International Journal of Corporate Law and Governance
Volume 1 Issue 1, 2026

Corporate Governance Code Enforcement

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Article Info
Received: 22-12-2025 Revised: 02-01-2026 Accepted: 08-02-2026 Published: 18-02-2026

Abstract
A number of European nations have developed corporate governance codes. While some are based on the law, the majority are self-regulatory. The codes' rules are applicable in both situations on a "comply and explain" basis. Market mechanisms, such as shareholders using their legal and factual rights inside the corporation, are the primary means of enforcement. Furthermore, these regulations are often absorbed into the legal system via blank norms like contract or liability laws. Further concerns come up in jurisdictions like Germany and the Netherlands where the code has been specifically included in the legislation. In these nations, the function of auditors and market supervisors has been specifically examined. The investigation comes to the conclusion that the optimal balance for creating flexible but still successful corporate governance procedures is market-led enforcement combined with a strengthening of company law processes.

Keywords: market supervisors, business law, corporate governance norms, enforcement, and the legal system.

Introduction

The topic of their implementation and enforcement is receiving a lot of attention now that new corporate governance rules or guidelines have been implemented in several European jurisdictions2. There are many methods used: some focus more on the de facto implementation, creating comparison tables of how businesses have been handling the requirements of the regulations.3. Others try to analyze the market's monitoring of the codes and gage their link to market trends. Another line of inquiry examines the legal enforcement of the codes, taking into account civil, criminal, and other remedies. Lastly, certain issues are brought up by the market supervisors' enforcement, such as the connection between public law enforcement and self-regulatory tools. Only the latter two points will be examined in this study.

Corporate governance regulations operate under a specific legal framework. Due to variations in the surrounding legal system as well as variations in the legal status of the codes, the relationship with the legal system is a complicated issue that varies greatly from state to state. The legality of the codes will have a direct impact on enforcement strategies and effectiveness.

In a number of European states, the codes are only guidelines created by academics and professional bodies, sometimes without the express backing of the government. These codes might be classified as self-regulatory as their enforcement is determined by market factors and its application is voluntary and based on self-proclamation. In some situations, the rules of an organization that upholds the code or other comparable documents, such contracts, may serve as the basis for enforcement.

Since the code's main goal is to portray listed firms as upholding "good" governance, it will be similar to how the stock market operates in other states. In this case, the code might be written as a listing requirement, a stock exchange recommendation, or a clause in the listing agreement. The concept of self-regulation does not actually apply, with the exception of the first scenario.

A third category pertains to codes created by a private organization with backing from the government. The code has been specifically mentioned by the legislation (the Companies Act) in at least two instances, giving the code or even its contents formal legal implications. The code is codified in the Companies Acts of Germany and the Netherlands. Although the language has been written in a way that would be appropriate for a legal document, many legal scholars have tried to discover the implications of this mix of public and private law6: the idea of self-regulation would probably not apply7.

The remedies and penalties for enforcing the law have been the main topics of discussion in these states.

Lastly, no European jurisdiction has adopted the strategy of formally establishing comprehensive, detailed corporate governance provisions in the law itself, as has happened in the US Sarbanes Oxley Act, despite the fact that rules on particular aspects of the companies' governance have always been part of traditional company law in the majority of national company laws. This does not negate the existence of corporate governance provisions in European company acts or financial regulations; there are a number of distinct national provisions pertaining to board composition, such as the requirement to establish complex internal controls (10), the installation of audit committees (11), or the establishment of comprehensive guidelines for conflicts of interest, including when it comes to groups of companies. However, European lawmakers are increasingly adopting concepts derived from the Sarbanes Oxley Act12.

In all European legal systems, a mix of the different types of regulation co-exist13. In fact the dividing line between self regulation and state regulation is a sliding one. On the longer term one sees a gradual incorporation of corporate governance rules that originally were good practice and formulated in the code into the statute. One can expect the requirement to establish an audit committee to be introduced in all company laws, as a consequence of the transposition of the European directive14.

The problem of variety at the level of the surrounding legal system is much more complicated than the diversity of national codes. The areas of the legal system that are most likely to be impacted by the governance codes include business law, liability regulations, contract law, labor law, and even criminal law. It is generally acknowledged that these codes, like many other self-regulatory tools, may be incorporated into the broader legal system in certain situations. The most common entrance sites for this absorption include directors' responsibility, general negligence liability, particular remedies related to gross negligence or mismanagement, and so forth. However, other legal systems should not be disregarded. European legal systems continue to diverge significantly in this regard, as seen by the very few case law that follows these guidelines. For all of these reasons, the topic cannot be discussed as a summary of the legislation that is already in effect, but rather as potential paths that the law may take.

3. It is suggested that several processes be distinguished based on the legal situation in which the corporate governance requirements may be invoked in order to organize the topic.

A code was adopted voluntarily, it is not legally binding, and there are no special enforcement methods in the first set of instances. Making ensuring the code is followed is the board's main duty. A number of tools will be used for enforcement, particularly depending on the company's stature and reputation in the financial markets. Some enforcement tools will be produced by the broader legal system.

In a second instance, there has been some "juridification," and the external legal instruments have enforcement tools.

The third category includes situations when the code has been specifically specified in the legislation, resulting in legal ramifications that are derived from the general legal system but are not specifically stated in the legislation.

Lastly, the public authorities may have been in charge of enforcing the code or it may have been incorporated into statute law. The latter is the case with the Sarbanes Oxley Act, although several corporate governance regulations are dispersed across company law requirements throughout Europe as well.

Corporate governance codes without an express legal basis.

3. In the majority of legal systems, corporate governance pronouncements or rules lack a particular legal foundation and are not enforceable

4. They convey their draftsmen's understanding of the growing significance that financial markets place on corporate governance as a key metric for assessing sound management and, therefore, the firm.

Corporate entities, particularly the board of directors and management, are responsible for enforcement. The pressure from significant shareholders may influence or even decide the board's stance, even though most legal systems prohibit the general meeting from interfering with the company's management15.

The market forces are responsible for enforcement, which includes their impact on price formation as well as judgments made by investment banks, rating agencies, the media, public opinion, and so forth16. The market supervisor sometimes shows support for this strategy, but it does not commit to enforcing it. It is debatable whether market enforcement is a useful tool for guaranteeing adherence to these regulations; actual data from Germany, based on a recent event research, indicates a somewhat negative response, at least not demonstrating a substantial positive association with market prices17. According to other research, price formation may be negatively impacted by the lack of reliable governance frameworks and regulations, but there is no evidence of a beneficial effect.

The voluntary adhesion strategy, in which market players willingly consent to certain behavior guidelines, should also be emphasized. Furthermore, this devotion might be made public, for example, by a mark in the price list of the stock market. This strategy has been tried twice in Germany, first for the insider regulations and then for the takeover rules, but it was not very successful18. In certain states, admission to the stock exchange is contingent upon a contractual agreement between the issuer and the exchange. The corporate governance code is then included in the agreement, and noncompliance may result in contractual penalties like name and shame, contractual fines, and other similar measures.

Other monitoring techniques have been developed in the Netherlands, where a government appointed commission will follow up the overall implementation of the Dutch code19. In Switzerland, the Stock exchange has imposed sanctions but obviously none seem to relate to a violation of the Swiss code20.

Can these monitoring instruments be considered as efficient? Enforcement is always the crucial element in the controversy about the choice for self regulation rather than for state regulation.

It is useful to distinguish formal compliance from substantive compliance.

The formal requirement to adhere to a corporate governance code and to implement its individual provisions can be the subject of external monitoring by the auditor, a specialised committee or the market supervisor: the company can publish a declaration of adherence to the code, and motivate the items on which it prefers to derogate. Much more difficult is the monitoring of the substance of the provisions: here the liability should essentially lie with the company's bodies. Only in exceptional cases, especially when questionable conduct has come to light, will monitoring by the market and by the press become a predominant instrument. In these cases disclosure, if necessary monitored by the market supervisor, will become crucial.

3. The norms of the code have legal significance even in the lack of a clear legal foundation. Like other soft law tools, corporate governance norms tend to be absorbed into the legal system wherever the law permits a blank norm. It is generally acknowledged that corporate governance codes and soft law instruments in general, particularly if they are widely accepted, will serve as a source of inspiration for judges searching for standards by which to measure specific director conduct, such as in liability or negligence cases, whether internally (i.e., for dealing with the relationship within the company) or externally (i.e., for dealing with third parties or for initiating investigations into the company's conduct). There are currently relatively few corporate governance instances that demonstrate this kind of juridification. Depending on the national laws and precedents of each member state, developments are likely to follow distinct paths.

4. The need to consult shareholders in support of a company's decision on a takeover or other private reorganization has "no legal basis in present law, nor in views accepted on corporate governance in the Netherlands," according to a Dutch Supreme Court ruling. Subscribing to such an obligation would result in intolerable confusion about the relevant law21, as a rule of that sort could not be adopted in the absence of a provision in the articles of organization or the Companies Act. if the Court's decision permits incorporating widely recognized corporate governance principles22 or if it should be seen as an inadequate foundation for incorporating corporate governance principles into the law23 is a topic of debate in legal literature.

4. Generally speaking, many countries have used the traditional method of interpreting blank norms to incorporate soft law standards into the law24. National legislation determines the "entry point" via which this absorption occurs. Here, one often refers to broad contract law standards, such as the Dutch law laws pertaining to the fundamental concept of "redelijkheid," general rules on civil liability25, and regulations on directors' responsibilities and liabilities26.

En billijkheid, or "reasonable and equitable conduct," is a fundamental concept in Dutch business law. 27.

There will be important additional entry points in a number of countries. The authority of the Dutch specialized "enterprise chamber," a division of the Amsterdam Court of Appeal, should be specifically mentioned here. According to art. 2:345 of the Dutch civil code, the court has the authority to order an inquiry ("enquň") into the "management and state of affairs" ("beleid en gang van zaken") of any business, enabling the court to take action in the event of "mismanagement" ("wanbeleid"). It is impossible to rule out the possibility that serious transgressions of significant corporate governance code rules or principles may be seen as "mismanagement"28. Acting contrary to the "elementary principles of responsible entrepreneurship" 29 would fall under this concept. Strengthened liability provisions for directors in cases of "manifest gross negligence" or other standards that resemble "wrongful trading" 30 are found in a number of other countries.Depending on the circumstances, corporate governance infractions may or may not meet the relatively stringent requirements. For example, it is widely believed that a number of the major scandals of the early years of this century demonstrated the dysfunction of their boards, which resulted in the absence of the required checks and

balances. Courts may find it helpful to use the codes' "good" governance principles when issuing punishments.
The issues are far from resolved when the code's enforcement is referred to the surrounding judicial system. The legal systems of the various countries vary greatly from one another. The general liability standard for negligence is a well-known example. In French law, any rule violation or negligence can be the basis for liability against the injured party, according to article 1382 of the Civil code. In German or Dutch law, however, a stricter standard is frequently thought to apply, where gross negligence or willful conduct may be required 31. Whether the plaintiff may only file a lawsuit if the regulation was created to safeguard his interests is a contentious issue. (the "Schutznorm" approach33) as opposed to serving as a tool to safeguard private companies generally34. The regulations controlling the liability of corporation directors, managers, or auditors are likely to be considerably more varied.

5. A "comply or explain" strategy is often the foundation of corporate governance standards. If businesses want to comply voluntarily because they believe that having a detailed corporate governance statement would boost market trust,
third parties – and especially investors, but also creditors - are entitled to rely on the honest and complete nature of the statements. The “comply or explain” technique therefore builds further on the idea of market enforcement: markets sanction both unsatisfactory governance arrangements and insufficient information. The latter matters are not specific to governance.
3. Despite the absence of a clear legal basis, the code's standards have legal meaning. Wherever the law allows for a blank norm, corporate governance standards are often included into the legal system, much like other soft law instruments.

4. It is widely acknowledged that judges looking for standards by which to measure specific director conduct, such as in liability or negligence cases, will find inspiration in corporate governance codes and soft law instruments in general, especially if they are widely accepted. This is true both internally (i.e., for dealing with the relationship within the company) and externally (i.e., for dealing with third parties or for initiating investigations into the company's conduct).
At the moment, there are very few examples of corporate governance that exhibit this kind of juridification. Developments are expected to take different directions depending on each member state's national laws and precedents.
A Dutch Supreme Court judgment said that there is "no legal basis in present law, nor in views accepted on corporate governance in the Netherlands" for a business to poll shareholders in favor of a takeover or other private restructuring. A rule of such kind could not be imposed in the absence of a provision in the articles of organization or the Companies Act, therefore adhering to such a duty would lead to unacceptable misunderstanding over the applicable law21. Legal literature debates whether the Court's ruling allows the incorporation of generally accepted corporate governance principles22 or if it should be seen as an insufficient basis for adopting corporate governance concepts into the law23.

4. In general, a lot of nations have incorporated soft law standards into their laws by using the conventional approach of interpreting blank norms24. The "entry point" via which this absorption takes place is decided by national law. In this context, general contract law standards are often referred to, such as the Dutch law legislation concerning the basic notion of "redelijkheid," general rules on civil liability25, and regulations on the obligations and liabilities of directors26.
A key idea in Dutch company law is "reasonable and equitable conduct," or en billijkheid. 27.

There will be significant new entry points in many nations. It is important to expressly emphasize the authority of the Dutch specialist "enterprise chamber," which is a branch of the Amsterdam Court of Appeal. In order to take action in the case of "mismanagement" ("wanbeleid"), the court may order an inquiry ("enquň") into the "management and state of affairs" ("beleid en gang van zaken") of any firm, according to art. 2:345 of the Dutch civil code. It is hard to completely rule out the potential that major violations of important corporate governance code principles or norms may be seen as "mismanagement"28. This idea would apply to actions that go against the "elementary principles of responsible entrepreneurship" 29. Many other nations have strengthened culpability laws for directors in situations involving "manifest gross negligence" or other requirements similar to "wrongful trading" 30.Corporate governance violations may or may not satisfy the rather strict criteria, depending on the situation. For instance, it is generally accepted that some of the big scandals that occurred in the early years of this century showed how dysfunctional their boards were, which led to the lack of necessary checks and balances. When imposing penalties, courts may find it useful to use the "good" governance standards included in the codes.
Referring the enforcement of the code to the local legal system does not address the problems. There are significant differences in the legal systems of the different nations. One well-known example is the general liability standard for negligence. Article 1382 of the Civil Code states that any rule breach or carelessness may give rise to liability against the injured person. However, a more stringent requirement is usually believed to apply under German or Dutch law, where purposeful behavior or gross carelessness may be necessary 31. It is controversial whether the plaintiff may only bring a case if the rule was designed to protect his interests. (the "Schutznorm" approach33) rather than acting as a mechanism to protect private businesses in general34. The rules governing the liability of managers, directors, and auditors of corporations are probably going to be much more diverse.

5. Corporate governance rules often start with a "comply or explain" approach. If companies choose to voluntarily comply because they think a thorough corporate governance statement will increase consumer confidence,

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Regardless of these particular issues, publishing false, misleading, or incomplete information may also result in responsibility penalties. Depending on the relevant legal system, this may be due to a breach of general civil liability laws or corporate law. The broad laws on carelessness (such as those found in the legal systems of France and Belgium) might be used to assess responsibility. In most legal systems, the extent to which this would allow individual shareholders to claim for damages is debatable, although injured parties would need to demonstrate causation. The total impact on the stock market price determines the harm. The corporation may ultimately file a lawsuit against the directors for harm done to the business at the request of the minority shareholders38.

According to German legal literature, this is known as "Vertrauenshaftung," and it has been thought that the corporation may be liable based on the trust established. A similar legal foundation would probably be approved in a number of other member nations. In severe circumstances, making false statements may result in criminal culpability. Based on BGH decisions, it has been suggested that the responsibility would be based on the aforementioned concept, which would result in the implementation of the prospectus liability rules40.
Enforcement might also take place through the intervention of the market supervisor41. In some jurisdictions, the market supervisor could step in if the information disclosed in the annual report

or in any other documents addressed to the securities markets, is incomplete or insufficient and could oblige the issuer to publish additional or corrected information.42 This type of intervention is not limited to information that has been imposed by public act, but might extend to any untrue or misleading information43. But supervisors are hesitant to act as enforcement agencies for private business rules: apart from the case that the information is false or misleading - in which case the supervisor would act within its statutory mandate to avoid false or misleading disclosures – supervisors are rather reluctant to intervene in the enforcement of corporate governance codes44.

Incorporating Corporate governance rules in other bodies of law.

Enforcement of corporate governance rules could also be achieved by relying on other parts of the legal system to which these would be linked. Several parts of the legal system could be involved here.

As the codes often have been developed by business associations, one could imagine that the rules of the association allows enforcement to be organised by the association of which the listed company is a member whether directly or through a participating business association. The members may explicitly endorse the code45 or be bound by a collective adhesion. It is however not clear how effective these membership techniques are. If sanctions would be imposed, and disclosed, the member may suffer reputation damage: however, expelling an important but unwilling member is likely to do more harm to the association than to that member.

Another and probably more significant case is the one in which the company's articles of association refer to the code, whether to all provisions of the code, or only to some or more of its most significant obligations46. Articles may contain the obligation to institute an audit committee, or impose a separation of the functions of chairman and CEO. In groups of companies, elaborate conflicts of interest clauses may be useful. Cases have been known whereby the parent restricted the activity of its listed subsidiary, e.g. by forbidding it from taking advantage of corporate opportunities that the group would prefer to reserve to another group entity, raising interesting corporate opportunity issues.

By writing these rules into the articles, they become part of the contractual relation between the company and its board members, become legally relevant and hence allow enforcement through existing internal company rules. Enforcement would take place by a decision of the general meeting, whether by declaring directors liable, or by way of imposing specific performance. The refusal to abide by clear provisions of the articles could also be a basis for the dismissal of board members for cause in cases in which they cannot be dismissed at will47 In some cases one may wonder whether the lack of compliance with some of the corporate governance rules might result in nullity of the decision: might the appointment of a board member without a regular proposal by the nomination committee lead to nullity of the appointment? Could the validity of a transaction violating the internal conflicts of interest rules, laid down in the articles of association, be challenged on that basis? The answer will depend on national law.49

According to the Dutch corporate governance code, - but not mentioned in the law – corporate governance decisions may belong to the competence of the general meeting of shareholders. According to the Dutch Code the corporate governance statement may be submitted for approval to the general meeting. This may change the nature of the document and interfere with the distribution of competences between general meeting and supervisory board. This would not imply however that it is mandatory to submit the corporate governance statement to the general meeting, as the annual report is not submitted for decision to the general meeting that applies only to the annual accounts50. There is controversy to what extent that governance statement could influence the discharge of liability, that is voted upon at the annual general meeting51.

As an alternative enforcement technique one might consider a rule whereby the law would mandate the listed companies to include in their articles of association a reference to the applicable corporate governance code, including to its “comply or explain” feature. This technique could be compared with the German-Dutch approach whereby the law imposes the board to take a position as to the applicable code, and allow it not to comply provided it publishes an explanation. It would allow the company to mould its governance requirements to its individual needs, but then backed with the full authority of the general meeting. However, one has to determine what would be the effect of this approach in the applicable legal system especially as it might result in heavier liability for the directors. Indeed, at least in some legal systems violation of the charter provisions call for stricter liability. This “charter” technique may also affect the balance of power between board and general meeting: the waiver of certain provisions of the code might become subject to a decision of the general meeting, unless the board has been empowered to do so.

Labour law may also offer a legal basis for certain corporate governance obligations: depending on national law and traditions, board members are subject to labour law52. Violations of essential provisions of good governance may be a reason for firing a manager. Some code provisions could be incorporated by contract: clauses could relate to conflicts of interest, to corporate opportunities and non compete clauses, to the disclosure of certain remunerations e.g. before the person was hired, etc. Here again, the effects of these clauses will have to be worked out on the basis of the applicable law.

A similar analysis can be made for corporate governance clauses in contracts in general: loan agreements can contain clauses on conflicts of interest or on corporate opportunities, or limit certain types of remuneration of executives. Again, enforcement will be a matter of performance of the contractual relationship and hence limited to contract parties. Apart from non-performance of the contract, one may accept that the clause would entitle the creditor to claim performance, accelerate the loan, or require the company to withdraw decisions that violated a contractual corporate governance clause. If e.g. the company has paid the executives a remuneration that was higher than what the creditor has expressly forbidden, would this violation entitle him to claim repayment of the excess remuneration? Under traditional civil law rules, the “action oblique53” might allow the creditor to sue on behalf of the debtor company against the director, the latter being a debtor to the company. Lenders may object again transactions with related parties that are likely to affect their position. The action of one creditor may seriously affect the future of the company, and hence determine the position of other creditors and shareholders as well54.

Among the contractual techniques, one may mention the cases in which listing on the exchange is purely contractual. The listing agreement could contain provisions on corporate governance.

The law expressly refers to a corporate governance code.

According to a third series of hypotheses, the companies act contains an express provision stating that the – or a – corporate governance code has to be respected. Two states have followed this approach: according to the German and the Dutch law, stock exchange listed companies have to state that they apply the corporate governance code, or state the reasons for not doing so. A comparable provision is laid down in the proposed revision of the 4th and 7th directives. In the UK, the listing rules provide that the combined code is applicable to listed companies.

(a) The German – Dutch approach

The relevant texts of the German and Dutch provisions – in their chronological sequence – are as follows:

According to § 161 of the German Company Law (AktG)
"The management board and the supervisory council of stock exchange listed companies declare annually that the "Regierungskommission Deutscher Corporate Governance Kodex" which has been released by the German Federal Ministry of Justice in the official part of the Electronic Official Journal, has been and is respected and which recommendations have not been or are not followed. This declaration has to be accessible to shareholders on a continuous basis".
The Dutch text is based on art 391(4) of the Civil Code, relating to the annual report of listed companies, the content of which has to be determined by decree. To article 391 the following was added in 2004: that
"by way of general administrative order, specific provisions about the content of the annual report will be enacted. These provisions will specifically relate to the implementation of a code of conduct, designated by the administrative order".
The implementing decree contains in substance that

"the annual report of the companies limited contains a report about the respect of the principles and best practice provisions, provided for in the code, addressed whether to the management or to the supervisory council. If the company has not respected the principles or the best practice provisions, or is intending not to respect these in the current and the following accounting year, it states in the annual report its reason for so doing'55

Regardless of these specific concerns, posting inaccurate, deceptive, or lacking information may also lead to fines. This might be the result of a violation of corporation law or general civil responsibility rules, depending on the applicable legal system. Responsibility may be evaluated using the general rules on negligence (such as those contained in the legal systems of France and Belgium). The extent to which this would enable individual shareholders to seek damages in the majority of legal systems is questionable, even if harmed parties would have to prove causation. The damage is determined by the overall effect on the stock market price. At the minority shareholders' request, the corporation may eventually sue the directors for damages done to the company38.
This is referred to in German legal literature as "Vertrauenshaftung," and it has been believed that the company may be held accountable based on the trust created. Many other member countries would likely accept a similar legal basis. Making false claims might lead to criminal liability in extreme situations. According to BGH rulings, it has been proposed that the obligation would be founded on the previously indicated idea, leading to the application of the prospectus liability regulations40.

It has been discussed in the Netherlands to what extent the corporate governance statement, or its deficiencies could be invoked by shareholders to apply for a court ordered investigation ("enquêterecht")65.
In the hypothesis that a company would not publish said statement, nor give any reasons for derogating, the board would expose itself v.à.v. its shareholders. The board – seen differently from the company - would be violating its legal duty. The general meeting could call on the board to adopt the code's rules and publish a declaration whether of compliance, or of non- compliance. A refusal to take position might have a negative influence on the stock's price. As this obligation is part of company law, the rules applicable for violating company law could be invoked

only with respect to the adherence to the code, not to the individual provisions66. The decision whether or not to comply, and to explain non-compliance will normally lie within the competence of the board (management board or supervisory council) not of the general meeting67. However, a different pattern appears from the Dutch Code, although not from the companies act: the annual corporate governance declaration should be submitted to the annual general meeting. Significant changes should be discussed in the general meeting an a separate item of the agenda68

One could wonder how shareholders could enforce the board's duty: could the general meeting require specific performance, and could a court enjoin the board to observe the code, or at least to make public its position? The general meeting could undertake such an action, and in case of refusal, could dismiss the members of the unwilling board. But the general meeting would not have the right to intervene in the board's decision for non complying and about the reasons for derogating. A direct intervention by the general meeting in the company's functioning would be contrary to the internal division of competences. Hence, shareholders could only call for having the board make a statement on the way it adheres to the code or states its reasons for non compliance. Individual shareholders a fortiori have no such right of intervention. In addition, it is likely that the board's unwillingness to adhere to the code, including its comply and explain principle, could result in liability of the directors towards the company, raising difficult questions what part of the code is addressed to the management board and what part relates to the supervisory council.

If the company published no statement whatsoever one could conclude to a violation of a legal obligation69. Apart from liability – provided causation is proved – the real sanction would lie in the censure by the general meeting and the negative reaction of the market.

Another issue relates to the consequences of deficient corporate governance statements. In this case, the board adheres to the code, and where applicable has published reasons for not following the specific provisions. However, the motivation disclosed may be deficient in several respects: it may be futile, or boilerplate, it may state untrue or incomplete reasons, or finally the information may be misleading or even false.

If the company publishes information that would be a formal explanation, but intrinsically insufficient to justify the derogation, there is no direct sanction applicable. Is it up to the general meeting to decide whether the board's statement is insufficient, and if so censure the board? But if the information is mandated by other provisions, e.g. of company law, or should be published according to financial regulation, there might be a violation of these provisions. In this context, one should recall the obligation to publish price-sensitive information. 72

In case of untrue, or incomplete or even misleading information, basically the same rules on board liability for disclosure would apply73. Untrue or misleading statements would expose directors to liability both towards the legal entity and towards third parties on the basis of the general rules on negligence. Whether these would be effectively applicable, and what the consequences might be, depends on national law. In some legal systems, if the violated rules belong to the companies act, a stricter liability regime would apply: this would not be the case with a violation of the corporate governance code, as it is not part of company law. In other systems, only gross negligence or an intentional violation would lead to liability74

Both in Germany and in the Netherlands, legal writers have considered that the corporate governance provisions do not aim to protect the individual shareholders, who therefore have no stand to sue in damages. It was considered that the function of the corporate governance rules consists of protecting the company and the company system, not the individual shareholders. More specifically under German law § 161 AktG should not be considered as a Schutznormgesetz75. In German law, more specifically with respect to the information to be disclosed on the basis of § 161 AktG, the issue has been raised whether liability should not be based on the broad principle of public confidence in public statements (Vertrauenshaftung76), underpinning the more specific rules on prospectus liability77.

It has been suggested that the damage to the buying or selling shareholders80 is the consequence of the negative valuation of their shares due to the absence of a credible corporate governance statement: generally - but here again, national laws may differ- it is discussed whether this is to be viewed as an individual damage, or rather as a damage inflicted to the company, for which shareholders as such cannot recover. At least in some jurisdiction, the first alternative would apply81.
The role of the statutory auditor has also been discussed in these two jurisdictions. Whether he will be called upon to review and report on the corporate governance statements depends on his role in general and more technically on the document in which his statement has to be included. This matter has not been analysed in great length in German and Dutch Law.
According to German law, it is mandatory to include the company's declaration in the annual report. This will render the auditor's review applicable but only to the mere formal corporate governance declaration82. His powers would not extend to the substance of the declaration: his intervention is limited to check whether the declaration has been delivered and whether it is accessible to the shareholders83. Some writers have referred to the question of a broader involvement of the auditor84. However, similarly as with the securities supervisor's role, it looks difficult to visualize to what extent an auditor could deliver a credible opinion on the items which are not reflected in the accounts and about relationships and developments about which he has only indirect evidence.

(B) The UK approach: link with the listing rules

In the UK the Combined Code has made applicable by the conditions for listing securities on the regulated market. Lack of observance of the code would normally be a bar to admission. Later non-observance might lead to delisting: this remedy is impracticable, as it inflicts damage to the innocent shareholders. Before the FSA was created, there were legal opinions denying a private right of action for violation of self regulatory instruments. . It is not known whether that position has changed since the FSA took over the responsibility for the listing conditions: the legal nature of these has been changed from private rules to public ones. On its role on enforcement the FSA has declared :"The FSA as listing authority makes no judgement about the accuracy or adequacy of the compliance statement: it is up to the board of the company and for the shareholders to make such evaluation. If a company fails to include a statement in the required form, the FSA has announced that it may make use of its powers, including its fining powers against that company. The FSA will use its compliance powers by sampling a number of annual reports on a routine basis". This quote indicates that the FSA's review would be limited to a formal check, leaving the substantive evaluation to the shareholders and to the market. Up to now, and as far as is known it has not acted in this field.

The Financial Reporting Council, and independent regulator for corporate reporting and governance, created from 1 April 2004 is in charge of setting, monitoring and enforcing accounting and auditing standards. It task has been widened to the promotion of high

corporate governance. standards by monitoring and maintaining the Combined Code and associated guidance. The FRC acts without explicit statutory base, although reference is made to the rules on listing on the exchange, which require compliance with the Code85.
The Code is applicable to listed companies, but also to other entities with a broad public interest, such as privately held, large companies, revision funds, large foundations, non-profit association, and so on.
The Committee on corporate governance follows up the corporate governance developments and practices, and may propose to the FRC changes to the Code. Enforcement of the code and of its individual provisions does not belong to the council's remit. This is considered to be the task of the market, of the institutional or other investors, if necessary acting in the general meeting. The Committee also can deliver interpretations about the code's provision, after suitable consultation.
c) the Spanish companies act

In Spain the "Almade" report pleaded for some minimal provisions to be included in the law, such as the basic duty of transparency and disclosure including the "comply and explain" rule, the introduction of a general fiduciary duty and the requirement that companies developed internal regulations dealing with the functioning of the board and of the shareholders meeting86.
The Spanish companies act, as modified by L. 26/2003 of 17 July 2003 contains a description of the information that has to be included in the annual report. Among the items that have been included, the act refers to the degree of implementation of the recommendations on corporate governance and where applicable, the explanations in case of non compliance87.
The securities commission has been mandated to follow up on these recommendations, and in case the company does not transmit its governance report, or the annual report with the governance chapter, or where the information is untrue, deficient or misleading the commission can request specific information to be published, with respect to the specific information as well as with respect to the degree of implementation88. The commission intervenes in cases of absence of any governance statement, and in case of gross deficiency in the governance statement.

THE ROLE OF THE SECURITIES MARKET SUPERVISOR

It is especially with respect to the Dutch code that a debate has sprung up about the role of the market supervisor in enforcing the corporate governance code. The subject is complex: on the one hand market supervisors are loath to enforce private guidelines, the more so as their legal status is unclear. When the case has received recognition by the legislator this perspective may change. The subject then becomes rather one of substance. By allowing the "comply or explain" rule, the law has recognized that the code's provisions should not be considered as the sole answer to a given issue, but that they invite the board to reflect and find adequate answers to the issues identified. Therefore the codes are to be viewed more as containing a process, a search for the optimal solution, than a ready made answer. Administrative supervision can only relate to whether a code has been identified and explanation given in case a provision is not followed but without entering into the substance of that explanation. In many instances the administrative supervisor would not be able to determine whether the answer was satisfactory or even true. It cannot be the intention that on the occasion of enforcing corporate governance codes the supervisor gets involved in the actual functioning of the board of listed companies, especially as its competences are generally limited to a disclosure approach.
The subject has been actively debated in several states, but most explicitly in the

Netherlands. Probably due to the fact that the code served as a response to the important cases that shook the Dutch stock market, the Dutch debate has always had a strong legal flavour.

End of 2004, a discussion took place whether the market supervisor, the AFM ("Autoriteit Financiële Markten") , would have a role to play in the follow up of the code. The AFM chairman, in a public speech held on November 2004, announced that he was considering exercising a "marginal review" of the application of the Code89. This was motivated by the fact that the code had been designated as a "legal obligation", and this by virtue of art 391, §§ 4 and 5, of Book 2 of the Dutch civil code. His statement provoked a rather angry reaction from a member of Parliament, who considered that the code as a self regulatory instrument developed by the private sector should not be the subject of government supervision. According to this parliamentarian the supervision of compliance with the code and of the information to be disclosed in the annual report is the task of the auditor, not of the markets' supervisor90. During the subsequent parliamentary debate the Minister of Justice clarified the role of both the AFM and of the auditor91. The AFM should, according to the minister, limit itself to determine whether the company has made reference in its annual report to the implementation of the code, and to verify whether that mention is consistent with the remainder of the annual report. The auditor on the other hand will check whether the board has mentioned in the annual report that it has complied with the code, and whether this mention is consistent with the remainder of the annual report and the financial statements92. It is, according to the minister, not the task of the auditor to check whether the firm has included all legally mandated information in whether the annual report or in the financials93. In case where the company would give no information on its compliance with the code, the auditor could mention this in his report 94

One could conclude that both AFM and the auditor would be restricted to "external monitoring" i.e. on the fact that reference is made to the code, and that information is given in cases of non-compliance, but without checking whether that information is adequate, true or complete. Recently it was decided that the so-called Tabaksblat Code will be monitored by a "Monitoring Commission Corporate Governance95, the eighth members of which have been designated by the ministers of finance, justice and economic affairs chaired by Prof. Frijns. The commission will review the usefulness of the Code, and its up to date character. It will follow up the implementation of the code by the Dutch business world. To that purpose it will make an annual inventory of the way Dutch firms have respected the code, will follow up on international developments and business practice, and identify lacunae or insufficiently clear provisions of the code. It may make proposals to amend the code, without being empowered to effectively change it. From this description follows that the commission has no mandate to ensure the individual follow up of the code, nor the power to investigate whether the code has been complied with, nor further impose any sanctions.

THE PROPOSED AMENDMENTS TO THE 4TH AND 7TH DIRECTIVE.

a reference to the mandatory corporate governance code; however a reference to a voluntary code may allowed by company law. In addition, the statement should contain "all necessary information about the corporate governance practices applied beyond the requirements under national law"97.
the "comply or explain rule" for departures from a corporate governance code:
This relates not only to specific provisions but to the code as a whole
Further information on internal controls

and risk management systems; information about anti-takeover protections and on the way shareholders can exercise their voting rights.

The directive further calls for liability of the members of the boards for the corporate governance statement and by calling for penalties applicable to infringements of the implementing national provisions. Administrative sanctioning is not mentioned, but is likely constitute an effective enforcement instrument, provided it is clarified who will be entitled to impose the fines 98.

Mandatory corporate governance rules - hard law

23 Dealing with corporate governance as a field in which only self regulation is used would be very misleading. Governance is the product of many influences, part of them rooted in the law, others in tradition, best practices and codified conduct of business rules, while some be laid down in the companies articles of association, in contractual arrangements, and any other source of law. “Corporate Governance” necessarily is a mix of all these. In many jurisdictions one witnesses an increasing migration from hard to soft law. This evolution which seems inevitable comes however at a price of cost, flexibility and risks. One of the advantages of the “comply or explain” approach is the possibility it offers to the company to draw up its governance according to its individual needs. By letting the best practices being transformed in hard law rules, the benefits of this evolutionary process are largely lost.

An increasing number of corporate governance rules are being including in legal instruments. It would require a very elaborate overview to list all of these, but some may be mentioned.

In France, the law on the “nouvelles regulations économiques” has introduced numerous changes on matters that would be found in corporate governance codes in other jurisdictions99

Conclusion

24. Corporate governance code enforcement is a complicated issue. In certain jurisdictions, the code can be compared to a default rule100: the code and all of its provisions are applicable, but the company is free to deviate if it so chooses. In many other jurisdictions, the interaction between private and public law rules also constitutes a novum that is of great scholarly interest. This creates a very unique and, in many ways, new relationship within the legal system.

Enforcing corporate governance rules is a more comprehensive topic than enforcing corporate governance codes since there are several linkages between the two, and a particular combination of enforcement tools will often be used. The additional tools, such liability regulations, will be used to enforce the codes. The boundaries between these many levels of regulation—voluntary, charter provision, legal support, and full legal provision—are ambiguous and constantly changing. It is important to emphasize how these levels interact.

The codes are voluntary in many countries, albeit they are not always self-regulatory. The reasons for favoring voluntary instruments are often cited as being flexible, adaptable, and permitting experimentation and innovation. Internal methods are the primary means of ensuring compliance: the board of directors and management are responsible for enforcing the code, either individually or at the general meeting, under the direction of the shareholders.

Since these codes are fundamentally market-led rather than self-regulatory, the efficacy of their external monitoring will rely on how well these "markets" function generally and how much power they have. Enforcing a code provision may be greatly aided by an active, investigative press. Furthermore, active shareholders and the growing focus on governance ratings are significant forces behind improved

governance. These tools will be more effective when significant events (or "scandals") have taken place, but they will be less effective when it comes to formal observance in the absence of real compliance. Outside monitoring may be considered: first one should determine what is to be monitored? Here it is useful to distinguish formal compliance from substantive one. It is widely admitted and practised that external monitors – be it the auditor, the supervisor, the regulated market, or any other body – could verify whether the company has formally declared to adhere to a code, has published its statement declaring which provisions it has not followed. A substantive review, this is whether the provisions have in fact been followed and whether the explanation for not complying is a credible one, is generally considered impossible, and creates unjustified expectations, while leading to a formalistic attitude. Where it appears that specific options should be imposed, they should be laid down in the law, and the price for the rigidity should be paid.
Formal compliance should not be considered on itself: it will support market enforcement, and where applicable legal enforcement. If markets do not necessarily value good governance, they put a negative premium on bad governance. The liability risk is not to be underestimated, while the awareness of the reputation risk is being increasingly perceived by the boards.

Is a legal backing of the code, as is the case in Germany and in the Netherlands a useful model? In order to avoid a flat refusal to apply the code, it certainly would be, but it is insufficient. Even in the two mentioned cases, the same outside monitoring remains necessary, as it offers no answer to the issue of weak implementation. It also adds very little with respect to the internal functioning of the board, what is the core of the corporate governance codes.

The law could step in and provide for appropriate sanctions. This is already the case for many specific governance rules that are part of the company laws. Should it be extended to the full range of governance rules? The American experience illustrates the burden and costs that th formally legal approach would create. But judicial enforcement is not necessarily stronger as one can witness with existing statutory governance rules. However, sometimes the law is needed to convince recalcitrant firms: the German case on director's remuneration illustrates the point. Notwithstanding many express calls to disclose individual management remunerations, business leaders continue to refuse, and the law finally has to step in.

Market-led enforcement is preferred when decisions must be made between several competing goals, but internal business monitoring systems should also be strengthened. The general meeting's and shareholders' roles should be strengthened. Company law tools that will improve the company's management and the board's accountability include the minority shareholders' right of action, an improved voting system with proxy or remote voting, and improved disclosure requirements. The entire governance structure is likely to be reinforced more by creating a closer connection between these internal governance tools and market-led enforcement than by enforcing formal regulatory requirements. The European Commission's recent shareholder rights initiatives101 are a source of inspiration.

References

Chairman of the Banking, Finance and Insurance Commission in Brussels and a professor at the University of Ghent. Only personal thoughts are expressed in this work.
2 See Corporate Governance and Enforcement, E. Berglöf and S. Claessens, www. Sept. 2004, World Bank Policy Research Working paper, nr 3409; available in SSRN.
3. See In France: Rapport de l'AMF sur le gouvernement d'entreprise et les procedures de control interne, January 13,

2005, Revue AMF, January 2005; A. von Werder, Kodex Report 2005: Die Akkeptanz der Empfehlungen und Anregungen des Deutschen Corporate Governance Kodex, Der Betrieb, 2005, 841, which provides an annual report on listed companies' adherence to the new standards.

4 In the UK, listing criteria were first developed by the exchange, which served as the listing authority. The nature of these listing restrictions may also vary and evolve over time. Given that the FSA now has that jurisdiction and that the regulations have been upheld, one could question what this means for the UK Combined Code's standing. The Government Commission on Corporate Governance in Germany also studied this strategy but rejected it (see Th. Baums (ed.), Report of the Government Commission on Corporate Governance (O. Schmidt V. Cologne), 2001, nr. 9, p. 54