COMPOSITION PROBLEMS OF SUPERVISORY BOARDS OF THE

GEORGIAN STOCK COMPANIES

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ABSTRACT

Law of Georgia on Entrerpreneurs contains loopholes regarding the composition of the supervisory boards of the Gerogian stock companies. These gaps cause bad corporate governance of corporations in practice. In order for Georgian corporations to comply with the best international standards and improve their corporate governance, amendments in the law is necessary. The present paper is focused on the analysis of German and U.S. corporate governance rules regarding the compsition of the boards of public companies. Comparing these two different corporate governance systems, I conclude, that the best solution for Georgian corporations is to compose their supervisory boards entirely with independent directors, to establish committees composed with qualified members and to reduce the number of the supervisory board members. Also, functions of the supervisory and management boards must be clearly seperated in corporate governance practices of the Georgian corporations, i.e.management boards must not elect the members of the supervisory boards.

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INTRODUCTION

"Power tends to corrupt, and absolute power corrupts absolutely."

Lord Acton

1887

One of the main problems of the corporate governance in Georgian stock companies, is that their supervisory boards exist formally, i.e. do not carry out their main task, control of the management board effectively.There are several reasons, that make supervisory boards weak in Georgian corporations. In my paper I will refer to some of them, in particular: a) lack of independent directors and representation of the members of the board of directors in the supervisory boards. b) nondevelopment of committee works and c) a large number of members of the supervisory boards.

Having strong supervisory board is essential for the development of corporate governance in corporations. Weak supervisory board concentrates powers in the hands of management boards, who may use those powers for their interests and to the detriment of shareholders. Consequently, shareholders will refrain from investing in the corporations with uncontrolled managers, as nobody wants to invest in the company, where the directors of the company give their interests priority to the interests of the shareholders.[1] Lack of investments will be a hindrance for the development of the country's economy.

To have investor confidence, develop private sector and overcome poverty, Georgia must have good legislation. Law of Georgia on Entrerpreneurs contains lots of loopholes regarding the composition of the supervisory boards of the Georgian corporations. In particular, it permits the members of the supervisory boards to be at the same time the members of the

[1] Avto Svanidze, *What is Corporate Governance*, International Finance Corporation, Quarterly Bulletins №1 September-November 2003, pp.3-4.
http://www.ifc.org/ifcext/gcgp.nsf/Content/ProjectMaterialsPublications.

boards of directors (management boards), while the modern corporate governance rule is to decrease the number of insiders in the controlling organ and increase the number of independent directors. The law does not make existence of committees in the corporations mandatory, neither defines qualification requirements for the supervisory board members. However, nowadays, in developed countries' public companies, committes have important role in working of the boards and composition of the boards with professionals is one of the priorities of the corporations. Also, addittional diasdvantage of the Georgian law is that it requires the members of the supervisory boards to be minimum 3 and maximum 21, while, according to international standards, the members of the supervisory boards should be no more than 9.[2] It is worth to note, that in practice, according to the survey[3] of Georgian companies, gaps of the law are reflected on unhealthy composition of the supervisory boards of the Georgian corporations. The number of independent directors is insignificant and there are no committees at all in the majority of the corporations.

For the improvement of composition of the Georgian corporations' supervisory boards, valuable work is done by International Finance Corporation (IFC) through advisory corporate governance program and Organziation of Economic Cooperation and Development (OECD), which held several roundtables in Georgia devoted to the Corporate Governance problems in Georgian companies. However, importance of the issues raised in my paper requires broader analysis, which I will make by comparying two different corporate governance systems: Anglo-American and European on the examples of the U.S. and German corporate governance rules. Analysing the U.S. and German laws regarding the compositon of the boards, shows that notwithstanding

[2] Boris Janjalia, Legal Consultant, Georgia Corporate governance Project, *Rights and Obligations of a Supervisory Board*, International Finance Corporation, February 14, 2008.
http://www.ifc.org/ifcext/gcgp.nsf/Content/ProjectMaterialsPublications
Lado Chanturia, *Corporate Governance and Directors' Liability*, (author's translation), p.133, Tbilisi, 2006.
[3] International Finance Corporation,World Bank Group, Georgia Corporate Governance Project, *Corporate Governance Survey in Companies*,Tbilisi, Georgia, November, 2008.

the differences in structures of the boards, both systems recognize the division of functions between the managing and controlling organs and the people carrying out these functions should not be the same. Also, both systems recognize the existence of committees in the boards. While, U.S. law makes it mandatory, German corporate governance code, requires the listed companies to have committees under the comply or explain rule and in practice, German public companies have committees. Regarding the size of the boards, U.S. public companies' boards are small, however, supervisory boards of German stock companies are of a large size and this is considered as on of the disadvantages of the German stock companies.

The present paper will be divided into three chapters: In the first chapter, I will raise the problems of composition of the supervisory boards of the Georgian stock corporations, than I will review how these issues are regulated under U.S. and German law, as well as how these rules are implemented in practice. In the second chapter, I will discuss, why I find these issues problematic and why they must be changed in law and corporate governance practices of Georgian corporations. I will make comparative analysis of these two systems, find what is the advantage of one and what of another, and in the end, I will suggest recommendations to the Georgian legislative makers and Georgian stock companies, to make improvements in law and to improve their corporate governance practices. In the final chapter, I will discuss the problem that exist in corporate governance practices of Georgian corporations, in particular, members of the boards of directors are electing the members of the supervisory boards, the people who should control them.

For successful economic transformation to a market-based economy, existence of good corporate governance is essential.[4] It is worth to note, that just existence of good legislation cannot ensure the success of the private sector. Enforcement of this legislation by the

[4] Corporate Governance in Eurasia: A Comparative Overview, Organization for Cooperation and Economic Development (OECD), 2004.

corporations is needed. This is the only way toward the success of the corporations and consequently the prosperity of the whole society.[5] For this reason, my research is aimed not just to legislative-makes, but also to corporations to improve their corporate governance practices, as ”it is the business community that actually develops effective corporate governance practices.”[6]

[5] Avto Svanidze, *What is Corporate Governance*, IFC, 2003.
[6] Corporate Governance in Eurasia: A Comparative Overview, OECD, 2004.

CHAPTER 1. PROBLEMS OF COMPOSITION OF THE SUPERVISORY BOARDS OF GEORGIAN CORPORATIONS AND COMPOSITION OF THE U.S. AND GERMAN PUBLIC COMPANIES

1.1. Problems of composition of supervisory boards of Georgian corporations

Composition of the supervisory boards of the Georgian stock companies (corporations) is defined by article 55 of the Law of Georgia on Entrepreneurs. According to the legislative changes implemented in law in April, 2008, companies can now choose between unitary or two tier structure of the boards. However, despite the changes, currently most joint stock companies have two-tier boards,[7] that means, corporations have supervisory board and management board. Supervisory board is responsible for setting strategic direction of the company's activities and controlling management board[8], while the management board manages day-to-day operations of the company.[9]

According to article 55, the member(s) of the supervisory board can be a director(s) of that corporation, although the directors in the supervisory board must not be in the majority.[10] The law does not require the chairman of the supervisory board to be independent director, thus the chairman can be director of that corporation. The supervisory board must be composed of no less than 3 and no more than 21 members.[11] Meetings of the supervisory boards are held separately from the meetings of the management board.[12]The law does not require the existence of committees in the supervisory boards, as well as does not provide any qualification requirements for the supervisory board members.[13]

[7]International Finance Corporation,World Bank Group, Georgia Corporate Governance Project, Corporate Governance Survey in Companies,Tbilisi, Georgia, November, 2008.
http://www.ifc.org/gcgp.
[8] Article 55, (7), Law of Georgia on Enterpreneurs, 1998.
[9] *Ibid*, Article 56.
[10] *Ibid*, Article 55.
[11] *Ibid*, Article 55, (1).
[12] *Ibid.* Article 55, (5).
[13] Boris Janjalia, *Rigths and Obligations of a Supervisory Board*, IFC , 2008. Lado Chanturia, *Commentaries on Law of Georgia on Enterpreneurs* (author's translation), 3d edition, Tbilisi, 2002.

Regarding the situation in practice, I will refer to the International Finance Corporation's survey of Georgian companies in 2008.[14] According to the survey, respondents ascribed low importance to the presence of independent members on the supervisory board. Only 19.3% of the companies have requirement in their charters for the election of independent members in their supervisory boards and only 2.7 % of the companies plan to include independent directors in their supervisory boards in order to improve their corporate governance. Based on the survey results, 58.7 % of the companies do not have committees at all. Only 24.0% has audit committees. Remuneration and compensation committees exist only in 8.7 % corporations. In addition, corporations are composed with non-qualified members, relatives and friends. Only 37.3% of the surveyed companies have qualification requirements for the supervisory board member candidates in their charters. Despite the gap in law, in practice, the size of the supervisory boards is in accordance with international standards. The survey revealed that the average number of the supervisory boards of the Georgian corporations is 5.

Having discussed the problems of composition of the supervisory boards of the Georgian corporations existing in Georgian law and Georgian corporations' corporate governance practices, now, I will discuss how these issues are regulated under U.S. and German corporate governance rules.

1.2. Composition of board of directors of the U.S. public companies

Composition of boards of directors of the U.S. public companies are defined by the articles of association or charter of the corporations, state and federal laws do not make a specific composition of the boards mandatory.[15] U.S. public companies mostly have unitary board structure, that means, both managing and supervisory functions are carried out by the same

[14] IFC *Corporate Governance Survey in Companies*, 2008.
[15] Stephen T. Giove, Catherine Kemnitz, *Separation and Oversight: A Matter of Checks and Balances*, Shearman & Sterling LLP February 01, 2008.
http://www.shearman.com/files/Publication.

board - board of directors.[16] Model Business Corporation Act[17] provides, that "all corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed by or under the direction of, its board of directors."[18] However, modern boards of directors do not carry out day-to-day business of the corporation, the management is carried out by the chief executive officer (CEO) and other officers of the corporation.[19]

For companies listed on New York Stock Exchange (NYSE) and National Association of Securities Dealers Automated Quotations Exchange (Nasdaq) markets, composition of the board of directors is defined by these stock exchanges' listing standards.Both, NYSE and Nasdaq exchange listing rules make the composition of the board of directors of the listed companies with the majority of independent directors mandatory,[20] in order to increase the quality of board oversight and lessen the possibilities of conflicts of interest of the directors.[21] Along with the requirement of having majority independent directors in the board, definition of "independence" is necessary. According to NYSE rules, "for a director to be deemed "independent," the board must determine that the director has no material relationship with the listed company."[22] Nasdaq, provides, that "the director can be considered independent

[16] Stephen Giove, Matthew Musselman, Jennie Ingram, Dorman Tong, *Corporate Governance and Directors' Duties*, Shearman & Sterling LLP, 2008.
http://www.shearman.com/files/Publication.
[17]Majority of the states in the U.S. base their legislation on Model Business Corporations Act or Delaware law, according to Shearman & Sterling LLP's article *Corporate Governance and Directors' Duties* 2008.
http://www.shearman.com/files/Publication.
[18] Sec.8.01 (b), Model Business Corporation Act, 2002.; § 141(a), Delaware General Corporation Law, 1976..
[19] Robert W. Hamilton, *Cases and Materials on Corporations including Partnerships and Limited Liability Companies*, American Casebook Series; Seventh Edition, West Group A Thomson company, St. Paul, Minn. 2001, pp. 644, 650.
[20] Sec. 303A 00 , 303A.01, New York Stock Exchange Listed Company Manual (NYSE Listing Manual), 2004. Rule 4350. (c) (1), National Association of Securities Dealers Automatic Quotation System Marketplace Rules (NASDAQ Marketplace Rules), 2004.
[21] New York Stock Exchange Corporate Accountability and Listing Standards Committee, June 6, 2002. http://www.nyse.com/pdfs/corp_govreport.pdf.
Charles M. Elson, Christopher J. Gyves, *The Enron Failure and Corporate Governance Reform,* 38 Wake Forest L. REV. 855, 2003.
[22] 303A.02, NYSE Listing Manual.

even if a relationship exists between the director and the company, however this relationship must not interfere with the exercise of the director's independent judgement."[23]

In practice, the boards of major U.S. corporations are changing in accordance with the revised rules.[24] Scholars state that an increasing number of boards consist solely of the CEO and independent, outside directors, the number of "inside" directors has declined to zero.[25] Shearman & Sterling's survey[26] results also show that in practice companies exceed the NYSE and Nasdaq requirements, in particular, 52 of the 100 companies have adopted stricter standards regarding the minimum number of independent directors than required by the NYSE and Nasdaq listing standards.

Regarding the chairman of the board of directors, in some corporations, the positions of CEO and chairman of the board of directors are separated, so that the chairman of the board of directors is an independent director, however, in most corporations, the CEO also serves as a chairman of the board of directors.[27]

[23] Rule 4200(a)(15), NASDAQ Marketplace Rules.
[24] BARRY D. BAYSINGER, HENRY N. BUTLER, *Corporate Governance and the Board of Directors: Performance Effects of Changes in Board Composition*, Journal of Law, Economics, and Organization, 1985. http://jleo.oxfordjournals.org/
[25] Robert W. Hamilton, *Cases and Materials on Corporations, ,* American Casebook Series, 2001, p. 661. John J. Madden and Lisa E. Toporek , *New Directions for Corporate Governance*, http://library.findlaw.com/2002/Nov/19/132402.pdf;Joseph McCahery, Piet Moerland, Theo Raaijmakers, "*Corporate Governance Regimes Convergence and Diversity* ,“ Oxford University Press, 2002, p.291.; John Madden, Lisa Toporek, *How does Your Company Compare?* The Corporate Compliance & Regulatory Newsletter,Volume 3, Number 6 / February 2006. http://library.findlaw.com/business-organizations/corporations.
[26] Shearnman & Sterling LLP, *2008 Trends in Corporate Governance of the Largest U.S. Public Companies, General Governance Practices*, www.shearman.com.

[27] Bayless Manning, *The Business Judgement rules and The Director's Duty of attention: Time for Reality*, 39 Bus. Law 1477, 1481-92 (August 1984) ; Gilbert Fischsberg, *Chief Executives See Their Power Shrink*, Wall Street Journal., March 15, 1993 at B1, col.3, in Robert W. Hamilton, *Cases and Materials on Corporations*, American Casebook Series, 2001, pp.664,659.

In order for non-management directors to check management more effectively,[28] NYSE and Nasdaq exchange listing standards require non-management directors to meet in regularly scheduled executive sessions without management present.[29] Regularly scheduled executive sessions are considered to encourage and enhance communication among independent directors.[30] According to the Shearman and Sterling's survey, over the past few years, the number of board meetings has increased.[31]

In U.S. public companies, working in committees is well-developed.[32] Creation of some committees is mandatory for the listed corporations in order to increase audit committee effectiveness.[33] In particular, Sarbanes-Oxley act (SOX), NYSE and Nasdaq exchange listing rules require the public companies to have an audit committee staffed entirely by independent directors.[34] According to these rules, "it is the sole authority of the audit committee to hire, fire, evaluate and compensate independent auditors, also, approval of audit and non-audit services."[35] To ensure independence of the audit committee members,[36]these rules prohibit audit committee members to receive any compensation from the company

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[28]Jean Jacques du Plessis, James McConvill, Mirko Bagaric, *Principles of Contemporary Corporate Governance,* Cambridge University Press, 2005, p.299.
[29] 303A.03, NYSE Listing Manual. § 3, New York Stock Exchange Corporate Accountability and Listing Standards Committee; June 6, 2002. Rule 4350(c), NASDAQ Marketplace Rules.
[30] Rule 4350(c), NASDAQ Marketplace Rules.
[31] survey of U.S. Public Companies, Shearnman & Sterling LLP, 2008.
[32] Reinier Kraakman, Paul Davies, Henry Hansmann, Gerard Herting, Klaus Hopt, Hideki Kanda, Edward Rock, *The Anatomy of Corporate Law, A Comparative and Functional Approach*, Oxford University Press, 2004, p.168.
[33] John Armour, Joseph McCahery, *After Enron: Improving Corporate Law and Modernising Securities Regulation in Europe and the U.S.*, Oxford: Hart, 2006.; Charles M. Elson, Christopher J. Gyves, *The Enron Failure and Corporate Governance Reform,* 38 Wake Forest L. REV. 855 2003. http://scholar.google.com/scholar
[34] 303A.06, NYSE Listing Manual . Rules 4350 (d), NASDAQ Marketplace Rules. Sec.301, Sarbanes-Oxley Act 2002.
[35] Rule 4350(d), NASDAQ Marketplace Rules. Sec. 303A.07, NYSE Listing Manual. § 6, New York Stock Exchange Corporate Accountability and Listing Standards Committee, June 6, 2002. Sec 301, SOX.
[36] John J. Madden and Lisa E. Toporek , *New Directions for Corporate Governance,* http://library.findlaw.com/2002/Nov/19/132402.pdf

other than director's fee.[37] In practice**,** all corporations have audit committees that are staffed solely by independent directors.[38]

In addition to audit committee, companies listed on NYSE stock exchange market, must have nomination and compensation committees.[39]The committees must be composed entirely of independent directors.[40] Under the NYSE rules, the nomination committee's responsibility is to identify individuals qualified to become board members[41]and the compensation committee's role is to evaluate the CEO's performance, determine and approve the CEO's compensation level based on this evaluation.[42] Nasdaq does not require the existence of nomination and compensation committees but requires the compensation and nominating actions to be made only by independent members of the board.[43] In practice, most companies listed on Nasdaq, have such committees.[44]According to Shearman & Sterling's research, many companies have established executive, finance and public policy committees in addition to audit, compensation and nominating committees. Establishing addittional committees indicates that the boards of directors are increasingly focusing on specific aspects of their companies' businesses.[45]

Regarding the qualification issues, generally, state corporate laws do not require specific qualifications for the persons to become corporate directors,[46] however, SOX, as well as NYSE and Nasdaq listing standards provide qualification requirement for the members of

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37 Sec. 301 SOA; Rule 4350(d) NASDAQ; Sec. 303A.02 NYSE Listed Company Manual;
38 Robert W. Hamilton, Corporate Governance in America 1950-2000: Major Changes But Uncertain Benefits. 25 J. Corporate Law 349, 359-373 (1999), p.662.
39 Sections 303A.04; 303A.05 of NYSE Listing Manual
40 NYSE Listing Manual 303A.04 Nominating/Corporate Governance Committee; 303A.05 Compensation Committee;
41 NYSE Listing Manual, 303A.04 (ii) Nominating/Corporate Governance Committee
42 NYSE Listing Manual, 303A.05 Compensation Committee
43 Rule 4350(c), NASDAQ Marketplace Rules.
44 Stephen T. Giove, Catherine Kemnitz, *Separation and Oversight: A Matter of Checks and Balances*, Shearman & Sterling, 2008.
45 Shearnman & Sterling's survey of U.S. Public Companies, 2008.
46 John Madden,Lisa Toporek, *How does Your Company Compare?*, 2006.

the audit committees of the listed companies.[47]In particular, they provide that all members of the audit committee must be financially literate and at least one of the independent directors must be a “financial expert.”[48] The U.S. Securities and Exchange Commission (SEC) requires all public companies to disclose whether they have “financial expert” as a member of the board’s audit committee and if not, they must explain the reason.[49]

Regarding the size of the board of directors, most states do not require a minimum number of directors and leave the size of the board to be set by the company’s certificate of incorporation or bylaws.[50] In practice, U.S. boards tend to be small by international standards.[51]

1.3. Composition of the supervisory boards of German Stock Corporations

Composition of the supervisory boards of German stock corporations (Aktiengesesellschaften) is defined by German Stock Corporation Act (Aktiengesetz), German Co-Determination Act (Mitbestimmungsgesetz), and German Corporate Governance Code (Deutscher Corporate Governance Kodex, the "Code") of 2002.

German stock corporations (*Aktiengesellschaften*) have a two tier structure of the board, [52] i.e. there is a management board (*Vorstand*) that carries out the management of the corporation [53] and the supervisory board (*Aufsichtsrat*) that supervises the activities of the management board.[54] The members of the supervisory board cannot be at the same time the

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[47] Rule 4350(d)(3), NASDAQ Marketplace Rules; Sec. 303A.07, NYSE; Sec.301, SOA.
[48] Ibid
[49] Comparison of Corporate Governance Proposals, ALSTON + BIRD LLP, Securities Law Advisory, June 20, 2003.
http://library.findlaw.com/2003/Oct/24/133118.pdf
[50]. Stephen T. Giove, Catherine Kemnitz, Separation and Oversight, 2008. § 8.03 (a) Revised Model Business Corporation Act, 2002. § 141 (b) Delaware General Corporation Law, 1976.
[51] Kraakman, supra note 32, at p.167
[52] Prof. DR. Wilhelm Haarmann, DR. Tobias Fenck, The Supervisory Board of German Stock Corporations, Haarmann Partnerschaftsgesellschaft, Frankfurt Am Main, Germany.
http://pdfserver.amlaw.com/tal/p04_05_Haarmann
[53] § 76 (1) of German Stock Corporation Act.
[54] § 111 of German Stock Corporation Act.

members of the management board,[55] thus, members of the German supervisory board are all non-executive directors.[56]

The supervisory board is composed of the shareholders' and employees' representatives. [57] Depending on which co-determination law applies, the number of shareholders' and employees' representatives is different:[58] either 1/3 of the board is made up of employees, or shareholders and employees appoint equal number of representatives.[59] One person cannot be a member of more than 10 supervisory boards.[60] Chairman of the supervisory board is elected by the supervisory board from among its members.[61]

Unlike NYSE and Nasdaq listing rules, which require separate meetings for the independent directors, German law does not require the holding of the meeting of the non-executives separately from managers of the company. Only prohibition refers to the persons who are not members of either supervisory or management board. According to Article 109 (1) of the Stock Corporation Act, they cannot attend meetings of the supervisory board.

Under German law, mediation committee is the only committee which must be formed in all companies subject to the principle of co-determination.[62] The Supervisory board may create other committees composed of supervisory board members to prepare the supervisory board resolutions or to supervise the execution of its resolutions.[63] However, the existence of such committees is not mandatory. German Corporate Governance Code recommends the listed companies to establish committees at the supervisory board level under the comply-or-

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[55] *Ibid*, § 105 (1)
[56] *supra* note 32, at p.168
[57] § 96 (1), German Stock Corporation Act
[58] *Ibid*, § 96 (1)
[59] §7, German Co-determination Act , 1976.
[60] *Ibid*, § 100 (2)
[61] *Ibid*, § 107 (1), AktG
[62] *Significant Differences Between German and US American Corporate Governance Practices,* http://www.altana.com/corporate_governance_differences.php.
[63] § 107 (3), German Stock Corporation Act

explain rule.[64] In particular, audit committee, to handle issues of accounting, risk management and compliance.[65] Except audit committee, the code recommends the creation of nomination committee, to propose suitable candidates of the supervisory board for recommendation to the general meeting.[66] The committee must be composed entirely of shareholder representatives.[67] Under the code, the supervisory board can create other committees and delegate handling of other subjects, such as: strategy of the enterprise, the compensation of the management board, investments and financing to these committees.[68]

In German supervisory boards working in the committees is not developed, as a result, the meetings of the supervisory boards are rare, and this does not give the possibility of operative reaction to the ongoing problems of the company.[69] However, The idea that the board should be assisted by committees in fulfilling its functions has gained considerable support over recent years in Germany.[70] There is a strong tendency towards creation of nomination, remuneration, and audit committees and many listed companies have already installed them.[71]

German Stock Corporation Act does not provide qualification requirements for the supervisory board members,[72] except the rule, that a person may not be a member of the supervisory board if he\she is already a member of the supervisory boards in ten commercial

64 Armour, supra note 33, at p.75.
65 § 5.3.2, German Corporate Governance Code.
66 Ibid, § 5.3.3
67 Ibid, § 5.3.3
68 Ibid, § 5.3.4
69 Lado Chanturia, Corporate Governance and Directors' Liability, (author' translation), Tbilisi, 2006, p.242.
70 Udo Brändle & Jürgen Noll, The Power of Monitoring - Part I/II, German Law Journal, Review of Developments in German, European and International Jurispudence, No. 11, November, 2004. www.germanlawjournal.com
71 Udo Brändle & Jürgen Noll, The Power of Monitoring - Part I/II, German Law Journal, Review of Developments in German, European and International Jurispudence, No. 11, November, 2004. www.germanlawjournal.com
72 Armour, supra note 33.

enterprises.[73] However, German Corporate Governance Code recommends the supervisory board to be composed of members “who have the knowledge, abilities and experience to properly complete their tasks and are sufficiently independent.”[74] The code provides definition of “independence,” in particular, to be considered independent “the supervisory board member must not have business or personal relations with the company or its management board which cause a conflict of interests”, also no more than two former members of the management board shall be members of the supervisory board and “supervisory board members shall not exerccise directorships or similar positions or advisory tasks for important competitors of the enterprise.”[75] The code also recommends specialist knowledge and experience for the chairman of the audit committee.[76]

Regarding the size of the supervisory board, the Co-determination Act of 1976 prescribes a varying size of the supervisory boards depending on the number of the corporation’s employees.[77] Under the Stock Corporation Act, the supervisory board must have a minimum of 3 and maximum of 21 members.[78] Code provides, that the supervisory board shall include “what it considers an adequate number of independent members.”[79]

[73] § 100, German Stock Corporation Act
[74] § 5.4.1, German Corporate Governance Code
[75] *Ibid*, § 5.4.2
[76] *Ibid*, § 5.3.2
[77],Reinier Kraakman, Paul Davies, Henry Hansmann, Gerard Herting, Klaus Hopt, Hideki Kanda, Edward Rock, *The Anatomy of Corporate Law, A Comparative and Functional Approach*, Oxford University Press, 2004, p.237
[78] § 95 , German Stock Corporation Act .
[79] § 5.4.2, German Corporate Governance Code.

CHAPTER 2. IMPORTANCE OF THE RAISED ISSUES AND COMPARATIVE ANALYSIS OF BOARDS' COMPOSITION IN THE U.S. AND GERMAN PUBLIC COMPANIES

Having reviewed composition of the boards in U.S. and German public companies, in this chapter I will discuss the importance of the raised issues, why I think they are problematic and must be changed in Georgian law as well as in Georgian corporations' corporate governance practices.While discussing, I will refer to the advantages and disadvantages of U.S. and German systems in order to find the best solutions for the Georgian corporations.

1.1. Importance of having independent members in the boards

As I have reviewed in the previous chapter, having majority independent directors in the boards is mandatory for the U.S. public companies listed on NYSE and Nasdaq stock exchange markets**.** These rules are stricter implemented in practice, companies are not satisfied with simple majority and are composed with absolute majority of the independent directors, that means the only inside director in the board is CEO. In Germany,composition of the supervisory board only with independent directors is ensured by law, in particular, Stock Corporation Act prohibits the members of the supervisory board to be at the same time the members of the management board.[80] According to OECD Eurasia Comparative Analysis, "Globally, laws, listing requirements and codes are calling for more independent boards and more independent board members."[81]

***Why independence of the supervisory board member is necessary*?** According to the Nasdaq marketplace rules, existence of independent directors in the board assures investor confidence, since independent directors can exercise independent judgment. [82]

[80] § 105 (1), German Stock Corporation Act.
[81] Corporate Governance in Eurasia: A Comparative Overview, Organization for Cooperation and Economic Development (OECD), 2004
[82] Rule 4350(c), NASDAQ Marketplace Rules.

Independence of the boards is supported in many scholars' works. Plessis, McConvill and Bagaric state that the board as a monitoring body must be independent of management.[83] According to Elson and Gyves, independence, i.e. absence of any economic ties to company is important since, it provides director with the distance and objectivity necessary to examine management action in the most effective manner.[84] Baysinger and Butler also state, that a director who depends on management for his/her position is incapable of making a critical appraisal of management and in order to be an effective governing body, board must be composed mostly of independent directors.[85] Breeden also supports the idea, that the ideal board should not have any inside director, except for the chief executive officer.[86]

Independence of the board members is also advocated in OECD Principles of Corporate Governance that is recognized as a standard of corporate governance.[87] According to the Principles:

"Independent board members can contribute significantly to the decision making of the board. They can bring an objective view to the evaluation of the performance of the board and management. In addition , they can play an important role in areas where interests of management, the company and shareholders may diverge ." [88]

***Which system ensures independence of the boards best*?**

I think, advantage of the German system is that there is a separation of management and control functions between the management and the supervisory boards. The supervisory board is composed only by non-executive directors and it has a non-executive chairman.

[83]Jean Jacques du Plessis, James McConvill, Mirko Bagaric, *Principles of contemporary Corporate Governance*, , Cambridge University Press, 2005 p.292.
[84]Charles M. Elson, Christopher J. Gyves, *The Enron Failure and Corporate Governance Reform,* 38 Wake Forest L. REV. 855 2003.
[85] Bayinger, *supra* note 24, Brändle, *supra* note 70.
[86] Richard C. Breeden, *RESTORING TRUST,* Report to The Hon. Jed S. Rakoff , The United States District Court For the Southern District of New York On Corporate Governance For The Future of MCI, Inc. August, 2003,
http://www.findlaw.com; www.thedirectorscollege.com.
[87] Chanturia, *supra* note 69.
[88] OECD Principles of Corporate Governance, 2004

Although there is no explicit requirement under German law that the member of the supervisory board of the German stock corporation must be independent, independence is assured by the fact that, member of the supervisory board cannot at the same time be the member of the management board of the same company.[89] In addittion, German corporate governance code recommends that no more than two former members of the management board be members of the supervisory board and supervisory board members should not exercise directorships or accept advisory tasks for important competitors of the stock corporation.[90]

Disadvantage of the German system is that former member of the board of directors can and in practice often become a member and even the chairman of the supervisory board.[91] The survey of the German stock companies showed that 43 % of the members of the board of the directors moves to the supervisory board.[92] This may hamper the degree of independence of supervisory board, [93] since it is unlikely that the chairman of the supervisory board will challenge decisions made while being a member of the management board.[94] The degree of independence of supervisory boards may also be hampered by interlocking directorships, (when a person is a member of one or more supervisory or management boards[95]) and by holding supervisory board meetings together with the managerial board, that commonly happens in practice.[96]

As for U.S. public companies, although there are no seperate controlling and management organs, and board of directors can be composed both with insiders and outsiders, if the public

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[89] *Supra* note 62.
[90] §5.4.2, German Corporate Governance Code.
[91] Joseph McCahery, Piet Moerland, Theo Raaijmakers, "*Corporate Governance Regimes Convergence and Diversity* ,"Oxford University Press, 2002, p291.
[92] Lado Chanturia, Corporate Governance and Directors' Liability, Tbilisi, 2006, p.135
[93] Brändle, *supra* note 70. Hamilton, *supra* note 19, at p.661.
[94] Prof. DR. Wilhelm Haarmann, DR. Tobias Fenck, The Supervisory Board of German Stock Corporations, Haarmann Partnerschaftsgesellschaft, Frankfurt Am Main., Germany. www.google.com
[95] Brändle, supra note 70.
[96] McCahery, *supra* note 91.

corporations want to list their securities on stock exchange markets, they have to comply with the listing standards' requirement, in particular to compose their boards with majority of independent directors. Requirement of majority independent directors in practice ensures separation of control and management functions.[97]Moreover, if we take into consideration , that companies are not satisfied with just „simple majority" requirement of the listing rules and board of directors of the U.S. public companies are composed with "absolute majority' of the independent directors, that means the only insider in the board is CEO and as result, CEO has less control over the board**,** [98] we may conclude that in practice the difference between the U.S. and German systems regarding the degrees of independence of the members of the boards is not significant.

Disadvantage of U.S. system from German, is that in U.S. boards of directors the same person serves as a chairman of the board of directors and manages the day-to-day operations of the company.[99] As Breeden states, in the right hands, the structure works fine, but is dangerous if the CEO behaves in an inappropriate manner, since all the powers are concentrated in a single individual[100] and the CEO has substantial influence.[101]In such cases, the board members too often are dependent on the CEOs, they lack independence.[102] There is also a risk that CEOs with such a considerable power, appoint sympathetic members in the

[97] Joseph McCahery, Piet Moerland, Theo Raaijmakers, "*Corporate Governance Regimes Convergence and Diversity* ,"Oxford University Press, 2002, p291
[98] USC/Center for Effective Organizations, Heidrick & Struggles 10th Annual Corporate Board Effectiveness Study 2006-2007, The University of Southern California's Marshall School of Business, http://www.heidrick.com
[99] Shearman & Sterling survey*, 2008 Trend in largest publi companies.*
[100] Breeden, *supra* note 86.
[101] Reinier Kraakman, Paul Davies, Henry Hansmann, Gerard Herting, Klaus Hopt, Hideki Kanda, Edward Rock, *The Anatomy of Corporate Law, A Comparative and Functional Approach*, Oxford University Press, 2004, p.239.
[102] *Supra* note 70.

board.[103] Thus, separation of the chairman of the board of directors from the leader of the management is desirable, since the separation of functions is a constructive check and balance against excessive concentration of power.[104] No one individual should have unfettered powers of decision.[105]Nowadays, separation of the positions of CEO and chairman of the board, is a suggestion of all corporate governance codes**.** [106]

Except of objective monitoring, having independent directors in the board has other advantages. **First**, outside directors are critical link to external environment and they may provide access to resources and information to the corporation, that is not accessible to inside directors.[107] In addititon to primary function to monitor the management's performance, directors can make positive contributions through their advices to the management.[108]They can bring their experience and valuable network of contacts to strengthen the board's capabilities.[109] For example, outside directors who represent financial institutions may provide ready access to credit and useful information concerning the financial markets.[110] In practices of both, U.S. and German public companies, the directors are providing advice to the managers in addittion to fullfilling their monitoring functions.[111]

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[103] Oliver E. Williamson, *Corporate Boards of Directors: In Principle and in Practice*, University of California, Berkeley –Business & Public Policy Group, The Journal of Law, Economics, & Organizations, Vol. 24, Issue 2, pp.247-272, 2008.
http://papers.ssrn.com
[104] Breeden, *supra* note 86.
[105] Governance and Performance in Corporate Britain. Association of British Insurers, (ABI) Research Paper 7. February, 2008.
[106] Udo Brändle & Jürgen Noll, *The Power of Monitoring* - Part I/II, German Law Journal, Review of Developments in German, European and International Jurispudence, No. 11, November, 2004.
[107]Dan R.Dalton, Catherine M.Daily, Alan E.Ellstrand and Jonathan L. Johnson,*Meta-Analytic Reviews of Board composition, Leadership Structure, and Financial Performance*, School of business, Indiana university, U.S.A., Strategic Management Journal, Vol. 19, 269-290 (1998).http://www.jstor.org/stable/pdfplus/3094100.pdf; McConvill, *supra* note 28 at pp103-104.
[108] Reiter Barry J., *Building a Great Board of Directors: A Committed and Sustained Process,* Torys LLP, August , 2004, http://library.findlaw.com.
[109]John Armour, Joseph McCahery, *After Enron: Improving Corporate Law and Modernising Securities Regulation in Europe and the U.S.*, Oxford: Hart, 2006.; p.16.
[110] Baysinger, *supra* note 24.

Second, director independence is important not only for its impact on director conduct, but for its impact on the management activity as well. The managers will not feel responsibility to the controllers, unless the controllers are independent themselves.[112]

Having independent directors in the boards of directors has its opponents.Their argument is that the real power to manage the company is in the hands of the managers and not in the hands of the boards, as the inside directors are full-time employees of the company and for outside directors, membership of the board is not their main activities.[113] Inside directors have detailed knowledge about the actual operation of the corporation,[114]they are better informed than outside directors, who depend on the information prepared by and received from management to fulfill their monitoring or supervisory functions.[115] According to Hermalin and Weisbach, ineffectiveness of independent directors was proved in practice, as most US companies had a majority of independent directors since the 1970s without any legal requirement, however, there is no evidence that these directors have improved corporate performance.[116]

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[111] Myles L. Mace, *Directors: Myth and Reality*, 1971. Jay W. Lorsch, *Pawns or Potentates: The Reality of America's Corporate Boards*, 1989; Oliver E. Williamson, *Corporate Boards of Directors: In Principle and in Practice*, University of California, Berkeley –Business & Public Policy Group, The Journal of Law, Economics, & Organizations, Vol. 24, Issue 2, pp.247-272, 2008.
http://papers.ssrn.com
Udo Brändle & Jürgen Noll, *The Power of Monitoring* - Part I/II, German Law Journal, Review of Developments in German, European and International Jurispudence, No. 11, November, 2004.
www.germanlawjournal.com

[112] Charles M. Elson, Christopher J. Gyves, *The Enron Failure and Corporate Governance Reform,* 38 Wake Forest L. REV. 855, 2003.
http://scholar.google.com/scholar

[113] Jean Jacques du Plessis, James McConvill, Mirko Bagaric, *Principles of contemporary Corporate Governance,* Cambridge University Press, 2005, p.116; Oliver E. Williamson, *Corporate Boards of Directors: In Principle and in Practice*, University of California, Berkeley –Business & Public Policy Group, The Journal of Law, Economics, & Organizations, Vol. 24, Issue 2, pp.247-272, 2008.
http://papers.ssrn.com

[114] Madden, *supra* note 36.

[115] McConvill, *supra* note 28 at p.78.

[116] Kraakman, *supra* note 32 at p.168; Benjamin E. Hermalin and Michael S. Weisbach, *The Effects of Board Composition and Direct Incentives on Firm Performance*, 20 Journal of Financial Management 101 (1991); Sanjai Bhagat and Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 Business Lawyer 921 1999; Rodd Zolkos, *Good governance from bad press*, BI Industry Focus, September 1, 2007. http://www.lexisnexis.com BARRY D. BAYSINGER, HENRY N. BUTLER,

However, under U.S.and German law, the role of the independent directors is not just monitoring the managers.Under German stock corporation act, the right of the supervisory board in addition to the supervision of the management board is to inspect the books and records of the company, also, specific types of transactions may be entered into only with the consent of the supervsiory board.[117] German corporate governance code provides, that "supervisory board must be involved in decisions of fundamental importance to the enterprise."[118]Under Model Busines Act and Delaware corporation laws, "all corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed by or under the direction of, its board of directors."[119]

In U.S.corporations, boards of directors have an advantage in access to information, because of one-tier structure of the board.[120] In German public companies, supervisory board is dependent on the information provided by the management board. However, under the law, management board is obliged to report to the supervisory board about the company's performance.[121] Moreover, the supervisory board has right to inspect and examine the books, records and assets of the corporation.[122] The supervisory board may request special reports from the management board at any time.[123]

Proffessors Barry and Butler suggest that the optimally constituted board should have a mixture of insiders and outsiders and the reason for having insiders in the board is that they

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Corporate Governance and the Board of Directors: Performance Effects of Changes in Board Composition, Journal of Law, Economics, and Organization, 1985. McConvill, supra note 28 at p292.

[117] § 111, German stock corporation act.

[118] § 5.1.1., German Corporate Governance Code.

[119] Sec.8.01 (b), Model Business Corporation Act, 2002.; § 141(a), Delaware General Corporation Law, 1976..

[120] Udo Brändle & Jürgen Noll, The Power of Monitoring - Part I/II, German Law Journal, Review of Developments in German, European and International Jurispudence, No. 11, November,2004.

[121] § 90 of German stock corporation act.

[122] Prof. DR. Wilhelm Haarmann, DR. Tobias Fenck, The Supervisory Board of German Stock Corporations, Haarmann Partnerschaftsgesellschaft, Frankfurt Am Main, Germany.
http://pdfserver.amlaw.com/tal/p04_05_Haarmann

[123] Significant Differences Between German and US American Corporate Governance Practices, http://www.altana.com/corporate_governance_differences.php.

will facilitate the communication of relevant information to outside directors during the board meetings.[124] ABI research paper [125]also provides that, too great increase in the percentage of non –executive directors on a board can be associated with a decrease in profitability. Finally, there is a view in the scholars work that there is no relationship between board composition and the firm's financial performance.[126]

1.2. Importance of having committees and qualifiied members in the boards

As I have discussed in the previous chapter, the U.S. law requires the existence of audit, nominating and compensation committes for the listed companies.While German law does not make the existence of such committees mandatory, the German corporate gopvernance code reccommends the listed companies to create the committees under the comply-or explain rule and in practice there is a trend in German public companies to have the committees.

***Why the existence of committees in boards is necessary*?**

Many scholars suggest the directors to give priority to the committee works,[127]as the committees assist the boards to fulfill their functions effectively.[128]Advantage of having committees is that they are operative and have narrow specializations.[129]Also, when the board is assisted by committees, the meeting of the board members is more

[124] Baysinger, *supra* note 24.
[125] *Governance and Performance in Corporate Britain*. Association of British Insurers (ABI) Research Paper 7, February, 2008. http://www.abi.org.uk/BookShop/ResearchReports/Research_Feb_08.pdf
[126] Dan R.Dalton, Catherine M.Daily, Alan E.Ellstrand and Jonathan L. Johnson,*Meta-Analytic Reviews of Board composition, Leadership Structure, and Financial Performance*, School of business, Indiana university, U.S.A., Strategic Management Journal, Vol. 19, 269-290 (1998).
http://www.jstor.org/stable/pdfplus/3094100.pdf
[127] Lado Chanturia, *Corporate Governance and Directors' Liability*, Tbilisi, 2006, p. 55.
[128] Jean Jacques du Plessis, James McConvill, Mirko Bagaric, *Principles of contemporary Corporate Governance*, , Cambridge University Press, 2005, pp103-104.
[129] USC/Center for Effective Organizations, Heidrick & Struggles *10th Annual Corporate Board Effectiveness Study 2006-2007*, The University of Southern California's Marshall School of Business.

frequent.[130]Corporations must have audit committees, as audit committee is a watchdog on financial irregularities.[131] It serves as the channel of communication between the board, the external auditor, and the executives involved in the internal auditing function.[132]Nominating committees are important since they can address director recruitment as a continuous ongoing activity rather than a task undertaken only when the need is current and pressing.[133] According to "OECD Eurasia Comparative Analysis," existence of nomination and remuneration committees in the corporations is important, since they allow non-executive board members to determine company policy in an area where conflicts of interest are likely, e.g. nominating board members and paying executives.[134] The need for compensation committees are gradually becoming mandatory, in many jurisdictions most boards have such committees.[135]

Advantage of the U.S. system is that it makes the existence of committees and qualification of the members mandatory, while in Germany the existence of these committees and the qualification of the members is not mandatory, but recommendation by the code. U.S has committees and they are meeting more frequent than German supervisory boards, where the working in committees is not well-developed.[136]

[130] USC/Center for Effective Organizations, Heidrick & Struggles *10th Annual Corporate Board Effectiveness Study 2006-2007*, The University of Southern California's Marshall School of Business.
[131] Barry J. Reiter, *The Role of Compensation Committees in Corporate Governance*, Torys LLP, August , 2004, http://library.findlaw.com.
[132] Corporate Governance in America 1950-2000: Major Changes But Uncertain Benefits. 25 J. Corporate Law 349, 359-373 (1999) in Hamilton, *Cases and Materials on Corporations*,American Casebook Series; Thomson company, 2001, p.662
[133] *Supra* note 98; Hamilton, *Cases and Materials on Corporations*, 2001, p.663.
[134] Corporate Governance in Eurasia: A Comparative Overview, Organization for Cooperation and Economic Development (OECD), 2004
[135] Barry J. Reiter, *The Role of Compensation Committees in Corporate Governance*, Torys LLP, August , 2004, http://library.findlaw.com.
[136] Heidrick & Struggles *10th Annual Corporate Board Effectiveness Study*, 2006-2007.

Qualification of the board members is necesary to achieve the proper level of director accountability,[137]since board members with financial or business expertise can make more sound judgment and informed critique than those who lack the necessary qualifications.[138] Unlike U.S. law, German law does not require any qualifications for the supervisory board members. However, German corporate governance code recommends specialist knowledge and experience for the chairman of the audit committee.[139]

1.3. Advantage of having smaller number of supervisory board members

As I have discussed in the first chapter, German supervisory boards have a large size and this is considered as one of their disadvantages.[140] Small boards are considered to monitor the management better than do large boards,[141] since a small number of directors permits genuine discussion and consultation among all the directors and promotes positive group interaction.[142] Disadvantages of the large board include: less participation of the boards' members, problem of coordination between the members due to their large number and finally, more possibilitites for the development of coalitions, that can increase the difficulty of reaching a consensus on critical decisions.[143]

According to international standards, the size of the board should be 8-10. In the U.S., this figure ranges from 12 to 16, in Gemrnay, number of the supervisory board members is more

[137]Lado Chanturia, *Commentaries on Law of Georgia on Enterpreneurs* (author's translation), 3d edition, Tbilisi, 2002. Breeden, *RESTORING TRUST*, 2003; Corporate Governance in Eurasia: A Comparative Overview, OECD 2004.

[138] Oliver E. Williamson, *Corporate Boards of Directors: In Principle and in Practice*, University of California, Berkeley –Business & Public Policy Group, The Journal of Law, Economics, & Organizations, Vol. 24, Issue 2, pp.247-272, 2008. http://papers.ssrn.com; Lado Chanturia,

[139] § 5.3.2 , German Corporate Governance Code

[140] Chanturia, *Corporate Governance and Directors' Liability*, p.133.

[141] Reinier Kraakman, Paul Davies, Henry Hansmann, Gerard Herting, Klaus Hopt, Hideki Kanda, Edward Rock, *The Anatomy of Corporate Law, A Comparative and Functional Approach*, Oxford University Press, 2004. p. 167; Udo Brändle & Jürgen Noll, *The Power of Monitoring* - Part I/II, German Law Journal, Review of Developments in German, European and International Jurispudence, No. 11, November,2004. www.germanlawjournal.com

[142]. Breeden, *RESTORING TRUST*, 2003.

[143] Jerry Goodstein, Kanak Gautam, Warren Boeker, The effects of Board Size and Diversity on Strategic Change, Strategic Management Journal, Vol. 15, 241-250v(1994). http://www.jstor.org/stable/pdfplus/2486969.pdf

than 20.[144] Optimal boards should not exceed 9 members,[145]since the size of the supervisory board should make influence on the decision-making process[146] and larger the board, more it is difficult to reach coordination between its members. It is worth to note, that the board of directors should be of size that provides a range of the necessary skills, such as experience in finance and accounting, etc.[147]

However, large size of the boards has its advantage, in particular, it provides organization with more expertise and resources, than the small one. Larger boards in the U.S.may reduce CEO domination and make it more difficult for the CEO to build a broad consensus within the board to take actions, that might not be in shareholders interests.[148]

[144] Chanturia, *Corporate Governance and Directors' Liability*, 2006, p.133
[145] Boris Janjalia, *Rigths and Obligations of the supervisory Board*, International Finance Corporation, Quarterly Bulletin, February 14, 2008.
[146] Kraakman, *supra* note 32, p. 167.
[147] Restoring trust, findlaw article
[148] Goodstein, *supra* note 142.

MY RECCOMMENDATIONS TO GEORGIAN CORPORATIONS REGARDING THE COMPOSITION OF THE SUPERVISORY BOARDS

SUPERVISORY BOARDS OF GEOGIAN CORPORATIONS MUST BE COMPOSED ENTIRELY BY INDEPENDENT DIRECTORS

Although there are pros and cons, I believe the composition of the supervisory boards entirely with independent directors would be better solution for the Georgian corporations, for the several reasons:

First, in order to control objectively, controllers must be independent of people who they are controlling. Essencial in carrying out the control is that the director must be questioning and skeptical in holding management accountable[149] and director who depends on management for his/her position is incapable of making a critical appraisal of management.[150] This idea is supported in U.S. and German laws as well as in public companies' corporate govrenance practices and I think, it should be the rule for Georgian corporations as well.

Second, to control effectively independent directors must be in the majority.[151]Although, according to Georgian Law on Enterpreneurs directors cannot be in the majority, this prohibiotn is not enough, since according to this article it is possible for the Georgian supervisory boards to be composed with a very slight difference between the inside and independent directors.As we have observed, trend in modern corporate governance rules and practices of U.S. public companies is the composition of the boards with more than simple majority of the independent directors in order for the independent directors to carry out their

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[149] Barry J. Reiter , *Building a Great board of directors. A committed and Sustained Process.*, Torys LLP, Newb York, Toronto, 2004.
http://library.findlaw.com/2004/Apr/5/133373.html
[150] Baysinger, Butler, Corporate Governance and the Board of Directors, 1985
[151] OECD Eurasia comparative analysis.

responsibilities effectively.[152] In Germany, the supervisory board is compose entirely with non-executive directors. More non-executive directors (NEDs) on the board improve performance.[153]

Third, according to Georgian law on Entrerpreneurs, the chairman of the supervisory board can be inside director. I suggest, the chairman of the supervisory board to be independent director, since when corporation has seperate supervisory and management borads, the boards must have seperate chairs as in the German public companies. Even in the U.S., where the board has one-tier structure, having CEO as a chairman of the board is considered as a disadvantage of the U.S. system and independent chair of the board is recommended.[154]

Fourth, except objective monitoring, advantage of having outsiders in the boards is that they are link to external environment and they can give valuable advice to inside directors.Composition of the supervisory boards entirely with the independent directors will increase the opportunities for the corporations to have more access to resources and information that is unavailable for inside directors and consequently strengthen the board's capabilities.

Fifth, addititonal argument for having independent supervisory boards is that the director's independence is important for its impact on management activity. Inside directors must be under discipline that they are controlled and they will not feel responsibility to the controllers unless the controllers are independent themselves.

[152] Rule 4350(c), NASDAQ Marketplace Rules.
[153] Governance and Performance in Corporate Britain. ABI Research Paper 7. February, 2008
[154].Breeden, *Restoring trust*, 2003.

Why insiders should not be in the supervisory boards **?**

First, Georgian public companies have separate supervisory and management boards (when company chooses two-tier structure) and seperation of these functions, I think requires the member of controlling organ not to be at the same time the member of the management board.

Second, advantage of the inside directors in the U.S. boards of directors is considered that they are better informed than outside directors and as the membership of the board is not main activities of the outside directors, real power to manage the company is in the hands of the managers. However, under article 55 of the Law of Georgia on Entrepreneurs, the role of the supervisory board in Georgian coporations is not confined with the monitoring of the activities of the managers. Certain business transactions requires the approval of the supervisory board. It takes decisions on matters that are outside the competence of the shareholders' meeting or the management board , also, if it is defined by the charter of the corporation, functions of the management board may be transferred to the supervisory board.[155]Georgian law also ensures the members of the supervisory boards to be well informed to fulfill their functions effectively.In particular, management is obliged to provide supervisory board with all necessary information.[156] In addititon, supervisory board has right to inspect the books, require information any time from management board about the business of the corporation.[157] Thus, if the law will be enforced, outside members of the supervisory board will be well- informed about the business of the corporation.

Finally, my arguments against the view that the composition of the boards by independent directors does not show any result on firm's financial performance are:

[155] Article 55 (7), (8), Law of Georgia on Entrepreneurs.
[156] *Ibid.* article 57.
[157] *Ibid*, article 55 (7).

First, publicly held corporations are social as well as economic institutions and the evaluation of changes in corporate governance should not be based solely on their effect on shareholder wealth, but the consideration should be given to the effect of corporate action on other “constituencies”, like creditors of the corporation, suppliers, employees and the states in which the corporations operate.[158]Independent boards ensure protection of their interests by monitoring the managers’ activities and by not allowing them to abuse their powers.

Second, existence of the independent directors assures the investors’ confidence, that their money is not spent illegally by the directors who are in agreement between each other.[159]

How to ensure effective monitoring by the independent directors.

In addition to recommending Georgian corporations independent supervisory boards, I will make some suggestions to the legislative-makers and Georgian corporations how to ensure effective monitoring by the independent directors. ”Independence” of the supervisory board members ensures objective monitoring, but for effective monitoring the following recommendations must be taken into consideration:

First, law must provide definition of “independence” of the members of the supervisory boards. Definition of independence is necessary in order, to avoid any confusions, whether the member of the supervisory board is independent or not.

Second, the corporations must ensure that the members of the supervisory boards receive all the necessary information in time, otherwise, they will be unable to carry out monitoring functions effectively. [160] Examples from the past (Watergate scandals, WorldCom, Enron)

[158] Robert W. Hamilton, Cases and Materials on Corporations, American Casebook Series., 2001, p.666.
[159] Chanturia *supra* note 92.
[160]Oliver E. Williamson, *Corporate Boards of Directors: In Principle and in Practice*, University of California, Berkeley –Business & Public Policy Group, The Journal of Law, Economics, & Organizations, Vol. 24, Issue 2,

show that, if "gatekeepers" are unaware of the details of management's activities and as a result cannot stop improper practices at the outset, it can cause the total collapse of the corporation.[161] Thus, exchange of information, consultation and collaboration should be key features between the supervising and managing organs.[162]

Third, meetings of the supervisory boards must be held seperately from the management boards as is the rule for independent directors in the U.S. public companies.

Fourth, there must be limit for the board membership, since the degree of independence may be hampered by interlocking directorships.In the U.S. public companies, directors are reducing the number of boards on which they serve.[163] Director serving on a large number of boards will not focus sufficiently on his/her responsibilities.[164]

Fifth, during the selection of the candidates for the supervisory board membership, personal qualities of the candidates must be taken into consideration. Whatever structures are created to ensure corporate honesty, they won't work unless you have the right people in them.[165]

Finally, to monitor effectively, the supervisory board members must have motivation to monitor. Good compensation can be a good motivator for the supervisory board members to fulfill their responsibilities well.[166] In Georgia, according to IFC survey of 2008, common problem in Georgian corporations is low remuneration of the members of the supervisory

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pp.247-272, 2008. http://papers.ssrn.com;; Breeden, *RESTORING TRUST*, 2003, http://www.findlaw.com; John J. Madden and Lisa E. Toporek , *New Directions for Corporate Governance*, http://library.findlaw.com/2002/Nov/19/132402.pdf

[161] Hamilton, *Cases and Materials on Corporations*, p.649;

[162]Jean Jacques du Plessis, James McConvill, Mirko Bagaric, *Principles of contemporary Corporate Governance,* , Cambridge University Press, 2005 p.65.

[163] Barry J. Reiter *Building a Great Board of Directors*; Haarmann, Fenck, *The Supervisory Board of German Stock Corporations,*

[164] Breeden, *Restoring Trust*, 2003.

[165] Plessis, McConvill, Bagaric, Principles of contemporary Corporate Governance, , Cambridge University Press, 2005, pp.103-104; Baysinger, Butler, Corporate Governance and the Board of Directors; Breeden, Restoring Trust; John J. Madden and Lisa E. Toporek .*New Directions for Corporate Governance*.

[166] Dr. PK Rao, *Any Limits to Globalisation?* Corporate Governance Journal, Vol 4: Issue No.5 : May, 2004, http://www.academyofcg.org/ejournal.htm

boards. The survey indicated that 34 percent of companies do not pay supervisory board members at all.[167] Low compensation contains the risk that the members of the board may not devote enough time to their role.[168]

SUPERVISORY BOARDS OF GEORGIAN CORPORATIONS MUST BE ASSISTED BY AUDIT, NOMINATION AND COMPENSATION COMMITTEES

Having discussed importance of the committees in the U.S. and German public companies, I can conclude that the existence of audit, nomination and compensation committees would be helpful for the supervisory boards of the Georgian corporations in fulfilling their tasks. In particular, working in the committees will enable the members of the supervisory boards to focus on specific issues, to react operatively to the problems of the corporations and to have meetings more frequently. Frequent meetings of the supervisory board members, will enhance their understanding of the specific problems of the corporation and as a result, they will be able to react in time to the raised problems.

Existence of audit committee is important as this committee can reveal in time information about the financial irregularities in the corporation.[169] Existence of nomination and remuneration committees in the corporations is important, since they allow non-executive board members to determine company policy in an area where conflicts of interest are likely, e.g. nominating board members and paying executives.

Members of the committees must be qualified to fulfill their functions well. The mix of skills and experience among directors greatly influences the board's ability to work effectively on

[167] International Finance Corporation, *Corporate Governance Survey in Companies*, 2008.
[168] Breeden, *Restoring Trust*, 2003.
[169] Barry J. Reiter, *The Role of Compensation Committees in Corporate Governance*, Torys LLP, August , 2004, http://library.findlaw.com.

specific issues.[170] Qualification of the board members is necesary to achieve the proper level of director accountability,[171] as board members with financial or business expertise can make more sound judgment and informed critique than those who lack the necessary qualifications.[172]

SUPERVISORY BOARDS OF GEORGIAN CORPORATIONS MUST BE OF A SMALLER SIZE

Regarding the size, I would suggest smaller size of the supervisory board, since a small number of directors promotes positive group interaction, discussion and consultation among all the directors.[173] I think the proper numebr of the superviory board members must be no more than 10, if we take into consideration that according to international standards number of directors in the board should be from 8 to10, in the U.S., this figure ranges from 12 to 16, and in Germany, where the number of board members is more than 20, many supports the decrease of the supervisory board members.[174]

[170] Heidrick & Struggles 10th Annual Corporate Board Effectiveness Study 2006-2007.
[171] Breeden, *Restoring Trust*, 2003; .Corporate Governance in Eurasia OECD, 2004.
[172] Oliver E. Williamson, Corporate Boards of Directors: In Principle and in Practice, University of California, Berkeley –Business & Public Policy Group, The Journal of Law, Economics, & Organizations, Vol. 24, Issue 2, pp.247-272, 2008. http://papers.ssrn.com
[173] Breeden, *Restoring Trust*, 2003,
[174] Lado Chanturia, Corporate Governance and Directors' Liability, Tbilisi, 2006 p.133

CHAPTER 3. PROBLEMS OF APPOINTMENT AND REMOVAL IN CORPORATE GOVERNANCE PRACTICES OF GEORGIAN CORPORATIONS

1.1. PROBLEMS IN GEORGIAN CORPORATIONS

In this chapter, I will refer to the problems existing in corporate governance practices of Georgian corporations, in particular, members of the boards of directors are electing and removing the members of the supervisory boards, including the chairmen of the supervisory boards. Also, they define the composition of the boards of directors themselves. I think this practice is dangerous, since the directors are electing the people who must control them. Addittionally, they are carrying out supervisory boards' task by electing the members of the boards of directors.

According to Georgian Law on Enterpreneurs, election and removal of the members of the supervisory boards is the task of the shareholders' meeting.[175] Supervisory board from its composition, elects chairman and deputy chairman.[176] Elected supervisory board in turn appoints and removes with or without cause members of the board of diectors.[177]

However, according to IFC survey of 2008,[178] the functions of supervisory boards and management boards are abused in practice.The members of the supervisory boards are elected by the management boards in 2.0 % of the surveyed companies, chairman in 1.3%. Although, this is a significant decrease from IFC survey results of 2004,[179]according to which members of the management boards elected and removed the members of the supervisory boards in 35% and elected chairman in 47%, the problem still exists in practice. The supervisory boards' function to remove and appoint the members of the boards of directors is

[175] Article 54 (6) (v), Law of Georgia on Enterpreneurs.
[176] *Ibid*, Article 55 (3).
[177] *Ibid*,Article 55 (7) (v).
[178] IFC Corporate Governance Survey in Companies, 2008.
[179] IFC Corporate Governance Survey in Companies, 2004.

carried out by the management boards in 6.7% corporations.(according to survey of 2004, in 20 %.). Thus, despite the corporations have improved their corporate governance practices since 2004 according to the survey results, the problem still remains and members of the management boards must not given right to appoint the members of the controlling organ.

Now, I will discuss the importance of these issues , how they are regulated under U.S. and German laws, and in the end I will make recommendations to Georgian corporations, in order to improve their corporate governance practices.

3.2. APPOINTMENT AND REMOVAL IN THE U.S. PUBLIC COMPANIES

In the U.S. public companies, directors are nominated by the board of directors.[180] NYSE and Nasdaq rules require the listing companies , the members of the boards of directors to be nominated by the independent directors, (NYSE through nomination committee).[181] Shareholders may also suggest the board its nominees.[182] Often nominees are suggested or approved by CEO.[183] Directors are elected by the shareholders, at the annual shareholders' meeting.[184] The board of directors appoints and removes the corporation's management.[185]

Generally, director or entire board of directors may be removed, with or without cause, by the holders of a majority of the shares.[186] Except shareholders, directors can be removed by the board of directors if this right is defined by the charter.[187]Also, modern statutes provide that shareholders can be removed by judicial proceeding, if the court finds that "the director engaged in the fraudulent conduct with respect to the corporation or its shareholders, or the

[180] **§** 141 Delaware General Corporation Law, **§** 8.03 Model Business Corporation Act
[181] Sec. 303A.04NYSE; Rule 4350(c), NASDAQ Marketplace Rules.
[182] **§** 141, Delaware General Corporation Law
[183] Reinier Kraakman, Paul Davies, Henry Hansmann, Gerard Herting, Klaus Hopt, Hideki Kanda, Edward Rock, *The Anatomy of Corporate Law, A Comparative and Functional Approach*, Oxford University Press, 2004.
[184] § 211 Delaware General Corporation Law; **§** 8.03 Model Business Corporation Act
[185] **§** 142 Delaware General Corporation Law **;** **§** 8.40 **§** 8.43 Model Business Corporation Act.
[186] § 141, Delaware General Corporation Law ; **§** 8.08, Model Business Corporation Act.
[187] Chanturia, *Corporate Governance and Directors' Liability*, 2006

removal of the shareholder is in the best interest of the corporation."[188] The CEO has responsibility for the management team and can replace managers if he loses confidence in the managers.[189]

3.3. APPOINTMENT AND REMOVAL IN GERMAN STOCK CORPORATIONS

In German public companies, supervisory boards are elected by shareholders' and employees' of the companies.[190] Shareholder representatives are elected by the shareholders' meeting.[191]Employee representatives are elected by the employees of the company.[192] Supervisory board members elected by the shareholders' meeting may be removed by the shareholders' meeting.[193] Supervisory board member may resign from office, however, there is agreement that supervisory board member may not resign from office without material reason, if such resignation would create an undue inconvenience for the company.[194]Employee representatives may be removed by the employees according to the co-determination act.[195] Supervisory board appoints and removes the members of the management board.[196] Under German corporate governance code, supervisory board has choice to delegate preparations for the appointment of managing directors to a nomination committee. German Corporate Governance Code impose a duty to install a nomination committee, composed solely of shareholder representatives and the task of the committee is to propose suitable candidates to the supevisory board for recommendation to the general meeting.[197]

[188] Ibid; **§** 8.09 Model Business Corporation Act
[189] Hamilton, *Cases and Materials on Corporations*, p. 646.
[190] Dr. Thomas O. Verhoeven, Ivo Posluschny, *The Stock Corporation*, Kirkland & Ellis International, 25 Old Broad street, London, EC2N 1HQ, p 24-91.
[191] §101, German Stock Corporation Act, § 8, German Co-determination Act.
[192] § 9 German Co-determination Act.
[193] §103, German Stock Corporation Act
[194] *Supra* note p. 24-96.
[195] §23 Co-determination Act.
[196] § 84, German Stock Corporation Act.
[197] Sec.5.3.3,German corpprate governance code; Athanasios Kouloridas, Jens von Lackum, Recent Developments of Corporate Governance in the European Union and their Impact on the German Legal System,

3.4. Comparative analysis of the U.S. and German laws regarding the appointment and removal of the board members

Appointment and removal strategies are the most basic protections of shareholders' interests both under the U.S. and German laws.[198] In the U.S., directors are representatives of the shareholders, however, in practice directors are selected by management or the boards of directors and then approved on a management proxy without any meaningful choice for shareholders.[199] Under this system, selection of the members of the boards of directors is left to the discretion of the parties whose behavior the board is supposed to monitor.[200] However, justification for this system might be the fact that the shareholders of the U.S. public companies are extremely numerous and widely dispersed, thus, selection of the members of the boards of directors by the shareholders would be complicated. Also, this system ensures protection the interests of the minority shareholders, since the large shareholders may not represent their views during the selection of the board members.[201]

German law relies on the appointment strategy to safeguard the interests of both shareholders and labor.[202] However, there are cases, when the boards of directors are so strong, that they compose the supervisory boards themselves. In this case it is unlikely, that supervisory board, composed by the management board will be an objective monitor on the management's activities.[203]

German Law Journal, Review of Developments in German, European and International Jurispudence, October, 2004.
http://www.germanlawjournal.com/article.

[198] Kraakman, Davies, *The Anatomy of Corporate Law, A Comparative and Functional Approach*, Oxford University Press, 2004. p.170

[199] Breeden, Restoring Trust, 2003.

[200] Baysinger, Butler, Corporate Governance and the Board of Directors, 1985.

[201] Breeden, *Restoring Trust*, 2003.

[202] Kraakman, Davies, *The Anatomy of Corporate Law, A Comparative and Functional Approach*, Oxford University Press, 2004. p.166.

[203] Chanturia, Corporate Governance and Directors' Liability, 2006, p136.

As Breeden provides, [204] the right to remove the members of the boards must be carried out by the shareholders.This rule ensures avoidance of undue pressures on directors while they are carrying out their responsibilities. However, if the director involves in illegal conduct that violates the director's fiduciary duties, there should be a mechanism for the board to remove one of its members for cause. Germany provides both a lengthy term of office for the supervisory board members and makes a weaker removal power mandatory, combination that is especially dangerous, given that Germany's lower-tier management board also enjoys legal protection from removal.[205]

MY RECOMMENDATION TO GEORGIAN CORPORATIONS REGARDING THE APPOINTMENT AND REMOVAL OF THE SUPERVISORY BOARD MEMBERS

As the comparative analysis of the U.S. and German laws revealed, appointment and removal of the board members by the shareholders protects them from composing the boards with undesirable people. Role of the supervisory board is to controll the managemnt activities and the shareholders must not be deprived of their right to appoint the "gatekeepers" of their investments.Otherwise, if the managers have freedom in appointing the members of the controlling organ, this will create a risk of composing the supervisory board with people who are favourable to managers and as a result, the controling function by the supervisory board will not be carried out objectively and effectively.Thus, in Georgian corporations , practice of appointing and removing the supervisory board members by the management boards must be eliminated and carried out in accordance with Georgian law and international standards.

[204] Breeden, Restoring Trust, 2003.
[205] Kraakman, Davies, *The Anatomy of Corporate Law, A Comparative and Functional Approach*, Oxford University Press, 2004, .p.167.

Conclusion

Discussion of the composition of the U.S. and German public companies' boards leads me to conclude that amendments in the Law of Georgia on Entrepreneurs is necessary. In particular, article 55, that defines the composition of the Geogian corporations must be changed taking into consideration the following recommendations: First, supervisory boards of Georgian corporations must be composed entirely with independent directors. Article 55 permits the members of the management board to be at the same time the members of the supervisory board and this rule lags behind the modern corporate governance standards and practices. As we have observed, both German and U.S. corporate goverannce rules require public companies to have independent boards. Main reason for this rule is that independent directors can be more objective in monitoring the managers than directors, who are dependent on management board. Second, law does not make the existence of committees in the corporations manadatory, while having committees is one of the conditions for corporations to be listed on stock exchange markets in the U.S. In Germany, although not manadatory by law, it is recomended by the code under comply-or-explain rule and in practice German corporations have committees in order to enhance the effectiveness of their supervisory boards' work.Committies in Georgian corporation will assist the supervisory boards in carrying out their functions effectively. In addittion to independent board and requierment of having committees, qualification of the supevisory board members must be mandatory by Georgian law, as is the rule for the members of the U.S. corporations' board of direcors and as is reccomended for the German supervisory board members by the German code. The reason for this rule is that qualified mmebers can make more sound judgment and informed critique than those who lack the necessary qualifications.[206]For the effective work of the supervisory board, the board must not be composed with more than 10 members, as the smaller size of the board promotes positive group interaction, discussion and consultation among all the directors. Finally, appointment and removal of the supervisory board members must not be carried out by the management board, since this contains a risk of composing the supervisory board with people favourable to the mangers and this may be the reason for the ineffective monitoring on the managers.

In addition to legislative changes, Georgian corporations' attitude toward their corporate govenance must be changed. Just legislative amendments will not bring results unless they are enforced in practice. Enforcement of the legislation is the task of the corporations and they must carry out this task in compliance with international standards.Corporations are social as well as economic institutions and while carrying out business they should take into consideration the interests of the whole society. Thus, improving the corporate governance is important not just for corporations' financial success, but for the whole society, as it will increase the investments in country develop economy and create opportunities for people to escape poverty and improve their lives.

[206] Oliver E. Williamson, Corporate Boards of Directors: In Principle and in Practice, University of California, Berkeley –Business & Public Policy Group, The Journal of Law, Economics, & Organizations, Vol. 24, Issue 2, pp.247-272, 2008. http://papers.ssrn.com

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