets and shareholder will be indirectly compensated as well.

If the corporation is unwilling to sue the wrongdoers, the shareholders may act on behalf of the company through a "derivative suit". Similarly, compensation will be addressed to the corporation and shareholder can indirectly benefit from it by way of the increase of the corporate assets.

However, sometimes it hard to precisely identify the line between a derivate suit and a direct action, as it depends on whether a direct harm was caused to the individual shareholders or to the company as a whole.

The legal imposition of passing through a derivative action on behalf of the corporation in the event of management misconduct traces back to the autonomous legal personality of the company. The corporation and its shareholders are two distinct legal entities, this means that when damage is caused to the corporation's property, such as its assets, it is the corporation that should act. Other than legal considerations, there are also other reasons like the political need to avoid an excessive amount of lawsuits, that could undermine the efficiency of the judiciary system¹⁶⁰.

When shareholders feel that they have been directly damaged by the actions of management, they will try to bring a direct action before the court, claiming a direct injury. The court will however make a determination on the basis of the damage itself and not solely on the basis of the plaintiff's claim. It follows that the harm claimed by the shareholder, in order for the court to permit the direct

¹⁶⁰ J. B., "Distinguishing between direct and derivative shareholder suits", University of Pennsylvania Law Review, Vol. 110:1137

action, has to be separate and independent from the harm suffered by the company.

Cases that are more doubtful in regards of the distinction between indirect and direct shareholders' damage are the instances of unlawful misappropriation of corporate assets or corporate opportunities, as they might be abstractly viewed as both harmful to the company and to shareholders.

However, they are more commonly included in the category of derivative suits.

The relationship intercurring between direct and derivative actions has been described by the Delaware Court by affirming that “the line of distinction between derivative suits and those brought for the enforcement of personal rights asserted on behalf of a class of stockholders is often a narrow one, the latter type of actions being designed to enforce common rights running against plaintiffs' own corporation or those dominating it, while the former are clearly for the purpose of remedying wrongs to the corporation itself.¹⁶¹”

Other than the difference regarding the abstract legal basis for a derivative suit or for a direct action, which is the direct or indirect harm to shareholders, these two types of actions also bear distinct procedural rules.

As regards derivative suits, shareholders can assert claims against other shareholders, management or against specific directors but, most often derivative suits are carried out against corporate insiders such as directors or majority shareholders. Derivative actions serve two functions: compensation and deterrence. In fact, directors or corporate insiders in general will likely be more careful about their actions within the company knowing that they could be sued by shareholders, even if the company rejects the derivative suit request.

In fact, in order to successfully bring a derivative suit before a court, shareholders are obliged to first present a written demand to the board of directors and thus invite the board to pursue to claim itself. The board may as well refuse the request, but this will enable the shareholders to challenge the

¹⁶¹ *Abelow v. Symonds*, 156 A.2d 416, 420 (Del. Ch. 1959)

board's decision as a breach of a fiduciary duty. The court will then scrutinize the board's decision and if such decision cannot be comprised into the business judgement rule, the shareholders will be then allowed to pursue their derivative claim before a court and eventually obtain a judicial decision.

By comparing derivative suits to direct claims, it is easily understandable why shareholders would always prefer direct actions over derivative ones. The main reason is that, if the court finds the shareholder's claim to be reasonable, compensation will be directly attributed to the shareholder instead than to the corporation. Secondly, the procedure established for direct actions does not bind shareholders to previously ask, through a written demand, the board to pursue litigation itself.

Courts tend to allow shareholders to bring direct suits when the harm they claim to have suffered is direct and independent of any harm caused to the company. Example of this type of independent damage are the case in which shareholders are deprived of their right to inspect the company's books or of their voting rights, or when there is a claim that directors have compelled them to sell their stock in the company. The criteria that courts use to differentiate between direct and derivate suits varies and may thus lead to different results depending on the court before which the claim is brought.

According to the practice used in many areas of corporate law in which courts have to decide whether a certain matter falls into one category or the other, US courts have developed three tests to determine whether the action can be brought forward as a direct action or as a derivative action. These three tests are based on the finding of a direct harm, a special injury or a duty owed.

The direct harm test relies on the finding of whether the shareholder or the corporation were harmed first. If the shareholder was harmed first than the company, courts will therefore allow the damaged shareholder to sue directly. Conversely, if the corporation was harmed first, the shareholder will have to act on behalf of the company and bring a derivative claim.

The direct harm test has been endorsed by the American Law Institute (ALI), who encourage court to use this test to differentiate between derivative and direct suits¹⁶².

The second test is more specific and requires a deep analysis of the claimed harm by the court. Under the special injury test, shareholders can bring direct suits only if the harm is separate and distinct from any harm suffered by the corporation. This test has different degrees of application: the most strict interpretation of it requires that the injury must be distinct from any injury suffered not only by the company but by the other shareholders as well¹⁶³. Some jurisdictions apply a more lenient interpretation of the special injury test and only require the claimed injury to be distinct from the corporation's.

The Delaware Supreme Court adopted an organic definition of special injury, combining both interpretations of it by stating that a special injury must be considered as such when it is “not suffered by all stockholders generally or where the wrong involves a contractual right of the stockholders, such as the right to vote.”¹⁶⁴ However, the Delaware courts no longer use the special injury test but rely on the analysis of who suffered the harm, instead.

The third test encompasses two considerations: the finding of whether a duty was breached and the further discovery of the person to whom the breached duty was owed. Under the duty owed test, a claim can be brought forward as a direct claim if the corporation or a director have infringed a primary right belonging to the shareholder deriving from the company's articles, state law or from agreements concluded between shareholders or between the shareholder and the corporation. The rights stemming from the abovementioned sources all have in common the fact of being shareholders' rights and not pertain to the corporation. It follows that the duty owed test is the only test that allows shareholders to bring a direct

¹⁶² A.L.I, Principles of Corporate Governance: Analysis and Recommendations, Paragraph 7.01(a)

¹⁶³ A perfect example of such distinct injury is the case of a breach of a separate contract between the individual shareholder and the company.

¹⁶⁴ In *Tri-Star Pictures, Inc.* 634 A.2d 319, 330 (Del. 1993).

suit even if the company has suffered a harm as well. What is required, according to the test, is that the injury stems from the breach of a duty owed to the shareholder-plaintiff, independently of his status of shareholder.

As mentioned earlier, Delaware courts used the special test until recently. The change of approach occurred in 2004 in the *Tooley v. Donaldson*¹⁶⁵ case, in which the court applied the direct harm test instead. The current direct harm test used by the state of Delaware is based on the considerations of who suffered the harm and of who would eventually receive the benefit from the recovery or remedy. In this specific case the court did not conclude whether the claim was direct or derivative because it sustained that the claim was not ready to be brought forward but the courts did use the direct harm test in the litigation following the *Tooley* case in order to establish whether the claim was derivative or direct.

Of course, the distinction between derivative and direct claims is significant in the eyes of the plaintiff, as it determines the direct or indirect recovery of the damage. Therefore, the choice of one test or the other by the courts assumes a remarkable importance for shareholders' litigation¹⁶⁶.

If the courts adopt the direct harm or the duty owed tests, it is more likely for shareholders to succeed in their attempt to bring a direct claim instead of a derivative one as the elements to be considered under both tests are more generic and less specific than those contained in the special injury test.

Derivative suits were the earliest and main instrument to constrain management and its misconduct. The importance of derivative suits as a mean to control management however has reduced since the first decade of the twenty-first century as a result of the development of other types of control, such as the market and the legislative introduction of class actions.

¹⁶⁵ *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, 845 A.2d 1031 (Del. 2004)

¹⁶⁶ E. J. Thompson, "Direct Harm, Special Injury, or Duty Owed: Which Test Allows for the Most Shareholder Success in Direct Shareholder Litigation?", *The Journal of Corporation Law*, 2010

The number of class actions claiming violations of fiduciary duties by managers has increased significantly throughout the past years. Class actions are particularly common in the context of mergers and acquisitions and, in this field, significantly exceed¹⁶⁷ the number of derivative suits¹⁶⁸.

Class actions are the most controversial form of litigation not only in the corporate world, in which class actions are allowed in the field of securities law, but in every area in which they are allowed.

They certainly provide an opportunity for private citizens, or in our case for shareholders, to bring claims that would not be considered by the courts if they were to be brought forward by a single shareholder. But, in the eyes of directors, they are only seen as a legal instrument that lawyers use to enrich themselves.

Securities class actions deal with the managers' duty to disclose information regarding the actual value of securities. Such duty is prescribed by the Securities Act of 1933 and the Securities and Exchange Act of 1934. The principal aim of these disclosure duties is to prevent outsiders to assume opportunistic behaviours in spite of outsiders and, by reducing the asymmetry of information, enhancing outsiders to provide capital to the company. Whenever lawyers have the suspect that directors of a company have breached their disclosure duties towards the public, they collect the necessary information to initiate a class action against directors. It is not in our interest now to go through the procedural rules prescribed for securities class actions as what interests us in regards of our analysis is the consideration of how and if the introduction of independent directors by the SOX has had an impact on the frequency of securities class actions.

As we know, the SOX has tried to shift the power from management to corporate boards, by requiring that certain board members be independent, by establishing the duty to form audit committees comprised exclusively of independent

¹⁶⁷ In the State of Delaware

¹⁶⁸ R. B. Thompson, R. S. Thomas, *"The Public and Private Faces of Derivative Lawsuits"*, *Vanderbilt Law Review*, 2004

directors. However, following the enactment of the SOX, the amount of settlements for claims of financial fraud through securities class actions has not decreased. Perhaps this shows the inability of independent directors, who are not charged of the day-to-day management of the corporation and therefore are not always fully informed of the company's business, to monitor and prevent frauds of securities law. It follows that, for independent directors to more efficiently perform such monitoring function, they should be maybe entrusted with more consistent powers within the corporation¹⁶⁹.

5.3 The breach of fiduciary duties and the role of D&O insurance

In the United States, the legislative formulation of the duties owed by company directors are often vague and requires judges to fill in the gaps, in order to properly scrutinize the actions of the directors and eventually hold them liable.

Even though the US Model Business Corporation Act only expressly mentions the duty of care and the duty of loyalty, it can be affirmed that case law has created two other types of duties: the duty to disclosure and the duty to apply special care in the event of a take-over operation¹⁷⁰.

It is thus evident that corporate directors face significant exposure as a result of their role in the corporation and, in order to not discourage directors to serve on boards because of the risk of liability, the company carries out several protective measures, and director and officer insurance is one of them.

This is because shareholders claims may range, as we have seen in the previous paragraph, from derivative or direct suits to class actions for the violations of securities law. This means that, even when directors are found by the courts to be

¹⁶⁹ S. Avci, C. A. Schipani, H. N. Seyhun, *"Do Independent Directors Curb Financial Fraud? The Evidence and Proposals for Further Reform"*, Indiana Law Journal, February 2017

¹⁷⁰ This duty has been so defined by Professor Bernard S. Black in *"The Core Fiduciary Duties of Outside Directors"*

not liable, the company might still have to sustain legal expenses. D&O insurance and company indemnifications serve the purpose of releasing directors from the burden of monetary liability. Such measures are not only protective tools for directors or officers but provide a protection for shareholders as well.

Hence, there are three ways through which the corporation can protect a director's wealth during his time as a director: D&O insurance, corporate indemnification and the so-called limited liability provisions, which helps directors of financial distressed companies to take risky business actions and potentially save the company's capital.

Regarding the functioning of D&O insurance, the insurance coverage is not made available until a claim has been made against the company. Every insurance has different policies but they almost universally include, as being considered part of the definition of claim, lawsuits, demands for monetary relief and administrative proceedings before courts.

Along with a claim, there must be a loss, in the sense of an amount for which directors are financially liable, including settlements, damages and judgements.

Of course, the insurance coverage only applies in the case that the plaintiff's claim alleges the committing of a wrongful act by the director-defendant. The most common unlawful conduct lamented before a court is the director's breach of a duty.

D&O insurance policies potentially cover for every unlawful act carried out by the directors, but they often provide for specific exceptions in respect of fraud, intentional violations of law and illegal profit¹⁷¹.

The theory according to which D&O insurance does not only benefit directors, but shareholders as well, is based on the consideration that directors already enjoy two other forms of protection, indemnification and limited liability

¹⁷¹ L. J. Trautman, K. Altenbaumer-Price, *"D&O Insurance: A Primer"*, American University Business Law Review, 2012

provisions. It follows that directors' insurance will always ensure shareholders' relief when directors cannot rely on their own wealth¹⁷².

The shareholders' protection theory is also linked to the consideration of whether the presence of D&O insurance reduces the deterrence effect of shareholders litigation. In fact, shareholders protection and the deterrence effect are closely connected, as the latter implies the former. This is because liability rules are designed to enhance good governance, thus maximizing shareholders' interest.

D&O insurance can play a role in ensuring the deterrence effect of shareholders litigation¹⁷³.

The first strategy that the insurer may apply is to adapt the insurance pricing to the corporation's risk to be involved in litigation. This will naturally push corporations to avoid lawsuits in order to receive a lower insurance price.

Secondly, the insurer may impose certain behaviour requirements upon directors, preventing *ex-ante* conducts that might lead to liabilities. Another way of ensuring deterrence is to impose on the director to eventually pay part of the settlement, thus incentivizing them to avoid misconduct.

However, the empirical results of this theory shows that D&O insurance does not really contribute to maintain the deterrence effect because, firstly, the insurance pricing depends on factors that go beyond corporate governance.

Regarding the second technique, one might bring forward the consideration that the reason why companies buy D&O insurance is because they do not want to be excessively constraint by corporate governance prescriptions and prefer to buy insurance in order to be covered in the event they breach one of the corporate governance rules and are ordered to pay the damages. It would therefore be illogical to expect from insurers to cover both roles: protecting from corporate governance violations and, at the same time, imposing corporate governance rules.

¹⁷² M. M. Boyer, "Directors' and Officers' Insurance and Shareholder Protection", CIRANO, 2005

¹⁷³ According to a study conducted by Professor S. Griffith and Professor T. Baker on whether D&O insurance undermines the deterrence effect of shareholders litigation

The third solution, proposing the directors obligation to pay part of the settlement, does not seem feasible. This is because the only way through which an insurer may refuse to pay the coverage, is by rescinding the policy.

However, this would not be a wise move from the part of the insurer because of the consequential reputational costs¹⁷⁴.

In conclusion, in order to bring the rationale behind D&O insurance closer to the shareholders interests and less closely connected to directors convenience, further solutions should be brought forward by legal scholars and regulators.

¹⁷⁴ F. Pastre, *“How Shareholder Litigations Deter Directors and Officers. U.S and Italy, a Comparative Analysis”*, 2011

Conclusion

In light of the complexities analysed throughout this paper, it is evident that in order for independent directors to properly perform their functions, it is necessary, first of all, that the core element of their existence, their independence, is thoroughly defined and regulated. This means that the actual regulatory framework, which provides for different independence requirements depending on the source of regulation, should be overcome and leave room for precise and defined independence requirements, by finally shedding light on the relationships, whether only financial and familial, or whether including social ties as well, potentially able to undermine director's independence.

In fact, the current regulatory climate is only capable of giving a general, and sometimes confusing picture of the qualifications that are to be satisfied by the independent director.

If such directors do not serve the role for which they have been ideated, they might potentially bring more burden to the company rather than benefits.

Many studies have focused on proving the actual usefulness of independent directors in terms of better returns for shareholders, improved transparency and general better functioning of company boards. However, following the many empirical studies in this sector, it cannot yet be affirmed that independent directors do bring such benefits to the companies in which they serve.

Moreover, after the SOX has imposed the presence of independent directors, a study has found that outside directors' compensation has increased comparing to the compensation issued by companies pre-SOX. Consequently, the cost of corporate boards has increased the law has required the presence of independent directors as mandatory.

Again, such cost would not be a problem if independent directors were successfully carrying out their tasks and duties towards the company. One of the reasons behind the so far partial success of independent directors is to be linked

to the information deficit due to their lack of knowledge about the company and its intrinsic dynamics.

Personally, I think that the concept of independent directors as a corporate governance instrument and, thus, as the potential solution behind the many agency problems pertaining to companies is valid.

In order to better organize their tasks and pursue a more efficient performance of such duties, it is imperative, in my opinion, that the law puts in place a more organic and robust regulation of independent directors.

Last but not least, the efforts made by legislators should be met by efforts from the part of courts, for a better coordination of the entire legal framework concerning independent directors.

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