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Legal Regulation of the Board Structure of Public Limited Companies in the light of Regulatory Communication between the European Union and Member States

Communication denotes a link, connection, movement, announcement and also at the same time interaction, as well as the sending and receipt of information.^{*1} It has been noted in literature that communication as a term is so frequently used that it has become ambiguous and carries too many different meanings for people. The most general is considered to be the definition of communication as a certain dissemination of experiences, and one of the possible definitions of communication could be the process of creation of meaning between two or more subjects, one of the important features of which is that the delivery of a message by the sender changes, to a certain degree, not only the addressee of the message but also its sender.^{*2}

The law also plays a big factor in the role of creating meanings and delivering a message in society, since one of the possible approaches towards the law is to regard it as a system of regulations; as an intermediary of behavioural models.^{*3} On the one hand, according to the general model of communication, the state may serve as the sender of the message in the law, while the persons whose behaviour is regulated serve as the addressees. However, in the contemporary world, communication exceeds the boundaries of communication between the creator of the regulation and its addressees — messages are exchanged between the regulatory systems of different countries and even different legal systems. Due to Estonia's position as a European Union member state, that part of regulatory communication which is manifested in the interaction

¹ R. Kleis, J. Silvet, E. Väari. *Võõrsõnade Leksikon (Lexicon of Foreign Words)*. 2nd ed. Tallinn 1978 (in Estonian).

² S. L. Tubbs, S. Moss. *Human Communication*. 6th ed. New York 1991, pp. 6–7.

³ A. Aarnio. *Õiguse tõlgendamise teooria (The Theory of Interpretation of Law)*. Tallinn 1996, p. 21 (in Estonian).

between a member state and supra member state regulations, carries significant weight. In this way, both the Community and its members signal each other as to which mechanisms of legal regulation are mutually desirable and efficient, in order to ensure the compliance of the content of law with its objective. The same mechanisms also apply in company law — on the one hand, the European Union provides guidelines for member states, aimed at guaranteeing freedom of establishment and the organised architecture of the common economic environment; on the other hand, there is also interaction between the legal environments of different member states. It has even been noted in legal literature, recently, that the competition between legal environments need not be a negative phenomenon, since it compels national legal systems to adjust themselves to the demands of investors and thus contributes to their development.⁴ Harmonisation has been less painful and faster in several areas of law than in the issues concerning the structure of the boards of large public limited companies.⁵ The objective of this article is to analyse the differences found in the legal regulations of the board structure of the public limited company in European Union member states, what kind of interactions operate between the law and implementation practices of different states, what relevant development trends can be identified in the European Union, and what message such trends could deliver to Estonian statutory company law. The article also discusses what the message is that the board structure rules, contained in Estonian law, carry for the other member states. Because of the manner of setting the theme above, the possible development of Estonian company law in legal regulation of the board structure of the public limited company has also been discussed.

1. One or two-tier board structure?

It is well known in comparative company law that some countries have maintained the one-tier board structure in the public limited company, while other countries have just as consistently legalised the two-tier structure. The United States of America and the United Kingdom, above all, have been referred to in literature as the representatives of the monistic model, whereas Germany is designated as being the representative of the dualist model.⁶ The border separating the area of application of one-tier and two-tier governance models cannot be drawn in the same place as the boundary between the Anglo-American and continental European legal systems. In addition to England and Ireland, according to the classification developed by Klaus Hopt at the end of the 1990s⁷, the representatives of the monistic model also include Southern European countries such as Spain, Italy, Portugal and Greece; whereas the representatives of the two-tier model comprise, in addition to Germany, Switzerland, Austria, the Netherlands and the Scandinavian countries. France and Belgium, in turn, represent a model in which it is possible to choose between a one and two-tier structure.⁸ Since German company law has also served as an example for the development of national legal systems in several Eastern European countries, the representatives of the two-tier model also include countries like Poland, the Czech Republic, Slovakia, Bulgaria and Latvia.⁹

It is a characteristic of the one-tier model that the board structure of the company, as a rule, comprises one body that is entrusted with the task of both organising the everyday economic activities, strategic management and supervision in a wider sense. Within one body, competence may be divided between different persons; however, this does not mean that the board structure has two tiers. Further to that, the board structure comprising several directing bodies need not represent purely two-tier management. Udo Brändle and Jürgen Noll have pinpointed as the main distinguishing criterion, the fact that the management and monitoring functions are separated on the level of the organisation and individual.¹⁰ A similar principle has also been used for distinguishing between one and two-tier management in the comparative study of the company governance codes of the member states, prepared by the Commission of the European Communities in 2002.¹¹ It must be considered determinative to what extent the principle of separation of powers within the

⁴ S. Mock. Harmonization, Regulation and Legislative Competition in European Corporate Law. – German Law Journal. European and International Law 1.12.2002 (3) 12. Available at <http://www.germanlawjournal.com/article.php?id=216>.

⁵ For example, in the United Kingdom this type of company is called a public limited company, in Germany *Aktiengesellschaft*, in France *société anonyme*, in Sweden *publikt aktiebolag*, in the Netherlands *naamloze vennootschap*, in Denmark *aktieselskabet*.

⁶ B. Grossfeld. Management and Control of Marketable Share Companies. – International Encyclopedia of Comparative Law. Vol. XIII. Business and Private Organizations. Chapter 4, *S.a.*, p. 7.

⁷ To date, the opportunities arising from law have become wider in scope in several countries. See details below.

⁸ K. J. Hopt. The German Two-Tier Board: Experiences, Theories, Reforms. – K. J. Hopt, H. Kanda, et al. (eds.). Comparative Corporate Governance – The State of the Art and Emerging Research. Oxford 1998, p. 228.

⁹ V. Kõve. Äriseadustiku põhialused (Foundations of Commercial Code). – Juridica 1995/4, p. 134 (in Estonian).

¹⁰ U. C. Brändle, J. Noll. The Power of Monitoring. – German Law Journal. Private Law 1.02.2003 (4) 2, p. 1353.

¹¹ Comparative Study of Corporate Governance Codes relevant to the European Union and its Member States. European Commission Internal Market Directorate General. 27.03.2002. Available at http://www.ecgi.org/codes/documents/comparative_study_eu_i_to_v_en.pdf, p. 44.

company has been developed, while above all it must be assessed to what degree the management of everyday economic activities has been separated from the monitoring exercised over that and how the formation of bodies has been regulated from the aspect of independence of supervision. Proceeding from this criterion of assessment, the board structure of British listed companies may sooner be considered to be a two-tier one, while the management of Swedish public limited companies is carried out on one tier. The contrasting of the one-tier board structure of the public limited company with the two-tier one became topical in law, above all, within the framework of the European Union because articles 44 of the consolidated version of the Treaty establishing the European Community^{*12} *inter alia* sets the goal to ensure freedom of establishment in the Community by harmonising the company law of the member states to the greatest extent possible.^{*13} At the time it was found that, ideally, the creditors of the companies of all member states should be legally in the same position so that economic, not legal, environments could compete among themselves.^{*14} Since the board structure of public limited companies differs both in the European Union and on the world scale, it has been important for scientists and practitioners planning harmonisation to identify the reasons behind such differences.

The main reason for the different development of board structures of public companies in different states has been, as mentioned in literature, the capital market differences between the states. For example, in Germany, a considerably higher number of companies are under the influence of majority shareholders as compared to those in the United Kingdom.

Thus, in 1996, 85.4% of the biggest listed public companies in Germany had one majority shareholder who held over 25% of the shares, and 57.3% had a shareholder holding the absolute majority (i.e. a shareholder holding over 50% of the votes).^{*15} A similar situation also prevailed in France and Belgium, according to literature.

The concentration of participation is somewhat smaller in the remainder of continental Europe; however, it is still significantly higher than in the United Kingdom, where the interest in public companies is extremely fragmented.^{*16} The structure of the shareholders in Anglo-American and continental European public limited companies also differs — it is much more common to invest via institutional investors^{*17} in the United Kingdom, where the latter control over 50% of the large companies^{*18} and the proportion of non-professionals among investors is consequently much lower (only about 20–30%). Companies which are not professional investors also hold 20–30% of the shares of comparable companies in Germany, France and Italy, whereas institutional investors only hold 10–30%, and private persons 15–35% of the shares. The third difference is that the public limited companies of the countries that represent the Anglo-American model are, as a rule, larger companies than their counterparts in continental Europe; a significantly higher number of them have been listed, and consequently their shares are more liquid.^{*19} The establishment of different board structures has also been attributed to the different political as well as socioeconomic trends of the countries.^{*20}

It has been noted in legal literature that the establishment of different goals for corporate governance can be identified in European countries; for example, the United Kingdom and the Netherlands are still trying to maximise the investments of shareholders, whereas for instance Germany and France pay less attention to this objective.^{*21} This, however, implies a different setting of goals even within the groups of states representing the monistic or dualist model, respectively. It has also been found in literature that the main cause between differences does not lie so much in different financing as in the different methods used for solving the conflict between ownership and control — Anglo-American solutions are more focused on shareholders, while continental European ones are more geared towards stakeholders.^{*22} The term 'stakeholders' is

¹² OJ C 325, 24.12.2002.

¹³ C. Timmermans. Harmonization in the Future of Company Law in Europe. — K. J. Hopt, H. Kanda, et al. (eds.). *Comparative Corporate Governance – The State of the Art and Emerging Research*. Oxford 1998, p. 624.

¹⁴ S. Mock (Note 4).

¹⁵ K. J. Hopt (Note 8), p. 232.

¹⁶ C. Van der Elst. *Economic Analysis of Corporate Law in Europe: an Introduction*. — Financial Law Institute Working Paper Series. WP 2002-01. Available at <http://www.law.ugent.be/fli/WP/WP2002-pdf/WP2002-01.pdf>, p. 13.

¹⁷ Institutional investors include, for example, banks, investment funds, insurance companies, pension funds and other organisations for whom collection and investment of resources in listed companies is their everyday economic activity.

¹⁸ The share of institutional investors was as high as 60% in the United Kingdom according to some sources. See U. C. Brändle, J. Noll (Note 10), p. 1367.

¹⁹ H. Ooghe, V. Van de Vuyst. *The Anglo-Saxon versus the Continental European Corporate Governance Model: Empirical Evidence of Board Composition in Belgium*. Available at <http://www.vlerick.be/research/workingpapers/vlgms-wp-2001-06.pdf>, pp. 3 and 5.

²⁰ A. Dorresteyn, I. Kuiper, G. Morse. *European Corporate Law*. Stockholm 1995, p. 101.

²¹ D. Brounen, A. de Jong, K. Koedijk. *Corporate Finance in Europe: Confronting Theory with Practice*. — *Financial Management*, Winter 2004, p. 99.

²² H. Ooghe, V. van de Vuyst (Note 19), pp. 3–4.

intended to cover both shareholders and other investors, and also suppliers, consumers of products or services, employees, the state, and society as a whole.^{*23}

As appears from the above, many potential reasons have been highlighted in literature for the establishment of diverse board structures, and one way or another the majority of them are related to the economic environment of the relevant country. When the main problem in high shareholding concentration is the protection of minority shareholders, the control of the board serves as one in dispersed ownership. Thus, the multitude of management models is the result of the different economic and social developments of the countries.

2. Member state experiences: convergence of board structures

A harmonisation trend can be detected in the development of the legal environments of the member states concerning the board structure of public limited companies. This is firstly manifested in the fact that in addition to the original one, that is the traditional board structure, an opportunity to choose a different model has also been provided for public limited companies in many countries. One such example is France where, as early as 1966, public limited companies got an opportunity to use a two-tier board structure as an alternative to the original or one-tier model, whereby the German model served as the basis.^{*24} On 1 January 2004, a law that reformed contract law also entered into force in Italy, for instance, and according to the amendments Italian public limited companies could choose between three different management models (so-called traditional, German and British models).^{*25}

Besides the above, several board structures of public limited companies have historically developed in European countries, which are hard to classify as one or two-tier models. One of the examples here can be the board structure of Danish public limited companies, which has been prescribed as two-tier by law. Danish law stipulates that the public limited company must have two boards — the everyday management is handled by the management board (*direktion*) and supervision is carried out by the supervisory board (*bestyrelse*); however, unlike the states that prescribe a two-tier structure, strictly founded on the separation of powers, the members of the management board are permitted to serve simultaneously as members of the supervisory board, on the precondition that not more than one-half of the positions of the supervisory board members are filled this way. As a consequence, the board structure of Danish public limited companies has also been described as ‘semi-two-tier’.^{*26} According to the comments on Swedish company governance code^{*27}, the Swedish company governance model lies somewhere between the one-tier Anglo-American and two-tier continental European model (comm. 2 (8)).

Secondly, when regarding practice in addition to laws, it appears that the differences between the monistic and dualist models are much less significant in the European Union member states than it seems at first. Similarities are particularly great in the management of listed companies because the same principles have been largely taken as the basis when developing company governance practices. The United Kingdom does not recognise the supervisory board as an independent supervisory body, yet in practice, a unit with such competence exists, one way or another. The non-executive members of a British listed company are comparable to the members of the supervisory board in their duties.^{*28} However, the non-executive members differ from the members of the supervisory board in the fact that they can participate in the adoption of management decisions concerning everyday activities, as the directing competence of the management board is rather homogeneous. German legal practice has, in turn, converged with the Anglo-American model to a certain extent, and although the immediate participation of the supervisory board in the direction of everyday economic activities has been ruled out, according to law, the supervisory board still has important points in common with the management board’s competence. For example, the meetings of an acting supervisory board carry great significance with regard to governance in its wider meaning and it is common that the members of the management board also participate in the supervisory board meetings (while naturally not

²³ M. M. Blair. *Ownership and Control: Rethinking Corporate Governance for the Twenty-First Century*. – T. Clarke (ed.). *Theories of Corporate Governance: The Philosophical Foundations of Corporate Governance*. Oxon 2004, pp. 174–178.

²⁴ B. Grossfeld (Note 6), p. 8.

²⁵ P. Montalenti. *The New Italian Company Law: an Outline*. – *European Company and Financial Law Review* 2004 (1) 3, October, pp. 368–370.

²⁶ C. Rose. *The Composition of Semi-Two-Tier Corporate Boards and Firm Performance*. – *Corporate Governance: An International Review*, 2005 (13) 5, September, p. 692.

²⁷ *Swedish Code of Corporate Governance. Report of the Code Group*. Swedish Government Official Reports. SOU 2004: 130. 16.12.2004. Available at http://www.ecgi.org/codes/documents/swe_codes_group_en_mar2005.pdf.

²⁸ B. Grossfeld (Note 6), p. 9.

entitled to vote). It has also been emphasised in literature that the supervisory board plays an increasingly important role as the advisor to the management board.^{*29} Such practice is perhaps common in Estonian public limited companies, where the supervisory board has a substantive but not nominal role.

As the choice between one and two-tier board structures is largely motivated by economic distinctions, it is not correct to ask which system is more efficient in the abstract sense. The one-tier model focuses more on counterbalancing the authorised powers of the management board, whereas the two-tier model centres on the restriction of influence of a majority shareholder. The protection of the general interests of the company is concerned in both cases.^{*30}

It has been opined in literature that the general trend of convergence expresses movement towards two-tier management, as implied, for example, by several British company governance principles.^{*31} The reduction in substantive differences between the one and two-tier structure has also been pointed out as a general development trend, for instance, in the German Corporate Governance Code^{*32} and its comments.^{*33}

Nevertheless, both models have been criticised in legal literature. Several critics of the supervision theory are of the opinion that the appropriate level of supervision should not be set by the state through imperative regulations, but instead by the market, and that investors should have the right to choose both the form of supervision and its intensity. According to the critics of the two-tier board structure, the management system should be homogeneous and protected from external interference. It is claimed that, in reality, it is difficult to maintain a clear distinction between management (in the narrower sense) and supervision as a function of management (in a wider sense)^{*34} The heaviness of the mechanisms designed for actualisation of the responsibility of the supervisory board members has also been an object of criticism.^{*35} A deficiency characteristic of the common law system — a particular uncertainty arising from the fact that case law serving as law based on cases evolves over a longer period — has been pointed out as a weakness of the one-tier management model. Thus, it is not possible to say how far practice can go and from what point onwards the law will restrict its implementation. Uncertainty is increased by the fact that the objectives, customs, practices and protected values of business are in the process of continuing change, and the changes occur so rapidly that they are not immediately reflected in case law.^{*36}

It appears from the above that communication, as an exchange of meanings concerning the legal regulation of the board structure of the public limited company, is in progress in the member states, both on the level of provisions and legal practice, while convergence of legal regulation and practice can be detected in the relevant area. A flexible approach and availability of choice in board structure can be considered to be the general trend.

²⁹ U. C. Brändle, J. Noll (Note 10), p. 1356.

³⁰ H. Ooghe, V. van de Vuyst (Note 19), p. 8.

³¹ Already since 1.12.1992, it has been advisable in the United Kingdom that listed companies comply with a collection of company governance practices called Cadbury Report, the objective of which is to ensure balance of powers in the management board of listed companies. The Report directly prescribes that the board of every public company must consist of a combination of executive directors, with their intimate knowledge of the business, and of non-executive directors, who can bring a broader view to the company's activities, under a chairman who accepts the duties and responsibilities which the post entails (clauses 4.1 and 4.2). See Report of the Committee on the Financial Aspects of Corporate Governance. 01.12.1992. Available at <http://www.ecgi.org/codes/documents/cadbury.pdf>.

³² Regierungskommission Deutscher Corporate Governance Kodex in der Fassung vom 21.05.2003. Available at http://www.ecgi.org/codes/documents/code_200305_d.pdf.

³³ H. M. Ringleb, T. Kremer, et al. Kommentar zum Deutschen Corporate Governance Kodex. 2. Aufl. München 2005, Präambel, paragraph 111.

³⁴ B. Grossfeld (Note 6), p. 9.

³⁵ Michel Tison has comparatively studied the issues of liability of supervisory board members and he describes different forms of liability of supervisory board members as exemplified by credit institutions and the resulting dilemma of the supervisory, manifested above during economic hardship of the company. In doing so, Tison finds that part of the arguments certainly speak for reserving the majority of risks for creditors and shareholders as well as a solidary guarantee foundation established for such purpose to bear. However, this should not replace the internal liability of the company, or otherwise, the entire regulatory framework covering the management would become pointless. Nevertheless, the guarantee system as a special feature of credit institutions aside, the issue of the liability of supervisory board members becomes more acute. See M. Tison. Challenging the Prudential Supervisor Liability: Liability versus (Regulatory) Immunity. Financial Law Institute Working Paper Series. WP 2003-04. Available at <http://www.law.ugent.be/fli/WP/WP2003-pdf/WP2003-04.pdf>, pp. 4–6.

³⁶ J. Rickford. Fundamentals, Developments and Trends in British Company Law — Some Wider Reflections. First Part: Overview and the British Approach. – European Company and Financial Law Review 2004 (1) 4, December, p. 407.

3. European Union message to member states: freedom of choice and differentiated regulation

Against a background of diverse legal regulations applicable in the member states, and practice that increasingly approximates rules to each other; we must ask how the European Union perceives such developments. The harmonisation of issues related to the management of the public limited liability company has received attention in the European Union for quite a while. Differences in corporate governance in various member states are also likely to have a certain influence on the process of development of international companies.³⁷ It was initially planned to adopt a relevant Council directive to regulate the structure of the company, the competence and functions of its bodies. The original draft of the Fifth or Structure Directive³⁸ was prepared in 1972. It was changed several times and the last text originates from 1991.³⁹ In its original shape, the draft Structure Directive encapsulated the spirit of the era — the directives developed and adopted at the time were in fact not aimed at harmonising the law of the member states but rather at their immediate legal regulation, hence one could not speak about harmonisation *ad minimo*.⁴⁰ The issues concerning the themes related to the board structure of limited liability companies have generated numerous disputes and this has been considered to have been caused by the fact that if in other cases the governing area of directives has largely comprised the relations between a company and third parties⁴¹, then the board structure has been more related to the internal organisation of the company. Disputes were caused by the initial contrasting of the one and two-tier structures as well as the idea stemming from German law, and its historical and social background, to involve employees in the management of public limited companies.⁴² The disputes led to the submission of a supplemented version of the Structure Directive by the European Commission in 1990, which offered the ample selection of different management models (including different possibilities of employee participation) so that, all in all, the draft lost the potential regulatory function that it would have had when enforced.⁴³ Since various jurists and specialists expressed the opinion that there was no need for adopting the Structure Directive in such a form, the efforts aimed at its enforcement also gradually faded.

In 2002, the High Level Group of Company Law Experts prepared the so-called Winter Report⁴⁴, the third chapter of which also discussed issues related to corporate governance. The Group of Experts focused on four main aspects in the area — firstly, on the improvement of disclosure requirements (including the remuneration of directors), secondly, on the protection of the interests of shareholders (and above all minority shareholders), thirdly, on the obligations of the boards (particularly in the case of the bankruptcy of the company) and fourthly, on the necessity of the European corporate governance code. From the point of view of the theme analysed in this article, the issues concerning the members of the board are the most important in the document. The experts' approach to companies having either a one or two-tier board structure is, in principle, similar. It should be considered of importance that, although the report acknowledges the continuing academic discussion of the differences, strengths and weaknesses of the one and two-tier board structure, it concludes that in fact there is a lack of evidence clearly proving the advantage of one system over the

³⁷ I. De Voldere, L. Sleuwaegen, A. van Pelt, R. Veugelers. Corporate Structure of Leading Firms in Europe: Does Country of Origin Still Matter? Vlerick Leuven Gent Management School. – Vlerick Leuven Gent Working Paper Series 2004/12. D/2004/6482/13, p. 4.

³⁸ Proposal for a Fifth Directive on co-ordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of article 59 (2) of the Treaty, with respect to company structure and to the power and responsibilities of company boards. – OJ C 131, 13.12.1972, p. 0049.

³⁹ Second amendment to the proposal for a Fifth Council Directive based on article 54 of the EEC treaty concerning the structure of public limited companies and the powers and obligations of their organs. – OJ C 007, 11.01.1991, p. 0004.

⁴⁰ S. Mock (Note 4).

⁴¹ For example, the First Council Directive of 9.03.1968 on co-ordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of article 58 of the Treaty, with a view to making such safeguards equivalent through the Community (68/151/EEC. – OJ L 65, 16.03.1968, pp. 8–12) discusses the issues related to the register and the nullity of companies, the Second Council Directive of 13.12.1976 on coordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of article 58 of the Treaty, in respect of the formation of public limited liability companies and the maintenance and alteration of their capital, with a view to making such safeguards equivalent (77/91/EEC. – OJ L 26, 31.01.1977, pp. 1–13) discusses the issues related to capital protection.

⁴² The involvement of employees in the management of public limited companies has gradually established its position in German company law, where the relevant management model contributed to rebuilding the state both after World War I and II. See P. C. Leyens. German Company Law: Recent Developments and Future Challenges. – German Law Journal. Private Law 1.10.2005 (6) 10, p. 1413; A. F. Conard. The Supervision of Corporate Management: A Comparison of Developments in European Community and United States Law. – Michigan Law Review 1984 (82), pp. 1483–1487.

⁴³ A. Dorresteyn, I. Kuiper, G. Morse (Note 20), pp. 51–52.

⁴⁴ Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe. Brussels, 4.11.2002. Available at http://ec.europa.eu/internal_market/company/docs/modern/report_en.pdf.

other. According to the report, both models have developed in parallel and via a different path, and Good Corporate Governance, in its contemporary sense, is possible within the framework of both board structures. The experts clearly express the opinion that neither of the models should be made compulsory as a whole in Europe; rather, both listed companies and other public limited liability companies should have the opportunity to choose a management model.

It appears, from the above, that in converging Europe, it is entirely possible to regulate the important issues of corporate governance so that various governance models are viewed as different possibilities for achieving the same goal. Speaking about the members of the board responsible for monitoring, both the supervisory directors of the dualist model and the non-executive directors of the monistic model are meant. The Group of Experts emphasises that it is not necessary to provide rules on how the board should be composed as a whole on the European level; however, it is important to ensure that the executive directors, their remuneration and issues related to the audits of listed companies in all member states be decided by the monitoring members of the board, the majority of whom should be independent. In such issues, the Group of Experts considered it necessary for the Commission of the European Communities to develop the relevant recommendations for the member states. The experts also found that the efforts of the member states, both in improving their national company law and codifying the corresponding practices, should be coordinated.

In 2003, the Commission of the European Communities prepared the action plan for Modernising Company Law and Enhancing Corporate Governance^{*45}, consolidating the development trends of the relevant area for the near future. The action plan also includes perspectives related to corporate governance, focusing, above all, on disclosure requirements, measures for strengthening shareholders' rights, modernising the board as a directing body, and coordinating the corporate governance efforts of member states in legal regulation.

The mentioned action plan was followed by the recommendations of the Commission of the European Communities to the member states — on 14 December 2004, the Commission issued recommendations fostering an appropriate regime for the remuneration of directors of listed companies^{*46} and on 15 February 2005, on the role of non-executive or supervisory directors of listed companies and the committees.^{*47}

Hence, to date, the European Union has abandoned the idea of enforcing the Structure Directive and is focusing instead on the regulators of governance, such as disclosure, financial reporting and internal audits, and the independence of the board members, their remuneration, rights, duties and liability. Yet, it is not entirely correct to say that the above-mentioned plans and recommendations do not discuss the board structure at all because, for example, as regards the formation of the boards, both the Winter Report and the recommendations issued by the Commission to the member states suggest that a committee or committees for the appointment of board members, their remuneration and monitoring be established for handling the areas that are most likely to cause conflicts, while their number and structure are determined by the board (by the executive directors in the one-tier structure and by supervisory directors in the two-tier structure). At the same time, it is advisable, according to Commission recommendations that the committees consist mainly of independent members.^{*48} The principal areas that are recommended for delegation to committees are the appointment of executive board members, their remuneration and issues related to auditing (including the selection of auditor candidates). In clause 14 of the recommendation on the role of non-executive or supervisory directors of listed companies and committees, it is noted that in audit issues, a transfer of the relevant competence to corporate bodies external to the (supervisory) board or structure may be taken into consideration, in order to ensure the impartiality and objectivity of the procedure. The task of the committee responsible for the preliminary selection of board members should be *inter alia* to periodically assess the board structure, composition of the board, its size and architecture, and to make the necessary proposals for changes.^{*49} The recommendations also naturally emphasise that such committees cannot, in principle, replace the body itself or change its competence and above all liability; however, their tasks should be to prepare the decisions to be adopted by the board or supervisory directors, and the delegation of certain decisions to the committee should be permitted on the precondition that such an opportunity is in compliance with national law (preamble, § 9). Nevertheless, such guidelines generate suspicion about whether such structuring ultimately fosters better organisation of management and protection of the interests of shareholders, and the company as a whole, since in such a situation many issues that are of importance for

⁴⁵ Commission of the European Communities. Communication from the Commission to the Council and the European Parliament. Modernising Company Law and Enhancing Corporate Governance in the European Union — A Plan to Move Forward. Brussels, 21.05.2003. COM (2003) 284 Final. Available at http://europa.eu.int/eur-lex/pri/en/dpi/cnc/doc/2003/com2003_0284en01.doc.

⁴⁶ Commission recommendation fostering an appropriate regime for the remuneration of directors of listed companies (2004/913/EC). 14.12.2004. — OJ L 385, 29.12.2005, pp. 55–59.

⁴⁷ Commission recommendation on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board (2005/162/ EC). 15.02.2005. — OJ L 52, 25.02.2005, pp. 51–63.

⁴⁸ A. Koulouridas, J. v. Lackum. Recent Developments of Corporate Governance in the European Union and their Impact on the German Legal System. — German Law Journal. European and International Law 1.10.2004 (5) 10, pp. 1286–1288.

⁴⁹ *Ibid.*, p. 1286.

the company may be decided by a substantially smaller body than the board, and the importance of the board may thus become a mere formality.

As a result of the above, the message to be communicated to the member states by the European Union supports as little legal regulation as possible on the level of the European Union, and member states should be granted the maximum freedom to decide whether to enable national limited liability companies to use the one or two-tier board structure, as well as the legalisation of alternative management models.

4. Estonia's message to other member states: rigid legal regulation

The Commercial Code (CC) that entered into force on 1 September 1995^{*50} provided for the two-tier board structure compulsory for Estonian public limited companies. The introduction of the dualist model can be attributed to the example of German law comprising the principles of independent supervision^{*51} — it was considered necessary to establish a system ensuring strong internal supervision for the public limited company that is presumably a legal form of a large enterprise.^{*52} When developing the CC, a proposal was first made to also provide, in addition to the public and private limited company, a third type of a limited liability company, the so-called closed public limited company, which could have also led to differentiation of management models, yet the idea was abandoned.^{*53} The low differentiation of the management models was also caused by the fact that there was no regulated securities market in Estonia at the time when the CC entered into force.

In addition to the CC, the management of Estonian listed companies is also governed by the Corporate Governance Code^{*54} (CGC). As to the structure of the directing bodies, the CGC repeats the requirements of the CC: the two-tier board structure is also compulsory for listed companies.

According to CC § 306 (1), the management board is the directing body of a public limited company, which represents and directs the public limited company. The supervisory board shall plan the activities of the public limited company, organise the management of the public limited company and supervise the activities of the management board (CC § 316). A member of the supervisory board shall not be a member of the management board (CC § 308 (3)) or *vice versa* (CC § 318 (4)). The supervisory board shall give orders to the management board for organisation of the management of the public limited company, and on the precondition that it has not been provided otherwise in the articles of association of the public limited company, the consent of the supervisory board is required for the management board for conclusion of transactions which are beyond the scope of everyday economic activities (CC § 317 (1)–(3)). Being a classical supervisory body, the supervisory board has the right to examine all documents of the public limited company and to audit the accuracy of accounting, the existence of assets, and the conformity of the activities of the public limited company with the law, the articles of association and resolutions of the general meeting (CC § 317 (6)). The duty to exercise supervision of the management board has also been expressed in CC § 317 (8), pursuant to which the supervisory board shall decide on conclusion and terms and conditions of transactions with members of the management board and, for that purpose, shall appoint a representative of the public limited company. The supervisory board shall also decide on the conduct of legal disputes with a member of the management board, appointing a representative of the public limited company for that purpose. The supervisory board is competent to elect and remove the members of the management board (CC § 309 (1) and (3)). As to the supervision concerning the annual report, the supervisory board shall review the annual report and shall prepare a written report concerning the annual report, which shall be presented to the general meeting together with the annual report. The supervisory board shall indicate in the report whether it approves the annual report prepared by the management board; in addition, the report shall indicate how the supervisory board has organised and directed the activities of the public limited company (CC § 333 (1)). The supervisory board has the right to make amendments to the profit distribution proposal before its presentation to the general meeting (CC § 333 (2)). Thus, the structure of the directing bodies of Estonian public limited companies comprises all the features, according to which it can be classified as two-tier, with the greatest similarity to the German model.

⁵⁰ Riigi Teataja (State Gazette) I 1995, 26–28, 355; 2006, 7, 42 (in Estonian).

⁵¹ V. Kõve. 10-aastane äriseadustik – tagasivaade senisele arengule (Ten Years of Commercial Code — Retrospect of Development). – *Juridica* 2005/9, p. 598 (in Estonian).

⁵² V. Kõve (Note 9), p. 134.

⁵³ A. Vutt. Osaühing ja aktsiaselts (A Private and a Public Limited Company). – *Juridica* 1995/4, p. 149 (in Estonian).

⁵⁴ Available at <http://files.ee.omxgroup.com/bors/press/HYT.pdf>.

Whereas, in many member states, large companies may also choose their board structure, this is not possible even in smaller public limited companies in Estonia.⁵⁵ As a result, the message delivered by Estonia to other member states clearly implies the rigidity of the local legal environment in this area. We can always ask the question of whether it would not be possible to evade that requirement, knowing the rigidity of the management model of the public limited company, by selecting for action the parallel form of the public limited company, the private limited company. But due to its closed nature, the private limited company cannot compete with the public limited company intended for investment firms. In addition, Estonian law also contains rather rigid board structure requirements for larger private limited companies. According to CC § 189 (1), if the share capital is greater than 400,000 kroons, the management board of the private limited company must have at least three members, and if the number of the members of the management board is lower, a supervisory board must be elected in addition to the management board. Hence, the Estonian regulator has assumed a principal position that in the case of fixed capital exceeding 400,000 kroons⁵⁶ it is by all means necessary to replace sole management with a collegial one. At the same time, it is still questionable whether 400,000 kroons is currently the amount beyond which share capital would definitely require collegial management and a more complicated board structure with stricter supervision requirements, and it is also questionable whether the form of the public limited company and the amount of share capital should serve as the sole indicators on the basis of which precepts should be issued to entrepreneurs concerning the number of the members of the directing body and its structure. The author of the article does not believe this to be so. Perhaps it would be reasonable to prescribe, with a certain amount of share capital (but why not also turnover, number of employees, balance sheet total or other economic indicators characterising the activities of the company), imperative management regulations that would better help protect both the investment of shareholders and the interests of the creditors; nevertheless, at the moment, the creditors' interests are in a position of advantage, as the possibilities of the shareholders of the company, the share capital of which only slightly exceeds 400,000 kroons, to determine the board structure and the number of the board members are relatively limited, while the amount of fixed capital, at 400,000 or slightly below it, provides an opportunity to use sole management. According to the author, the main reproach to applicable law can be considered to be the fact that the enforcement of disproportionate legal regulations may lead to the formalisation of the board's composition — to a situation in which the actual board structure and the formal structure do not coincide. This, however, cannot be considered right, since the aim of legal regulation is not the establishment of formal provisions but the regulation of actual social relationships. Pursuant to the theory of law, the idea of law consists of three elements — justice, legal guarantees and the purposefulness of law⁵⁷ and it is doubtful whether this case involves purposeful regulation. The message delivered to other member states in the course of regulatory communication embodied in the strict regulations concerning the board structure of the Estonian public limited company (and also of the private limited company having a larger share capital) hardly contributes to the making of larger investments in Estonia through the fixed capital of this type of company.

5. Development trend of Estonian company law: need for change

Due to the message delivered by Estonia to other member states concerning the rigid board structure of small public limited companies and taking into account both the developments in the European Union and the overall convergence of management models in the member states, Estonian company law should head for the liberalisation of the management of small companies.

In order to determine the suitability of a model for a particular type of company, due regard should be given to different criteria. The first could be the size of the public limited company, while different features can be taken as the basis for determining the size, such as the amount of share capital, other economic indicators (balance sheet total, turnover), number of employees or other features. The criterion for the size of the public limited company is similar, for instance, to the particular significance of the company (undertaking dominating market or other), which may necessitate imposition of imperative board structure rules. All of the above expresses the scale of the public limited company and also through that its significance to society. The other criterion, on the basis of which one can choose between one and another management model for the particular public limited company, is the structure of shareholders and the interrelations between shareholders and

⁵⁵ Only a *Societas Europaea* registered in Estonia may choose between organising the management of the company on one or two tiers. See Council Regulation (EC) No 2157/2001 on the Statute for a European company (SE) Implementation Act, 10.11.2004. – Riigi Teataja (State Gazette) I 2004, 81, 543 (in Estonian).

⁵⁶ This makes about 25,565 euros.

⁵⁷ R. Narits. *Õiguse entsüklopeedia* (Encyclopaedia of Law). Tallinn 2004, p. 33 (in Estonian).

the directing bodies of the company (self-management *versus* external management). It is clear that, for example, the public limited company, the shareholding of which is divided between many different shareholders, needs management rules that differ from those of a public limited company that has a controlling shareholder. In the face of the information contained in the share registers of Estonian listed companies⁵⁸, it may be inferred that the companies listed on the Tallinn Stock Exchange have, as a rule, shareholders who control the company or, at least in eight cases out of fifteen, a shareholder whose holding exceeds 50%. The share of institutional investors remains between 10–30%.⁵⁹ There are also controlling shareholders in public limited companies not listed on the stock exchange. The shareholder structure of Estonian listed companies is largely similar to the economic model that has evolved in continental Europe and it should be taken into account when planning for changes.

As within a legal order, the needs of different public limited companies for different management models vary, it should be considered justified to give freedom of choice to the companies with regard to which the interest in legal management regulation on the level of society is not very high (small public limited companies), whereas the structure of the directing bodies of larger companies should be regulated more strictly. The need to distinguish between various types of companies from the aspect of legal regulation was also emphasised by the High Level Group of Company Law Experts in the Winter Report (recommendation II.4).

It is also worth noting that on 6 May 2003, the European Commission adopted recommendations concerning small and medium-sized companies⁶⁰, the objective of which was to cover the companies conforming to certain characteristics (regardless of their legal form) with the same definition. Although the objectives of adopting these recommendations can be considered economic rather than legal, *per se*, it has been mentioned in literature that small and medium-sized companies constitute a significant majority of all the enterprises in the European Community and they can be regarded as transferring to an international sphere of influence, so the law must help them transcend strictly national limits.⁶¹ Hence, it is necessary to legalise, in Estonia, the possibility to shape the board structure of the public limited company so that the Estonian legal environment would be in conformity with the differentiated approach, and help to liberalise the management of smaller companies. The recommendations for delimiting very small (micro), small and medium-sized companies include — as with large companies in the Netherlands, with the potential to adjust the structural regime⁶² — the number of employees, balance sheet total and turnover for the financial year.⁶³ Although the recommendations do not specifically state that the indicators should be used for determining the differences in the board structure, consideration should be given to such a possibility.

Thus, from the point of view of the legal regulation of the board structure, a distinction should be made between large and small public limited companies. The criteria for making the distinction could include the amount of share capital, the balance sheet total, and the turnover during the financial year, while the number of employees and the dominant position of the undertaking on the market should also be taken into account. The legal regime of the ‘large public limited company’ should also extend to listed companies, and two-tier management should remain compulsory for all of the public limited companies conforming to such criteria. Small and medium-sized public limited companies should be allowed to choose between a one and two-tier board structure. The preservation of more rigid rules is not justified, according to the author of the article, and it would damage the competitiveness of the Estonian legal environment in terms of the founding of smaller companies, considering the general liberal tendencies in the European Union. Yet, when asking whether all Estonian public limited companies should be allowed to choose the one-tier management model, the answer should be no. Naturally, the substitution of internal supervision for some external form of supervision is not precluded; however, this would presume a rather important reform of company law. Perhaps, the state is not interested in assuming such supervisory obligation because it would bring about high costs.

⁵⁸ See http://statistics.e-register.ee/shlist/?lang=et%20_blank.

⁵⁹ The size of the holding of shareholders does not involve assessment of the possible actual situation since the formally different shareholders may in fact be under the influence of the same persons. In relation to that, the cases in which a controlling shareholder exists are currently the ones where a particular person holds over 50% of the shares. In reality, it is very likely that other listed companies also have shareholders having significant control.

⁶⁰ Commission Recommendation of 6.05.2003 concerning the definition of micro, small and medium-sized enterprises (notified under document number C(2003) 1422) (2003/361/EC). – OJ L 124, 20.05.2003, pp. 0036–0041.

⁶¹ W. F. Ebke. Kleine und mittlere Unternehmen im Aufwind der Globalisierung. – Zeitschrift für Vergleichende Rechtswissenschaft. Archiv für Internationales Wirtschaftsrecht. Bd. 104. Februar 2005, pp. 1–3.

⁶² In the Netherlands, the two-tier structure is obligatory only for large companies that have been subjected to the so-called structural regime, while the size is determined by the simultaneous presence of several features. The criteria comprise: firstly, the number of employees in the company and its subsidiaries; secondly, the existence of a works council; and thirdly, the amount of equity capital after the balance sheet date. For details, see A. Dorresteijn, I. Kuiper, G. Morse (Note 20), p. 125; T. J. B. M. Postma, H. van Ees, E. Sterken. Board Composition and Firm Performance in Netherlands. Available at <http://som.eldoc.ub.rug.nl/FILES/reports/themeE/2001/01E01/01E01.pdf>, pp. 6–9.

⁶³ W. F. Ebke. Kleine und mittlere Unternehmen im Aufwind der Globalisierung. – Zeitschrift für Vergleichende Rechtswissenschaft. Archiv für Internationales Wirtschaftsrecht. Bd. 104. Februar 2005, pp. 1–3.

The existence of the supervisory board as an independent monitoring body cannot prevent all potential abuses by the management board; yet the activities of the management board can be more easily monitored than by a large number of shareholders. Conflicts of interests cannot be ruled out in one or two-tier structures, but independent monitoring would provide a certain advantage in a company subjected to external management in which shareholding is dispersed.^{*64}

An unbalanced one-tier board structure could not be introduced without reforming Estonian company law, because the supervisory elements on the different levels of the company are interrelated.^{*65} Regardless of the fact that the legal traditions of the implementation environment possess certain significance for the development of a legal framework, according to the author, the full preservation of the already existing system cannot be justified merely by the fact that it has existed already for ten years. The aim of the state should be not the establishment of any legal framework but instead the creation of rules that would enable the state to achieve its main goal in legislation — to furnish law with just content.^{*66}

When planning for amendments to Estonian laws, one argument is the flexible attitude of the European Union and member states to the regulation of the directing bodies when justifying the legalisation of alternative management models. It is inevitable to give a choice, above all, to smaller public limited companies for Estonia's message to other member states and Europe as a whole to signal clearly the flexible regulation of the relevant area.

⁶⁴ J. Rickford (Note 36), p. 407.

⁶⁵ For example, according to Estonian law, exercise of supervision by shareholders over the activities of the management board is currently limited to submission of a request for information at a general meeting according to CC § 287 (1), to proceedings on petition according to CC § 287 (3) and to the request of a special audit on the basis of CC § 330.

⁶⁶ R. Narits. Eesti omariiklus ja õigus (Estonian Independent Statehood and Law). – *Juridica* 2000/2, p. 72 (in Estonian).