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The Legal Control of Directors' Conflicts of Interest in the United Kingdom: Non-Executive Directors Following the Higgs Report

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This paper makes the case for using the independent non-executive directors of a company listed in the United Kingdom exclusively as monitors and regulators of management, particularly as regulators of executive directors' conflicts of interest, rather than as participants in management who also have a control function. It is suggested that these proposals can be accommodated within current (and anticipated) corporate law in the United Kingdom, that they are practicable, and that they are desirable. The proposals are made against the background of a continued strong emphasis in the United Kingdom on non-executive directors' dual role both as managers of a company's business and as monitors of its executive directors. It is suggested that this dual role for non-executive directors tends significantly to undermine the effectiveness of their control function, and that consequently the dual role should be abandoned in favor of the more focused role proposed in the paper. Improving the effectiveness of non-executive directors as regulators of executive directors' conflicts of interest is vitally important to corporate governance in the United Kingdom: as the paper explains, other legal methods of controlling those conflicts in the United Kingdom suffer from serious deficiencies.

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INTRODUCTION

English company law sets strict standards of loyalty for directors; some would even say too strict.[1] Yet the enforcement of those obligations — whether prospectively through corporate governance structures or retrospectively through litigation — is one of the most intractable problems in the law. Enforcement of directors' duties through private civil litigation has proven problematic and unsatisfactory. Enforcement through public proceedings, such as criminal proceedings or, more recently, directors' disqualification proceedings, has become more prominent, but these methods of enforcement are still the subject of very mixed comment. In short, existing corporate governance structures apparently fail to control executive directors to the satisfaction of shareholders.

The recent Higgs Report on Corporate Governance in the United Kingdom,[2] commissioned by the Department of Trade and Industry, does not adequately address these problems of enforcement. However, if suitably modified, the proposals in the Higgs Report could provide one useful basis — though not the only basis — for better legal control of directors' conflicts of interest in the listed (publicly traded) companies to which the Report applies. In short, independent non-executive directors (outside directors) could and should be given the focused tasks of monitoring management in general and controlling executive directors' conflicts of interest in particular. The Higgs Report is wrong to suggest that non-executive directors, including independent non-executive directors, should continue to have a significant management function in addition to these other roles. Unsurprisingly, however, the new United Kingdom Combined Code on Corporate Governance, published on July 27, 2003, adopted the recommendations of the Higgs Report in this regard, as in most others.[3]

1 The classic criticism of the severity of duties of loyalty in English law is Gareth H. Jones, *Unjust Enrichment and the Fiduciary's Duty of Loyalty*, 84 Law Q. Rev. 472 (1968).

2 Derek Higgs et al., Review of the Role and Effectiveness of Non-Executive Directors (2003) [hereinafter Higgs Report]. The committee that produced the Report was led by Derek Higgs, deputy chairman of The British Land Company and a senior adviser to UBS Warburg.

3 Financial Reporting Council, Combined Code on Corporate Governance (2003) [hereinafter New Combined Code], *available at* http://www.frc.org.uk/documents/pdf/combinedcodefinal.pdf. The New Combined Code applies to listed companies with financial reporting years beginning on or after November 1, 2003; see the Financial Reporting Council's press release at http://www.frc.org.uk/publications/

A clearer, less ambiguous role for independent non-executive directors would have several benefits. It would provide a plausible mechanism for the enforcement of duties that, in a widely-held company, cannot realistically be enforced by shareholders, save in rare cases. That need not encumber executive directors with inflexible, onerous terms of service, however. The control function of independent non-executive directors should include not merely power to enforce executive directors' duties, but also power to waive them after full and frank disclosure by the directors concerned. That would increase the efficiency of fiduciary duties as a mechanism for redressing the informational advantage enjoyed by managers of a firm in a situation where their duty and interest conflict. Strict duties, coupled with a realistic process for enforcing those duties, would act as a deterrent to disloyalty — as a "stick." An equally realistic process for seeking consent to a deviation from duty would act as a "carrot": it would encourage managers to make disclosure in the hope of sanction for proposed action that would otherwise amount to a breach of their duties.

The suggested role for independent non-executive directors should also help to increase their effectiveness. It would free them from any conflicting pressures they might experience if they were managers of a company's business as well as monitors of the company's other directors. Furthermore, clear areas of responsibility, both for independent non-executive directors and for other directors, should reduce (if not eliminate) the occasions for conflict between those two groups of directors in any given company and allow management proper discretion to get on with running a successful business subject only to limited, and justifiable, intervention where management is at risk of deviating from its tasks. In turn, a clear role for independent non-executive directors should make it easier for shareholders to judge the performance of those directors.

This paper begins its argument with a critical examination of two aspects of English law: the rules controlling directors' conflicts of interest and the mechanisms currently available for enforcement of those rules. The second aspect is every bit as important as the first: a proper appreciation of how directors' duties may be enforced is absolutely crucial for understanding corporate governance in the United Kingdom.

The paper then considers the recommendations of the Higgs Report in the context of various earlier reports on corporate governance in the United

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publication419.html (last visited Sept. 30, 2003). The press release also details the points (not relevant for the purposes of this paper) at which the New Combined Code departs from the recommendations in the Higgs Report.

Kingdom. While many aspects of those recommendations are useful, some are nevertheless seriously flawed. This paper suggests that the Report is wrong to support the continued involvement of independent non-executive directors in the management of a company's business, partly because such involvement does not appear to improve the company's economic performance, but mainly because such a role will tend to undermine significantly the effectiveness of independent non-executive directors as monitors of management.

Next, the paper turns to its positive proposals. Most importantly, it seeks to show why and how the existing, highly flexible structures of English company law can be used to give independent non-executive directors a strong, focused role monitoring executives and controlling those executives' conflicts of interest.[4] The frequently-expressed argument, that English law requires directors to be involved in the management of a company's business, is demonstrably wrong. So the present proposals most certainly need not involve the introduction of two-tier boards into English companies. Indeed, the structural rigidities that two-tier boards would introduce into English corporate law make them undesirable.

Of course, practical implementation of these suggestions requires a supply of suitable candidates to become independent non-executive directors; but limiting and focusing the tasks of such directors should make it easier to find the necessary candidates. This is because there should be more people properly suited to undertake a limited number of tasks than are suited to undertake both those and additional tasks. Professionals may well constitute one suitable and large group of people from which to draw independent non-executive directors, in addition to the businesspeople who currently serve as such.

It is unlikely, however, that markets alone will produce the suggested reforms, and certainly not within a politically realistic timescale. Consequently, this paper goes on to advocate the use of a code of corporate governance to achieve these aims, created and enforced in the same way as the existing United Kingdom Combined Code on Corporate Governance[5]

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4 The Company Law Review, a thorough-going revision of corporate law in the United Kingdom, began in 1998 and has already generated a plethora of working papers and a White Paper (official United Kingdom government policy paper). The history and work of the review are at http://www.dti.gov.uk/cld/review.htm (last visited Sept. 30, 2003).

5 The U.K. Listing Authority, Combined Code on Corporate Governance (2000) [hereinafter Old Combined Code], formed an Appendix to the United Kingdom Listing Rules.

and its replacement, the New Combined Code. Such a code is needed to redress the inefficiencies of the normal contracting processes through which English corporate governance structures are formed. There is, however, no need for legislation to that end.

At this point, it is perhaps useful to describe briefly how codes of corporate governance are created and enforced in the United Kingdom, because they are complex, hybrid regulatory tools.[6] Such codes were, in the beginning, essentially private sector initiatives, responding to both private and public concerns, as well as to the risk of government intervention in outstanding questions of corporate governance. The codes grew out of the work of various different committees, later committees building on earlier work. Of particular interest for present purposes is the work of the Cadbury Committee,[7] the Greenbury Committee,[8] and the Hampel Committee.[9] These committees were established by interested participants in the London financial markets, trade associations, and professional bodies;[10] the committees consulted widely amongst interested parties, and they finally drew up codes or recommendations of best practice. In 2000, the work of these committees was consolidated into the original Combined Code. Later, the state became involved, but it did not usurp the private sector. So, while it was the Department of Trade and Industry that commissioned the Higgs Report, it was the Financial Reporting

6 See generally Eilís V. Ferran, *Corporate Law, Codes and Social Norms — Finding the Right Regulatory Combination and Institutional Structure*, 1 J. Corp. L. Stud. 381, 384-85 (2001), discussing the Old Combined Code. The institutional structure relating to codes of corporate governance in the United Kingdom has changed slightly since that article was published.

7 Sir Adrian Cadbury et al., Report on the Financial Aspects of Corporate Governance (1992) [hereinafter Cadbury Report], *available at* http://www.ecgi.org/codes/country_documents/uk/cadbury.pdf. The chairman of the committee that wrote the report was Sir Adrian Cadbury, Chairman of the Cadbury Group from 1965 to 1989 and a director of the Bank of England from 1970 to 1994.

8 Sir Richard Greenbury et al., Directors' Remuneration: Report of a Study Group chaired by Sir Richard Greenbury (1995) [hereinafter Greenbury Report], *available at* http://www.ecgi.org/codes/country_documents/uk/greenbury.pdf. Sir Richard Greenbury is a former Chairman and CEO of Marks & Spencer and, amongst other things, a director of Lloyds TSB, British Gas, ICI, and Zeneca.

9 Sir Ronnie Hampel et al., Report of the Hampel Committee (1998) [hereinafter Hampel Report], *available at* http://www.ecgi.org/codes/ country_documents /uk/hampel_index.htm. The Committee was chaired by Sir Ronnie Hampel, then-Chairman of ICI.

10 *Id.* at Foreword 1, 2; Cadbury Report, *supra* note 7, § 2.1; Greenbury Report, *supra* note 8, § 1.1.

Council[11] that created the New Combined Code, after much consultation on the suggestions in the Higgs Report.[12]

Enforcement of the Old Combined Code and the New Combined Code was left to market regulators, first to a private body (the London Stock Exchange) and later to a state agency (the United Kingdom Listing Authority ("UKLA")).[13] These bodies (one followed by the other) set the Listing Rules with which a company listed — traded — on the London Stock Exchange must comply. One of the obligations of the Listing Rules is the obligation *either* to comply with the Code *or* to explain why not (so-called "comply or explain").[14] A company must agree (as a matter of contract) to abide by the Listing Rules in order to be traded on the Exchange.[15] Historically, this contract formed the basis for enforcement of the Listing Rules. Since 1984, however, first the London Stock Exchange and then UKLA have also had statutory powers to enforce the Listing Rules:[16] power to suspend or expel shares from trading,[17] power to publicize non-compliance (so called "name and shame"),[18] power to fine a non-compliant company,[19] and power to fine a director of such a company.[20]

Thus, the creation and enforcement of codes of corporate governance in the United Kingdom are complex mixtures of private and public action. There is, nevertheless, a clear trend of greater state involvement over time.

Finally, once the paper has addressed the use of a code in implementing its suggestions, it briefly addresses some other possible techniques for limiting

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11 The Financial Reporting Council is a private organization funded by the United Kingdom accounting and legal professions, the financial community, commerce, and the Government. See the information about the Financial Reporting Council at http://www.frc.org.uk/about.html (last visited Sept. 30, 2003).

12 See the Financial Reporting Council's statements at http://www.frc.org.uk/publications/publication415.html and http://www.frc.org.uk/summary.html (last visited Sept. 30, 2003).

13 The Financial Services Authority, a government regulatory body with delegated, statutory powers, currently acts as the United Kingdom Listing Authority (hereinafter "UKLA"). The transfer of functions from the London Stock Exchange to UKLA was made by the Official Listing of Securities (Change of Competent Authority) Regulations 2000 (SI 2000/968).

14 Listing Rules, *supra* note 5, § 12.43A.

15 *Id.* § 1.1.

16 *See presently* Financial Services and Markets Act, 2000, §§ 77, 78, 91-94.

17 Listing Rules, *supra* note 5, § 1.15 (suspension of listing for non-compliance), § 1.19 (cancellation of listing).

18 *Id.* § 1.5.

19 *Id.* § 1.8.

20 *Id.* § 1.9.

the agency costs faced by a company in respect of its executive directors: for example, the use of executive compensation packages and reliance on the market for corporate control. These techniques are not adequate substitutes in the United Kingdom at present for independent non-executive directors who monitor management, but neither are they ruled out by the proposals made in this paper. Indeed, if some or all of those strategies proved more successful in future and came to command greater public confidence, they might supplant reliance on independent non-executive directors.

I. CONTROLLING DIRECTORS' CONFLICTS OF INTEREST IN ENGLISH COMPANY LAW THROUGH FIDUCIARY PRINCIPLES: LAW, THEORY, AND PRACTICE

Fiduciary obligations are still the central mechanism through which English law controls directors' conflicts of interest. As will be seen, fiduciary obligations have been supplemented by statute, and by codes of conduct, but those obligations still have a vital, primary role in controlling directors' conflicts of interest. This central importance of fiduciary obligations emerges very clearly from even a glance at the law reports: breach of fiduciary duty remains the most common complaint against directors, whether litigated as a civil claim against the director(s) concerned or as the subject matter of proceedings to disqualify a person from holding office as a director in the future.[21] A proper theoretical understanding of these obligations is therefore crucial if any stable corporate governance structures are to be built on them.[22]

In recent years, the English courts, encouraged by developments in Australia,[23] have focused ever more carefully and closely on what is meant by fiduciary obligations — on just what is their function.[24] They have sought to refine and sharpen the usage of concepts that, historically, simply drew an analogy with principles of the law of trusts. Though it is still contested, the view clearly emerging from the leading cases can be summarized in two propositions. First, fiduciary obligations serve to secure due performance of

21 For an outline of such proceedings in the United Kingdom, see *infra* text accompanying note 71.

22 The author is greatly indebted to Dr. Matthew Conaglen, his former doctoral student at the University of Cambridge, for his work on, and immensely useful discussions of, fiduciary duties in England, Australia, and New Zealand.

23 The leading Australian cases are Breen v. Williams (1996) 186 CLR 71, and Pilmer v. Duke Group (2001) 207 CLR 165.

24 *See especially* Bristol & West Bldg. Soc'y v. Mothew, 1998 Ch. 1 (C.A.).

a pre-existing, logically prior, undertaking where there is, or is likely to be, some temptation for the person performing that undertaking to subordinate it to his own interests or to other duties. Second, fiduciary obligations seek to achieve this goal by prohibiting certain conduct unless particular authorizations are obtained.[25] In company law, therefore, fiduciary obligations are principally concerned with prohibiting a director from taking action, without due authorization, where he or she has some interest or duty that conflicts, or might conflict, with his or her duty to manage the company properly for the benefit of its shareholders.

So, in English law, fiduciary obligations are not duties of good faith, in the sense that they do not mandate and require some higher quality of action or behavior from those subject to them. Fiduciary obligations invariably presuppose that a person has assumed some primary undertaking to act,[26] and that undertaking almost invariably imports duties of diligence — care and skill.[27] The function of fiduciary obligations is to safeguard the undertaking, not to extend or expand it in any way: the undertaking (in the case of directors, a consensual undertaking) is prime, and it establishes the scope of the task(s) to be fulfilled by the person in question.[28] Consequently, fiduciary obligations are contractible:[29] they mould themselves to whatever

25 Fiduciary obligations prohibit action where there is a conflict of duty and interest, or a conflict of duty and duty. They do not *per se* mandate disclosure by the fiduciary to the principal: disclosure is not compliance with the duty but, rather, a prerequisite to release from it. See *Breen v. Williams* noted by the author in Richard C. Nolan, *A Fiduciary Duty to Disclose?*, 113 Law Q. Rev. 220 (1997). *See also* Richard C. Nolan & Dan D. Prentice, *The Issue of Shares — Compensating the Company For Loss*, 118 Law Q. Rev. 180 (2002).

26 See Bhullar v. Bhullar [2003] EWCA 424 Civ., [2003] 2 B.C.L.C. 241 (C.A. 2003), for a recent leading case where the existence and extent of a director's duties of management were in question and were the single material determinant of whether that director had a conflict of interest in a transaction. In that case, the Court of Appeal explained the law, and justified its decision, by reference to the basic general principles about conflicts of interest and duty, rather than adopting and applying a specific doctrine about corporate opportunities.

27 Directors are under increasingly strict duties of care and skill. The leading English authority is now *Re* Barings plc. (No. 5), [1999] 1 B.C.L.C. 433, 486-89 (H.C.), approved, insofar as raised for its decision, by the Court of Appeal in [2000] 1 B.C.L.C. 523, 534-35.

28 *See, e.g.*, Re Goldcorp Exch. Ltd., [1995] 1 A.C. 74 (P.C. 1994) (appeal taken from N.Z.).

29 See Brian R. Cheffins, *Law, Economics and Morality: Contracting Out of Corporate Law Duties*, 19 Can. Bus. L.J. 28 (1991), as to whether such contractibility is desirable. Professor Cheffins reviews the relevant arguments and suggests that

undertaking they support[30] and can be modified explicitly or implicitly.[31] This has very significant consequences for corporate governance in England, which will be addressed shortly.

Understanding fiduciary obligations in English law as clearly contractible in positive law, and as amenable to contractarian theory and explanation, is only a part of explaining the current structure of those obligations. The fact that fiduciary obligations can be explained as implied bargain does not, of itself, explain the precise form of the obligations (the bargain) in English law. Various theoretical justifications for fiduciary obligations have been proffered in the literature:[32] for example, fiduciary obligations have

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fiduciary duties should be contractible. The debate in North American jurisdictions about the extent to which directors' duties, particularly their fiduciary duties, should be contractible must be approached with some care in its application to the United Kingdom, however, because it is far from clear that the relevant law in the respective jurisdictions starts from the same premises about the very functions of fiduciary duties. The Australian High Court has articulated the extent to which the Australian (and United Kingdom) understanding of fiduciary duties is different from the North American, *see* Breen v. Williams (1996) 186 CLR 71.

30 *See, e.g.*, Kelly v. Cooper, 1993 A.C. 205 (P.C. 1992) (appeal taken from Berm.); Clark Boyce v. Mouat, [1994] 1 A.C. 428 (P.C. 1993) (appeal taken from N.Z.).

31 In corporate law, this is most commonly achieved through the terms of a company's articles of association (constitution). Such stipulations even occur in the standard form articles: see regulations 85 and following of Table A in the Companies (Tables A-F) Regulations 1985 (SI 1985/805). This standard form of articles is colloquially (and hereinafter) simply called "Table A." Stipulations of this sort are generally effective in English law, notwithstanding section 310 of the Companies Act, 1985, which attempts to limit contracting round directors' duties in response to failures in the contracting process. As to the genesis of the law currently re-enacted as section 310, see Lord Greene et al., The Report of the Company Law Amendment Committee 1925-26, §§ 46-47 (1926), *available at* http://www.takeovers.gov.au/Content/Resources/CASES/CompanyLawAmendment.asp. For examples of defects in the process of contracting round directors' duties in a company's constitution, see *infra* text accompanying note 46. As to the current interpretation and application of section 310, see, e.g., Movitex v. Bulfield, [1988] B.C.L.C. 104 (1986), and, more generally, Pippa J. Rogerson, *Modification and Exclusion of Directors' Duties, in* The Realm of Company Law 93 (Barry A.K. Rider ed., 1997).

32 A relatively recent review of fiduciary obligations in English company law was undertaken for the English Law Commission by Cambridge University's Centre for Business Research. It formed the basis of sections 3.19-3.31 of the Law Commission's consultation paper Company Directors: Regulating Conflicts of Interests and Formulating a Statement of Duties (1998), *available at* http://www.lawcom.gov.uk/files/cp153.pdf. This consultation paper in turn formed the basis of further work by the Company Law Review.

been rationalized as an attempt to counterbalance a principal's vulnerability to the improper exercise of power by his or her fiduciary;[33] or as a response to a principal's reasonable expectation of loyalty from his or her fiduciary;[34] or as a means to redress the informational advantage of a fiduciary over his or her principal in dealings that involve them both and to create an incentive structure in which the self-interest directs the fiduciary to act in the best interests of his or her principal.[35]

Each of these ideas explains some features of a fiduciary relationship, but they are hard pressed to explain the limited implication of fiduciary obligations in English law and to explain why fiduciary obligations in English law principally prohibit or proscribe certain conduct, unless duly authorized, rather than direct or prescribe particular action.[36] Why, for example, is a car mechanic not a fiduciary for his or her customer, forbidden by fiduciary duties from engaging in self-interested action, given the power of the mechanic to affect the customer's interests and given the informational imbalance between mechanic and customer, and so forth? From the perspective of English law, the answer seems to be that it is possible to control the car mechanic's action through specific, easily contracted duties to perform a set task with a set measure of diligence. There is a bounded task around which parties can contract, not merely in theory, but in practice too: performance of the task can be assessed relatively easily, and consequently it is practicable *ex ante* to stipulate (or to have the law imply) specific constraints on the parties' conduct. In contrast, it is exceptionally difficult to stipulate specifically for the conduct to be undertaken by a trustee managing a trust fund or a by director managing a company, without abolishing managerial freedom: there are so many different circumstances that may arise in the course of

33 This idea has attracted considerable attention in Canada, *see* Frame v. Smith, [1987] 42 D.L.R. (4th) 81, 99. Note the varying reactions to the idea in Lac Minerals Ltd. v. Int'l Corona Res. Ltd., [1989] 2 S.C.R. 574, and Hodgkinson v. Simms, [1994] 3 S.C.R. 377.

34 *See* Paul D. Finn, *The Fiduciary Principle, in* Equity, Fiduciaries and Trusts 1, 46 (Timothy G. Youdan ed., 1989).

35 *See generally* Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 Colum. L. Rev. 1403 (1985); Robert Cooter & Bradley J. Freedman, *The Fiduciary Relationship: Its Economic Character and Legal Consequences*, 66 N.Y.U. L. Rev. 1045 (1991); Rutheford B. Campbell Jr., *A Positive Analysis of the Common Law of Corporate Fiduciary Duties*, 84 Ky. L.J. 455 (1996); Victor Brudney, *Contract and Fiduciary Duty in Corporate Law*, 38 B.C. L. Rev. 595 (1997).

36 *See supra* text accompanying note 25.

conducting the undertaking and so many different, unobjectionable ways of performing the undertaking.[37]

Now, clearly, English law does not want the chilling effect on managers, particularly business managers, of strict duties of care and skill. English company law has for more than a century regarded such strict duties as inefficient and undesirable, tending to the inhibition of entrepreneurial business activity.[38] However, the rejection of strict, prescriptive duties to act, and to act with diligence, does not alone explain the proscriptive content of fiduciary obligations in English law: at first sight, it would appear that the law could have just as easily used broad, open-textured, open-ended prescriptive rules (for example, a duty to act in someone else's best interests) in order to control managers without unduly limiting their discretion. However, such rules would still be very uncertain in their application and therefore correspondingly likely to inhibit entrepreneurial activity. Consequently, English law has instead concluded that it is more efficient to imply duties that remove specified conduct from the realm of the permissible, because it would tend to jeopardize performance of the positive undertaking in question, rather than to impose duties which stipulate in very broad terms the way in which that undertaking should be performed. Proscribing particular conduct, where a fiduciary has an interest that conflicts (or may conflict) with some identified part of his undertaking, may not be a perfectly precise exercise, but it is at least clearer and more practicable than prescribing in necessarily vague terms the entire conduct of the undertaking.

The practical manifestations of this theoretical approach are the greater importance in English law of fiduciary obligations as a means by which to

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37 *See* Cooter & Freedman, *supra* note 35.

38 It should be remembered that the United Kingdom has no business judgment rule, but, instead, allows discretion and freedom of action to directors by setting a flexible (and relatively low) standard of diligence. The older cases display a particularly indulgent attitude to directors. *See, e.g.*, Re Denham & Co., 25 Ch. D. 752 (1884); *In re* Cardiff Sav. Bank, [1892] 2 Ch. 100; Re Brazilian Rubber Plantations, [1911] 1 Ch. 425; and *Re* City Equitable Fire Ins. Co., 1925 Ch. 407 (all cases in the High Court). More recently, the courts have expected greater diligence from directors, but the courts still show an understandable reluctance to judge business decisions. *See, e.g.*, Norman v. Theodore Goddard, [1991] B.C.L.C. 1028 (H.C. 1991); Copp v. D'Jan, [1994] 1 B.C.L.C. 561 (H.C. 1993); *Re* Barings plc. (No. 5), [1999] 1 B.C.L.C. 433 (H.C. 1998); *Re* Barings plc., [2000] 1 B.C.L.C. 523 (C.A. 2000). Consequently, cases about directors' incompetence are much rarer than those about their disloyalty; and the cases where directors have been held negligent far more often concern a failure of management *process* than poor business *performance*, as witness *Re Barings plc. (No. 5)*.

control directors, as opposed to duties of care and skill, and the corresponding importance of efficient means of enforcing fiduciary obligations, both *ex ante* and *ex post.* Unfortunately, the very contractibility of the obligations undermines their enforcement in company law. This problem has two aspects.

First, English law allows a company's constitution (which explicitly represents a bargain between the shareholders)[39] to modify directors' fiduciary obligations so that they can be waived *ex ante* by the company's board, usually provided the interested director takes no part in that decision and always provided that the decision is made *bona fide* in the best interests of the company — something that may be hard to disprove.[40] This all tends very materially to weaken *ex ante* control over directors' self-interested behavior. Directors who are together involved in the management of a business are unlikely to constitute the best people to regulate each others' conflicts of duty and interest: considerations of collegiality and the incentives towards mutually supportive behavior at board meetings and elsewhere all make it unlikely that executive directors will adequately regulate each others' conflicts of duty and interest.[41]

Second, English law essentially allows a company's constitution to vest powers where it likes, unless mandatory rules provide otherwise.[42] In

39 *See* Companies Act, 1985, § 14; note also sections 9 and 18 of the Act as regards changes to a company's constitution.

40 *See, e.g.*, Table A, *supra* note 31, Regulations 84-87, 94. The requirement of directors' bona fides is a general implication of law. *See, e.g.*, *Re* a Co. (No. 00370 of 1987), 4 B.C.C. 506, 512 (1988). *See also supra* note 31.

41 While considerations of collegiality may impede the regulation by executives of their peers' conflicts of duty and interest, those same executives may have the incentive of self-advancement to monitor their colleagues' underperformance. This may be suggested by Kaplan's work on board turnover in Japan where boards tend to be dominated by insiders, Steven N. Kaplan, *Top Executive Rewards and Firm Performance: A Comparison of Japan and the US*, 102 J. Pol. Econ. 510 (1994). Different considerations apply to German public companies, as to which, see Steven N. Kaplan, *Top Executives, Turnover and Firm Performance in Germany*, 10 J.L. Econ. & Org. 142 (1994). German companies have a distinct supervisory board (*"Aufsichtsrat"*) to monitor the management board (*"Vorstand"*). One possibly significant difference between the present situation — *ex ante* control of executives' conflicts of interest by their peers — and executives' monitoring of each others' performance is that when authorizing a conflicted transaction in advance, a director has the hope of similar indulgence from his or her colleagues in the future, whereas there are not such obvious incentives to overlook others' past incompetence in the same hope: people seem not to worry so much about the possibility of their own future failure.

42 Note, by way of example, the provisions of Table A, *supra* note 31, Regulation 70.

particular, the constitution may vest power in a company's board to institute proceedings *ex post* to redress a breach of directors' duties;[43] and virtually all company constitutions contain provisions to this effect.[44] For the reasons just given, executive directors are unlikely to be the best people to decide whether to sue one of their number or a former director. This tends very materially to weaken *ex post* control over directors' self-interested behavior. Occasionally, proceedings are brought against former directors when control of a company changes, following either a sale or the opening of insolvency proceedings. Equally, there are occasions when the law will allow shareholders to bring proceedings against directors for the benefit of the company, but it is notoriously difficult to take advantage of those rare opportunities and often very risky to do so.[45]

In fact, it is hardly surprising that the constitution of a listed company will contain provisions such as those just described, because the management of the company invariably proposes the terms of its constitution, to be

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See also Automatic Self-Cleansing Filter Syndicate v. Cuninghame, [1906] 2 Ch. 34 (C.A.); Quin & Axtens Ltd. v. Salmon, 1909 A.C. 442; John Shaw & Sons (Salford) Ltd. v. Shaw, [1935] 2 K.B. 113 (H.C.). For examples of mandatory rules that limit this basic freedom, see *infra* Part III.

43 *See, e.g.*, Table A, *supra* note 31, Regulation 70; Breckland Group Holdings Ltd. v. London & Suffolk Prop. Ltd., [1989] B.C.L.C. 100 (Ch. 1988); Mitchell & Hobbs (UK) Ltd. v. Mill, [1996] 2 B.C.L.C. 102 (Q.B. 1995).

44 For the purposes of another article on voting rights in United Kingdom companies, Richard Nolan, *Indirect Investors: A Greater Say in the Company?*, 3 J. Corp. L. Stud. 73 (2003), the author undertook a survey of the constitutions of the FTSE 100 companies and of United Kingdom companies listed on the NYSE or NASDAQ. This survey confirms the assertion in the text: no company surveyed had a constitution with provisions different to those described in the text.

45 Shareholder suits are still governed in the United Kingdom by the notoriously opaque rule in Foss v. Harbottle, (1843) 2 Hare 461, and the various exceptions to the rule. *See generally* Prudential Assurance Co. Ltd. v. Newman Indus. Ltd., 1981 Ch. 257 (H.C.); Prudential Assurance Co. Ltd. v. Newman Indus. Ltd., 1982 Ch. 204 (C.A.); Section B of the Law Commission's consultation paper, Shareholder Remedies (1996), *available at* http://www.lawcom.gov.uk/files/cp142.pdf. Just as important as those jurisdictional rules, however, are the rules about the costs of court proceedings. In principle, a shareholder who brings a derivative action on behalf of a company will be responsible for his own costs; and contingency fees are very rare in English commercial litigation. The shareholder may pass those costs (or a fraction of them) on to a defendant who is found liable and is solvent, but correspondingly may have to bear the costs of a defendant who is not held liable. *See* Civil Procedure Rules, 1998, Part 44.3. The shareholder can seek an indemnity from the company for any of these costs, but such indemnities are not often awarded. *See* Civil Procedure Rules, 1998, Part 19.9(7).

simply adopted or rejected as a whole by shareholders. Consequently, shareholders generally accept the terms proposed by management: in the rhetoric of a shareholders' meeting they are easily justified as "standard terms"; shareholders are often ignorant of the practical effect of terms that look unobjectionable on their face, and even those who have doubts are often unwilling to "go nuclear" and reject the entire package proposed by management in a single resolution, so risking damage to the company by undermining or de-motivating its incumbent managers.[46]

The previous paragraphs demonstrate the central problem of English company law in controlling directors' conflicts of interest: fiduciary obligations are vitally important, but those fiduciary obligations are very difficult to enforce and are correspondingly rarely litigated.[47] The practical result of all this is to undermine radically the effectiveness of the law. In the absence of other control mechanisms, directors are left with significant scope for unchecked abuse of their positions.

Of course, there are other, non-legal factors that may restrict directors' behavior: reputational concerns, for example. The usefulness of these may be overstated, however. For example, executive directors in the United Kingdom have shown little sign of moderating their self-interested demands for remuneration in the face of considerable public and shareholder protest.[48] Indeed, even allowing that reputational controls have some useful effect, they alone have clearly not met investors' present dissatisfaction with directors' self-interested behavior, particularly in relation to directors' remuneration. It is no reply to question the utility of shareholders' wishes to control company managers: shareholders may be unwise, or even irrational, in their judgment of directors, but their views are entitled to prevail unless their very role in

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46 These are examples of failure in the process of contracting round directors' duties in a company's constitution. *See supra* note 31.

47 Stapledon notes that "actions to enforce the duties of directors of quoted companies have been almost non-existent." Geoffrey Stapledon, Institutional Shareholders and Corporate Governance 13-14 (1996). See also the position paper prepared by the ESRC Centre for Business Research at the University of Cambridge for the English and Scottish Law Commissions, Simon Deakin & Alan Hughes, Directors' Duties: Empirical Findings — Report to the Law Commissions § 5.1 (particularly Table 4), § 5.2 (1999), *at* http://www.lawcom.gov.uk/files/study.pdf.

48 See the recent (2003) annual general meetings of, for example, Royal & Sun Alliance plc., Barclays plc., Reuters plc., Grenada plc., and The "Shell" Transport and Trading Company, plc. (Shell Oil). At its 2003 AGM, Tesco plc. faced vocal shareholder resistance to its directors' remuneration report; it indicated that it would reconsider the contracts awarded to its directors.

the company is recast, so as to curtail the powers and liberties corporate law presently allows them.[49]

The problems outlined in this part of the paper have, quite understandably, led policymakers to conclude that there should be some other mechanism(s) in English law for enforcing restraints on directors' self-interested behavior. However, before turning to the role of non-executive directors, it is useful to examine briefly other legal means of holding directors accountable in English law. They form a rather heavy-handed, incoherent, "scatter-gun" selection of responses to the problems just described.

II. OTHER MECHANISMS FOR HOLDING DIRECTORS ACCOUNTABLE

The first response of UK legislators to the problems outlined in the previous part of this paper has been to reserve power to shareholders by mandatory stipulation: provisions of the companies legislation have limited the extent to which directors can be given the power in a company's constitution to validate self-interested behavior by one of their number. The number of such provisions has increased over the years.[50] Under Part X of the Companies Act, 1985, gratuitous payoffs to directors must be approved (sections 312, 313); substantial property transactions between a company and its director (or someone connected to a director) must be prospectively authorized by shareholders (sections 320-322); and loans by a company to its directors (or connected persons) are banned in most circumstances (sections 330-342).

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49 The Government has recently made it quite clear that the basic economic structure of the corporation in the United Kingdom is not to be changed: it will remain fundamental to English corporate law that a commercial company exists to create wealth for its shareholders, albeit in an "enlightened" fashion. *See* Government's White Paper, Modernising Company Law 9, 26 (2002). This paper set out the Government's response to the Company Law Review and endorsed the Review's conclusions as to the functions of company law, which were set out in Modern Company Law for a Competitive Economy: The Strategic Framework at ch. 5.1 (1999); Modern Company Law for a Competitive Economy: Developing the Framework at ch. 3 (2000); and Modern Company Law for a Competitive Economy: Completing the Structure at ch. 3.5 (2000). Consequently, this paper takes it as axiomatic that the fundamental function of directors in a commercial company is to further the creation of wealth through the company for its shareholders. The aim of the paper is to consider some of the implications of the role conferred on such directors.

50 See Appendix C to the Law Commission's consultation paper, Company Directors: Regulating Conflicts of Interests and Formulating a Statement of Duties, *supra* note 32.

Under Part XA of the 1985 Act, substituted into the Act by the Political Parties, Elections and Referendums Act, 2000, political expenditure by companies must first be approved by shareholders. Under sections 234B, 234C, and 241A of the 1985 Act, introduced on August 1, 2002, a report on directors' remuneration must be submitted to a vote by shareholders, though the result of the vote is non-binding.[51] Regulators have also insisted on shareholders having power in relation to transactions where a director might have a conflict of duty and interest. Under the Listing Rules issued by the United Kingdom Listing Authority, companies listed on the London Stock Exchange must normally obtain shareholder approval for "related party transactions": that is, transactions between a company (or any of its subsidiaries) and a director or certain of his or her associates.[52] This strategy of returning power to shareholders has its limitations, however, in a widely-held, listed company.[53]

First, any provision that requires the prospective consent of shareholders to a proposed transaction by a company will involve a general meeting of shareholders: the only present alternative — informally obtaining unanimous consent — is simply not a practical option in a listed

51 Before these provisions were introduced, Cheffins & Thomas predicted that shareholder voting would only operate as a check on executive pay when the pay deviates far from the norm. Brian R. Cheffins & Randall S. Thomas, *Should Shareholders Have a Greater Say over Executive Pay? Learning from the US Experience*, 1 J. Corp. L. Studies 277 (2001). Their prediction appears to have been borne out in 2003, the first year in which companies had to put executive pay to a vote of shareholders. Only one such vote has been lost, in respect of a package that did deviate significantly from the norm: on May 19, 2003, shareholders in Glaxosmithkline plc., by a very narrow margin, rejected the company's remuneration report, principally because of the remuneration package of its CEO, Jean-Pierre Garnier, result *at* http://www.gsk.com/financial/AGM_Poll_Results_2003.pdf. The company's chairman, Sir Christopher Hogg, said "Although Resolution 2 [on the remuneration report] is advisory, the Board takes this result very seriously." GSK Press Release, May 19, 2003, *at* http://www.gsk.com/media/pressreleases.htm. In other shareholder votes on executive remuneration, major (institutional) shareholders have often abstained, to indicate concern about the remuneration, but they have not actually voted against it. *See supra* note 48.

52 Listing Rules, §§ 11.4-11.8.

53 The evidence from the United States about shareholder proposals tends not to support the case for expanding shareholder powers in public companies; *see* Roberta Romano, *Less Is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance*, 18 Yale J. Reg. 174 (2001); Bernard S. Black, *Shareholder Activism and Corporate Governance in the United States, in* 3 The New Palgrave Dictionary of Economics and the Law 459 (Peter Newman ed., 1998); Jonathan M. Karpoff et al., *Corporate Governance and Shareholder Initiatives: Empirical Evidence*, 42 J. Fin. Econ. 365 (1996).

company. Unless the transaction is sufficiently predictable that it can be scheduled for consideration at a company's annual general meeting (for example, approving directors' remuneration),[54] obtaining shareholders' consent will involve calling an extraordinary general meeting of the company, something that is slow, inconvenient, and expensive.[55] Furthermore, seeking shareholders' approval for a transaction that would otherwise be prohibited will necessarily involve full and frank disclosure of all material facts surrounding the proposal.[56] This can be inappropriate where it would risk disclosure to the world at large of commercially sensitive information.

Second, even where shareholder consent is required, but is not obtained, so that a civil remedy flows from that omission, the power to bring proceedings is vested in the board, and consequently proceedings are unlikely to be brought.[57] Only one set of provisions — those in Part XA of the Companies Act, 1985 (political donations) — addresses this problem and allows a shareholder suit for breach of the prohibitions in that Part. However, even that does not resolve other, more serious problems. These are the problems of apathy and collective action.[58] Why should a particular shareholder in a company take action that will benefit all such shareholders, rather than just the one who took the action? Worse still, under English civil procedure, a shareholder litigant is at severe risk as to the costs of the litigation.[59] Unsurprisingly, these possibilities exert a severe chilling effect on contemplated litigation by shareholders. In short, there is very little reason or incentive for a particular shareholder to take action that has the aim and, if successful, the effect of procuring a remedy that, in legal terms, is awarded to the company and, in economic terms, inures for the benefit of all those with claims against the defined fund of assets known as the company's property. It is simply not worthwhile.

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54 Generally, a company must in any event have an annual general meeting. Provisions that derogate from this general rule do not apply to listed public companies, *see* Companies Act, 1985, §§ 366, 366A.

55 Note, as regards "corporate opportunities," Deakin & Hughes, *supra* note 47, § 5.2.

56 *See, e.g.*, Imperial Mercantile Credit Ass'n v. Coleman (1873) L.R. 6 H.L. 189, 201 (Lord Chelmsford); New Zealand Netherlands Soc'y v. Kuys [1973] 1 W.L.R. 1126. Note also the commentary on section 320 of the Companies Act, 1985, in Buckley on the Companies Acts (Mary H. Arden et al. eds., 15th ed. 1998).

57 *See* text at *supra* note 43.

58 *See, e.g.*, Bernard S. Black, *Shareholder Passivity Reexamined*, 89 Mich. L. Rev. 520 (1990); Mark J. Roe, Strong Managers, Weak Owners: The Political Roots of American Corporate Finance (1994). These works deal with the situation in the United States, but the situation in the United Kingdom is similar.

59 *See supra* note 45.

Another strategy adopted by English company law is to control directors' conflicts of interest through the criminal law.[60] The principal techniques used by the law are to criminalize conflicted conduct by a director[61] or to criminalize the director's failure to disclose the conflict.[62] It is highly questionable whether these criminal offences concerned with conflicted transactions by a director are in fact useful: they are virtually never prosecuted.[63] However, they are often defended on the grounds that they exert a severe chilling effect and thereby control directors' conflicts of interest.[64] It is argued that they do this principally through two mechanisms.[65] First, the threat of criminal sanctions is said directly to condition a director's behavior. Second, it is suggested that the provisions give a lever to professional advisors who seek to ensure that directors do not fall into conflicts of interest: for example, a lawyer can point out the criminal sanctions attaching to certain conduct, tell the client to comply with the law, and refuse to be party to any illegal conduct.

It is very difficult to say whether these criminal sanctions are effective by virtue of the rather more oblique consequences suggested above. There is, however, one study in the United Kingdom that addresses professional advisors' reactions to criminal penalties for undisclosed, conflicted action by directors.[66] On the basis of "background interviews with legal practitioners," this study suggests that "the possibility of criminal sanctions can concentrate the minds of directors," because "[a]dvisers feel that without the threat of such

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60 See generally Ronald J. Daniels, *Must Boards Go Overboard? An Economic Analysis of the Effects of Burgeoning Statutory Liability on the Role of Directors in Corporate Governance*, 24 Can. Bus. L.J. 229 (1994-95), and the research note for the Company Law Review by the ESRC Centre for Business Research at the University of Cambridge, Economic Effects of Criminal and Civil Sanctions in the Context of Company Law, *at* http://www.dti.gov.uk/cld/deakin_z.pdf (2000).

61 For example, the Companies Act, 1985, § 342, criminalizes certain loans made by a company to a director.

62 For example, the Companies Act, 1985, § 317, criminalizes a company director's failure to disclose his or her interest in a contract with the company.

63 Company Directors: Regulating Conflicts of Interests and Formulating a Statement of Duties, *supra* note 32, § 10.3. *See also* Department of Trade & Industry, Companies in 2002-2003, Section D (2003), *available at* http://www.dti.gov.uk /cld/dtiannualreport.pdf [hereinafter Companies in 2002-2003].

64 Modern Company Law for a Competitive Economy: Completing the Structure, *supra* note 49, ch. 13; Company Law Review, Company Law Review, Modern Company Law for a Competitive Economy — Final Report at ch. 15 (2002).

65 See also Ferran, *supra* note 6, at 406-09, for a consideration of these arguments as well as others raised by the Company Law Review in favor of using criminal sanctions as a means to control directors.

66 Deakin & Hughes, *supra* note 47, § 5.3.5.

sanctions, it would be more difficult for them to persuade certain directors to avoid certain transactions of dubious legality." Consequently, the study concludes, "We do not have any direct evidence of this use of the law, but frequent references by practitioners suggest that the threat of criminal liability may, through the medium of legal advice, have a significant influence on behaviour in practice." Suffice it to make three comments. First, the author's experience in legal practice tends to suggest that those who are deterred by the criminal law, when it is manifestly not enforced, are those who also worry about, and are constrained by, civil liabilities and reputational concerns, while those who are not worried about such matters behave with cynical contempt for the criminal law — they simply calculate the likelihood of being held to account for a crime and conclude that it is not great in the present context. Second, and much more importantly, it must be questionable for the law to rely on provisions the effectiveness of which is admitted to be anecdotal.[67] Third, the control of dealing in securities by the criminal law (insider trading)[68] has been the subject of much criticism,[69] and Parliament has more recently enacted civil ("administrative") controls on transactions in securities.[70]

There is, however, a new dimension to criminal sanctions, which may yet prove to be extremely important and render them very effective — perhaps too effective. This is the impact of the Proceeds of Crime Act, 2002. The relevant portions of that Act (Parts 5 and 7) only came into force in December 2002 and February 2003. As they are so recent, they are not addressed in the existing scholarly literature on the efficacy of criminal sanctions in corporate law. This is a significant gap in the literature, which must certainly be filled.

The 2002 Act not only provides for the recovery of benefits made through criminal activity, but it can also implicate professional advisors. Under section 329 of the 2002 Act, a person who acquires, uses or has possession of "criminal property" commits an offence, subject to applicable defenses. For these purposes, property is "criminal property" if it constitutes

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67 Ferran, *supra* note 6, also casts doubt on the continued heavy emphasis of criminal sanctions to control directors. That said, a policy consensus is likely to ensure that criminal sanctions will remain a feature of the English law of directors duties. *See* Modern Company Law for a Competitive Economy — Final Report, *supra* note 64, § 15.4.

68 *See* Criminal Justice Act, 1993, pt. V.

69 *See, e.g.*, Barry A.K. Rider, Insider Crime: The New Law (1993). The number of prosecutions for insider trading each year in the United Kingdom is in low single figures. *See* Companies in 2002-2003, *supra* note 63, at 50.

70 Financial Services and Markets Act, 2000, pt. VIII (the "market abuse" regime).

a person's "benefit" from criminal conduct, or it represents such a benefit, and the alleged offender knows or suspects that it constitutes or represents such a benefit. Section 329 could well catch fees earned by professionals who advise in connection with a transaction that involves commission of a criminal offence, given the width of the relevant definitions in section 340 of the Act. In addition, under section 328 of the 2002 Act, a person commits an offence, again, subject to relevant defenses, if he enters into, or becomes concerned in, an arrangement which he knows or suspects facilitates the acquisition, retention, use or control of "criminal property" by or on behalf of another person. This too could catch professionals advising on corporate transactions that involve illegal action. A defence to both of these crimes is to make an "authorised disclosure" of the facts to the relevant governmental authorities, under section 338 of the Act. In future, professional advisers may well have to make such a disclosure, and abstain from acting, in order to avoid committing a crime themselves. Finally, under Part 5, Chapter 2 of the Act, any property which is obtained through unlawful conduct (and its proceeds) will be prima facie "recoverable property", and so can be seized in civil recovery proceedings by the relevant governmental enforcement authority. All this may yet give real teeth to criminal sanctions in the context of corporate law.

The next, and much discussed, mechanism in English law for controlling directors' conflicts of interest is directors' disqualification proceedings.[71] Breach of fiduciary or statutory duty by a director is a ground, under section 6 of the Company Directors Disqualification Act, 1986, for disqualifying that director. If a person acts as a director in breach of a disqualification order, he or she will be liable to criminal prosecution and will also be exposed to civil liability for the debts incurred by a company while he or she was wrongfully a director of it.[72] Public authorities — principally the Insolvency Service, an agency of the Department of Trade and Industry — enforce the disqualification regime, acting most commonly on the reports provided by liquidators of companies.[73] There have been some very high-profile disqualification proceedings — directors of Barings Bank were disqualified for their managerial inadequacies in the "Nick Leeson Scandal" that broke

71 *See generally* Adrian Walters & Malcolm Davis-White, Directors' Disqualification: Law and Practice (1999).

72 Company Directors Disqualification Act, 1986, §§ 13, 15.

73 See the guidance provided by the Insolvency Service *at* http://www.insolvency.gov.uk/information/guidanceleaflets/guide/chapter6.htm (last visited Sept. 30, 2003).

the Bank.[74] Nevertheless, the limitations of disqualification proceedings are readily apparent.

Enforcement depends on public bodies, which tend to be underfunded. Furthermore, though the effect of proceedings in a particular case is salutary, discussions with practicing lawyers reveal that disqualification proceedings are taken in a small minority of possible cases.[75] More importantly still, the immediate effect of disqualification proceedings is inevitably after the event: disqualification proceedings respond directly to the past wrongdoing or inadequacies of directors. The only prospective, normative effect of such proceedings is in the general culture they engender, something that is very difficult to measure. Given that there are considerably more directors disqualification cases than prosecutions relating to directors' conflicts of interest,[76] it is very likely that disqualification proceedings have a much more significant normative impact than the threat of prosecution; but such indirect and nebulous effects are hardly a substitute for proper *ex ante* and *ex post* internal control mechanisms within a company.

The Department of Trade & Industry also has powers to investigate companies, principally contained in Part XIV of the Companies Act, 1985, and especially section 447. These powers are used moderately,[77] but generally only where there has been a fraud on creditors of a company or on the public

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74 *Re* Barings plc. (No. 5), [1999] 1 B.C.L.C. 433 (High Court); [2000] 1 B.C.L.C. 523 (C.A.).

75 Government statistics reveal that there are around 1800 disqualification orders made each year, *see* Companies in 2002-2003, *supra* note 63, at 49. This may seem like a large number — and it is by comparison with the number of criminal prosecutions for infractions of prohibitions on conflicts of duty and interest — but two points should be made. First, according to evidence from leading practitioners, it is but a small fraction of the cases for disqualification referred to the Department of Trade & Industry. Secondly, and more importantly, the number of disqualification orders is somewhat misleading, because they include not just court proceedings but also disqualifications by consent, *see* Company Directors Disqualification Act, 1986, § 1A, though consent orders were made in substance by compromised court proceedings — the so-called "Carecraft" procedure — before section 1A was introduced. So, 1275 of the 1777 disqualifications made in the year 2002-03 were made by consent, *see* Companies in 2002-03, *supra* note 63, at 49. It must be admitted, however, that even disqualification by consent represents some effort at enforcement by the Insolvency Service.

76 The point is made forcefully in the annual statistics prepared by the Department of Trade and Industry. For the most recent set of figures, see Companies in 2002-2003, *supra* note 63, Section D. *Compare also* text at *supra* note 63.

77 *See* Companies in 2002-2003, *supra* note 63, at 21.

at large.[78] The provisions have little relevance to the control of directors' conflicts of duty and interest.

Finally, before turning to the Higgs Report itself, one more provision of English company law deserves a brief mention, if only for the sake of completeness: section 459 of the Companies Act, 1985. Section 459 allows a shareholder to bring proceedings in his or her own name for redress of "unfairly prejudicial conduct" of a company's affairs. The section has become extremely important in the context of small, "quasi-partnership" companies, but it has little significance for large, listed companies. While a shareholder in a listed company can use section 459 to seek a remedy on behalf of the company of which he or she is a member,[79] and can thereby sidestep the procedural problems of a derivative action in the English courts,[80] section 459 does nothing about the lack of incentives for the shareholder to bring action on behalf of the company to remedy a wrong.[81] Furthermore, the courts will not give the shareholder such an incentive, by allowing him a personal remedy under the section. This is because the courts have restricted the meaning of "unfairly prejudicial conduct" of a listed company's affairs to circumstances that involve the company's directors breaching their legal duties to the company,[82] and the courts appear unwilling to reward a shareholder with a personal remedy in respect of this sort of unfairly prejudicial conduct, even though they have jurisdiction to do so. Presumably, the reason for the courts' reluctance is that they are aware that an award of funds from a defaulting director to one particular shareholder could prejudice any chance of recovery by, or on behalf of, other shareholders whose interests were equally harmed. Similarly, section 459 does nothing about the problems of funding shareholder litigation.[83] In short, section 459 has little relevance to listed companies.

Given the various inadequacies of legal controls on the executive management of listed companies, it is hardly surprising that there has been great interest over the past fifteen years or so in the use of non-executive directors as a means by which executive directors can be held to account. Indeed, the evidence is that non-executive directors have already come to be the most significant mechanism for the control of

78 *See id.* at 21-22.
79 Companies Act, 1985, § 461(2)(c).
80 *See supra* note 45 and accompanying text.
81 *See* text at *supra* note 58.
82 *See especially Re* Astec plc., [1998] 2 B.C.L.C. 556. *Note also Re* Blue Arrow plc., [1987] B.C.L.C. 585; *Re* Tottenham Hotspur plc., [1994] 1 B.C.L.C. 655.
83 *See supra* note 45 and text at *supra* note 59.

executive directors' conflicts of duty and interest in listed companies.[84] Admittedly, such reliance may well suggest that other reforms of English corporate and procedural law are desirable. However, it is unlikely that there will be timely and effective reform of the relevant law. For example, while the current review of company law in the United Kingdom proposed a reformed derivative action,[85] the incentives to use a new, reformed derivative action will (apparently) remain unchanged, so that it will not likely be of significant utility. This reflects the deep policy ambivalence in the United Kingdom towards shareholders' engagement in corporate governance: shareholder activism is lauded and encouraged;[86] but the encouragement does not seem to go as far as shareholder litigation, which is seen as economically wasteful.[87] There is still less chance of increased public enforcement of directors' duties: whatever the rhetoric, it is simply not a sufficient political priority to attract increased funding — and that may be no bad thing. In short, problems with other means of holding executive directors to account have turned the use of non-executive directors into the preferred method (at least for the time being) of improving corporate governance in United Kingdom listed companies. And given that such problems look set to continue (at least for the foreseeable future), change in the governance practices of United Kingdom listed companies will most likely come about in the short- to medium-term through the better use of non-executive directors.

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84 Deakin & Hughes, *supra* note 47, § 5.1.

85 Modern Company Law for a Competitive Economy: Completing the Structure, *supra* note 49, §§ 5.82-5.90; Modern Company Law for a Competitive Economy — Final Report, *supra* note 64, §§ 7.46-7.51.

86 See, e.g., Paul Myners et al., Institutional Investment in the UK: A Review (2001) [hereinafter Myners Report], *available at* http://www.hm-treasury.gov.uk/media//843F0/31.pdf, which was endorsed by the United Kingdom Government in the Chancellor of the Exchequer's Budget Speech of March 7, 2001, *available at* http://www.hm-treasury.gov.uk/budget/budget_2001/bud_bud01_speech.cfm.

87 A good example of the English courts' negative attitude is Prudential Assurance Co. Ltd. v. Newman Indus. Ltd. (No. 2), 1982 Ch. 204 (C.A.). This attitude has led one leading commentator, Professor Len Sealy, to comment bluntly that "[i]t has become far too easy for our [United Kingdom] judges to say to such a [shareholder] plaintiff: 'Go away.'" Len S. Sealy, *Problems of Standing, Pleading and Proof in Corporate Litigation, in* Company Law in Change 1, 1 (Ben G. Pettet ed., 1987). For a comparison with the position in the United States, see Deborah A. DeMott, *The Figure in the Landscape: A Comparative Sketch of Directors' Self-Interested Transactions*, 3 Company Fin. & Insolvency L. Rev. 190, 210 (1999).

III. MANAGERS AND MONITORS: THE DUAL ROLE OF NON-EXECUTIVE DIRECTORS

Non-executive directors rose to prominence in United Kingdom corporate governance following the report of the Cadbury Committee in December 1992.[88] The Cadbury Report saw a wide role for non-executive directors: it stated that "[n]on-executive directors should bring an independent judgment to bear on issues of strategy, performance, resources, including key appointments, and standards of conduct."[89] In particular, the Nomination Committee, a committee of the board that proposed directors for appointment, was to have a majority of non-executive directors;[90] and the audit committee was to be composed of non-executive directors,[91] a majority of whom ought to be "independent" within the meaning of the Cadbury Report.[92] These last two important roles involve the monitoring of executive directors: non-executive directors could review the reappointment of executive directors, who are invariably elected to serve for a fixed period of time;[93] and they could monitor management of the company through their activities on the audit committee. Nevertheless, the Cadbury Report envisaged a company's non-executive directors as more than just monitors of the company's other directors: the non-executives were to engage in managing the company through their input into the company's strategy.

The subsequent report of the Greenbury Committee[94] recommended that the board of a company, and particularly of a listed company, should create a remuneration committee, which would set executive directors' remuneration packages.[95] This remuneration committee should be comprised exclusively of

88 Cadbury Report, *supra* note 7.

89 *See id.* § 4.11.

90 *See id.* § 4.30.

91 *See id.* § 4.35.

92
> This means that apart from their directors' fees and shareholdings, they should be independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgement. It is for the board to decide in particular cases whether this definition is met. Information about the relevant interests of directors should be disclosed in the Directors' Report.

Id. § 4.12.

93 *See* Old Combined Code, *supra* note 5, Principle A.6; New Combined Code, *supra* note 3, Principle A.7.

94 Greenbury Report, *supra* note 8.

95 *Id.* draft code § A1.

independent non-executive directors.[96] The board as a whole would continue to set non-executive directors' fees.

In January 1998, the Hampel Committee on Corporate Governance reaffirmed the two roles of non-executive directors, monitoring and the formation of strategy. Indeed, the strategy role was emphasized above the monitoring role, something on which investors in the United Kingdom might usefully reflect:

> The importance of corporate governance lies in its contribution both to business prosperity and to accountability. In the UK the latter has preoccupied much public debate over the past few years. We would wish to see the balance corrected.
>
> .....
>
> Non-executive directors are normally appointed to the board primarily for their contribution to the development of the company's strategy. This is clearly right. We have found general acceptance that non-executive directors should have both a strategic and a monitoring function. In addition, and particularly in smaller companies, non-executive directors may contribute valuable expertise not otherwise available to management; or they may act as mentors to relatively inexperienced executives.[97]

In June of that same year, the work of these various committees was consolidated into the Old Combined Code, which still forms an appendix to the United Kingdom Listing Rules and governs the behavior of companies, on a "comply or explain basis,"[98] so long as they seek to maintain a listing on the London Stock Exchange.[99]

The Old Combined Code broadly continued the previous arrangements for non-executive directors to act as a check on executive directors. So, non-executive directors were to comprise at least one third of a board.[100] A nomination committee still controlled recommendations for appointment to the board; and a majority of the committee's members were still to be

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96 *See id.* § A4.

97 Hampel Report, *supra* note 9, §§ 1.1, 3.8.

98 *See* text at *supra* note 14.

99 The Old Combined Code is superseded by the New Combined Code in relation to a listed company for the company's accounting years beginning on or after November 1, 2003. *See supra* note 3.

100 Old Combined Code, *supra* note 5, § A.3.1. The New Combined Code requires at least one half of the board to be comprised of independent non-executive directors, New Combined Code, *supra* note 3, § A.3.2.

non-executive directors.[101] The audit committee was to continue to monitor management and was still to be composed of non-executive directors, and a majority were to be independent.[102] A remuneration committee comprised of independent non-executive directors was to set executive directors' remuneration packages.[103]

Yet, notwithstanding that the specifically identified tasks of independent non-executive directors are almost invariably concerned with controlling executive directors' conflicts of duty and interest, or else with monitoring executive management, the role of the non-executive director still apparently extends into managing a company's business. As the Old Combined Code put it, "All directors should bring an independent judgement to bear on issues of strategy, performance, resources, including key appointments, and standards of conduct."[104]

Only the Law Commission, writing in September 1998, saw the role of non-executive directors as "principally that of monitors rather than managers."[105] It is, in itself, very interesting that government lawyers — law reformers — should have such different ideas from the businessmen (and their legal advisors) involved in writing the Cadbury, Greenbury, Hampel, and Higgs Reports. Much more recently still, the courts have drawn attention primarily to the monitoring function of non-executive directors:

> It is well known that the role of non-executive directors in corporate governance has been the subject of some debate in recent years. ... It is plainly arguable, I think, that a company may reasonably at least look to non-executive directors for independence of judgment and supervision of the executive management.[106]

Clearly, the expectations of those businessmen and their advisors are not

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101 Old Combined Code, *supra* note 5, § A.5.1, continued by New Combined Code, *supra* note 3, § A.4.1, but specifically requiring the non-executive directors to be *independent*.

102 Old Combined Code, *supra* note 5, § D.3.1, continued by New Combined Code, *supra* note 3, § C.3.1, but again specifically requiring the non-executive directors to be *independent*.

103 Old Combined Code, *supra* note 5, §§ B.2.1, B.2.2, continued by New Combined Code, *supra* note 3, § B.2.1.

104 Old Combined Code, *supra* note 5, § A.1.5. The substance of that paragraph is continued by New Combined Code, *supra* note 3, Principle A.1 and Supporting Principles.

105 Company Directors: Regulating Conflicts of Interests and Formulating a Statement of Duties, *supra* note 32, § 3.46.

106 Equitable Life v. Bowley [2003] EWHC 2263 (Comm) at 41 (per Langley J.).

universally shared. Such a mismatch of expectations and understandings is fraught with the risk of disappointment and consequent strife. At the very least, therefore, what is needed is an open, prominent debate to establish the role of non-executive directors.

The Higgs Report has adhered to, indeed has reemphasized, the dual management and monitoring role of non-executive directors in the United Kingdom.[107] It is worth setting out at some length what the Report has to say on the point.

> The role of the non-executive director is frequently described as having two principal components: monitoring executive activity and contributing to the development of strategy. Both Cadbury and Hampel identified a tension between these two elements.
>
> Research commissioned for the Review drew a somewhat different conclusion. Based on 40 in-depth interviews with directors, the research found that while there might be a tension, there was no essential contradiction between the monitoring and strategic aspects of the role of the non-executive director. Polarized conceptions of the role, the research noted, bear little relation to the actual conditions for non-executive effectiveness. An overemphasis on monitoring and control risks non-executive directors seeing themselves, and being seen, as an alien policing influence detached from the rest of the board. An overemphasis on strategy risks non-executive directors becoming too close to executive management, undermining shareholder confidence in the effectiveness of board governance.
>
> The research concludes that it is important to establish a spirit of partnership and mutual respect on the unitary board. This requires the non-executive director to build recognition by executives of their contribution in order to promote openness and trust. Only then can non-executive directors contribute effectively. The key to non-executive director effectiveness lies as much in behaviours and relationships as in structures and processes.[108]

This paper suggests that the Higgs Report is wrong to recommend

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107 *See, e.g.*, Higgs Report, *supra* note 2, § 4.2.

108 *See id.* §§ 6.1-6.3. See also suggested Code provision A.1.4 in Annex A to the Higgs Report, *id.*, and the draft guidance for non-executive directors in Annex C to the Report, *id.* Paragraph A.1.4 of the code suggested by the Higgs Report has been incorporated into the New Combined Code, *supra* note 3, § A.1, Supporting Principles.

continued, conflated management and monitoring roles for non-executive directors. The role of *independent* non-executive directors should be the audit of management in general, and in particular the control of managers' conflicts of interest, though a company should have the option of retaining other non-executive directors for other reasons, such as input into the company's business strategy. This suggestion has both positive and negative aspects. These are outlined below and are developed in more depth through the rest of the paper.

On the positive side, properly focused, independent non-executive directors are well placed to monitor and control executive directors' conflicts of interest: their continuous, if not day-to-day involvement in the governance of a company means that they do not face many of the difficulties, outlined earlier, that shareholders in a company encounter when trying to control its management. Also on the positive side, giving independent non-executive directors a more limited role, but more power within that role, would actually meet the concerns of executive directors who do not want to be constantly constrained when running the company's business: the executive directors would be allowed to get on with their economic function of managing the company for the shareholders profit,[109] constrained by the independent non-executive directors only when there is a risk that they will deviate from that function, either because of conflicts of interest or because of negligence. In short, a clear, limited role for independent non-executive directors would preserve managerial freedom for executive directors: the role of independent non-executive directors can be so defined as to preserve executive management from undue interference.

On the negative side, it is suggested that giving a mixed set of functions to non-executive directors makes it less likely they will perform any of them well, particularly under pressure. The Higgs Report's confidence to the contrary is optimistic, to say the least. Furthermore, there is good evidence, addressed shortly, that nothing would be lost by removing the insistence that non-executive directors should participate in management, principally the formation of strategy.

The proposals put forward in this paper can be achieved within the current, very flexible structure of English company law, as will be demonstrated. Statements in the Higgs Report that suggest the contrary are, with respect, unsound as a matter of current English law. To give a clear monitoring role to independent non-executive directors would

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109 This has historically been the purpose of the managers of a commercial company. *See supra* note 49.

not mean adopting a German style two-tier board structure, something that, historically, has been anathema in the United Kingdom.[110] Present corporate structures, involving a unitary board, are quite flexible enough and are, for other reasons, preferable to the German system.[111] Indeed, for any suggestion to be practically and politically viable in the United Kingdom, it simply must involve a single board: neither business nor the Government is willing to accept two-tier boards, as the Higgs Report itself very clearly recognized.[112] In addition, the suggested, more focused role for independent non-executive directors is practical — at the very least, as practical as the proposals of the Higgs Report.

A code will be necessary to ensure that change comes about, whether as proposed by the Higgs Report or as proposed by this paper. A code will also be necessary to ensure that independent non-executive directors only serve for a limited period, so as to avoid the risk of long-serving independent non-executive directors becoming too close to management, thus impairing, or even subverting, their monitoring role. In fact, the Higgs Report itself makes suggestions to this end.[113] The provisions in such a code should be enforced in the same way as the Old and New Combined Codes: "comply or explain."[114] This seems to have been effective so far, without being heavy-handed.[115]

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110 See, for example, the response to consultation reported in Modern Company Law for a Competitive Economy: Developing the Framework, *supra* note 49, § 2.17.

111 In short, if the law creates a single board structure for all companies, large and small, but allows sufficient flexibility in that structure, the law can avoid all the problems and complexities that arise from imposing different structures on different sizes of enterprise, problems that become very acute as an enterprise grows.

112 *See* Higgs Report, *supra* note 2, §§ 1.7, 4.2, 4.3, 14.1.

113 The Higgs Report proposes that more than ten years' service as a director will raise an inference that the director has ceased to be "independent," *id.* § 9.14, and suggested Code provision A.3.4. The New Combined Code, *supra* note 3, § A.3.1., has reduced the period to nine years. It may be over-optimistic to expect a director's "independence" to survive as long as nine years' service on a board.

114 *See* text at *supra* note 14.

115 See the Modern Company Law for a Competitive Economy: Developing the Framework, *supra* note 49, § 3.129, and the empirical evidence cited there.

IV. THE SUGGESTED CLEAR AND FOCUSED ROLES FOR NON-EXECUTIVE DIRECTORS

Independent non-executive directors could make a more useful contribution to the control of executive directors' conflicts of interest if monitoring and controlling management were explicitly made their central task. Non-executives are better placed than shareholders to discover other directors' conflicts of interest precisely because they are continuously involved in governing the company concerned, even if they do not run its business. For the same reason, they are better placed to exert control over such conflicts when required, and they do not face the same problems of collective action as shareholders. That is not to say they are a substitute for shareholder power, any more than a nation's constitutional separation of powers is a substitute for its democratic process. Indeed, there are good reasons not to place exclusive or even overly strong emphasis on non-executive directors, to the exclusion or marginalization of shareholders: non-executive directors must themselves be chosen and held to account. There is no reason to expect an improvement in corporate governance if shareholders are expected to write a blank check to non-executive directors rather than executive directors: non-executive directors, if themselves unchecked, are unlikely over time to perform effectively.

There are, of course, practical issues entailed by this suggestion, but as will be seen, it should be possible to manage them adequately. Giving this more limited but more focused role to independent non-executive directors will make it possible to recruit such directors from a larger pool of people, including United Kingdom professionals, who are used to working for fees. Before addressing these practicalities at proper length, however, the proposal itself should be explored more fully.

The use of independent non-executive directors to control conflicts of interest within management would also allow the proper separation and performance of the two aspects of a conflicted transaction that have often been elided together. There has been for years a debate about the proper characterization of conflicted transactions: Are they really management decisions, to be taken by management, or are they decisions about the enforcement of directors' fiduciary duties, to be taken by shareholders? This debate has often focused on the directors who want to take corporate opportunities or information, but it applies equally to questions of executive pay. The reality is that conflicted transactions raise both questions of management — whether the proposal is a good deal from the company's perspective — and questions of directors' fiduciary duties — whether it is prudent to waive a prohibition on directors' self-interested behavior, human nature being as it is.

The proposed use of independent non-executive directors to control directors' conflicts of interest would allow each aspect of a conflicted transaction to be given proper consideration. Executive directors would consider the merits of the transaction as they see it from the company's perspective, and if they think the transaction should be authorized, they would propose that, making the business case for it as is their job. The independent non-executive directors would then consider the risks of managerial disloyalty inherent in the transaction and confirm it only if they thought the business case for the proposal had been adequately established and outweighed the risks inherent in it. In this way, managerial discretion, limited by a flexible duty of competence, is reserved to those entrusted with management of the company; but the enforcement of the fiduciary duties, which buttress those duties of competence, is located elsewhere in independent arbiters. Admittedly, nothing will abolish the risk that, in a meeting, independent non-executive directors might be overly swayed by executives, though the risk could, if necessary, be mitigated by separate informal meetings of independent non-executive directors.[116] In any event, the risk is surely less than the risks of inappropriate collegial behavior when, as at present, executives vote on other executives' conflicts of interest.[117]

The strictness of directors' fiduciary duties in English law, coupled with a practical, workable gateway procedure for authorizing directors' conflicts of interest, should result in a balanced, effective mechanism for controlling those conflicts. Strict duties coupled with lax authorization procedures are useless: hence the criticisms of the current situation in many companies where the board (other than the director concerned) can authorize a director lawfully to engage in a conflicted transaction. Strict duties with onerous authorization procedures, such as a requirement of shareholder consent, either involve costly compliance with those authorization procedures[118] or else invite attempts to avoid the duty by asserting that there is no conflicted behavior.[119] Neither consequence is desirable. By contrast, strict duties, coupled with an effective and practical authorization procedure, would

116 The New Combined Code, *supra* note 3, § A.1.3, already adverts to this possibility.

117 *See supra* note 41 and accompanying text.

118 The evidence as regards listed companies is that shareholder authorization is rarely sought, precisely because it is expensive, *see* Deakin & Hughes, *supra* note 47, § 5.2.

119 The author has on various occasions encountered this line of reasoning in professional practice. Overly strict duties may also have undesirable second-order effects, such as directors' premature resignation from office or potential

encourage managers to disclose fully any potential conflicts of interest and seek the requisite consent to act, notwithstanding the conflict. The consequences of a breach of fiduciary obligation, weighed against the practical possibility of obtaining binding consent to an act that would otherwise amount to a breach of duty, would give directors incentives either to comply with their fiduciary obligations or to seek permission to engage in a conflicted transaction, rather than to avoid those obligations. In short, this would increase the efficiency of fiduciary duties as a mechanism for redressing the informational advantage enjoyed by managers of a firm in a situation where their duty and interest conflict[120] and thereby reduce the risk that the managers will deviate from their set tasks.[121]

So far, the focus has been on the role of a company's independent non-executive directors as gatekeepers, authorizing conflicted transactions (or not). There is no reason, however, why their role should be limited to control *ex ante*. It would be quite possible to vest in them the power to enforce directors' duties *ex post*, by giving them the power to cause the company to bring proceedings against directors who have breached their duties. This would mitigate the problems in English law of enforcing directors' duties, problems noted earlier, without thereby opening the company to a plethora of shareholder actions.[122]

Another advantage of the suggestions made in this paper is that giving a more closely defined role to independent non-executive directors would have the corresponding effect of liberating management in its proper sphere of activity. The independent non-executive directors would be powerful within their competence, but their power would only interfere with managers in precisely those circumstances where it is too risky to leave management unconstrained. This division of powers would have several beneficial consequences.

First, it should help to alleviate the concern that the reforms proposed in the Higgs Report will undermine the collegiality and effectiveness of a

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directors' reluctance to serve on a board; *see, e.g.*, Ronald J. Daniels, *Must Boards Go Overboard? An Economic Analysis of the Effects of Burgeoning Statutory Liability on the Role of Directors in Corporate Governance*, 24 Can. Bus. L.J. 229 (1994-95); Bruce Chapman, *Corporate Stakeholders, Choice Procedures and Committees*, 26 Can. Bus. L.J. 211 (1995-96).

120 *See* Company Directors: Regulating Conflicts of Interests and Formulating a Statement of Duties, *supra* note 32, §§ 3.30-3.31. Note also texts cited at *supra* note 35.

121 See *supra* Part II of this paper.

122 Compare the practice of using litigation committees in the United States.

single managerial board, because it will pit executive directors against non-executive directors, creating tension and hostility.[123] Indeed, there is a risk of this problem precisely because the role envisaged for non-executive directors by the Higgs Report is so wide and could easily trespass on the proper territory of executive management. Clearly defined, separate, but complementary roles for different directors are much less likely to result in "turf wars" between directors. Of course, there will inevitably be occasions of tension between executive and independent non-executive directors, when each group wants a different result in respect of a transaction that concerns them both: those tensions are inherent in a control mechanism. Nevertheless, a properly defined and distinct role for each group would at least reduce the number of occasions for such conflict, and its likelihood: while executive directors of a company might properly be concerned by the threat of a "perpetual rolling audit" of their activities, the control of their conflicts of interest, and possibly also a periodic review of executive directors' performance, should not alarm an executive director who is, by definition, an accountable agent and not a free actor.[124] Indeed, an agent's resistance to proposals for duly limited monitoring and control should be a source of concern, not a reason to abandon the proposals.

Second, distinct roles for executive and independent non-executive directors should make it easier for companies to find and retain effective directors. It is inherently more likely that a company will find an individual who has one set of skills — be they entrepreneurial skills, managerial skills, or monitoring skills — than an individual who has all of them. The mixed role for non-executive directors proposed by the Higgs Report will require non-executive directors to have a very wide set of skills if they are to perform their tasks adequately. By contrast, more focused roles require narrower — but more readily available — sets of skills. So, if the suggestions made in this paper were adopted, companies would be more easily able to meet another goal of the Higgs Report, namely, the recruitment of non-executive directors from a wider range of backgrounds.[125] This would, in turn, have another beneficial effect: if independent non-executive directors are recruited from a

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123 *See also* Higgs Report, *supra* note 2, § 6.2.

124 Following the recommendations of the Higgs Report, *id.* §§ 11.19-11.24, the idea of performance reviews of the board, of board committees, and of individual directors has been incorporated into the New Combined Code, *supra* note 3, § A.6. The possible drawback to entrusting a performance review to independent non-executive directors (rather than just a review of executives directors' conflicts of duty and interest) is the risk that independent non-executive directors will trespass onto the proper domain of management, though that need not necessarily occur.

125 Higgs Report, *supra* note 2, ch. 10. *See also infra* Part VII.

wider range of backgrounds, they will likely be more effective, because they will correspondingly be less likely still to form a "closed cadre of directors who sit on each others' boards and enjoy a common culture on matters such as [executive] contracts — a culture not shared by anyone else."[126]

Separating the roles of executive and independent non-executive directors should improve corporate governance, but failing to do so is not merely an opportunity cost: a confused role for non-executive directors carries within it inherent risks to good governance. If non-executive directors are to function effectively as part of the management of a company's business, they have to get on with their co-directors: some degree of collegiality is necessary for a board to function. If that it so, it is hard to see how non-executive directors are especially well-placed to resist the temptation of trading their managerial goals against their audit functions: they may well not monitor and control other directors as closely as they could because they wish to secure cooperation from those directors in another business context.[127] This may go some way to explain why non-executive directors so far do not appear to have been very successful in controlling levels of executive pay.[128] None of this is to say that non-executive directors as proposed by the Higgs Report will never be effective in controlling directors' conflicts of interest. It is, rather, to say that there are significant risks in vesting too many functions in a non-executive

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126 *Blame the Board for GSK Fiasco*, The Times, May 20, 2003, at 23 (Business Editor's Comment). The same point was made more bluntly the very next day: "[B]ecause many chief executives sit on each other's remuneration committees, there is a suspicion of mutual back-scratching." Christopher Haskins, *Investors Need Help to Tackle Corporate Greed*, Fin. Times, May 21, 2003.

127 Franks et al. argue that the present difficulties faced by United Kingdom (rather than United States) non-executive directors in holding other directors to account in fact encourages non-executives to focus on their role as business advisors, rather than monitors of management. *See* Julian Franks et al., Who Disciplines Management in Poorly Performing Companies? (Centre for Economic Policy Research Discussion Paper 2949, Sept. 2001) (particularly at §§ 5.1.2, 5.3.2), *available at* http://www.cepr.org/pubs/new-dps/dplist.asp?dpno=2949. The proposals in this paper would address such problems.

128 The evidence from the United States generally suggests that independent non-executive directors currently tend not to limit executive remuneration. *See* John E. Core et al., *Corporate Governance, CEO Compensation, and Firm Performance*, 51 J. Fin. Econ. 143 (1999); David Yermack, *Good Timing: CEO Stock Option Awards and Company News Announcements*, 52 J. Fin. 449 (1997); Brian K. Boyd, *Board Control and CEO Compensation*, 15 Strategic Mgt. J. 335 (1994). Drawing non-executive directors from a wider range of backgrounds (*see* text at *supra* notes 125, 126) might well help to improve their performance in this connection: there might be less cultural collusion amongst directors in setting remuneration packages.

director. In summary, while the various roles of the Higgs non-executive director can be complementary, they are not necessarily so;[129] and problems will tax the weak points in any strategy, not its strengths. Furthermore, in a time of significantly reduced public confidence in corporate governance, there is ever more force in the argument that conflicts must not only be controlled but must be seen to be controlled.[130]

There are other reasons why the Higgs Report envisages a managerial role for non-executive directors: it started from the premise that

> [n]on-executive directors play a central role in UK corporate governance. The Company Law Review noted "a growing body of evidence from the United States suggesting that companies with a strong contingent of non-executives produce superior performance". ... From the point of view of UK productivity performance, progressive strengthening of the quality and role of non-executives is strongly desirable.

In fact, the proposals made in this paper can accommodate these points, if they are correct; but there is good evidence that they are not.

First, there is no reason why a company should not be free to recruit talent in the shape of non-executive directors, who will add value to the company's business, as well as having *independent* non-executive directors to control conflicts of interest. The suggestions in this paper about independent non-executive directors do not preclude the recruitment of other directors (including non-executive directors) for other purposes, though limits on the size of a functional board will constrain such recruitment.[131]

Second, it is in fact highly questionable that non-executives directors *per se* add value to a company's business. A majority of studies do not indicate any relationship between board composition and the firm's performance, as variously defined.[132] Several other studies suggest that increasing the representation of independent non-executive directors on the board is actually

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129 *But see* Higgs Report, *supra* note 2, § 1.12.

130 Popular opinion is moving alarmingly against the directors of listed companies, *see* Roger Blitz, *UK Survey Shows Wide Distrust of Directors*, Fin. Times, June 30, 2003, at 1. Politicians have been known to react to popular opinion.

131 *See* Higgs Report, *supra* note 2, §§ 4.9-4.10; New Combined Code, *supra* note 3, Pt. A.3, Supporting Principles.

132 Benjamin E. Hermalin & Michael S. Weisbach, *The Determinants of Board Composition*, 19 Rand J. Econ. 589 (1988); Hamid Mehran, *Executive Compensation Structure, Ownership and Firm Performance*, 38 J. Fin. Econ. 163 (1995). Stapledon & Lawrence's Australian study suggests analogous conclusions,

associated with weaker performance.[133] Interestingly, one area in which boards dominated by independent non-executive directors have performed better is in relation to the risk of fraud in financial reporting: the risk of fraudulent accounts seems to diminish.[134] Furthermore, United Kingdom firms with independent boards seem to adopt fewer income-increasing accounting techniques,[135] though evidence from the United States is equivocal.[136]

Finally, the findings cited in the Higgs Report are open to a rather more cynical interpretation. There is every reason of self-interest to expect that executive directors will not be delighted at the prospect of greater control. While such a response is in part perfectly legitimate (it has long been recognized that management cannot effectively manage if there is constant interference in its management activities), the need for managerial freedom does not justify a failure to control conflicts of interest. What it does justify

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Geoffrey Stapledon & Jeffrey J. Lawrence, Do Independent Directors Add Value? (Working Paper, Univ. of Melbourne, 1999) (on file with author). Baysinger & Butler report that independent non-executive directors may be associated with higher performance, but with an unusually and dubiously long time-lag of ten years, Barry D. Baysinger & Henry N. Butler, *Corporate Governance and the Board of Directors: Performance Effects of Changes in Board Composition*, 1 J.L. Econ. & Org. 101 (1985).

133 David Yermack, *Good Timing: CEO Stock Option Awards and Company News Announcements*, 40 J. Fin. Econ. 185 (1996); Scott W. Barnhart & Stuart Rosenstein, *Board Composition, Managerial Ownership and Firm Performance: An Empirical Analysis*, 33 Fin. Rev. 1 (1998); Sanjai Bhagat & Bernard S. Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 Bus. Law. 921 (1999); Sanjai Bhagat & Bernard S. Black, *The Non-Correlation between Board Independence and Long-term Firm Performance*, 27 J. Corp. L. 231 (2002). Klein finds that the composition of the audit, compensation, and nomination committees (where independent non-executive directors are supposed to be most important) has little impact on performance; however, *insider* representation on investment committees is associated with better performance, April Klein, *Firm Performance and Board Committee Structure*, 41 J.L. & Econ. 275 (1998).

134 Patricia M. Dechow et al., *Causes and Consequences of Earnings Manipulation: An Analysis of Firms Subject to Enforcement Actions by the SEC*, 13 Contemp. Acct. Res. 1 (1996); Mark S. Beasley, *An Empirical Analysis of the Relation Between the Board of Director Composition and Financial Statement Fraud*, 71 Acct. Rev. 443 (1996).

135 Ken V. Peasnell et al., Outside Directors, Board Effectiveness and Earnings Management (Working Paper 1998), *available at* http://papers.ssrn.com/paper.taf?abstract_id=125348.

136 David W. Wright, Evidence on the Relation between Corporate Governance Characteristics and the Quality of Financial Reporting (Working Paper 1996), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=10138.

is a properly defined and limited monitoring of such conflicts that does not elide into the inhibition of management.

V. ARE THE SUGGESTED STRUCTURES TECHNICALLY VIABLE?

What is suggested by the Higgs Report is a code, not legislation.[137] Indeed, at present, there is little evidence of any enthusiasm in the United Kingdom for widespread legislative intervention in the control of directors' conflicts of interest,[138] though that may change if politicians perceive codes to have failed.[139] The question therefore arises: Can the suggestions made in this paper be realized within the present structures of English company law? This is an important question. If they cannot, the suggestions will certainly lie as marginal comment for years yet. There are two aspects to this question.

First, is English company law sufficiently flexible to encompass the allocation of powers suggested by this paper? The answer is a resounding "yes." English company law explicitly proceeds on the basis that the allocation of powers within a company is fundamentally contractible:[140] formal power vests where those who create the company's constitution choose to put it, save only as mandatory law provides otherwise.[141] No mandatory rule of law precludes the allocation of powers suggested in this paper; consequently, such allocation could be accomplished by means of appropriate

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137 Higgs Report, *supra* note 2, at 3.

138 The Department of Trade and Industry currently plans to codify existing directors' duties in statute (*see* Modernising Company Law, *supra* note 49, Pt. II(3)), but that is not a matter that affects the present issues.

139 In the United Kingdom, the levels and terms of executive pay constitute the one area of continuing, significant public concern about directors' conflicts of duty and interest, notwithstanding the various codes of corporate governance. *See supra* notes 48, 51, 128 and accompanying text. Consequently, the government is exploring further action to meet such concern. *See* Department of Trade & Industry, Rewards for Failure: Directors' Remuneration — Contracts, Performance and Severance (2003), *available at* http://www.dti.gov.uk/cld/4864rewards.pdf.

140 Companies Act, 1985, §§ 9, 14, 18. There is no evidence that this will change when corporate law in the United Kingdom is reformed and reenacted as anticipated by Modernising Company Law, *supra* note 49. Chapter 1, sub-chapter IV, of the Delaware General Corporation Law is similarly permissive, very largely allowing corporators to allocate power as they think fit, but contrast the rather more proscriptive approach of the ALI's Principles of Corporate Governance: Analysis and Recommendations § 3.02 (Functions and Powers of the Board of Directors) (1994).

141 *See supra* note 42 and accompanying text.

terms in a company's constitution. Alternatively, a company's board could delegate its management powers to the company's executive directors and its monitoring powers (including the control of directors' conflicts of interest, so far as these are presently a matter for the board) to independent non-executive directors, leaving the entire board to review these arrangements periodically.[142] Indeed, a company can already choose to create an *ad hoc* committee of independent directors to determine the fate of a proposed conflicted transaction; and the author (as counsel) has in fact encountered this practice.

There is another problem, however. Does English law demand a certain, irreducible, minimum degree of activity from directors — involvement in the business of their company — which they could not satisfy if the suggestions made in this paper were adopted? The Higgs Report asserts as follows:

> In the UK, the general legal duties owed to the company by executive and non-executive directors are the same. All directors are required to act in the best interests of the company. Each has a role in ensuring the probity of the business and contributing to sustainable wealth creation by the company as a whole.[143]

This is an ambiguous statement. Under English law, all the directors of a company must involve themselves in the management of the company's *affairs*; but it is simply not true that the law requires all directors of a company to be involved in the management (as opposed to review) of the company's *business*. Recent case law in the United Kingdom on directors' duties makes this plain. There is, therefore, no legal bar to adoption of the suggestions put forward by this paper. Nevertheless, given the importance of the point at issue, it is well worth examining the cases carefully, if briefly.

In *Re Westmid Packing Services Ltd.*,[144] a directors' disqualification case, Lord Woolf M.R. made various important points about a director's duties when delivering the judgment of the Court of Appeal. These can be summarized as follows. First, the collective responsibility of the board of directors of a company is of fundamental importance to corporate governance under English

142 Indeed, at present a listed company's Audit Committee, Nomination Committee, and Remuneration Committee, being committees of its board, derive their powers from the board by delegation under the company's articles. (All companies' articles permit delegation by the company's board to committees, *see, e.g.*, Table A, *supra* note 31, Regulation 72. This is confirmed by a survey undertaken by the author in another context, *see* Nolan, *supra* note 44.)

143 Higgs Report, *supra* note 2, § 4.4.

144 [1998] 2 All E.R. 124 (C.A.).

company law. Second, that *collective* responsibility is based on the *individual* responsibility of each director to keep himself informed of the company's affairs. Third, a proper degree of delegation is permissible, but not total abdication of responsibility. Fourth, a director must not permit himself to be dominated by a co-director. None of this is at all inconsistent with the suggestions made in this paper. Non-executive directors may be used to oversee and control directors' conflicts of interest, and they must certainly review and monitor the conduct of the company's business and the rest of its affairs; but non-executive directors do not have to be business managers. So too in *Re Lendhurst Leasing Ltd.*,[145] another directors' disqualification case, Hart J. accepted that, "[e]ach individual director owes duties to the company to inform himself about its affairs and to join with his co-directors in supervising and controlling them," adopting Lord Woolf's approach in *Westmid.*[146] Hart J. certainly does not assert that directors are obliged to be business managers: monitors, reviewers, and ultimately controllers, yes; business managers, not necessarily.

The leading English authority on directors' duties of diligence — what they must do for a company, rather than what they must refrain from doing — is now *Re Barings plc. (No. 5).*[147] This is another directors' disqualification case, one that arose out of the spectacular collapse of Barings Bank in 1995. It, too, is consistent with the suggestions made in this paper. The judge, Jonathan Parker J., started from first principles: "Directors have, both collectively and individually, a continuing duty to acquire and maintain a sufficient knowledge and understanding of the company's business to enable them properly to discharge their duties as directors."[148] Consequently,

> "Each individual director owes duties to the company to inform himself about its affairs and to join with his co-directors in supervising and controlling them." ... This does not mean, of course, that directors cannot delegate. Subject to the articles of association of the company, a board of directors may delegate specific tasks and functions. Indeed, some degree of delegation is almost always essential if the company's business is to be carried on efficiently: to that extent there is a clear

145 [1999] 1 B.C.L.C. 286 (H.C.).

146 [1998] 2 All E.R. 124, 130 (C.A.).

147 [1999] 1 B.C.L.C. 433, 486-89 (H.C.). The ruling of Jonathan Parker J. was upheld by the Court of Appeal, which endorsed those aspects of his judgment it was invited to review, at [2000] 1 B.C.L.C. 523, 534-35.

148 [1999] 1 B.C.L.C. 433, 489a (H.C.).

> public interest in delegation by those charged with the responsibility for the management of a business.[149]

So directors can delegate specific tasks and functions (how else could a company be run?), but *overall responsibility* is not delegable. Even where there has been delegation and even though the delegate may appear trustworthy and competent, each director still owes the company a duty to take reasonable steps to monitor and control what is going on. The extent of this duty will depend on the facts of each case. Finally, Jonathan Parker adopted and approved the following statement of a director's duty of care and skill set out in the Australian case of *Daniels v. Anderson.*[150]

> A person who accepts the office of director of a particular company undertakes the responsibility of ensuring that he or she understands the nature of the duty a director is called upon to perform. That duty will vary according to the size and business of the particular company and the experience or skills that the director held himself or herself out to have in support of appointment to the office. None of this is novel. It turns upon the natural expectations and reliance placed by shareholders on the experience and skill of a particular director. ... The duty includes that of acting collectively to manage the company.[151]

The application of these general standards will depend on the facts of the case, but factors such as the business of the company, the size of the company, the organization of the company, the role assigned to or assumed by the director, and the experience and skills the director has or has held himself out as having will all be relevant in filling out the standard.

As well as directors' general duties, which would not stand in the way of the suggestions made in this paper, there are circumstances where all the directors of a company must act in relation to a proposed transaction.[152] However, these are very often circumstances where a decision involves both commercial aspects, where input from the company's executive directors is vital, and the opportunity for the executive directors to further their own interests at the expense of the company's shareholders, where independent non-executive directors should target their input. In other words,

149 [1999] 1 B.C.L.C. 433, 485-86 (H.C.).

150 [1995] 16 A.C.S.R. 607 (N.S.W. C.A.).

151 *Id.* at 668, *adopted in* [1999] 1 B.C.L.C. 433, 488 (H.C.).

152 One important example is that the all directors of the intended target of a takeover offer must give their views (not necessarily the same views) on the offer: United Kingdom Takeover Code, Rule 25, *supplemented by* Rule 19.2.

these circumstances require participation by all directors precisely where this paper would suggest it, and they do not, therefore, constitute a reason for rejecting the proposals in this paper on the grounds of impracticability. Indeed, circumstances where all directors must act in relation to a transaction are relatively very uncommon and, as such, should not dictate the form of basic corporate structures: if need be, independent non-executive directors could, exceptionally, participate in a management decision if the law demanded it, without undermining the benefits that would flow from focusing their attention on monitoring executive directors. Corporate law has never been a matter of complete ideological purity.

In summary, the Higgs Report is correct to point out that "[i]n the unitary board structure, executive and non-executive directors share *responsibility* for both the direction and control of the company";[153] but that certainly does not imply, as the Higgs Report suggests, that "[t]he role of the non-executive director is therefore both to support executives in their leadership of the business and to monitor and supervise their conduct."[154] There is a clear distinction to be drawn between responsibility for a company and a role setting strategy for a company: the one, which is required by law, does not necessarily entail the other. Unfortunately, the Higgs Report blurs this important legal and practical distinction. It is, in other words, quite possible to give effect to the suggestions in this paper without modification of the English law of directors' duties.

Indeed, legislation to alter directors' duties, and formally to partition the roles and responsibilities of various types of director, would introduce quite undesirable structural rigidities into English law: a particular pattern of governance introduced by legislation may very well not exactly suit all companies within the scope of the relevant statute.[155] A code such as that proposed by the Higgs Report, based on principles of "comply or explain,"[156] leaves the flexibility to cope with the non-standard case. That is not to say the "comply or explain" is perfect: there is still the risk that investors will not read and give due consideration to the explanations of those who do not comply and that this will therefore encourage a "box-ticking," mechanistic approach to compliance.[157] Nevertheless, imperfect as it may be, "comply or explain"

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153 Higgs Report, *supra* note 2, § 4.2 (emphasis added).

154 *Id.* § 6.6. See also suggested Code Provision A.1.4 in Annex A to the Report, *id.*, implemented in substance by the New Combined Code, *supra* note 3, § A.1, Supporting Principles.

155 For a consideration of the relative merits and suitability of the various techniques of regulating companies, see Ferran, *supra* note 6.

156 *See* text at *supra* note 14.

157 One frequently repeated criticism is that "comply or explain in practice means

at least allows the possibility of flexibility: it does not lock practice into a particular path in anything like the same firm way as mandatory statute law.

This flexibility also allows the principles of a code to be drafted in comprehensible, relatively broad language: a code does not need to draw extremely sharp distinctions or to stipulate for every contingency. Consequently, as investors can readily understand such a code, it gives them comfort and confidence. By contrast, traditional, mandatory statute law is implemented in a much stricter fashion and must be drafted tightly with that in mind. None of this prevents a code having statutory force, however: indeed, both the Old and New Combined Codes already have the backing of statute.[158]

Finally, codes allow satisfactorily for the evolution of corporate structures in response to market practices and concerns: if some term of a code is proven to be inappropriate or inadequate, it can be changed without great difficulty. This has been demonstrated in the development of codes from the Cadbury Report to the New Combined Code.[159] By contrast, statute law changes but slowly, at least at present.[160] This distinction might become less important, however, if new institutional arrangements allowed for swifter development and revision of the statute law that governs companies.[161]

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comply or else face the same tedious questions every time, until it's not worth the hassle," *Where Higgs Would Be Truly on the Money*, Daily Telegraph, May 15, 2003, at 40 (City Comment). This criticism is rejected by the Higgs Report, *supra* note 2, § 1.19. Indeed, if investors keep on asking the same question until there is compliance, that could be taken as evidence that the Code is being implemented efficiently, just as much as evidence that the terms of the Code are inappropriate.

158 *See supra* note 16 and accompanying text.

159 *See* text accompanying *supra* note 6.

160 The current Company Law Review process in the United Kingdom is regarded as the most fundamental review of the country's corporate law since 1862. See the speech delivered at Cambridge University of the minister responsible for corporate law reform in the United Kingdom, the Rt. Hon. Patricia Hewitt M.P., Secretary of State for Trade and Industry, Keynote Speech to the Cambridge Faculty of Law (July 5, 2002), *available at* http://www.law.cam.ac.uk/cccl/Keynote_speech.pdf. Even the review process is itself now progressing more slowly than originally anticipated; see the Government's announcement in Press Release, U.K. Government, New Companies Legislation (July 10, 2003), *available at* http://www.dti.gov.uk/companiesbill/index.htm.

161 *See generally* Ferran, *supra* note 6.

VI. ARE THE SUGGESTED STRUCTURES PRACTICAL?

The proposals made in this paper are, therefore, technically viable. The next question is whether they are practical. In particular, there are three significant questions: Who will be these independent non-executive directors, how will they be appointed, and what will motivate them to undertake their tasks?

The first question is by far the easiest. The Higgs Report itself addressed this question, recommending that more care be given to the selection of non-executive directors and that they be drawn from a wider pool of talent.[162] The pool could easily extend to include professionals who, while they may not be used to running a business, are nevertheless highly alert to conflicts of interest and used to judging and controlling them, Arthur Andersen notwithstanding;[163] and there are plenty of suitably qualified professionals in London (and the United Kingdom at large) who could act as independent non-executive directors.[164] Indeed, the suggestions made in this paper, that independent non-executive directors should have a focused role, controlling directors' conflicts of interest, should actually make it easier to find the necessary talent: it is inherently more likely that a company will find an individual who has monitoring skills than an individual who has entrepreneurial skills, managerial skills, *and* monitoring skills.[165]

What, then, of the mechanisms for appointing non-executive directors? The Higgs Report is right to ensure independence in the process of appointing non-executive directors, recommending that "[a]ll listed companies should have a nomination committee which should lead the process for board appointments and make recommendations to the board. ... The nomination committee should consist of a majority of independent non-executive directors."[166] The board, acting on the recommendations of the nomination

162 Higgs Report, *supra* note 2, ch. 10, *particularly* §§ 10.15-10.33.

163 *Id.* § 10.29.

164 London, for example, has a huge professional service sector, one of the largest in the world; see the empirical evidence at http://www.cityoflondon.gov.uk/business_city/research_statistics/pdf/lonny/chapter6london.pdf (last visited Sept. 30, 2003).

165 *See* text at *supra* note 125.

166 Higgs Report, *supra* note 2, § 10.9. The further recommendation, that the nomination committee "may include the chairman of the board, but should be chaired by an independent non-executive director," was not adopted, following fierce criticism from company chairmen. Illustrative criticism is reported in the Business Opinion section of *The Times*, Robert Cole, *Welcome Response to Higgs Critics*, The Times, May 10, 2003, at 51. Confirmation that the recommendation was deliberately not adopted as part of the New Combined Code

committee, would then ensure that, in due course, names of non-executive directors were put to a vote of shareholders.

Setting the necessary incentives so that independent non-executive directors are likely to perform their monitoring task efficiently is a much more difficult matter. The Higgs Report essentially envisages fees for non-executive directors, rather than any more sophisticated form of remuneration,[167] recommending

> that non-executive directors' fees should be more clearly built up from an annual fee, meeting attendance fees (to include board committee meetings) and an additional fee for the chairmanship of committees (typically a multiple of the attendance fee) or role as senior independent director. The level of remuneration for non-executive directors should be a matter for the chairman and the executive directors of the board.
>
> In addition, companies should expect to pay additional, reasonable expenses in addition to the director's fee to cover related costs incurred by their non-executive directors (such as travel and administrative costs). Any significant support of this kind should be agreed in advance.[168]

In addition, the Report recommends that non-executive directors be permitted to take shares in the company concerned, in lieu of a cash fee, but that non-executive directors should not hold options over the company's shares.

Fees are hardly novel; but they are an appropriate mechanism for remunerating someone whose function is not primarily entrepreneurial.[169]

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is at http://www.frc.org.uk/publications/publication419.html (last visited Sept. 30, 2003).

167 *See generally* Higgs Report, *supra* note 2, §§ 12.20-12.30. A similar position has been taken in Australia, *see* Australian Stock Exchange Corporate Governance Council, Principles of Good Corporate Governance and Best Practice Recommendations, Principle 9.3 (2003), *available at* http://www.shareholder.com/shared/dynamicdoc/ASX/364/ASXRecommendations.pdf.

168 Higgs Report, *supra* note 2, §§ 12.24-12.25.

169 It has been suggested that investors should both seek to appoint and meet the fees of non-executive directors who look after investors' interests, possibly individually, possibly collectively. *See* Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 Stan. L. Rev. 863 (1991). For the moment, there is no prospect of investors, particularly institutional investors, shouldering that burden directly in the United Kingdom. Even if there were, such remuneration would have to be structured very carefully to avoid the risk of non-executive directors being captured by the large, institutional investors who would meet all, or a very substantial portion of, their fees. Quite aside from

If an independent non-executive director is put in office to undertake certain specific, limited tasks, his role is much more like that of a professional advisor than an entrepreneur. Professionals in the United Kingdom are used to working for fees, and this has not stopped London from becoming one of the world's leading centers for professional services.[170] Indeed, the use of professionals as non-executive directors has another benefit: they can be both motivated and controlled by the effect of good or bad performance in a given task on their respective professional reputations. Indeed, reputation, for a professional in a highly competitive market like London, is vital to economic survival. By contrast, the recommendations of the Higgs Report, which envisage some sort of management role for non-executive directors, will surely face greater problems in setting the correct incentives for non-executive directors to act (at least in part) as entrepreneurial management. Why should non-executive directors who act in an entrepreneurial capacity be willing to accept rewards so very different in quality, and not just quantity, from those of executive directors? In short, there is no getting away from the problems of incentives, but the suggestions made in this paper, to create a clear, focused role for independent non-executive directors, ameliorate the problem, if not resolving it entirely. By contrast, the recommendations of the Higgs Report regarding the remuneration of non-executive directors run directly into problems generated by the mixed role for those directors that the Report so advocates.

Aside from these problems, there is still one aspect of the recommendations in the Higgs Report that is truly worrying. This is the suggestion that executive directors should set the pay of non-executive directors. There are real risks in creating a situation where those who are controlled by non-executive directors in turn, through remuneration, control those very non-executives. (There is a clear analogy to be drawn with the position of auditors who, in substance, if not in form, were appointed by

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any unwillingness to meet the costs of non-executive directors, there are at least two reasons in the United Kingdom why institutional investors might not want to appoint and meet the costs of non-executive directors. First, there is a risk that they could become shadow directors under the Companies Act, 1985, though this risk could be adequately managed. Secondly, and more importantly, they could easily come into possession of unpublished price-sensitive information relating to a company through a director whom they had appointed to its board, with the consequence that they would be debarred *pro tempore* from trading in its securities under one or both of the insider trading regime (see Part V of the Criminal Justice Act 1993, imposing criminal sanctions) and the market abuse regime (see Part VIII of the Financial Services and Markets Act, 2000, imposing administrative penalties).

170 *See supra* note 164.

management to check on management;[171] and it need hardly be said where such a system can lead.) Instead, the non-executive directors themselves could propose their fees, subject to approval by shareholders. Though shareholder approval is a cumbersome process, this item of business, being recurrent and predictable, could easily be undertaken at an annual general meeting.[172]

VII. IMPLEMENTATION — DO WE NEED A CODE?

This paper has already expressed a preference for a code, rather than legislation, as the means through which its suggestions might be implemented.[173] Yet is has so far assumed that there is a need for some degree of regulation to ensure the use, and proper use, of independent non-executive directors as it suggests. The actual justification for such intervention in companies lies in the processes through which their corporate governance structures are created.

The distribution of competences within an English company is achieved essentially by two mechanisms: the terms of the company's constitution, which are adopted by shareholders and operate as a binding agreement between them,[174] and delegation of functions pursuant to the constitution.[175] Both of these raise problems for shareholders, however.

The formation of the company's constitution is not an efficient process

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171 *See* Companies Act, 1985, pt. XI, ch. V: auditors are appointed by a shareholders' resolution (other than auditors appointed to fill temporarily a casual vacancy); but directors propose the resolution to the shareholders. The New Combined Code, *supra* note 3, § C.3.2, seeks to mitigate this risk by prescribing that a company's Audit Committee should recommend the appointment of the company's auditors and review their retainer, following the recommendations of Sir Robert Smith et al., Audit Committees: Combined Code Guidance (2003), *available at* http://www.ecgi.org/codes/country_documents/UK/ac_report.pdf. *See also* Higgs Report, *supra* note 2, §§ 13.4-13.7. In Singapore it is now proposed to require by law (not just by a code) that a listed company have an audit committee, comprising a majority of independent non-executive directors, and to give the committee power to nominate the company's auditors. *See* Companies (Amendment No. 2) Act, 2003 (Sing.), *available at* http://www.mof.gov.sg/cor/doc/DraftCos(Amdt No.2) Bill 2003-PublicCons.doc.

172 *See* text at *supra* note 54.

173 *See* text at *supra* note 155.

174 *See* Companies Act, 1985, §§ 9, 14, 18.

175 See, e.g., Regulations 71 and 72 of Table A, *supra* note 31, terms that are adopted in substance, if not in exact form, by all companies, as confirmed by the author's survey detailed in Nolan, *supra* note 44.

from the perspective of shareholders in a widely held company. Though in legal form, shareholders contract for what they want in a company, the reality is that the company's directors employ lawyers to draft the constitution (and subsequent amendments to, or replacements of, it) in terms that reflect what the directors want, tempered by their good faith to shareholders and, in some cases, by their appreciation of what the shareholders will accept. Given recent resistance to the Higgs Report from many boardrooms,[176] it is very unlikely that proposals to implement the Report, still less any more radical suggestions, would come from the boards of many leading companies. Some degree of compulsion, however gentle, is clearly needed to redress inefficiencies in the process of contracting for corporate constitutions. Directors who are well-intentioned may choose to implement proposals without compulsion; but those who wish to resist proposals emanating from shareholders, or from those who campaign for the investor interest in companies, are well-placed to do so. For reasons mentioned earlier,[177] a code (enforced on the basis of "comply or explain")[178] has much to recommend it as the appropriate means of enforcement in the present context.

The other mechanism through which powers are distributed within a company is delegation by those with power — normally the board — in accordance with the company's constitution. This mechanism of distributing power within a company is also problematic from the perspective of shareholders who wish to ensure good corporate governance. Such delegation is an executive act; and as such, it is very difficult indeed for shareholders to direct or control it. Again, some degree of compulsion is necessary to redress an imbalance of power. Indeed, that is what has happened so far: both the Old Combined Code and the New Combined Code ordain that certain powers of a listed company's board should be delegated to, for example, the company's Audit Committee, its Nomination Committee, and its Remuneration Committee.[179]

176 *See, e.g.*, Cole, *supra* note 166.

177 *See supra* note 115 and accompanying text.

178 *See* text at *supra* note 14.

179 *See supra* notes 101-03 and accompanying text.

VIII. THE INTERACTION OF SUGGESTIONS MADE IN THIS PAPER AND OTHER APPROACHES TO THE CONTROL OF CONFLICTS OF INTEREST

The suggestions made in this paper crucially involve the use of independent non-executive directors. There are, however, other significant approaches to managing directors' potential conflicts of interest. For the present, at least, these other approaches would not form an adequate substitute for independent non-executive directors, properly utilized. Nevertheless, they could be tested in companies that do make appropriate use of independent non-executive directors, to establish whether they would constitute a useful adjunct to independent non-executive directors or even, in due course, a substitute for them.

The main means of controlling or constraining directors' conflicts of interest that are of relevance here are compensation packages for directors who seek to align their interests with those of shareholders, the market for corporate control, and the use of "invested directors" as self-interested guardians of the company's interests. Each has its problems. In reality, executive compensation packages are the product of one-sided bargaining arrangements that favor management,[180] and public faith in such arrangements is low.[181] The disciplinary effect on managers of the market for corporate control is equivocal.[182] Any attempt to align managers' and owners' interests by ensuring that a company's directors are also shareholders in it faces difficulties when applied to widely-held, listed companies. Admittedly, a private equity house that holds a large stake in a firm may nominate directors of the firm whose personal interests are closely aligned to the firm's interests.[183] Nevertheless, the director of a listed company will very rarely hold a significant stake in the company, and when faced with a conflict of interest and duty, the benefit to that director from self-interested action may

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180 *See especially* Lucian A. Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. Chi. L. Rev. 69 (2002).

181 *See supra* note 126 and accompanying text.

182 *See* Franks et al., *supra* note 127.

183 There has recently been a strong call in the United Kingdom for institutional investors to take a greater role in the oversight of companies. See Myners Report, *supra* note 86, and the subsequent trenchant comment of the author of that report, Paul Myners, Travers Smith Braithwaite Lecture, delivered at University of Cambridge's Centre for Corporate and Commercial Law, May 7, 2003, *available at* http://law.cam.ac.uk/cccl/Paul_Myners_Speech.doc.

well exceed the return he or she will see as an investor in the firm if duty were done.

Crucially, however, these problems are not the real issue for present purposes. The point is, rather, that investors — particularly institutional investors — at present require independent non-executive directors to safeguard shareholders' interests:[184] investors do not seem presently to have enough confidence in other means of managing directors' conflicts of interest. That is not to say that these other means of controlling directors' conflicts of interest are irrelevant or unsuitable: the use of independent non-executive directors does not preclude a market for corporate control, nor properly structured executive compensation packages, nor other directors with different motivations, such as investor-directors. Indeed, proper use of independent non-executive directors can maintain — or even increase — confidence whilst other methods of controlling directors' conflicts of interest gather support, or not. If, in due course, independent non-executive directors are no longer needed, so be it: it is hardly news that solutions to the problems of corporate governance are context- and time-specific.

CONCLUSIONS

To date, non-executive directors appear to have a mixed record as monitors: they generally appear to be a useful mechanism for securing honest financial reporting, but they have not done much, if anything, to control levels of executive pay. However, contrary to the assertions of the Higgs Report, they do not appear to add much, if anything, to a company's economic performance. So long as the role of non-executive directors remains mixed and unfocused, there is no reason to believe this will change. Even if more and better people are recruited to be non-executive directors, as envisioned by the Higgs Report, a confusion of roles will still make it difficult for them to be effective. The Higgs Report represents a lost opportunity to revise and clarify what non-executive directors are expected to do.

The central concern of this paper is to devise the best strategy for the use of independent non-executive directors in the governance of English companies. Independent non-executive directors should act essentially as monitors within

184 See, for example, the policies of activist fund-managers such as Morley and Hermes, available, respectively, at http://www.morleyfm.com/cgov.pdf and www.hermes.co.uk/corporate-governance/PDFs/International_Governance_Principles.pdf (both last visited Sept. 30, 2003).

a company, controlling whatever possible conflicts of duty and interest the company's executive directors may have and monitoring the company's performance and systems. Any other non-executive directors of a company should be free to play whatever role — in business development or otherwise — that the company sees fit. Such a focused role for independent non-executive directors is quite feasible and, it is suggested, useful as part of a strategy to control directors' conflicts of interest.

The basic flexible structures of English company law are well-suited to accommodate the proposals made in this paper. Indeed, it is to be hoped that the Company Law Review retains the basic flexibility of United Kingdom corporate structures, precisely because it is so useful in accommodating the very different circumstances and objectives of different enterprises, though the technical detail of those structures might usefully be clarified. Other aspects of the law, such as that relating to shareholder actions, might very usefully be reformed, however.

Codes of corporate governance (whether backed by statutory powers or not) are an appropriate mechanism through which the reforms suggested in this paper can be achieved. Codes are much preferable to "traditional" forms of legislation: codes can respond to events and experience much more easily than such legislation, maintaining their objectives and thereby retaining their legitimacy, while evolving their techniques of implementation.

The Higgs Report has much to commend it, but its treatment of non-executive directors is flawed. Nevertheless, the Report's recommendations have largely been implemented, with only relatively few amendments, none of which addresses the concerns of this paper. If, in the coming years, it transpires that the concerns raised in this paper are well-founded, the Financial Reporting Council and the UKLA should act swiftly to amend the New Combined Code. Otherwise, the chances are that political pressure will build for legislative intervention, whatever the economic drawbacks of such action: politicians, who control Parliament, do not respond solely to the dictates of long-term economic rationality.