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# FOCUS

## *Mediating Corporate Governance Conflicts and Disputes*

By Eric M. Runesson and  
Marie-Laurence Guy

Foreword from Mervyn E. King, SC



Global  
Corporate  
Governance  
Forum



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By Eric M. Runesson and Marie-Laurence Guy

Foreword from Mervyn E. King, SC

Global Corporate Governance Forum  
Focus 4

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## FOREWORD

By Mervyn E. King SC

A company is as integral to society today as the family unit is. Many of us spend the greater part of our lives in companies that provide our livelihood. We establish friendships and relationships through our work. Our children become friends of our colleagues' children, and our companies at times help us educate our children. Many of us, too, have become equity holders of the world's greatest companies, either directly or indirectly through investments of our pension funds. By pooling together human and capital resources efficiently and effectively, companies help economies achieve prosperity.

In modern governance, the board remains accountable to the company as the principal, but a board must make decisions that take into account the legitimate expectations of the company's stakeholders. A board must do so to be seen as a decent citizen in the community in which it operates.

Corporate governance concerns not only how a board steers or directs a company and monitors management, but also how managers manage. As Sir Adrian Cadbury explained, corporate governance is simply defined as how companies are directed and controlled. Corporate governance provides principles and practices to aid directors and managers in discharging their responsibilities. They must make business judgment calls on issues in which no one can be right all the time because one is dealing with uncertain future events and risks. But the decisions and conduct of directors and managers have a huge impact on society because companies today are so integral to society. Better companies mean better societies.

When a dispute arises, what is in the best interests of the company? The answer is to resolve it effectively, expeditiously, and efficiently. It is thus an important governance issue for the board to ask: Do we have an adequate mechanism to resolve disputes which may arise? If mediation is a tool to resolve conflict, why can it not be used to manage relationships? In corporations, the human resource director, for example, has become that manager of conflict between employer and employee. Mediation can become a management tool and thereby strive for conflict prevention rather than conflict resolution.

Managing business relationships between a company and important stakeholders must be of concern to a board practicing good governance. CalPERS, in advancing its corporate governance principles, provides that disputes among boards, management, shareholders, and regulators should, if possible, be resolved by negotiation, mediation, and, if not, then arbitration.

Mediation used as a management tool can add shareholder value. A New York dispute resolution organization points out that, if this is so, a board should be asking these questions: Does our corporation have a system of early-case assessment if such a dispute arises? Does the company have mechanisms to manage disputes around its critical procurement functions? Are there dispute management clauses in all critical contracts? As we do business across borders, with our reputation and goodwill at stake, do we have cross-border dispute mechanisms?

Mediation provisions in contracts put the dispute resolution framework in place at the relationship's beginning, not when a conflict arises. The parties to a contracted mediation become used to the process. Their minds actually become attuned to meeting, discussing, and identifying disputes and then resolving them because of an identity of interest – the preservation of the relationship to achieve agreed goals. Skilled mediators can help parties enter into contracts to avoid future conflicts. There is also the value of immediate knowledge, by having a mechanism to resolve the disputes when they arise. Imperfect knowledge recalled in litigation three to five years later actually adds fuel to the dispute, which could have been avoided if handled immediately.

When one thinks about contracts, board relationships, etc., they all involve trust, mutuality – a meeting of the minds. It must be in the interests of stakeholders to a construction contract, for example, to have an upfront agreement to encourage collaborative problem-solving in order to achieve agreed goals. Mediation as a management tool is good governance, building and reinforcing relationships based on trust and mutuality.

If this is correct, should a corporation's constitution have a negotiation, mediation, and arbitration clause? This would give providers of capital, directors, managers, employees, and stakeholders a readily available mechanism for dealing with their disputes. Their minds will be attuned to resolution to achieve contractually defined goals.

Mediation can result in the parties agreeing to novel solutions, which an arbitrator or a judicial officer can never do. It is quicker, less expensive, confidential, and preserves relationships, whereas litigation is adversarial and destroys relationships. The cost of executive time is saved and a dilution of focus on the business is avoided. When one is involved in litigation, there is the discovery of documents, recalling of events, a hunt for witnesses, interrogation, etc. – all very distracting for a business.

The duty of care of directors must involve an endeavor to ensure that there is a mechanism to manage disputes and, if conflict arises, to resolve them as effectively, expeditiously, and efficiently as possible.

In various countries such as Canada, a settlement conference must be held before the court registrar will give the litigants a trial date. So, effectively, mediation has become mandatory in Canada and other jurisdictions. I have been in the fortunate position of having sat as a judge, an international arbitrator, and mediator. I have witnessed that which is well-known, namely that with corporate disputes, over 80 percent in any jurisdiction is settled before reaching the court doors. On the court steps, 80 percent of the balance is settled. And of those that go to trial, several are settled after a few days of adversarial litigation.

There is the new constitution of commerce. The company is seen in a different light. It is integral to society and, as such, we can no longer continue to ignore the question of using alternative dispute resolution (ADR) mechanisms as a management tool. I have, together with the Global Corporate Governance Forum and other institutions, advised several countries on corporate governance codes. It never ceases to interest me that they may develop a good code, but if a corporate dispute arises, it can take more than a decade in some instances to obtain a trial date. A country needs a well-managed and trusted ADR institution to administer mediation and arbitration which, absent agreement of the parties, can determine the processes involved in the mechanisms.

If parties to contracts had their minds attuned to ADR mechanisms as a management tool, enormous corporate pain and suffering could be avoided. It is good governance to be in a position to resolve disputes efficiently and effectively, thereby preserving relationships.

I welcome the Global Corporate Governance Forum's initiative to lead groundbreaking work on the use of ADR mechanisms in the field of corporate governance. This publication constitutes an important first step in this direction, and I look forward to the development of a new toolkit that will address both the role of mediation in solving corporate governance-related disputes and the use of mediation as a board management tool. There is tremendous need for this, and I am very enthusiastic about the Forum's leadership in this regard.

A handwritten signature in blue ink that reads "Mervyn King". The signature is written in a cursive, flowing style.

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# MEDIATING CORPORATE GOVERNANCE CONFLICTS AND DISPUTES

by Eric M. Runesson and Marie-Laurence Guy

## *Introduction*

The processes by which companies are directed and controlled are subject to rules and standards embedded in countries' corporate governance frameworks and companies' by-laws. These processes are intended to help companies avoid trouble, outperform their peers, and reduce the costs of capital by assuring shareholders and bondholders that they can obtain a fair return on their investment.<sup>2</sup> If the rules are to fulfil these purposes, investors must rely on the adherence of a company's officers and directors to the rules.

## *The importance of enforcement*

In recent years, the degree of reliance or trust in corporations was widely questioned due to well-publicized corporate scandals. This, in turn, has underscored the importance of implementing strong, effective corporate governance frameworks. The quality of governance largely depends on the structures and rules in place. As a result, investors have been increasingly examining countries' corporate governance frameworks and companies' individual practices prior to making any investment decision. Investors review existing rules, the effectiveness of enforcement procedures, and companies' dispute resolution mechanisms.<sup>3</sup>

“There is no advantage in having good governance if, when a dispute arises, you haven't got a good method to resolve it. If it would take several years to bring a dispute to trial, it is vital that mediation mechanisms exist to achieve resolution in the kind of time frame that big business can live with.”<sup>1</sup>

The better that companies are governed, the more likely it is that they will have fewer disputes.

Yet, conflict is inevitable, and rules are not always respected. As part of a good corporate governance framework, investors need to have a suitable venue to seek redress and deal with emerging disputes in a timely, cost-effective manner. A good framework, therefore, requires having a reliable way to resolve emerging and existing disputes. According to the OECD<sup>4</sup>, a crucial prerequisite for effective enforcement is the availability of efficient mechanisms for dispute resolution. These mechanisms include the main court system, specialized courts, regulatory bodies, mediation, panel rulings, and arbitration.

Mervyn King

“...an important determinant of the degree to which shareholder rights are protected is whether effective methods exist to obtain redress for grievances at a reasonable cost and without excessive delay.”<sup>5</sup>

*OECD Principles of Corporate Governance, 2004*

Ideally, market supervisory authorities should have a sufficient amount of qualified staff and financial resources to carry out their tasks. Courts should be able to process cases within a year. Independent arbitration panels, consisting of accepted market experts, should be established to resolve conflicts between non-controlling and controlling shareholders and achieve market-oriented, self-regulatory solutions. Such panels, already implemented in Brazil and Jordan, should be able to make decisions within three months and, thus, relieve courts from unnecessary work that can be settled directly among the parties.<sup>6</sup>

### *The limits of judiciary enforcement*

In many countries, especially developing ones, judiciary enforcement remains weak. While much has been achieved in raising awareness and improving corporate governance rules and procedures, progress is severely constrained by poor regulatory and judicial enforcement. These constraints result from inadequate funding, the lack of trained staff, and systemic corruption. Ownership concentration often remains the most efficient response to weak enforcement of corporate governance rules.<sup>7</sup>

Yet, even in countries where the rule of law is effectively in place, court proceedings and other forms of adjudication (any process – including arbitration – where a private party obtains a judgement that can be enforced by a state) are costly and slow. Moreover, in some countries, the sheer volume of cases makes it impossible for judges to deal with each case thoroughly.

Most importantly, the quality and spirit behind corporate governance standards and principles cannot always be achieved through court activism. In an era when there is a growing number of national corporate governance codes, monitoring interpretation and compliance with these codes cannot be done within traditional court systems.

## *The increased use of alternative dispute resolution systems*

While conflict management can have positive results and help define the important issues needing resolution, full-blown disputes are always bad news for a company. They can lead to poor performance, scare investors, produce waste, divert resources, cause share values to decline, and, in some cases, paralyze a company. It is not surprising, then, that many corporate disputes have been settled outside of the courts,<sup>8</sup> and that companies are increasingly resorting to alternative dispute resolution (ADR).

Corporations have progressively engaged in the development of alternatives to traditional adjudication in response to weak enforcement, the lack of trust in the judiciary system, the high costs and delays of trials, the difficulties of enforcing non-binding standards, and reputational costs. The 1979 formation of the Center for Public Resources (CPR, now known as the International Institute for Conflict Prevention and Resolution) was groundbreaking. CPR brought together the corporate counsels of Fortune 500 companies and partners in leading law firms to develop commercially oriented dispute-resolution forums.

In the US, approximately 800 companies – including Time Warner, UPS, General Electric, the Prudential, and Coca-Cola – have since pledged to explore ADR before litigation whenever a dispute arises with a company that has made a similar pledge.<sup>9</sup>

In Colombia, out of the 97 companies that have adopted their own corporate governance code, 52 have included a dispute resolution clause promoting ADR. Arbitration is mentioned the most, followed by conciliation (mediation).<sup>10</sup>

Courts and judges themselves are increasingly seeing mediation's benefits and have started sending disputes to court-annexed mediation centers. In countries such as Uganda, Bosnia-Herzegovina, and Pakistan, these centers have encouraged ADR approaches for cases filed in court. This has the benefit of resolving either the whole or part of the case before litigation begins.

## *Mediating corporate governance conflicts and disputes*

This paper explores how consensus-based alternatives to adjudication – especially mediation – can help resolve corporate disputes and, consequently, contribute to improving corporate governance practices, strengthening investor confidence, supporting business continuity, and reducing the costs resulting from disputes.

Building on existing research, this paper:

- *Reviews* corporate governance conflicts;
- *Considers* the main characteristics of mediation and how mediation could help;
- *Discusses* obstacles to effective mediation; and,
- *Offers* specific recommendations on how best to introduce mediation in order to better implement good corporate governance practices.

Experience with how best to design, implement, and evaluate corporate governance-related dispute resolution is still at an early stage. There is little empirical data about the use of alternatives to adjudication in corporate governance disputes and the role that ADR can play in improving or enforcing corporate governance practices. The conclusions and observations below draw on discussions and materials presented at an international experts workshop held by the Global Corporate Governance Forum in Paris in February 2007.<sup>11</sup> The comments are largely based on theoretical research and ADR experiences in commercial disputes.

The alternatives to adjudication<sup>12</sup> considered in this paper all involve a neutral third party who cannot render a judgment or make an award. This third-party involvement distinguishes ADR techniques from ordinary inter-party settlement negotiations.<sup>13</sup> For convenience, the term mediation will be used to refer to the techniques in question. This excludes traditional arbitration, but may include non-binding arbitration<sup>14</sup> and other evaluative dispute resolution techniques (e.g., mini-trials and different forms of case evaluation where a neutral person tries to assess how a judge, arbitrator or regulatory agency may decide the dispute if the parties fail to agree).<sup>15</sup> The neutral party may even recommend a particular solution.<sup>16</sup>

Irrespective of traditional adjudication's shortcomings and mediation's benefits, this paper recognizes that any policy that favors alternatives to traditional adjudication should be seen as complementary to adjudication, and not as a substitute for it. In developing countries, further efforts should be made to strengthen the rule of law and the judicial system.

## 1. CORPORATE GOVERNANCE CONFLICTS AND DISPUTES

### *1.1. Boardroom conflict*

In the boardroom, conflict is often unavoidable – especially when the board is composed of independent-minded, skilled, and outspoken directors. This is not a bad thing. Board decisions should result from a process in which directors consider all the information reasonably available to them and engage in a vigorous debate.<sup>17</sup> These issues include strategy, company control, conflicts of interest, and executive compensation. A board that never argues or disagrees is most likely to be an inactive or passive board – in other words, a bad board that is neither fulfilling its oversight function nor carrying out its duty of care. This, in turn, can lead to a major corporate failure, such as the well-publicized bankruptcy case of WorldCom in the US. As established by the Chancery Court of Delaware in 1985<sup>18</sup>, a board that does not fully consider issues and available information before reaching a decision will fail to meet its fiduciary duties.<sup>19</sup>

Governance issues, standards, and requirements can be a fertile source for misunderstandings and conflict. Such examples include:

- the relationship between independent directors and the CEO;
- the line between oversight and management;
- the directors' need for information versus management providing too much or too little information; and,
- the balancing of the company's short- and long-term interests.

Each of these can lead to serious tension, which can be triggered or intensified by personality disputes.<sup>20</sup> Changes in the corporate ownership structure, poor corporate performance, a crisis, and disputes involving the company's stakeholders—these can lead to or exacerbate existing disagreements among board members. How those disagreements are handled will determine whether the discord will work itself out, stabilize or ripen into a dispute.

The traditional role of the chairman and eventually the lead director, or a board committee's head, is to address disagreements, resolve them, and, most importantly, keep them within the boardroom. Corporations hate to go public with

their disputes. Corporate disputes reported in the press inevitably have a negative impact on the way the company will be perceived by the public. Yet, in some cases, the dispute – if mishandled or if the chairman is part of the issue – will escalate as more board members are drawn into the conflict. More of the board's resources and time will be diverted. The conflict could metastasize into a full-blown dispute, which cannot always be contained within the boardroom. Such counter-productive disputes can disrupt company operations and lead to huge financial costs and losses.

It can happen that the board divides into highly polarized camps. This occurred with Hewlett Packard over its merger with Compaq. In the end, the merger happened, but much time and money was lost in the machinations. The dispute reflected badly on the company's reputation.

### **Situations Causing Conflicts within Boards**

- Transitional periods, such as those following a merger or acquisition in which a significant group of new directors has joined the board
- Lack of concurrence on the role of the board or its committees versus management's role
- A new CEO who has trouble building relationships with the board or certain directors
- Disagreement or dissatisfaction with content and conduct of meetings
- A difficult period for a company stemming from adverse publicity, poor earnings, stock performance, ethical lapses, or executive misconduct
- New long-term strategies
- Poorly performing directors
- Board dissatisfaction with CEO or other senior management performance
- Director engagement with corporate constituencies such as shareholders, communities, or employees.

Source: Jon J. Masters and Alan A. Rudnick, *Improving Board Effectiveness: Bringing the Best of ADR into the Boardroom – A Practical Guide for Mediators*. Washington, D.C.: American Bar Association, 2005.

## **Boardroom Conflict over Appointing New Board Members:**

Phoenix Timber Corporation

In 1985, a group of minority shareholders, led by board member Michael Hermann, sought to appoint three independent directors. The board's chairman then, Dennis Cook, wanted to keep executive members on the board. Hermann argued that the existing structure was counter-productive and lacked innovation and team spirit due to high internal competition. In a very stormy meeting, both sides claimed to represent the legacy of the former CEO. Hermann's request was neither heard nor followed; the board structure remained the same. The board's instability nevertheless continued and led to poor corporate performance. Phoenix had to announce a substantial loss for that year. This, in turn, led to the resignation of several directors, including its chairman, in the year following the dispute.

Source: R. Reuben, *Corporate Governance: A Practical Guide for Dispute Resolution Professionals*. Washington, D.C.: American Bar Association, 2005.

## **Dispute over a Merger:**

The Hewlett-Packard Case

In 2002, the board became embroiled in a fight over the company's strategy, specifically whether HP should merge with Compaq. Every director supported the merger except for Walter Hewlett, the son of HP co-founder Bill Hewlett. Soon after Walter Hewlett voiced his opposition, the family of David Packard, the other co-founder of HP, supported the Hewlett family's position. Together, the two families owned 18 percent of the outstanding voting shares. The rest of the board was very vocal in supporting the merger; they authorized letters to shareholders that discredited Walter Hewlett's opinion, saying that he was a "musician and academic" and "never worked for the company." Walter Hewlett responded by revealing that the CEOs of the two companies would receive a total compensation package of \$115 million if the merger is completed. HP management then accused Walter Hewlett of disseminating misinformation about employment terms of senior executives. They also clarified that the CEO of HP then, Carly Fiorina, would only get a sizable compensation package if she remained in her position for three years and delivered a significant increase in the share price. The dispute between Walter Hewlett and the board led to a costly lawsuit for both sides. Walter Hewlett was not reappointed as a director on the merged HP-Compaq company, and the company's image was hurt by the media campaign.

Source: R. Reuben, *Corporate Governance: A Practical Guide for Dispute Resolution Professionals*. Washington, D.C.: American Bar Association, 2005.

When disputes are discussed in the press or trigger litigation, they indicate a serious failure of governance. They demonstrate a mismanagement of conflicts within a corporation or between the company and its stakeholders (including shareholders, suppliers, clients, creditors or other constituencies). They reflect the inability of executive managers or directors to deal with issues and emerging conflicts. Litigation exposes a breakdown in relationships, often personal ones.<sup>21</sup>

## *1.2 Corporate governance-related disputes*

Disputes that qualify as corporate governance disputes (or disputes directly related to a company's governance) mostly involve the corporation's shareholders, board members, and senior executives. Although they may also influence a corporation's governance and should concern the board, disputes involving employees, other than senior executives, traditionally fall into the field of labor disputes. Disputes involving the company's outside stakeholders (e.g., customers and suppliers) are traditionally addressed through commercial disputes.

Corporate governance disputes may concern *inter alia*: conflicts of interest by board members or executives; the appointment of board members/executives; remuneration/bonuses to board members; discharging individual board members/executives; share valuation (in relation to an issue of new shares or bonds or a squeeze out); the terms of a proposed takeover; and, acquisition or disposal of company assets.<sup>22</sup>

From 2001 to 2006, 20 percent of the company law-related disputes settled by the International Chamber of Commerce concerned corporate governance-related disputes. Examples include: valuation of shares; disputes among shareholders; board remuneration; bankruptcy-related disputes; shareholder participation in decision-making processes; and, takeovers.<sup>23</sup>

As is clear from the list of examples compiled by the OECD, the concept "corporate governance disputes" is heterogeneous and includes many types of disputes – each with its own dynamics and focus.

## CATEGORIES OF CORPORATE GOVERNANCE-RELATED DISPUTES

### **Self-interested transactions**

Related party transactions, insider trading, conflicts of interest by board members, executives, and senior management

### **Annual accounts**

Disputes between shareholders and the board and/or auditor over the withholding of shareholder approval

### **Nomination/appointment of board members**

Disputes between shareholders and the nomination committee and/or the board over nomination and/or appointment of board members/executives, as well as the criteria for nomination/appointment

### **Remuneration/bonuses of board members**

Disputes between shareholders and the remuneration committee and/or the board over remuneration and/or bonuses of board members/executives, as well as the criteria for remuneration/bonuses

### **Share valuation**

Disputes between shareholders and the board and/or auditors on the valuation method in case of (a) squeeze out, and (b) share/bond issues

### **Takeover procedures**

Disputes between shareholders and boards regarding terms and conditions of a proposed takeover, and/or compliance with internal (articles of association) and/or external (listing rules, securities legislation, etc.) rules

### **Disclosure requirements**

Disputes between shareholders and boards regarding compliance with non-financial disclosure requirements

### **Corporate control (in M&A transactions)**

Disputes between shareholders and boards regarding a proposed acquisition or disposal of a substantial part of the company's assets

### **Minority shareholders' rights**

Disputes between majority and minority shareholders in squeeze-out scenarios or on nomination/appointment of board members

### **Bankruptcy/suspension of payments**

Disputes between shareholders and/or bondholders and boards and/or receivers in corporate restructuring

### **Share/bond issues**

Disputes between shareholders/bondholders and boards on dilution issues

### **Discharge of individual board members/executives**

Disputes between shareholders and board members/executives on individual discharge regarding their performance in the past fiscal year

### **Mismanagement**

Disputes between shareholders and boards on alleged mismanagement of the company

### **Non-compliance with corporate governance codes**

Disputes between shareholders and boards on the application of "comply or explain" principles as provided in corporate governance codes

### **Works' council**

Disputes between shareholders/boards and works' councils on the interpretation and applicability of works' council legal corporate governance-related rights

Source: L. Bouchez and A. Karpf, *Exploratory Meeting on Resolution of Corporate Governance-Related Disputes*. Stockholm: OECD, March 2006. Available at: <http://www.oecd.org>.

Without attempting to make a full classification, the following categories, which are based on the identity and characteristics of complainant and defendant, could usefully facilitate further analysis:

- **Disputes among corporate officers:** auditing, conflict of interest or remuneration issues.
- **Disputes among investors (shareholders and/or bondholders):** share valuation, a proposed takeover, acquisition or disposal of company assets.
- **Disputes between shareholders and the corporation:** voting rights or dividend payments.

### **Disputes between Shareholders and the Corporation:**

#### *The Bulgarian State v. E.ON Bulgaria*

As a 33-percent shareholder in the now foreign-owned regional power distribution companies, the Bulgarian state has received no dividend, Economy Minister Petar Dimitrov said on Wednesday. In his view, the interaction between the government and the current owners of the utilities leaves much to be desired. The sale of the seven regional power distributors generated EUR 693.2 million in sell-off proceeds. The contract for the sale of the regional power distributors in Gorna Oriahovitsa and Varna to Germany's E.ON was drafted in late 2004 and entitled the state to a 50-percent stake for 2003. If the deal was to be concluded before April 30, 2005, the 2004 dividend was to be distributed proportionally based on the equity holdings of the state and the investor. The sell-offs were finalized in early 2005. E.ON Bulgaria admitted the non-payment of dividend, but said it was due to the peculiar environment in which the regional power distributors operate. The power distributors faced high restructuring costs in the past two years while booming construction spiked electricity demand and entailed investment in the antiquated transmission grid, according to E.ON. The company said that the entire profit of the regional power distributors should be reinvested, quashing allegations that the earnings were expatriated. Austria's EVN, the owner of the regional power distributors in Plovdiv and Stara Zagora, said it has also reinvested all of its earnings.

Source: *Dnevnik*, "Bulgaria raps power distributors for dividend non-payment," August 9, 2007.

- **Disputes between the corporation and its corporate officers:** These typically concern fiduciary breach. The shareholders, acting in the corporation's name, may initiate such disputes. The shareholders then usually present a claim against the board for allowing misconduct or rule violation. Since shareholders

act as if they are the aggrieved party, these disputes are referred to as “derivative disputes.”

Other suggested ways of classifying corporate governance disputes include looking into:<sup>24</sup>

- **The activity that is the subject of complaint:** This classification could be divided between routine corporate governance procedures (e.g. disclosure of financial information, exercise of voting rights, declaration and payment of dividends), and extraordinary corporate events (e.g. takeovers, mergers and acquisitions, material related-party transactions; allegations of misuse of confidential information).

### **Dispute over the Exercise of Shareholder Voting Rights:**

*Robert McEwen v. Goldcorp and Glamis Gold*

Goldcorp and Glamis Gold entered into an agreement, the result of which may be the creation of one of the world’s largest gold-mining companies. After the transaction’s completion, current Goldcorp shareholders will own about 60 percent of Goldcorp and current Glamis shareholders will own 40 percent of Goldcorp. McEwan is the largest individual shareholder of Goldcorp and holds 1.5 percent of its shares. He asked the court to order Goldcorp to conduct a shareholder meeting to vote on the transaction and requests relief, including a declaration that Goldcorp has failed to comply with the requirements of the “Ontario Business Corporation Act.”

Goldcorp states that it has complied with all statutory and regulatory obligations and that the transaction is in the best interest of Goldcorp and, hence, does not require shareholder approval.

Glamis supports Goldcorp’s position and relied on the fact that the Goldcorp shareholders were not required to and would not vote on the transaction, since it would materially increase the execution risk profile and introduce a greater possibility that the deal would fail.

In conclusion, McEwen was not granted the orders he had requested mainly because he didn’t demonstrate irreparable harm. Goldcorp’s board exercised its business judgment in declining to seek shareholder approval as an exercise of its discretion, as found in the company’s by-law, in approving the transaction’s substance.

Source: *McEwen v. Goldcorp Inc.*, Ontario Superior Court of Justice (06-CL-6669). October 24, 2006. Available at: <http://www.canlii.org/en/on/onpsc/doc/2006/2006canlii35985/2006canlii35985.html> .

- **The nature of the alleged harm:** failure to receive required documents or information; misappropriation of corporate assets; inability to participate in annual meetings.
- **The type of remedy requested:** removal of individual from board; removal of external auditor; payment of damages or restitution; annulled transaction.
- **The type of companies involved:** family firms; state-owned enterprises; banks; listed companies; partnerships; cooperatives.

### Shareholder Dispute in a Non-listed, Family-controlled Company

When the company's founder died, it was like opening a Pandora box. He had developed a market-leading, world-class company, and left it with a professional management structure and a shareholder's agreement that included an arbitration clause. That failed, however, to prevent conflicts among the heirs. The founder's two sons soon engaged in a fierce judicial battle, which has lasted for more than three years. One brother is a big-spender, whose top priority is to control the company and finance his lavish lifestyle. The other has large cash reserves, refuses to negotiate, and favors adjudication. They only speak to each other through their lawyers. The board consists of six non-executive directors who were relatively successful in shielding the company from the conflict's effects, but didn't stay neutral. The board's meetings became a fighting arena where lawyers set most of the strategy. The judiciary has been ineffective because judges often prefer a "Salomon justice" to balance the involved parties' interests instead of making decisions to help the company. The almost-ruined brother eventually escalated the conflict by seeking help from a "white knight," who proved instead to be a "knight of darkness" because of his shady methods. Prospects worsened for both shareholders and the company. The stakes got higher and the company began suffering as the dispute expanded to involve other stakeholders and attracted media attention.

Source: Example contributed by Leonardo Viegas, member of various boards and director of IBGC, Brazil, 2007

Most disputes cannot be that easily categorized. A corporate governance dispute may concern a single issue. One example is a dispute over the right to damages due to a breach of fiduciary duties. A corporate governance dispute may also concern several intertwined issues; the solution of one issue affects the determination of an acceptable solution to all the other pending issues (polycentric disputes).<sup>25</sup> An example of this is a dispute regarding the terms of a proposed takeover.

## 2. HOW CAN MEDIATION HELP?

Whether in developed or developing countries, the traditional way to settle a dispute is by litigation. To some extent, court litigation of corporate disputes and, especially, cross-border disputes, has been replaced by litigation before international arbitration tribunals. Yet, traditional arbitration is litigation and, hence, burdened with the many drawbacks of court proceedings, including time and costs.<sup>26</sup>

Although mediation is relatively new and limited in corporate governance practices, it can prove useful in preventing disputes and could be used more systematically to efficiently and effectively deal with corporate governance-related disputes.

Mediation has successfully been introduced to solve commercial, labor, and cross-border investor disputes. Corporate governance disputes could increasingly benefit from this trend.

Mediation can help prevent and effectively deal with corporate governance-related disputes

The increase in the number of complicated disputes involving shareholders of listed companies and the inability of court systems to properly understand and litigate such cases

has, for example, led the Jordanian Code of Corporate Governance to recognize ADR as an optional right that shareholders can resort to in settling disputes with boards. The code mentions arbitration and mediation as possible procedures, but leaves the door open for other techniques. The Jordanian Securities Commission is running a pilot project to test the efficiency of ADR techniques.<sup>27</sup>

According to data collected by IFC's Commercial Mediation pilot project in Bosnia, only six percent of the cases filed in court between 2005 and September 2006 were related to corporate governance disputes and inadequate protection of minority shareholders' rights. During the same period, 220 out of 300 mediation agreements signed involved individual shareholders or corporate investors and led to the release of EUR 4.2 million.<sup>28</sup>

## 2.1 What is mediation?

Mediation is the most common ADR technique. The term is now internationally accepted. In some cases, these techniques are no longer depicted as “alternative” but instead are called “effective dispute resolution.”<sup>29</sup>

Mediation (or conciliation) is formally defined in Article 1 of the 2002 UNCITRAL Model Law on International Commercial Conciliation as, “a process ... whereby parties request a third person or persons ... to assist them in their attempt to reach an amicable settlement of their dispute arising out of or relating to a contractual or other legal relationship. The conciliator does not have the authority to impose upon the parties a solution to the dispute.”<sup>30</sup>

In more practical terms, mediation is about mending fences and finding a constructive approach to conflict resolution that brings to the surface issues of mutual concern; reviews the various angles of the issue at stake; and, allows the conflict to be used as a learning tool and as a basis for improved relations among the parties. Mediation enables parties to resume, or sometimes to begin, negotiations.

The Centre for Effective Dispute Resolution (CEDR) defines mediation as: “A flexible process conducted confidentially in which a neutral person actively assists parties in working towards a negotiated agreement of a dispute or difference, but with the parties in ultimate control of the decision to settle and the terms of resolution.”<sup>31</sup>

### **Settling without Admission of Liability:**

*Pirelli Armstrong Tire Corp. Retiree Medical Benefits v. Hanover Compressor Company, et al. (2004)*

“Plaintiffs accused Hanover of failing to disclose certain financial developments. Hanover settled the case without admitting or denying fault. As part of the settlement, Hanover agreed to several governance changes, including those that would give its institutional investors an automatic say in the nomination of directors.”

Source: National Association of Directors, USA, January 3, 2005. Available at: <http://www.nacdonline.org>

## Characteristics, Benefits of Mediation

**Cost:** Transaction costs are considerably lower than those of adjudication.

**Speed:** The process can start as soon as the parties agree to mediation. This rarely takes more than a few days.

**Quality:** Mediators can be selected according to their skills and field of expertise.

**Predictability:** The decision cannot be imposed on the parties.

**Control:** The parties own the dispute and craft its solution.

**Flexibility:** The parties can decide on the type of mediation and how to set up the procedure, including the timing and the location.

**Confidentiality:** Parties can disclose only what they wish to. The content of the mediation and information exchanged usually remains confidential, but the parties may agree on disclosing the agreement.

**Limited risk:** Parties do not have to settle and have the choice to seek another form of dispute resolution – including a court decision.

**Liability:** It doesn't have to be admitted to reach a settlement.

**Non-binding:** While the process is non-binding, the outcome may be enforced as a contract or registered as a consent judgment.

**Voluntary:** Unless required by court, the parties do not have to go to mediation. In all cases, parties do not have to settle.

**Perspective:** Parties can gain a more objective, detached view of their positions before their views solidify and the battle lines are drawn, which makes a resolution more difficult to achieve. Further, the parties' circumstances may have altered from those prevailing when the conflict occurred, thus allowing for an interim assessment.

Mediation is flexible and allows the parties to control both the process and the outcome of the dispute. The parties own their dispute and own the solution. One important aspect of mediation is that liability doesn't have to be admitted to reach a settlement.

The process is typically initiated through an exchange of written submissions. Since the mediator does not evaluate the dispute's substance, the written submissions are brief, unless the parties have a need to inform each other about their positions. The next step usually involves arranging a joint meeting. After a brief opening, the mediator meets privately with each party. These meetings may be conducted through "shuttle diplomacy." The mediator asks open-ended questions about participants' needs and interests. Often, the mediator learns information that the party does not want the other side to know. The information often concerns priorities and preferences that could help forge a solution. A mediator who receives such information may gradually discover the contours of an optimal agreement that the parties would, otherwise, have failed to see in ordinary negotiations because of their (rational) unwillingness to share information for fear of being exploited by the other side. The mediator gradually moves from exploration to negotiations. The negotiations may be conducted in the presence of both parties or initiated in private meetings. During the negotiation, the mediator monitors the communications process and tries to eliminate practical and psychological obstacles to a settlement. It is critical that the mediator always remains neutral and avoids being seen as favoring one party or a solution.

There are many ways that mediation can be used as an efficient, effective way to prevent or resolve disputes while avoiding costly, timely, and relationship-damaging litigation. Various types of mediation include consensus-building, fact-finding, evaluation, mini-trial, etc. As there is abundant literature on these various approaches, this paper doesn't discuss their respective characteristics, advantages, or disadvantages. Annex A describes various ADR techniques and Annex B provides references for further reading.

## *2.2 Mediation vs. Litigation*

Unless it has been made binding by a contract or imposed by a court, mediation is a voluntary process triggered by such external constraints as time, reputation, cost, and the uncertainty of an imposed decision. Parties engage in a private, cooperative process that enables them to influence each other to act in a way that is mutually beneficial and, thereby, controls damage for both sides. Instead of coming out of a dispute with a winner and a loser, mediation helps create a win-win solution. Because of its relatively flexible approach, mediation can often produce outcomes that better satisfy participants than adjudication does. In some cases, an unforeseen creative solution might even emerge. Adjudication is often said to lead

to an adversarial atmosphere that can hurt or break down ongoing relations. This risk is clearly diminished with a mediated approach to a dispute.

Moreover, by holding up a more objective and detached mirror on their positions to executives who become devoured by personalized or corporate conflict, mediation can help provide a useful reality check. By doing so, it constitutes a good risk-management technique. This means that mediation may not be only about win-win outcomes, but can help all parties face up to the worst losses or risks (whether in terms of costs or reputational impact) they may face if they fail to settle.

Another often underplayed factor is that, in most mediations, the parties' circumstances will have altered from those prevailing at the conflict's onset. Mediation thus allows for interim reassessment that may be otherwise hard to achieve once battle positions have been drawn.

### **Mediating Corporate Governance Disputes:**

*K.M. Patel and another v. United Assurance Company Ltd.*

Company Cause No 5 of 2005 (Commercial Court, Uganda)

In this case, two Asian shareholders, the Patel brothers, filed a minority petition against one of Uganda's largest private insurance companies. They allege that their 40-percent shares in the company had been wrongfully and illegally diluted during the company's restructuring and sale without prior notice. United Assurance officials requested the court to reject the case because it was based on false accusations and lacked proper grounds to petition.

With the consent of both parties, Commercial Court Justice Geoffrey Kiryabwire offered to mediate the case. "Both parties should sit down as business partners and come to an amicable understanding because at the end of the day, you may find that no one has benefited if the company has wound up."

As a result, the mediation was successful and led to a consent judgement in which the insurance company bought out the two shareholders and settled the dispute. The company's CEO later declared: "We are happy this has been amicably concluded. I believe the Patels as the founders will leave us with their blessings...."

Source: G. Kiryabwire, "Mediation of Corporate Governance Disputes through Court-Annexed Mediation: A Case Study from Uganda." Paris: 12, February 2007. Available at: <http://www.gcgf.org> .

Although they may be “dressed up” as conflicts over rights and obligations, most disputes—including corporate governance disputes—have at least three dimensions; legal, commercial, and emotional. These dimensions may not be equally important to the parties; their relative importance may vary from one dispute to the other. Interests and business needs can be the real drivers behind a legal position.

It is an important feature of mediation that there is room to consider all dimensions of the dispute. By contrast, the adjudicative process only considers a case's legal dimension. Because of its broader view on disputes, a mediated decision is more likely to be perceived as fair by all parties. To explain how mediation works, practitioners often use the following example:

Two children are fighting over the last orange in a bowl. Each argues that they are entitled to the orange since they took it first. This seems to be a matter of rights. The rule is: *“He who takes possession of something first shall have it.”* It is not possible to say who is going to win if the dispute were to be adjudicated. The outcome is uncertain and depends on how the judge will perceive the evidence. Who can prove that they are right? One way to resolve the dispute is through a position-driven negotiation that would result in splitting the orange in halves. This seems fair, since both parties are facing uncertainty as to the possibilities to prove early possession. Another way to resolve the dispute would be to have a mediator help explore the interests behind the legal position and facilitate an interest-driven negotiation that may reveal that one child claims the orange because he wants to eat it while the other child wants it because he is going to make jam. Each can have full satisfaction if one child gets the meat of the orange and the other gets the peel.<sup>32</sup>

Mediation can be designed to allow for a desirable degree of openness and therefore has a greater potential to unlock hidden values in multi-issue disputes. It, therefore, seems that adjudication, by missing some issues, can result in lost value.

Adjudication is said to be binary in character because its decisions completely favor one party over another.

Adjudication is especially inadequate in multi-issue disputes where the challenge is to find an optimal solution that enables the parties to make trade-offs. The parties who bring a multi-issue dispute to adjudication may end up with a 50/50 decision. With mediation, however, the total “pie” can be enlarged, meaning that both parties

may get more than 50 percent of the disputed value. The parties who successfully negotiate a solution may get a 70/70 decision (or, depending on bargaining skill, 85/55 which still makes both better off compared to the alternative of adjudication). The potential to find win-win solutions in multi-issue negotiations increases if the parties can work in an atmosphere of transparency and divulge private information about priorities and preferences without fear of being exploited.<sup>33</sup>

Adjudication requires that the parties entrust the dispute's resolution to a stranger, whereas the resolution depends entirely on the parties in ADR.<sup>34</sup> The adjudicator draws his or her authority from the principle of objectivity – particularly in rationalizing the judgment. This may explain the three main procedural differences between adjudication and mediation:<sup>35</sup>

**First, the adjudicator has little room for the application of rules that depend on the personal characteristics and the relation between the parties – even if the parties think that such norms are of relevance.** Further, when rules collide, the adjudicator tends to choose one rule as superior rather than trying to find an in-between solution that is characteristic for mediation and negotiation.

**Second, the adjudicator will treat alleged facts as either true or false under some burden of proof rule.** With mediation, the parties can recognize that the other party's allegations may have some value and, with this in mind, accept an in-between solution.

**Third, the choice of remedy for breach against a rule is constrained in the adjudicative process.** The principal remedy is monetary compensation when specific performance of promises and duties is not feasible. With mediation, the gamut of remedies is in principle limited only by the parties' imagination and by practical considerations. Sometimes, an excuse is sufficient to settle a dispute.<sup>36</sup>

These three main procedural differences between adjudication and ADR demonstrate mediation's advantage over adjudication in many legal situations.

With adjudication, disputes typically have a distributional zero-sum outcome: “more for you is less for me.” The total value at stake, or the “pie,” is always the same size – irrespective of its distribution. In contrast, mediation is graduated and accommodative. The total pie can be enlarged, meaning that both parties can get more than 50 percent of the disputed value.

More so than process, the main reasons that drive businesses towards mediation are time and cost constraints. The delays and litigation costs have reached proportions, at least in some countries, that make it questionable to say that access to the courts can provide investor redress.<sup>37</sup> The data presented by the World Bank in *Doing Business 2006, Enforcing Contracts*, is illustrative in respect of time and direct costs for resolving simple debt collection disputes by court adjudication.<sup>38</sup>

### **Time and Direct Costs for Resolving Simple Debt Collection Disputes by Court Adjudication**

| Region                    | Time (days) | Cost (% of debt) |
|---------------------------|-------------|------------------|
| East Asia, Pacific        | 477.3       | 52.7             |
| Europe, Central Asia      | 408.8       | 15.0             |
| Latin America, Caribbean  | 641.9       | 23.4             |
| Middle East, North Africa | 606.1       | 17.7             |
| OECD                      | 351.2       | 11.2             |
| South Asia                | 968.9       | 26.4             |
| Sub-Saharan Africa        | 581.1       | 42.2             |

Source: *Doing Business, Enforcing Contracts*, World Bank 2006.

It can be assumed that time and costs increase with the dispute's complexity, and that mediation can be decisively less costly and less time consuming than adjudication.<sup>39</sup> The direct costs of any dispute resolution mechanism mainly depend on the need to obtain and convey information to the other party and to the third neutral person, whether that is a judge, an arbitrator or a mediator. It seems that mediation techniques, by minimizing the need for the parties to inform the third neutral person about the substantive issues, have the greatest cost advantage over adjudication. Mediation is, therefore, likely to work best when information asymmetries between the parties are minimal. A notable inter-firm dispute that can illustrate this point is the court battle between Texaco and Pennzoil in the mid-1980s.

Yet, transaction costs do not just refer to expenses associated with dispute resolution (direct costs). They also include the time value of a speedy resolution, the aggravation and loss of focus that people in an organization may feel when involved in a dispute, bad will, etc. It is sufficient to say that a monetary equivalent of the transaction cost is what you would maximally pay to a sorcerer, if you could find one, to swing his wand and present an instant resolution to the dispute.

### **Time and Costs of Disputes:**

#### *Pennzoil v. Texaco*

In 1985, a Texas state court jury unexpectedly found Texaco liable to pay USD \$11.12 billion to Pennzoil for inducement of breach of contract. Following this, the parties got entangled in procedural moves and counter-moves for about three years. Studies of how the market value (stock price) of the two parties developed during this period revealed that setbacks for Texaco market value decreased. Pennzoil's market value increased, but not so as to set off Texaco's loss. In November 1987, the two companies had lost more than 30 percent of their joint value before the dispute broke out. On December 11, 1987, a settlement payment of USD \$3 billion was considered by the parties. The settlement proposal resulted in increased market value for both parties. Texaco's value increased by USD \$898.3 million; Pennzoil's value increased by USD \$264 million. A settlement was eventually reached in April 1988. It appears that the risk of being held personally liable made Texaco's management reluctant to accept a settlement as long as there was a small chance that Texaco could win. It was not until Texaco's directors were given discharge that the settlement went through.

Source: Robert H. Mnookin & Robert B. Wilson, "Symposium on the Law of Economics of Bargaining: Rational Bargaining and Market Efficiency: Understanding *Pennzoil v. Texaco*," *Virginia Law Review* 75 (1989): 295; David Cutler and Lawrence Summers, "The Cost of Conflict Resolution and Financial Distress: Evidence from the Texaco-Pennzoil Litigation," *Rand Journal of Economics*, 19 (1988): 157.

### *2.3 Mediation Tools and Skills<sup>40</sup>*

More than helping solve corporate governance disputes in a more efficient and effective way, mediation can also help manage conflicts and, therefore, prevent disputes. Conflict has the potential to be constructive, by bringing to the surface issues, interests, perspectives, and concerns that need to be addressed so that the corporation can perform more effectively and efficiently. The challenge for effective boards today is to harness the potential for conflict, which would lead to constructive outcomes rather than destructive ones.<sup>41</sup> It is a director's fiduciary duty to resolve disputes as efficiently and effectively as possible. As Amanda Bourgardt, head of the Southern African Institute of Director's Centre of Mediation, explained, "Directors should be compelled, at least by their consciences, to put aside their emotions and find an alternative way to resolve the dispute."<sup>42</sup> This makes mediation an especially relevant process to use in the boardroom.

Board effectiveness often suffers from too much or too little information. Developing an adequate system to inform directors is important for good corporate governance. At the heart of the problem can be a lack of agreement on several factors, including directors and managers' understandings of a board's oversight role; its monitoring duties; performance indicators versus operation facts; and, decision-making criteria.

Mediation skills and techniques can improve governance and board effectiveness by fostering discussions and collaboration on decisions, while surfacing and working through disagreements and personality issues. By doing so, the directors build stronger, more constructive working relationships.<sup>43</sup>

### **Mediation Techniques to Improve Board Governance**

- Identifying interests as opposed to positions
- Surfacing issues, both emotional and factual, involved in potential or actual disputes
- Helping the parties focus on their long-term objectives and interests
- Using procedures that encourage collaboration and emphasize flexibility
- Promoting discussions and encouraging free flow of ideas
- Uncovering information relevant to the problem and its solution
- Facilitating the parties' collaborative development of their own solutions, rather than imposing solutions on them
- Using a third party, when appropriate, to facilitate and broker communications

Source: Jon J. Masters and Alan A. Rudnick, *Improving Board Effectiveness: Bringing the Best of ADR into the Boardroom – A Practical Guide for Mediators*. Washington, D.C.: American Bar Association, 2005.

A third-party facilitator will most likely not be invited to join boardroom discussions or otherwise be involved in the board's decision-making process. Most boards will be reticent to have a dispute resolution professional, whether a mediator, facilitator or an external consultant, attend regular board meetings – and rightly so. As mentioned in the previous section, it is the role of the chairman, lead director, or a committee chair, as the person presiding over a meeting, to facilitate meetings and create an environment where open, frank discussion is encouraged. Directors should receive appropriate training on conflict resolution and mediation techniques as part of their ongoing professional education programs. Institutes of directors, or other organizations training directors, could include a module on dispute resolution

skills and procedures in their curricula. After directors better understand mediation goals and processes—the board may be more prone to hire a professional facilitator to mediate governance disputes.

Even with adequate training, disputes cannot always be contained and managed within the boardroom. This is true mainly because directors, even though they may be independent, are not neutral parties. The most effective approach, then, would be to involve a neutral, third-party dispute resolution professional to assist the board. In cases where there are signs of poor board management and miscommunications between the board and management, an outsider with appropriate corporate governance skills may help establish a more effective flow of information and a framework for effective, collaborative decision making. Such a facilitator would be expected to have the necessary objectivity in relaying concerns between management and the board, working with both groups to arrive at an appropriate solution. The facilitator in those cases typically acts as a mediator who sounds the board's and management's viewpoints and requirements, and then ties them together to help reach an agreement on the best processes for the board's operation and the company's performance.

A facilitator can be invited to board evaluation or induction meetings, annual retreats or meetings dedicated to long-term strategy planning. During a retreat, for example, the facilitator/mediator can collect directors' views and put them on the table for discussion without attribution. The facilitator's task may end after the issues have surfaced, putting directors in a better position later to craft their own resolution through internal leadership.

The facilitator or mediator should be an expert on corporate governance and knowledgeable about board practices. To carry out their job properly, especially with a skeptical board, the facilitator needs to have sufficient credibility to gain the board's trust. Mediation of corporate governance conflicts could, therefore, typically be carried out by institutes of directors, corporate governance centers or corporate governance consultants. This doesn't mean that the selected corporate governance expert or advocate doesn't require any mediation skills. On the contrary, professional mediators would even argue that it is more important to have

By focusing on “interests”  
as opposed to “positions,”  
by looking at the future  
rather than the past, and by  
promoting open discussion,  
mediation as a management  
tool can greatly improve the  
quality of board meetings.

the appropriate mediation skills and experience in helping solve disputes than to be an expert in the industry in which the parties operate.

Mediation has often been regarded as a variation of arbitration and handled by lawyers. Adjudication is unquestionably a matter for lawyers, but mediation requires different skills. Although lawyers can become good mediators (and law practices increasingly offer mediation services), they are trained to support clients, beat opponents' lawyers, and win a dispute. Other kinds of professionals (e.g. business consultants, investment analysts, accountants, auditors, board directors, and managers) could develop the skills required to be a good mediator.

### **Skills Required for Mediating Corporate Governance Disputes**

- Impartiality
- Independence
- Diligence
- Discretion
- Reputation
- Responsibility
- Tact
- Interpersonal relations
- Experience with corporate governance disputes
- Conceptual understanding of corporate governance
- Understanding of corporate governance issues
- Knowledge of corporate legal framework

Source: Rafael Guillermo Bernal, "Mediating Corporate Governance Disputes," Paris: February 12, 2007. Available at: <http://www.gcgf.org> .

It may be difficult to find individuals with all the skills listed above, so the board or parties to the dispute will have to decide on the skills that matter most when jointly selecting and agreeing on a mediator. Co-mediation, or a mediator with an assistant who has corporate governance expertise, may constitute the best solution.

In countries where no institutes of directors or corporate governance organizations have been established, corporate governance disputes may well be picked up by commercial mediation centers, chambers of commerce, law firms, and even business schools or universities that have a conflict resolution department (e.g. Harvard University in the US or the European Institute of Research and Education on Negotiation based in France [Institut de Recherche et d'Enseignement sur la Négociation en Europe, IRENE]). In this case, it would be most beneficial for mediators to receive additional training in the field of corporate governance.

Last, but not least, stock exchanges could offer mediation services to their members to help identify and possibly solve issues related to the understanding of listing requirements and the implementation of best practice codes.

### 3. LIMITATIONS AND RECOMMENDATIONS

#### *3.1 Obstacles to Effective Mediation*

Mediation is only a practical alternative if both parties are willing to try to resolve the dispute with good faith in a speedy manner. When a plaintiff seeks to extort concessions by putting forth a bad faith claim, or a defendant seeks to delay an unavoidable payment by dilatory court tactics, there is little room for mediation.

There is also criticism that mediation could turn into a time-wasting fishing expedition. In jurisdictions where court-annexed mediation has been introduced, fines can be levied on parties who purposefully delay mediation or use it as a way to defer a court judgment.

#### *Negotiation Barriers*

Although the parties are willing to try to resolve a dispute in good faith, they may fail to settle their disputes for economic, strategic or psychological reasons.

The classical economic rationale to explain why people dismiss mediation or fail to settle is that they have divergent beliefs about the likely outcome of adjudication.<sup>44</sup> This is based on the belief that parties only settle if a settlement is better than the expected utility of adjudication. The expected utility is a function of a party's degree of risk aversion.<sup>45</sup>

People may, however, also fail to settle for strategic reasons. A party can be expected to ask why a settlement offer should be accepted if they believe that it can be accepted later, providing an opportunity for a better offer to emerge. The parties fail to split the pie because each misjudges the other's willingness to compromise.<sup>46</sup> The situation may be worse if the parties are represented by lawyers who are motivated by their own self-interest and think that they can earn more by protracted litigation than by a quick settlement.<sup>47</sup>

The parties must also overcome a number of psychological barriers to settlement.<sup>48</sup> Among the psychological – or cognitive – explanations for why settlement negotiations fail is the tendency toward partisan perception and over-optimism.

A good mediator may often be able to leverage or deal with these obstacles by advising the parties (without divulging any confidential information) to look at the disputes from the other side's perspective.

To mention just one example of how over-optimism and partisan perceptions can work: In an experiment, two groups of managers were given exactly the same

information regarding an insurance dispute.

They were asked to evaluate as objectively and correctly as they could the probable outcome if the matter went to litigation. The members in the first group were told that they represented the insurance company, while the others were told that they represented the insured. The two groups arrived at entirely different results and focused on different pieces of information.<sup>49</sup>

It is precisely the role of a good mediator to help reduce the impact of settlement obstacles.

### *The threat of costly litigation as a game of destruction*

The rules governing the distribution of the adjudication costs may affect the incentives to either pursue weak claims – those with a low probability of success – or settle.<sup>50</sup>

There are basically two systems for cost distribution. According to one principle (known as the American rule), each party covers its own costs. According to the other principle (known as the English rule), the loser compensates the winner for the costs. It has been argued that the English rule is better at discouraging suits, given the low-probability of prevailing plaintiffs, but that the American rule is better if one takes into consideration that the parties can settle the dispute before adjudication.

A party who is seemingly willing to initiate litigation and also appears able to afford the costs, can gain leverage in settlement negotiations against a less wealthy or more risk-adverse party. In other words, even if the claimant has a weak case, by threatening to go to court, they can push a defendant who doesn't want to bear the costs and risks of a court case to settle.<sup>51</sup>

The incentive, for example, of a group of shareholders to bring forth a low-probability-of-prevailing claim against the corporation that they own shares in can be reduced or eliminated if the defendant beforehand commits to an anti-settlement policy. Thus, an interest in avoiding plaintiffs' attacks with weak claims can be an

argument against adopting a policy in favor of ADR. However, a policy that favors mediation can be flexible. Such a policy could, for example, simply promote as a general rule the use of mediation as a first instance. This doesn't mean that parties have to settle or even agree to mediate in all cases.

In many cases, the problem is that neither the plaintiff nor the defendant knows enough to calculate the odds of either one's success at the outset. As the parties prepare for adjudication, they learn more about the strengths and weaknesses in the case. The possibility to start adjudication based on claims with initially unknown chances for success is therefore akin to a real gamble. The adjudication costs do not come at once; instead, they accrue gradually, as does the information about the odds. The plaintiff can always drop his claim if he considers that the chances for a settlement or a favorable judgment are too small. If he decides to drop the claim, he has to carry his own costs and, in most legal systems, those of the defendant up to that point. However, the plaintiff has gained the value of knowing more about the odds and this knowledge may well outweigh the costs.<sup>52</sup>

### *Agency costs*

The pros and cons of mediation in the corporate governance context can hardly be discussed without considering the agency costs, which a corporation incurs when corporate officers and shareholders have divergent interests. Also, because shareholders cannot fully observe the quality of the corporate officers' work, they incur agency costs to help monitor company management.<sup>53</sup>

Some of the previous observations on the threat of adjudication can probably be explained by the agency theory.

The risk for adjudication has been identified as a driver to under-pricing initial public equity offerings.<sup>54</sup> Furthermore, corporations that are defendants in adjudication proceedings with potentially large damage awards, may also attempt to reduce the size of those damage awards by making income-decreasing accounting choices.<sup>55</sup> Similarly, there seems to be a tendency for managers who are rewarded with options – which in itself may increase the probability of disputes<sup>56</sup> – to manipulate earnings upward, exercise more options, and sell more shares during litigation periods, leaving post-adjudication stock returns abnormally low.<sup>57</sup> There is also substantial research showing how adjudication risks are an incentive for delaying disclosure of bad news to investors. The results, though, are open to interpretation.<sup>58</sup>

Although adjudication is not a positive net-present-value event, settlement by agreement may be even worse due to the agency costs. In an empirical study by Bruce Haslem, the resolution of disputes by adjudication dominates settlement of litigation from the point of view of the shareholders as publicly listed defendants. This holds, even if the defendant loses. Why? Shareholders (the market) suspect that the corporate officers who settle disputes by agreement are doing it in their own interest – not the corporation's. The difficulty of observing the agents' diligence is considerable. The study also concludes that the shareholders (the market) react more negatively to settlements involving firms with a higher potential for agency costs.<sup>59</sup>

### **Agency Conflicts between Shareholders and Management**

“Based on large sample of events, I find that there is a negative market reaction to settlements, and that firms that settle underperform for up to a year following the resolution of the lawsuit, in comparison to other firms that continue with the litigation process until a judgment is received. Clearly, it does not take a year for the market to react to the initial event, so this pattern might indicate that firms that settle could have structural deficiencies that lead them to settle litigation sub-optimally, as well as perform poorly following litigation. I attribute these inefficiencies to agency conflicts between shareholders and management [...].

“The result ... implies that for firms with higher agency conflicts between shareholders and management, shareholders would prefer that the firm go to trial where the outcome is less likely to be manipulated by management. This preference is not necessarily based on whether the firm is innocent or guilty, but rather on to what degree management can be trusted to act on the shareholders behalf. The fact that firms with weaker corporate governance settle earlier in the litigation process also implies that corporate litigation does help reduce information asymmetry between management and the shareholders, providing a benefit to shareholders despite the cost of litigation.”

Source: Bruce Haslem, *Managerial Opportunism during Corporate Litigation*, August 30, 2003. SSRN. Available at: <http://ssrn.com/abstract=442060> .

The findings presented in Haslem's study appear to support an argument against all forms of ADR that require confidentiality and thus make it more difficult for shareholders to monitor whether a decision to settle is made in the best interests of the shareholders and bondholders. An example of a settlement made in the managers' interest would be if a low-probability claim is pursued so that the

defendant's management can avoid personal scrutiny in litigation. In another scenario, management may also block a settlement if it makes a loss definite and if the managers feel that they risk personal liability in a derivative shareholder action for damages.

In the US, the use (or threat) of class action lawsuits, is increasingly used by shareholders as a mechanism to influence companies' governance. In these cases, a shareholder brings a lawsuit against a company on behalf of other shareholders in the same class. This provides a mechanism to pursue financial compensation. Approximately 200 class action lawsuits are filed in federal courts each year.<sup>60</sup> However, the costs involved for the companies can actually be a deterrent for large investors and companies. All shareholders ultimately bear the litigation costs involving the company in which they have a stake.

### **Cost of Class Action Lawsuits in the US**

"The possibility of being sued for huge sums, while also bearing high costs of legal defence, has brought many companies to a moment of reckoning that mitigates against registering their securities in the United States. The total value of settlements in securities litigation class action lawsuits has continued to increase from \$150 million in 1997 to \$9.6 billion in 2005. Given the risk and threats to their bottom line, regrettably, foreign companies are simply concluding that it's not worth it to come to our market".

Source: Marshall N. Carter, Chairman of the NYSE, "America's Capital Markets: Maintaining Our Lead in the 21st Century," Testimony before the Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, United States House of Representatives, Washington DC, April 26, 2006. Available at: <http://www.nyse.com>.

The argument against mediation may be stronger for intra-firm disputes and disputes among the corporate officers, since the potential for agency costs are greater. The argument against mediation, however, is weaker for disputes between a shareholder and the corporation. It is particularly weak in derivative disputes between the corporation and its managers, where the shareholders can monitor the quality of the settlement and decide whether it should be accepted.

Some studies support the view that the threat of adjudication may not effectively alleviate the corporate agency problem.<sup>61</sup> While the threat of litigation may curb the agency problem somewhat, the threat is weaker when it comes from an isolated shareholder. This is due to the collective action problem; the adjudication costs usually outweigh the shareholder's *pro rata* benefit, although the costs are less than

the aggregate gain across all owners. The problem can be remedied by providing incentives to lawyers to pursue such claims on a contingency basis. The solution, however, gives rise to a lawyer-client agency problem.<sup>62</sup>

It has been noted that the agency problem is compounded when the interaction between the legal regime on indemnification and directors' and officers' liability insurance is taken into consideration. Individual expenditures on settlements or adjudication may not be indemnified, while liability insurance policies exclude deliberate dishonesty or fraud. Individual directors and officers have a powerful incentive to settle, even if the case has no merit, to avoid the possibility of an adjudication of fraud invalidating the insurance policy, however remote, and thereby guarantee no out-of-pocket expenditures.<sup>63</sup> This can lead to overcompensation of weak claims and under-compensation of strong claims.<sup>64</sup>

These studies' results do not mean that mediation should be avoided because of agency problems. But they do highlight the importance of transparency and how the parties to the disputes decide how to communicate with outside stakeholders who might be affected by the decision without being part of the decision-making process. In some cases, the issue of transparency may be mitigated by allowing for an observer in the mediation. This furthermore shows the importance of the board's role and the need to define and implement clear policies on how best to communicate, disclose, and address internal and external disputes.

Choosing the right approach to dispute resolution will depend on several factors, including the dispute's nature, the parties involved, and the importance they attach to the dispute.

### **Criteria to Consider for Dispute Resolution**

- Finality of the solution
- Effect on future relations
- Speed
- Transparency
- Effect on related stakeholders
- Satisfaction with the outcome
- Transaction costs<sup>65</sup>

## *The issue of enforcement*

Adjudication typically results in a final decision being imposed on the parties; the winning party can enforce it against the losing party's will. One major criticism against the use of mediation remains the problem of enforcing the agreement. A claimant who accepts a settlement agreement in lieu of a judgment seems to run the risk that the other party may breach the agreement. The claimant must then initiate adjudicatory proceedings in order to transform the settlement agreement into an enforceable judgment. This risk is naturally mitigated by the fact that voluntary enforcement of the decision is much higher since it was achieved by an accord between the two parties. The effect on future relations, the satisfaction with the outcome, and the reputation aspects may be sufficient to ensure "self-enforcement."

Moreover, the demand for a final solution does not, however, have to be an argument against considering mediation for corporate governance disputes. A court can often confirm a mediated solution in a judgment. In some countries, it may also be possible to ask a mediator to confirm the settlement agreement in an arbitration award.<sup>66</sup>

Enforceability of mediated agreements is also foreseen under Article 14 of the "2002 UNCITRAL Model Law on International Commercial Conciliation."

Some jurisdictions have adopted a system by which courts may refer cases to mediation. If the parties come to a satisfactory solution, the result would be registered as a court consent judgment for purposes of enforcement. If the mediation is not successful, litigation remains an option.

In other words, even though there may be some obstacles to mediation, it doesn't hurt to try. There is no obligation to settle, and either party can always abandon the process to seek redress in the courts. Mediation doesn't take much time, and there is more to win than to lose. In most jurisdictions, parties can file a case in court and decide to try mediation while the case is still pending. Even if the dispute doesn't settle, most parties find that mediation has helped clarify the issues and avoid some unnecessary entanglements in court proceedings.

### *3.2 The Way Forward*

Corporations and their stakeholders will need to learn more before ADR mechanisms can be generally accepted and viewed as a standard operating procedure for the resolution of corporate governance-related disputes. Yet, existing ADR mechanisms – such as negotiation, mediation and, in some cases, arbitration – constitute important tools to help implement and enforce good corporate governance practice and improve shareholder protections. The ability to solve, as much as to prevent, internal and external disputes affecting the corporation can contribute to improved investor confidence and the company's performance in the best interests of all stakeholders.

The following points summarize how mediation can contribute to improving the corporate governance framework:

#### *Implementing good corporate governance practices in a weak enforcement environment*

Although much has been achieved in raising awareness and improving corporate governance rules and procedures, regulatory and judicial enforcement remain a major issue in transition and developing countries. Enforcement, more than laws and regulations, is key to effective corporate governance. Corporate governance and enforcement mechanisms are intimately linked as they affect a company's ability to commit towards their stakeholders, in particular external investors.

The problem of enforcement obviously extends far beyond corporate governance. While the problem of enforcement for development obviously extends far beyond corporate governance, it particularly affects overall confidence in the market and the ability of firms to obtain financing. Thus, countries seeking to create a capital market – and private and state-owned enterprises seeking to attract local or global capital – must develop a framework that assures investors of two things: first, the assets they provide will be protected and, second, disputes related to the company's governance can be addressed effectively.

Where courts are unreliable or impractical, ADR mechanisms can prove to be a helpful, efficient option. A policy that favors an increased use of ADR and mediation may reduce the number of cases burdening the courts. This can make the availability of court adjudication more effective in inducing compliance with

corporate governance rules. However, such a policy must be designed so that agency costs aren't increased and plaintiffs aren't encouraged to present claims with a low probability of success.

This does not preclude countries from pursuing judicial reform; on the contrary, the better the court system, the more efficient the use of mediation.

### *Addressing corporate governance disputes in a more effective way*

Mediation often provides for faster, cheaper, and more innovative solutions while strengthening business continuity and preserving existing relations through win-win resolutions.

### *Dealing with disputes that are not covered by laws and regulations*

Many governance principles and requirements are covered by soft laws (e.g. corporate governance codes) and company by-laws. Disputes, therefore, arise over issues that have not been foreseen by laws and regulations or spelled out in contracts. Arbitration panels and mediation can in such cases help clarify issues and address the ambiguities and gaps that the law leaves open. This is especially true when articulating the concept of fiduciary relationships between managers and directors on the one hand and directors and investors on the other.

### *Preventing disputes within the boardroom*

Disputes within the boardroom are relatively common and can be the sign of a healthy debate. These disputes can nevertheless become personal, blown out of proportion, and, in some cases, prevent the board from fulfilling its duties. A company's reputation may be ultimately damaged. Traditionally, these disputes are handled or mediated by a leading figure on the board – the chairman in most cases. Board utilization of mediation techniques – after training directors to use dispute resolution techniques as a management tool – can both help prevent disputes, deal with intra-board disputes, and improve the board's overall performance.

Even if redress can be sought in court, it may often be in a company's or the disputed parties' best interest to try to mediate and settle the dispute outside of court.

### *Adopting clear ADR policies at the company level*

Corporate governance systems define processes that enable the corporation to make decisions in the corporation's best interests. Corporate governance and corporate boards are therefore concerned by all disputes that may materially affect the corporation. It is the board's duty to ensure that dispute resolution policies involving negotiation, mediation, and arbitration are established as a management tool and to ensure the efficient, effective, and expeditious resolution of disputes.

Establishing a framework to efficiently prevent and solve emerging disputes that may affect a company's reputation and performance constitutes good corporate governance practice. The board should therefore ensure that proper dispute resolution mechanisms are adopted and in place to deal with internal and external disputes.

### *Introducing ADR in capital market institutions*

In order to improve countries' corporate practices and enforcement, stock exchanges, and capital market regulators should consider introducing ADR mechanisms such as arbitration panels to deal with disputes arising from listing rules, corporate governance codes, and other similar requirements. Brazil's Novo Mercado, for example, has introduced such a mechanism (in the form of an arbitration panel) for shareholders and companies to address any straying from requirements not enforced by laws.

## RECOMMENDATIONS

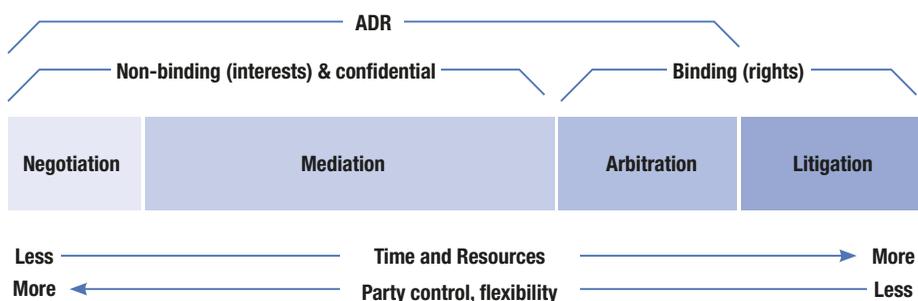
- Corporate boards should ensure that proper ADR policies are adopted and carried out to effectively deal with any type of corporate disputes prior to engaging in litigation.
- Board members and other stakeholders involved in or advising on the governance of corporations should familiarize themselves with ADR and conflict management and prevention techniques. They should continue to improve their understanding of how these tools can benefit corporations.
- Chairmen, lead directors, corporate secretaries in particular, should be trained on mediation techniques within the context of traditional professional development.
- Modules on mediation techniques and conflict resolution should usefully be included in any director training curriculum.
- Professional mediators specialized in corporate and commercial disputes should improve their knowledge of corporate governance issues and corporate ownership-related disputes.
- Professional organizations such as Institutes of Directors should be encouraged to provide mediation services and conflict management training to their members.
- Stock exchanges or regulatory bodies should establish conflict resolution or arbitration processes.
- Listing rules should require companies to agree to seek out mediation prior to filing a court case.
- Corporate governance codes of best practice should recommend the use of mediation to deal with governance disputes and recommend that directors receive training in ADR.
- International organizations and supra-national bodies should provide adequate guidelines to promote industry pledges and help introduce corporate governance dispute resolution clauses in codes of best practice, corporate by-laws, and contracts.



## ANNEX A:

### *Selected ADR Procedures*

Extract from *Alternative Dispute Resolution Manual: Implementing Commercial Mediation* by Lukasz Rozdeiczer and Alejandro Alvarez de la Campa. (Washington, D.C.: IFC, 2006 )



#### **Arbitration**

Arbitration is a private process where disputing parties agree that one or several individuals can make a decision about the dispute after receiving evidence and hearing arguments. Arbitration is different from mediation because the neutral arbitrator has the authority to make a decision about the dispute. The arbitration process is similar to a trial in that the parties make opening statements and present evidence to the arbitrator. Compared to traditional trials, arbitration can usually be completed more quickly and is less formal. For example, often the parties do not have to follow state or federal rules of evidence and, in some cases, the arbitrator is not required to apply the governing law.

After the hearing, the arbitrator issues an award. Some awards simply announce the decision (a “bare bones” award), and others give reasons (a “reasoned” award).

The arbitration process may be either binding or non-binding. When arbitration is binding, the decision is final, can be enforced by a court, and can only be appealed on very narrow grounds. When arbitration is non-binding, the arbitrator’s award is advisory and can be final only if accepted by the parties.

In **court-annexed arbitration**, one or more arbitrators, usually lawyers, issue a non-binding judgment on the merits after an expedited, adversarial hearing. The arbitrator’s decision addresses only the disputed legal issues and applies legal standards.

Either party may reject the non-binding ruling and proceed to trial; sometimes, cost sanctions may be imposed in the event the appellant does not improve his/her position in court. This process may be mandatory or voluntary.

**Private (v. court-annexed) arbitration** may be “administered,” meaning managed by private organizations, or “non-administered,” meaning managed by the parties. The decisions of arbitrators in private arbitration may be non-binding or binding.

**Binding arbitration** decisions typically are enforceable by courts and not subject to appellate review, except in the cases of fraud or other defect in the process. Often binding arbitration arises from contract clauses providing for final and binding arbitration as the method for resolving disputes.

### **Early Neutral Evaluation**

Early neutral evaluation is a process that may take place soon after a case has been filed in court. The case is referred to an expert, usually an attorney, who is asked to provide a balanced and unbiased evaluation of the dispute. The parties either submit written comments or meet in person with the expert. The expert identifies each side’s strengths and weaknesses and provides an evaluation of the likely outcome of a trial. This evaluation can assist the parties in assessing their case and may propel them towards a settlement.

### **Mediation**

Mediation is a private process where a neutral third person called a mediator helps the parties discuss and try to resolve the dispute. The parties have the opportunity to describe the issues, discuss their interests, understandings, and feelings, provide each other with information and explore ideas for the resolution of the dispute.

While courts can mandate that certain cases go to mediation, the process remains voluntary’ in that parties are not required to come to agreement. The mediator does not have the power to make a decision for the parties, but can help the parties find a resolution that is mutually acceptable. The only people who can resolve the dispute in mediation are the parties themselves. There are a number of different ways that mediation can proceed. Most mediations start with the parties together in a joint session. The mediator will describe how the process works, will explain the mediator’s role and will help establish ground rules and an agenda for the session.

Generally, parties then make opening statements. Some mediators conduct the entire process in a joint session. However, other mediators will move to separate sessions, shuttling back and forth between the parties. If the parties reach an agreement, the mediator can help reduce the agreement to a written contract, which may be enforceable in court.

**Conciliation** is a type of mediation whereby the parties to a dispute use a neutral third party (a conciliator), who meets with the parties separately in an attempt to resolve their differences. Conciliation differs from arbitration in that the conciliation process, in and of itself, has no legal standing, and the conciliator usually has no authority to seek evidence or call witnesses, usually writes no decision, and makes no award. Conciliation differs from mediation in that the main goal is to conciliate, most of the time by seeking concessions. In mediation, the mediator tries to guide the discussion in a way that optimizes parties' needs, takes feelings into account and reframes representations. In conciliation the parties seldom, if ever, actually face each other across the table in the presence of the conciliator, instead a conciliator meets with the parties separately ("caucusing"). Such form of conciliation (mediation) that relies on exclusively on caucusing is called "shuttle diplomacy".

### **Mini-Trial**

A mini-trial is a private, consensual process where the attorneys for each party make a brief presentation of the case as if at a trial. The presentations are observed by a neutral advisor and by representatives (usually high-level business executives) from each side who have authority to settle the dispute. At the end of the presentations, the representatives attempt to settle the dispute. If the representatives fail to settle the dispute, the neutral advisor, at the request of the parties, may serve as a mediator or may issue a non-binding opinion as to the likely outcome in court.

### **Negotiation**

Negotiation is a voluntary and usually informal process in which parties identify issues of concern, explore options for the resolution of the issues, and search for a mutually acceptable agreement to resolve the issues raised. The disputing parties may be represented by attorneys in negotiation. Negotiation is different from mediation in that there is no neutral individual to assist the parties negotiate.

### **Neutral Fact-Finding**

Neutral fact-finding is a process where a neutral third party, selected either by the disputing parties or by the court, investigates an issue and reports or testifies in court. The neutral fact-finding process is particularly useful for resolving complex scientific and factual disputes.

### **Ombudsman**

An ombudsman is a third party selected by an institution – for example, a university, hospital or governmental agency – to investigate complaints by employees, clients or constituents. The ombuds works within the institution to investigate the complaints independently and impartially. The process is voluntary, private and non-binding.

### **Private Judging**

Private judging is a process where the disputing parties agree to retain a neutral person as a private judge. The private judge, who is often a former judge with expertise in the area of the dispute, hears the case and makes a decision in a manner similar to a judge. Depending on court rules, the decision of the private judge may be appealable in the public courts.

### **Settlement Conference**

A settlement conference is a meeting in which a judge or magistrate assigned to the case presides over the process. The purpose of the settlement conference is to try to settle a case before the hearing or trial. Settlement conferencing is similar to mediation in that a third party neutral assists the parties in exploring settlement options. Settlement conferences are different from mediation in that settlement conferences are usually shorter and typically have fewer roles for participation of the parties or for consideration of non-legal interests.

### **Summary Jury Trial**

In summary jury trials, attorneys for each party make abbreviated case presentations to a mock six-member jury (drawn from a pool of real jurors), the party representatives and a presiding judge or magistrate. The mock jury renders an advisory verdict.

The verdict is frequently helpful in getting a settlement, particularly where one of the parties has an unrealistic assessment of their case.

### **Settlement Week**

In a typical settlement week, a court suspends normal trial activity and, aided by volunteer mediators, sends numerous trial-ready cases to mediation sessions held at the courthouse. The mediation sessions may last several hours, with additional sessions held as needed. Cases unresolved during settlement week return to the court's regular docket for further pretrial or trial proceedings as needed. If settlement weeks are held infrequently and are a court's only form of ADR, parties who want to use ADR may have to look outside the court or may incur additional litigation expenses while cases await referral to settlement week. This can be overcome by regularly offering at least one other form of ADR.

### **Case Evaluation ("Michigan mediation")**

Case evaluation provides litigants in trial ready cases with a written, non-binding assessment of the case's value. The assessment is made by a panel of three attorneys after a short hearing. If the panel's assessment is accepted by all parties, the case is settled for that amount. If any party rejects the panel's assessment, the case proceeds to trial. This arbitration-like process has been referred to as "Michigan mediation" because it was created by the Michigan state courts and subsequently used by the federal district courts in Michigan as well.

**Med-Arb., or Mediation-Arbitration:** An example of multi-step ADR, parties agree to mediate their dispute with the understanding that any issues not settled by mediation will be resolved by arbitration, using the same individual to act as both mediator and arbitrator. The parties may, however, be unwilling to speak candidly during the mediation when they know the neutral may ultimately become a decision maker. They might believe that the arbitrator will not be able to set aside unfavorable information learned during the previous mediation. Additional related methods have evolved to address this problem.

In **Co-Med-Arb**, different individuals serve as neutrals in the arbitration and mediation sessions, although they both may participate in the parties' initial exchange of information. In Arb-Med, the neutral first acts as arbitrator, writing up an award and placing it in a sealed envelope. The neutral then proceeds to a mediation stage, and if the case is settled in mediation, the envelope is never opened.

**Fact-finding:** A process by which a third party renders binding or advisory opinions regarding facts relevant to a dispute. The third party neutral may be an expert on technical or legal questions, may be representatives designated by the parties to work together, or may be appointed by the court.

**Judge-Hosted Settlement Conference:** In this court-based ADR process, the settlement judge (or magistrate) presides over a meeting of the parties in an effort to help them reach a settlement. Judges have played a variety of roles in such conferences, articulating opinions about the merits of the case, facilitating the trading of settlement offers, and sometimes acting as a mediator.

**Private Judging:** A private or court-connected process in which parties empower a private individual to hear and issue a binding, principled decision in their case.

The process may be agreed upon by contract between the parties, or authorized by statute (in which case it is sometimes called **Rent-a-Judge**).

## ANNEX B

### *Further Reading*

ABA (American Bar Association). 2003. *Mediation Practice Guide: A Handbook for Resolving Business Disputes*. 2nd ed. Washington, DC: ABA.

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Sullivan, John, Catherine Kuchta-Hebling, Jean Rogers, and Aleksandr Shkolnokov. 2003. *In Search of Good Directors: A Guide to Building Corporate Governance in the 21st Century*. Washington, DC: CIPE.

United Nations. 2002. *UNCITRAL Model Law on International Commercial Conciliation with Guide to Enactment and Use*. New York: UN

## NOTES

- 1 Institute of Directors in Southern Africa, *Bulletin*, 1st Quarter 2007.
- 2 Andrei Shleifer and Robert Vishny, "A Survey of Corporate Governance," *Journal of Finance*, 52 (1997): 737. For a summary of other research findings, see *The Irresistible Case for Corporate Governance*, IFC, September 2005. According to a broader view, the purpose of corporate governance rules is to induce an efficient use of resources and support economic growth. See the Preamble of OECD *Principles of Corporate Governance* (2004). Available at: [http://www.oecd.org/document/49/0,3343,en\\_2649\\_34813\\_31530\\_865\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/49/0,3343,en_2649_34813_31530_865_1_1_1_1,00.html).
- 3 The investors and the corporate officers will be the focus of this paper, although employees and other interest groups may be viewed as corporate governance stakeholders, too. See James E. Post, Lee E. Preston, and Sybille Sachs, *Redefining the Corporation. Stakeholder Management and Organizational Wealth* (Palo Alto, Calif.: Stanford University Press, 2002). See Erik Bergl of and Sijn Claessens, "Enforcement and Corporate Governance," *The World Bank Research Observer*, 123 (2006). Available at: [www.gcgf.org](http://www.gcgf.org).
- 4 The OECD Corporate Affairs Division is conducting work on corporate governance and dispute resolution, which will ultimately result in an inventory of policy options on how various forms of dispute resolution can complement each other in contributing to effective redress and enforcement. See L. Bouchez and A. Karpf, "Exploratory Meeting on Resolution of Corporate Governance-Related Disputes," Stockholm, March 2006, OECD.
- 5 OECD, *Principles of Corporate Governance – Annotations to the OECD Principles of Corporate Governance – The Equitable Treatment of Shareholders* (Paris: OECD, 2004). Available at: <http://www.oecd.org/dataoecd/32/18/31557724.pdf>.
- 6 Christian Strenger, "Dealing with Non-Controlling Shareholders: Issues and Best Practice," *Private Sector Opinion – Issue 1*, IFC 2006. Available at: <http://www.gcgf.org>.
- 7 Bergl of and Claessens *supra*.
- 8 Besides adjudication and negotiation as dispute resolution mechanisms, a third form, self-help, is often mentioned. See William Ury, Jeanne Brett and Stephen Goldberg, *Getting Disputes Resolved: Designing Systems to Cut the Costs of Conflict* (San Francisco: Jossey-Bas Publishers, 1988). Unilateral self-help relies on power. One form of unilateral self-help is when the state, often through a governmental agency, prosecutes, judges, and enforces its judgment on a private party.
- 9 Unpublished. Available at: <http://www.gcgf.org>.
- 10 Rafael Guillermo Bernal, "Arbitration Mediation in Corporate Governance Disputes: The Experience of the Bogota Chamber for Arbitration and Conciliation." Paris, February 2007. Presentation available at <http://www.gcgf.org>.
- 11 Presentations and materials from this workshop can be found on the Forum in text.
- 12 There are many forms of ADR with even more names. A typology could be based on a distinction between "dispute anticipation and prevention techniques," "dispute management techniques," and "dispute resolution". For a thorough discussion on the typology and a brief description of the techniques, see Eric Green, "Corporate Alternative Dispute Resolution," *Ohio State Journal on Dispute Resolution*, 1 (1985-1986): 203.
- 13 Henry Brown and Arthur Marriott, *ADR Principles and Practice*, (London: Sweet & Maxwell, 1999), p. 12.
- 14 Some authors argue that the term ADR should include even arbitral proceedings that result in final, binding, and enforceable awards. See e.g. Luke R. Nottage, "Is (International) Commercial Arbitration ADR?," *The Arbitrator and Mediator*, 20 (2002): 83 – 92. Regarding the use of non-binding arbitration, see Steven C. Bennett, "Non-Binding Arbitration: An Introduction," *Dispute Resolution Journal* 22 (2006): 61.
- 15 A technique that is not aiming for a direct resolution of a dispute but may pave the way for an agreement is to resort to fact-finding proceedings, where an expert or another neutral person determines a fact or sets a value. The decision may be a recommendation or be binding as if the fact or value had been agreed between the parties. Regarding the use of fact finding, see e.g. Donald Lee Rome, "Resolving Business Disputes: Fact-finding and Impasse," *Dispute Resolution Journal* 55 (2000): 8.
- 16 A particular form of ADR which may seem close to adjudication is when the parties delegate to the neutral party to make a decision on their behalf. The decision will then be binding as an agreement between the parties but not be considered as an enforceable arbitral award. This procedure is often referred to as contract adaptation and is mainly used in international direct investment agreements. See e.g. Klaus Peter Berger, "Renegotiation and Adaptation of International Investment Contracts: The Role of Contract Drafters and Arbitrators," *Vanderbilt Journal of Transnational Law*, 36 (2003): 1346 and Abba Kolo and Thomas W. W alde, "Renegotiation and Contract Adaptation in International Investment Projects – Applicable Legal Principles and Industry Practices," *The Journal of World Investment*, 15 (2000): 5.
- 17 Jon Masters and Alan Rudnick, *Improving Board Effectiveness: Bringing the Best of ADR into the Corporate Boardroom* (Washington, D.C.: American Bar Association, 2005).
- 18 Smith v. Van Gorkom 488 A.2d 858
- 19 Wikipedia: A fiduciary duty is the highest standard of care imposed at either equity or law. A fiduciary is expected to be extremely loyal to the person to whom they owe the duty (the "principal"): they must not put their personal interests before the duty, and must not profit from their position as a fiduciary, unless the principal consents. Available at: <http://en.wikipedia.org/wiki/Fiduciary>.
- 20 J. Masters and A. Rudnick, *ibid*.
- 21 See research conducted by Thomas Walde, "Mediation / Alternative Dispute Resolution in Oil, Gas and Energy," *CEPMLP Journal* (2005):
- 22 *Supra*. The list draws on a Questionnaire on Corporate Governance-Related Dispute Resolution, OECD DAF/CA; 03/01/06.
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- 27 Elias Tarawneh, "The Jordanian Initiative," Paris, February 2007. Available at: <http://www.gcgf.org> .
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- 29 Centre for Effective Dispute Resolution, *The CEDR Mediator Handbook: Effective Resolution of Commercial Disputes*, 4th Edition (London: CEDR, 2004).
- 30 Official Records of the General Assembly, Fifty-seventh Session, Supplement No. 17 (A/57/17), annex I.
- 31 CEDR, *supra*.
- 32 The orange dispute is widely used in the negotiation literature. It appears to have its origin in Mary Parker Follet's "Constructive Conflicts" that dates back to 1940.
- 33 See Howard Raiffa, *Negotiation Analysis* (Cambridge: Belknap Press, 2002), p. 195-268.
- 34 Vilhelm Aubert "Courts and Conflict Resolution," *Journal of Conflict Resolution* 40 (1973): 40.
- 35 See Melvin A. Eisenberg, "Private Ordering Through Negotiation. Dispute-Settlement and Rulemaking," *Harvard Law Review*, 89 (1976): 637.
- 36 See Russell Korobkin and Chris Guthrie, "Psychological Barriers to Litigation Settlement: An Experimental Approach," *Michigan Law Review* 93 (1994): 107 at 142 et seq. See also Stephen B. Goldberg, Eric D. Green, and Frank E. A. Sander, "Saying You're Sorry," *Negotiation Journal*, 3(1987): 221.
- 37 Cf. Simeon Djankov, Rafael La Porta, Florencio Lopez de Silanes, and Andrei Shleifer, "Courts: The Lex Mundi Project" (April 2002). NBER Working Paper No. W8890. Available at SSRN <http://ssrn.com/abstract=307127>.
- 38 Available at: <http://www.doingbusiness.org/ExploreTopics/EnforcingContracts>.
- 39 Although not relating to corporate governance disputes, see data regarding costs and time for resolving the international business disputes reported in Eileen Carol and Karl Mackie, *International Mediation. The Art of Business Diplomacy* (New York: Aspen Publications, 1999).
- 40 Much of this sub-section draws on the key finding of Jon Master and Alan Rudnick *supra* and Richard Reuben *supra*.
- 41 Richard Reuben, *supra*.
- 42 Institute of Directors in Southern Africa, *Bulletin*, 1st Quarter 2007.
- 43 Master and Rudnick, *supra*.
- 44 See William L. Landes, "An Economic Analysis of the Courts," 14 *Journal of Law and Economics*, 14 (1971): 61; Richard A. Posner, "An Economic Approach to Legal Procedure and Judicial Administration," *Journal of Legal Studies* 2 (1973). John P. Gould, "The Economics of Legal Conflicts," *Journal of Legal Studies* 2 (1973). Steven Shavell, "The Social Versus the Private Incentives to Bring Suit in a Costly Legal System," *Journal of Legal Studies*, 11 (1982): 333. In the 1980s there was a great deal of research about the impact of asymmetric information about the value at stake and the fact that the parties often fail to adjust their assessment of the outcome. For a survey, see e.g. J. Kennan and R. Wilson, "Bargaining With Private Information," 31 *Journal of Economic Literature*, (1991): 381.
- 45 Let us assume that A demands 100 from B, the costs of adjudication is 10 per party and that the loser pays the costs. A can win 100 or lose 20. B can lose 0 or 120. If the odds are 50/50, A's expected monetary value is  $0,5 \cdot 100 + 0,5 \cdot -20 = 40$ . B's expected monetary value is  $0,5 \cdot -120 + 0,5 \cdot 0 = -60$ . The dispute can be resolved and both parties be made better off if B agrees to pay more than 40 but less than 60. A settlement on 50 would be 10 better for both than the expected monetary value of the adjudication alternative. As can be seen, the settlement range in this simple model corresponds to the private adjudication costs. Given this, it would be rational to settle.
- 46 See Robert Cooter, Stephen Marks, and Robert H. Mnookin, "Bargaining in the Shadow of the Law: A Testable Model of Strategic Behavior," *Journal of Legal Studies*, 11 (1982): 225.
- 47 G. Miller, "Some Agency Problems in Settlement," *Journal of Legal Studies* 16 (1987): 189.
- 48 Robert H. Mnookin, "Why Negotiations Fail: An Exploration of Barriers to the Resolution of Conflict," *Ohio State Journal on Dispute Resolution*, 8 (1993): 235. Discussing empirical findings, see Korobkin and Guthrie, *supra* note 24 *passim*.
- 49 Reported in Robert J. Robinson, Errors in Social Judgement: Implications for Negotiation and Conflict Resolution, p 76-81 in Ibarra et al., *Business Fundamentals as Taught at the Harvard Business School. Negotiation* (HBS no 1771), 2001. Robinson refers to several similar studies, *inter alia* Babcock et al., "Biased Judgements of Fairness in Bargaining," *American Economic Review*, 85 (1995): 1337.
- 50 See Mitchell A. Polinsky and Daniel L. Rubinfeld, "Does the English Rule Discourage Low-Probability-of-Prevailing Plaintiffs?," *Journal of Legal Studies*, 27 (1998): 517.
- 51 A simple example can illustrate this "destruction game." Let us assume that the chances are 10 in favor of the plaintiff A and 90 in favor of defendant B. The expected monetary value is negative for plaintiff;  $0,1 \cdot 100 + 0,9 \cdot -20 = -8$ . By initiating litigation, A is eight times worse off compared to his alternative action, specifically to drop the claim. In spite of the bad odds, it may be rational for A to go ahead if B is likely to agree to a settlement. The expected monetary value for B is:  $0,1 \cdot -120 + 0,9 \cdot 0 = -12$ . B can reduce the risk by agreeing to settle for any amount below 12. Thus, A can win just below 12 in a settlement by risking eight.
- 52 See Joseph A. Grundfest with Peter H. Huang, "The Unexpected Value of Litigation: A Real Options Perspective," *Stanford Law Review* 58 (2006): 1267. One possibility to use ADR may be to design procedures that allow for transparency and efficient exchange of information between the corporation and its investors. Whether this would increase the likelihood that the corporation becomes a target for speculative claims is a field of further research.
- 53 See generally [http://en.wikipedia.org/wiki/Agency\\_cost](http://en.wikipedia.org/wiki/Agency_cost).

- 54** See D. A. Hensler, DA, "Litigation Costs and the Underpricing of Initial Public Offerings," *Managerial and Decision Economics* 16 (1995): 111 and Michelle Lowry and Susan Shu, "Litigation Risk and IPO Underpricing," *Journal of Financial Economics*, 65 (2002): 309.
- 55** Steven C. Hall and William W. Stammerjohan, "Damage Awards and Earnings Management in the Oil Industry," *The Accounting Review*, 72 (1997): 47.
- 56** Eric L. Talley and Gudrun Johnsen, "Corporate Governance, Executive Compensation and Securities Litigation" (May 4, 2004). USC Law School, Olin Research Paper No. 04-7; and USC CLEO Research Paper No. C04-4. SSRN. Available at: <http://ssrn.com/abstract=536963>.
- 57** See Lin Peng and Ailsa Röell, *Executive Pay and Shareholder Litigation* (December 2005). Available at: <http://www.olin.wustl.edu/firs/conf/shanghai/PDF/062.pdf#search=%22Shareholder%20Litigation%20and%20Corporate%20Disclosures%20%22>.
- 58** See e.g. Douglas J. Skinner, "Why firms voluntarily disclose bad news?" *Journal of Accounting Research* 32 (1994): 38; R. Kasznik and B. Lev, "To Warn or Not to Warn: Management Disclosures in the Face of an Earnings Surprise," *The Accounting Review*, 70 (1995): 113; Douglas J. Skinner, "Earnings disclosures and stockholder lawsuits," 23 *Journal of Accounting and Economics*, 23 (1997): 249; and S. P. Kothari, Susan Shu, and Peter Wysocki, "Do Managers Withhold Bad News?" (October 2005). Available at: <http://management.bu.edu/academics/departments/documents/Do-Managers-Withhold-Bad-News-12-05.pdf>.
- 59** Bruce Haslem, *supra* note 36.
- 60** "Caution – D&Os Working: Reducing Liability Exposure in 2005," National Association of Corporate Directors, DM Extra, January 3, 2005.
- 61** Sanjai Bhagat and Roberta Romano *supra* note 33 with reference to R. Romano, "The Shareholder Suit: Litigation Without Foundation?," *Journal of Law, Economics, and Organization*, 7 (1991): 55 and R. B. Thompson and R. S. Thomas, "Shareholder Litigation: Reexamining the Balance between Litigation Agency Costs and Management Agency Costs," Vanderbilt University manuscript (2002).
- 62** J. C. Coffee, Jr., "The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation," *Law and Contemporary Problems*, 48 (1985): 5.
- 63** Sanjai Bhagat and Roberta Romano, *supra* note 33. See also Mark D. West, "Why Shareholders Sue: The Evidence from Japan," *Journal of Legal Studies*, 30 (2001): 351.
- 64** R. Romano, "The Shareholder Suit: Litigation Without Foundation?," *Journal of Law, Economics, and Organization* 7(1991):55.
- 65** William Ury, Jeanne Brett, and Stephen Goldberg, *Getting Disputes Resolved: Designing Systems to Cut the Costs of Conflict*, (San Francisco: Jossey-Bas Publishers, 1988). For further reading in the field of dispute resolution design, see Eric Brahm and Julian Quellet, "Designing New Dispute Resolution Systems" in Guy Burgess and Heidi Burgess, ed., *Beyond Intractability*. (Boulder, Colorado: Conflict Research Consortium, University of Colorado, September 2003). Available at: [http://www.beyondintractability.org/essay/designing\\_dispute\\_systems](http://www.beyondintractability.org/essay/designing_dispute_systems). Regarding conflict management specifically in relation to M&As, see Cynthia F. Cohen, Stanley J. Birkin, Murray E. Cohen, Monica J. Garfield, and Harold W. Webb, "Managing Conflict During an Organizational Acquisition," *Conflict Resolution Quarterly*, 23 (2006): 317.
- 66** Whether this is feasible will in most cases depend on how the term "dispute" is understood in the country where the seat of arbitration is determined to be. *Cf.* Berger, *supra* note 11 at 1371 *et seq.* The possibility to ask the mediator to become an arbitrator with the limited mandate to confirm the settlement in an arbitral award is particularly mentioned in Article 12 of the 1999 Rules of the Mediation Institute of the Stockholm Chamber of Commerce. Available at: <http://www.sccinstitute.se/se/Startsida>.



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