

E S C R I T O R I O

**PALACIOS**

**ORTEGA**

**& A S O C I A D O S**

**BOOSTING INVESTORS' TRUST  
- NYSE'S CORPORATE GOVERNANCE RULES AND  
VENEZUELAN DIRECTORS' LIABILITIES SYSTEM -**

By Arturo H. Banegas Masía\*

**Extract**

*In response to serious lack of diligence, ethics and controls that led significant public companies as Enron, Global Crossing and MCI WorldCom to bankruptcy, the U.S. Congress passed the Sarbanes-Oxley Act.*

*This act contains many new standards and regulations on corporate governance matters, and as Commissioner Paul S. Atkins mentioned, it also*

---

\* Attorney. Partner of PALACIOS, ORTEGA Y ASOCIADOS, a Venezuelan corporate law firm. The analysis contained in this article has been revised by Dr. Luis Esteban Palacios and Dr. José Manuel Ortega. Thus, it reflects the opinion of the law firm.

*represents what formerly would have been an unimaginable incursion of the U.S. federal government into the corporate governance matters.*

*Regarding the corporate governance, the Act is keen in independency of Directors. Therefore, it establishes several limitations to the eligibility and compensation of directors, as well as to loans and to other economic benefits for the members of the board of directors. Likewise, it matches the new governance standards with the improvements in financial reports or disclosures in the obligation for public companies to create an Audit Committee composed of independent directors, and it orders the Securities and Exchange Commission to set new standards of professional conduct for attorneys appearing and practicing before the Commission.*

*In connection with disclosure improvements, the Act starts by requiring CEOs and CFOs to certify Financial Reports and to assume responsibility on its contents.*

*Following the Act's mandate, on August 16, 2002, the New York Stock Exchange submitted for approval by the SEC new Corporate governance and disclosure standards. These regulations are based in large part on the recommendations contained in the Report of the NYSE Corporate Accountability and Listing Standards Committee of June 6, 2002, suggesting significant changes to listing standards on corporate governance to NYSE's board.*

*The changes to corporate governances, as well as the proposed rules to amend the listing standards, while innovative and promoters of trust, lack of allocating the real responsibility of directors vis-à-vis its constituencies. For instance, rather than suggesting a majority of independent directors in the board of directors, which could present many pitfalls such as losing focus on corporate goals, the recommendations should address real controls over such directors by the shareholders and prompt and accurate mechanisms to enforce any liability against them.*

*Rather than outsider directors-dominated boards, if directors were jointly and severally liable vis-à-vis all investors, independence would not be necessary as each director would be personally responsible for the actions and omissions of the entire board, then no independence would be necessary. The jointly and several liability constitutes an incentive for each director to act proactively in order to ensure a performance of a "good head of family," and to avoid eventual penalties, as it occurs in the Venezuelan system.*

## I. INTRODUCTION

In the wake of the collapse of public companies such as Enron, which is the biggest bankruptcy in US history, and WorldCom, on July 30, 2002, the President of the United States of America, signed the Sarbanes-Oxley Act<sup>1</sup> (the “Act”) into law. It consists of eleven titles and it is purported “to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws.”<sup>2</sup> It also pretends to repair the damage done to investor confidence by the recent events of illegal and unethical behavior led to the referred financial scandals.

The Act has become the most important reform in securities regulations since the Securities Exchange Act of 1934, and it basically incises in the governance of public corporations and disclosure standards.

Regarding the corporate governance, the Act is keen in independency of Directors. Therefore, it establishes several limitations to the eligibility and compensation of directors, as well as to loans and to other economic benefits for the members of the board of directors.<sup>3</sup> Likewise, it matches the new governance standards with the improvements in financial reports or disclosures in the obligation for public companies to create an Audit Committee composed of independent directors,<sup>4</sup> and it orders the Securities and Exchange Commission (the “SEC” or the “Commission”) to set new standards of professional conduct for attorneys appearing and practicing before the Commission.<sup>5</sup>

In connection with disclosure improvements, the Act starts by requiring CEOs and CFOs to certify Financial Reports and to assume responsibility on its contents.<sup>6</sup>

Following the Act’s mandate, on August 16, 2002, the New York Stock Exchange (the “NYSE”) submitted for approval by the SEC<sup>7</sup> new Corporate governance and disclosure standards. These regulations are based in large part on the recommendations

---

<sup>1</sup> Sarbanes-Oxley Act of 2002.

<sup>2</sup> See Sarbanes-Oxley Act of 2002, 107<sup>th</sup> Cong. (2002) (enacted), H.R. 3763.

<sup>3</sup> Sarbanes-Oxley Act of 2002 § 304-306.

<sup>4</sup> Sarbanes-Oxley Act of 2002 § 301.

<sup>5</sup> Sarbanes-Oxley Act of 2002 § 307.

<sup>6</sup> Sarbanes-Oxley Act of 2002 § 302.

<sup>7</sup> SR-NYSE-2002-33: Corporate Governance Rule Filing (visited Jun. 03, 2003) <[http://www.nyse.com/pdfs/corp\\_gov\\_pro\\_b.pdf](http://www.nyse.com/pdfs/corp_gov_pro_b.pdf)>, amended on April 4, 2003: SR-NYSE-2002-33: Amendment No. 1 to Corporate Governance Rule Filing (visited Jun. 03, 2003) <<http://www.nyse.com/pdfs/amend1-04-09-03.pdf>>. Please be advised that the SEC has not yet approved these proposed rule changes. In addition, the rule filings that are eventually published in the Federal Register by the SEC may differ from the texts posted here.

contained in the Report of the NYSE Corporate Accountability and Listing Standards Committee of June 6, 2002,<sup>8</sup> suggesting significant changes to listing standards on corporate governance to NYSE's board.

Finally, the Act establishes the required means of enforcement, highlighting the whistleblower protection,<sup>9</sup> and the strengthening of existing criminal penalties and expanding the number of securities law-related criminal prohibitions. The Act strengthens SEC's powers to request that a court grant any equitable relief that may be appropriate for the benefit of investors and to add civil penalties to compensate victims of securities regulations violations.

The changes to corporate governances, as well as the proposed rules to amend the listing standards, while innovative and promoters of trust, lack of allocating the real responsibility of directors *vis-à-vis* its constituencies. For instance, rather than suggesting a majority of independent directors in the board of directors, which could present many pitfalls such as losing focus on corporate goals,<sup>10</sup> the recommendations should address real controls over such directors by the shareholders and prompt and accurate mechanisms to enforce any liability against them.

We believe, according to the following analysis, that Venezuelan current legislation as well as legislation in many other civil code system countries could be very helpful in designing a system of directors' liabilities towards investors and third parties.

## II. HIGHLIGHTS OF THE AMENDMENTS PROPOSED BY NYSE

NYSE's proposal complies with the mandates of the Act by strengthening diligent directors, granting them better tools to encourage excellence. It is designed to further the ability of honest and well-intentioned directors, officers and employees to perform their functions effectively, as well as to allow shareholders to more easily and effectively monitor the performance of companies and directors in order to reduce instances of lax and unethical behavior.<sup>11</sup>

---

<sup>8</sup> Report of NYSE Corporate Accountability and Listing Standards (visited Jun. 17, 2002) <[http://www.nyse.com/pdfs/corp\\_govreport.pdf](http://www.nyse.com/pdfs/corp_govreport.pdf)>.

<sup>9</sup> Sarbanes-Oxley Act of 2002 § 806.

<sup>10</sup> See Jun Liu and Joshua Weisser, *Through the looking glass: An analysis of the potential effects of Sarbanes-Oxley on the independent director system under the management hegemony and independency director responsiveness theories*, Bus. L. Rev., at 41 to 44 (2003).

<sup>11</sup> See No. 7 at 2.

A. INCREASING THE ROLE AND AUTHORITY OF INDEPENDENT DIRECTORS.

Listing standards should require listed companies to have a majority of independent directors.

Independent directors should create a nominating/corporate governance committee whose purpose should be disclosed in a written charter and, at minimum, should be (a) selecting or recommending that the board select the director nominees for the next annual meeting and (b) develop and recommend to the board a set of corporate governance principles applicable to the corporation. The charter should contain as well, the committee's goal and responsibilities (the board's criteria for selecting new directors, and oversight of the evaluation of the board and management) and an annual performance evaluation.

Independent directors should conform a compensation committee, which should overtake the board's responsibilities relating to compensation of the company's executives, and to produce a report on executives' compensation for inclusion in the company's proxy statement. This committee should determine corporate goals and objectives in connection with CEO's compensation and evaluate his or her performance. It should make recommendations to the board with respect to incentive-compensation plans and equity-based plans. This committee should be subject to an annual performance evaluation, as well.

The audit committee should have the authority to retain and terminate company's independent auditors, and to approve any significant non-audit relationship with the independent auditors. The audit committee should check the independent auditor's performance not just with the company but also in general. It should discuss with the independent auditor, as well, any of the company's financial information to be disclosed to the public and meet at least quarterly with independent auditors, management and internal auditors.

The audit committee must have a written charter. Such charter should contain the committee's purpose, which, at minimum, should be: (a) assisting board's check of (i) the company's financial statements, (ii) compliance with legal and regulatory requirements, (iii) independent auditor's qualifications and independence, and (iv) performance of the company's internal audit function and independent auditors; and (b) prepare the report to be included in the annual proxy statement.

The audit committee should be subject to an annual performance evaluation.

B. TIGHTENING THE DEFINITION OF "INDEPENDENT" DIRECTOR AND ADDING NEW AUDIT COMMITTEE QUALIFICATION REQUIREMENTS.

The board of directors should qualify the director as "independent" if it has no material relationship with the listed company (as a partner, shareholder or officer of an organization that has a relationship with the company).

Additionally, the Committee recommends a five-year “cooling-off” period to former employees of the listed company, affiliates or employees of auditors of the company, members of interlocking directorate in which an executive officer of the listed company serves on the compensation committee of another company that employs the director, and to immediate family members in the foregoing categories.

Finally, the Committee recommends setting clear hiring policies for employees or former employees of independent auditors.

Regarding the audit committee’s members, they should have accounting or related financial management expertise. A director who meets the definition of “independence” mandated for all audit committee members, but who also holds 20% or more of the company’s stock cannot chair, or be a voting member of the audit committee. Such committee’s members should only receive director’s fees from the company.

#### C. FOSTERING A FOCUS ON GOOD CORPORATE GOVERNANCE.

The non-management directors should monitor the management more effectively. They should meet in executive sessions more often without management. The independent directors should elect the head of such sessions, whose name should be publicly disclosed.

Additionally, listed companies should adopt and disclose their corporate governance guidelines, which, at minimum, should address: (a) Directors’ qualification standards, (b) directors’ responsibilities, (c) directors’ access to management and, as necessary and appropriate, independent advisors, (d) directors’ compensation, (e) directors’ orientation and continuing education, (f) management succession, and (g) an annual performance evaluation of the board.

Finally, listed companies should adopt a code of business conduct and ethics.

#### D. GIVING SHAREHOLDERS MORE OPPORTUNITY TO MONITOR AND PARTICIPATE IN THE GOVERNANCE OF THEIR COMPANIES.

Shareholders should control any equity-based compensation plans. A broker, however, may not vote a customer’s shares on any equity-compensation plan unless it is expressly instructed in such regard.

Listed companies must publish codes of business conduct and ethics, and key committees’ charters.

Listed foreign issuers must disclose any significant difference between their corporate governance practices and those from NYSE listing standards.

#### E. ESTABLISHING NEW CONTROL AND ENFORCEMENT MECHANISMS.

CEOs must certify annually to NYSE that the company has verified the accuracy and completeness of all information provided to investors and that there is no reasonable cause to believe that such information is not accurate and complete. Moreover, the CEO should certify that the board has reviewed the procedures to verify the accuracy and completeness of the information and that the company has complied with them.

CEOs must also certify annually that they are not aware of any violations of NYSE listing standards by the company. However, should the CEO find a violation of such listing standard, the NYSE may issue a public reprimand letter to any listed company and ultimately suspend or de-list an offending company.

In a nutshell, the recommended changes to NYSE listing standards focus on the independence of directors, the audit committee functions and monitoring, and a stronger participation of shareholders in the governance of the company. But such recommended changes do not focus on the real issue, that is, the directors' liabilities *vis-à-vis* investors and other third parties.

Venezuelan current legislation on corporate governance might be helpful in this regard.

### III. HIGHLIGHTS OF VENEZUELAN LEGISLATION ON DIRECTORS' LIABILITIES

Venezuela, as many other civil code law system countries, has legislation applicable to any corporation in matters of corporate governance. Likewise, Venezuelan Capital Markets Law establishes certain rules concerning corporate governance in order to protect minor shareholders' interests. Finally, in order to protect creditors or the like, other legislation as banking and insurance companies provide other standards in connection with the administration and governance of companies in such fields. Companies in these fields could be subject to Capital Markets standards if their securities are publicly traded.

We will focus our analysis on Venezuelan Commercial Code and Capital Markets legislation.

#### A. COMMERCIAL CODE

According to Venezuelan Commercial Code, administrators<sup>12</sup> are responsible not only for managing the corporation but also for keeping the corporate financials

---

<sup>12</sup> Venezuelan Commercial Code uses the term "administrator" referring to directors, as used by the US regulations.

in good standing. Moreover, administrators have a legal obligation of informing shareholders and other relevant third parties, such as creditors, of the development of the corporate business. However, they are not obliged to disclose the corporate business strategies.

Specifically, the Commercial Code expressly establishes that administrators are responsible for:<sup>13</sup>

1. The truth of the shareholders' deliveries to corporate treasury.
2. The actual existence of the dividends paid.
3. The implementation of shareholders' resolutions.

Administrators in Venezuela, though, are responsible for not complying with the above-mentioned responsibilities. Likewise, their liability is extended to the correct performance of other duties imposed by law and corporate bylaws. Therefore, if administrators fail to comply with the above obligations, they would be deemed responsible as well.

The whole board is compelled to comply with the above legal duties. Otherwise, administrators would be deemed to be jointly and severally liable<sup>14</sup> *vis-à-vis* investors and relevant third parties.

However, if administrators expressly state in the minutes of the board's meetings their discomfort with the resolutions of such meeting, they will be deemed excluded from any joint and several liability.<sup>15</sup> Administrators that proceed in such a way should immediately contact the corporate statutory auditor.<sup>16</sup>

If the information disclosed to the shareholders is accurate, the approval of the balance sheet at the shareholders meeting settles administrators' obligations and they would be released of further liabilities.

For this analysis, we will divide administrators' obligations in three sections. The first section is related to investors' confidence. It refers to the obligation of disclosing to the public the corporate actual financial situation. The second section refers to administrators' duties *vis-à-vis* the corporation, its shareholders and third parties. Finally, although this section could be included within the second block of

---

<sup>13</sup> Art. 266, Commercial Code

<sup>14</sup> According to Venezuelan legislation, under Article 1221 of the Civil Code:

*"An obligation is joint and several when several debtors are obliged to the same thing, such that each debtor can be compelled to pay for the whole obligation, and the payment made by one of them shall release the others, or when several creditors are entitled to demand each the full payment of the credit and payment made to only one of them shall release the debtor in respect of all."*

<sup>15</sup> Art. 268, Commercial Code

<sup>16</sup> *Idem.*

obligations, due to its importance as confidence boosters, we decided to include in a separate section. It refers to administrators' conflict of interests and prohibition of self-dealings.

*1. Administrators' obligation of disclosing accurate financial information*

As established above, administrators have the legal duty of disclosing the actual corporate financial information. If administrators fail to comply with this obligation, they will be considered to be jointly and severally liable for any damage caused to shareholders and even, relevant third parties, as creditors.

The elaboration of the balance sheet and financial statements is a fundamental duty of administrators. This obligation is intended to inform the shareholders and the creditors of the corporate financial situation.<sup>17</sup> Any damages caused to the company, the shareholders or any third party as a result of an inaccurate balance sheet can be claimed against the administrators, and again, they would be deemed to be jointly and severally liable for such damages.

Accordingly, the Commercial Code establishes that:

*"The administrators will present to the statutory auditors, at least one month in advance to the day established for the shareholders meeting that will discuss it, the respective balance sheet and its supporting documents. Said balance sheet will clearly state:*

*"1. The actually existing capital stock.*

*"2. The deliveries made and those delayed.*

*"The balance sheet will demonstrate with evidence and accuracy the benefits actually made and the losses suffered, determining the corporate assets items by their actual or presumed value. No value shall be ascribed to non-collectible credits."<sup>18</sup>*

A copy of the balance sheet, together with the internal auditors' report, shall remain deposited at the offices of the Company during the fifteen days preceding the shareholders meeting and until such balance sheet is approved.

Any person who proves to be a shareholder will be entitled to examine both documents.<sup>19</sup> Shareholders are entitled to examine the inventory and the shareholders' lists at the place where the corporate site and may also ask for a copy of the general balance sheet and the statutory auditors' report. All this

---

<sup>17</sup> Art. 35 and Art. 304, Commercial Code

<sup>18</sup> Art. 304, Commercial Code

<sup>19</sup> Art. 306, Commercial Code

information must be made available to shareholders fifteen days before their meeting is held.<sup>20</sup>

Statutory auditors will have an unlimited right to inspect and supervise all operations of the company. According to law, they have the authority to examine the books and correspondence and, in general, all of the corporate documentation. Auditors must review the balance sheet and issue a report with their opinion and notes to the balance sheet submitted by the administrators.

According to Article 287 of the Commercial Code:

*“The discussion at the shareholders meeting in connection with the approval of the balance sheet and the accounts will be null and void unless it has been preceded by the statutory auditors’ report.”*

Additionally, this disclosure obligation is not limited to just informing the shareholders about the corporate financial situation. Administrators should act proactively. If they become aware that the capital stock has decreased by one third, they also have the obligation to call the shareholders to ask them whether they will repay the lost in capital or limit it to the remaining amount or wind up the company. Moreover, if the capital decreases below two thirds, the latter company be necessarily liquidated when the shareholders do not choose to repaying such capital or limiting the corporate fund to the existing capital.<sup>21</sup>

Although Venezuelan accounting standards establishes that business corporations must have a monthly trial balance sheet, Venezuelan Commercial Code requires the administrators to present every 6 months a summary statement of the corporate assets and liabilities. This statement shall be submitted to the statutory auditors.<sup>22</sup>

In bankruptcy situations, failure to comply with the above obligations may lead to criminal penalties.<sup>23</sup>

Bankruptcy in Venezuela could be declared culpable (*culpable*)<sup>24</sup> or fraudulent. The bankruptcy is considered to be culpable, if administrators do not comply with the formalities established in the Commercial Code, whereas it would be deemed to be fraudulent if administrators intentionally

---

<sup>20</sup> Art. 284, Commercial Code

<sup>21</sup> Art. 264, Commercial Code

<sup>22</sup> Art. 265, Commercial Code

<sup>23</sup> Art. 920, Commercial Code and Art. 342 and 343, Criminal Code.

<sup>24</sup> According to Venezuelan criminal law, tried people could be deemed to be guilty of a crime even if they acted with no intention, but negligently caused such crime.

misinformed the shareholders and third parties about the actual corporate financial situation.<sup>25</sup>

2. *Administrators' duties vis-à-vis the corporation, its shareholders and third parties*

Administrators' default obligations on the management of the corporation, as established by law could be summarized as follows:

- Administrators should keep a Share Record<sup>26</sup> where they will register all information about the shareholders—including the original incorporators and those who have purchased any stock—together with the capital increases and any stock transfers that may have been made.<sup>27</sup>
- Administrators should keep a Minutes' Books of both the Shareholders and the Board of Administrators meetings.
- Administrators shall allow shareholders to inspect the corporate premises, the Share Register and the Shareholders Meeting Minute Book of the company.<sup>28</sup>
- If a fifth of the corporate shareholders require so, administrators shall call for an extraordinary shareholders meeting within the period of one month. In the notice, administrators must state the items to be discussed and approved in such meeting.<sup>29</sup>

Administrators shall also refrain from discussing or resolving any matter in which they may have any conflict of interests with the corporation.

In any event, directors in Venezuela must be very proactive, as they would be deemed responsible for any lack of diligence. According to Venezuelan law, negligence is determined by comparing the performance with certain culpability's standards. The basic standard is called *buen pater familiae* (good head of the family). This standard refers to the care an ordinarily prudent person would be expected to exercise under similar circumstances.

---

<sup>25</sup> Art. 920, Commercial Code

<sup>26</sup> According to Venezuelan commercial practice, books could be kept in electronic means, provided that

<sup>27</sup> Art. 260, Commercial Code

<sup>28</sup> *Idem.*

<sup>29</sup> Art. 278, Commercial Code

Administrators in Venezuela must act like a “good head of the family” and exercise their powers for the benefit of the company. Therefore, Administrators’ duty is to act with as much diligence as possible.

Administrators are not liable for other than the performance of the mandate and obligations assigned to them by the law and the corporate charter. They cannot exceed such mandates and obligations. Otherwise, they would be personally responsible *vis-à-vis* third parties and the corporation.

Administrators are not responsible for the day-to-day management of the corporate business, though. According to the Commercial Code, directors,<sup>30</sup> managers or other agents could be appointed according to the corporate charter.<sup>31</sup>

However, there is no provision, however, in Venezuela Corporate law that would prevent the members of the board of directors of being members of management.<sup>32</sup>

### 3. *Administrators’ duties and prohibitions regarding conflict of interests*

As the administrators have the above obligations, they are also compelled to be set aside from any discussion or resolution in which they might have personal interests.

Accordingly, article 269 of the Venezuelan Commercial Code regulates the conflict of interests within the members of the Board of Administrators:

*“The administrator that in any given operation has in his own name or on behalf of a third party, a contradictory interest of the corporate interest, should communicate such conflict to the rest of the administrators and must abstain from participating in deliberating on such matter”*

The above prohibition bases its scope on the concept of “contradictory interest”. Such term does not necessarily mean that the administrator must have any interests opposed to the interest of the company in order to abstain himself from the discussions.

---

<sup>30</sup> In the context of this provision, directors are not the same as the members of the board of directors as defined by US law. According to the Venezuelan Commercial Code, the members of the board of directors are called “administrators” (*administradores*), whereas the term “directors” in this provision is referred to management.

<sup>31</sup> Art.270, Commercial Code

<sup>32</sup> See *Corte Superior del Trabajo del Distrito Federal y Estado Miranda* (Superior Labor Court of the Federal District and the State of Miranda), May 16, 1960. *Jurisprudencia de los Tribunales de la República*, Vol. VIII, pp. 183-184.

Abstention is mandatory when any given administrator is proposing or participating in any matter in which such administrator has personal direct or indirect interest that may affect his judgment of fairness.

As responsables for running the corporate business, administrators should follow the principles established by the shareholders. However, the administrators are not subject to those principles in an absolute manner, since they can refuse to comply with such shareholders' resolutions if they are contrary to the Law or the corporate bylaws.

Vivante, quoted by Manuel Acedo Mendoza on his book *“La Sociedad Anónima”* states: *“The Board of Administrators can and must resist such decisions of the shareholders meeting that violate the law or the bylaws, and may not avail of the release obtained by the shareholders meeting in order to evade the civil and criminal liability inherent therein.”*<sup>33</sup>

The law establishes several restrictions applicable to the administrators. The following are some of the most important:

*“Neither the administrators nor the statutory auditors or the management can be proxies for other shareholders at the general shareholders meeting”*<sup>34</sup>

*“The administrators cannot cast votes:*

*“1. On the approval of the balance sheets.*

*“2. On discussions referring to their responsibility.”*<sup>35</sup>

## B. ENFORCEMENT OF ADMINISTRATORS' LIABILITIES

Venezuelan Commercial Code defines the responsibility of directors and ensures its enforcements in the following terms:

*“In the event of grounded suspicion of serious irregularities in the performance of their duties by the administrators, and of lack of surveillance by the statutory auditors, a number of shareholders who represent one fifth of the capital stock and duly accrediting the capacity with which they act may report the facts to the Commercial Court.*

*“The Court, if it finds evident the urgency of deciding before the Shareholders meeting is held, and having heard the administrators and the internal auditors, may order the inspection of the company's books by appointing for this purpose one or more examiners at the expense of the claimants and determining the guaranty that must be given by the former for the expenses that may be incurred in these efforts.*

*“The examiners' report shall be filed with the Clerk of the Court.*

---

<sup>33</sup> ACEDO, Manuel and LEPERVANCHE, Luisa Teresa Acedo de. *La Sociedad Anónima*. Ed. Schnell, C.A., Caracas, 1985.

<sup>34</sup> Art. 285, Commercial Code

<sup>35</sup> Art. 286, Commercial Code

*“When no indication that the reports are true is obtained, the Court will make a statement to that effect and this will end the procedure; in the opposite case, the Court will order to call a meeting of the shareholders forthwith. No appeal, but to one effect, will be heard against these orders.”<sup>36</sup>*

Together with the above provision, in cases of bankruptcy, Venezuelan commercial Code is very precise in establishing the situations where directors might be declared responsible or not for any breach of their duties.

*“In the case of bankruptcy of corporations or limited liabilities companies, the promoters and the administrators will be sanctioned as culpable bankrupted, if they are found responsible of not complying with the formalities established in sections II, VI and VII of Title VII of Book I of this Code, or if they are found responsible for the bankruptcy of the corporation.*

*“And they will be sanctioned as fraudulent bankrupted:*

*“1°-When they have intentionally omitted to public the corporation’s charter as established by law.*

*“2°-When they have untruthfully declared the subscribed or paid-in Capital.*

*“3°-When they have paid dividends of profits that evidently did not exist and, therefore, the capital of the company has been decreased.*

*“4°-When they have intentionally taken more funds than those allowed by the corporate charter.*

*“5°-Those who intentionally or as a consequence of fraudulent transactions have caused the bankruptcy of the corporation.”<sup>37</sup>*

### C. CAPITAL MARKETS LAW

Capital Markets Law in Venezuela establishes other specific duties for the administrators or directors of public corporations, as well as bars and prohibitions intended to prevent self-dealings for the benefit of such officers. For the purpose of our analysis, we will quote Article 121, which refers to prohibitions on disclosing privileged information; and Article 138, which establish very severe and specific criminal penalties for corporate officers who have acted

*“Article 121.- Directors, administrators, managers, officers, and employees, as well as the examiners and legal representatives of the companies mentioned in the foregoing Article, and all others who, in performing their functions and duties or professional activities, have access to privileged information, and, in general, all those who may be aware of such information, may not:*

*“1. Transfer or give such information to others before it is released to the market as provided for in Article 119 of this Law; and*

*“2. Act, or allow others to act, on the basis of said privileged information to obtain capital or economic benefits in general for themselves or for others, whether as profit or by avoiding losses.”<sup>38</sup>*

---

<sup>36</sup> Art. 291, Commercial Code

<sup>37</sup> Art. 920, Commercial Code

<sup>38</sup> Art. 121, Capital Markets Law

*“Article 138.- Penalty of imprisonment for a period from two (2) to six (6) years shall be imposed on:*

*“1. The administrators or officers of collective investment companies or entities that, with respect to the trading of public offering securities, provide false information on the operations or the financial condition of the company, thus affecting the valuation of investments;*

*“2. Public accountants engaged in the independent exercise of their profession that provide a false opinion on the financial condition of the collective investment company or entity;*

*“3. The members of the Rating Board of a risk rating company that, in order to obtain a benefit or profit for themselves or for other persons, have issued a rating of a security with the intent to manipulate the market;*

*“4. Any person or entity supplying false information to the National Securities Commission in order to obtain the required authorizations to perform the public offering of securities or to avoid the suspension or cancellation of the respective registration;*

*“5. Members of the Board of Directors, advisors, administrators, managers, officers, employees, examiners, auditors, and attorneys of transfer agents of securities or brokerage houses, issuing false certificates on the operations in which they are involved or on shares they must have available;*

*“6. The administrators and other officers of stock exchanges, collective investment entities and other companies certifying false or non-existent operations as having been actually performed therein;*

*“7. Those performing fictitious operations intended to cause an artificial variation in price of the securities; and*

*“8. Individuals, or representatives of legal entities, who make public offering of securities without having obtained the respective authorizations from the National Securities Commission.*

*“Sole Paragraph: Stock exchanges shall have the obligation to inform the National Securities Commission of abnormal price fluctuations of the securities traded therein, so that the pertinent investigation is made pursuant to the stipulations of the internal regulations of the respective stock exchange.”<sup>39</sup>*

#### D. OTHER LEGISLATION

There are other duties of the administrators, which refer to the General Law of Banks and Other Credit Institutions and the Insurance and Reinsurance Company Law.

Each one of the above provides for specific obligations that the administrators must comply with in order that the shareholders, and most importantly, the creditors of the banks (depositors) and the insured of the insurance companies, can be aware of the net worth situation of the Banks, the Insurance Companies or the other companies that trade their stock in the stock exchanges.

---

<sup>39</sup> Art. 138, Capital Markets Law

#### E. CONCLUSIONS FROM VENEZUELAN CORPORATE GOVERNANCE SYSTEM

The above may lead to the conclusion that Venezuelan corporate system is based on the liabilities and responsibilities a director may have *vis-à-vis* the shareholders and creditors.

Investors' trust is gained in our system not through the independence between the management and the directors. It is rather built over enforceable liabilities provisions with severe criminal penalties. Moreover, according to Venezuelan law, shareholders appoint a "guardian" within the company—the statutory auditor, whose responsibility is to supervise the corporate financial performance on behalf of the shareholders.

#### IV. QUICK COMPARISON BETWEEN VENEZUELAN STANDARDS AND NYSE'S PROPOSED CHANGES

Basically, the main difference among US and Venezuelan corporate governance system is that in Venezuela, directors are jointly and severally liable *vis-à-vis* all shareholder, whereas in the US, directors have to comply with the so-called fiduciary duties of care, loyalty and disclosure to shareholders. Venezuelan corporate system is not based on the concept of "trusts" to understand the corporations. Since the Roman ages, corporations and associations exist and that has given the opportunity to build an independent concept.

Under Venezuelan law, administrators are liable as a matter of law, while under the US law, liabilities arise from the fiduciary duty that the administrators have with respect to the shareholders and third parties.

In the Venezuelan law, all directors have a personal and joint and several liability and no division into independent, professional or executive directors is present as the performance and contingent liabilities of the directors start at the moment they are elected.

- SPECIAL CONSIDERATION ON THE CONCEPT OF "INDEPENDENT DIRECTOR"

As mentioned above, the changes proposed by the NYSE as well as the Sarbanes-Oxley Act of 2002, are keen in the concept of Independent Director, but confidence of investors should be re-built in a system that would allow them to ensure that the company is driven by truthful and diligent officers, while the company is conducted by directors involved with the business, heading it to profits. We believe that Independent Directors cannot match both goals.

Independent Directors lack of strong ties with the business, which in turn, weakens their control over the management, too. Moreover, as the independence ought to be ensured, Independent Directors should hold office for a limited time.

Therefore, this situation may create instability, affecting the company's long term projects.<sup>40</sup>

There are two theories that address whether Independent Directors are appropriate to monitor the management and run the business of a company: (1) the management hegemony theory, and (2) the independent director responsiveness theory.<sup>41</sup>

Studies on the first theory lead to the conclusion that a board constituted by a majority of "independent directors" does not ensure an appropriate monitoring over management. Managers may still influence on board decisions basically for the lack of strong ties of outsider directors with the business, which allows the management to convince the board and to control the information, which deters board's monitoring. Moreover, independent director's lack of financial incentive may discourage their surveillance over the management.

On the other hand, the independent director responsiveness theory suggests that directors have other incentives. Even before the Sarbanes-Oxley Act, duty of care/duty of loyalty rules penalized lax directors and exposed them to potential criminal and civil liability, as well as to social controls. Although there is no statistical data, empirical studies suggest that independent director-dominated boards are more efficient in removing the CEO on the basis of financial performance.<sup>42</sup> Accordingly a study by Baysinger and Butler concluded that *firms that had relatively more outsider directors on their boards enjoyed better financial performance than firms with less outsider directors.*<sup>43</sup>

In any event, due to the lack of close relation between outsider directors and the limited time they will hold office, the concept of Independent Directors may jeopardize corporations' financial performance in the long run, as the board ought to be renewed from time to time.

If directors were jointly and severally liable *vis-à-vis* all investors, independence would not be necessary as each director would be personally responsible for the actions and omissions of the entire board, then no independence would be necessary. The jointly and several liability constitutes an incentive for

---

<sup>40</sup> See James D. Cox, *The ALI, Institutionalization, And Disclosure: The Quest For The Outside Director's Spine*, 61 Geo. Wash. L. Rev. 1232 at 1236 (presenting a survey shows that independent directors fell frustrated about the limited time, available information, manner of board operation, which don't allow them to evaluate the management adequately.) cited by Liu and Weisser, *Supra* at 42.

<sup>41</sup> See Liu and Weisser, *Supra* at 41 – 44.

<sup>42</sup> See Laura Lin, *The Effectiveness of Outside Directors As A Corporate Governance Mechanism: Theories and Evidence*, 90 Nw. U. L. Rev. 926 (1996); Also See Cox, *Supra* 1233 – 1234.

<sup>43</sup> See *Id.* at 922-927.

each director to act proactively in order to ensure a performance of a “good head of family,” and to avoid eventual penalties, as it occurs in the Venezuelan system.

Venezuelan system has an additional stage. If directors fail in complying with their obligations, the statutory auditor, who is appointed by the shareholders, may force them to comply and if the auditor fails, investors may act against the director, seeking relief.

## V. CONCLUSION

Changes proposed by the NYSE as well as the Sarbanes-Oxley Act of 2002, are keen in the concept of Independent Director, but confidence of investors should be rebuilt in a system that would allow them to ensure that the company is driven by truthful and diligent officers, while the company is conducted by directors involved with the business, heading it to profits. We believe that Independent Directors cannot match both goals.

Rather than outsider directors-dominated boards, if directors were jointly and severally liable *vis-à-vis* all investors, independence would not be necessary as each director would be personally responsible for the actions and omissions of the entire board, then no independence would be necessary. The jointly and several liability constitutes an incentive for each director to act proactively in order to ensure a performance of a “good head of family,” and to avoid eventual penalties, as it occurs in the Venezuelan system.

Should you wish further information on the above analysis, please do not hesitate to contact any of our lawyers listed below:

Luis Esteban Palacios  
lepalacios@palaciosortega.com

José Manuel Ortega Pérez  
jmortega@palaciosortega.com

Arturo H. Banegas Masiá  
abanegas@palaciosortega.com

Calle Guaicaipuro con Av. Ppal. Las Mercedes, Torre Forum, Piso 6, Ofic.  
A, Urb. El Rosal.

Master: +58 (212) 951 3333 Fax: +58 (212) 951 2851

Apartado Postal 1423 – 1010-A. Caracas – Venezuela.

E-mail: general@palaciosortega.com

## VI. TABLE OF CONTENTS

Extract.....	I
I. Introduction.....	3
II. Highlights of the amendments proposed by NYSE.....	4
A. Increasing the role and authority of independent directors.....	5
B. Tightening the definition of “independent” director and adding new audit committee qualification requirements.....	5
C. Fostering a focus on good corporate governance.....	6
D. Giving shareholders more opportunity to monitor and participate in the governance of their companies.....	6
E. Establishing new control and enforcement mechanisms.....	7
III. Highlights of Venezuelan legislation on Directors’ liabilities.....	7
A. Commercial Code.....	7
1. Administrators’ obligation of disclosing accurate financial information	9
2. Administrators’ duties vis-à-vis the corporation, its shareholders and third parties	11
3. Administrators’ duties and prohibitions regarding conflict of interests	12
B. Enforcement of administrators’ liabilities.....	13
C. Capital Markets Law.....	14
D. Other legislation.....	15
E. Conclusions from Venezuelan corporate governance system.....	16
IV. Quick comparisson between Venezuelan standards and NYSE’s proposed changes	16
• Special consideration on the concept of “Independent Director”.....	16
V. Conclusion.....	18
VI. Table of contents.....	19