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ABSTRACT

In recent years, debate has intensified regarding the accountability of large public companies. In particular, the present regulatory regime in the UK has subject to sustained critique, largely as a result of a number of spectacular corporate failures. This thesis focuses on one element of the above debate, namely the particular controls which exist in the UK to regulate the conduct of directors. The present legal and regulatory regime is examined with a view to assessing the adequacy of the present controls. In addition, reforms which have been proposed in order to strengthen the regulation of directors will be evaluated. The focus is on directors, as the regulation of directorial conduct is a first and important step towards regulating corporate activity as a whole.

CONTROLLING THE CONDUCT OF COMPANY DIRECTORS

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1996



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CONTENTS

CONTROLLING THE CONDUCT OF COMPANY DIRECTORS

	Page No.
Introduction	1
Chapter One	3
Governance by the Market: The Ability of the Market to Control the Conduct of Directors	
A. Introduction	3
B. The Market for Corporate Control	4
1. The operation of the market for corporate control	4
2. Regulation of the market for corporate control	5
2.1 The City Code on Takeovers and Mergers	5
2.2 The fiduciary duties of directors	7
2.3 Competition law	8
2.4 Summary of regulatory issues	9
3. The efficacy of the market for corporate control	9
4. The social costs of the market for corporate control	12
C. The Product Market	15
D. The Managerial Market	17
E. Conclusions: The Market as a means of Directorial Control	20
Chapter Two	23
An Analysis of Directors' Fiduciary Duties	
A. Introduction	23
B. Directors' Fiduciary Duties	23
1. To whom are fiduciary duties owed?	24
1.1 The company	24
1.2 Shareholders	25
1.3 Creditors	27
1.4 Employees	29
2. The nature of directors' fiduciary duties	31
2.1 The duty to act <i>bona fide</i> in the interests of the company	31
2.2 The duty not to act for a collateral purpose	32
2.3 The duty to act with skill and care	34
2.4 The no-conflict rule	37

2.5	The duty not to profit from the position of director	39
3.	The enforcement of directors' duties	41
3.1	The rule in <i>Foss v Harbottle</i>	41
3.2	Section 459 and unfair prejudice	42
C.	Conclusions: Directors's Duties as a Means of Controlling Directorial Conduct	43

Chapter Three 47

Structural Reform of the Board of Directors

A.	Introduction	47
B.	Board Structure and the Influence of Europe	49
1.	The draft Fifth Company Law Directive	49
2.	Works councils and corporate governance	52
C.	The Cadbury Report on Corporate Governance	54
1.	Background	54
2.	The composition of the board of directors	55
3.	The efficacy of non-executive directors as a means of supervision and control	56
4.	Cadbury's Committees	61
4.1	Audit committees	61
4.2	Nomination committees	62
4.3	Remuneration committees	63
4.4	The efficacy of extra-board committees	64
D.	The Greenbury Report on Directors' Remuneration	65
E.	Conclusions: Reforming the Board of Directors as a Means of Improving Directorial Control	66

Chapter Four 69

Shareholder Democracy in the Shareholders' City State

A.	Introduction	69
B.	The Relationship between the Board of Directors and the Shareholders	70
C.	The Shareholders Power to Remove Directors from Office	71
D.	Institutional Shareholders	73
1.	Introduction	73
2.	Investor Protection Committees	74
3.	The Cadbury Report	75
4.	The Greenbury Report	77
5.	An analysis of institutional activism	78
E.	Conclusions: The Utility of Shareholder Democracy	81

Conclusion 85

Bibliography 89

INTRODUCTION

In recent years, debate has intensified regarding the accountability of large public companies.¹ The question of accountability has arisen in both the internal context of the company, i.e. whether shareholders exercise sufficient power to control companies, and in a context external to the company, namely the ability of governments and/or appropriate transnational organisations to control corporate activity. Allied to questions of accountability and control is the issue of in whose interests the company should be managed and controlled. Should the interests of shareholders be the sole concern of corporate boards, or should companies and directors owe duties to interests wider than shareholders, such as employees, customers, consumers and the public in general?² Should companies be more socially responsible? Further debate concerns the appropriate means of regulating transnational corporate enterprises; if regulation is indeed considered appropriate in the light of many problematic issues relating to capacity, jurisdiction and enforcement.³ In particular, the present regulatory regime in the UK has subject to sustained critique, largely as a result of a number of spectacular corporate failures.⁴ Thus, consideration has to be given not only to questions of the nature of regulation and governance of companies, but also to the most appropriate level at which such regulation can best be achieved, in particular whether the European Union is better placed to regulate transnational companies.

This thesis will focus on one element of the above debate, namely the particular controls which exist in the UK to regulate the conduct of directors. The present legal and regulatory regime will be examined with a view to assessing the adequacy of the present controls. In addition, reforms which have been proposed in order to strengthen the regulation of directors will be evaluated. The focus is on directors, as the regulation of directorial conduct is a first and important step towards regulating corporate activity as a whole.

¹ This thesis will concentrate on the mechanisms of control exercised over directors in large public companies, although reference will be made, where appropriate, to other forms of business organisation.

² Although consideration of such issues has intensified in recent years, such questions were first raised in the early part of this century. See, for example: Dodd, 'For Whom are Corporate Managers Trustees?', (1932) 45 *Harvard Law Review* 1145; Berle, 'For Whom are Corporate Managers Trustees? A Note', (1932) 45 *Harvard Law Review* 1365.

³ See further, Bradley, 'Corporate Power and Control in the 1990s: The Transnational Dimension', (1995) 15 *Oxford Journal of Legal Studies* 269.

⁴ For example, a large number of investors lost funds as a result of the collapse of the BCCI bank, and thousands of pensioners were worse off as a result of the Maxwell scandal.

To this end, Chapter One will examine the ability of the markets for corporate control, products and managerial talent to influence and control directors. This analysis draws on the work of a number of scholars who have articulated an economic basis for legal analysis and reform, arguing that allowing free economic activity is the most cost-effective and successful means by which to control and regulated directorial conduct. In opposition to such reasoning, the contentions of those who consider that the market places unnecessary costs on third parties and that alternative means of regulation are more effective will be analysed.

Chapter Two considers the present common law fiduciary duties imposed on directors by an examination of the relevant case law. In addition, the ability of shareholders to enforce such duties is analysed, together with a number of reform proposals. The structure of the board of directors is examined in Chapter Three by analysing the structural reforms proposed by the Cadbury Committee on the financial aspects of corporate governance⁵, and more recently, the Greenbury Report.⁶ In addition, the reform proposals emanating from the European Union regarding the structure of the company and its regulatory mechanisms will be investigated.

Many of the present means by which the conduct of directors is regulated, as well as a number of reform proposals, rely on the activism and participation of shareholders in corporate activities. Accordingly, the ability and suitability of such reliance on shareholder power, both individual and institutional. will be examined in Chapter Four.

⁵ Cadbury Report, *The Financial Aspects of Corporate Governance*, 1992.

⁶ Greenbury Report, *Directors' Remuneration - Report of a Study Group Chaired by Sir Richard Greenbury*, 1995.

CHAPTER ONE

GOVERNANCE BY THE MARKET: THE ABILITY OF THE MARKET TO CONTROL THE CONDUCT OF DIRECTORS

A. Introduction

'Markets' are economic interactions between a variety of actors, including firms, individuals and governments. In this thesis, the term 'market/s' is used generically to describe several interlocking fields of economic activity, in particular: the market for corporate control, the product market and the market for managerial talent. Central to the theory of the free market is the view that the extended conflict among selfish economic actors produces the optimal allocation of resources.¹ In the context of controlling the conduct of directors, the market is a means of control external to the company, and unlike, for example, shareholder regulation of corporate activity, is beyond the influence of the company or its shareholders. The fact that the control exercised by the free market is external to the company is one of its principal attractions. It is argued that the operation of the market redresses the perceived weakness in the separation of ownership and control in the large company², exercising the control which eludes the shareholders.³ The end product of this means of controlling directorial conduct is said to be the efficient and optimum distribution of talent, products and resources. This, in turn, achieves maximum profit realisation, which, it is advocated, should be the sole aim of a company. The remaining sections of this chapter will examine this thesis.

¹ The rhetoric of markets is well-rehearsed elsewhere, the original exposition of the theory being attributed to Adam Smith's *An Inquiry into the Nature and Causes of the Wealth of Nations*, 1776. See also: Posner, *The Economics of Justice*, Harvard University Press, 1981; *The Journal of Law and Economics Symposium on Corporations and Private Property*, June 1993, Vol XXV1(2); and, Easterbrook and Fischel, *The Economic Structure of Corporate Law*, Harvard University Press, 1991.

² The thesis that in a large company there is a separation of ownership and control, and that this has led to a managerial revolution of managers pursuing their own interests free from control, and not those of shareholders, was most famously espoused by Berle & Means, *The Modern Corporation and Private Property*, New York: Commerce Clearing House, 1932.

³ See, *inter alia*, Easterbrook and Fischel, "The Corporate Contract", (1989) 89 *Columbia Law Review* 1416, at 1419, who state that "[m]anagers may do their best to take advantage of their investors, but they find that the dynamics of the market drive them to act as if they had investors' interests at heart".

B. The Market for Corporate Control⁴

1. The operation of the market for corporate control

The principal market which controls the conduct of directors is the market for corporate control. It does so by providing that "inefficient managers ... can be removed by stockholders' acceptance of takeover bids induced by poor performance".⁵ In deciding whether to accept a bid, the bench-mark by which shareholders will judge the activities of directors is their ability to maximise the resources of the company. Thus, if directors do not maximise profits, the company may be the subject of a takeover bid, and the shareholders will accept the takeover offer as a means of increasing the value of their shares, in order to ensure that the resources of the company are managed by those most capable of maximising profits. The likely result of the takeover is that the directors will be removed from their positions and, thus, the market for corporate control operates by way of a threat to directors, inducing their efficient management of corporate resources. Accordingly, the self-interested preoccupations of directors, i.e. the protection of their positions as directors, is channelled to maximum effect so that their self-interest coincides with the best interests of the company.

The efficiency of management is measured by the price of a company's shares, which is accordingly the means by which the market for corporate control assesses management. If the price of the company's shares reflects the market's perception of the optimum value of the shares, there will be no benefit to a predator company in taking over the company. In such circumstances, the market will sustain in office the directors who are maximising resources. However, it is not required that the price of the shares accurately reflect the value of the company. Indeed, it is recognised by the proponents of market control that the share price does not perfectly reflect the value of the company: it is sufficient that "the prices will be more informative than the next

⁴ See, *inter alia*: Manne, "Mergers and the Market for Corporate Control", (1965) 73 *Journal of Political Economy* 110; Bradley "Corporate Control: Markets and Rules", (1990) 53 *Modern Law Review* 170; Farrar (ed), *Takeovers, Institutional Investors and the Modernisation of Corporate Laws*, Oxford University Press, 1993; Putterman (ed), *The Economic Nature of the Firm*, Cambridge University Press, 1986; Alchian and Demsetz, "Production, Information Costs, and Economic Organisation", (1972) 62 *The American Economic Review* 777; Fama, "Agency Problems and the Theory of the Firm", (1980) 88 *Journal of Political Economy* 288; Coase, "The Nature of the Firm", (1937) 4 *Economica* 386; and the citations *supra* note 1.

⁵ Herman, *Corporate Control, Corporate Power*, Cambridge University Press, 1981, at 10.

best alternative"⁶, which is the "regulators".⁷

Accordingly, where the share price does not reflect the market's value of the company's resources, a "control opportunity"⁸ is created. A predator company will be able to offer a higher price for the company's shares, safe in the knowledge that, *post* takeover, a new management should be able to secure a higher share price. The shareholders, with only increased share price in mind, will accept the takeover bid which will increase the value of their shareholding. The utilisation of the control opportunity not only benefits the particular company which is taken over, by replacing management and increasing the share price, but it reinforces the threat of the takeover to the management of other companies, acting as a spur to efficient management.

2. Regulation of the market for corporate control

A number market advocates propose entirely free markets: markets devoid of all regulation. For example, Hayek has gone so far as to argue that the "whole idea that we can replace the market by central planning is based on intellectual error".⁹ However, even Hayek recognises, though not explicitly, the need to ensure that markets are "free", and that to do so may require certain interventions in the operation of the markets.¹⁰ That the market for corporate control in the UK is regulated is axiomatic. The mode in which it is so regulated will be considered briefly in order to illuminate later consideration of the value of the market for corporate control as a means of controlling the conduct of directors. A multitude of provisions regulate the market for corporate control: the common law, statute law, market mechanisms, quasi-legal regulations and European law. A brief analysis of each will be given before examining the efficacy of the market for corporate control.

2.1 The City Code on Takeovers and Mergers

The City Code on Takeovers and Mergers ('the Code') sets out the means and manner in which a takeover bid may be launched, conducted and concluded: it does not

⁶ See Easterbrook and Fischel, *supra* note 1, at 19.

⁷ *Ibid* at 20. Easterbrook and Fischel, *ibid* at 20, dismiss the idea that the "regulators" may be able to accurately determine the value of a company and its shareholding: "Few believe that regulators are better at valuing terms of corporate governance than are markets."

⁸ Bradley, *supra* note 4, at 171.

⁹ Hayek, *Law, Legislation and Liberty*, 1979 Vol. 3, at 93.

¹⁰ See, Wedderburn, "Freedom of Association and Philosophies of Labour Law", (1989) 18 *Industrial Law Journal* 1, at 14/15.

determine questions of whether a takeover will be beneficial and whether it should proceed, nor does it consider matters of competition policy. The Code is interpreted and enforced by the Panel on Takeovers and Mergers, which is not directly legally enforceable as it lacks a statutory basis; it was established in 1959 as a means of self-regulation. However, it has the force of law by means of The Stock Exchange's Admission of Securities to Listing, which provides that the terms of the Code must be complied with if shares are to be listed on the London Stock Exchange. Its terms are also enforceable indirectly via the obligation on persons authorised to carry on investment business under the Financial Services Act 1986 to observe the Code under the Securities and Investment Board's Conduct of Business Rules. Further, the courts recognise the Code as laying down appropriate standards and practice in the conduct of takeovers¹¹; and, in *R v Panel on Takeovers and Mergers, ex parte Datafin plc*¹², it was held that the rulings of the Panel may be subject to judicial review.

In addition to a large number of detailed provisions, the Code sets out a number of general principles to which companies must adhere in the conduct of a takeover.¹³ These general principles have the advantage of not being unduly prescriptive in that they can be interpreted in line with their spirit, and not necessarily their letter. Similarly, the Panel are able to waive a number of the rules.¹⁴ In general, the terms of the Code are intended to ensure "fair and equal treatment of all shareholders in relation to takeovers".¹⁵

¹¹ See, *inter alia*: *Dunford & Elliott Ltd v Johnston & Firth Brown Ltd*, [1977] 1 Lloyd's Rep 505; *Morgan Crucible Co plc v Hill Samuel Bank Ltd*, [1991] 1 All ER 148.

¹² [1987] QB 815.

¹³ See further: Prentice, "Takeover Bids and the System of Self-Regulation", (1981) 10 *Oxford Journal of Legal Studies* 406; Alexander, "Takeovers: the Regulatory Scene", (1990) *Journal of Business Law* 203.

¹⁴ See, for example, the application made by Trafalgar House plc to the Panel to waive Rule 35.1 which was in the end rejected. See the *Financial Times*, 18 March 1995.

¹⁵ See the Introduction to the Code at section 1(a).

2.2 The fiduciary duties of directors¹⁶

The provisions of the Code are complemented by the fiduciary duties of directors in the conduct of a takeover. Principally, the fundamental duty of a director is to act bona fide in what the director considers to be the best interests of the company, and not for a collateral purpose.¹⁷ In addition, the director must avoid all conflicts of interest¹⁸, and act with the requisite skill and care.¹⁹ In the context of a takeover, these duties most often manifest themselves in terms of the "proper purposes" test. This test protects the interests of shareholders by preventing management from taking certain actions in an attempt to defeat a bid, e.g. by issuing a large number of shares to a third party, and also by deterring action which may prevent a bid being launched in the first place, e.g. by disposing of valuable assets immediately prior to the bid launch.²⁰ In a number of circumstances, directors will actually owe duties directly to shareholders. In *Gething v Kilner*²¹, it was held that the duties owed by directors to shareholders, in the takeover context, include a duty to be honest and not to mislead shareholders. Furthermore, directors are obliged to inform shareholders of a better bid offer, even if this is in breach of a "lock-out" agreement with a first bidder.²²

However, the remedies available to shareholders aggrieved by a breach of directors' fiduciary duties are limited. The proper plaintiff to bring an action for a wrong done to the company (directors' duties being owed to the company), is the company²³, and the difficulties of a shareholder bringing such a derivative action on behalf of the company are well documented.²⁴ Nonetheless, it appears that there is an increasing

¹⁶ For a more detailed examination, see Chapter Two.

¹⁷ *Re Smith and Fawcett*, [1942] Ch 304.

¹⁸ *Bray v Ford*, [1896] AC 44. This duty is confirmed in the Code, General Principle 9 of which states that the "directors of an offeror and offeree company must always, in advising their shareholders, act only in their capacity as directors and not have regard to their personal or family shareholdings or to their personal relationships with the companies".

¹⁹ *Re City Equitable Fire Insurance Co Ltd*, [1925] Ch 407; *Norman v Theodore Goddard*, [1991] BCLC 1028.

²⁰ See Parkinson, *Corporate Power and Responsibility - Issues in the Theory of Company Law*, Clarendon Press Oxford, 1993, at 137-151, where he critiques in detail the proper purposes rule and its application in the context of a takeover bid.

²¹ [1972] 1 All ER 1166, at 1170.

²² *John Crowther Group plc v Carpets International plc*, [1990] BCLC 460.

²³ *Foss v Harbottle*, [1843] 2 Hare 461. In the case of a duty owed directly to shareholders, i.e. the duty not to mislead, it is possible that a shareholder could bring an action for breach of the duty owed individually to her or him. However, the shareholder would only be able to prove damage if it could be proved that the takeover would not have succeeded had it not been for the misleading statements of the directors. See Bradley, *supra* note 4, at 80, who confirms that such an action would be unlikely to succeed.

²⁴ See, *inter alia*: Wedderburn, "Shareholders' Rights and the Rule in *Foss v Harbottle*", (1957) 15 *Cambridge Law Journal* 194, and (1958) 16 *Cambridge Law Journal* 93; Sullivan, "Restating the

willingness on the part of the judiciary to utilise other avenues of redress, to the benefit of shareholders, such as the extended scope and interpretation of section 459 of the Companies Act²⁵, and the employment of a wide interpretation of the shareholders' personal rights exception to the rule in *Foss v Harbottle*.²⁶

2.3 Competition law²⁷

Whereas the City Code on Takeovers and Mergers, and the fiduciary duties of directors, regulate the procedure and conduct of a takeover, it is the realm of competition law which determines whether the takeover itself should be allowed to proceed. Both UK and EC competition law control the activities of takeovers in the UK. Although the European Commission will only have jurisdiction to consider a takeover if the thresholds contained in the Merger Regulation²⁸ are satisfied, the thresholds are substantial and will catch only the largest of takeovers.²⁹ Moreover, an assessment of a merger under the Merger Regulation is based solely on the affect which the takeover would be likely to have on competition, as opposed to being an overall assessment of the management capability of the incumbent directors, or the wider socio-political effects of the merger. If a takeover does not satisfy the thresholds of the Merger Regulation, it will be subject to the Fair Trading Act 1973.

The Fair Trading Act 1973 also has certain financial thresholds which must be satisfied, as well as a market share test, but these are much lower and it is only the smallest of transactions which will not be caught by its terms. Under the Fair Trading Act, the Director General of Fair Trading may investigate a takeover or merger which satisfies the thresholds, and may recommend to the Secretary of State for Trade and Industry that the Monopolies and Mergers Commission ('MMC') investigate the

Scope of the Derivative Action", (1985) 44 *Cambridge Law Journal* 236; Lowry and Griggs, "Minority Shareholder Remedies: A Comparative View", (1994) *Journal of Business Law* 463; Gower, *Principles of Modern Company Law*, 5th ed, Sweet & Maxwell, 1992, at 643-672; Farrar, Furey and Hannigan, *Farrar's Company Law*, 3rd ed, Butterworths, 1991, at 442-475.

²⁵ See, *inter alia*: Riley, "Contracting Out of Company Law: Section 459 of the Companies Act 1985 and the Role of the Courts", (1992) 55 *Modern Law Review* 782; Prentice, "Minority Shareholder Oppression: Sections 459-461 of the Companies Act 1985", (1988) 8 *Oxford Journal of Legal Studies* 55; and, MacIntosh, "The Oppression Remedy: Personal or Derivative?", (1991) 70 *The Canadian Bar Review* 29.

²⁶ *Re a Company (No 0051136 of 1986)*, [1987] BCLC 82, and Gower, *supra* note 24.

²⁷ For a detailed analysis of the issues see Whish, *Competition Law*, Butterworths, 1993, 3rd ed; and, Bellamy and Child, *Common Market Law of Competition*, Sweet & Maxwell, 1987.

²⁸ OJ L 1989 395/1.

²⁹ The European Commission is attempting to review upwards the financial limits of the Merger Regulation and to harmonise the takeover procedures of Member States. See *European Voice*, 30 November to 6 December 1995.

matter further. If so requested, the MMC will investigate the takeover and report to the Secretary of State as to whether it may be expected to operate against the public interest.³⁰ The public interest manifests itself predominantly in a consideration of whether "competition would be adversely affected" by the takeover or merger under consideration.³¹ Although examples can be found where the MMC has considered a multitude of factors when deciding whether a transaction is in the public interest, including the implications of foreign ownership³², the present orthodoxy, exemplified by the recent statements by the present UK Government, suggest that the primary factor to be considered is the impact of the transaction on competition.³³

2.4 Summary of regulatory issues

The regulation of the market for corporate control outlined above is premised on competition *per se* being beneficial, and it can be seen that the market needs a substantial amount of help if it is to allocate the resources as efficiently as it is said to do. There is considerable scope for value judgments to be made by the judiciary, the Takeover Panel, and the competition authorities in the regulation of the market for corporate control. It is not a free market in which the "invisible hand" does its work: the very real and vivid hand of the regulatory authorities is clearly discernible.

3. The efficacy of the market for corporate control

Thus far, the theoretical designs of the market for corporate control, and the reality of its regulation, have been considered in isolation from considerations of the efficacy of the market as a means of achieving an optimum allocation of resources. Critiques abound as to the how and the why the theory of the market for corporate control cannot operate in practice as its theory suggests.³⁴ Thus, it is argued that predator

³⁰ Sections 69(1)(b), 69(4) and 84 of the Fair Trading Act 1973.

³¹ *Annual Report of the Director General of Fair Trading for the period January to December 1985*, HC 403, 1986.

³² See *Enserch Corporation and Davy Corporation Limited*, Cmnd 8360, 1981.

³³ 1988 Blue Paper, *Mergers Policy*, particularly chapter 20. See also, for example, the controversy surrounding the decision of the President of the Board of Trade not to refer the proposed acquisition by Trafalgar House plc of Northern Electric plc to the MMC. See DTI Press Notice, 14 February 1995. The controversy arose as it concerned the acquisition of a public utility company by a privately owned company raised questions of the public interest which should properly be considered by the MMC. See the *Financial Times*, 3,4,11 February 1995; and, *The Observer*, 5 February 1995.

³⁴ See, *inter alia*: Bradley, *supra* note 4; Farrar, Furey and Hannigan, *supra* note 24, at 605-644; Farrar (ed), *supra* note 4; Stokes, "Company Law and Legal Theory", in Twining (ed), *Legal Theory and Common Law*, Blackwell Oxford, 1986; Parkinson, *supra* note 20; Bratton, "The Nexus of Contracts Corporation: A Critical Appraisal", (1989) 74 *Cornell Law Review* 407.

companies may wish to takeover a company for a number of reasons not connected with the poor management of the target. In such circumstances, the takeover is not functioning as a means by which the resources of the company will be more effectively managed, but it is a method by which the predator company can satisfy its own particular aims, be they short term growth, the personal advancement of the directors³⁵, or that the management of the predator company wishes to take over another company in order to increase its own size, thereby reducing the threat of a takeover of their company. A takeover for the latter purpose may be made at a price which does not reflect the company's worth. Moreover, if a takeover is made solely to increase the size of the company and its impenetrability, the company may begin to engage in anti-competitive practices, thus protecting the position of the directors.³⁶

Alternatively, the threat of a takeover may induce the management of the target company to take action which does not improve efficiency and therefore the price of the shares of the company, and which is not in the interests of the shareholders of that company. Such defensive tactics may include the issue of a large number of shares to another company in the hope that they do not sell them, thereby making the acquisition of control more difficult. Alternatively, a company may include a provision in its articles enabling shareholders to be bought out at a certain higher price if there is a change in control, thereby placing a substantial financial premium on the takeover of the company. More usually, the criticism of acting in their own interests is levelled at companies which attempt to increase their share price in the short term, at the expense of long term profitability, which may obscure the underlying inefficiency of the company.³⁷

It is this criticism of short termism which is most often the basis for a critique of the market for corporate control. It is argued that the market for corporate control produces and sustains a culture of short term investment and profitability. As a company's share price is the determinant of a control opportunity, a company will, not

³⁵ A recent study by Conyon and Gregg, *National Institute Economic Review*, 18 August 1994, see also, *The Guardian*, 18 August 1994, considered the determinants of directorial remuneration and concluded that companies which are more cash-constrained, often as a result of takeover activity, are more likely to increase directorial pay, even though the company is actually less financially stable as a result of the action of the management. Further, executives who manage to increase their company's sales through takeover activity are likely to be better rewarded than those who achieve the same result through organic growth. Thus, the easier and more reliable route to higher pay is by means of a takeover.

³⁶ Such practices would be regulated by the Competition Act 1980, the Fair Trading Act 1973, and articles 85 and 86 of the Treaty of Rome. See Whish, *supra* note 27.

³⁷ In the UK, defensive tactics by the boards of target companies, such as those described above, are regulated by the City Code on Takeovers and Mergers and the Companies Act.

surprisingly, be concerned with its share price. Thus, it is argued that a company will pay less attention and give less consideration to those investments which in fact may be more productive in the long term but which are not immediately profitable. Thus Bradley concluded that: "If the market for corporate control does tend to discourage corporate managements from investing in projects which might result in large profit in the future in favour of projects which will result in certain profits in the short term, the market may not be as effective in ensuring the efficient allocation of resources as is often suggested."³⁸

Unfortunately, there is an absence of conclusive empirical evidence on the efficacy of the market for corporate control. To exemplify this, two recent inquiries will be considered. Manson, Stark and Thomas published in 1994 a study of 38 takeovers and concluded as follows:

the findings support the view that the market for corporate control:

- (i) exists to promote competition between management teams for the use of resources and, as such, acts as an incentive mechanism to promote efficiency of many different kinds. This is particularly so with respect to operational efficiency; and
- (ii) [it] helps shareholders establish, and is set within a context which shareholders have established, sufficient disciplinary controls over management to ensure that managers act in the interests of firms' owners.³⁹

Thus, the study contends that its results do not support the view that changes in corporate control are as result of managers pursuing their own self-interest: or, at least, if they are pursuing their self-interest that this coincides with the interests of shareholders. Further, it shows that the market for corporate control is an effective means of controlling the conduct of directors: it provides a discipline which produces operational gains. As the study notes, the role played by the market for corporate control is a matter of some dispute and that the results of the study are contrary to previous studies.⁴⁰ Nonetheless, the results are clear, and its authors state that the study should inform "takeover policy", and form the basis of future debate

³⁸ Bradley, *supra* note 4, at 177.

³⁹ Manson, Stark and Thomas, *A Cash Flow Analysis of the Operational Gains from Takeovers*, The Chartered Association of Certified Accountants, 1994, executive summary.

⁴⁰ *Ibid* at 1.

surrounding how to measure the gains or losses from takeovers.⁴¹

On the contrary, a study by Jenkinson and Mayer concludes that there should be "no presumption that unfettered markets for corporate control are always appropriate", and that "the debate over corporate governance and control has been raging long enough to suggest that some alternative approaches should be considered".⁴² The study found that in 40% of bids there was no evidence of financial failure, and that impressive firms are more likely to be taken over than those whose performance is impeachable.⁴³

This thesis cannot attempt to establish which view point is economically superior.⁴⁴ One conclusion however which can clearly be made is that there is no clear evidence either way.⁴⁵ However, proponents of the case against the market for corporate control look to more than economic analysis to establish their case. The market for corporate control, as is evident from the discussion above, is primarily concerned with returns to shareholders. Therefore, if one considers that a company should not be managed solely in the interests of shareholders, the market for corporate control, whether or not the economic data supports its contentions, is not to be supported. These considerations manifest themselves in a consideration of "externalities" - the effects of the market for corporate control on third parties.

4. The social costs of the market for corporate control

As noted above, critics of the market for corporate control point to its third party effects to counter the argument that it is an efficient allocator of resources. Such third party effects take two general forms. First, it is considered that the emphasis of the market for corporate control on share prices, management, and shareholders, distracts attention from those who are also affected, be they employees, consumers, creditors or

⁴¹ *Ibid* at 17.

⁴² Jenkinson and Mayer, *Hostile Takeovers: Defence, Attack and Corporate Governance*, McGraw-Hill Book Company, 1994.

⁴³ *Ibid*.

⁴⁴ For example, the majority of the Manson, Stark and Thomas study is taken up with detailed accounting analyses, mathematical formulae and equations, which are beyond the scope of this author.

⁴⁵ Indeed, economic data aside, the veracity of the claims of the markets advocates are the subject of substantial political debate. The polarity of views can also be seen by, for example, The Labour Party's, *Winning for Britain - Labour's strategy for industrial success*, which states, at 7-8, that: "There is little evidence that the takeover boom of the eighties produced lasting benefits for British industry, although it most certainly saddled firms with the cost penalty of servicing the debt required to finance their acquisitions." Contrast the position of the present UK Government in DTI, *Mergers Policy. A Department of Trade and Industry Paper on the Policy and Procedures of Merger Control*, HMSO, 1988, paragraph 2.27: "The Government believes that the threat of the takeover is a powerful spur towards efficiency in the management of companies."

the public in general.⁴⁶ Secondly, it is argued that the market for corporate control is a costly means by which to control the conduct of directors and that greater emphasis should be given to other means of control, e.g. to the structure of the board of directors.

Nonetheless, it is clear that the market has a number of effects on third parties which are "often ignored".⁴⁷ The criticism of short termism was noted above in the context of whether the market for corporate control is effective, but it also forms the basis of criticisms of the market for corporate control in terms of its third party effects. The preoccupation with the share price of a company is said to detract from long term considerations which will be more beneficial to the public generally. For example, a "management which feels subject to the threat of displacement through takeover is likely to be reluctant to invest in research and development or in any activity which is unlikely to generate profits in the near future, even if that activity were a sensible long term strategy".⁴⁸

Alternatively, a takeover may yield a concentration of interests of that company in a particular field, potentially leading to monopolistic practices. The most blatant abuses of such practices will likely be curbed by the actions of the relevant competition authorities, but many less blatant abuses will remain.⁴⁹ Where a takeover is made for reasons not connected with the inefficiency of the incumbent management, a predator may pay significantly over the odds for the shares in the target company. This may have the effect of increasing the debt of the company, and therefore the likelihood of the predator company having financial difficulties which will adversely affect employees and creditors. Further, it was noted above⁵⁰, that a takeover may be a means of increasing the prestige and remuneration of senior executives, at the expense of shareholders and the public generally.

For a recent example of the criticisms which may be levelled at the market for corporate control, consideration may be given to the proposed acquisition by Trafalgar House plc for Northern Electric plc. Although the takeover would not have resulted in a concentration of market share, the bid did give rise to substantial questions of the

⁴⁶ See, *inter alia*: Coase, "The Problem of Social Cost", (1960) 3 *Journal of Law and Economics* 1; Buchanan and Faith, "Entrepreneurship and the Internalization of Externalities", (1981) 24 *Journal of Law and Economics* 95.

⁴⁷ Bradley, *supra* note 4, at 171.

⁴⁸ *Ibid* at 177.

⁴⁹ See Whish, *supra* note 27.

⁵⁰ Conyon and Gregg, *supra* note 35.

public interest, as it would be a takeover of an utility company providing an essential service, electricity. Nonetheless, the President of the Board of Trade decided that the bid raised no significant issues which should be the subject of detailed consideration by the MMC.⁵¹ However, of greater concern was the proposed defence tactics of Northern Electric plc. The board of Northern Electric plc proposed a package of incentives, amounting to £5.07 per share, which would have substantially increased the debt of the company.⁵² Moreover, it would have resulted in a considerable pay-out to shareholders, at the expense of reductions in prices to consumers, or further investment in the industry.⁵³ Instead, it would have increased the debt of the company. The proposed acquisition of Northern Electric plc exemplified how the market for corporate control diverts management from the task of the efficient management of their companies. In the light of the proposed bid, other electricity companies were put on "bid-alert", preparing their company and themselves for hostile takeover attempts - thus ensuring that that is the top priority at the expense of the company, the industry and the public.⁵⁴

It would appear from the regulation of the market considered above that there is some form of recognition of the social costs of the market for corporate control. The City Code on Takeovers and Mergers is concerned with the position of target shareholders and seeks to ensure that they are all treated equally. It further provides that directors are to give consideration to the interests of their employees.⁵⁵ In addition, competition law provides a mechanism by which the public interest, and the interests of consumers and employees, may be considered in the context of a takeover bid (albeit to a limited extent). Nonetheless, the regulation of the market for corporate control is primarily concerned with "freeing" the market so that it is as effective as possible. Third parties are still left with the hope that the market does actually benefit a greater number than it hinders, and that those who are hindered are not too close by.

The second element of the social costs of the market for corporate control is concerned with its costs. It is the "transition costs necessarily involved in the change from an inefficient use of resources to a more efficient use of resources" which are

⁵¹ *Supra* note 33.

⁵² See, *inter alia*, *Financial Times* 18 February 1995; *Independent* 21 February 1995.

⁵³ As a result, the Director General of Electricity Supply announced a review of electricity prices. See OFFER Press Notice, 7 March 1995.

⁵⁴ See, *inter alia*: *Independent* 15 February 1995; *The Times*, 15 February 1995; *Glasgow Herald*, 15 February 1995.

⁵⁵ See, The City Code on Takeovers and Mergers, general principle 9, which states: "It is the interests of shareholders as a whole, together with those of employees and creditors, which should be considered."

considered to be too costly.⁵⁶ Thus, a consideration of the additional costs of takeovers and mergers reveals that although the market may allocate resources more effectively, it comes at a price. There are costs involved in defending a takeover bid: the study by Jenkinson and Mayer considered above, found that in the UK, two out of three bids are contested, sometimes involving more than one bidder.⁵⁷ On the contrary, in Germany there has been only three contested takeovers since 1945. Each time a takeover bid is launched, an army of advisers to the company are employed - solicitors, accountants, financial advisors, and public relations consultants to name a few - not forgetting that the time of management will become almost solely concerned with the takeover battle at the expense of normal management. If a takeover succeeds, the same advisors will continue to be employed: this time to restructure the new firm, and smooth the transition from two companies to one.

Nonetheless, proponents of the market for corporate control do not agree that the market for corporate control imposes costs on third parties: Easterbrook and Fischel state that the market does not "impose costs on strangers".⁵⁸ This argument is based on the premise that "what is optimal for the firms and investors is optimal for society".⁵⁹ Accordingly, it is not said that the market for corporate control corrects all abuses and weeds out all inefficiency; it is "inevitable that a substantial amount of undesirable slack or self-dealing will occur".⁶⁰ A broadly utilitarian view is taken: the market for corporate control will not prevent all abuses, and therefore some will suffer, but in the long run it will be beneficial for more people than it is detrimental.

C. The Product Market

The product market is premised on similar economic principles to those considered above in relation to the market for corporate control. Essentially, the market for a company's products comprises the market in which we all play a part, via the purchase, or non-purchase, of particular goods and services. The theory of the market for a company's goods or services, its "products", is that the market ensures that a company's management makes effective use of the company's resources in order that its products are competitive. Only if a company's products are competitive, will the company be profitable, thereby determining its success or failure. An inefficient

⁵⁶ Bradley, *supra* note 4, at 176.

⁵⁷ *Supra* note 42.

⁵⁸ *Supra* note 1, at 6.

⁵⁹ *Ibid* at 7.

⁶⁰ *Ibid*.

company will face higher production costs and may eventually become insolvent as customers purchase elsewhere.⁶¹ The product market is therefore another means of directorial control: "if managers are to keep their jobs they must ensure that the company is profitable which requires that the company's products are competitive".⁶²

There is an obvious correlation between the product market and the market for corporate control: if a company's products are not competitive, the company will become a target on the market for corporate control. However, the product market may entail more effective control of management than the market for corporate control. The market for a company's products will operate in cycles of the economy where there is little corporate takeover activity, for example, in times of economic recession. During such stages of the economic cycle, there will be little reallocation of resources via takeovers and mergers, thus rendering the market for corporate control all but redundant. On the contrary, the market for a company's products, if, that is, such products have survived the effects of the economic recession, will be ever present. Indeed, at a time of economic struggle, the market may be even more effective in its allocation of resources. Further, the product market may be utilised in the calculation of management remuneration; it is a gauge by which to judge the performance of management in the market. The thesis is that if a company's products are successful, the company is performing well under the incumbent management and should be so rewarded. The product market will be a useful incentive to management to secure an improved position for the company.⁶³

However, as with the market for corporate control, the theory is not always borne out in practice. The study by the National Institute of Economic and Social Research referred to above, showed that the remuneration of directors had more to do with reducing union power and the blunt effect of increased sales figures as a result of takeover activity, than the measure of a company's performance.⁶⁴ The study raises the question of whether there is "effective control of managerial pay setting by shareholders", via the product, or any other, market.⁶⁵

It is also clear that the product market will not be effective where a company operates in a virtual, or actual, monopoly situation. In such circumstances, the company can

61 Posner, *supra* note 1, at 383.

62 Parkinson, *supra* note 20, at page 114.

63 *Ibid.*

64 *Supra* note 35.

65 *Ibid.*

effectively control the price for its products, without reference to the market. Further, even where a company does not operate in a monopoly, it may be dominant and engage in anti-competitive practices. Such practices and monopoly industries are regulated by UK and EC competition law. However, it should be noted that "an imperfectly competitive market will not quickly convert ... inefficiency into insolvency"⁶⁶, nor will the regulatory authorities be keen to intervene. However, despite the aforementioned drawbacks to the efficiency of the product market, it is argued that it is the market which "affects management behaviour in the most obvious way".⁶⁷ This is because, with the exception of the monopoly, the product market cannot but have an affect on a company's performance and profits. It is the extent, and utility, of the control which is exercised, which is the source of dispute.

D. The Managerial Market⁶⁸

The market for managerial services is the market of professional executive directors. This market is often the justification for substantial directorial remuneration packages; the argument being that if a director is not paid a particular sum, the director will be engaged elsewhere as his or her services are more highly valued on the market for managerial talent, than the particular company acknowledges via its remuneration package. Much emphasis has been placed on the market for managerial talent as legitimating the management structure of a large corporation. Fama explains that "the viability of the large corporation with diffuse security ownership is ... explained in terms of a model where primary disciplining of managers comes through managerial labor markets, both within and outside the firm".⁶⁹ Thus, the theory is that although in a large company, shareholders have little direct control of management, the control is exercised via the managerial market. This argument is greatly similar to that advanced in support of the market for corporate control: shareholders may exercise little control over inefficient management, but the market does.

The market for managerial talent is said to work in two particular ways. First, the market works internally within the particular company. The managers of a particular firm are those best placed to judge whether or not the performance of other managers is optimum. Thus, managers who do not believe that others are managing efficiently

⁶⁶ Eisenberg, "The Structure of Corporation Law", (1989) 89 *Columbia Law Review* 1461, at 1489.

⁶⁷ Parkinson, *supra* note 20, at 114.

⁶⁸ See, *inter alia*, Fama, *supra* note 4.

⁶⁹ *Ibid* at 295.

and effectively, will bring such conduct to the attention of either the shareholders or the markets.⁷⁰ The markets and/or the shareholders will then be able to make an assessment of the manager under scrutiny; the manager will either be removed from office, or his or her value in the market for managerial services will be reduced. However, such a model depends upon the directors of each company engaging in monitoring, and reporting on the very people with whom the directors is supposed to be working. Parkinson notes that this market can barely be cost effective if the managers are concerning themselves with the conduct of their fellow directors rather than the management and performance of the company.⁷¹ Thus, in order for the managerial market to operate effectively, increased regulation of the company may be required in the form of non-executive directors (to monitor the executive directors on the board), or at least a mechanism for reporting on allegedly errant directors. The resulting paradox is that the effectiveness of the managerial market depends upon the regulation of management itself, exactly what the market is supposed to replace. It is such regulation which is anathema to the market theorists who advocate corporate regulation by markets. Moreover, the power of management is particularly dominant and it would be a very unusual director who risked his or her own position, and the company's, by exposing inefficiency or incompetence. Thus, Parkinson concludes that "the forces of the internal market, such as they are, will often be defeated by management power and board cohesiveness".⁷²

Secondly, the market works outside the company and its directors, and operates in the market place; this is the market for managerial services between companies. The presumption is that the remuneration and performance of an executive is transparent, thereby affording the opportunity of widespread comparison. The theory of the market for managerial talent has immediate resonance. It is part of a general public perception that if a position is particularly valued, or if a person is particularly able, then that person and any person doing that job, should be well remunerated. Thus, the argument is made that, only if a person is highly paid, is worth attached to the position. In the market for managerial services, this translates into the argument that the market itself will highlight the able executives and remunerate them accordingly: the higher paid an executive in the market is the more valued and therefore able the person.

⁷⁰ Fama and Jensen, "Separation of Ownership and Control", (1983) 26 *Journal of Law and Economics* 301, at 315.

⁷¹ Parkinson, *supra* note 20, at 117.

⁷² *Ibid.*

There are a number of drawbacks with the basis and operation of this market. The performance of an executive will not be easily discernible by company outsiders. An executive may appear to be supremely able, but actually the company's products are particularly efficient at a particular time, perhaps because of changes made a number of years previous by a different executive. An executive may appear able, but actually has a number of very able people working for him or her, without which the executive would not be able to perform. Further, the actual remuneration package of the particular executive may not be easily comparable; the remuneration of a director may be made up of a number of components, for example, salary, performance related pay, share options and share ownership. Substantial criticism has been levied recently concerning the lack of transparency of the remuneration packages of directors⁷³, and it was noted above that the remuneration of executives did not necessarily reflect corporate performance. Thus, the remuneration which an executive receives does not necessarily reflect a market appreciation of the benefits which a particular person may bring to another company. More particularly, remuneration may reflect the power of the particular executive over the board of the company and the general meeting.⁷⁴

A recent relevant innovation in terms of corporate governance has been the remuneration committee comprising a majority of non-executive directors.⁷⁵ Such committees are intended to monitor the remuneration of executives and ensure accountability. However, recent comment on the level of executive pay has argued that the existence of remuneration committees, rather than restricting remuneration of executives, are encouraging a spiral of increasing remuneration.⁷⁶ Thus, the

⁷³ See, *inter alia*: the report of the Greenbury Committee *Directors' Remuneration - Report of a Study Group Chaired by Sir Richard Greenbury*, 17th July 1995, which was established by the Government, under the auspices of the Confederation of British Industry, see CBI Press Release, 16 January 1995, as a result of continuing public concern over the remuneration of senior executives, particularly those in the newly privatised industries; Accounting Standards Board's Urgent Issues Task Force abstract on the Disclosure of Directors' Share Options, 29 September 1994; the announcement by the Government that it is considering an amendment to the Companies Act ensuring greater disclosure of share options, *Financial Times*, 3 November 1994; Association of British Insurers, *Long Term Remuneration of Senior Executives*, 25 May 1994.

⁷⁴ See Ramsay, "Directors and Officers' Remuneration: The Role of the Law", (1993) *Journal of Business Law* 351, for a detailed analysis of recent studies regarding the levels of directorial remuneration.

⁷⁵ See further Chapter Three which considers the Cadbury Report on corporate governance and the Greenbury Report and their recommendations for remuneration and other committees to be established to monitor management.

⁷⁶ See, for example, "Boom time on the Boards", *The Guardian*, 18 June 1994, where the issue of directors' pay is examined *post-Cadbury*. The report concludes that the existence of remuneration committees, primarily made up of non-executives who themselves hold executive positions at other companies, has led to an increase in the levels of remuneration of executives, even at a time of recession and decreasing productivity.

remuneration of executives may often not be representative of the particular skills of the relevant executive and this is a consequence of the emphasis on the market for managerial services. The final point to raise when questioning the value of the market for managerial services, is the issue of whether there can truly be said to be a market for the services of top executives. The number of companies which command particularly high salaries for top executives is small and, as noted, the remuneration of the small number of executives may be unrepresentative of the market. Thus, the market that there is, is dominated by a small number of individuals, thus reducing any efficiency of the market.⁷⁷

E. Conclusions: The Market as a Means of Directorial Control

The contention of those who advocate market control of the company may be summarised as follows: "the operation of the market imposes a discipline which is sufficient to secure an acceptable level of managerial efficiency, without giving rise to the costs that flow from reliance on a liability regime".⁷⁸ In other words, there must be some control of companies, and the market is the most efficient method. The market is said to be the most cost-effective method of corporate regulation as it does not involve the costs of non-executives, self-regulatory bodies, governmental agencies and the courts. Any external regulation of markets which is required is merely regulation in order to free the markets; such regulation being justified if it corrects the distortions of the market. The market theorists recognise the problems highlighted by the debate on the separation of ownership and control in large companies, but argue that the control of shareholders is replaced by the market, which is more efficient than shareholder control.⁷⁹ Further, the theory of market control does not state that every example of wrongdoing will be eradicated, but that "[m]arkets that let particular episodes of wrongdoing slide by, or legal systems which use deterrence rather than structural change to handle the costs of management, are likely very effective in making judgements about optimal governance structures".⁸⁰

However, as has been shown, the reality of the market theories may not always be borne out in practice. Brudney emphatically states that "there is little doubt that the

⁷⁷ Parkinson, *supra* note 20, at 118.

⁷⁸ *Ibid* at 113.

⁷⁹ For a defence of the present position, see Alcock, 'Corporate Governance: A Defence of the Status Quo', (1995) 58 *Modern Law Review* 898.

⁸⁰ Easterbrook and Fischel, *supra* note 3, at 1422. However, it is not explained why this should be the case.

market is inadequate to foster responsible corporate behaviour in many areas".⁸¹ Hopt notes that there are difficulties with market regulation, particularly in regard to "how to develop such market forces if they do not yet exist or work satisfactorily", "determining the right mix between state regulation and self-regulation", and how "state-controlled corporations, groups of companies and international enterprises can be effectively exposed to the such market forces".⁸² Hopt concludes that "improving corporate governance through market forces is ... problematic".⁸³

Moreover, the regulation of the market, even if it is only to "free" the market, and it was considered above that this is not solely the case, imposes significant costs on the economy. The regulatory regime outlined above in relation to the market for corporate control is detailed and complex, and involves considerable costs in terms of its compliance, interpretation, enforcement and creation. In the product market, significant sums are spent regulating the practices of, *inter alia*, the creation, marketing, selling of the products. The managerial market also has abuses which are considered to be contrary to the public interest, hence the controversies over the remuneration of executives and the steps now being taken to correct such abuses.

However, objections to market regulation are theoretical as well as practical. Stokes argues that the market does not act in the interests of shareholders and other stakeholders in the company and that this, of itself, is not satisfactory.⁸⁴ Others argue that regulation ought to be in the control of those whom it affects, i.e. not in the hands of the market: "the necessary regulation and administration ought to be as far as possible be removed from the centralised state to structures more amenable to popular control and influence".⁸⁵ Thus, employees, consumers and shareholders should be regulating companies, not the 'invisible hand'. In addition, it is argued that companies should be regulated in order to achieve wider social goals than merely profit maximisation.⁸⁶

⁸¹ Brudney, "The Independent Director - Heavenly City or Potemkin Village?", (1982) 95 *Harvard Law Review* 597, at 658. See also: Bratton, *supra* note 34; Brudney, "Corporate Governance, Agency Costs and the Rhetoric of Contract", (1985) 85 *Columbia Law Review* 1403; Buxbaum, "Corporate Legitimacy, Economic Theory and Legal Doctrine", (1984) 45 *Ohio State Law Journal* 515.

⁸² Hopt, "New Ways in Corporate Governance: European Experiments with Labor Representation on Corporate Boards", (1984) 82 *Michigan Law Review* 1138, at 1342.

⁸³ *Ibid* at 1343.

⁸⁴ Stokes, *supra* note 34, at 174-175.

⁸⁵ Cotterrell, "Feasible Regulation for Democracy and Social Justice", (1988) 15 *Journal of Law and Society* 5, at 20, arguing that those who are most closely affected by decisions should play a part in their determination.

⁸⁶ See, for example, Wedderburn, "The Social Responsibility of Companies", (1985) 15

Whatever the normative arguments, it is clear that the debate will continue. Further, it is clear that markets do effect some control over corporate conduct but that such control entails compliance costs and may adversely affect third parties. Accordingly, it is appropriate to consider the alternative means of regulating the conduct of directors in an attempt to consider whether such means will be more effective, and less destructive. The following chapters will consider a number of alternative means of regulating the company and its officers in this context.

CHAPTER TWO

AN ANALYSIS OF DIRECTORS' FIDUCIARY DUTIES

A. Introduction

Chapter One considered the control exercised by the market over the conduct of directors. In particular, the markets for products, managerial talent and corporate control were examined. It was noted that markets are an external means of controlling the conduct of directors, and as such are not easily open to manipulation by shareholders and directors. Further, markets are only regulated in order to make them function more efficiently, and that otherwise, markets are allowed to tread their own course. It was considered that whether markets controlled directorial conduct in an effective manner was a moot point. Further, whether or not markets did perform effectively, the costs of their so doing may outweigh the benefits. Such costs include the financial costs of the regulation, and the compliance costs associated therewith, together with the effects which markets have on third parties. Accordingly, it was considered that it is appropriate to examine alternative means of regulating the conduct of directors in order to consider whether such means are more cost-effective and less harmful to third parties.

In this light, this chapter will analyse a further external control on directorial conduct, namely the fiduciary duties of directors. Directors' duties are described as external as they are imposed on companies and their directors by the legislature, or the common law, and proscribe certain types of behaviour, and demand others. The control exercised by directors' duties is contrasted with the internal controls which are the subject of the Chapters Three and Four.

B. Directors' Fiduciary Duties¹

This section will be divided into three parts: first, it will be considered to whom fiduciary duties are owed; secondly, the content of the duties will be examined; and, thirdly, the enforcement of the duties will be addressed.

¹ The discussion which follows will refer to "directors", but it should be noted that the fiduciary duties of directors will apply to all senior executives authorised to act on behalf of the company. See *Canadian Aero Service v O'Malley*, [1973] 40 DLR 371, at 381. For a detailed consideration of the nature of the director as fiduciary, see Sealy, "Director as Trustee", (1967) 25 *Cambridge Law Journal* 83.

1. To whom are fiduciary duties owed?

1.1 The company

The orthodox position is often stated by reference to the judgment of Greene MR in *Re Smith and Fawcett* wherein he stated that directors must always act "bona fide in what they consider, not what the court may consider, is in the interests of the company, and not for any collateral purpose".² Greene MR's assessment is often considered to be the definitive statement of the law. However, it does not answer all questions. The iteration that the directors must act *bona fide* in the interests of the company is ambiguous. Clearly, it does not mean that "the directors must use their powers to promote the welfare of the legal entity, though technically the duty is owed to the entity", as a "requirement to benefit an artificial entity, as an end in itself, would be irrational and futile, since a non-real entity is incapable of experiencing well-being".³ Therefore, the meaning of "bona fide in the interests of the company" means something other than the interests of the "company". The "interests of the company" only has meaning when considered in the context of the company's purpose and the purpose is determined by reference to the purposes attributed thereto by human actors. As Parkinson concludes: "The correct position is thus that the corporate entity is a vehicle for benefiting the interests of a specified group or groups."⁴

The group in whose interests the company is to be managed are the shareholders. Thus, in *Greenhalgh v Arderne Cinemas Ltd*, Lord Evershed MR stated that "the phrase "the company as a whole" does not ... mean the company as a commercial entity as distinct from its corporators".⁵ Further, in *Kinsella v Russell Kinsella Pty Ltd*, it was stated that "the proprietary interests of shareholders entitle them as a general body to be regarded as the company when questions of the duty of directors arise".⁶ Thus, the exhortation to act *bona fide* in the interests of the company can be interpreted to mean that "[t]he duty of management can accordingly be stated as a duty to promote the success of the venture, in order to benefit the members".⁷

However, this does not of itself clarify the position. Are the directors to act in the

² [1942] Ch 304, at 306.

³ Parkinson, *Corporate Power and Responsibility - Issues in the Theory of Company Law*, Clarendon Press Oxford, 1993, at 76.

⁴ *Ibid* at 77.

⁵ [1951] Ch 286, at 291.

⁶ [1986] 10 ACLR 395, at 401.

⁷ Parkinson, *supra* note 3, at 77.

interests of present shareholders only or are they to have regard to possible future shareholders? Further, is the duty owed to shareholders as individuals or only collectively? The traditional interpretation is that the directors must exercise their discretion and balance the interests of "present and future members".⁸ Thus, whereas it was initially posited that the objective of imposing fiduciary duties on directors was to act as a means of control; it can be seen that in the exercise of their duties, directors have considerable discretion. If directors can act by reference to the interests of future shareholders, they are not restricted to follow the interests of the present shareholders, the owners of the company in whose interests the duties were imposed in the first place. It would seem that the directors may regard the interests of the members of the company as a continuum.⁹

1.2 Shareholders

It was considered above that directors are obliged to act *bona fide* in the interests of the company, which manifests itself in a duty to act in the interests of shareholders generally: the duty is not owed to individual shareholders, except in certain limited circumstances. This basic principle was confirmed in *Percival v Wright*.¹⁰ Although this decision has been widely criticised¹¹, the only significant inroad into its sanctity is the decision of the New Zealand Court of Appeal in *Coleman v Myers*.¹² *Coleman v Myers* involved directors giving advice to shareholders in a small family company in which the directors held a position of trust. The New Zealand Court of Appeal held that directors can owe fiduciary duties to individual shareholders, but that this does not arise by reason of the shareholder/director relationship: there must be other supporting evidence which would lead a court to finding that the directors had

⁸ *The Savoy Hotel Ltd and the Berkeley Hotel Company Ltd: Investigation under section 165(b) of the Companies Act 1948: the Report of E Milner Holland QC*, DTI Investigation Report, 1954.

⁹ It has, therefore, been argued that the "'shareholder' to which management should regard itself as accountable is not simply those individuals who happen to be shareholders today ... but to "ownership" as an institution over time". See Williams, "Corporate Accountability and Corporate Power", in Williams & Shapiro, *Power and Accountability: The Changing Role of the Board of Directors*, 1979, at 23.

¹⁰ [1902] 2 Ch 421. In *Percival v Wright* the directors purchased shares from some of the company's shareholders without disclosing that they themselves were presently negotiating the sale of the entire undertaking to a third party which would have substantially increased the value of the shares. It was held that the directors were not under a duty to inform the shareholders of the negotiations; they did not owe a duty to the individual shareholders.

¹¹ See, *inter alia*: *Report of the Committee on Company Law Amendment*, the Cohen Committee, Cmnd 6659, paragraphs 86-87; *Report of the Company Law Committee*, the Jenkins Committee, Cmnd 1749, paragraph 89.

¹² [1977] 2 NZLR 225.

breached "sensible and fair principles of commercial morality".¹³ Whether or not such a duty will be imposed in particular circumstances will depend upon all the circumstances of the case and the nature of the responsibility which in a real and practical way the director/s assumed towards the shareholder/s.¹⁴ On the facts, the directors were held to have breached their duty by withholding information from the shareholders and were held liable to account.

Although, the decision in *Coleman v Myers* has not been directly followed in the English courts, a number of cases have considered the obligations which directors do owe directly to shareholders. These cases have mainly arisen in the context of takeover bids, where shareholders will often rely heavily on the advice of directors in determining the outcome of the bid. In *Gething v Kilner*¹⁵ it was held that directors had a duty to be honest and not to mislead shareholders. The courts went further in *Heron International Limited v Grade*¹⁶ where it was held that directors were obliged to obtain for shareholders the opportunity to reject or accept the highest bid possible. This case has been doubted¹⁷, and, it is argued, should be considered to turn on its particular facts. Nonetheless, the position in *Gething v Kilner* has been confirmed, and further, it has been held that directors must not exercise their fiduciary duties in a manner which would inhibit the choice of the shareholders. The exact nature of these duties were considered fully in *Dawson International plc v Coats Paton plc*¹⁸, wherein it was held that the obligations of honesty and not to mislead were not pre-existing fiduciary duties, but could be characterised as a potential liability arising out of their words or actions which can be based on ordinary principles of law. In addition, in exceptional circumstances, directors can assume fiduciary duties towards shareholders individually, where, for example, shareholders appoint the directors as their agents.¹⁹

¹³ *Ibid.*

¹⁴ The factors which the New Zealand Court of Appeal held were relevant to its finding in *Coleman v Myers* included: the closely held nature of the company; the dependence of the shareholders for information on the directors; the existence of a relationship of trust and confidence; the significance of the transaction to the parties; and, the extent of any positive action taken on behalf of the directors to promote it.

¹⁵ [1972] 1 All ER 1166. There are considerable questions over the ability of a shareholder to bring an action for a breach of this duty. See, for example, Bradley, "Corporate Control: Markets and Rules", (1990) 53 *Modern Law Review* 170, at 180.

¹⁶ [1983] BCLC 244.

¹⁷ See *Re A Company (no 008699 of 1985)*, [1986] BCLC 382, and *Dawson International plc v Coats Paton plc*, [1989] BCLC 233.

¹⁸ [1990] BCLC 560.

¹⁹ *Allen v Hyatt*, [1914] TLR 444.

1.3 Creditors

It has already been noted that directors may exercise a substantial discretion in interpreting their duty to act *bona fide* in the interests of the company in that their fiduciary duties are not owed to particular shareholders, or to all present shareholders collectively, but to the members of the company as a continuum. In addition, recent developments in respect of the rights of creditors show that the discretion of the directors to act in the interests of the company extends to non-shareholders, including creditors. The orthodox position that directors owe no duties to creditors was confirmed in *Multinational Gas and Petrochemical Co v Multinational Gas and Petrochemical Services Ltd*²⁰ where three large multinational companies formed a subsidiary which went into liquidation owing approximately £114 million. Dillon LJ held that a company owed no duty of care to creditors "present or future".²¹ However, as a result of the several recent cases discussed below, the position is no longer clear.

In *Kinsela v Russell Kinsella Pty Ltd* the position was stated to be as follows:

In a solvent company the proprietary interests of the shareholders entitle them to be regarded as the company when questions of the duty of directors arise. If, as a general body, they authorise or ratify a particular action of the directors, there can be no challenge to the validity of what the directors have done. But where a company is insolvent the interests of the creditors intrude. They become prospectively entitled, through the mechanism of liquidation, to displace the power of the shareholders and the directors to deal with the company's assets.²²

This statement was approved by Dillon LJ in *West Mercia Safetyware Ltd v Dodd*²³, and in *Lohnro Ltd v Shell Petroleum* Lord Diplock stated that the duties of the directors to consider the interests of the company were not "exclusively those of its shareholders but may include those of its creditors".²⁴ The position was taken further by Nourse J, who, in *Brady v Brady*, stated that "where the company is insolvent, or doubtfully solvent, the interests of the company are in reality the interests of existing creditors alone".²⁵

²⁰ [1983] Ch 258.

²¹ *Ibid* at 288.

²² *Supra* note 5, at 401.

²³ [1988] BCLC 250.

²⁴ [1980] 1 WLR 627, at 634.

²⁵ [1989] AC 755. Although the House of Lords, [1988] 2 All ER 617, overruled Nourse J on

Thus, it has been recognised by the courts that within the company there are competing proprietary interests: those of shareholders and creditors. It having been recognised that there is a transfer of property rights in the company when it becomes insolvent, the creditors thus becoming the owners of the company²⁶, the law, in keeping with protection afforded to proprietary interests, now safeguards the interests of creditors.²⁷ However, the recognition of the interests of the creditors in the company is not without conceptual and practical difficulties. It is obvious that the interests of the shareholders exist from the inception of the company. But, if the interests of the creditors only intercede when the company is insolvent, or, more unlikely, "doubtfully solvent"²⁸, when exactly do the interests of creditors arise? Is it the moment that the company is unable to pay its debts? Does this therefore preclude the directors from taking action to recover the position of the company and return to solvency, which could, arguably, be in the interests of the shareholders?²⁹ Moreover, can the shareholders ratify the failure of the directors to consider the creditors? Prentice states that were the shareholders to be able to ratify the breach of duty this would "drive the entity principle to absurd lengths".³⁰ He continues that the point of the *Kinsella* judgment is that, *inter alia*, there comes a point when the interests of the shareholders cease to have any relevance to the company and this should simply "denude"³¹ the shareholders of any power to ratify this breach. Exactly how this is to operate in practice is, however, far from clear.

the facts, finding that the creditors interests had been considered, the *obiter* statements of Nourse J were not disputed. See also *Winkworth v Edward Baron Development Co Ltd*, [1986] 1 WLR 1512, where Lord Templeman stated that: "A duty is owed by the directors to the company and to the creditors of the company to ensure that the affairs of the company are properly administered and that its property is not dissipated or exploited for the benefit of the directors themselves to the prejudice of the creditors". This suggests that the duty owed by directors to creditors arises long before the company is actually insolvent or even nearing insolvency.

²⁶ In keeping with the analysis of the extension of fiduciary duties being owed to creditors on the basis of property rights, it is doubtful whether the judgment of Nourse J in *Brady v Brady*, *supra* note 25, stating that the interests of creditors intrude, even where a company is "doubtfully" solvent, is an accurate or appropriate statement of the law.

²⁷ See also *Kuwait Asia Bank EC v National Mutual Life Nominees Ltd*, [1990] 3 All ER 404, where it was held, at 407, that "although directors are not liable *as such* to creditors of the company, a director may by agreement or representation assume a special duty to a creditor of the company". To the extent that this judgment holds that directors could be held to assume a special obligation towards creditors when the company is insolvent, or doubtfully insolvent, it is consistent with the law as it stands.

²⁸ Nourse J, *supra* note 25.

²⁹ A similar conflict is apparent in the interpretation of section 214 of the Insolvency Act 1986. See Farrar, Furey and Hannigan, *Farrar's Company Law*, Butterworths, 1991, 3rd ed, at 716-718.

³⁰ Prentice, "Directors, Creditors and Shareholders", in McKendrick (ed), *Commercial Aspects of Trusts and Fiduciary Obligations*, Clarendon Press Oxford, 1992, at 80.

³¹ *Ibid.*

It would seem, therefore, that directors may, at some stage, owe duties to the creditors of their companies, but exactly when this duty arises and how it is to be enforced is not clear. The absence of clear guidance can only add to the discretion of the directors, as directors are obliged to act in what *they* consider to be the interests of the company. This is a subjective test which therefore gives a director considerable freedom to argue that, in his or her opinion, the particular action was in the interests of the company, whether it manifest itself in terms of the interests of the shareholders or creditors.

1.4 Employees

Thus far, it has been established that directors must act in the interests of the shareholders and, in particular circumstances, the creditors. The law seeks to protect creditors and shareholders in the form of directors' fiduciary duties by virtue of their proprietary interests in the company. In this context, it would appear unlikely that directors would be held to owed duties directly to employees, who have, in traditional jurisprudence, no proprietary rights in the company.³² This is confirmed by the fact that although directors are obliged to consider the interests of employees in certain circumstances, this obligation may only be enforced by shareholders, thus supporting the view that the directors only, effectively, owe duties to those with proprietary interests in the company.

Historically, it was considered that directors may consider the interests of a company's employees, but only as part of determining the interests of the company generally; the interests of the employees were not free standing. This position was evident from the decision in *Parke v Daily News*³³ where directors wished to donate the proceeds of the sale of the business to the employees, in order to compensate them for the loss of their employment. It was held that the directors did not have the power to make such a payment to the employees, as this would not be in the interests of the company as a whole, but only in the interests of the employees.³⁴

³² For a discussion of proprietary interests being formed on the basis of an interest in property as opposed to a legal entitlement, see, *inter alia*: Cotterrell, "Feasible Regulation for Democracy and Social Justice", (1988) 15 *Journal of Law and Society* 5; and, de Sousa Santos, "On Modes of Production of Law and Social Power", (1985) 13 *International Journal of the Sociology of Law* 299.

³³ [1962] Ch 927.

³⁴ The Companies Act 1980 reversed the decision in *Parke*, by allowing the directors to make provision for the employees in connection with the transfer of the undertaking of the company, notwithstanding that the exercise of the power is not "in the best interests of the company". See section 74 of the Companies Act 1980, now sections 719 Companies Act 1985 and 187 of the Insolvency Act

However, the Companies Act 1980 placed a specific duty on directors to consider the interests of the employees, although this raises as many questions as it purports to answer.³⁵ The now section 309 of the Companies Act provides that: "The matters to which the directors of a company are to have regard in the performance of their functions include the interests of the company's employees in general as well as the interests of its members." Does this mean that the duty of directors to consider the interests of the employees is now free standing and justiciable? Will directors be able to overlook the interests of shareholders, having a defence to a shareholders' action for breach of duty? Or, if not, is it that the directors must first consider the interests of the employees, then carry on regardless, following the interests of the shareholders?³⁶

A consideration of the enforcement mechanism provided in section 309 discloses the futility of the section, in terms of ensuring protection and consideration of the interests of employees. Section 309(2) states that "the duty imposed by this section [section 309(1)] on the directors is owed by them to the company (and the company alone) and is enforceable in the same way as any other fiduciary duty owed to a company by its directors". It was shown above that owing duties to the company in effect means owing duties to shareholders' in general and, in certain circumstances, creditors. Thus, the duty imposed by section 309 is owed to shareholders and creditors. Furthermore, section 309(2) states that the duty is to be enforced in the same manner as other directors' duties owed to the shareholders, namely the derivative action. Thus, the mechanism for enforcement is reliant on a shareholder taking action against the directors of the company, relying on the "tired, old learning of the rule in *Foss v Harbottle*".³⁷ As Wedderburn points out, there was never any "intention to encourage shop stewards to come to work clutching a derivative writ in one hand and the rule in *Foss v Harbottle* in the other".³⁸ It is unlikely, even if a shareholder were to attempt to take action in defence of the rights of the employees, that the breach by the

1986.

³⁵ See, *inter alia*, Prentice, "A Company and Its Employees: The Companies Act 1980", (1981) 10 *Industrial Law Journal* 1.

³⁶ It has been pointed out that the section could have been worse: the duty to consider the interests of the employees is mandatory, not optional: "are to have regard" instead of "are entitled to have regard". The draft bills leading to the Companies Act 1980 used the optional wording. See, *inter alia*, Birds, "Making Directors Do Their Duties", (1980) 1 *Co Law* 67, at 72: "Obviously this is an important difference in that directors who are shown to have failed to give any consideration at all to the interests of employees would be in breach of duty", although Birds notes the futility of this proposition; "But surely this will be virtually impossible to prove?".

³⁷ *Supra* note 35, at 4.

³⁸ Wedderburn, "Trust, Corporation and the Worker", (1985) 23 *Osgoode Hall Law Journal* 204, at 235.

directors of this duty would amount to a fraud on the minority, one of the exceptions to the rule in *Foss v Harbottle*.³⁹

Furthermore, were it to be established that the directors had breached their duty to consider the interests of the employees, the shareholders are entitled to take action to ratify certain breaches of directors duties.⁴⁰ Thus, the breach of duty which is aimed at including the employees in the "interests" of the company, widening the overly restrictive duties to act in the interests of the shareholders, can be ratified by the very party whose interests may be presumed to be in conflict with those of the employees.

It can be seen that the scope of directors to act in the interests of the employees is not, on its face, meaningful, largely because of the problems of enforceability, and resolution conflicts of interest. What is significant is that section 309 represents another step forward in making the duties of directors extremely vague and protean. A director can defend him or herself in an action for breach of duty, by claiming to have considered, *inter alia*, the interests of present shareholders, future shareholders, creditors and employees.

2. The nature of directors' fiduciary duties

The fiduciary duties imposed on directors take a number of forms, the substance and delineation of which overlap. Broadly, the duties of directors can be identified as follows: the duty to act *bona fide* in the interests of the company; the duty not to act for a collateral purpose; the duty to act with skill and care in the performance of the director's duties; the duty not to pursue conflicting interests; and the duty not to profit from the office of director, other than with the appropriate approvals. Each of these duties will be considered in turn.

2.1 The duty to act *bona fide* in the interests of the company

There are two elements to this duty: the duty to act *bona fide*, and the duty to act in the interests of the company. The nature of the obligation to act in the interests of the company was broadly examined by section B 1.1, above, when considering to whom

³⁹ [1843] 2 Hare 461. See *infra*.

⁴⁰ Where the breach is *mala fides*, it is not ratifiable, *Cook v Deeks* [1916] 1 AC 554; but it is ratifiable where otherwise, see *Regal (Hastings) Ltd v Gulliver*, [1942] 1 All ER 378. Where the breach is ratifiable, the directors can, as shareholders, vote to ratify their own wrongdoing, *Grant v United Kingdom SwithBack Railways Co*, [1888] 40 ChD 135.

fiduciary duties are owed. The discussion in B 1.1 concentrated on the meaning of the term "interests of the company" and found that this meant, very broadly, the interests of the shareholders generally, present and future. However, the interests of the company will also encompass the interests of creditors and employees, but only in certain limited circumstances.

The first element, the duty to act *bona fide* is subjective. The duty is to act in what the director considers to be the interests of the company. Thus, a court will be extremely reluctant to impose its view of what is in the best interests of the company, and, presuming that the action of the director is within a reasonable range of responses, then the judgment of the director will not be called into question. Notwithstanding this subjective test, it has been held that if the actions of a director are such that no reasonable director would have taken such steps, then the actions can be set aside.⁴¹ This test is not a test of what a court would consider in the best interests of the company, but what another director would so consider.

2.2 The duty not to act for a collateral purpose

The corollary of the duty to act *bona fide* in the interests of the company is the obligation not to act for a collateral purpose, the "proper purposes" doctrine. The objective of this duty is to prevent directors from insulating themselves from control, whether such control comes from the shareholders in general meeting, or from the market for corporate control.⁴² The ability of shareholders to remove directors from their positions, by means of an ordinary resolution passed in general meeting, is one of the fundamental principles of shareholder control of directors.⁴³ Accordingly, where directors are able to circumvent the exercise of such a power by means of, for example, share allotments, the control of the shareholders would be limited. Thus, the duty is particularly important in the context of the allotment of shares by directors, but is not limited to such circumstances.⁴⁴ Transactions by directors which are found to have been activated for an improper purpose can be set aside by the court,

⁴¹ *Shuttleworth v Cox Bros & Co (Maidenhead) Limited*, [1927] 2 KB 9, at 18.

⁴² For a consideration of the market for corporate control, see Chapter One, and Parkinson *supra* note 3, at 137-158.

⁴³ Section 303 of the Companies Act. Note, however, the ability of shareholders and the company to agree to the restriction of the statutory power by means of weighted voting rights. Such action was held to be valid in *Bushell v Faith*, [1970] 2 WLR 272. See further, McGlynn, "The Constitution of the Company: Mandatory Statutory Provisions v Private Agreements", (1994) 15 *Co Law* 301.

⁴⁴ It will apply to all powers of directors, including, for example, the power to make calls on shares, to register shares, to declare a dividend, and to order the forfeiture of shares.

notwithstanding the alleged good faith of the directors.⁴⁵

The relationship between the duty to act for a proper purpose, and the shareholders' ability to control the board, is shown in the decision of *Howard Smith Ltd v Ampol Petroleum Ltd*.⁴⁶ In this case, the directors allotted shares in order to dilute the shareholding of the majority shareholder, enabling a third party to takeover the company. The allotment was set aside, the court holding that the power to allot shares was not exercised for a proper purpose. The Privy Council held that in order to establish whether a power was exercised properly, one had to consider, first, the nature of the power and the limits, if any, placed on it, and, secondly, the substantial purpose for which the power was exercised. Once a court has determined the scope of the power, and the substantial purpose for which it was exercised, the court will be able to judge, objectively, whether the power was exercised for a proper purpose.

Much criticism has been levied at this judgment and exposition of the law.⁴⁷ In particular, the doctrine of "substantial purpose" has been criticised as being virtually impossible to define in any given circumstance. Further, it introduces a subjective element into the consideration of the exercise of the power which will be difficult to challenge. Parkinson states that, other than in circumstances where there is a takeover bid outstanding, there will usually be a number of reasons why a particular course of action is taken, some of which may be improper purposes. However, the difficulties in defining which are improper purposes and, moreover, whether they are substantial, will be considerable and results in boards of directors having "considerable freedom in practice to entrench their position without the need to seek shareholder consent".⁴⁸ This is so notwithstanding the *dictum* of Lord Wilberforce in *Howard Smith v Ampol* wherein he stated that it was "unconstitutional" for directors to use their powers to alter the majorities in the company, as to do so was to interfere with those elements of the company's constitution which are set against their powers.⁴⁹ Such words are, in reality, empty words: directors have considerable latitude in the exercise of their powers, and whether or not a particular course of conduct is considered improper or not will rarely be questioned.

⁴⁵ *Piercy v Mills & Co Ltd*, [1920] Ch 304; *Hogg v Cramphorn Ltd*, [1967] Ch 254.

⁴⁶ [1974] AC 403.

⁴⁷ See, *inter alia*: Parkinson, *supra* note 3, at 137-151; Burridge, "Wrongful Rights Issues", (1981) 44 *Modern Law Review* 40; and, Birds, "Proper Purposes as a Head of Directors' Duties", (1974) 37 *Modern Law Review* 580.

⁴⁸ Parkinson, *supra* note 3, at 144.

⁴⁹ *Supra* note 45.

2.3 The duty to act with skill and care

The common law standard of skill and care demanded from directors was espoused in *Re City Equitable Fire Insurance Co Ltd*.⁵⁰ The three basic components of the standard of skill and care to be exercised by a director were set out in *Re City Equitable* as follows: first, a director need not exhibit, in the performance of his or her duties, a greater degree of skill than may reasonably be expected of a person with that director's knowledge and experience; secondly, a director is not bound to give continuous attention to the affairs of the company but is bound to attend all meetings s/he reasonably can; and, thirdly, a director, in the absence of grounds for suspicion, is justified in trusting officials to perform duties honestly where s/he had allocated these duties properly, having regard to the exigencies of the business and to the Articles of Association.

The law, as espoused in *Re City Equitable* gave rise to some remarkable decisions. For example, in *Re Denham* a "country gentleman" was held not to be liable to the company for any breach of duty where he had failed to attend any board meetings for four years and had therefore failed to notice that the Chairman was falsifying the accounts.⁵¹ In *Re Cardiff Savings Bank, the Marquis of Bute's Case*, the Marquis of Bute, the President of the bank, escaped liability for the debts of the company despite having attended only one board meeting in thirty-eight years.⁵²

The directors who were the subject of the above cases were not held to have breached their duties to the companies as the test of a directors' skill and care is subjective, and therefore variable depending upon the skill of the person concerned: "The director is obliged only to do as much as could be expected from someone as incompetent and foolish as he happens to be."⁵³ Accordingly, it has been accurately stated that the "common law operates to give directors remarkable freedom to run companies incompetently".⁵⁴

The reason for this seemingly lax standard of skill and care to be expected from a

⁵⁰ [1925] Ch 407. The position is no different for an executive director than a non-executive. In *Dorchester Finance Co Ltd v Stebbing*, [1989] BCLC 498, the argument that a lower standard of skill and care is required of a non-executive director was dismissed.

⁵¹ [1883] 25 Ch D 752.

⁵² [1892] 2 Ch 100.

⁵³ Mackenzie, "A Company Director's Obligations of Skill and Care" (1982) *Journal of Business Law* 460, at 461.

⁵⁴ Finch, "Company Directors: Who Cares About Skill and Care?", (1992) 52 *Modern Law Review* 179, at 179.

director results from the fact that, until recently, the law continued to espouse the standard laid down in the nineteenth century, and early twentieth, when directors were not, on the whole, professional, full-time managers, but were part-time, well-meaning amateurs. In addition, at that time, it was considered that, as shareholders elected their directors, it was not up to the courts to impose a particular standard upon the directors so chosen.⁵⁵

As the conception of the company has developed beyond the narrow consideration of it as a playground for the investor, and amateur director, so the standard demanded of those involved in the management of companies has increased. The majority of executive directors are today employed by the company on terms specified in a contract of employment. Such executive directors are in a contractual relationship with the company; their standard of skill and care is regulated by the express and implied terms of the employment contract, as well as the common law standard considered above. Thus, as it is an implied term of all employment contracts that the employee exercise reasonable skill (an objective standard) in the performance of his or her duties⁵⁶, the actions of an executive director will be measured on an objective standard. Moreover, a failure to exercise this degree of skill and care constitutes a breach of contract, which is enforceable via ordinary contractual principles.

As a result of the contract of employment now governing the majority of directors' relationships with companies, the standard of skill and care expected from a director is more in line with the demands of a professional businessperson, rather than a well-meaning amateur. However, the common law standard remains, and is a reflection of the law's attitude to directors, which remains of significance, as it continues to form the standard of a director who is not in a contractual relationship with the company. In recent years, this common law standard of skill and care has been made more objective, largely as a result of the impact of the wrongful trading provision in the Insolvency Act 1986.⁵⁷

The interpretation of section 214 of the Insolvency Act 1986 was considered in *Re Produce Marketing Consortium Ltd (No 2)*, where Knox J stated that the consequence of the section was that there are "certain minimum standards" which a director must

⁵⁵ See *Re New Mashonaland Exploration Co*, [1892] 3 Ch 577, at 585 *per* Vaughan-Williams J; and, *Turquand v Marshall*, [1869] 4 Ch App 376, at 386, *per* Lord Hatherly LC.

⁵⁶ *Lister v Romford Ice and Cold Storage Co Ltd*, [1957] AC 555.

⁵⁷ Particularly section 214. The Company Directors' Disqualification Act 1986 has also had an impact.

attain.⁵⁸ Such minimum standards included, *inter alia*, the obligation to keep accounting records, lay them before the general meeting, and file them at Companies House. In *Norman and another v Theodore Goddard (a firm) and others*⁵⁹ a contribution was sought from a director on the basis that he had breached his duty of skill and care to the company. Hoffman J stated that "a director performing active duties on behalf of the company need not exhibit a greater degree of skill and care than may be reasonably expected from a person undertaking those duties".⁶⁰ He continued that the test of a director's skill and care is accurately stated in section 214 of the Insolvency Act 1986. This standard is more demanding than Romer J's formulation in *Re City Equitable*. However, the deployment of the statutory standard is not all-encompassing: Hoffman J approved that part of Romer J's dictum in *Re City Equitable Fire* that "[b]usiness cannot be carried on upon principles of distrust".⁶¹ Accordingly, "men in responsible positions may be trusted until there is reason to distrust them".⁶² The common law standard of the trusting, honest, "gentlemanly" conduct of a director still prevails.

Norman v Theodore Goddard is a first instance decision, and moreover, one in which a thorough examination of the authorities was not undertaken, nor was there argument from opposing counsel. However, the judgment was followed in *Re D'Jan of London Ltd*, Hoffman LJ giving judgment, who held that "the duty of care owed by a director at common law is accurately stated in section 214(4) of the Insolvency Act 1986".⁶³ However, in this case, it was considered that the director could be relieved of responsibility under section 727 of the Companies Act which gives the court the power to relieve a director of liability for breaches of duty, including negligence, wholly or in part, if the court considers that the director acted reasonably and ought fairly to be excused. Hoffman LJ pointed out the obvious ambiguity in finding a director negligent but to have acted reasonably⁶⁴, but resolved this difficulty by reference to the fact that the section exists and therefore can presumably be used in the circumstances of the case. Finch points out that the effect of this discretion makes "the application of an uncertain rule [a director's duty of skill and care] yet more uncertain".⁶⁵

58 [1989] BCLC 520, at 550.

59 [1991] BCLC 1028.

60 *Ibid* at 1030.

61 *Ibid* at 1031.

62 *Ibid*.

63 [1993] BCC 646, at 648.

64 *Ibid* at 649.

65 *Supra* note 54, at 201.

The impact of *Norman v Theodore Goddard* and *Re D'Jan*, together with the application of section 727, on the directors' duty of skill and care is unclear. The cases do mark a departure from the common law as it was understood, and recognise a need to update the law in line with current thinking. However, the application of section 727 reduces the impact of the advances made: it may be that the standard expected from directors is higher, but the corollary is that they will be relieved of liability where, in previous times, they would not have been liable. The advance is one of form, but not yet of substance.

2.4 The no-conflict rule

A further duty imposed on directors is that they must not place themselves in a position where their personal interests are in conflict with the interests of company. This fiduciary duty arose from the concept of the director as trustee⁶⁶: a director is the keeper of the assets of the company which belong to others, and therefore the interests of the director must not come into conflict with the position of director. The rule was clearly set out in *Aberdeen Railway Co v Blaikie Bros*:

It is a rule of universal application that no-one having such (fiduciary) duties to discharge shall be allowed to enter into an engagement in which he has or can have an interest conflicting or which may possibly conflict with the interests of those whom he is bound to protect.⁶⁷

The duty is strict: it will be sufficient that there is a "real possibility"⁶⁸ of a conflict, and the courts will not enquire as to the fairness, good faith or otherwise of the director.⁶⁹ If a director is placed in a position of conflict, any contract entered into as a result of the conflict will be voidable at the instance of the company. Further, the director may be called to account to the company for any gains.

The strictness of the rule may be ameliorated in two ways. First, it was noted above that any contract concluded as a result of a conflict is voidable at the instance of the company. Accordingly, the company may ratify the contract by a resolution in general meeting, at which the director may vote in favour if a shareholder.⁷⁰

⁶⁶ Sealy, *Company Law and Commercial Reality*, Sweet & Maxwell, 1984, pages 37-39; and, Sealy, *supra* note 1.

⁶⁷ [1854] 1 Macq 461, at 471-472. This position was forcefully re-affirmed by the House of Lords in *Guinness plc v Saunders*, [1990] 2 AC 663.

⁶⁸ *Boulting v ACTAT*, [1963] 2 QB 606.

⁶⁹ *Aberdeen Railway Co v Blaikie Bros*, *supra* note 67.

⁷⁰ *North-West Transportation Co Ltd v Beatty*, [1887] 12 App Cas 589.

Secondly, the company may waive the no-conflict rule by, for example, a provision in its articles.⁷¹ Such a general provision can be drafted so that each contract does not have to be put before the general meeting; directors merely disclose their interests to the board and are thereby not prevented from being a party to a transaction. Such an ability to "contract out"⁷² of the fiduciary obligation is, however, robustly policed by the courts.

In *Guinness plc v Saunders*⁷³, the House of Lords was faced with a claim from a director for remuneration which was granted to him by a committee of directors in circumstances where his personal interests were in conflict with those of the company. The House of Lords endorsed the strictness of the no-conflict rule; directors are precluded from entering into contracts for their services with the company except in circumstances authorised by the articles. Moreover, where a contract was entered into which was not so authorised, the director would not be entitled to remuneration by way of a *quantum meruit*.⁷⁴ Accordingly, the director was not entitled to any remuneration. Thus, no encouragement is to be given to directors who may breach the no-conflict rule by allowing them an equitable allowance.

Disclosure of conflicts of interest is also required by section 317 of the Companies Act. This provides that disclosure must be made to the board of any contract or proposal in which they are interested. Although a director who has a conflicting interest must disclose it under this section on pain of a fine⁷⁵, disclosure in this manner does not have the same effect as a disclosure pursuant to an article in the form of article 85 of Table A. Thus, a contract would remain voidable at the behest of the company.

It can be seen that on its face, the no-conflict rule is extremely strict. However, in practice, disclosure is only made to the board, and directors frequently have an interest in transactions with the company. Indeed, it is commonplace for directors to be on the board of other companies; the companies involved considering that there is a benefit to each company in doing so. Thus, there is a conflict in the policy of the law itself. The strict no-conflict rule first arose as a means of protecting the interests of

⁷¹ See, for example, Table A, paragraph 85.

⁷² Farrar, Furey and Hannigan, *supra* note 29, at 405.

⁷³ *Supra* note 67.

⁷⁴ The House of Lords distinguished *Boardman v Phipps*, [1967] 2 AC 46, on the basis that an equitable allowance would be granted where the policy of the rule, the discouragement of fiduciaries being put in a position where their interests conflict, is not threatened.

⁷⁵ Section 317(7) of the Companies Act.

shareholders, borrowed from the equitable duties of trustees, and is therefore strict. However, as commerce has developed and become ever more competitive, it has been understood that the strict application of the rule may not be in the interests of shareholders: giving directors greater freedom may allow them to manage the company in a more productive and competitive manner. Thus, the protection of shareholders has been reduced, and, in its place, reliance is placed on the personal interests of directors coinciding with the interests of the company.

2.5 The duty not to profit from the position of director

Allied to the no-conflict rule is the duty not to profit from the office of director, except in express circumstances. This duty is similar to that of the no-conflict rule as it arises from the equitable considerations of the director as controller of a third party's assets, who must not profit from his or her position of guardianship. The rule is strict, although a liberalisation can be discerned from the recent case law.

The rule is also characterised as the rule that directors must not appropriate corporate opportunities. It is considered that a corporate opportunity is an asset of the company, and therefore were directors to appropriate the opportunity without authority, i.e. exploit it themselves, directors would be benefiting from the position of director and from the assets of the company, when any such benefits should, in fact, belong to the company. Liability has been based on a very strict capacity approach; if the director came across the information, the opportunity, in the capacity of director, then the director will be liable to account to the company for any profit subsequently made by the personal exploitation of the opportunity.

The *locus classicus* is *Regal (Hastings) Ltd v Gulliver*⁷⁶ where the directors of the company invested personally in an enterprise in which the company was involved. The directors committed personal funds to the venture at a time when the company had no further funds, and, were the venture to go ahead, the company, as its investment stood, would make substantial sums of money. The directors were, therefore, not appropriating an opportunity which could have been the company's. Herein lies the strictness of the judgment; it did not matter that the company could not have pursued the opportunity any further, the mere fact that the directors put themselves in a position to benefit personally from an activity which came their way as directors was sufficient to establish a liability to account for the profits of the

⁷⁶ [1942] 1 All ER 378.

venture to the company.

The uncompromising position taken in *Regal Hastings* was confirmed in *Industrial Development Consultants Ltd v Cooley*⁷⁷ where a director was involved in negotiating a contract for the company. The third party to the contract indicated to the director that it would not grant the contract to the company, but would consider granting it to the director in his personal capacity. The director resigned from his position as director, and was subsequently awarded the contract. The director was held liable to account to the company for any profits, it being held that, as a director, he had only one capacity, that of director of the company.

It was noted above that this strict position arises from the conceptualisation of the director as trustee, and therefore a strict standard of conduct is expected from a director, at the expense of individual innovation and risk-taking. In recent years, in the spirit of enterprise and liberalisation, inroads have been made into the strict application of the no-profit rule.

A number of Commonwealth cases have liberalised the rule⁷⁸, and in *Island Export Finance Ltd v Umunna*⁷⁹ a more flexible approach was taken by the English courts. In *Island Export*, a director resigned because of general dissatisfaction with the company. He was later awarded a contract, which the company with which he had previously been engaged, had been pursuing. It was held that the director had not appropriated a "maturing business opportunity", and was not therefore liable to account to the company for any profits.⁸⁰ Accordingly, where there is a lapse of time between a director leaving a company, and pursuing a corporate opportunity, the no-profit rule has no place, and the director no longer has only the one capacity of director.

The approach of the court in *Island Export* reflects a more liberal interpretation of directors' duties, sacrificing corporate, and therefore shareholder, protection, for the greater benefit to society by allowing the most advantageous exploitation of resources. This is a similar argument to the one raised in connection with the market for corporate control.⁸¹ In Chapter One it was noted that the market for corporate control

⁷⁷ [1972] 2 All ER 162.

⁷⁸ See, for example, *Canadian Aero Services v O'Malley*, *supra* note 1; and *Queensland Mines Ltd v Hudson*, [1978] 52 ALJR 399.

⁷⁹ [1986] BCLC 460.

⁸⁰ Thus, following the earlier case of *Canadian Aero Services v O'Malley*, *supra* note 1.

⁸¹ See Chapter One.

may have adverse effects on third parties, but proponents of the market argue that this is not as important as securing, by the market, the optimum allocation of resources. Similarly, although one company may suffer if a corporate opportunity is appropriated from it, the economy as a whole will benefit as the person best placed to exploit the opportunity is allowed to do so.

3. The enforcement of directors' duties

Clearly, without adequate enforcement measures, the duties considered above would be all but mere exhortations. The following section will consider the ability of shareholders to enforce directors' duties.⁸² Thus, the rule of *Foss v Harbottle*, and its exceptions, will be considered, followed by an examination of the alternative means by which shareholders can seek redress for a breach of duty.

3.1 The rule in *Foss v Harbottle*

The rule in *Foss v Harbottle* is complex and confused, and has largely been replaced as an effective means of redress by the remedies available to shareholders in section 459 applications.⁸³ Accordingly, the nature of the remedy available by means of the derivative action will only be briefly considered.⁸⁴

The fiduciary duties of directors are, with limited exceptions, duties owed to the company. Accordingly, the proper plaintiff for taking any action in respect of a breach of duty is the company. This is the orthodox position as stated in *Foss v Harbottle*.⁸⁵ However, the decision as to whether to commit the company to legal action is a management decision, within the purview of the board of directors.⁸⁶ Accordingly, where it is one of the directors, or the directors as a whole, who are alleged to have breached their duties, it can be seen that it would be extremely surprising were the board itself to commence legal action against the director, or the board of directors as a whole. Thus, should a shareholder wish to commence such action, s/he must come within one of the exceptions to the rule in *Foss v Harbottle*, of

⁸² Although sections 431, 432, 447 and 460 grant powers to governmental agencies to investigate the affairs of companies and take appropriate action, these are rarely utilised and will not be considered further here. See Farrar, Furey and Hannigan, *supra* note 29, at 509-519.

⁸³ See Gower, *Gower's Principles of Modern Company Law*, Sweet & Maxwell, 1992, 5th ed, at 643-672.

⁸⁴ See further the references cited in Chapter One, note 24.

⁸⁵ [1843] 2 Hare 461.

⁸⁶ Whether there is a right for the general meeting to commence action is a moot point: see Wedderburn, "Control of Corporate Litigation", (1976) 39 *Modern Law Review* 327.

which there are four: first, where the transaction is *ultra vires*; secondly, where the transaction requires a special majority; thirdly, where the transaction infringes the personal rights of the shareholder; and, fourthly, where the transaction amounts to a fraud on the minority. Where the action contemplated is a breach of fiduciary duty, it is the fourth exception which is relevant.⁸⁷ A fraud on the minority occurs, broadly, where there is "wrongdoer control". In other words, where the directors, who may be the subject of the enquiry, are in control of the board and thereby prevent the company taking action.

The use of the derivative action has all but been forgotten. In *Prudential Assurance Co Ltd v Newman Industries Ltd*⁸⁸, a derivative action was brought by a large institutional investor, in an attempt to seek redress for the company from a director. The action by the Prudential Assurance Co Ltd was a failure and is thought to have sounded the death knell for the derivative action: if a large institutional shareholder, with experience and resources, cannot bring a successful action, what hope is there for an individual shareholder. There have been a number of actions since the *Prudential* case⁸⁹, but the use of the remedies and procedure available by a section 459 unfair prejudice petition are now more usual.

3.2 Section 459 and unfair prejudice

Section 459 of the Companies Act provides a remedy to shareholders who can prove that the company's affairs have been or are about to be conducted in a manner which is unfairly prejudicial to the interests of its members generally. Under section 461 of the Companies Act, the court has extensive jurisdiction to take such action as it thinks fit to remedy the situation. The section 459 jurisdiction has given rise to a substantial case law which is currently being interpreted widely, and allows remedies for actions which previously came solely within the preserve of the derivative action.⁹⁰ Actions have been successful where a director appropriated company property⁹¹; where a corporate opportunity was appropriated⁹²; and, diversion of corporate business⁹³.

⁸⁷ For a consideration of the other exceptions, see Farrar, Furey and Hannigan, *supra* note 29, at 442-462.

⁸⁸ [1980] 2 All ER 841.

⁸⁹ For example, *Smith v Croft*, [1988] Ch 114, *Taylor v NUM*, [1985] BCLC 237.

⁹⁰ The fact that a shareholder could have a remedy by means of a derivative action, does not prevent action being taken under section 459: *Re A Company (no 005287 of 1985)*, [1986] 2 All ER 253. See further Gower, *supra* note 83.

⁹¹ *Re Bovey Hotel Ventures Ltd*, 13 January 1982, unreported.

⁹² *Re Cumana Ltd*, [1986] 2 BCC 99.

⁹³ *Re London School of Electronics Ltd*, [1986] Ch 211.

Following the increasing use of section 459, in *Re Elgindata Ltd* it was stated that "it is open to the court to find that serious mismanagement of a company's business constitutes conduct that is unfairly prejudicial to the interests of the minority shareholders".⁹⁴ However, the court noted that it would be "reluctant" to come to this conclusion.⁹⁵ To date, the section 459 jurisdiction has been mostly utilised by small private companies, quasi-partnerships, which cannot have recourse to the open market for the sale of their shares. However, the jurisdiction is not confined to such companies.⁹⁶

Nonetheless, the future of the section 459 jurisdiction is not clear. Whether the courts in section 459 applications will continue to be liberal in their interpretation of the section remains to be seen.⁹⁷

C. Conclusions: Directors' Duties as a Means of Controlling Directorial Conduct

Section B above considered the nature of directors' fiduciary duties, in whose interests they are to be exercised, and their enforcement. The variety of interests for whom directors must act accords directors substantial freedom of action. A director's duty not to profit from the office of director, not to have conflicting interests, and to act for proper purposes, are all protean concepts which are open to abuse: it would be difficult to dispute what is a substantial purpose and what is not; conflicts can easily be approved by a clause in the articles; and, the corporate opportunity doctrine is becoming more market orientated. Each of these advances are not of themselves adverse for shareholders. Indeed, they can bring increased competitiveness and financial rewards: a director may usefully exploit personal contacts for the benefit of the company; a director may bring a corporate opportunity to one company, although having taken it from another; and, a director may act to prevent a takeover which would result in substantial job losses. However, with all such potential benefits, come increased risks. As the controls in the form of directors' duties are reduced, so directors have the potential to benefit substantially the company, but also to ruin it. It is suggested that the changes in the nature of directors' duties which are evidenced by

⁹⁴ [1991] BCLC 959, at 993.

⁹⁵ *Ibid* at 993.

⁹⁶ See further Riley, "Contracting Out of Company Law: Section 459 of the Companies Act 1985 and the Role of the Courts", (1992) 55 *Modern Law Review* 782.

⁹⁷ *Ibid*.

the case law are a result of an increasing application of market analysis to corporate activity, bringing with it inherent unpredictability.

There have been regular calls for the reform of directors' duties. In particular, the codification of directors' duties has been advocated. An attempt was made in 1978 to introduce a codification into the Companies Act 1980, but this proved abortive. However, it is not clear that codification would bring advantages.⁹⁸ As discussed above, that directors have considerable discretion may be beneficial. More fruitful analysis has therefore centred on the reform of particular standards expected of directors, in particular the standard of skill and care. Finch argues that "in an era of full-time directors and rising standards of commercial education, the standards of skill required from directors could well be raised".⁹⁹ The Cadbury Report¹⁰⁰ welcomed the preparation of a course by the Institute of Directors to be run for newly appointed directors¹⁰¹, and the existence of many such courses in the business schools around the country, concluding that : "it is highly desirable that [directors] should undertake some form of internal or external training".¹⁰² The Cadbury Report continues that the "training and development of directors is of importance to good governance".¹⁰³

As long ago as 1961, Professor Gower advocated an objective standard against which a director's performance was to be measured.¹⁰⁴ Gower stated that: "As the business world comes to expect higher standards, the law should develop in step. What has handicapped legal development so far has been the failure of the courts to recognise that "directing" is becoming a profession with developing standards of expertise."¹⁰⁵ Finch argues that an objective standard is required but one that "does not chill enterprise and which does not discourage directors from seeking to improve their own level of skills".¹⁰⁶ She suggests the following: a director should exhibit the skill and care reasonably to be expected of a person who has undertaken their kind of role in their kind of company. Such a test is intended to retain flexibility of interpretation,

⁹⁸ See Birds, "Making Directors Do Their Duties", (1980) 1 *Company Lawyer* 67, at 67.

⁹⁹ Finch, *supra* note 54, at 179.

¹⁰⁰ Cadbury Committee, *The Financial Aspects of Corporate Governance*, 1992.

¹⁰¹ *Ibid* paragraph 4.19.

¹⁰² *Ibid*.

¹⁰³ *Ibid* paragraph 4.20. See *The Daily Telegraph*, 18 April 1995, which reported that the Institute of Management report had proposed the establishment of an independent "college of directors". The college would be established to "promote and maintain the highest standards of directorship and corporate governance", and its central responsibility would be to foster training for directors.

¹⁰⁴ Report of the Commission of Enquiry in Company Law of Ghana, 1961.

¹⁰⁵ *Ibid*.

¹⁰⁶ *Supra* note 54, at 202-204.

and to be applied fairly to the different size and type of company covered. It is suggested that reform of this nature would be a welcome change in the law, reflecting the significant part which directors play in the success of the economy as a whole, and the responsibility attached to their position.

Allied to such reforms, must be reform of the means by which directors' duties are enforced. The present law is loaded against the shareholder, individual or institution. The law of the derivative action is detailed and complex, and as a result has been largely avoided in recent years by the increasing use of section 459 of the Companies Act. Gower confirms that the detailed twisting and turning of the case law of the derivative action is "needed no longer".¹⁰⁷ A more appropriate method of enforcement would come in the form of the draft fifth EC Directive on Company Law, if it is ever enacted.¹⁰⁸ The draft fifth directive provides that shareholders may bring an action against a company if they hold 10% of the nominal share capital of the company, or such lower percentage as legislation may provide. Parkinson welcomes the enactment of a provision such as that in the draft fifth EC Company Law Directive, but argues that the percentage should be as low as 5%.¹⁰⁹ As Finch states, such a statutory right would overcome the problems of the restrictive rule in *Foss v Harbottle* and enable shareholders to take effective action against errant directors.¹¹⁰ Accordingly, the results of the Law Commission's inquiry into shareholders' rights and remedies, which was announced by the Government in January 1995, is eagerly awaited.¹¹¹

This chapter has considered the part played by the fiduciary duties imposed on directors as a means of controlling their conduct. The duties were termed external controls in the introduction of this chapter, as they are imposed on companies from the outside, and are not concerned with the internal regulation of the company, nor with the (in)activity of shareholders. However, it can be seen that the efficacy of directors duties are to a large extent dependent on shareholder activity, because of the predominant belief that the appropriate persons to take such action against directors, and therefore to control corporate property are the shareholders. The ability and utility of this form of shareholder governance and democracy will be considered in detail in Chapter Four. However, it is noted here that the controls which shareholders

¹⁰⁷ *Supra* note 83, at 603.

¹⁰⁸ OJ C 1983 No 24012, as amended, see DTI, *Amended proposal for a fifth directive on the harmonisation of company law in the EC: A Consultative Document*, 1990.

¹⁰⁹ *Supra* note 3, at 257.

¹¹⁰ *Supra* note 54, at 204.

¹¹¹ See British Chamber of Commerce's *Business Briefing*, 13 January 1995.

are supposed to effect and utilise have become increasingly lax, with more discretion being given to directors. This means that, taken together with the increasing futility and inhibiting factors relating to shareholder action, the controls are being weakened, and shareholders are having to rely more on hope than on power.

CHAPTER THREE

STRUCTURAL REFORM OF THE BOARD OF DIRECTORS

A. Introduction

Chapter One considered the means by which the conduct of directors is controlled by the operation of the markets for corporate control, products and managerial talent. Although it was noted that such markets do exert an influence on directorial conduct, they are also associated with a number of costs; compliance costs and third party costs. In this light, Chapter Two examined a number of prophylactic controls which are intended to influence directorial conduct, together with their associated enforcement mechanisms and remedies. It was found that such controls are a fundamental part of the company law regime, but that, although such powers gave directors remarkable freedom to act in a manner which may benefit a company, such freedom also gives the opportunity to act in ways detrimental to a company's interests. Accordingly, this chapter will consider a further means by which directorial conduct may be regulated, by means of the structure and composition of the board of directors.

The board of directors is the situs of the management of the company. The authority to manage is delegated to the board by the shareholders, whose control thereover is limited.¹ The reform of the structure of the board of directors is concerned with the internal composition of the company; reforming company structure as a means of ensuring that conduct which is sought to be avoided does not take place. Thus, the reforms are preventative, and are intended to engender a particular, accountable and responsive, form of management.

The focus of this chapter will be the proposals for the reform of the structure of the board of directors which have emanated from the European Union, and from a number of ad hoc non-governmental organisations in the UK. The European Union first promulgated reform of the board of directors in 1972, as a measure essential to the

¹ Delegation by the shareholders to the board of directors of the management function is usual by means of an article similar to that in Table A, article 70. Of course, a company may choose not to be managed in this manner, although such companies are unusual. For a discussion of the ability of shareholders to control the board of directors, see Chapter Four.

common market.² Influenced by the European proposal, the UK Government set up a committee to examine potential means of reforming the structure of boards.³ However, with the change of government in 1979, the debate on the reform of the board of directors, at least in the UK, died.⁴ However, notwithstanding the view of the UK Government, increasing pressure in the late 1980s over concern about certain aspects of corporate governance, led to the establishment of the Cadbury Committee by the financial institutions of the City.⁵ The remit of the Cadbury Committee was to "help raise the standards of corporate governance"⁶, in the light of the "continued concern about the standards of financial reporting and accountability, heightened by BCCI, Maxwell and the controversy over directors' pay".⁷ In addition, and perhaps a recognition of the failings of the Cadbury Report, the UK Government, together with the Confederation of British Industry ('CBI') also established the Greenbury Committee which reported on the means by which companies should regulate the remuneration of senior corporate executives.⁸

Debate continues, not least because the draft fifth EC company law directive has yet to be implemented, and the Cadbury Committee Mark 2 is expected to meet and produce another report during 1996/7.⁹ It is therefore timely to examine the reform proposals noted above, the impact of the reforms which have been made, and future possibilities for the reform of the board of directors.

² OJ L 131/72, 13 December 1972.

³ *Report of the Committee on Inquiry on Industrial Democracy*, Cmnd 6706, 1977, chaired by Lord Bullock.

⁴ See Wedderburn, "Trust, the Worker and the Law", (1985) 23 *Osgoode Hall Law Journal*, pages 243-244: "By 1980 ... the "industrial democracy" debate in Britain was silent."

⁵ The Cadbury Committee was established in May 1991, under the chair of Adrian Cadbury, by the Financial Reporting Council, the London Stock Exchange and the Accounting Standards Board. The Committee reported on 1 December 1992, *The Financial Aspects of Corporate Governance*.

⁶ Dine, 'The Governance of Governance', (1994) 15 *Co Law* 73, at 73.

⁷ Cadbury Report, *supra* note 5, at 9.

⁸ The report, *Directors' Remuneration - Report of a Study Group Chaired by Sir Richard Greenbury*, was published on 17th July 1995, and offered a Code of Practice to govern remuneration issues. See *infra*.

⁹ Paragraph 3.12 of the Cadbury Report, *supra* note 5. The next committee has been established and is due to produce an interim report by mid-1997, followed by a final report at the end of 1997. See *The Times*, 21 February 1996.

B: Board Structure and the Influence of Europe

1. The draft Fifth EC Company Law Directive

The first proposals emanating from the European Union regarding the reform of the board of directors of public companies came in 1972 with the proposal for a fifth company law directive.¹⁰ As a result of harsh criticism of the proposal, it was reformed in 1983¹¹, and again in 1989.¹² The EC was, and remains, of the view that the coordination of the laws relating to public companies is an essential prerequisite to the achievement of a common market, and the proposed reforms must be seen in this context. Thus, the reforms proposed owe more to the general objective of harmonizing the laws of the Member States of the Community, that to ensuring that the conduct of directors is appropriately regulated and controlled. Notwithstanding this caveat, the proposed fifth EC Company Law Directive has much to offer the UK.

The first draft of the directive proposed the levelling-up of the structure of the board of directors to that in place in Germany, thus the 1972 draft provided for a mandatory two-tier structure for public companies. Amidst much criticism, particularly from the UK Government, the draft was amended and has now "moved a long way from its very rigid and germanic original formulation".¹³ The latest text provides that companies will have the choice of a two-tier or unitary board structure, the preamble to the draft directive noting that the "general introduction of the two-tier system on a compulsory basis is for the time being impracticable though such systems should be made generally available at least as an option for public limited companies".¹⁴ The two-tier scheme provides for management by the management organ, under the supervision of the supervisory organ. The management organ, the board of directors, will have responsibility for day to day management of the company and will be appointed by and accountable to the supervisory board. Employee participation is mandatory and may take one of three forms: one third to one half of the supervisory board are to be appointed by the employees, where it is the latter, the voting

¹⁰ *Supra* note 2. See also Clough, 'Trying to Make the Fifth Directive Palatable', (1982) 3 *Co Law* 109, at 110, where he states that: "It is rumoured that the [draft fifth company law] Directive owes its existence to a bargain struck between the Germans and the British during the negotiations for British entry to the Community whereby the Germans agreed to the Regional Fund in exchange for acceptances by the other states of a Directive on company structure and employee representation."

¹¹ Document 1-862/81, 15 January 1983.

¹² The proposed amendments to the draft appear in *DTI, Amended Proposal for a Fifth Directive on the harmonisation of Company Law in the European Community: A Consultative Document*, 1990.

¹³ Sealy, *Company Law and Commercial Reality*, Sweet & Maxwell 1984, at 82.

¹⁴ *Supra* note 2, preamble.

procedures are to ensure that the decisions are ultimately taken by the members appointed by the general meeting¹⁵; a body representing the employees shall have a right to regular information and consultation on, *inter alia*, the administration, situation, progress and prospects of the company; and, employee participation through collectively agreed systems, ie. the right to appoint the supervisory board, information via the body representing the employees, or the right to object to the appointment of persons to the supervisory board.

The proposed unitary board would delegate management to executive members of the board, being less in number than the other directors. Employee participation in the unitary board can also take three forms: employees shall appoint between one third and one half of the members of the unitary board; employee representation through a body representing company employees; and employee participation through collectively agreed systems.

Under the present form of the draft directive, UK companies would be able to maintain their unitary boards, the two-tier structure being an option where preferred. Indeed, employee participation on the unitary board is not mandated. The least obtrusive form of employee participation could be implemented, either through an "organ representing the company" or through "collectively agreed systems". The board would still be appointed by the general meeting, although there must be a number of non-executives, divisible by three, who are to appoint a smaller number of executives. Indeed, for "many public listed companies this combination of permitted Fifth Directive models would involve little change in either the existing law or in board practice as far as board structure was concerned".¹⁶

Nonetheless, the UK Government, and employers organizations in the UK, including

¹⁵ Hopt, "New Ways in Corporate Governance: European Experiments with Labor Representation on Corporate Boards", (1984) 82 *Michigan Law Review* 1138, at 1346, states that the provision granting ultimate supremacy to employees was included so that the model would be compatible with the German Constitution. The Bullock Report on Industrial Democracy, *supra* note 3, stated that it would be "illogical and frustrating", to the true object of industrial democracy to put employees onto the board but allow shareholders to retain ultimate control, chapter 8 paragraph 34. To alleviate these difficulties the Bullock Report recommended that the composition of the board should be divided equally between employee representatives, shareholders' representatives and independent directors.

¹⁶ Boyle, 'Draft Fifth Directive: Implications for Director's Duties, Board Structure and Employee Participation', (1991) 13 *Co Law* 6. See also: Andenas, 'The Future of EC Company Law Harmonisation', (1994) 15 *Co Law* 121, at 122, who states that "in the Commission's amended proposal the provisions about board structure will not require major change in UK corporate practices"; Welch, "The Draft Fifth Directive - A False Dawn?", (1983) 8 *European law Review* 83.

the CBI, remain opposed to the proposals contained in the draft fifth directive, even though "in theory, the functions of the supervisory board mirror those of the ideal unitary board described in the CBI's booklet on the responsibilities of the British public company".¹⁷ The UK Government's objections continue despite the fact that the draft directive in its present form would little alter the structure and business of UK companies. Moreover, it has expressed the belief that the contents of the directive fall under the protean concept of "subsidiarity", thus raising a whole new constitutional diversion to the debate, moving away from the actual proposals and the problems which initially motivated reform.¹⁸ The UK Government's objections would appear to be more ideological than particular; it is likely that whatever the form of the proposal, they will not be accepted by an UK Government opposed to any form, however anodyne, of compulsory employee participation in the supervision of management.

However, as was suggested above, the proposals could offer useful alternatives to the present corporate structures employed in the UK. The arguments against the proposals are wide-ranging. It is argued that sectional representatives of the supervisory board will inevitably look to their constituency for support and guidance and thus, at worst, deadlock may result; at best, the interests of the company will not be followed, but, rather, a range of sectional preferences. In particular, it is argued that employee directors, particularly those without the support of a works council or similar organisation, will lack an effective support and training. Further, conflicts may arise between a works council and the traditional UK machinery of collective bargaining, leading to subsequent problems between non-union and union representatives. Moreover, the impact which employee representatives can have on a unitary board is negligible.

On the other hand, proponents of the two-tier board argue that allowing a unitary board is a negation of the intention to improve governance. A unitary board cannot hope to have the range of expertise available to the two-tier board, and, as management is delegated to executives, the unitary board has no mechanism by which to monitor the executives. In addition, as the responsibility of the executive board and the supervisory board are clearly identified, governance will be less haphazard, and more thorough. It is recognised that it is executives who effectively manage the company, but with a supervisory board, that management is more closely and openly

¹⁷ Welch, *ibid* at 31.

¹⁸ See *Agence Europe*, 7/8 December 1992.

supervised. A supervisory board can provide an appropriate forum for the airing of the views of those involved in the company, as opposed to the limited interests and perspectives of those on the unitary board of directors. Such a forum would improve the consultation and information processes of the company which would contribute to improving the management of companies.

The unifying concern is that the large company has an increasingly complex management structure which ensures that an outsider, a non-executive director or employee representative, has difficulty in becoming "sufficiently familiar with the intricacies of the business to ask the right questions at the right time".¹⁹ However, the present structure of UK company boards, the unitary board comprising executive and non-executive directors, is that which has presided over the notable failures of corporate governance which have caused the public debate, and the establishment of the various committees of inquiry noted above. In this context, the proposals contained in the draft fifth directive represent a variety of ways in which the present concerns could be counteracted, and, in time, alleviated. However, without greater encouragement and interest in adopting new ways of governance, the enactment of the draft fifth directive would likely see very little change in the UK as companies seek to do as little as necessary to implement the directive.

2. Works councils and corporate governance

The influence of the European Union extends not only to the structure of the board of directors, but to reforms aimed at improving the management structure of companies as a whole. Such reforms have primarily come in the form of measures to improve the information, consultation and participation of employees in the undertakings in which they are employed. The objective of these particular reforms is to improve the quality of decision making in enterprises by including, and taking into account, the views of the representatives of employees. In so doing, it is considered that the governance of the company will improve as management has to consider a wider range of opinions, which, together with the knowledge that consultation is mandatory, with penalties for enforcement, will lead to a change in attitudes and decisions altered: management will be accountable for their decisions.

The information and consultation of employees is piece-meal but ever growing. There are provisions mandating information and consultation in the following

¹⁹ Welch, *supra* note 16, at 99.

circumstances: on the transfer of an undertaking²⁰; where large scale redundancies are proposed²¹; on all questions relating to the health and safety of workers²²; and, on all transnational issues affecting employees.²³ The directives require, *inter alia*, consultation with a view to reaching agreement, and thus involve the management of a company to an important extent. Moreover, there are substantial penalties in the some cases for a refusal to consult.

These directives have had the most impact in Member States, such as the UK, where works councils, or other representative bodies, are not already established as an integral part of corporate governance and activity. The impact in the UK is particularly acute because of the Government's ideological opposition to any mandatory involvement of employees in the management of companies.²⁴ As a result of such opposition, the UK Government failed to implement effectively the Acquired Rights and Collective Redundancies directives, resulting in the Commission taking action against the Government which was upheld by the European Court in June 1994.²⁵ The judgment of the European Court has yet to be implemented in the UK.

Although the circumstances in which management must consult employees are increasing, it should be emphasised that the directives do only provide for the information and consultation of employees; although the rejected draft Fifth Company Law Directive, and the proposal for a European Company²⁶, both included proposals for the participation of employees in the management of companies. Further, the Vredling directive, rejected by Member States, would have established works councils in all multinational corporations.²⁷ Information and consultation procedures do not restrict the management prerogative to listen and then ignore. As one senior UK

²⁰ The Acquired Rights Directive, 77/187/EEC.

²¹ The Collective Redundancies Directive, 75/129/EEC.

²² The Health and Safety Framework Directive, 89/391/EC.

²³ The European Works Councils Directive, OJ L 254/64, 30.9.94. It should be noted that the Works Council Directive does not apply to the UK, although an increasing number of UK companies are choosing voluntarily to adopt the provisions of the directive. See McGlynn, 'European Works Councils: Towards Industrial Democracy?', (1995) 24 *Industrial Law Journal* 78 and *The Times*, 9 January 1995.

²⁴ *Supra* note 11.

²⁵ *Commission v United Kingdom*, [1994] IRLR 392. The European Court held that the UK had failed to implement the directives by not providing a mechanism for the consultation of employees in the circumstances set out in the directives; the UK had chosen to rely on the voluntary (on the part of the employer) mechanism of recognition of trade unions. This had the effect of denying the benefit of the directives to those employees who either were not union members, or who, though a member of a union, were members of unions not recognised by the employer. See further, Davies, "A Challenge to Single Channel", (1994) 23 *Industrial Law Journal* 272.

²⁶ DTI, A Consultative Document, *Revised Proposal for a European Company Statute*, 1992.

²⁷ OJ 1983 C217.

director has stated, "[w]e will be able to manage the system so that it has relatively little impact".²⁸ Thus, although the growth of a system of employee information and consultation may lead to greater "industrial citizenship"²⁹, unless employees become involved in the decision making functions of the enterprise, no significant improvements in terms of governance and accountability will be made in the short term. In the longer term, the directives do provide a mechanism by which greater employee participation in the management of companies could prove successful.³⁰ Moreover, it may be that the increasing participation of employees in corporate management acts as a spur to shareholders to increase their activity and involvement in the management of companies.

C. The Cadbury Report on Corporate Governance

1. Background

It was noted above that the Cadbury Committee was set up in 1991 in an attempt to counteract the increasingly critical adverse publicity regarding standards of corporate governance.³¹ It became the focus of attention in public debate³², principally because it was evident that there would be no governmental action on corporate governance. The report of the Cadbury Committee was primarily concerned with the financial aspects of corporate governance, but a substantial part of the report addressed the board of directors, its composition, and the committees which should form a part of the governance function. It is these aspects of the report which will be the focus of this section. However, in order that an accurate assessment can be made of the proposals, the underlying bases of the report will be outlined.

The introduction to the report states that the "basic system of corporate governance in Britain is sound".³³ Thus, from the very outset, radical change was never envisaged. The introduction continues that its proposals aim to "strengthen the unitary board system and increase its effectiveness, not replace it".³⁴ Thus, the supervisory

²⁸ Quoted in the *Financial Times*, 20 April 1994.

²⁹ McGlynn, *supra* note 23, at 84.

³⁰ *Ibid* at 82-84.

³¹ See text accompanying note 5.

³² The chair of the Cadbury Committee, Adrian Cadbury, stated in the preface to the report, at 9, that the committee "became the focus of far more attention than I ever envisaged when I accepted the invitation to become its chairman".

³³ *Supra* note 5, paragraph 1.7.

³⁴ *Ibid* paragraph 1.8. This statement was included as a result of the criticism of the published draft report. See Dine, *supra* note 6.

mechanisms of two-tier boards, such as those of the European Community Member States were not under consideration. The approach of the report is "based on compliance with a voluntary code coupled with disclosure", which, it is argued, "will prove more effective than a statutory code".³⁵ It is for shareholders to ensure compliance with the terms of the report, and it is "such market-based regulation" to which the Committee is looking to turn its proposals into action.³⁶ Thus, there will be no compunction on companies to adopt the recommendations of the report, other than a requirement to state in their annual accounts whether or not they are complying with the report's Code of Best Practice.³⁷ Finally, the introduction contains the disclaimer that "no system of control can eliminate the risk of fraud without so shackling companies as to impede their ability to compete in the market place".³⁸ The proposals made by the report each have a varying status. There are general comments, recommendations, and the provisions of the Code of Best Practice. It is only compliance with the Code of Best Practice, compliance with which is required to be disclosed in company's annual accounts.

2. The composition of the board of directors

The Cadbury Report begins by stating that "[e]very public company should be headed by an effective board".³⁹ Such an effective board is to be made up of executive and non-executive directors, and a chair. Domination of the board by one individual is said to be contrary to good governance and something that shareholders should avoid.⁴⁰ The two principal recommendations of the Report, in respect of the composition of an effective board, are that the positions of chief executive and chair should not be held by the one person⁴¹, and that there should be a sufficient number of non-executive directors whose calibre will be such that they carry significant weight, and a majority of whom are to be independent of the company.⁴² It is further

³⁵ *Supra* note 5, paragraph 1.10.

³⁶ *Ibid* paragraph 6.16.

³⁷ See The London Stock Exchange Admission of Securities for Listing, rule 12.43(j). It should be emphasised that the listing rules do not require a company to comply with the Cadbury Code of Best Practice. It merely requires that companies state whether they are complying or not. Note that the Confederation of British Industry, when responding to a query as to whether it considered compliance with the Cadbury Code of Best Practice should be a listing requirement of the Stock Exchange, it stated that this "could lead to excessive bureaucracy". In other words, compliance should not be mandatory.

³⁸ *Supra* note 5, paragraph 1.9.

³⁹ *Supra* note 5, paragraph 4.1.

⁴⁰ *Ibid* paragraph 4.2.

⁴¹ *Ibid* paragraph 4.9.

⁴² *Ibid* paragraphs 4.11 and 4.12. Note that it is not a requirement that all non-executives are independent of the company. Accordingly, it is presumed by Cadbury that a previous executive director, for example, will be an effective check on the governance of the company.

recommended that non-executives are appointed for a fixed term.⁴³ However, it is only "good practice", not a recommendation, that there be a minimum of three non-executive directors, that they be appointed by a nomination committee⁴⁴, and that they have the same access to information as executive directors.⁴⁵

Non-executive directors form a fundamental part of the Cadbury recommendations. They are to be the main players in the various committees to be established by a Cadbury company; namely, the remuneration, nomination, and audit committees.⁴⁶ Further, non-executives are to review the performance of the board⁴⁷, are to take a lead when potential conflicts of interest arise⁴⁸, and are to "bring an independent judgement to bear on issues of strategy, performance, resources, including key appointments, and the standards of conduct".⁴⁹ The conclusion of the Report states that the "key safeguards" of sound corporate governance include "properly constituted boards".⁵⁰ However, as noted above, the Code of Best Practice only states that non-executives be of sufficient calibre and number for their views to carry significant weight, that a majority of their number be independent of the company, and that they should be appointed for a fixed term.

3. The efficacy of non-executive directors as a means of supervision and control⁵¹

Accordingly, it can be seen that the Cadbury Report placed great emphasis on the part which can be played by non-executive directors in controlling the directorial conduct of executive directors. It saw non-executives as the panacea to the ills of present day UK corporate governance. The utility of non-executive directors has long been a focus of attention in corporate governance debates. A Government White Paper on the Conduct of Company Directors stated in 1977 that: "non-executive directors ... are able to take a detached look at the way in which the company is being run ... They

43 *Ibid* paragraph 4.16.

44 *Ibid* paragraph 4.15.

45 *Ibid* paragraph 4.14.

46 See *infra*.

47 *Supra* note 5, paragraph 4.5.

48 *Ibid* paragraph 4.6.

49 *Ibid* paragraph 4.11.

50 *Ibid* paragraph 7.2.

51 See, *inter alia*: Finch, "Board Performance and Cadbury on Corporate Governance", (1992) *Journal of Business Law* 581; Picciotto, McCahery and Scott (eds), *Corporate Control and Accountability*, Clarendon Press Oxford, 1994; Rowe and Maw, *Corporate Governance*, Dartmouth, 1993; Finch, "Corporate Governance and Cadbury: self regulation and alternatives", (1994) *Journal of Business Law* 51; Dine, *supra* note 6.

should provide independent supervision of the company's management."⁵² The White Paper was followed by the establishment of the Bullock Committee which recommended that the board structure of large companies be constituted by an equal number of directors elected by shareholders and employees, balanced by an unequal number of independent directors greater than one, to be co-opted onto the board by the agreement of the shareholder and employee directors.⁵³ The Bullock Report was widely criticised, mostly on the basis of the so-called "bid for union power"⁵⁴, and was relegated to the "archaeology of comparative studies in industrial democracy"⁵⁵ by the election of the present Conservative Government in 1979.

Since the Bullock Report, there has been little clamour for changes to the composition of the board of directors, until the Cadbury Report.⁵⁶ As a result of the Cadbury Report, it is now commonplace to have non-executives on the boards of listed companies⁵⁷; however, their effectiveness is much disputed. Brudney states that from the "panoply of structural changes being discussed" in the United States, "few have come with such broad support as the notion of the "outside" or "independent" director".⁵⁸ However, this is not to say that independent/non-executive directors are so effective that their utility is without question. It is suggested that their presence on a board merely acts as a palliative to public concern without actually changing or improving governance structures.

Non-executive directors are largely dependent on the board and the managing director for information regarding the progress and business strategy of the company. Establishing various extra-board committees concerning remuneration, nominations and audits, may help offset this lack of knowledge, although the information at the disposal of such committees will be dependent on the executive directors. The position of non-executive director is not full time; it is usually in addition to the

⁵² Cmnd 7037, 1977, paragraphs 19-21.

⁵³ *Supra* note 3.

⁵⁴ For a refutation of such criticisms, see Wedderburn, *supra* note 4, at 244.

⁵⁵ *Ibid*

⁵⁶ See, however, the work of the organisation PRO-NED, Promotion of Non-Executive Directors, which was set up in 1982 with the backing of the Stock Exchange, Confederation of British Industry and the Bank of England. It has been striving to promote independent, and non-executive directors as a normal feature of corporate boards. See Pro-ned, *The Role of the Non-Executive Director*, 1982 and 1986.

⁵⁷ See, *inter alia*: 3i, *The Independent Director*, 1993; PIRC Limited, *The PIRC Corporate Governance Review: A Company Health Check*, 1995.

⁵⁸ Brudney, "The Independent Director - Heavenly City or Potemkin Village?", (1982) 95 *Harvard Law Review* 597, at 598.

individual's other commitments, often a full time executive directorship.⁵⁹ The fact that non-executives are not full time reduces their motivation to enquire into company activities, and also confounds the lack of resources. The Cadbury Committee expects non-executive directors to review the conduct of the executive directors, but the extent and nature of this obligation is not clear. Clearly, such an obligation is not judicially enforceable.⁶⁰

Finch highlights the different motivating factors between executive and non-executive directors, an analysis of which demonstrates how little incentive there is for non-executives to monitor management.⁶¹ The motivation of executive directors can clearly be traced through their dependence on the company for income, employment and reputation. Non-executives are usually appointed by the directors and are largely dependent upon them for their continued employment: the Institute of Directors points out that "the outsider ... can become the Chairman's confidant and mentor."⁶² There may be a "perceived need to relate constructively"⁶³ to executive directors, or a wish not to be implicated in their shortcomings.⁶⁴ The Government's Corporate Affairs Minister in 1990, John Redwood, suggested that to counteract this patronage non-executives should be "truly independent".⁶⁵ He did not, however, explain what this meant, or how it was to be achieved. Even were the non-executive to be motivated to monitor the executives, it is doubtful whether this would result in effective action against errant executive directors. The non-executive may not have sufficient support

⁵⁹ For analyses of the inter-locking nature of many directorships in large companies in the UK, see, *inter alia*: *The Sunday Times*, 14 June 1992; and, *The Independent on Sunday*, 4 October 1992.

⁶⁰ For a consideration of the duties of skill and care expected of a director, see Chapter Two. See further: *Re City Equitable Fire Insurance Co Ltd*, [1925] Ch 407; in *Re Produce Marketing Consortium (No 2)*, [1989] BCLC 520, at 550-551, Knox J held that the standard of skill and care expected of a director included, *inter alia*, the director being apprised of any documentary material available at the time of any financial difficulties, eg. the accounts, and any factual information which was ascertainable, given a reasonable amount of diligence and enquiry. Thus directors would have to ensure that they maintained their acquaintance with the affairs of the company, lest they be in breach of their fiduciary duties. See *Bell v Lever Bros. Ltd*, [1932] AC 161, for a consideration of the absence of an obligation on a director to report the conduct of other directors, which was distinguished in *Sybron Corp v Rochem Ltd*, [1985] Ch 299, following *Swain v West (Butchers) Ltd*, [1936] 3 All ER 261, holding that an executive director may be under a duty to disclose the misconduct of employees, even though doing so may disclose the director's own misconduct.

⁶¹ Finch, "Company Directors: Who Cares about Skill and Care", (1992) 55 *Modern Law Review* 179, at 197-199.

⁶² See Institute of Directors, *Code of Practice for the Non-Executive Directors* (undated), Chapter 1, reference 7.

⁶³ *Supra* note 61, at 199.

⁶⁴ Such risks are now insurable. For a consideration of the issues raised, see, Finch, "Personal Accountability and Corporate Control: The Role of Directors' and Officers' Liability Insurance", (1994) 57 *Modern Law Review* 880.

⁶⁵ Quoted in Finch, *supra* note 61, at 207.

on the board to call a general meeting to dismiss the director, or indeed may be reticent in canvassing such support. The same difficulties will be present in attempting to resolve that the board institute legal action against a negligent director, coupled with the fact that the company, via the board, is unlikely to want to take action which will court adverse publicity.

The Cadbury Report's recommendations can usefully be analysed by a comparison with the role of non-executives proposed by Finch.⁶⁶ Finch suggests that non-executives would be better able to monitor management if they were better resourced and perhaps had the same right of access to company information as executive directors. Their influence would increase were their numbers on each board to rise, perhaps in line with the provisions of the draft fifth EC Company Law Directive which provides that there should be a majority of non-executives on the board.⁶⁷ However, Finch concludes that overall the problems of non-executives taking a monitoring role are "intractable" and are best seen as a "means of supplementing other methods ... rather than as solutions in themselves".⁶⁸ Whether non-executive directors can restrain "unbridled corporate power" appears to be uncertain.⁶⁹

Further criticism of the emphasis placed on the non-executive as the panacea for all governance ills is to be found in the North American literature on the independent director.⁷⁰ Solomon points out that the inquisitorial role envisaged for the non-executive is adversarial in nature; the non-executive is supposed to investigate management inefficiency and abuse of power, which is "inimical to the spirit of cooperation which it is widely believed the board and management must maintain".⁷¹ In reality, a non-executive will take up a cooperative stance with the company. If the board were to operate otherwise, the speed and efficiency of decision-making would likely be impaired, contrary to the intentions of those proposing reform. As already noted, non-executives are likely to be appointed by the board, perhaps approved and

⁶⁶ *Ibid.* It should be noted that the Cadbury Committee were reporting on the financial aspects of corporate governance and Finch is concerned with rooting out incompetence and enforcing directors' duties of skill and care.

⁶⁷ *Supra* note 11, article 21a. Cf Finch, "Corporate Governance and Cadbury: self regulation and the alternatives", *supra* note 82, at 55, where she states that the debate on corporate governance would be improved were it to be "[f]reed from the "heat" of discussion of the draft fifth Directive's worker participation and supervisory boards" debate.

⁶⁸ *Supra* note 61, at 199.

⁶⁹ Brudney, *supra* note 58, at 597.

⁷⁰ See, *inter alia*: Brudney, *supra* note 58; Solomon, "Restructuring the Corporate Board of Directors: Fond Hope or Faint Promise?", (1978) 76 *Michigan Law Review* 581; and, Mace, *Directors: Myth and Reality*, Harvard University Press, 1971.

⁷¹ Solomon, *ibid* at 589.

recommended by the chief executive. This of itself may engender a lack of motivation to "blow the whistle". The independence of the directors is put in doubt by the fact that, even if not themselves executives, they "tend nevertheless to share common business and professional backgrounds with, and to live in the same social and economic milieu as does, management".⁷² In sum, "corporate boards form a closed club of elites sharing similar experiences and views".⁷³

Brudney goes on to suggest that for non-executives to regulate self-dealing they must overcome the disincentives to report colleagues. The psychological and social pressures not to report suspicious actions mean that such actions must be "so grossly overreaching as not often to be proposed by management" if they are to be reported.⁷⁴ To support this conclusion Brudney examined cases involving self-dealing or misappropriation of assets by management and found that the cases did not disclose "many" instances of outside directors challenging the offence.⁷⁵ Solomon, having detailed his case study of board reforms made in a spirit of improving governance, found that although many reforms have been implemented and are indeed commonplace in many large corporations, eg. audit committees and independent directors, the changes did "not represent genuine changes in corporate governance".⁷⁶ Indeed, "management had simply adopted the language and form of the restructured board in response to the pressure for "reform"", with few "substantive" changes being made.⁷⁷ Solomon's pessimistic, though perhaps accurate, conclusion is that so long as directors are drawn exclusively from the ranks of past and present corporate executives and professionals, "we are unlikely to witness major shifts in the character of the board".⁷⁸ More cynically, he describes the proliferation of committees to monitor management as a means of occupying the time of outside directors to "create only the illusion of board independence"⁷⁹, and he concludes by stating that attempts

⁷² Brudney, *supra* note 58, at 612.

⁷³ Solomon, *supra* note 70, at 586. Such observations apply equally to non-executives in the UK. Indeed, there has been considerable criticism that the staffing of remuneration committees by non-executive directors, who are themselves executive directors with other companies, has led to increases in remuneration as non-executives seek to increase the "going-rate" to further their own self-interest. For example, a report by the Social Market Foundation found that, contrary to the intention of remuneration committees, they are having the opposite effect of restraining executive pay. The committees are intent on ensuring that the pay for the executives of the particular company does not lag behind the market salary with the result that remuneration is "levelling up" rather than being restrained. See *The Guardian*, 18 June 1994.

⁷⁴ *Supra* note 58, at 616.

⁷⁵ *Ibid* at 617-618.

⁷⁶ Solomon, *supra* note 70, at 591.

⁷⁷ *Ibid.*

⁷⁸ *Ibid* at 610.

⁷⁹ *Ibid.*

to improve corporate governance by reforming the board of directors are described as "anachronistic".⁸⁰

In placing such emphasis on the role of the non-executive director, the Cadbury Report implicitly recognised that shareholders do not have the monitoring role often assumed to them, as they do not have the ability, time or access to information to allow them to do so. The Cadbury Report attempted to redress this lack of supervision by providing for an increased role for non-executive directors. However, non-executive directors cannot sufficiently exercise the role arrogated to them. The institutional barriers to the non-executive have not been reformed; the board of directors and company law have largely remained the same. Inclusion of non-executives is merely tinkering with the present system, and is not sufficiently radical to alter dramatically the status quo. However, this is not to say that the non-executive has not made any impact. Lip-service is now paid to non-executives, and their mere presence on the board presumably has an effect in reducing the secrecy of the board. However, the management of the company does not take place in the boardroom, the strategic decisions of the company are taken on a day to day basis by executive management, into which the non-executive has no insight. It is therefore suggested that the non-executives are a palliative: they can but help, but they cannot cure the ills.

4. Cadbury's committees

It has already been noted that the Cadbury Report recommended that companies establish a number of extra-board committees to monitor various parts of the management function. It proposed the creation of audit, remuneration, and nomination committees.

4.1 Audit committees

The Cadbury Report recommended that all listed companies establish an audit committee.⁸¹ Its duties are to include making recommendations as to the appointment of the external auditor, reviewing the accounts, reviewing the audit with the external auditors, and reviewing the findings of any internal investigations. There should be a minimum of three members, and membership should be confined to non-executives, a majority of whom should be independent. The external auditor and the finance

⁸⁰ *Ibid* at 583.

⁸¹ *Supra* note 5, paragraphs 4.33 - 4.38.

director should attend the meetings. The Report intended that the board should appoint an audit committee in order to delegate some of its functions to the committee. An annex to the Report sets out specimen terms of reference for an audit committee. Establishing an audit committee is a requirement of the Code of Best Practice.

The proposals made in respect of the audit committee were watered down between the draft and final report.⁸² In the draft report, there was a requirement that audit committees be established within two years - this was dropped. The committee was to meet at least three times a year, and executive directors were only allowed to attend by invitation. These proposals were changed so that the committee need only meet twice a year, and executive directors have the right to attend. From these changes, it can be seen that the Cadbury Committee did consider initially that audit committees were to play an important role in corporate governance. Their independence was to be guaranteed by allowing executive directors to attend only by invitation. Moreover, a time limit was placed on their establishment. The final Report therefore represents a compromise; one which is clearly influenced by those wishing to dilute the effect of the Report's recommendations, and delay the implementation of corporate controls.

4.2 Nomination committees

The Cadbury Report states that it would be good practice (it is not a recommendation, nor is it in the Code of Best Practice) to establish a nomination committee. This committee would have "the responsibility of proposing to the board, in the first instance, any new appointments, whether executive or non-executive directors".⁸³ A nomination committee is to have a majority of non-executive directors on it.

Thus, a nomination committee is another means of delegation of board function, and one that is intended to reduce nepotism and patronage, ensuring fairer selection procedures. It is suggested that it fails to do either, as the establishment of a nomination committee is neither a recommendation of the report, nor is it in the Code of Best Practice. There is, therefore, no compunction on boards to appoint such a committee, nor is there any great emphasis placed on it. Moreover, in light of the comments made above regarding the ability of non-executives to be sufficiently robust, and their kinship with other executives and non-executives, it is unlikely that

⁸² Dine, *supra* note 6, at 77-79.

⁸³ *Supra* note 5, paragraph 4.30.

the mere delegation of the proposing of corporate appointees would dramatically improve the present system.

4.3 Remuneration committees

The Cadbury Report's recommendations relating remuneration committees are closely tied to its recommendations on the remuneration of directors. It states that the overriding principle in respect of board remuneration should be that of openness.⁸⁴ It recommends that when disclosing the remuneration details of the chair and highest paid director, separate figures are given for salary and performance related bonuses.⁸⁵ In order to assess the levels of remuneration to be paid, the Report recommends that boards appoint remuneration committees, consisting wholly or mainly of non-executive directors.⁸⁶ The remit of the remuneration committee is to "recommend to the board the remuneration of executive directors in all its forms, drawing on outside advice as necessary".⁸⁷

The establishment and practice of remuneration committees is supported by a number of institutional investors committees, the Institute of Directors, and the Greenbury Report.⁸⁸ In May 1994, the Association of British Insurers issued guidelines on the *Long Term Remuneration of Senior Executives* which emphasised the role which remuneration committees must play in ensuring that performance related targets are set for share option schemes, and that "clear remuneration strategies for executive directors" are established.⁸⁹ The Institute of Directors published in January 1995 its guidelines entitled *A Framework for Remuneration Committees*.⁹⁰ The guidelines set out matters which should be considered by remuneration committees when recommending remuneration packages, and the principles upon which such remuneration packages should be based.

Notwithstanding such support, it was noted above that the practices of remuneration committees in setting directors' remuneration have been heavily criticised.⁹¹ The

⁸⁴ *Ibid* paragraph 4.40.

⁸⁵ *Ibid* paragraph 4.40. Schedule 6 to the Companies Act provides that disclosure must be made in the annual report and accounts of the aggregate amount of directors' emoluments, only those of the chair and highest paid director must be shown separately.

⁸⁶ *Ibid* paragraph 4.42.

⁸⁷ *Ibid*.

⁸⁸ See *infra*.

⁸⁹ Association of British Insurers, 25 May 1994.

⁹⁰ Institute of Directors, 25 January 1995.

⁹¹ *Supra* note 73 and *The Guardian*, 7 May 1993.

controversy over the remuneration of directors has not ceased, and resulted in the establishment of the Greenbury Committee⁹², and the promulgation of the Accounting Standards Board's Urgent Issues Task Force Abstract 10 providing for greater disclosure of share options.⁹³ Further, recent reports show that companies are disclosing far more information in their annual reports regarding the remuneration of directors than required to do so by the Companies Act, or by the Cadbury Report.⁹⁴ This, of itself, shows that Cadbury did not go far enough; and, if it had gone further, it would not have encountered undue criticism from corporate boards, nor could the argument have been raised that such disclosure was not beneficial. Accordingly, it is suggested that the Cadbury Report singularly failed to recommend sufficient action in respect of directors' remuneration to satisfy an unconvinced public. Nonetheless, the Report does state that board remuneration and the disclosure thereof is something which will be considered by the Committee's successor.⁹⁵

4.4 The efficacy of extra-board committees

In general, the self-regulatory reliance of the Cadbury Report was criticised, particularly in regard to the extra-board committees. The Institute of Internal Auditors criticised, particularly, the lack of statutory backing to the internal audit recommendation.⁹⁶ The Chartered Association of Certified Accountants argued that the "flaw" of the report was the lack of the backing of any enforcement agency.⁹⁷ The *Financial Times's* Lex column stated that the Committee's faith in self-regulation was "touchingly naive".⁹⁸

Finch has suggested that the only positive benefit of board committees is that they pave the way for a two-tier board, with management and supervisory organs.⁹⁹ By establishing a detailed system of delegation from the board, the transition to a supervisory board may be more efficient and less obvious. Thus, it could be argued by proponents of the two-tier structure, that the board committees established by Cadbury may not have a particular benefit now, but that they lay the ground work for

92 *Supra* note 8.

93 *Disclosure of Directors' Share Options*, 29th September 1995.

94 *The Daily Telegraph*, 16 April 1995.

95 *Supra* note 5, paragraph 4.46. The new committee has been established and a draft report is expected mid-1997, with the final report at the end of 1997. See *The Times*, 21 February 1996.

96 *The Guardian*, 2 December 1992.

97 *Ibid.*

98 *The Financial Times*, 28 May 1992.

99 Finch, "Board Performance and Cadbury on Corporate Governance", *supra* note 61, at 593.

future improvements.¹⁰⁰ However, it can only be presumed that it was on this basis that there was such concerted criticism of the draft report, leading to a watering down of the proposals regarding non-executive directors, and the structure and remit of the board committees. Moreover, it is such criticism which prevented consideration of a two-tier board structure, and resulted in the patchwork quilt of supervision by committees. The board committees, in their present form, certainly improve the responsiveness of boards, as they are placed under closer scrutiny. However, whether non-executive directors will be able to overcome their inherent reticence to actually involve themselves as boardroom police is a moot point, and leads to the conclusion that the board committees are an effective smoke-screen to real action being taken to improve governance.

D. The Greenbury Report on Directors' Remuneration

As noted above¹⁰¹, the Greenbury Committee was established by the Government, in collaboration with the CBI, in response to grave public concern over the remuneration levels of senior corporate executives, particularly those in the newly privatised utilities. The remit of the committee was to identify good practice in determining directors' remuneration and to draw up a Code of Practice for use by all UK plcs. In terms of reforming the structure of the board of directors, and improving the governance and control of directors, the Greenbury Report merely resulted in another Code of Practice, following the Cadbury example, giving particular emphasis to an enhanced remuneration committee.

The Code of Practice promulgated by the Greenbury Report covers four areas of remuneration policy: first, the formation and composition of the remuneration committee; secondly, increase duties of disclosure; thirdly, pension policy disclosure; and, fourthly, remuneration policy in general. The principal reforms made are: the requirement that all non-executives on the remuneration committee are independent (Cadbury required that only a majority were independent); all elements of the remuneration package of all directors to be disclosed (Cadbury and the Companies Act require only disclosure regarding the chairperson and the highest paid director); service contracts to be reduced to one year (Cadbury advocated no more than three

¹⁰⁰ In much the same way as it is argued that the EC directives on the information and consultation of employees are not particularly effective at present, but they may enable employee participation in management to be more effective when such provisions are enacted. See McGlynn, *supra* note 23.

¹⁰¹ *Supra* note 8.

years without shareholder approval); and, a report is to be made to AGM of the remuneration policy of the company.

Thus, it can be seen that the Greenbury Report simply follows the example of Cadbury, strengthening Cadbury policy in a few discrete areas. The Code of Practice, again following the Cadbury example, is voluntary, relying on self-regulation, and is backed by the Stock Exchange which will require a compliance statement to be included in the company's accounts in order for the company to be listed.¹⁰² It is suggested that in terms of improving the accountability of directors, the Greenbury Code of Practice is a step in the right direction. Nonetheless, it is premised on the same false bases as the Cadbury Report, namely a reliance on self-regulation and shareholder power. As will be considered in the next chapter, the ability of shareholders to exercise sufficient control over the board of directors is limited, and the very fact that the Greenbury Committee was established shows the inability of companies to put their own house in order.

E. Reforming the Board of Directors as a Means of Improving Directorial Control

This chapter has been concerned with an analysis of the recent reforms, and reform proposals, made in respect of the structure of the board of directors, in the context of improving directorial control. It should be emphasised that the real power in a company is in the hands of the executive directors who have day to day control and management of the company. Thus, reforming the board of directors is not going to alter directly the management power structure of the company. Accordingly, considerations as to the reform of the board of directors must recognise their limitations, and, it is suggested, focus on improving the supervision of the executive directors so that in the exercise of their management function, they are accountable and supervised.

The Cadbury and Greenbury Reports made a number of recommendations as to the structure of the board of directors, many of which have now been implemented.¹⁰³ It was noted, however, that the proposals made by the Reports were limited in that they

¹⁰² See Jeffcote and Walsh, 'Directors' Remuneration - The Greenbury Committee', (1995) *Practical Law for Companies* 43, at 44. Note that the requirement to state compliance with the Code of Practice does not mean that a company has to comply, merely that it has to inform its shareholders as to whether or not it does comply.

¹⁰³ See the PIRC Limited report, *supra* note 57, and Belcher, 'Compliance with the Cadbury Code and the Reporting of Corporate Governance', (1996) 17 *Co Law* 11.

do not substantially alter the status quo. Some of these limitations are the result of sustained criticism of the draft Cadbury Report published for comments. It was perceived that increasing the number and resources of non-executives constituted a threat to the unitary board, and that, accordingly, the proposals would lead to the creation of an actual or *de facto* supervisory board on the continental model. For example, one respondent to the draft report stated that: "The Committee's proposals would create a two-tier board within the legal structure of the unitary board. We do not regard this as tenable."¹⁰⁴ In the face of this reaction, the final report sought to make it clear that its "proposals aim to strengthen the unitary board system and increase its effectiveness, not replace it".¹⁰⁵ Thus, for the large UK companies to whom the Report was addressed, the threat of "boardroom police" was expunged and it was business as usual.

The Cadbury and Greenbury proposals seek their enforcement through the general meeting, and particularly via institutional shareholders.¹⁰⁶ The efficacy of relying on shareholders to supervise the board, and ensure accountability, will be examined in the next chapter. However, it is suggested here that such a sole means of reliance limits the reforms and will not lead to any dramatic improvement in the governance of directors.

This chapter also considered proposals for a two-tier board. Notwithstanding opposition to such reforms, it is suggested that a two-tier board would alleviate the difficulties of the piece-meal nature of the committees recommended by Cadbury and Greenbury, and the protean nature of the responsibilities of non-executive directors. Such a board structure would also facilitate the involvement of parties other than shareholders, and non-executive directors. The representatives of employees could participate, allowing further views to be expressed, with different experiences. Thus, a two-tier board, as well as fostering improved supervision of directors, could foster other objectives such as securing longer-term investment by shareholders via institutional shareholder involvement in the supervisory board, and employee involvement in the company, together raising standards of corporate citizenship.

¹⁰⁴ See Dine, *supra* note 6, at 75. See also, *Company Law Committee of the Law Society Response to the Draft Report*, 1992; Sir O Green, "Why Cadbury Leaves a Bitter Taste", *Financial Times*, 9 June 1992. The new chair of the Cadbury Committee's successor committee has stated that he does not consider the model of the two-tier board to be appropriate in the UK. See *The Times*, 21 February 1996.

¹⁰⁵ *Supra* note 5, paragraph 1.8.

¹⁰⁶ See further Chapter Four.

However, it is recognised that to impose such a structure onto all companies may be more detrimental than advantageous. The Labour Party has proposed that legislation is enacted to provide a statutory basis for a two-tier board structure for those larger companies wishing to adopt it¹⁰⁷, akin to the present format of the draft fifth EC Company Law Directive. In respect of two-tier and unitary boards, there would be minimum standards for the composition of the board.¹⁰⁸ Such proposals are welcomed. Moreover, it is suggested that whether a company chooses to adopt a two-tier board structure should be open to a certain percentage of the shareholders, and/or a number of the employees, to mandate.¹⁰⁹

¹⁰⁷ The Labour Party, *Winning for Britain - Labour's strategy for industrial success*, 1994.

¹⁰⁸ *Ibid.*

¹⁰⁹ It is suggested that this figure is substantially lower than 50%, so that the threshold is reached by a relatively small number of investors acting together. Otherwise, the option would remain in the hands of the board in whose interests it is to limit supervision.

CHAPTER FOUR

SHAREHOLDER DEMOCRACY IN THE SHAREHOLDERS' CITY STATE

A. Introduction

Chapters One, Two and Three considered a variety of means of controlling the conduct of directors. A number of the controls examined relied on shareholder participation and action to make them effective. This chapter will focus on the ability of shareholders to participate and take appropriate action to control the activities of directors.

In the early nineteenth century, when companies were first incorporating, it was usual that shareholders were involved in the management of the enterprise.¹ That this was necessarily so was largely due to the lack of any market for 'shares' in the company, and a strong emphasis between ownership and responsibility.² However, as the size of companies grew, it was increasingly inappropriate for the members of the company to participate in day to day management. Thus, management began to be delegated to directors, and the interests of the shareholders were protected by statutory controls and fiduciary principles. It is this conception of the company which is described as the shareholders' 'city state' - the 'fundamental model of British Company law'.³ The analogy with the processes of representative democratic government has immediate resonance. The shareholders of the company elect their representatives to the board of directors, who manage the company on their behalf, and are accountable to them. It is in this context that the regulation of corporate activity must be considered: generally, such regulation is aimed at increasing the power of shareholders to control their

¹ See, *inter alia*: Schmitthoff, "The Origin of the Joint-Stock Company", (1939) *University of Toronto Law Journal* 74; Hahlo, "Early Progenitors of the Modern Company", (1982) *Juridical Review* 139; Campbell, "Adam Smith, Farrar on Company Law and the Economics of the Corporation", (1990) *Anglo-American Law Review* 185; Santuari, "The Joint Stock Company in Nineteenth Century England and France: *King v Dodd* and the *Code de Commerce*", (1993) 14 *Legal History* 39; Butler, "General Incorporation in Nineteenth Century England: Interaction of Common Law and Legislative Processes", (1986) *International Review of Law and Economics* 169; Gower, *Principles of Modern Company Law*, Butterworths, 5th ed, 1992, at 19-54 and the citations therein.

² See, Grigg-Spall, Ireland & Kelly, "The Conceptual Foundations of Modern Company Law", in Fitzpatrick and Hunt (eds), *Critical Legal Studies*, Basil Blackwell, 1987; Wedderburn, 'Companies and Employees: Common Law or Social Dimension', (1993) 109 *Law Quarterly Review* 220.

³ See generally Wedderburn, "The Legal Development of Corporate Social Responsibility: For Whom will Corporate Managers be Trustees?", in Hopt and Teubner (eds), *Corporate Governance and Directors Liabilities*, Walter de Gruyter, 1985.

assets, the stewardship of which has been put in the hands of the directors. Regulation of corporate activity and directorial conduct did not arise from a wish to direct and control the activities of large scale enterprises for the greater social and economic good, but had the proprietary interests of shareholders at heart. This principle of 'shareholder democracy' continues to be a fundamental principle of company law, of great influence and symbolic significance.

Nonetheless, from around the time of Berle & Means⁴ classic study showing the inability of shareholders to control the management of a large corporation where there is a clear separation of ownership and control, the utility of shareholder control of corporate activity and directorial conduct has been brought into question. This chapter will consider whether such criticisms are justified.

B. The Relationship between the Board of Directors and the Shareholders

The traditional relationship between the board of directors and the shareholders is that the board exercises control over the day to day management of the company, delegated to executive directors, while the shareholders remain the final arbiters of constitutional changes, and have ultimate power to remove the board from office. The standard formulation of the relationship between the board and shareholders can be found in the statutory articles of association, Table A. Article 70 of Table A states that "subject to the provisions of the Act, the memorandum and the articles and to any directions given by special resolution, the business of the company shall be managed by the directors who may exercise all the powers of the company". Thus, unless the articles, or the Companies Acts, specifically provide otherwise, shareholders can only intervene in the management of the company by passing a special resolution in general meeting.⁵

⁴ Berle and Means, *The Modern Corporation and Private Property*, New York: Commerce Clearing House, 1932.

⁵ The power of the shareholders to mandate the board to act in a particular manner by means of passing a special resolution was inserted into Table A by the Companies Act 1985. The analogous article under the 1948 Companies Act Table A, Article 80, which still forms part of the articles of a large number of companies, provided only that shareholders could direct the conduct of directors "as may be prescribed by the company in general meeting". This caused much controversy as to whether or not shareholders could control the conduct of directors by means of an ordinary or special resolution. The words, on their face, would seem to indicate that an ordinary resolution was all that was required, but there was confusion in the case law. In *Automatic Self-Cleansing Filter Syndicate Co v Cunningham*, [1906] 2 Ch 34, the Court of Appeal held that where the articles of the company stated that the power of management was vested in the directors, the members, in general meeting, could not take management decisions. This was confirmed by the House of Lords in *Quin & Axtens v Salmon*,

In reality, in the large public company, shareholders are unlikely to command a 75% majority to pass the required special resolution, particularly where there is opposition from the board of directors. Further, shareholders do not have knowledge of the day to day management of the company, and it is therefore unrealistic to expect them to be aware of the potential need for preventative action.⁶ Moreover, the management function is ordinarily delegated by the board to a number of executive directors; thus, the shareholders are even further removed from the decision making processes.

Accordingly, in practice, shareholders do not have power to directly regulate the management of the company by the board. Although it would appear that shareholders are able to control management by means of passing a special resolution, the dynamics of corporate practice prove this exercise of shareholder control and democracy to be largely illusory.

C. The Shareholders' Power to Remove Directors from Office

The primary power of the shareholders is the right to remove directors from office by means of an ordinary resolution.⁷ It is this power which is relied on as the means by which shareholders can control the conduct of directors: the threat of removal is supposedly ever present. Thus, the Cadbury Report states that "the shareholders as owners of the company elect the directors to run the business on their behalf and hold them accountable for its progress".⁸ Accordingly, "[i]t is for the shareholders to call the directors to book if they appear to be failing in their stewardship and they should use [the section 303] power".⁹ The accountability of boards to shareholders will be "strengthened", the Cadbury Report argued, if shareholders require their companies to comply with the Code of Best Practice. In addition, the guidelines issued by the Institute of Directors concerning the remuneration of directors endorse this view of shareholder control, stating that if shareholders are not content with the remuneration

[1909] AC 442. However, the position may still be far from clear, and will continue to be relevant where companies still have articles in the form provided by the Companies Act 1948. See Gower, *supra* note 2, at 150-152. For the opposing view see: *Marshall's Valve Gear Co v Manning Wardle & Co*, [1909] 1 Ch 267; Sullivan, "The Relationship Between the Board of Directors and the General Meeting in Limited Companies", (1977) 93 *Law Quarterly Review*, 569; Goldberg, 'Article 80 of Table A of the Companies Act 1948', (1970) 33 *Modern Law Review* 177.

6 Action would need to be taken in advance as, once committed to a contract, a third party is protected, see section 35 of the Companies Act.

7 Section 303 of the Companies Act.

8 Cadbury Committee, *The Financial Aspects of Corporate Governance*, 1992, paragraph 6.1.

9 *Ibid* paragraph 6.6.

of the directors, or of their management of the company, then they should take action to remove them from the board.¹⁰

Thus, the governance of the company is in the hands of shareholders, and it is their duty to see that directors are taking all steps necessary to manage the company effectively. However, in a large public company, the ability of shareholders to secure a majority of 50% for the passing of an ordinary resolution removing a director is remote. A shareholder would have to bear the entire cost of publicity in attempting to persuade other shareholders to support the resolution. Moreover, the command of the board of the proxy machinery is renowned. Thus, it is suggested that the ability of shareholders to take action to remove directors, though theoretically possible, is deceptive.

More significant than the inability of shareholders to remove directors, due to a lack of resources and the requirement of an ordinary resolution, is the financial premium on such removal. Section 319 of the Companies Act provides that shareholder approval must be given to the service contract of a director which exceeds five years. Criticism of the five year period led the Cadbury Report to suggest that the period be reduced to three years.¹¹ As a result of the Cadbury Report and continuing public concern, the length of directors' service contracts has been slowly decreasing.¹² However, although three year rolling contracts may be in the minority¹³, even a two or one year rolling contract still places a substantial financial premium on the removal of a director from office.

In smaller companies, often termed quasi-partnerships, action can be taken to entrench a director in office. Thus, in *Bushell v Faith* a director was given weighted voting rights so that he could not be removed from office.¹⁴ In *Harman v BML Group plc* it was held that the right of a director to remain in office could take the form of a class right, thus preventing his removal.¹⁵ In such circumstances, the provisions of section

10 Institute of Directors, *The Remuneration of Directors - A Framework for Remuneration Committees*, 25 January 1995, at 2.

11 *Supra* note 8, paragraph 4.41.

12 See, for example: *The Times*, 23 February 1995; *The Guardian*, 18 February 1995; *The Guardian*, 25 January 1995; *The Financial Times*, 8 November 1994.

13 In *The Financial Times*, 8 November 1994, the results of a study were published showing that 39% of directors were still on three year rolling contracts.

14 [1970] 2 WLR 272. See further, McGlynn, 'The Constitution of the Company: Mandatory Statutory Provisions v Private Agreements', (1994) 15 *Co Law* 301.

15 [1994] 1 WLR 893. See further, McGlynn, 'Re-Writing the Corporate Constitution', (1995) *Journal of Business Law*, 585.

303 of the Companies Act are effectively evaded and the position of directors entrenched. In addition to such preventative measures, it may also be possible to allege, under section 459 of the Companies Act, that the removal of a director from office amounts to unfairly prejudicial conduct.¹⁶

Thus, it can be seen that in both the large public company, and the small quasi-partnership, there are substantial limitations on the power of shareholders to take action to remove directors from office. It is suggested that the focus which has been placed on the power of shareholders to remove directors from office is misplaced, as in practice this power only acts as a threat, and not a particularly effective one in light of the limited chances of success.

D. Institutional Shareholders

1. Introduction

Thus far, the ability of shareholders to take action to control the conduct of directors has focused on the individual shareholder who, in a large public company with diverse ownership, is one of many thousands, and therefore largely powerless. As a result of such a weak position, it was suggested that the ability of shareholders to take action, whether it is action against a director for breach of fiduciary duty or action to remove a director from office, is limited. Shareholders of large public companies have a far simpler, and potentially economically rational, means of showing their concern with management - selling their shares. Partly in response to a recognition of the futility of individual shareholder control, it was found in Chapter Three that the Cadbury Report placed great emphasis on the ability of non-executive directors to become boardroom police, exercising control where shareholders had failed.¹⁷ In addition, however, the Cadbury Report focused on the part played by institutional shareholders. This section will consider the ability of institutional shareholders to exercise control over directorial conduct.

The institutional shareholder is the large pension fund owner, insurance company, manager of unit and investment trusts. Institutional shareholders are, in effect, holding shares on behalf of individuals and it has therefore been suggested that there is an "important degree of common interest"¹⁸ between the individual and the

16 *Re Bird Precision Bellows Ltd*, [1984] Ch 419.

17 *Supra* note 8 and Chapter Three.

18 *Supra* note 8, paragraph 6.9.

institution. The dominance of institutional shareholders is a "well-established fact".¹⁹ In 1963 institutions owned 22.1% of the ordinary shares of listed UK companies; in 1990 the figure was 61.3%.²⁰ Clearly, therefore, institutional shareholders have the potential to exercise substantial control over the companies in which they invest. It is the willingness and ability of institutions to exert control which is much disputed.

2. Investor Protection Committees

The institutions have become increasingly vocal in recent years, and regularly issue recommendations or guidelines relating to the management of corporate affairs through via the Investor Protection Committees . The Investor Protection Committees (IPCs) is a collective term for the Investment Committees of the Association of British Insurers (ABI) and the National Association of Pension Funds Limited (NAPF). The aim of the IPCs is to provide institutional shareholders with a set of guidelines and recommendations to enable them to exercise their collective voting power in a manner the IPCs consider necessary to enhance the value of institutional shareholdings. This collective voice is concerned not only with matters of corporate profit-making, but also, increasingly, with issues of corporate governance. The IPCs have issued extensive guidelines and recommendations on a variety of subjects, including: the role and duties of directors²¹; the responsibilities of institutional shareholders²²; long term remuneration for senior executives²³; service contracts²⁴; and, good investor relations.²⁵

Broadly, the guidelines and recommendations of the IPCs follow the path already tread by Cadbury. They urge more openness, increased information to shareholders, compliance with the Cadbury Code of Best Practice, increasing numbers of non-executive directors, and the establishment of numerous extra-board committees. The

19 See further, Davies, "Institutional Investors in the United Kingdom", in Prentice and Holland (eds), *Contemporary Issues in Corporate Governance*, Clarendon Press Oxford, 1993, at 70.

20 Central Statistical Office, *Economic Trends*, October 1991, at 153. In recent years the incidence of individual shareholding has increased, see the Central Statistical Office's publication "Economic Trends No. 480", HMSO, 1994, which found that the long period of decline in individual ownership of shares has stopped as individual shareholding increased to an estimated 20% of the UK market.

21 ABI, 12 June 1990; IPC, 18 April 1991.

22 IPC, December 1991.

23 ABI, 25 May 1994.

24 NAPF, *The Times*, 18 November 1994.

25 NAPF. The other guidelines and recommendations issued are: the dis-application of statutory pre-emption rights and directors' authority to allot securities; vendor placings; purchase of own shares; scrip dividends; management buy-outs; share schemes; research and development expenditure; investment trust company guidelines; good investor relations; and mortgage debenture stock.

IPCs support the unitary board, and endorse the right of management to manage free from intervention.

The IPCs consider their obligations to be that, as the proprietors of companies, institutional investors are under a strong obligation to exercise their influence in a responsible manner.²⁶ Such obligations are to be met by means of, *inter alia*: strong communication with the boards of the companies in which the institutional shareholders invest; support of boards should be given by the positive exercise of voting rights; votes should be registered on a regular basis; the composition of the board should be monitored and action taken where there are deficiencies; and, opposition to the issue of non-voting shares.

Accordingly, it can be seen that the IPCs ensure that institutional shareholders, although individually important and having a significant voice, are collectively very effective in mobilising compliance with their particular concept of good governance and management. However, the caveat remains that institutional shareholders have a particular constituency to protect, the value of their shareholdings, and a limited agenda that has the maximisation of investment returns at the top.

3. The Cadbury Report

The agenda of the institutional shareholders is closely matched by that of the Cadbury Report which placed great importance on the role of institutional shareholders in its corporate governance vision. The Report stated that: "[g]iven the weight of their votes, the way in which institutional shareholders use their power to influence standards of corporate governance is of fundamental importance".²⁷ In particular, the Cadbury Report endorsed the statement of the IPCs on the responsibilities of institutional shareholders, considered above, with specific emphasis on: regular and systematic contact with senior executives of the companies in which the institutional shareholder has invested; positive use of voting rights and registration of votes on a regular basis; institutional investors taking a positive interest in the composition of boards.²⁸ The Cadbury Report recommends further that institutional shareholders disclose their policies on the use of voting rights.

26 *Supra* note 8, at 1.

27 *Ibid* paragraph 6.10.

28 *Ibid* paragraph 6.11.

Owing to the "collective stake"²⁹ of the institutions, the Cadbury Report seeks to rely on the institutional shareholders to use their influence to ensure that the Report's recommendations are implemented. The Cadbury Committee was essentially looking to such "market-based regulation to turn its proposals into action".³⁰ This leads to a clear paradox. The Cadbury Committee was established as a result of concern regarding standards of corporate governance. Hitherto, shareholders had been the focus of the control of directors, and, as this was obviously failing, the Cadbury Committee was established. Therefore, where shareholders had in the past failed to monitor companies and reform board practices, the Cadbury Committee now hoped that they would be able to do so by the mere existence of their Report. The weight on the shoulders of the institutions is great: they are to be expected effectively to replace the effort by individual shareholders in monitoring the effectiveness of the directors, and are to ensure no less than the implementation of the Cadbury Report itself.

However, it has been argued that the recommendations may "excessively" institutionalise an already "*de facto* lack of parity"³¹ between the institutional and individual shareholders, leaving the individuals less empowered than ever before. The Cadbury Report envisages that the institutional shareholders will represent the individuals as there is a common interest between them. However, there will not always be such common accord. An institution which depends on both long term profits and interim high results, may have a different agenda from the individual who wishes to invest in the long term aims of the company and/or wishes to have an easily resaleable commodity. There may be a real conflict of interest between the institution and the individual, the institution seeks to pursue its own aims and returns, which may be quite different from those of the individual investor.³² Further, it could be argued that, seeking to control the unbridled exercise of power by large companies, by diluting the control of individual shareholders and improving the position of the institutions, is merely passing power from one large institution to another, thus raising a whole set of new questions regarding accountability and governance.

In the end, it may be that the Cadbury Committee's clear intention to improve corporate governance within the framework of current company law and practice, is

29 *Ibid* paragraph 6.16.

30 *Ibid*.

31 Finch, 'Board Performance and Cadbury on Corporate Governance', (1992) *Journal of Business Law* 581, at 587.

32 For example, an institution may be able to ride out a financially risky course of conduct, taking the risk of failure. An individual shareholder may not wish to follow this course of action as their shareholding represents their limited savings and investments.

its principal failure. It is this very practice and law which was the original root of criticism. The paradox is that the Committee sought to reform the control of shareholders in the 'city state', as it recognised the inherent limitations of this approach. However, its reform proposals place great store on institutional shareholder control. Where the Cadbury Committee failed was that although it recognised the limitations of individual shareholder control, it omitted to suggest a departure from such control, other than emphasising an increased role for institutional shareholders. It is suggested that only if traditional concepts and modes of practice are reformed will debate be open to new and alternative reform proposals. In this context, it is disappointing to note that the Cadbury Committee's recommendations were criticised as being too wide-ranging and radical, particularly where it was considered that the recommendations in the Report were a means of introducing a two-tier board by the back door. However, this does not of itself suggest that their recommendations were too broad and radical. Rather, it confirms that those involved in the Cadbury Committee, and those who responded thereto, are those with vested interests in maintaining the status quo.

4. The Greenbury Report

As discussed in Chapter Three, the Greenbury Committee was established in 1995 as a result of continuing public concern regarding the remuneration of directors. The resultant Report³³ promulgated a Code of Practice akin to that of the Cadbury Report, setting out guidelines for companies and in particular remuneration committees. The Code of Best Practice is to be enforced in the same manner as the Cadbury Code, namely by means of the Stock Exchange Listing Requirements.³⁴ Thus, the Greenbury Report follows the Cadbury example of self-regulation and governance by encouraging full disclosure of corporate information. Reliance on full disclosure implies that someone has to read the information disclosed and act upon it if necessary. The Greenbury Report envisages that such surveillance is to be carried out by institutional shareholders. It states that the 'investor institutions should use their power and influence to ensure the implementation of best practice as set out in the Code'.³⁵

The Greenbury Committee recognised, as the Cadbury Committee before it had done

³³ Greenbury Committee, *Directors' Remuneration - Report of a Study Group Chaired by Sir Richard Greenbury*, 1995.

³⁴ *Ibid* paragraph 3.3.

³⁵ *Ibid* paragraph 3.4.

so, the futility of individual shareholder activism, and instead placed emphasis on institutional shareholders to ensure compliance with their Code. However, the institutions are not given new powers by the Greenbury Report, nor by any recommendations for statutory reform in the Report. Accordingly, the same institutional shareholders which are now to be vigilant over the remuneration of directors, to see that it does not conflict with the Greenbury Code, are the self same institutions which took no action when directors were being remunerated at levels which caused the pressure for the establishment of the Greenbury Committee. It therefore remains to be seen whether any improvement in standards and accountability of directors' remuneration will result.³⁶

5. An analysis of institutional activism

The Cadbury Committee espoused the view that the increasing activism of the institutional shareholders was beneficial, and the Report sought to encourage such participation. However, there is a body of opinion which views the activism of institutional shareholders with more than scepticism. The proposition advanced is that a greater degree of managerial discretion is preferable to increasing shareholder involvement, as shareholder participation leads inevitably to short-termism.³⁷ Short-termism has been described as the "fundamental deficiency of the UK economy; a systematic failure to commit"³⁸ to ownership in the long term. Essentially, it is argued that "enhancing shareholder pressure causes corporate management to take decisions that increase the company's revenues in the short term, but at the expense of its long-term profitability and competitiveness".³⁹ This is an argument which is often levelled at the UK's emphasis on the value of shares and on the controlling of investment by institutions. It is asserted that the prices of shares are "inadequate conveyors of information"⁴⁰, and that the way to improve the governance of companies is not by increasing the interests of the shareholders, but by ensuring that a company acts in the interests of other constituencies, most often named as employees, consumers, creditors, and society in general. Only if this is the case, it is contended, will the company act in its long term interests. Whatever the veracity of this argument, it must be considered whether institutions, whether acting in the short or long term, are

³⁶ *Ibid* paragraph 3.11. The effectiveness of the Greenbury Report is to be examined by the Cadbury Committee's successor which is due to produce an interim report mid-1997, followed by a final report at the end of 1997. See *The Times*, 21 February 1996.

³⁷ See further Davies, *supra* note 19, at 78-81.

³⁸ See *The Guardian*, 22 February 1993.

³⁹ See, Davies, *supra* note 19, at 79.

⁴⁰ See *The Guardian*, *supra* note 38.

efficient controllers of directorial conduct.

Many institutions do not wish to take on the mantle of shareholder monitoring, they are "rationally apathetic".⁴¹ To such institutions, the costs of monitoring and voting exceed the benefit of their investment. This is recognised by NAPF who have established a "voting issues service" which considers annual general meeting notices, and reports on matters which may be of concern to institutions. The tradition of UK institutions is to limit the extent of involvement in any one company to approximately 1-2%. This "reflects the preference of British institutions for liquidity over control".⁴² There are exceptions. M & G have a policy of securing a significant holding, 2.5-5%, in a company in order to influence management.⁴³ However, the judgment of the Court of Appeal in *Prudential Assurance v Newman Industries* did not exactly encourage institutional investor monitoring.⁴⁴ During the case, which involved complex and detailed questions of the scope of the derivative action, the Court of Appeal were invited to give judicial approval to the public spirit of the plaintiffs, who, it was said, were pioneering control of companies in the public interest without involving regulation by a statutory body. The Court of Appeal responded by stating that, in its view, the voluntary regulation of companies is a matter for the City, and declined to make any general observations.

Even in the light of evidence that historically UK institutions do not become involved in corporate management, there are examples of areas where the institutions have succeeded in achieving changes in corporate practice. Postel, one of the largest fund managers, announced in 1994 that it would be utilising its vote to vote against the re-election of any director who has a service contract longer than two years.⁴⁵ This has had a significant effect on the service contracts of directors. In addition, the institutions have long run a campaign against non-voting shares.⁴⁶ Weinberg notes that "a number of proposals to make capitalisation issues to ordinary shareholders in non-voting shares have been dropped following institutional objections" and that "there are no instances in recent years of a company seeking a listing for any class of

41 See Coffee, "Institutional Investors as Corporate Monitors: Are takeovers Obsolete?", in Farrar (ed), *Takeovers, Institutional Investors and the Modernisation of Corporate Laws*, Oxford University Press, 1993, at 15.

42 *Ibid* at 50.

43 *Ibid*.

44 [1980] 3 WLR 543.

45 *The Guardian*, 25 June 1994. See also the statement by Ifma of their intention to vote against directors' "long-term" service contracts, *Financial Times*, 6 June 1993.

46 Ironically though very few institutions exercise their votes. See Coffee, *supra* note 41, at 50.

non-voting equity capital".⁴⁷ Also, pressure from institutional shareholders, and the second EC Company Law Directive, led to statutory reform in respect of shareholder pre-emption rights, and institutions frequently gain greater rights than statutorily demanded.⁴⁸

In addition, it is argued that the part the institutional shareholder can play in the monitoring of management is much wider than the context of individual companies. Coffee argues that the institutional shareholder can replace the need for the takeover as the means of regulation of company management. This thesis is based on an analysis of the costs to institutional shareholders of monitoring, and effectively acting prior to management incompetence, and the costs of the market for corporate control. Coffee asserts that the costs of institutional monitoring are less than the market for corporate control, arguing that "institutional pressure on corporate managers could conceivably work as well as takeover bids - but involve less disruption, waste and undesired side effects".⁴⁹

Although institutional shareholders are being active in the regulation of companies, it is not likely that they will seek to exercise more power than they already have. Institutions have to strike a balance between losing the liquidity of their shareholding, and the benefits of participation in corporate control. Moreover, it is not likely that mere exhortation will encourage the institutions to be more interventionist. Indeed, it is argued that "it is not difficult to see that intervention itself might bring its own rather different political risks with it, involving a question of the legitimacy of the power sought to be exercised by the institutions".⁵⁰ The problem of regulating the regulators was not considered by the Cadbury Committee, but Coffee notes that this may become an issue with the increased role of institutions. He recognises that in many cases the "institutional investors are less accountable to their "owners" than are corporate managements to their shareholders".⁵¹ Finch notes the increased involvement of institutions in the management of companies, but doubts their long term commitment by questioning whether, "such interventionism will evaporate as the

47 Weinberg, *Weinberg and Blank on Take-Overs and Mergers*, London, 1989, paragraphs 3-805. Note, however, the view of the proponents of the markets as a means of control, who consider that the issue of non-voting shares would make little difference to the activities of the company: "shareholders interests are not protected by voting but by the market for stock, the market for goods and the market for managers services". See, Easterbrook and Fischel, (1993) XXVI(2) *Journal of Law and Economics*, Symposium on Corporations and Private Property, at 397.

48 Companies Act 1985 sections 89-95. See also Davies, *supra* note 19, at 85-87.

49 See, Coffee, *supra* note 41, at 13.

50 See, Davies, *supra* note 19, at 90.

51 See, Coffee, *supra* note 41, at 19.

recession ends and investors find it easier once more to vote with their feet rather than fight for improved management".⁵²

E. Conclusions: The Utility of Shareholder Democracy

This chapter has been concerned with the fact that, as owners of the company, shareholders have traditionally been the primary focus of directorial control. It was considered that, in reality, the relationship between the board of directors and shareholders does not afford great shareholder power to control the conduct of directors, nor does the power to remove a director from office a significant weapon in the shareholders' armoury. Accordingly, the position of institutional shareholders was analysed, and it was noted that recent innovations in corporate governance, namely the Cadbury and Greenbury Reports, place considerable emphasis on the ability of institutional shareholders to exercise control over directors in a manner which eludes individuals.

This focus on shareholder control of directorial conduct has been heavily criticised. Wedderburn argues that this is the "shareholders' democracy of the nineteenth century joint stock company", and that directorial control should have moved with the times.⁵³ As long ago as 1945, the Cohen Committee noted the "illusory nature of the control theoretically exercised by shareholders over directors".⁵⁴ The Jenkins Committee of 1962 opined that shareholder democracy was "theoretically desirable", but its severe limitations were recognised.⁵⁵ Indeed, it has now become common place to deride the idea of shareholder democracy. Sealy argues that it is "an easy catchword"⁵⁶, leading the legislature to be "mesmerised by the congenial but false analogy with parliamentary democracy; their assumptions belong only to dream-world".⁵⁷ This analogy, Sealy argues, is false in that the majority of small companies do not hold meetings; larger companies do hold meetings but they are unrepresentative because of the management's control of the proxy votes; the initiative is with management; shareholders are generally apathetic; and, institutional shareholders mainly proceed on

⁵² Finch, "Corporate Governance and Cadbury: self regulation and the alternatives", (1994) *Journal of Business Law* 51, at 58. Note, however, the fact that there are a number of institutions where their shareholding is so great that "exit" is not such a viable choice.

⁵³ *Supra* note 3, at 6.

⁵⁴ DTI, *Report of the Committee on Company Law Amendment*, Cmnd 6659, 1945, paragraph 7(e).

⁵⁵ Cmnd 1749, paragraph 14.

⁵⁶ Sealy, *Company Law and Commercial Reality*, Sweet & Maxwell, 1984, at 29 and 61.

⁵⁷ *Ibid* at 61.

the basis of letting things be.⁵⁸ Sealy concludes that "any idea that shareholder democracy can be made to work as a counter to managerial powers is baseless, and has been shown to be false by every fieldwork study that has been undertaken, from those of Berle and Means in the 1930s to the present day."⁵⁹

Hopt argues that European moves away from shareholder democracy as a method of taming corporate power result from an apparent "dissolution" with the effectiveness of shareholder democracy.⁶⁰ Hopt continues that this is "hardly surprising" because, apart from the problems inherent in a large and varied ownership attempting to control powerful management, "the cost-benefit balance for small shareholders of investing more effort in participation and control is clearly negative".⁶¹ The Bullock Report on Industrial Democracy argued from a different direction, namely that "to regard the company as solely the property of shareholders is to be out of touch with the complex reality of the present day company as a complex social and economic entity, in which the powers of control have passed from the legal owners to the professional management".⁶² Wedderburn "reveals" by his analysis of the case law surrounding the doctrine of *ultra vires*, "the tensions of courts caught in a web of legal rules based upon "shareholders' democracy" against which the social facts rebel".⁶³ Moreover, he argues that the analogy of the 'city state' cloaks the relationship between the shareholders and the directors with unwarranted legitimacy.⁶⁴

Easterbrook & Fischel, advocates of the markets as means of control, decry the significance attached to shareholder control: "corporations are not participatory democracies "governing" the shareholders but are business entities affected by the market for their products".⁶⁵ Thus, opponents of shareholder democracy and control come not only from those concerned to regulate the company in the interests of wider constituencies (e.g. Wedderburn's emphasis on companies being more socially responsible), but from market theorists who decry all intervention in company management.

58 See, Sealy, *supra* note 56, and Finch, "Company Directors: Who Cares About Skill and Care?", (1992) 55 *Modern Law Review* 179.

59 Sealy, *supra* note 56, at 61.

60 Hopt, 'New Ways of Corporate Governance: European Experiments with Labor Representation on Corporate Boards', (1984) 82 *Michigan Law Review* 1138, at 1340.

61 *Ibid.*

62 DTI, *Report of the Committee of Inquiry on Industrial Democracy*, Cmnd 6706, 1977, Chapter 6, paragraph 2.

63 *Supra* note 3, at 23.

64 *Infra.*

65 Easterbrook and Fischel, *supra* note 47, at 396.

Yet the law reformers, despite the "illusion", continue to advocate increased powers for the general meeting and the shareholders' generally; the "reformers and would-be reformers will not give up their nostalgic striving after a wholly unattainable ideal".⁶⁶ This is not to say that shareholders are not able to exert and influence over management: shareholders can affect the management of a company, but this is not the continuous and effective control by owners, as is supposed in the true shareholders' city state. This view is not necessarily out of step with the criticisms referred to above. The ideal of shareholder democracy suggests that shareholders ought to be able to control their property, and that the company should act in their interests. The failure of this ideal in practice is not necessarily at odds with a recognition that shareholders can be influential; it merely recognises that shareholder control cannot be the sole means of control if there is to be effective regulation of directorial conduct.

The pursuit of the "unobtainable ideal" does continue. Thus, the Cadbury Committee saw its objective in terms of enhancing management accountability to the owners of the company, the shareholders.⁶⁷ In other words, it exactly espoused the classical orthodoxy criticised above to be so outdated and ineffective. Criticism of the Cadbury Report has come from all sides⁶⁸, although the Government's Corporate Affairs Minister, Neil Hamilton, stated that the report was an "authoritative statement of what needed to be done in a crucial area".⁶⁹ Moreover, the Confederation of British Industry stated that the increased responsibility on investors, particularly the institutional investors, set the "right sort of framework" for increasing directorial control.⁷⁰ A leader comment in one national newspaper⁷¹, criticised the Cadbury Report in that it did "little to re-engage the cogs of ownership with the engine of management from which it has been cut adrift". Thus, the Cadbury report was criticised on the basis that it did not improve the power of shareholders, the owners. Shareholder power is still considered a panacea for all regulatory ills.

However, it has been shown that the ability of shareholders to exert the required influence over their property is limited. That shareholders, particularly institutional

66 Wedderburn, *supra* note 3, at 23.

67 *Supra* note 8, paragraph 6.16.

68 See Chapter Three.

69 Reported in *The Guardian*, 2 December 1992. The opposition spokesperson on Corporate Affairs dubbed the voluntary Code a "recipe for inactivity", quoted in Finch, *supra* note 31, at 584.

70 *The Guardian*, 2 December 1992.

71 *Ibid.*

shareholders, can, to a certain extent, control the conduct of directors is accepted. It is the tacit approval of shareholder control as a substitute for all controls, and as the cure for all ills, which is refuted on a number of bases. First, shareholders do not have the zeal to concentrate on controlling the conduct of directors: it is more cost effective to sell their shares. Secondly, those shareholders who are interested in participating in the regulation of corporate activity may do so, pursuing their own agenda, which is contrary to the general interests of the company, or stakeholders other than shareholders. Thirdly, shareholders who do have the interests of the company at heart, and wish to take action to control the conduct of directors, lack the resources, knowledge and incentive, and face substantial legal obstacles, to taking such action.

Finally, the focus on shareholders alone refuses to acknowledge the other competing interests in corporate and directorial activity. Creditors have an interest in the company not becoming insolvent; shareholders may wish to write off the losses so that further are not incurred. Employees have an interest in maintaining employment levels, together with appropriate terms and conditions of employment; it is in the interests of shareholders wishing to achieve higher returns, to reduce staffing and pay. Consumers may be adversely affected by the sale of a product which has not been adequately tested; shareholders may benefit from immediate sales, even taking into account costs of future legal action. Society may wish rivers not to be polluted; shareholders wishing to achieve maximum profits may find it more cost-effective not to treat waste appropriately. The thesis is not that all the competing interests should have a say in management and control; the argument is that sheer reliance on shareholder self-interest is neither effective nor appropriate.

CONCLUSION

This thesis has examined the means by which the conduct of directors is controlled. Chapter One considered the operation of the markets for corporate control, products, and managerial talent. It was found that the markets exercised a discipline over corporate managers, but that such discipline may have adverse affects on third parties in terms of: first, the compliance costs associated with effecting the changes mandated by the markets; secondly, the impact of the markets on employees, consumers and creditors; and, thirdly, the adverse impact which focus on a company's share price may have on investment and management generally. Moreover, it was found that markets are not free, but are heavily regulated in order to facilitate one view of the operation of markets; namely, regulation in order to "free" the markets. In this light, it was concluded that consideration should appropriately be given to alternative means of regulating directorial conduct and markets.

Chapter Two examined the fiduciary duties of directors. It was found that the control mechanisms studied were either dependent on shareholder or governmental action. As a result of lack of funds, and lack of purpose, governmental control is negligible in comparison to the daily management of corporate activity in the UK. Governmental control tends to be focused on a small number of extreme cases where retributive action is taken in the interests of the public.¹ Control by shareholders is limited because of their lack of knowledge, resources, experience, and apathy. Thus, the part played by directors' fiduciary duties, and other specific controls and prohibitions, is important, but should not be relied on to control effectively directorial conduct.

Chapter Three considered the effect of the structure of the board of directors on directorial conduct. It was found that in this area substantial reforms have been made, primarily as a result of the report of the Cadbury Committee, and potentially the Greenbury Report. Although the Report endorsed the unitary board structure, it recommended that non-executive directors be increased in number, and that their role be substantiated in order to improve corporate governance. The Report's principal recommendation was its Code of Best Practice which it urged all companies to implement. However, it is unlikely that, even were the Code of Best Practice to be implemented in the spirit and letter by all companies, this would resolve all corporate governance questions. As the Chair of the committee, Adrian Cadbury, conceded:

¹ See Finch, "Personal Accountability and Corporate Control: The Role of Directors' and Officers' Liability Insurance", (1994) *57 Modern Law Review* 880, at 880-887, for a consideration of the purposes of the various means of corporate control.

"Codes will not catch rogues."² Brudney has argued that the reason why governments and boards of directors support non-executive directors is that they "function as a market substitute that is less costly than regulation".³ Moreover, it is a sop which may have the result of alleviating concern regarding governance, though achieving little. Further, to accept the non-executive director as a substitute for governmental aid results in "less protection for consumers, suppliers, workers, and the general public".⁴ The paradox is that non-executive directors would be better able to carry out their governance duties were they to be operating within a defined system of regulation. However, it is the very presence of the non-executive director which such a system is to replace.⁵ Moreover, since publication of the Report more stringent corporate governance practices have become the norm, particularly regarding the disclosure of directors' remuneration.⁶

Accordingly, it was suggested that a statutory structure for the board of directors be established which incorporates the benefits of non-executives, but also other parties which may improve the governance and control exercised over directors, particularly employees. Such a structure could take the form of a two-tier board. To this extent, the influence of Europe in terms of the draft Fifth EC Company Law Directive, and the moves to increase the participation of employees in companies, is to be welcomed.

Finally, Chapter Four analysed the role of shareholders in corporate governance, particularly the focus of shareholders as owners of the company, with rights akin to those of citizens in a representative democracy. It was found that institutional shareholders do have the power to exert considerable influence over corporate boards and individual directorial conduct, but that they often prefer not to become involved in detailed questions of corporate activity and management. Moreover, replacing control by individual shareholders with that of institutions was considered to be of potential concern as this may simply lead to domination by institutional shareholders following their own agendas, free from accountability, raising a whole new set of questions of accountability.

² Quoted in *The Guardian*, 17 July 1993.

³ Brudney, "The Independent Director - Heavenly City or Potemkin Village?", (1982) 95 *Harvard Law Review* 597, at 653.

⁴ *Ibid* at 654.

⁵ *Ibid* at 658.

⁶ See, *inter alia*, *Daily Telegraph*, 15 April 1995, and the Greenbury Report, *Directors' Remuneration - Report of a Study Group Chaired by Sir Richard Greenbury*, 1995..

Thus, it can be seen that each individual aspect of directorial control has its place in regulating the conduct of directors, but that the present regime, considered as a whole, does not adequately control the conduct of directors. Further, the question of in whose interests control should be exercised is becoming increasingly complex as companies increasingly have to consider interests wider than shareholders alone. It is suggested that such moves towards an increasingly pluralist view of the company are to be welcomed and should be reflected in any changes to the means of controlling the conduct of directors. Hence, markets could be regulated more in the interests of the public, rather than in the interests of competition for its own sake. This would not amount to an interference in free markets: markets are already heavily regulated, this would simply be altering the focus of such regulation. Corporate boards could be urged to take into consideration wider interests than those of the company's shareholders. Thus, the management function would remain with the executive directors, pursuing profit maximisation, but the interests of other constituencies would be more voluble and, in turn, increasingly pursued. The notion that shareholders can effectively regulate, or indeed should do so alone, directorial conduct, should finally be jettisoned. In its place, a more proactive part could be played by government: increasing the use of its powers of intervention in corporate affairs, disqualification of directors, regulation of markets in the public interest, and using statute to ensure effective governance of directors rather than reliance on self-regulation.

It should be noted that at present a number of areas of company law and activity are undergoing review. In November 1992, the Department of Trade and Industry announced that it would be looking at selected areas of company law as part of a "rolling programme of reform".⁷ Thus, a number of the areas of law which have been the focus of this thesis are being reviewed. However, the review is being carried out with "deregulation" in mind, which is unlikely to improve governance of directorial conduct.⁸ Moreover, the review is a piece-meal study of selected areas. Although the Law Commission is involved in a number of the reviews⁹, and a Law Commissioner

⁷ DTI Press Notice, 18 November 1992. The areas of law for reform identified by the DTI are as follows: private companies, Part X of the Companies Act 1985, Part V1 of the Companies Act 1985, the law on groups, section 151 of the Companies Act 1985, dis-incorporation, registration of company charges, the 11th and bank branches directive (registration of overseas companies), public companies and paid up capital, company names, written resolutions, objects clauses, execution of documents, redeemable shares, company voluntary arrangements, disqualification and accounting reference dates.

⁸ Speech by Neil Hamilton, Minister for Corporate Affairs, to the Institute of Company Accountants, quoted in *Palmer's In Company*, 20 October 1993, at 1.

⁹ For example, the Law Commission is conducting a review of shareholders' rights and remedies, see (1995) 16 *Co Law* 61, and Freedman, 'Reforming Company Law' in Patfield (ed) *Perspectives on Company Law: 1*, Kluwer Law International, 1995.

has been appointed with specific responsibility for company law¹⁰, there remains lacking an overall review of company law as a whole. The subtle changes in the focus of company activity noted above, namely the increasing role of third parties in corporate activity, will not be considered as the whole system, and its fundamental principles, are not under review. It is exactly this type of short term, and incomplete, review which has been so criticised in the past.¹¹

Thus, it does not appear that in the near future legislative action on controlling the conduct of directors will be taken. A number of reviews may produce improvements, for example in relation to shareholder remedies, but the system will continue to be piece-meal and subject to many of the criticisms made in this thesis. It is to be hoped that such a view does not represent what will actually happen. However, in the meantime, the pressure must continue to be applied to those proponents of the status quo, in order that the governance of the company is effected in a manner which adequately supervises directors, and is in the interests of a wider body of persons than only shareholders.

¹⁰ *Ibid.*

¹¹ Sealy, *Company Law and Commercial Reality*, Sweet & Maxwell, 1984; Morgan, "A Cold Climate for Business?", *Law Society Gazette*, 8 December 1993, at 3; *Palmer's In Company*, 20 October 1993, at 1; editorial, (1993) 14 *Co Law*, at 162. Moreover, paragraph 6.5 of DTI, *Company Law Review: The Law Applicable to Private Companies*, A Consultative Document, November 1994, states that precise conclusions on its proposals cannot be made as other reviews are still pending. Of course, this will apply to all reviews conducted, and it is suggested, will result in inconsistency and incoherence.

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