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# Perspectives in Company Law and Financial Regulation

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# Role of corporate governance reform and enforcement in the Netherlands

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## I. Introduction

As the recent wave of governance scandals and reforms has focused the public debate on how publicly held corporations should be structured and organized, it is hardly surprising that corporate governance of listed companies has captured the legal imagination. Books, articles and reports on the corporate governance of listed companies abound. Corporate governance reforms in developed countries as well as emerging markets are high on the policy agendas. Proposals have arisen to change, among other things, the role of non-executive directors, executive pay, disclosure, the internal and external audit process, and sanctions on director's misconduct. Suggestions have also been advanced to create new standards of integrity for auditors, analysts and rating agencies. Policymakers and lawmakers are prompted to design measures to protect shareholders from fraud, poor board performance and auditor failure. These most notably include CEO and CFO certification of accounts,[1] imposition of internal controls, the prohibition of company loans to managers and the requiring of firms to establish an independent audit committee.

While the question of the economic effect of the corporate governance regulation on the performance of listed companies has become a leading concern for both lawmakers and investors, the evidence, however, is mixed. On the one hand, it is widely acknowledged that corporate governance rules and standards promote efficiency, transparency and accountability within firms, thereby improving a sustainable economic

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[1] CEO: Chief Executive Officer; CFO: Chief Financial Officer.

development and financial stability. On the other hand, some scholars argue that the corporate governance movement has gone too far, entailing nothing more than a box-ticking exercise to ensure compliance with current corporate fashion trends. In this view, companies do not seem to benefit from the spillover effect of the application of disproportionate corporate governance rules and principles that have their origins in the Sarbanes–Oxley regulation.[2]

This paper focuses on the quality of corporate governance which varies widely across countries and firms. In a series of influential papers, La Porta et al.[3] have argued that the level of protection afforded to minority shareholders and creditors is associated with lower concentrations of share ownership positively related to valuable growth opportunities. La Porta et al. found that common law systems tend to outperform civil law systems by adopting legal rules that offer better protection both for expropriation of shareholders by management and the violation of the rights of minority shareholders by large shareholders. It appeared that shareholders and creditors received least protection in French civil law countries, like the Netherlands. The Scandinavian and German countries came somewhere in between. The implication of the work of La Porta et al. is that countries should move toward the more efficient common law system based on transparency and arm's length relationships.[4] However, the legal systems were generally insufficient to deter managerial abuses and misconduct within listed companies at the start of the twenty-first century. Policymakers

[2] See *Financial Times* (by Jeremy Grant), 'Sarbox changes welcomed but imitators still abound', 23 March 2007.

[3] R. La Porta, F. Lopez-de-Silanes, A. Shleifer, R.W. Vishny, 'Legal determinants of external finance', *Journal of Finance*, 52 (1997), 1131–50; R. La Porta, F.Lopez-de-Silanes and A.Shleifer, 'Law and finance', *Journal of Political Economy*, 106 (1998), 1113–1155; R. La Porta, F. Lopez-de-Silanes, A. Shleifer, R.W. Vishny, 'Investor protection and corporate governance', *Journal of Financial Economics*, 58 (2000), 3–29.

[4] In their study of forty-nine countries, they classified countries according to the origin of laws, quality of investor protection and quality of law enforcement. Moreover they investigated the extent to which a country adheres to the one-share-one-vote rule. A shareholder protection index was constructed which determined whether proxy voting by mail is allowed, whether minority protection mechanisms are in place and whether a minimum percentage of share capital entitles a shareholder to call for an extraordinary general meeting. Creditor rights are aggregated into an index that is higher when the creditor can take possession of the company in the case of financial distress, when there are no restrictions on workouts and corporate reorganizations and when the absolute priority rule is upheld. Finally, the rule of law index produced by the rating agency, International Country Risk, indicates the country risk and the degree to which laws are enforced.

and lawmakers across the board were forced to call for stricter legal measures that could serve to minimize the managerial agency problem inherent in corporations. Since then the legal landscape has changed rapidly. Part II of this chapter examines the recent and current governance reforms that are designed to lead to the increased accountability, transparency and enhanced performance within firms. We show that substantial progress has been made in corporate governance, bringing improvements from country to country to the legal, regulatory and commercial environments.

Recent empirical work by La Porta et al.[5] found that firms operating in jurisdictions with strong minority shareholder protections tend to have a higher Tobin's Q. The work of Lombardo and Pagano[6] supports the findings of La Porta et al., showing that better legal institutions influence equity rate of returns and the demand for equity finance by companies. They offer two reasons: (1) good laws and efficient courts curtail the private benefits of managers; (2) better law and more efficient courts facilitate the contractibility of corporate relations with customers and suppliers and the enforceability of such contractual relations. As a result, companies are more profitable which hence raise their rates of return and the amount of external financing. In their model, Lombardo and Pagano reduce managerial benefits by introducing legal limits to transactions with other companies that may dilute the income rights of minority shareholders. They also reduce the legal and auditing costs that shareholders must bear to prevent managerial opportunism. Such cost reduction may, for example, result from the introduction of class action suits or voting by mail. They conclude that the size of these effects on the equilibrium rate of return is increasing in the degree of international segmentation of equity markets.[7] This paper seeks to explore which specific corporate governance mechanisms are positively related to firm performance in the Netherlands. The wealth of recent empirical evidence supports the hypothesis of La Porta et al. that good corporate governance is among the most important factors responsible for good corporate performance.[8]

[5] R. La Porta, F. Lopez-de-Silanes, A. Shleifer, and R. Vishny, 'Investor Protection and Corporate Valuation', *Journal of Finance*, 57 (2002), 1147–1170.

[6] D. Lombardo and M. Pagano, 'Legal Determinants of the Return on Equity', in J.A. McCahery et al. (eds), *Convergence and Diversity*, (Oxford University Press, 2002).

[7] Lombardo and Pagano use the dividend yield as measure of the cost of capital.

[8] P.A. Gompers, J. Ishii and A. Metrick, 'Extreme Governance: An Analysis of Dual Class Firms in the United States', Working Paper, Harvard, Stanford and Wharton (2006);

This chapter is organized as follows. Section II takes a brief look at corporate governance in the Netherlands. Special attention is given to the channels through which corporate governance impacts valuation and firm performance in the case of the Netherlands. We focus on how the changes introduced by the Dutch Code are likely to improve the performance of publicly listed firms in the Netherlands. Section III supplies an account of the *ex post* enforcement regime in the Netherlands. Section IV concludes.

## II. The Dutch Corporate Governance Regime

In this section, we investigate the quality of the Dutch corporate governance regime, and consider how well the strategy of relying on principles-based measures can encourage transparency, an independent boardroom that monitors management, and a structure through which the company's objectives are met. The approach taken here is to focus on the consequence of the widespread adoption of the best practice code and which *ex ante* corporate governance practices are being implemented and enforced. In this part, our focus is on how effective the current round of *ex ante* measures are in substantially improving the general institutional environment of Dutch firms. Special attention is given to the channels through which corporate governance impacts valuation and firm performance. Our aim is to give directions to intervention to country policy makers and company shareholders. We first give a concise picture of the current status of corporate governance in the Netherlands and argue that recent developments and reforms have altered the rules of the corporate governance game (thereby improving the rights and protection of minority shareholders).

### *A. Investor protection and corporate governance in the Netherlands*

The Netherlands regime lies between the Anglo-American system of diffuse stockholders and the concentrated ownership regime characteristic of many continental European countries.[9] In the Netherlands, share ownership is widely dispersed and the quoted sector is a significant part

L.A. Bebchuk and A. Cohen, 'Firm's Decision Where to Incorporate', *Journal of Law and Economics*, 46 (2003), 383; L.A. Bebchuk, A. Cohen, and A. Ferrell, 'Does the Evidence Favor State Competition in Corporate Law?' *California Law Review*, 90 (2002), 1775.

[9] W.W. Bratton and J.A. McCahery, 'Restructuring the Relationship between Shareholders and Managers', in H. Schenk (ed), *Preadviezen van de Koninklijke Vereniging voor de*

of the economy. The percentage of closely held shares for the average Dutch listed company (7.30%), is much lower than the average European company (19.72%), but is still higher than the average UK (3.29%) or US (1.45%) company (LLSV 2000). However, about 22% of Dutch firms have a dual class structure which is relatively large compared to the European average (17.01%) and the average US (5.00%) and British (less than 1.00%) company. Similarly, research on the direct and indirect ownership of Dutch companies reveals a concentrated ownership structure to the extent that large blockholders (14.30%), pension funds (10.08%) and banks (7.75%) enjoy large stakes.[10] To be sure, whilst there is some evidence that concentrated control has a negative relationship for outside equity, there is some evidence for no effects[11] and positive effects[12].

Historically, the weaknesses in Dutch corporate governance most observers point out centred on limited influence of shareholders on management and extensive takeover defences. A large portion of Dutch listed companies are virtually immune to hostile takeovers. Many Dutch companies adopt one or more anti-takeover provisions, for instance through the use of preference shares. Other firms employ a depository receipt scheme, through which a listed company places its shares with a foundation. The foundation office then issues non-voting depository receipts, thus retaining control with 'insiders', and providing impediments to (hostile) takeovers. For large Dutch companies, shareholders had limited influence on corporate management as compared to the Anglo-Saxon countries. Companies that meet certain requirements for a period of three years are governed by the so-called 'structure regime', which means that a supervisory board is mandatory and able to veto important changes in the identity or structure of the company as well as to appoint the management board. Enactment of the legislation was largely a response to demands for increasing management's accountability to a broader set of stakeholders, and to ensure closer monitoring of managers. The structure regime has three variations: the Full Structure Model, the Mitigated Structure Model and the Common Model. The

*Staathuishoudkunde, Herpositionering van Ondernemingen* (Utrecht: Lemma, 2001), 63–85.

10 D. De Jong, G. Mertens and P. Roosenboom, 'Shareholders' Voting at General Meetings: Evidence from the Netherlands', *EMIM Report Series*, Reference No. ERS-2004–039-F&A (2004).

11 P.A. Gompers, J. Ishii and A. Metrick, 'Extreme Governance: An Analysis of Dual Class Firms in the United States', Working Paper, Harvard, Stanford and Wharton (2006).

12 R.B. Adams and J.A.C. Santos, 'Identifying the Effect of Managerial Control on Firm Performance', *Journal of Accounting and Economics*, 41 (2006), 55–85.

Full Structure Model is the most prevalent. The function of the supervisory board, which typically holds all voting rights and is granted considerable power, is to evaluate the performance of the top executives, ratify management decisions and reward or penalize performance. Until 1 October 2004, the supervisory board co-opted its own members, which explains historically the predominant position of the supervisory board at the expense of shareholders. In contrast, under new legislation the power to appoint the members of the supervisory board is given to the shareholders. However, the supervisory board retains the power to nominate its own members with the exception that the works council has a right to recommend one-third of the members of the supervisory board. Nevertheless, the general shareholders' meeting is empowered to discharge the entire supervisory board which requires the interference of the Enterprise Chamber in the process of appointing new members.

Even though there is little evidence on the effect of supervisory board control on management performance, there is evidence that contrasts firm performance between shareholder-controlled firms and companies organized under the structure regime. A study by the Netherlands Ministry of Finance[13] evaluated the supervisory board performance of Dutch listed, non-financial firms in terms of market returns, accounting returns and Tobin's Q. The study revealed that for the period of 1993–1997, the sampled firm's market returns were affected by ownership concentration (positive), the size of the supervisory board (negative), depository receipts for shares (negative) and the structure regime (negative). Further, the study showed that companies which voluntarily adopted the structure regime underperformed shareholder-controlled companies. The results in De Jong et al. support the magnitude of these effects of the structure regime on firm performance. Interestingly, they find that the effect is less for Dutch multinational firms that voluntarily adopt the structure regime. We believe that this result is consistent with international competition being an important reason why these firms are better governed and therefore explains why the structure regime has no significant effect on profitability. Our discussion of the structure regime shows that the regime imposes a significant cost on shareholders.

While some groups benefited from the traditional Dutch corporate governance norms, at the same time the increasing focus on

[13] Netherlands Ministry of Finance, *Zeggenschapsverhoudingen en Financiële van Beursvennootschappen*, Report prepared by Center for Applied Research (Tilburg University, 2000.

management accountability to shareholders led to the design and implementation of legal measures perceived to increase the rights of shareholders and holders of depository receipts. The actual governance arrangements adopted by Dutch legislators, effective 1 October 2004, include:

- increased powers for shareholders to ratify certain management board resolutions that effect the identity or character of the NV or its businesses;
- a new regulation that gives shareholders a right to vote on the adoption of the company's remuneration policy and an entitlement to vote on a yearly basis to approve the directors' option plans;
- a right to add resolutions to the agenda of a listed company's general meeting for members holding at least 1% of share capital or a stake with a market value of €50 million;
- a measure that gives depository receipt holders in a public company the right to use proxies to exercise their voting rights (except in the context of a hostile takeover);
- an obligation that the board of directors disclose yearly to the supervisory board the main elements of its strategy, business risks and management and control systems; and
- regulation that requires that quoted companies comply with the corporate governance code or explain the reasons for non-compliance.

The common thread running through the reforms is that they increase scrutiny and accountability of directors while providing shareholders with the institutional arrangements that give them the means to exercise their basic rights of voting and economic participation.

So far it is not possible to say what the effect of these reforms have been on the financial performance of Dutch firms. Nevertheless the Dutch government's reliance on disclosure and associated mechanisms appear to have improved shareholder participation in the affairs of quoted companies and induced management to improve performance. The Electronic Means of Communication (Promotion) Act, which came into force on 1 January 2007, enhances shareholder protection by allowing electronic participation in the general shareholders meeting as well as simplifying the issuance of proxies and voting instructions. Under this Act, firms could allow shareholders to cast their votes even before the actual shareholders meeting.

### B. The Dutch Corporate Governance Code

While there are differences in patterns of ownership and control in Europe and the US, the recent corporate scandals have occurred more in the US than Europe.[14] The Netherlands, however, has not been immune from corporate governance scandals, which attracted the media and regulator attention and highlighted some aspects and weaknesses of the Dutch system. Consistent with Coffee's observations, the Ahold scandal emerged in February 2003, when the company announced that a series of accounting irregularities in its US Food Services subsidiary had led it to overstate more than $500 million in profit booked in the previous two years. Subsequent disclosures revealed that Ahold's reported earnings had been overstated by more than $1 billion and that prior revenues had been overstated by $24 billion. This event focused observers on the state of Dutch corporate governance and prompted the promulgation of a new principles-based code of conduct (the Dutch Corporate Governance Code or Code *Tabaksblat*, hereinafter 'Code') based on a comply-or-explain standard.[15]

The Code contains general principles and detailed best practice provisions related to: the management board (role, remuneration, conflicts of interest); the supervisory board (role, independence, composition, the role of the chairman, remuneration, conflicts of interest); the general meeting of shareholders (powers, depositary receipts, provision of information, responsibility); and financial reporting (internal and external auditors, disclosure). In particular, the Code recommends the appointment of an audit, remuneration and nomination committee, which roles are to prepare the decision making of the supervisory board and supervise the management board. The members of such committees are appointed from among the members of the supervisory board. In case of a one-tier management structure, it advocates the separation between

[14] J.C. Coffee Jr., 'A Theory of Corporate Scandals: Why the USA and Europe Differ', *Oxford Review of Economic Policy*, 21 (2005), 198–211.

[15] In order to improve the quality of corporate governance practice of firms, the first Dutch Corporate Governance Committee ('Peters Committee') handed down a report in 1997 that introduced several recommendations designed to strengthen the monitoring role of the supervisory board including that there should be: 1) greater independence of supervisory board members, 2) greater independence of stakeholders associated with the company, 3) more selective procedures for the appointment of supervisory board members, and 4) shareholders should have a more active role in the annual general meeting (Bratton and McCahery, 'Restructuring the Relationship between Shareholders and Managers', 2001).

the Chairman and the CEO and the presence of a majority of independent non-executive directors on the board. On the matter of depositary receipts for shares, the Code states that they should not be used as an anti-takeover measure, but instead depositary receipt holders should have the possibility to exercise their voting rights.

Whilst compliance is not mandated legally, Dutch lawmakers since 2004 require an explanation for non-compliance pursuant to article 391 of Book 2 of the Dutch Civil Code. The Dutch Monitoring Committee's investigations show that there has been widespread adoption of the Code standards by a large majority of Dutch listed companies. However, a significant minority of companies do not explain the reasons for departing from best practice. This percentage is particularly high for the provision related to the anti-takeover devices. Indeed, a quarter of the companies in the survey provide no information about their anti-takeover measures, against the Code requirements. The report of the Monitoring Committee does not explicitly deal with the quality of the explanations provided by non-compliant companies, but it indicates some commonly given explanations, which appear to be standard, general and uninformative. Importantly, a study on the effectiveness of the comply-or-explain system in the UK[16] shows that shareholders should pay attention to the quality of the explanation. UK companies that do not provide any explanation for their non-compliance underperform all others. Conversely, companies which give detailed and narrative explanation in the matters of non-compliance are the best performers, even outperforming the companies that are fully compliant with the UK code of best practice. This could be explained by the fact that such companies, which have carefully considered their governance needs and eventually opted-out from best practice, are able to provide a justification to shareholders, and are well governed to deliver high returns to shareholders.

### *C. Benchmarking the Dutch corporate governance regime*

In this section, we will review the empirical studies assessing the Dutch corporate governance regime. We can look initially to the most well-known indicator of investor protection, the La Porta et al.[17] LLSV

[16] S.R. Arcot and V.G. Bruno, 'One Size Does Not Fit All, After All: Evidence from Corporate Governance', Working Paper (2006), http://ssrn.com/abstract=887947.

[17] R. La Porta, F. Lopez-de-Silanes, A. Shleifer, R.W. Vishny, 'Legal determinants of external finance', *Journal of Finance*, 52 (1997), 1131–50; R. La Porta, F. Lopez-de-Silanes and A. Shleifer, 'Law and Finance', *Journal of Political Economy*, 106 (1998), 1113–55.

anti-director rights index, which summarizes the level of protection of minority shareholders in the corporate decision-making process.[18] The Netherlands differs from the other countries in terms of the LLSV anti-director index. The index of investor protection in the Netherlands (3) is in line with the US (3) and Europe (3.1 on average), but it is well below the UK (5). In particular, minority shareholders in the Netherlands seem to have strong powers in challenging resolutions that they fear to be against the company's interests, but have impediments in the exercise of their voting rights.

According to the LLSV index, the law in the Netherlands does not explicitly allow vote by mail or proxy form, allowing shareholders to vote on the items on the agenda in absence.[19] Further, the law requires shareholders to deposit any of their shares prior to a general shareholder meeting. This requirement imposes a cost on shareholders. In addition, the law does not set a default rule specifying the possibility for shareholders to cast all their votes for one candidate for the board or supervisory board (cumulative voting), thus limiting shareholders' monitoring and decisional powers. The LLSV index reveals that the Netherlands shows a mixed corporate governance framework and practices. Compared to companies in other countries, Dutch companies have highly independent boards, but on average have an entrenched board and fewer board committees. In terms of legal regime, the Netherlands ranks relatively low in investor protection index too. Therefore, the corporate governance picture offered by Dutch companies is less favourable due to the presence of entrenched boards, few board committees and low protection of shareholders rights; investors are more cautious about the governance of companies. This gets reflected into lower valuation.

It is important to recall that the LLSV index on the value of investor protection is based exclusively on hard law. Fortunately the recent studies by the Monitoring Committee of the Corporate Governance Code ('Monitoring Committee') on the implementation of the Code allows us to have an idea on the role of the code in promoting best practices in the constitution of board committees, compensation and disclosure. Thus, in terms of actual corporate governance practices prompted by Code changes, the new results of the Monitoring Committee offer a

[18] The index has been updated since 1998 and the more recent data are used (see discussion below).

[19] As discussed above, the Electronic Means of Communication (Promotion) Act introduces (1) the electronic convening of a general meeting of shareholders, (2) electronic participation in the meeting, and (3) electronic voting prior to the meeting.

benchmark against which Dutch companies can be compared. The Monitoring Committee established on 6 December 2004 commissioned surveys in order to obtain information on how the Code is complied with in practice. The first report on compliance with the Code was released in December 2005. It shows Dutch companies to have embraced the regulation: the average non-compliance rate per code provision is 12%. This is quite high, although it does not provide comparison with how compliance was prior to the adoption of the Code. The second report was released in December 2006 showing the average application rate and compliance increasing to respectively 92% and 96%. Despite the improvement in compliance overall, the recommendations on internal risk management and remuneration are less than average.

Using the data from the Monitoring Committee Reports, we can begin to assess the impact of the code. While the period of compliance is very short, we can nevertheless assess the role of the Code in promoting best practice. For Part II of the Code, the Management Board, there is an average compliance rate of approximately 80%.[20] Importantly, all compliance percentages are higher than those of the 2004 financial year. Despite the improvements since last year, compliance with two important parts of this chapter of the Code is less than average. These are the provisions on internal risk management and control systems (II.1.3 and II.1.4) and on directors' pay (particularly II.2.9 and II.2.10). The rates of compliance in respect of all these parts are high, namely between 95% (role and procedure and independence) and 100% (one-tier structure). The application rates are on average 4% lower than 2004. The average compliance rates (89% and 91% respectively) are lower than the total average compliance rate of 96%. This lower average figure is caused in particular by the local companies, whose compliance rates are 84% for the powers of shareholders (Part IV.1) and 75% for information and logistics regarding the general meeting (Part IV.3).

In sum, two patterns emerge. First, corporate governance practices are improving dramatically in the short term. Not only is there a high overall compliance and application rate, but key characteristics of the Code have high compliance rates. It may be argued that when companies adopt good governance practices the probability of misconduct decreases and the returns on the stock are better than those with worse corporate governance. Second, some corporate governance practices still deviate in some respects from international best practices. The percentage of

[20] See Monitoring Committee (www.corpgov.nl).

companies with a committee dealing with corporate governance issues, for example, only slightly increases over years, from 16.3% in 2004 to 21.2% in 2005. The pattern suggests that companies follow only what the Code recommends, and not other best practices in corporate governance. Moreover, the persistence of control-enhancing mechanisms, such as dual class shares and opaque capital structures, are also likely to affect the governance ratings for Dutch firms.[21]

Finally, there is recent evidence[22] that the degree of investor protection against self-dealing is quite low viewed from a comparative corporate governance perspective. If this is the case, Dutch corporate governance needs to be corrected if the business environment for entrepreneurs is to improve. In the next section, we discuss the anti-self-dealing index of Djankov et al. and we interpret the Netherlands regulations in terms of the protection of investors against self-dealing.

### *D. Protecting investors against self-dealing*

This section looks at the legal rules and their enforcement which have been developed to regulate self-dealing transactions, with particular reference to the Netherlands. Here we look at evidence from other countries when discussing the developments in the Netherlands, which has more in common with other European countries than the UK or the US in this area.

There is widespread agreement about the important role that related party transactions can play in an economy. Concretely, a related party transaction is a situation where there is one man (Mr James) who controlled 60% of company A and proposes that the company buy fifty used vehicles from a company in which he owns 90% of the company. In this context, the price is likely to be higher and Mr James will clearly benefit from the transaction. Such transactions are authorized in many jurisdictions to permit flexibility and to make room for private contractual arrangements that are consistent with the furtherance of corporate objectives and are subject to appropriate checks and balances. In some of these cases, the company's financial situation might preclude it from negotiating arm's length arrangements with third parties.

[21] Deminor-rating (2005), *Application of the One Share-One Vote Principle in Europe*, A study commissioned by the Association of British Insurers, available at www.abi.org.uk.

[22] S. Djankov, R. La Porta, F. Lopez-de-Silanes and A. Shleifer, 'The Law and Economics of Self Dealing', NBER Working Paper 11883 (2006).

A key concern about related party transactions is that they can be influenced by the relationship between two sides of a transaction and not undertaken according to market prices. For both controlling shareholders and insiders such as management, related party transactions can be the mechanism for extracting private benefits at the expense of other shareholders. The limited ability of investors to protect themselves against opportunism by insiders and the high cost of regulating such transactions have influenced regulators' strategies. Moreover, the nature of the potential problem varies: in companies with controlling shareholders and with corporate groups the transactions and the measures needed to deal with them differ from those companies where ownership is dispersed and where the board and management are effectively entrenched. Corporate law in many countries allows related party transactions, but also includes a variety of techniques and measures to control the danger of opportunism.

As Djankov, La Porta, Lopez-de-Silanes and Shleifer have showed with their comparative work on protections against self-dealing, common law and civil law countries use similar legal strategies to control related party transactions, namely mandatory disclosure, board approval, the specification of fiduciary duties for the board and shareholder approval. For example, studies show that countries with very different corporate governance systems can achieve similar results in mitigating abusive transactions with different combinations of corporate governance mechanisms.[23] The most common and effective response is disclosure of potentially conflicted transactions. In fact, public disclosure is the predominate pattern around the world. In the US, for instance, publicly listed companies are required not only to publicly disclose all major transactions, but also certain relationships and material transactions between the company and its officers and/or their families and their enterprises. Most jurisdictions rely on board approval to screen conflicted transactions and evaluate whether a related party transaction is at arms length or whether it is detrimental to the company. Authorization for most self-dealing transactions can usually only be given by non-interested directors. Even though lawmakers in common law countries do not typically require mandatory board approval, it functions, nevertheless, to encourage interested managers to obtain approval of conflicted transactions.

[23] G. Hertig and H. Kanda, 'Related Party Transactions', in R. Kraakman, P. Davies, H. Hansmann, G. Hertig, K.J. Hopt, H. Kanda and E. Rock, *The Anatomy of Corporate Law, A Comparative and Functional Approach*, (Oxford University Press, 2005), 101–30.

Judging from Djankov's data, countries have made significant progress in establishing measures to protect investors from the wrongdoing of directors. The Netherlands approach of curtailing private benefits and other mismanagement (0.21) is, however, half as low as the average European country (0.40), three times lower than the US (0.65) and almost four times as low as the UK (0.93). This Dutch approach to the enforcement of investor protection from management and large blockholder fraud is based on board disclosure and approval of any conflict of interest or potential conflict of interest that may be of material significance to the company. Shareholders are also required to approve the interested transactions that have obtained board approval and ratification.

In fact, Book 2 of the Dutch Civil Code states in Section 146 (for publicly held corporations) and Section 256 (for closely held corporations) that if directors have a conflict of interest, the corporation shall be represented by the members of the supervisory board. The shareholders' meeting is authorized to appoint another person to represent the company. The Dutch Enterprise Chamber, a division of the Amsterdam Court of Appeals, and Supreme Court have clarified these statutory provisions and decided that the corporation is not bound to a conflicted transaction if the third party did not act in good faith. This 'external effect' is considered to be particularly cumbersome for banks that enter into credit facility agreements with a group of companies as banks run the risk that transactions and payments under the facility will be nullified by subsidiaries in a financially distressed group. Still, even though the legal literature does not approve the *ex post* clarification of the conflict of interest rule, the court's decisions seem to evince the court's intention to enhance shareholder rights by requiring the explicit and immediate approval of conflicted transactions. The following part will highlight the importance of specialized courts in resolving corporate governance related disputes.

## III. *Ex post* enforcement in Dutch corporate law

### A. *Role of gatekeepers*

An assessment of the corporate governance movement in the Netherlands would be incomplete if it neglected the role of institutions – corporate governance monitoring committees, supervisory authorities, securities regulators, investors' associations, stock exchanges, the judiciary, institutional investors, equity analysts, accountants and a probing media – in safeguarding and promoting the Dutch corporate governance principles.

Arguably these gatekeepers are responsible for interpreting, preserving and developing good governance. At first sight, the interaction of different institutions appears to be conducive to an efficient evolution of the corporate governance framework. Gatekeepers are complementary to each other, and so are more responsive to economic and social change. To see this, let us again look at the Dutch Corporate Governance Code and assess the effect of the code two years after its promulgation. It seems that the enabling ('comply-or-explain') nature of the code could not totally prevent firms from engaging in merely box-ticking, thereby adopting opportunistic strategies to subvert the norm.[24]

Nevertheless, it might be argued that the structure of the game between policymakers and lawmakers on the one side and gatekeepers on the other eventually tends towards a regulatory equilibrium. As noted, policymakers and lawmakers, having promulgated the Code to restore the public confidence in stock markets and to protect the shareholders from managerial opportunism and malfeasance, are compelled to revise, in the next round, their regulatory strategies to induce firm compliance to the stated norms. In response, we can expect gatekeepers to continue to develop innovative interpretations of the principles and give recommendation on how firms should implement the norms in order to be most effective for their own needs. Because the gatekeepers must anticipate being overruled by the necessary update of the policymakers and lawmakers, their explanations and interruptions appear to be consistent with the dictates of efficiency.

In practice, though, the ideal interplay may not prevail. For instance, the corporate governance movement in the Netherlands is more akin to a battleground – in which gatekeepers, preoccupied with their own interests, such as increasing their powers and prestige, strive for market share – than a system of checks and balances. This is evidenced by the

[24] EFFECT (VEB-magazine – 'Journal of the Dutch investors' association' – 24 December 2005) mentions ten tricks that firms use to circumvent the code. For instance, (1) firms create their own definitions of 'being independent'; (2) firms state that there are no indications that their internal control systems are not effective (firms do not show explicitly that the internal control systems are optimal); and (3) firms tend to use very general and brief statements, instead of giving the detailed explanations and descriptions as required by the Code. Naturally if all firms were mere box tickers this would lead to a pooling equilibrium. However, since high-quality firms will benefit from sending a signal to the market, firms are more likely to profit where the sophistication of the investors is high and it is more likely that external parties will have the incentives and abilities to benchmark the disclosures.

fact that the corporate governance principles are interpreted broadly by gatekeeper institutions in favour of the (minority) shareholders.

The gatekeepers seem to agree on one thing: so far the Code has resulted in a modest improvement of the diligence in doing business and reporting accurate information. In general, gatekeepers are of the opinion that more must be done to achieve good corporate governance practice in firms. They urge shareholders to be increasingly active and encourage judges and official monitoring agents to contribute to the strict compliance with the code's principles. The result is an avalanche of legal actions for an alleged loss suffered from violations of the corporate governance code, stemming in particular from the inadequate independence of members of the supervisory board in the decision-making process (Versatel and Begemann), the untransparent group structure of the firm (Unilever and ASMI), and the unclear business strategy of the company (Laurus).

### *B. Reinforcing shareholder rights in the Dutch Enterprise Chamber*

Although there is widespread perception that the Dutch Enterprise Chamber has played a long-standing role in the enforcement of corporate governance, the court has only recently made significant progress as the leading institution establishing its authority over the conflict of interest rules, takeovers and the implementation of the code. Under Dutch law, the Enterprise Chamber has jurisdiction in cases where: 1) there are doubts about if a company is properly managed, 2) the decisions of management are challenged as being inconsistent with the code's principles, 3) shareholders voice dissatisfaction with financial reporting, 4) complaints are made about the removal of a supervisory board of a company organized under the structure regime, and 5) squeeze-out procedures are initiated by a shareholder that has at least 95% of the share capital of a company. Judging from the number of cases, the Enterprise Chamber has properly exerted its influence on the governance arrangements in disputes over the way companies are managed.

In Figure 1 we can observe the main steps in an inquiry proceeding. At the first stage, a party can request an inquiry into the affairs of the corporation to determine whether the company has been mismanaged. If the Enterprise Chamber shares plaintiff's concerns, it will appoint one or more persons who will conduct an investigation and file

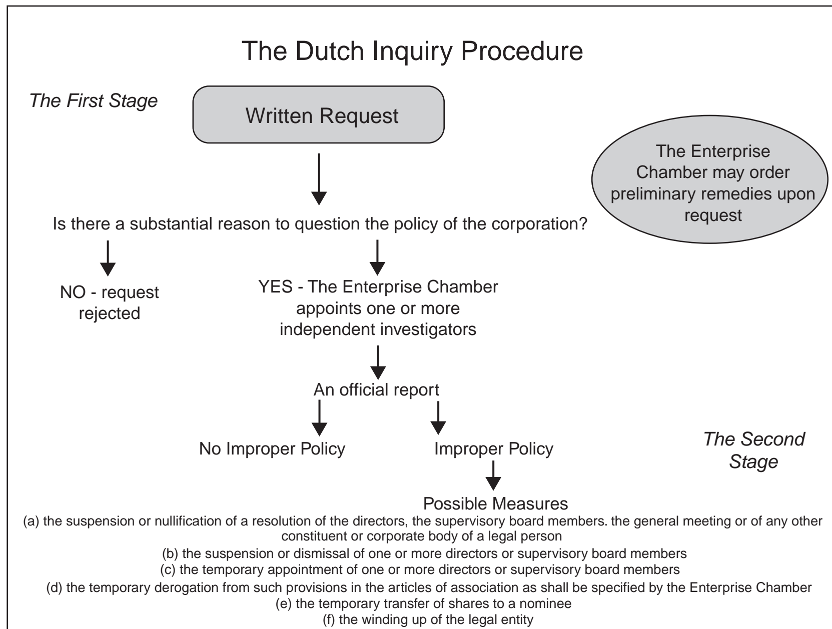


Figure 1 The Enterprise Chamber's Enquiry Procedure

a report with the court. At the second stage, the Enterprise Chamber can, based on the report finding improper conduct, take one or more measures (including dismissal of board members, nullification of board resolutions, appointing temporary directors, temporary transfer of shares) to mitigate the effects of the mismanagement.

## 1. Takeovers

Increasingly, parties are relying on the Enterprise Chamber to conduct inquiry proceedings in the context of a takeover. The shareholder interest in litigation involving takeovers has peaked recently with shareholders routinely bringing actions to investigate the target company's use of defensive measures. With recent decisions of the court, it is now becoming clearer that the assumption that Dutch law serve to protect the interests of large shareholders and incumbent management is no longer safe.

The Netherlands has a long tradition in defending its domestic companies against foreign acquirers. For instance, Royal Dutch/Shell Group defended itself already in 1907 by giving a 'friendly' foundation enhanced

voting powers in order to resist potential 'hostile' buyers.[25] However, over the past decade the mindset towards takeovers has changed in the Netherlands. Firstly, the corporate governance principles that were adopted in 1997 spurred the development of improved shareholder relations. Secondly, the resistance to international acquirers faded (while foreign companies that were incorporated in the Netherlands endeavoured to protect themselves by employing typical Dutch defensive mechanisms, such as the issuance of preference shares to a foundation). The Enterprise Chamber has played an important role in clarifying the acceptance of anti-takeover defences by deciding in the *Gucci* case (1997) and the *Rodamco North America* case (2002) that defensive measures should be proportional, reasonable and temporary.

The Enterprise Chamber continues its responsive role in recent cases involving activist shareholder influence. A recent decision of the Enterprise Chamber, arising out of a shareholder conflict between Stork, a European conglomerate, and two hedge funds, Centaurus Capital of the UK and Paulson & Co of the US, which emerged as its largest investors holding over 31.4% of the company's shares, reinforces the pattern of enhanced shareholder protection in Dutch company law. In 2005, the two hedge funds took up a high profile campaign against the managers of the company, who were content to operate an old-style conglomerate structure consisting of a food systems, technical services and aerospace division. Armed with a study of how Stork could realize shareholder value, the activist funds sought to unbundle Stork's conglomerate structure by reducing the number of unrelated divisions and concentrating solely on the high-value end of its business. Management would reject the hedge funds' advice claiming that the fund managers are merely short-term investors that care more about increasing Stork's share price through unbundling than the long-term interest of the company and its stakeholders. Responding to these allegations, the funds increased their pressure on management by calling a non-binding shareholder resolution that would ask investors to support their divestiture motion. Shareholders overwhelming supported the activists' non-binding resolution, which the board subsequently ignored on the grounds it was not binding legally.

To further underscore its determination to neutralize the activists' threat, Stork's board continued its refusal to discuss strategy with the fund managers. The funds were ultimately forced to call an extraordinary

[25] See *The Wall Street Journal* (by Adam Cohen), 'Going Dutch Has New Meaning in Corporate Takeover Battles', 30 May 2006.

shareholders meeting on 17 January 2007 to demand the dismissal of the members of the supervisory board on the grounds of mismanagement. Surprisingly, this action prompted the Stork Foundation, an unrelated but closely aligned entity, to trigger a poison pill device that diluted the hedge funds' interest in the Stork's equity, giving the company's board and its allies effective control of the company. The hedge funds had no choice but to challenge the legality of the poison pill device alleging that the company was guilty of 'mismanagement' by attempting to frustrate shareholders' rights. The Enterprise Chamber found that the use of the poison pill was illegal, but barred the shareholders' planned vote that called for the dismissal of the supervisory board. Instead, the Court decided to appoint three additional independent supervisory board members and to investigate the alleged mismanagement claims of shareholders. The Stork conflict illustrates the core principle of the Dutch Code to enhance the rights of shareholders and shows the ever-increasing important role of the Enterprise Chamber.

Also, another recent case involving a conflict with a majority shareholder in a tender-offer situation appears to show that the Enterprise Chamber will no longer rubber stamp a management protective environment. In Begemann, there was a tender by Tulip (of which company Begemann was the controlling shareholder) for the shares of Begemann, which was supported by the company's boards. Significantly, the tender was undertaken without a fairness opinion or other external support for the tender. Unsurprisingly, the Enterprise Chamber agreed with the minority shareholders and appointed a temporary director and member of the supervisory board in Begemann.

## 2. Conflict of interest

The other significant area of activity for the Enterprise Chamber is conflicts of interests. The court has for some time attempted to elaborate a standard to prevent the adverse consequences of such actions. Recently, the Enterprise Chamber determined that, in a case involving a struggle for corporate control, a company would be considered mismanaged not only if a potential conflict of interest existed, but if it also failed to take sufficient protections against such a conflict (see Laurus).

Besides setting a standard measure for remedies, the court has recognized a need to set a norm for complying with the code. An especially noteworthy example of the intense battleground shaping the contours of corporate governance in the Netherlands is the recent *Versatel* case. In this case, the Enterprise Chamber of the Amsterdam Court of Appeal

decided in favour of minority shareholders, supported by the Dutch investors' association, to forbid the change from compliance to non-compliance with the corporate governance code between two ordinary general shareholders meetings. Swedish Tele2 became the controlling shareholder of Versatel and appointed new 'Tele2-persons' as supervisory board members. According to the Netherlands code, these new members, due to their conflict of interest, would not be able to take part in the decision-making process to approve a merger with the aim to buy out minority shareholders. As a possible solution, Versatel proposed to amend its corporate governance policy by limiting compliance with the conflict of interest provisions of the code. This argument was rejected by the Enterprise Chamber on the grounds that Versatel, having agreed to abide by the Code in their annual accounts of 2004, would respect the expectations of minority shareholders. The effect of the Versatel decision is to dramatically strengthen the rule-based character of the Code.

The foregoing discussions together show that the Enterprise Chamber has reinvented itself, moving from a body engaged in specialized investigations into disputes arising in the context of bankruptcy proceedings to addressing the major governance claims of parties, particularly in the area of takeovers and conflicts of interest. By choosing to intervene in disputes to determine whether misconduct took place, and resolve quickly these actions in a decisive and definitive manner, the court has gradually increased its ability to improve the corporate governance environment in which companies operate. It follows that the Enterprise Chamber has become a leader in the ongoing discussion about the Code and best practices and as a result, has been transformed into the main body responsible for balancing the demands between management and shareholders in the Netherlands.

## IV. Conclusion

In this chapter, we discussed the effect of the corporate governance regulation on the performance of listed companies. We reviewed recent analyses that focus on the role of corporate governance rules that tend to promote efficiency, transparency and accountability within firms. With respect to the Netherlands, we identified the various legislative and soft-law measures that have emerged recently and attempted to benchmark the effect of the Dutch reforms. Having explained how corporate governance measures and reform are valued, we then considered if Dutch companies are undervalued relative to their international counterparts in

similar industries having similar corporate governance practices. While Dutch firms continue to be undervalued, there are indications that the recent changes introduced by the Dutch Code are likely to improve the performance of publicly listed firms in the Netherlands. Finally, we reviewed the Dutch *ex post* enforcement regime, pointing to a number of key decisions of the Enterprise Chamber that are likely to make minority shareholder protection more effective.

# SECTION 3

## Takeover law