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CHANGING PATTERNS OF CORPORATE RESPONSIBILITY AND ACCOUNTABILITY

By

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ABSTRACT

This thesis focuses attention on three central issues facing company law. One, the growth of corporate power and influence in society; two, the adequacy of the traditional concepts of company law; and three, the need to improve existing methods and devise new methods of monitoring the management of companies.

The first part of the study seeksto identify the conceptual foundations of modern company law and to analyse how these concepts have permitted the growth and institutionalisation of the company in society. Different attitudes towards, and changing patterns of, corporate responsibility are examined as are demands for greater accountability. In the context of the examination of corporate accountability, the experience of some European countries with employee representation on company boards is evaluated. This is followed by a discussion on the impact of employee representation on the functioning of company law concepts.

The second part of the study concentrates on the role of corporate boards in terms of law practice and institutional changes designed to give boards a more effective role in terms of monitoring managements, for example, through non-executive directors and audit committees.

The study concludes with an analysis of the role and function of disclosure, accounting and audit in the context of the debate on greater corporate accountability, and in particular, of the American and European experience and of the impact of the European Community's harmonisation programme.

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CHAPTER ONE

INTRODUCTION

1. Birth of Corporate Power

The notion of the corporation is deeply embedded into the history of the British legal system. It was originally applied mainly to ecclesiastical bodies to burghs, and to guilds both mercantile and craft. Such corporate form was achieved by a grant from the sovereign and later Parliament. Its principal legal incidents being the capacity to hold property, to sue and be sued, limited liability for its members and the ability to persist beyond the lives of its members. Its basic function was to regulate the affairs of its members not to create any form of trading association and to that end it had internal legislative and judicial power. The actual trading was carried out by individual members on their own account.

In the sixteenth and seventeenth centuries the notion of the legal entity of a group combined with the financial device of joint stock trading to bring about what might be termed the business corporation. As opposed to the original function of the corporation to regulate the internal administration of a trade or town, the purpose became external to the corporation, for example, the development of foreign trade. Here each member instead of trading with his own stock agreed to pool it in joint enterprise. Thus there grew up a distinction between regulated companies in which every member was free to trade as he pleased subject to the internal rules and the joint stock company in which individual trading was forbidden.

The device of incorporation soon became popular and indeed necessary as the objects pursued were beyond the reach of the members as individuals, the required amounts of capital too great, risk too high and the duration of the enterprise too long. The device of incorporation was the ideal legal institution which could hold the aggregated capital of many over a period of time unaffected by the death or withdrawal of individuals. It could be given a precisely defined objective tailored to a concrete state purpose. Its activity was under the effective control of the courts, through which it could be held within its granted powers and, if it failed to operate its powers could be withdrawn. Because of its very considerable position of privilege in the society, legal policy demanded that each corporate charter be granted only after thorough examination and evaluation. Strict limitations were placed on its size and the scope of its activities in the charter and were enforced stringently.

By the middle of the seventeenth century, however, the foreign trading companies began to decline as it was accepted that their governmental powers were best exercised by the state itself and their monopoly powers an unnecessary restraint on trade. This decline was aćcompanied by a rapid growth in domestic trade and the practice of companies being formed on a joint stock basis without formal legal incorporation of any kind. The basis of these bodies was contractual, they were formed by a deed of settlement predecessor of the modern company memorandum and articles. Due very largely to the ingenuity of the legal profession they emulated in many respects incorporated companies. In law they were nothing more than partnerships but capital was raised by subscription from the public and members received transferable shares. The property of the enterprise was settled on trustees who administered the funds on behalf of the members. Attempts were made to limit the liability of the members to the assets of the partnership by including a clause to that effect in the deed but these were of dubious validity.

Following a spate of company promotions and frantic speculation in stocks and shares climaxing in the South Sea Bubble, legislation was passed in 1720 which sought to prohibit unincorporated trading associations from creating transferable shares. In addition the Act sought to curtail the trafficking in charters of defunct companies. The effect of the legislation was that, apart from a few of the larger enterprises which secured charters, the business community was forced to operate within the limits of unincorporated partnerships in which participation of the parties was a personal matter which were exempt from the Act. As Gower points out, (1969 p.33) paradoxically the 1720 Act caused a rebirth of the type of business enterprise which it had sought to attack.. Instead of making incorporation more readily available to the business community the Government placed almost impossible difficulties in the way of incorporation and thus relinquished control to business and the legal profession who used their ingenuity to seek alternative devices. Thus the unincorporated partnership was developed throughout the eighteenth century as the standard form of business enterprise.

By contrast to the somewhat frantic activity in England, Scots law, with its strong continental links, was proving a more fertile ground for the development of an efficient unit within which to operate commercial activity. During the seventeenth century and earlier part of the eighteenth century the idea that the business unit is a separate persona from the members had already taken root and according to Clark -

> "there seems no reason to doubt that if this and kindred principles had been developed by equitable tribunals dealing with questions presented by commercial relations sufficiently numerous and varied, a system of partnership law would, almost independantly of legislative interference, have long grown up which while checking reckless speculation would have enabled bona fidei associations to attain the benefits of limited liability." (1866 p.2)

Indeed, the Bubble Act received little attention, there appears to be only one case where it was actually referred to[1]. Clark continues -

> "In Scotland the law of private partnership in as much as it recognised the separate personality of the firm, forced a much more favourable point of departure for the joint stock company - Scottish tribunals instead of being opposed to such associations were apparently inclined to foster their interests by giving as elastic interpretation as possible to the law of partnership. . . Indeed except for attaining limited liability and more precision in management, the want of legislation was scarcelyfelt. . ." (1866 p.6)

However with the industrial revolution and consequent increase in capital which could usefully be committed to single ventures, enterprises were reaching the situation where corporate organisation was the only answer. There arose a demand for corporate status on a more accessible basis in which the idea of legislative examination of each application was to become progressively more of an illusion.

Some had doubts about the proliferation of the limited company as a business enterprise, viewing it with suspicion as an institution which could develop to such an extent as to encroach upon individual liberty. One American jurist commented:

> "Although the value of this instrumentality in commerce and industry was fully recognised, incorporation for business was commonly denied long after it had been freely granted for religious, educational and charitable purposes. It was denied because of fear. Fear of encroachment upon the liberties and opportunities of the individual. Fear of the subjection of labour to capital. Fear of monopoly. Fear that the absorption of capital by corporations, and their perpetual life, might bring evils similar to those which attended mortmain. There was a sense of some insidious menace inherent in large aggregations of capital particularly when held by corporations." [2]

For the most part, however, changes in the legal framework governing the activities of business enterprises were seen as a wholly desirable objective. The greater accessibility of corporate status and limited liability would, it was argued, bring considerable benefits to society. For example, a Select Committee on Investments for the Savings of the Middle and Working Classes in 1850 asserted that changes in the legal framework were desirable on social grounds.

> "the great change in the social position of multitudes from the growth of large towns and crowded districts, renders it more necessary that corresponding changes in the law should take place both to improve their condition and contentment, and to give additional

> facilities to investors of capital which their industry and enterprise is constantly creating and augmenting. It is the conviction of your committee that if such measures were carried into effect, a stimulus would be given to the industry of the community, likely to cause additional employment and contentment without injury to any class and added security to the welfare of all." [3]

Members of Parliament were prompted to make somewhat extravagant claims as to the industrial and political benefits of the introduction of limited liability.

> ". . . the change proposed would have important social bearings tending materially to diminish the distance between capital and labour interests, sometimes apparently but in reality always identical; and that it would be socially, politically and economically beneficial." [4]
>
> ". . . because it is one of the social blots of this country that capital had such a tendency to accumulate in great masses and in few hands - because the removal of the present law would tend to diffuse capital - because it would tend to bridge over the gulf which now divided different classes, and to diminish that spirit of alienation between employers and employed which we all deplore - the Government should sanction the change".[5]

In reality what happened was exactly the opposite. Workers could hardly welcome a system in which they became wholly dependent on the success of the enterprise but which allowed the owners to limit their risk. The advent of limited liability arguably did much to dehumanise the employment relationship, alienating worker from the job.

By 1856 the basic foundations and philosophy of British company Law had been laid. Introducing the Companies Act 1856 Robert

Lowe expressed the objective of the legislation as follows:

> "The principle we should adopt is this, not to throw the slightest obstacle in the way of limited liability companies being formed ... and when difficulties arise to arm the courts of justice with sufficient powers to check extravagance or roguary. That is the only way the legislature should interfere with the single exception of giving the greatest publicity to the affairs of such companies that everyone may know on what grounds he is dealing." [6]

Thus the legal framework for the operation of the capitalist system was complete and has remained relatively intact despite the fact that the political philosophy which was its principle justification is no longer regarded as appropriate. The type of business,organisation that emerged after the mid-nineteenth century incorporation with limited liability by an easy process of registration, inevitably owed much to the earlier unincorporated partnership, based essentially on contract. This was in contrast to other countries where the model was the legislative or chartered corporation. Most notable was the USA where incorporation by registration under general legislative authority came earlier than in the UK and whose development owed more to public than private law.[7] As one judge observed:

> "A corporation is a creature existing, not by contract, but in this country is created or authorised by statute; and its rights and even modes of action, may be and generally are, defined and marked out by statute; and when they are, they cannot be changed; even by the contracts of the corporations".[8]

Because of the influence of the developing law of contract UK company law possessed the inherent flexibility of contract, which as a legal device, suited the business community. Based on the notion of freedom it became, as one writer commented:

> "a device for entering legally unsupervised relations",[9]

and did much to liberate the economy from the restrictions of the earlier periods. The nineteenth century entrepreneur demanded freedom to take on or dismiss employees at a moment's notice, thus there developed the notion of a contract of employment terminable at will; he also demanded easy access to capital for growth without too many constraints, leaving him free to run his business without outside interference. The capitalist demanded a mechanism whereby he could maximise the benefit to be derived from his capital without putting it at risk and giving him freedom to withdraw and reinvest in more profitable outlets. The law provided this by a combination of the corporate form entered into by a simple contract. There was no need for further state interference:

> "the charter which had once drawn its force from the grant of the sovereign became a bargain among the enterprises. Who was to limit the terms of the bargain? As in other areas of the law ... it came to be assumed that the bargainer knew best his own interest and how to secure it, and that the sum of the interests of the bargainers equalled the interests of the whole society".[10]

Where nations such as the USA developed mandatory legislative rules, British company legislation relied on the technique of providing a standard form of association which applies in the absence of contractual provisions to the contrary.[11] This constitution, as amended by the incorporators, is expressly declared by the legislation to bind the company and its members as if it were a contract under seal.[12] More particularly the contractual constitution specified the method of appointing directors, the division of authority between the board and the members and rules on voting and the members. As company law developed alongside the law of contract it embodied the same values of freedom, equality and self government.

> "Contract law was to be liberating and facilitive, a channel for the release of energies."[13]

As a substitute for the supervision that the state formerly exercised over the corporate administrators, the force of the market was seen as the primary means by which undesirable business activity was checked, that is the withdrawal of support resulting in financial failure. There was no need of a complex system of state regulation, this would hinder growth, stifle competition and reduce the flexibility of market operations. The theoretical model was one of a market consisting of a large number of participants able to adjust their actions in response to the changing economic climate. Management of the economy was surrendered by the state into the hands of private enterprise. In earlier periods the grant of corporate status had been used by private individuals for public purposes; the nineteenth century attitude towards corporate status was one whereby private groups used the state in the enrichment of private interests. As Davis asserts:

> "the growth of private corporations in Western Europe and the U.S.A. signified nothing less than a social revolution." (1905 page 248)

The introduction of more accessible corporate status, the flexibility provided by the law of contract and the general climate of opinion favouring the growth of business enterprise and the release of the energies of the individual, made it possible for the "incorporators" to assume considerable power. It was they, not the State, who defined the values of the company and fixed the allocation of the basic functions within the enterprise. In permitting this great power to be exercised by individuals in the name of freedom and enterprise with only a minimum of regulation Governments help create, in the words of a U.S. judge,"a Frankenstein monster".[14] Corporate controllers have through the exercise of constituent power been able to design the principal functions and distribute power within the enterprise in a basic structure which in many respects offends against any notion of democracy. Company constitutions as expressed in memorandum and articles and as interpreted by the judiciary, permit the disenfranchisement through manipulation of the voting rights of owners of the various classes of shares, they institutionalise minority rule through the diffusion of share ownership and separation of ownership from control, deny a voice within the enterprise for the workforce, community and the consumer. As Berle pointed out, in the exercise of their constituent power the corporate controllers have fashioned massive clusters of antidemocratic force and influence:

> "management has substantially absolute power
> and the only real control which guides or limits
> their economic and social action is the real,
> though undefined and tacit, philosophy of the men
> who comprise them." (1954 page 180)

2. Objective

It is intended in this study to examine the growth of corporate power and influence in the context of the legal framework and functioning of legal concepts. The study broadly focuses attention on two issues facing company law. One is the law's response to the institutionalisation of the corporate enterprise in society and changing patterns of responsibility and accountability. Second, and very much related to the first, is the need to improve existing methods and devise new methods of monitoring the management of companies. By its nature such a study necessitates drawing on developments in other jurisdictions, in particular postwar European experiments on employee representation and ~~and~~ the impact of the E.E.C. harmonisation programme. In addition analysis, evidence and experience from North America on certain issues of corporate accountability have been used.

Although essentially a study in company law, the intention has been to keep to a minimum the exposition of legal rules other than the basic framework outlined in chapter two. Using evidence and material drawn from other social sciences such as accounting, industrial relations and business studies, the study aims to obtain a broader picture of the corporate enterprise in society and thus expose the legal framework to more critical analysis.

Footnotes - Chapter One

1. Masons of the Lodge of Lanark v. Hamilton (1830) M14 554

2. Justice Brandeis in Liggett Co. v. Lee 288 US 517, 548, 1933 or see Berle A.A. Economic Power and the Free Society page 56 1957.

3. 1850 B.P.P. Vol. XIX 172.

4. S. Collier M.P. moving a resolution to modify the law on limited liability 1854 Han. 3rd Ser.Vol.134 Col.759

5. D. Cobden, M.P. Ibid col. 785-786.

6. Parl.Deb. 1856 Vol. 140 col.131.

7. See Dodd M. 1954

8. Perkins J. in Ohio Ins.Co. v. Nunnemacher 15 Ind. 294,195 (1860).

9. Selznick 1969 page 3.

10. Chayes- "The Modern Corporation and the Rule of Law" in The Corporation in Modern Society: Mason (Ed) p 36 1970.

11. See Companies Act 1948 Schedule 1 Table A.

12. Ibid section 20.

13. Selznick 1969 page 53.

14. Justice Brandeis in Liggett Co. v. Lee 288 US 517, 567 1933.

CHAPTER TWO

CONCEPTUAL FOUNDATIONS OF COMPANY LAW

In the context of this study five basic concepts of company law may be identified as central to the issues of corporate responsibility and accountability.

1. Corporate Existence

The most significant attribute of incorporation is the notion that the company is a legal entity quite distinct from its shareholders or officers. Unlike a partnership which in law is simply a collection of individuals, a company is a metaphysical entity, a fiction of law. In the words of the judiciary, "it is a mere abstraction"[1]; "at law a different person altogether from the subscribers to the memorandum"[2].

A company is thus able to enjoy rights and is subject to duties that are quite distinct from the members. Even where the company is dominated by one person with effective ownership and control over the company's business and is, to all intent and purpose, a one-man operation, the doctrine of separate legal identity will still operate. This was firmly established in what has since been described as the "calamitous decision"[3] in Salomon v. Salomon & Co.[4] where the House of Lords confirmed that in the absence of fraud the separate identity of a company will always be respected:

> "it was impossible to dispute that once the company was legally incorporated it must be treated like any other independent person with its rights and liabilities appropriate to itself, and that the motives of those who took part in the promotion of the company were absolutely irrelevant in discussing what those rights and liabilities were". (page 30)

The effect of this decision was that even where there is no particular business risk and no need for outside capital, traders were induced by the law on an increasing scale to conduct their business in the form of a limited liability company. The case gave judicial acceptance to the notion of the one man company and vividly illustrated how it was possible not just to limit liability to the extent of the investment that one makes but to avoid any serious risk to that investment by subscribing for debentures instead of shares.

The concept of separate entity thus enables the company to own property in its own right quite distinct from the members. Indeed, members have no direct proprietary rights in respect of the company's property, although they may claim residual assets in case of liquidation. The only rights of the members are in respect of the shares they hold:

> "shareholders are not in the eyes of the law part owners of the undertaking. The undertaking is something different from the totality of the shareholdings".[5]

As a consequence of the concept, companies are able to conduct litigation, enter into contracts and other simple legal transactions. Corporate status, in addition, gives perpetual succession and an efficient method of transferring the interests of the members.

It has, however, long been recognised by both the legislature and the judiciary that the concept of separate corporate personality may be ignored where equitable, economic or moral considerations no longer justify its application. The Companies Acts seek to protect the interests of creditors from the abuses of the concept by imposing personal liability on individuals who are knowingly party to any business carried on with intent to defraud creditors or for any fraudulent purpose;[6] as where, for example, the number of members falls below the statutory minimum every member aware of this breach is liable severally for the debts of the company[7]; or where there is a group of inter-related companies the group may be treated for certain purposes as the true entity rather than a group of individual entities.[8]

The legislature has thus taken what might be termed an enterprise view, on occasion treating a group as a joint economic entity. The courts, however, have never wholly overcome the formalistic restraints of Salomon's case. They have been prepared to disregard the separate entity principal in cases where the corporate form has been used as an alias or agent in order to perpetrate a fraud or improper conduct. Where the effect of a strict application of the doctrine is to frustrate the purpose of a legislative provision the courts have also been prepared to "pierce the veil". Arguably, the most interesting development has been the slow recognition by the courts, following the example of the legislature, to recognise that in certain circumstances a subsidiary may be treated as agent for a holding company. Lord Denning has said:

> "The doctrine laid down in Salomon's case has to be watched very carefully. It has often been supposed to cast a veil over the personality of a

> limited company through which the courts cannot see. But that is not true. The courts can, and often do, draw aside the veil. They can, and often do, pull off the mask. They look to see what really lies behind. The legislature has shown the way with group accounts and the rest. And the courts should follow suit. The subsidiary is the creature, the puppet, of Littlewoods in point of fact: and it should be so regarded in point of law".[9]

The same judge quoted with approval a statement by Gower that:

> "There is evidence of a general tendency to ignore the separate legal entities of various companies within a group, and to look instead at the economic entity of the whole group".[10]

Although in its infancy in the context of judicial attitudes in the U.K. such a principle has been recognised in other jurisdictions. In West Germany if a parent company owns all the shares of a subsidiary, although retaining separate legal personalities, they form one economic unit and the parent is liable jointly and severally for the debts of the subsidiary.[11] The Court of the European Communities has adopted a similar approach of recognising the economic entity:

> "The fact that the subsidiary has a distinct legal personality does not suffice to dispose of the possibility that its behaviour might be imputed to the parent company. Such may be the case in particular when the subsidiary, although having a distinct legal personality, does not determine its behaviour on the market in an autonomous manner but essentially carries out the instructions given to it by the parent company. When the subsidiary does not enjoy any real autonomy in the determination of its course of action on the markets, the prohibitions imposed by Article 85(1) may be

> considered inapplicable in the relations between the subsidiary and the parent company, with which it then forms one economic unit. In view of the unity of the group thus formed, the activities of the subsidiaries may, in certain circumstances, be imputed to the parent ..."[12]

In another case the Court held that:

> "Where a parent company legally and institutionally controls its foreign subsidiary and in fact favours its subsidiary in supplying an essential raw material which it is withholding from a competitor, then as regards that competitor the parent and subsidiary may be regarded as a single economic unit and jointly and severally responsible for the conduct complained of. In addition, the parent company, being registered in and a resident of U.S., will be regarded as doing business within the E.E.C. where its subsidiary is established within the Community".[13]

Company law is essentially based on property and throughout the concepts of company law seek to highlight the separation of entities' property from the members. Viewed in that light the tenacity with which the law and the legal policy has clung to the Salomon principle is hardly surprising. However, "concepts of company law must give way to the realities of life where ethical and economic considerations no longer justify their application."[14]

To that extent the moves towards legislative and judicial acceptance of the economic entity principle are a concession to reality.

2. Corporate Property

The notion of a company as a separate entity is the central thread of company law. It dictates much of the detailed fabric of the law, in particular the law's approach to corporate property. When individuals take shares in a company they do not acquire assets in the form of a claim over the property of the company, they simply acquire a bundle of rights.

> "The shareholder has no property in nor right to any particular asset. He has only the right to have all the assets administered by the directors in accordance with the constitution of the company."[15]

In the words of Lord Porter:

> "In the case of land the owner possesses a tangible asset, whereas a shareholder has no direct share in the assets of the company. He has such rights as the memorandum and articles give him."[16]

The Permanent Court of International Justice summarised the position as follows:

> "The decisions of the principle of the highest courts of most countries continues to hold that neither the shareholders nor their creditors have any right to the corporate assets other than to receive during the existence of the company a share of the profits, the distribution of which has been decided by a majority of shareholders and after its winding up a proportion of the assets."[17]

What then is a company entitled to do with its property? Is it free to deal and dispose of it as it pleases?

The answers to these questions lies in the application of the ultra vires principle, developed under British company law in the early days of the limited liability company of the mid-nineteenth century to protect investors and creditors.

Thus a company incorporated under the Companies Acts cannot lawfully carry out any activity which is not authorised by its stated objects.

The rule assumes that a company does not exist beyond its purpose and is incapable of acting outside of it. It has often, somewhat erroneously, been attributed to the application of the separate entity principle, but rather it developed as a response to the granting of limited liability. It had never been applied to partnerships, where although a partner could never bind his fellow partners without authority, the action could always be ratified.[18] Nor had it been applied to the early joint stock companies since investors were protected by the requirement for unanimous consent in respect of fundamental changes and creditors by unlimited liability.

In Ashbury Railway Carriage and Iron Co. v. Riche[19] reference was made to the legislation's requirement that the company's objects should be stated in its Memorandum:

> "It (the objects clause) states affirmatively the ambit and extent of vitality and power which by law are given to the corporation, and it states, if it is necessary so to state, negatively, that nothing shall be done beyond that ambit, and that no attempt shall be made to use the corporate life for any other purpose than that which is so specified." (at 668)

The doctrine thus became firmly embedded into company law with consequence that any ultra vires contract or activity by a company was technically of no effect, no rights arose, no rights could be enforced.

The severity of the rule was mitigated in two respects. First, by the implied powers doctrine that a company merely by its existence had certain implied powers. Thus the courts regarded everything reasonably incidental to the achievement of its objects as intra vires.[20] Second, by the ingenuity of the legal profession.

It became standard practice to include in memoranda a long list of objects and powers that a company might at some future date pursue. Indeed, judicial approval of subjective clauses giving the directors power to carry on any trade or business whatsoever which can, in their opinion, be advantageously carried on by the company, effectively frustrated the object of the rule.[21]

The courts have sought to restrain evasion of the rule by the application of the ejusdem generis rule of interpretation. However, the limiting effect of this rule has been avoided by the use of clauses stating that each object specified is to be regarded as independent to the others.

Thus in the words of the Cohen Committee:

> "In consequence the doctrine of ultra vires is an illusory protection for the shareholders and yet may be a pitfall for third parties dealing with a company" and that "as now applied to companies the doctrine serves no useful purpose but is, on the other hand, a cause of unnecessary prolixity and vexation." (Cmnd 6659 para 12)

To companies the inconvenience of the rule was greatly reduced by the changes in the 1948 Act making it easier to alter objects.[22] Section 9 of the European Communities Act now, however, operates to bind a company in favour of a person dealing with the company in good faith when the transaction has been decided on by the directors. The section does not abolish the ultra vires rule but, somewhat inadequately, seeks to protect innocent third parties dealing with a company.

3. Corporate Government

As indicated in the previous chapter, the basis of the law in respect of the organs of a company and its management is the law of contract. It was contract that provided the conceptual freedom that enabled the capitalist to liberate the economy of the nineteenth century. Section 20 of the 1948 Act provides that:

> "The memorandum and articles shall, when registered, bind the company and the members thereof to the same extent as if they respectively had been signed and sealed by each member and contained covenants on the part of each member to observe all their provisions."

This section thus creates "a contract of the most sacred character"[24], it is in fact more in the nature of an instrument of Government. Unlike ordinary contracts, its terms can be varied without the consent of all the parties[25] and indeed not all the normal contractual rules apply to it.

The contract under Section 20 is one which is not only enforceable against the company but also among the members inter se[26] but only in so far as it confers rights on a member in his capacity of member. The extent of the members' rights to sue in respect of a breach of the articles is, however, confused. All members have an unfettered right to a declared and payable dividend[27], and a right to exercise their vote.[28] It seems, however, that the rule is subject to the proviso that if the breach is one which could be put right by an ordinary resolution of the company, the individual shareholder may not raise an action.[29]

This contract based approach to company law gives the U.K. its most prominent feature, flexibility. The incorporators are enabled to draw up the constitution of the company in their own terms and ensure that a sufficient and sometimes unnecessary degree of freedom to manage is delegated to the directors. Since this is embodied in a contract the shareholders will not be entitled to interfere in the management of the company or to dictate to the directors how it shall be run.

> "If powers of management are vested in the directors, they and they alone can exercise these powers. The only way in which the general body of the shareholders can control the exercise of the powers vested by the articles in the directors is by altering their articles."[30]

> "The directors are not the agents of the shareholders. Once given the power to manage the company, they can exercise the power according to their best judgment, until removed from office."[31]

The ability of the incorporators to utilise the flexibility of contract in order to secure their position, even to the extent of thwarting a provision of the Companies Act and making a "mockery of the law"[32], was illustrated in Bushell v. Faith[33]. The right to remove a director at any time under a section 184 resolution was effectively removed by a clause in the articles weighting the shares held by the directors in the event of such resolution being proposed and voted on.

Articles can therefore be drafted to provide whatever allocation of power that is desired, and legal control may be enshrined in the articles by the use of carefully drafted clauses, non-voting shares, multiple and variable voting rights and special majorities.

4. Corporate Management - Duties

Company law thus gives the directors a constitutional independence of the general meeting. The shareholders elect the directors and delegate to them the power to manage the affairs of the company. In return the directors owe to the company fiduciary duties arising out of their special position of trust and duties of care and skill.

Such duties are owed to the company and not to any individual member. Thus, if a director makes use of confidential information at the expense of a shareholder he incurs no liability to account to that shareholder for breach of a duty[34], unless it can be proved that the director was acting on behalf of a shareholder in a transaction.[35]

(a) Fiduciary

There are two broad facets of the directors' fiduciary duties. One is that they are required to act in good faith for the benefit of the company, using their powers properly. Two, that they must not place themselves in a position in which their duties and personal interests conflict.

The first aspect of the duties requires the directors to exhibit the highest loyalty and good faith towards the company and act within the scope of powers granted by the internal regulations. They must exercise their discretion: "in what they consider, not what a court may consider, is in the interests of the company and not for any collateral purpose."[36]

Provided that the directors can establish to the satisfaction of the court that they honestly believed the action to be right, the court will not interfere:

> "I believe the directors' opinion of the needs of the company was imprecise, probably intuitive and may be erroneous, yet each of them addressed his mind to the relevant problem and exercised the power *bona fide*".[37]

If, however, the directors are perceived to be acting in the interests of some other party, or their own interests, irrespective of dishonest intent, without considering the interest of the company as a whole, they will be in breach.[38]

> "The proper test ... must be whether an intelligent and honest man in the position of a director of the company concerned could ...have reasonably believed that the transactions were for the benefit of the company."[39]

The expression "benefit of the company" has not always been clearly understood. It does not mean the company as an economic entity in terms of the *Salomon* principle: "the phrase the company as a whole does not mean the company as a commercial entity as distinct from the corporators."[40]

As was said in the Savoy Hotel case:

> "The company did not mean the sectional interests of some (it may be a majority) of the past members or even the present and future members of the company ... the board shall conduct the company's business upon the footing that it would be continued as a going concern and accordingly should balance a long term view against short term interests of the present members."[41]

There is no confusion as to the fact that the interests of the company excludes employees, consumers or even the wider public interest except in so far as they coincide with the shareholders.[42] Whilst the company has a viable long term future the fact that the directors must in law take account exclusively of the members' interests, presents few problems. A contented workforce and good consumer and public relations is in the interests of the shareholders and thus expenditure to that end may be justified under the legal formula.

As a Canadian judge has said:

> "In defining the duties of directors the law ought to take into account the fact that the corporation provides the legal framework for the development of resources and the generation of wealth in the private sector ... A classical theory that once was unchallengeable must yield to the facts of modern life. In fact, of course, it has. If today the directors of a company were to consider the interests of its employees no one would argue that in doing so they were not acting bona fide in the interests of the company itself. Similarly, if the directors were to consider the consequences to the community of any policy that the company intended to pursue and were deflected in their commitment to that policy as a result, it could not be said that they had not considered bona fide the interests of the shareholders." [43]

In the event that the company has no viable future there can be no point in pleasing other interest groups such as employees and in these circumstances the interests of the company is taken to mean those of the present members.[44]

Directors are not allowed to act for a "collateral purpose"; that is they must not use their powers, though acting within the literal scope, in order to benefit themselves. This does not mean, however, that they are required:

> "to live in an unreal region of detached altruism and to act in a vague mood of ideal abstraction from obvious facts which must be present to the mind of any honest and intelligent man when he exercises his power as a director".[45]

Nevertheless, even if the directors have acted without self-interest in using their powers to issue shares: "the absence of any self-interest is (not) enough to make an issue valid."[46]

In Howard Smith Ltd. v. Ampol Petroleum Ltd.[47] the Privy Council rejected the idea that all that is required of directors with regard to the exercise of their powers is that they must act in good faith in the interests of the company.

> "Having ascertained on a fair view the nature of this power, and having defined as can best be done in the light of modern conditions, or some limits within which it may be exercised, it is then necessary for the court, if a particular exercise of it is challenged, to examine the substantial purpose for which it was exercised and to reach a conclusion whether that purpose was proper or not." (at 832)

The second facet of the directors' fiduciary duties may be reduced to three propositions. First, a director, like any other agent:

> "has duties to discharge of a fiduciary character towards his principal, and it is a rule of universal application that no one having such duties to discharge shall be allowed to enter into engagements in which he has or can have a personal interest conflicting or which may possibly conflict with the interests of those whom he is bound to protect." [48]

Second, the director may not make any profit out of his position or make use of any corporate property:

> "Men who assume the complete control of a company's business must remember that they are not at liberty to sacrifice the interests which they are bound to protect and, while ostensibly acting for the company, divert in their own favour business which should properly belong to the company." [49]

The principle encompasses not only property in the orthodox sense, but trade secrets, plans, designs and any misuse of information. Thus if a director obtains information or an opportunity which is of such a nature that it ought to be disclosed to the company, a failure to do so will amount to breach.[50]

Third, it seems that this duty does not prohibit a director from being a member of a board of another company in direct competition with the company.[51] This rule appears to be at odds both with general principles of agency and partnership. Indeed, section 30 of the Partnership Act 1890 precludes parties from entering into competition with the business. The only protection for the members would be a clause in the articles or in the director's service contract.[52] This position contrasts sharply with the employees' common law duties where it has long been recognised that an employee is forbidden from working for a competitor.[53]

This is despite the fact that the general duty of fidelity that the employee owes to his employer has been recognised to be less onerous than an agent's duties. Thus if employees at some future date are allowed representation on company boards the anomqlous position will exist whereby an ordinary director may take office in a competing company but the employee director would be in breach if he took a spare time job with a competitor.

Lord Denning[54] has suggested that a director holding interlocking directorships who subordinates the interests of one company to the other risks an application under section 210. However, it seems that simply because a director sits on a competing board, does not of itself render his conduct within the scope of section 210.[55]

To add to the anomaly, in nationalised industries competing directorships are often forbidden by statute.[56]

(b) Duties of Care and Skill

The standards of care and skill that the law demands from directors are regrettably low. By comparison to auditors, agents and employees of a company where the law demands that they display such a degree of skill as would be expected of a reasonably competent member of that particular trade or profession, directors are required to display, "such care as is reasonably to be expected from them having regard to their knowledge and experience."[57]

Thus, if a company appoints an incompetent director all that it can expect from that director is that he shall apply to the affairs of the company the same standard of care as he would apply to his own affairs.

The problem lies in the fact that there is as yet no recognised profession of director, no notional reasonable director on the Clapham omnibus against whose conduct and competence individual activity may be judged. As one American judge commented:

> "Directors are not specialists, like lawyers and doctors. They must have good sense, perhaps they must have acquaintance with affairs; but they need not - indeed, perhaps they should not - have any technical talent. They are general advisers of the business and if they faithfully give such ability as they have to their charge, it would not be lawful to hold them liable."[58]

The present requirements are a positive disincentive for directors to take an active role in corporate affairs, a role such as may reasonably be expected of them by shareholders, employees and the public. The function of the law in the context of business should surely be to create the legal environment which protects and fosters the legitimate interests of the participants in industry and underpins society's expectations of business. There must be grave doubts about whether U.K. law even remotely performs this function when the judges advise directors under the present legal framework to, "avoid meetings and avoid experience. They will step up your duty of care."[59]

> "However ridiculous and absurd their (the directors') conduct might seem, it was the misfortune of the company that they chose unwise directors."[60]

A director will not therefore be liable for mere "errors of judgment" or "mere negligence" but only for "gross negligence in the business sense."[61]

It is intended to examine in the following chapters the effectiveness of corporate boards in monitoring the management of companies and rendering them more accountable to the various interest groups. It cannot be a hopeful start that the lower the director's qualifications, the less attention he pays to his job, the greater confidence he places in others, the lower will be his legal duty.

Corporate Democracy - Majority Rule

Theoretically, companies are governed by a majority of the members exercising their votes at the general meeting. They elect the directors and delegate to them the day to day running of the company. It is essential, as in all democratic institutions, that the directors secure the continued support or at least acquiescence of the majority, in order to retain office. The majority may confirm or ratify any breach of the directors' duties in the absence of fraud and provided that they act strictly in accordance with the constitution of the company. So long as majority support is secured no justification or explanation is required. The directors may themselves vote in their capacity as shareholders, in support of themselves, even to the extent of ratifying breach of duty.[62]

Majority rule is almost absolute and unless there is a deadlock or fraud, the courts have shown a marked reluctance at common law or under statute to interfere with the democratic process: "It is not the business of the courts to manage the affairs of the company. That is for the shareholders and directors."[63]

Even where the majority in voting take into their own interests, the courts will not normally interfere. Motives for casting a vote are regarded as irrelevant on the basis that:

> "Where men exercise their rights of property, they exercise their rights from some motive adequate or inadequate and I have always considered the law to be that those who have the rights of property are entitled to exercise them whatever their motives may be ... A man may be actuated in giving his vote by interests entirely adverse to the interests of the company as a whole. He may think it more for his particular interest that a certain course may be taken which may be in the opinion of others very adverse to the interests of the company as a whole, but he cannot be restrained from giving his vote in what way he pleases because he is influenced by that motive ... He has a right, if he thinks fit, to give his vote from motives or promptings of what he considers his own individual interests." [64]

More recently it has, however, been suggested that the exercise of a vote is subject to "equitable considerations which may make it unjust . . . to exercise it in a particular way."[65]

(a) Procedural Capacity

A further problem that was required to be resolved in the development of the concept of corporate personality was what may be described as the procedural capacity of the company. As the previous paragraphs illustrate, the concept of a company is rather more than simply an entity with the capacity to own property. It is an association of persons each of which have their own standing at law. It thus became necessary to decide whether a company's capacity to act at law was like that of a trust, related to those who comprise it or whether it has a separate and independent procedural capacity. Victorian courts resolved the question in favour of the latter approach by the development of two rules expressed in the decisions in Royal British Bank v. Turquand,[66] and Foss v. Harbottle[67]. The former decision held that an outsider who deals with a company can rely on its capacity to act itself, as a party to any transaction within its powers and a person is not required to inquire as to either the legal capacity of the members or the internal affairs of the company. The decision mitigated the problems which could confront persons dealing with a company by providing that they may assume in their favour that the internal affairs of the company are in order. The result is that a person does not make a contract with a complex association of separate persons but with one independent legal person. Outsiders cannot contract with or proceed against the members and the members cannot act as such against third parties.

The decision in Foss v. Harbottle decided that the members of a company have no capacity to act themselves or in the name of the company or on its behalf. It is this principle that formally reflects the weakness of the minority shareholders. It has two basic aspects summed up by Lord Davey:

> "It is an elementary principle of the law relating to joint stock companies that the court will not interfere with the internal management of companies acting within their powers and in fact has no jurisdiction to do so. Again it is clear law that in order to redress a wrong done to the company, or to recover moneys or damages alleged to be due to the company, the action should prima facie be brought by the company itself. These cardinal principles are laid down in the well known cases of Foss v. Harbottle and Mozley v. Alston." [68]

Without the rule in Foss v. Harbottle it is argued that companies would be "torn to pieces"[69] by litigation, "there would be futile actions and a multiplicity of suits".[70] The two aspects of the rule originate from an application of the separate entity principle and the law of partnership. If the individual shareholders are separate from the corporate body any injury caused to the company must be remedied by corporate action, not by the individual members.

The aspect of the rule that relates to non-interference was borrowed from early partnership law. The courts were formerly "averse to interfering at all between one partner and another unless it was for the purpose of dissolving the partnership."[71]

As Malins V.C. stated:

> "The court will not interfere with the internal affairs of joint stock companies unless they are in a condition in which there is no properly constituted governing body or there are such dissensions in the government body that it is impossible to carry on the business ... In such a case the court will interfere, but only for a l imited time, and to as small an extent as possible." [72]

In the context of partnership law the rules have been:

> "gradually relaxed; it having been discovered to be more conducive to justice to interfere to prevent some definite wrong; or to redress some particular grievance; but in dealing with disputes between the members of companies the rule is of greatest importance." [73]

Thus any matter which was of purely internal management was not for the courts' jurisdiction but rather the control of the majority:

> "If the thing complained of is a thing which in substance the majority of the company are entitled to do, or if something has been done irregularly which the majority of the company are not entitled to do ... there can be no use in having litigation about it, the ultimate end of which is only that a meeting has to be called and then ultimately the majority gets its wishes." [74]

Majority rule, thus, became recognised as the primary justification for judicial non-interference. If the ordinary majority of shareholders could ratify the activity or conduct complained of, it was outwith the reach of the courts. As the majority decided the internal management of the company they also decided whether to institute proceedings in the event of a wrong being committed against the corporation. They could, for example, agree not to bring action against a director in breach of duty and the minority would have no locus standi:

> "If an act is intra vires the corporation, and therefore one which could be sanctioned by the majority of the corporators properly assembled in general meeting, the court will not entertain in any proceedings to restrain the doing of the act resolved upon unless such proceedings are brought by the majority of the

> corporators. If the dissentient members desire to restrain an intra vires act the action must be brought in the name of the corporation." [75]

As Wedderburn concludes therefore: "It is then, plain that beneath the two parts of it is, after all, one 'Rule in Foss v. Harbottle', and the limits of that rule lie along the boundaries of majority rule."[76]

(b) Minority Rights

The central issue in cases of corporate irregularity is therefore the ability of the members to ratify the action complained of. The rule in Foss v. Harbottle and exceptions created to it simply illustrate the extent to which companies are regarded as constitutional associations and like any other associations the law sees its role as one of simply ensuring that the letter of the constitution is observed. To that extent each member is entitled to insist that the activities of the company be strictly limited to its expressed objects and the company articles, rules on voting and procedures are strictly adhered to. But there are also "matters which are intra vires the company but yet are of such a character that the majority cannot bind the minority."[77]

This occurs where a fraud has been committed against the company and persons who are alleged to have committed the act are in the control of the company and will not permit the action to be brought.[78] Here the minority bring a derivative action on behalf of the company.

The expression "fraud" is used in a wider sense than the traditional meaning attached to it in law. If the directors fail to act in good faith for the benefit of the company and in their own or a third party's interest, this may amount to a fraud on the minority.[79] In addition, wrongful expropriation of the company's property may be fraud, that is, depriving the company of property which belongs to it .[80]

The majority may relieve the directors of certain breaches of duty such as where they allow their personal interests to conflict with the company or where they make a secret profit[81] but the majority can never sanction a fraud on the minority.[82] Thus, a failure to exercise a reasonable degree of skill and care may be ratified by the general meeting and therefore no action may be taken by an individual shareholder,[83] except perhaps where the directors use their powers negligently to the extent that they receive a benefit at the expense of the company.[84]

As discussed earlier, the individual shareholder is bound to the company by a contract based on section 20. Thus, if the company infringe the shareholders' contractual rights, the individual shareholder may raise an action. Thus a shareholder may bring an action if the company purports to interfere with his right to vote[85], deprive a member of his shares or discriminate against a minority in circumstances such as to amount to a fraud on the minority.[86]

As said in Bamford v. Bamford:

> "The articles of a company constitute a contract binding on the company and all its members and each member is entitled as against the company and every other member to require that the affairs of the company shall be conducted according to the articles for the time being in force. This proposition is merely an exegesis of section 20(1) of the Act. Its purpose is to demonstrate that the plaintiffs are suing in respect of their own individual contractual rights and that the rule in Foss v. Harbottle is therefore excluded."[87]

A shareholder may therefore bring an action where the directors exceed their powers or use them for an improper purpose as in Bamford's case. This right, however, is subject to the proviso that if the act complained of is one which may be ratified, a shareholder will not be permitted to bring an action. The question always to be posed therefore even in respect of a shareholder suing on the basis of a contract is, was this an irregularity such that an ordinary majority may put it right? The possibility of ratification may not defeat the action, however, since in recent cases the courts have insisted that the act complained of be put to the shareholders before proceedings are stayed.[88]

More recently the English Court of Appeal has shown a greater awareness of the position of the individual shareholder suing in a representative capacity. In Wallersteiner v. Moir[89] it was held that when the wrongdoers are in control of a company the court has power to order that the costs incurred by a shareholder in a representative action be indemnified by the company, whether or not the action succeeds or not. In such a case the shareholder might sue in his own name on behalf of the company and then seek an indemnity by application to the court on providing that a reasonable cause of action exists.

This decision does not make the corporate action any more effective in controlling abuses, but it does mean that a member willing to initiate proceedings may do so at the company's expense on the basis that he acts as agent for the company. Although a significant advance in the development of shareholder rights there is no guarantee that it is sufficient to foster the more effective use of the minority action. Indeed, experience of the Canadian Province of Ontario which has a statutory shareholders' derivative action with an indemnity procedure suggests that this will not be the case. It is assumed that legal aid is not available to a shareholder bringing a representative action.

The restrictive nature of the rule in Foss v. Harbottle and the relative supremacy of majority rule led to the creation of statutory remedies designed to strengthen the position of the minority. A dissenting minority may petition to wind up the company on the basis that it is just and equitable to do so.[90] This somewhat drastic remedy is often applied in smaller closely run companies founded on personal relationships and where there is a deadlock in the management or a total breakdown of confidence.[91] More recently the courts have been prepared in the case of this type of company to protect the reasonable expectations of persons closely involved in them. The House of Lords recently indicated their willingness to subject the exercise of legal rights to equitable considerations in the context of winding up. Lord Wilberforce, for example, was prepared to look behind the framework of rights:

> "There is room in company law for recognition of the fact that behind it (a legal entity) or amongst it there are individuals with rights, expectations and obligations *inter se* which are not necessarily submerged in the company structure. That structure is defined by the Companies Act and by the articles of association by which the shareholders agree to be bound ... The 'just and equitable' provision does not ... entitle one party to disregard the obligation he assumes by entering a company, nor the court to dispense him from it. It does, as equity always does, enable the court to subject the exercise of legal rights to equitable considerations; considerations of a personal character arising between one individual and another, which may make it unjust or inequitable, to insist on legal rights, or to exercise them in a particular way."[92]

An alternative to winding up is provided for in section 210 which provides that any member of a company who considers that the affairs of the company are being conducted in a manner oppressive to some part of the members may apply to the court for relief.

This section has not, however, afforded much additional protection to shareholders. The section specifically requires the establishment of a case under section 222(f) as a condition for relief, a condition which has largely frustrated any attempt to develop section 210 as an effective remedy for minority shareholders. As the Jenkins Report observed: "The basic condition of relief under the section indicates a course of conduct as distinct from an isolated act. It is also suggested that oppressive is too strong a word to be appropriate in all the cases." (Cmnd 1749 para 202)

Oppression has been described as conduct which would be regarded as "harsh, burdensome and wrongful"[93] or "a visible departure from the standards of fair dealing and a violation of the conditions of fair play which every shareholder, who entrusts his money to a company, is entitled to rely."[94]

This latter statement would appear to be in accordance with the basic objective of the section but the courts, despite expressing such sentiments, have not been disposed, in practice, to attach such a liberal interpretation to the section.

Within this conceptual framework resting essentially on the pillars of private law, contract and property, the modern company has been permitted to flourish. In the following chapter it is intended to examine further the development of the company in society and legal theory in the context of this legal framework.

Footnotes - Chapter Two

1. Lord Selbourne in G.R. Railway v. Turner (1872) LR 8 Ch 149, 152

2. Lord Macnaghten in Salomon v. Salomon & Co. (1879) AC 22, 51

3. O.K.Freund 1944 page 54

4. (1897) AC 22

5. Short v. Treasury Commissioners (1948) AC 116, 122

6. Companies Act 1948 S 332

7. Ibid S31

8. Ibid S154

9. Littlewoods Stores v. IRC (1969) 1 WLR 1241, 1254

10. D.H.N. Ltd. v. Tower Hamlets (1976)IWLR 852, 860B. See Gower 1969 p. 216

11. Stock Corporation Law 1965 S 321

12. ICI & Others v. E.C. Commission (1972) C.M.L.R. 557

13. Commercial Solvents Corp. v. E.C. Commission (1974) ICMLR 309

14. Schmittoff 1975

15. Hood-Barrs v. IRC (1946) 2 AER 708, 775

16. Short v. Treasury Commissioners (1948) 2 ~~A~~ All ER 508, 512

17. Standard Oil Co. Claim (1927) BYB1L 156

18. See Partnership Act S5

19. (1875) LR7 HL 653

20. Attorney General v. Great Eastern Railway Co. (1880) 5 App Cases 473

21. Bell Houses Ltd. v. City Wall Properties Ltd. (1966) 2 QB 656

22. S10

23. See Collier & Sealy (1973) ~~C~~ Cam.L.J.1; Prentice (1973) 89 LQR 518

24. Clark v. Workman (1920) 11R 107, 112

25. See Companies Act S10

26. See Rayfield v. Hands (1960) Ch 1

27. Wood v. Odessa Waterworks (1889) 42 Ch D 676

28. Pender v. Lushington (1877) 6 Ch D 70

29. See pp 37-38

30. Shaw (John & Sons Ltd. v. Shaw (1935) 2 KB 549

31. Teck Corp. v. Millar (1973) 33 DLR 258

32. per Lord Morris Bushell v. Faith (1970) AC 1066, 1099 HL

33. Ibid

34. Percival v. Wright (1902) 2 Ch 421 cf Coleman v. Myers (1977) 2 NZLR 225

35. Briers v. Woolley (1954) AC 333; Allen v. Hyatt (1914) 30 TLR 444

36. per Lord Greene MR in Re Smith Fawcett (1942) Ch.304

37. Harlow Nominees Pty Ltd. v. Woodside Oil Co. (1968) 42 ALJ 123

38. Re W. M. Raith Ltd. (1967) 1 WLR 432

39. Charterbridge Corp. v. Lloyds Bank (1970) Ch 62

40. Greenhalgh v. Arderne Cinema (1951) Ch 286, 291

41. Savoy Hotel Inspectors Report HMSO 1954 Cmnd 4125

42. Parke v. Daily News (1962) Ch 927

43. Teck Corp. v. Millar (1973) 33 DLR 288

44. Ibid footnote 42

45. Mills v. Mills (1938) 60 CLR 150, 164

46. Piercy v. Mills & Co. (1920) 1 Ch 77

47. (1974) AC 829

48. Aberdeen Rly. v. Blaikie (1854) 1 Maq HL 461

49. Cook v. Deeks (1916) 1 AC 554, 563

50. I.D.C. v. Cooley (1972) 1 WLR 443

51. London & Mashonaland Exploration Co.Ltd. v. New Mashonaland Expl.Co.Ltd. (1891) WN 165 approved by Lord Blanesburgh in Bell v. Lever Bros. (1932) AC 161, 195

52. See Thomas Marshall Ltd. v. Guinlie (1978) 2 WLR 116

53. Hivac Ltd. v. Park Royal Scientific Instruments (1946) Ch 169

54. Scottish C.W.S. v. Meyer (1959) AC 324

55. Re Lundie Bros. (1965) 1 WLR 1057

56. See Air Corporation Act 1967, para 1 Schedule 6A

57. Re City Equitable Fire Insurance Co. (1925) Ch 407

58. Barnes v. An drews District Court NY 298 Fed Rep 614 (1924)

59. Marquis of Bute's Case (1892) 2 ChD100

60. Turquand v. Marshall (1869(4 ChDApp 376, 386

61. Re City Equitable Fire Insurance Co. ~~at 528~~ (1925) Ch D at 528

62. North-West Transportation v. Beatty (1887) 12 App Cas. 589

63. Shuttleworth v. Cox Bros.Ltd. (1927) 2 KB9, 12

64. Pender v. Lushington (1877) 6 ChD 70, 76

65. Clemens v. Clemens (1976) 2 AER 268, 282

66. (1856) 6E & B 327

67. (1843) 2 Hare 461

68. Burland v. Earle (1902) AC 89, 93

69. La Lie de Magrille v. Whitley (1896) Ch 788, 807

70. Foss v. Harbottle at 494

71. Lindley 12 Ed p 498

72. Featherston v. Cooke Probate 1873 LR 16

73. Lindley p 499

74. MacDougall v. Gardner (1875) 1 Ch. D 13, 25

75. Cotter v. N.U.S. (1929) 2 Ch 584

76. 1959 Cam.L.J. 194

77. Kaye v. Croydon Tramways (1893) 1 Ch 358, 377

78. Atwool v. Merryweather (1867) LR 5 Eq 464

79. Parke v. Daily News (1961) 1 WLR 493

80. Menier v. Hooper's Telegraph Works (1874) LR 9 Ch App 350

81. Pavlides v. Jensen (1956) Ch 565

82. Regal (Hastings) Ltd. v. Gulliver (1967) 2 AC 134

83. Pavlides v. Jensen (1956) Ch 565

84. Daniels v. Daniels (1978) Ch 406

85. Pender v. Lushington (1877) 6 Ch D70

86. Brown v. British Abrasive Wheel Co. (1919) 1 Ch 290

87. (1970) Ch 212

88. See Hogg v. Cramphorn Ltd. (1967) Ch 254

89. (No.2) (1975) QB 373

90. Companies Act 1948 S 222(f)

91. See Loch v. John Blackwood Ltd. (1924) AC 783; Re Yenidje Tobacco Co. (1916) 2 Ch 426

92. Re Westbourne Galleries Ltd. (1973) AC 360, 379

93. Scottish C.W.S. v. Meyer AC 324, 342

94. Elder v. Elder & Watson (1952) SC 49, 60

CHAPTER THREE

THE COMPANY IN SOCIETY AND LEGAL THEORY

In previous chapters it was shown that the company, the principal representative social institution of the capitalist economy, rests on the twin notions of contract and property. Entrepreneurs found protection and flexibility in the vindication of property rights and enforcement of promises. But today, although the concepts of property and contract are much the same as they were in the sixteenth century, changes in the economic and social environment have enabled these concepts to screen increased corporate power from legal control; at the same time reliance upon the traditional concepts has obstructed the development of a theory adequate to deal with the company.

1. Property

The concept of property comprises the most complete form of control that the law admits. An owner is allowed to exclude all and is accountable to no one, except the law may set limits upon him. For the most part, property implies a two-fold idea, the power to enjoy and the power to control.

In earlier society, the right of property was the central institution of private law. The ownership of property was the root of wealth and, in part, of social or political power. The owner of a workshop owned the land, stock and tools which enabled him to produce goods to exchange for others. But such enjoyment of property and the ability to work were related to power, a fact recognised by eighteenth century philosophers who considered the ownership of property as essential to the full development of personality and to the maintenance of individual freedom. As Holmes said:

> "In the annals of the law of property is still a vestigial of the expression of personality and owes its current constitutional position to its former association with liberty." (1881 page 246)

With the onset of the industrial revolution there occurred, however, a change in the emphasis between the economic and the social or political aspect of property rights. The power aspect of property rights became much more significant. The first capitalists were able, through ownership of property, to exercise not only power in respect of the production of goods through factories, but also power over workers. In the words of Renner:

> "A de facto right is added to the personal absolute dominion over a corporal thing ... It is the power of control, the power to issue commands and to enforce them ... Thus the institution of property leads automatically to an organisation similar to the state. Power over matter begets personal power ... Property from a mere title to dispose of material objects became a title to power as it exercises power in the private interest it becomes a title to domination." (1949 page 107)

The entrepreneur therefore began to exercise a "quasi public authority over people and social relationships that ought to belong to a public authority only."[1] However, the historic attribute of property, the right of dominion, represented an obstacle to the development of a legal framework based on responsibility and accountability, since commercial and industrial activity were seen as the use and disposition of private property. There was no reason why the law should inquire into and regulate the structure that lay behind any economic act.

The growth of the social power of the capitalist was assisted by the development of the law of contract which was "like all legal institutions, a blank without intrinsic social significance and adaptable to an infinite number of social objectives."[2]

The capitalist system demanded freedom and flexibility in employment policy, both of which were available to him through contracts of employment in which his domination was disguised by the theoretical equality of the parties to it and the doctrine of freedom of contract.

Marx was amongst the first to recognise the power that property ownership creates. To Marx the corporation enterprise was an association not of shareholders but was an organisation of labour and of industrial command.

> "An industrial army of workmen under the command of the capitalist required, like a real army,officers and sergeants who, while the work is being done, command in the name of the capitalist ... It is not because he is a leader of industry that a man is a capitalist. The leadership of industry is an attribute of capital, just as in fuedal times the functions of general and judge were attributes of landlord property." (1906 page 364)

Marx's sociological arguments were more fully developed from the jurisprudential point of view by Renner. The central feature of Renner's work was to show how the legal institution of property, though maintaining a formal continuity, underwent profound social and economic changes. He showed that what was once an institution whose principal feature was freedom and liberation became, without any change in form, an instrument for domination and control which the capitalist power supported by other institutions such as the contract of employment. To Renner the employment contract was a "Konnexinstitut", a complementary institution which served to give effect to the true social function of the right of private property, the right of control over others.

This is the conclusion of the Renner analysis: that ownership is the basis of control in capitalist society, albeit the means of exercising control may have become diversified through the "Konnexinstitut". His analysis, however, overlooked the growing divorce between ownership and control of the corporate enterprise in the contemporary capitalist economy. What had originally been individual property was becoming collective property, the fragmentation of share ownership bringing in its wake a separation of ownership from the control, the association of which was so essential to the early capitalist. This development was set out vividly in the classic work of Berle and Means, "The Modern Corporation and Private Property" 1932. Renner visualised the capitalist owners as the dominating and controlling force, but as Berle and Means demonstrate with regard to the corporate enterprise early in its development - by the beginning of this century - the owners, or shareholders, were becoming more and more powerless, as control slipped from them.

The basic insight of Berle and Means was that control of private property was, in the corporate context, no longer an adjunct of ownership. Shares in a company gave to their holders no direct control over the assets. Theoretically, they controlled the assets by the use of their voting power in appointing and dismissing the directors. In practice, this became obsolete by the profound changes in the incidence of shareholding, the great mass of shares in large companies becoming spread in small parcels over thousands of widely dispersed and unorganised individuals who showed little interest in the company apart from the dividends they received. Thus, small groups frequently became able to exercise de facto control over the company. Shortly, dominion passed from the de jure owners of the company, its shareholders, to a much smaller group. This shift of control seemed to increase with the size of the corporation since the larger it was, the more dispersed tended to be the bulk of its shares. Further, the inference Berle and Means drew from this separation was that the nature of property had changed and that it had become divided into active property and passive property. They assert that the traditional logic of the law of property was simply inadequate to provide a basis for treating the modern company. It makes no sense. The passive owners are not entitled to all profits nor are those in control entitled to unfettered power. Corporate development may be financed from retained earnings or debt financing so that the controllers are no longer totally dependent on public issues of shares for their capital. Thus "capitalism may still be there, but the capitalist has vanished."[3]

Individual ownership is vested in the company but the collective property remains private and therefore may claim freedom from legal supervision:

> "The birth of private collective ownership has created problems of legitimacy, it is not possible to justify it in terms of individual private rights which have a limited scope and personal significance. The modern institution of the corporate enterprise has hidden behind accidents of legal form which have shielded the massive growth of power from legal control."[4]

The problem facing the jurist is not simply, however, to justify this self-governing centre of power, but to temper it and find ways of exerting control by reconstructing the enterprises' internal machinery.

2. Financial Institutions and Property

The modern financial institutions possess enormous potential power and represent a challenge to both the traditional notion of property and ownership and the Berle and Means analysis of corporate ownership. Harbrecht noted the effect of the institutional investors on the corporate system and the creation of what he terms a "paraproprietal society". He argued that western economies are undergoing a change from an economic system of possessing property into an economic system of administrative power. The new centres of power, the financial institutions, have achieved the position because:

> "The control of society gravitates to those who can, by the use of property, perform a function valuable to society in this instance, distributing amongst the generality of people the wealth which the corporations are creating."[5]

The contributions to funds invest in the managers of them the incidents of ownership which give rise to power; while retaining title to investment or rights in insurance policies, the subscribers to funds delegate ________ the power which direct investment would have theoretically given them. Thus there occurs a vast accretion of power in those who manage the funds:

> "Power is following property into all of the financial institutions which purchase shares of capital for their clients and the economic power that is growing in the institutions is being shunted away from the generality of the people."[6]

The effect of this transfer of power results in a society organised by individual property ownership and diffused power. The organising principle is no longer property, but power and thus the move to a paraproprietal society. In this society "the connection between man and things, which is another way of saying property, is so attenuated that the fundamental function of property is not dominant though it still serves a purpose."[7]

Harbrecht argued that certain things were labelled property because they were said to have belonged to someone, they were an extension of personality. The idea of property was intimately associated with the idea of "own" and "ownership". But there is nothing personal about ICI or the Mutual Life Insurance Company. "Mine and thine have very little meaning when applied to them. Something that is owned by everyone is truly owned by no one. Ownership in connection with the modern institutional organisation of wealth has very little of its former meaning."[8]

The incidents of the concept of property have functions that persist, in Harbrecht's argument, as devices for transferring control over property:

> "Where once the concepts of the property served the functions of attaching things to men, they now serve the functions of assigning powers over things. The thing itself is not given to a man, power over it is. The objects exchanged in such a way are not things themselves but power over things. That is why we can say that our society has passed from a property system to a paraproprietal system."[9]

In other words, the concepts of property have been used to set up a new disposition of power over capital wealth. Those who preside over it do so because they occupy certain institutional positions as leaders of companies, pension funds and trade unions. If the rights of shareholders over the years have been eroded, managerial rights of the policy-holders or pension claimants never did exist.

The significance of this movement is that productive wealth is owned by companies that are beginning to be owned by other companies. Irrespective of their merits in the economic system, financial institutions have had the effect of alienating the individual still further from the effective direction of the use of productive property. This gradual erosion of property from its primary stage of personal ownership and control through the corporate form and now into the extremely attenuated claims that individuals hold in equity shares, and rights in pension funds, strikes at the root of the idea of private property as we have known it. As Berle stated:

> "Property is one of the most absurd words in the English language covering a surprising range of possible meanings and implications, few of which seem to have bothered twentieth century theorists."[10]

3. Institutionalisation of Company in Society

The rise of the modern business enterprise has brought about massive socio-economic changes. They have become, alongside trade unions, the biggest centres of non-government power in modern society. They are no longer a private phenomenon; they have a significant impact on the social, economic and political life of the country. They are indeed the "dominant institution of the western industrial system".[11] The largest comprise an enormous concentration of wealth and power; international companies such as BP with over 450 subsidiaries operating in over 50 countries have become supranational organisations whose internal policy decisions may have as much impact on a community's economic life as Government decisions. The controllers of such organisations thus exercise considerable influence over a nation's way of life through their decisions on employment, investment, productivity and prices. As Grossett observed:

> "The modern stock corporation is a sociological and economic institution that touches every aspect of our lives; in many ways it is an institutional expression of our way of life. During the past fifty years industry in corporate form has moved from the periphery to the very centre of our sociological and economic existence. Indeed, it is not inaccurate to say that we live in a corporate society." (1957 page 157)

Or as Drucker points out:

> "What we look for in analysing this society is therefore the institution which sets the standards for the way of life and mode of living of our citizens which leads, moulds and directs, which determines our perspective on our own society around which crystallise our social problems and to which we look for their solution. What is essential in society is, in other words, not the static mass but the dynamic element; not the multitude of facts but the symbol through which the facts are organised in a social pattern; not in other words the average over the representative. And this in our society today is the large corporation." (1946 p 11)

Concern, particularly amongst sociologists, over the business enterprise as a social institution, is not new. Marx perhaps more than any sociologist, recognised that the business institution was the institution which had to take a central place in our understanding of the processes of industrial society. For Marx with his analysis of alienation and his predictions as to the enduring pattern of business ownership, the business enterprise had already become the leading social institution.

In the context of U.S. society, Veblen sought to expose the exploitation and waste of resources and human skill which he saw developing under the increasing control of business financiers, a process in capitalist development which Marx had predicted.

Marx, Veblen and latterly Weber were concerned about the vast concentration of business power and its consequences for society. They were concerned as to who controlled such power, the means whereby such control was maintained and whether both the means and the uses to which business power were put were socially legitimate.

The business enterprise has attracted attention from not only sociologists and economists, but from lawyers, the latter, like the present author, concerned, "to translate the social transformation of business enterprise from private association to public organisation into legal terms."[12]

In attempting this it is necessary to appreciate that the enterprise is not simply a group of shareholders associating for a defined objective to the exclusion of all others, as the present legal framework would have us believe, but a social institution with much wider responsibilities and areas of accountability. Changes in the characteristics of enterprises, their greater size, influence over the pattern and path of the economy and the vast resources at their disposal, necessitates the erection of new safeguards, new areas of legal responsibility, far beyond those which the present legal framework acknowledges.

Hitherto, legal analysis an d legislative action have focused on the protection of shareholders' rights, directors' duties, company meetings, etc., all of which reflect the legal framework conceived in the nineteenth century, and which represented society's preferences in respect of companies, their owners and controllers at that time. Such preferences inevitably change as the underlying social and economic system changes and it is the function of law and legal analysis to accommodate these changes. It is submitted that in the U.K. we have largely failed to accommodate such changes. Until very recently, the state has allowed, indeed fostered, the emergence of a corporate economy without challenge of these changes. The original controls, based largely upon private law, have been removed, weakened or simply become inappropriate in the face of the economic advance of a corporate economy. Thus, the central dilemma facing us is the balance between demands for economic growth and efficiency, which large enterprises facilitate, and the demands for social control and new areas of responsibility and accountability to limit the powers of corporate controllers.

At present the legal framework conceals the true character of the enterprise as an institution: ". . . those who have a stake in it feel that their legal claims are precarious and that they live under the threat of arbitrary judgment".[13]

Berle in his analysis of the place of the company in the economy concluded that it "had ceased to be a private business device and had become an institution."[14] Moreover, in his analysis of the separation of ownership and control, he concluded that the passive stockholders "have surrendered the right that the corporation should be operated in their sole interest" and that the community is in a position "to demand that the modern corporation serve not only the owners or the controllers but all society."[15]

This is the inevitable implication of the institutionalisation of the business enterprise. What started as a purely private enterprise to assemble resources for a particular objective:

> " has become a captive of the broader interests that have become implicated in its existence. Sociologically, if not legally, there is a movement from private to public responsibility whenever leadership loses full freedom to manipulate resources and becomes accountable to the interests of these and to the enterprise itself as a continuing system ... The more enduring the organisation and the longer the scale and scope of its activities the more likely it is that the strain toward accountability will manifest itself."[16]

4. Corporate Government - Shareholder Control - Democracy

The accepted legal model of corporate government sets directors as accountable to the members who collectively exercise control over the company's affairs. As we have already observed, the reality is different. Shareholders do not exercise any meaningful ownership powers. This was confirmed in an investigation into the voting behaviour of shareholders in the U.K:

> "Companies were questioned as to whether during the last ten years any shareholders had attempted to exercise control by requisitioning any meetings proposing or amending resolutions, taking any legal proceedings concerning the company, initiating any enquiry. A negative answer was given in all cases except that one company recorded an unsuccessful attempt to amend a resolution and another the unsuccessful attempts by a ginger group to defeat the re-election of directors and propose the election of directors of their own choice."[17]

This confirms the widely held view since Berle and Means' original study, that shareholders as a body are "passive and apathetic about their rights and responsibilities."[18] In the same British survey it was found that on average only one quarter of one per cent of shareholders attend the general meeting. This has enabled corporate structure to change from a foundation of democracy to one centred on bureaucracy. This change is the inevitable result of the increasing scale of corporate activity, together with corresponding separation of ownership and control,and the inability or unwillingness of shareholders effectively to scrutinise management performance, the fact is that management through its access to the proxy system has become an automatic "self-perpetuating oligarchy".

As the Cohen Committee pointed out:

> "The growth of the investment trust companies and of unit trusts in recent years has tended to divorce the investor still further from the management of his investments. Executive power must inevitably be vested in the directors and is generally used to the advantage of the shareholders. There are, however, exceptional cases in which directors of companies abuse their power and it is, therefore, desirable to devise provisions which will make it difficult to secure the hurried passage of controversial measures and as far as possible to encourage shareholders carefully to consider any proposals required by law to be put before them by the directors."
> (Cmnd 6659 para 124)

But the sole legal response to the large scale company has very largely been to reverse, somewhat vainly, this process. In the U.K. and to a greater extent the U.S.A., efforts have been made to restore some meaning to the shareholders' position through judicial and legislative action. Legislation has provided for greater disclosure, the regulation of meetings and voting through proxies. Both the Cohen and the Jenkins Reports and the Companies Acts in the U.K. assume that shareholders' control should and could be made to work. In 1948 a provision was added to allow an ordinary majority to dismiss a director, in practice, however, the section amounts to nothing. Members may not even be able to discern what it will cost the company in damages to which the director will be entitled if he has a long term contract with the company. As we have seen it is possible to render the section useless by careful drafting.

The Jenkins Report tried to add to the legal structure a more democratic element by recommending that the shareholders' approval be obtained for certain acts, such as new share issues and the disposal of substantial assets. But the recommendations were not accepted and in any case, as in the case of section 184, it presented only a limited obstacle to the corporate controllers. Judicial doctrines developed over the years and the unwillingness of judges to enter into questions of "business" have further strengthened the controllers' hands. The doctrine developed in Shaw v. John Shaw effectively prevents the shareholders interfering in the directors' exercise of management functions, having contractually agreed to delegate management powers to them. If it should come to a vote, the directors are permitted to vote ratifying their own actions.

These observations draw us to the same conclusion as the Cohen Committee:

> "The illusory nature of the control theoretically exercised by shareholders over directors has been accentuated by the dispersion of capital among an increasing number of small shareholders who pay little attention to their investments as long as satisfactory dividends are forthcoming, who lack sufficient time, money and experience to make full use of their rights as occasion arises and who are in many cases too numerous and too widely dispersed to be able to organise themselves." (Cmnd 6659 para 7(c)

Even where management have no financial interest in the company it seems that "you can control your company very nicely and very tightly by management itself."[19]

A number of suggestions have been made to restore effective control to shareholders, in addition to the now traditional disclosure philosophy. Some go as far as to reverse the whole process that has enabled the corporate form to alienate property from its owners, though it could hardly be said that in the U.K. there is a general movement to have the "shareholders' hand returned to the economic throttle of the company."[20]

It has, for instance, been suggested that a fiduciary be appointed to represent the interests of the shareholders as a kind of second chamber distinct from the board of directors with more limited powers, but acting in the nature of a voting trust for shareholders.[21]

This might take a form similar to the West German supervisory board which represented a deliberate attempt to give shareholders a watchdog group to represent their interests and has subsequently been used as a vehicle for giving workers democratic rights in companies under the co-determination statutes. Such a body might, it is argued, have great difficulty in defining the area of supervision or control allocated to it from that which was reserved to management.

It has also been suggested that more effective use could be made of the vast concentration of shareholder power in the financial institutions. The CBI recommended that large institutional investors should use their weight as major investors much more freely in the nature of:

> "A regular continuing two-way relationship between a company and its shareholders in which shareholders of all kinds adopt a questioning and stimulating role, and directors endeavour to consult their shareholders both formally and informally on difficult questions of policy or practice." (1973 para 32)

The effect of these institutions on the corporate system has already been noted; traditionally their role has been somewhat passive. Berle suggested something along these lines in his theory of corporate control being held in trust for the members. Controlling shareholders could be said to owe a fiduciary duty to the non-controlling shareholders of the corporation.

The traditional method by which the institutions have exerted some control over corporations is the market mechanism. If a fund holds shares in a company that the administrators regard as being badly run, they simply sell out and invest in other shares. It is only rarely that they have involved themselves in the affairs of the company and then it is normally only to announce support of the management faction in a proxy vote. Such unwillingness to intervene actively is based on the solid ground that the managers of funds, like the directors of the companies in whom they invest, must look exclusively to the interests of their clients and not allow themselves to be deflected by involvement in individual company's affairs.

Such legal duties would surely, however, not preclude them from advising corporate managements, making suggestions or even veiled threats, since it may be in the interests of the fund to remove a cause of disaffection than to sell the shares.

There are signs in the U.K. that the institutions are assuming a more active role. Recently the financial institutions succeeded in delaying the controversial merger between Dalgety and Spillers to allow more time for appraisal and following the Allied Breweries and Lyons merger they managed to force the stock exchange to change its rules, thus giving shareholders the right to be consulted before major acquisitions. It has also been suggested that the Institutional Shareholders Committee and Equity Capital for Industry Group be used as a type of corporate ombudsman to whom shareholders or non-executive directors might turn for help in raising collective action by the institutions.[22]

Whilst these observations are aimed at improving the voice of shareholders in the corporate structure, the fact is that in the U.K. shareholder democracy does not arouse much interest. Shareholders are indifferent to voting, controlling or participating more actively in corporate affairs. Indeed, corporate democracy seems to have failed largely for want of an electorate. It is often argued that if management power be curtailed it should surely be in favour of the public interest or employees rather than as Gower argues: "a small section of the community who happen to have invested in the company - after all, we do not give a man more votes in parliamentary elections because he happens to have invested in government securities." (1969 page 500)

5. Extending Corporate Citizenship

In re-modelling the legal framework governing the business enterprise the first step must be to over come the almost ideological bias in favour of the private firm. The great delusion of the twentieth century has been the degree to which the ideology of the nineteenth century with its notion of the private enterprise firm transferred intact to the massive companies of this century. The sanctity of the private property owned by the entrepreneur became sanctified in the private property of the company. The modern multi-national companies, with gross receipts equivalent to the Gross National Product and workforce equivalent to the population of many nations, are viewed as private enterprise when in effect they are as public as the National Coal Board or Post Office. The first step therefore must be to recognise economic enterprise as a public service breaking away from the conceptual straightjacket of private property. How should such enterprises be governed democratically?

What corporate democracy means to most students of the modern corporation is not greater recognition of the shareholders' interests, but recognition of the legitimate interests of other groups. If the corporation is seen as an institution where a number of different groups converge it is argued that it is unrealistic that the shareholders be given such pre-eminence. As Selznick points out: "Institutionalisation sets problems for the legal system. It calls for recognition of claims founded in the reality of the association."[23]

Indeed, some have argued that the shareholders should have no voting rights. Chayes argues that the shareholders are the last group to warrant greater investment and protection since, unlike other interest groups, they can quite readily reduce their relationship into momentary terms.

> "The market affords him a way of breaking this relation that is simple and effective. He can sell his stock and remove himself qua shareholder at least from the power of the corporation."[24]

Chayes sees the sale of shares and the derivative action as the sole method of shareholder protection. Provided they are given adequate information, sufficient safeguards against fraud and maintenance of a share market, their interests are adequately protected: " ... they deserve the voiceless position in which the modern development left them." (page 41)

The privileged position of the shareholders is the anachronistic result of the fact that ownership, authority and productive work in an enterprise were once united in the same person: "It is a myth that ownership, internal control and legal rights to the profits have to be invested in the same person."[25]

The traditional private property view of authority in the company has deprived the right of citizenship in corporate government to all affected parties except the one group that does not, will not, and most probably cannot, exercise that right. No consideration has been given to splitting the various aspects of ownership so that internal control can be split from those that claim profits. Why should corporate citizenship be linked exclusively to those that claim profits? Chayes observes:

> "A concept of the corporation which draws the boundary of 'memberships' thus narrowly is seriously inadequate. It perpetuates and presses to a logical extreme the superficial analogy of the seventeenth century contributors to a joint stock company and members of a guild or citizens of a borough. The error has more than theoretical importance because the line between those who are 'inside' and those who are 'outside' the corporation is the line between those whom we recognise as entitled to regularised share in its processes of division and those who are not." [26]

A wider conception of "membership" and one closer to the facts of corporate life would include all those having a relation of sufficient intimacy with the corporation and subject to its power in a sufficiently specialised way.

There is a growing recognition in contemporary society that perhaps "those who will be substantially affected by decisions made by social and political institutions must be involved in the making of those decisions."[27]

The most readily identifiable group is the workforce whose relationship to the company is in many ways more intense and enduring than the shareholders, as the authors of the Donovan Report argued, in employment a worker invests his life in the company:

> "In reality people build much of their lives around their jobs. Their incomes and prospects for the future are inevitably founded in the expectation that their jobs will continue." (Cmnd 3623 para 526)

Having discussed the development of corporate power within a legal framework based on contract and property and the growing institutionalisation of the company in society, it is intended in the following chapters to examine some of the problems that this institutionalisation has set for the legal system. In particular, the nature of the responsibilities placed on companies and the changing patterns of corporate responsibility and accountability.

Footnotes - Chapter Three

1. Friedman W. 1972 100

2. Ibid

3. Berle - Capitalist Revolution 1955 27-60

4. Ibid

5. Harbrecht 1959

6. Ibid

7. Ibid

8. Ibid

9. Ibid

10. Berle 1965

11. Drucker 1946 9

12. Friedman 1957 176

13. Selznick 1969 45

14. Berle Preface to The Modern Corporation and Private Property 1932

15. Berle and Means 1967 312

16. Selznick 1969 45

17. Midgley 1975 54

18. Berle and Means 1967 311

19. Minutes of Evidence to Company Law Committee 1962 C. Clore p 529

20. Kelso and Adler 1958

21. Rostow 'To Whom and What Ends is Corporate Management Responsible' in Mason (ed) 1959 p 46-57

22. See Fogarty 1975 and Livingston 1958 Carr 1979

23. Selznick 1969 p 46

24. Chayes 'The Rule of Law' in Mason (ed) 1959 40

25. Fogarty 1964

26. See Footnote 23 p 41

27. Employee Participation and Company Structure 1975 p 7

CHAPTER FOUR

CORPORATE RESPONSIBILITY

We have already seen that in strict legal theory companies, whatever their size, must be run by the directors in the interests of the shareholders. The interests of other groups may be considered only in so far as they advance the interests of the shareholders. In the words of the often quoted dicta by Bowen L.J.

> "The law does not say that there are to be no cakes and ale but there are to be no cakes and ale except such as are required for the benefit of the company."[1]

In practice, however, this view represents only a formal limitation since the modern company cannot successfully operate without the co-operation of its workforce and goodwill of the community. Indeed, measures designed to secure such co-operation and goodwill may be justified as in the long-term interests of the shareholders. It is only when the company has no long-term future that conflict between the shareholders and other groups arises and must, in view of the narrowness of the legal definition of company objectives, be resolved in favour of the owners.

This is the classic view of corporate objectives and it accords with the classical nineteenth century pattern of management which judged performance of managers on the basis of profit achieved through economic competition, and their command over capital, accumulated through efficient use of resources. Profit was seen as the central objective of the venture and others involved in the enterprise do so on the basis of a free and flexible contract, not on any notion of co-operation or partnership.

We saw in the previous analysis that the modern business enterprise no longer approximates to the legal conception of the company. In so far as the objectives of companies are concerned, company law has ceased to correspond to reality. The separation of ownership from control in corporate activity has diminished to the dividend level the claims of substance of individual shareholders. The dependence of the employees and community on great corporate institutions has vastly increased the pressure of the social interest in their stability and efficiency as economic institutions. Why, then, do we continue to accept such a narrow definition? Indeed, if it is no longer the shareholders' efforts and abilities which directs the economic activities of the company, why should they continue to have the business run exclusively in their interests?

The obvious response would be that although it may be realistic in the 1970s to operate vast institutions, seemingly in the interests of one of the numerous groups that operate within the institution, such a system appears to work. Despite the lack of shareholder control the traditional limited liability company has broadly been a successful agency for economic growth and technological advance. The argument for change has not been advanced by the fact that the most obvious alternative form of ownership and control in the U.K., public ownership, has not been greatly successful.

1. Directors' Responsibility - An American View

Much discussion and some progress has been made in U.S.A. on the issue of admitting claims of others involved in company operations. The classic legal/economic conception of corporate activity came under attack in the 1930s in the debate between Berle and Dodd on the question, to whom are directors responsible?

Berle's argument was that:

> "All powers granted to a corporation or to the management of a corporation or to any group within the corporation whether derived from statute or charter or both are necessary and at all time exercisable only for the rateable benefit of all shareholders as their interest appears."[2]

He examined five corporate powers such as the power to issue new shares and declare dividends and although he held that company law becomes "in substance a branch of the law of trusts", he added that the rules of application "are less rigorous since the business situation demands greater flexibility than the trust situation."

Dodd agreed with Berle that legal control was required to prevent the diversion of corporate profits to managers instead of shareholders, but he challenged the emphasis on the view that business corporations exist for the sole purpose of making profits for their stockholders. He believed that:

> "Public opinion, which ultimately makes law, has made and is today making substantial strides in the direction of a view of the business corporation as an economic institution which has a social services, as well as profit making, function, that this view has already had some effect upon legal theory, and that it is likely to have a greatly increased effect upon the latter in the near future."[3]

Dodd referred to the chief executive of G.E.C. who maintained that he was a "trustee of the institution and not merely an attorney for the investor" and as such owed obligations to the shareholders, employees, customers and general public. He believed that this assumption of social responsibility had already manifested itself in such things as charitable contributions. It might be that voluntary acceptance of such responsibility could not reasonably be expected, but the legal issue, in his view, was whether experiments in that direction ran counter to fundamental principles of the law of business associations. They did if management acts as trustees only for shareholders, but such a result was so anomalous that it required clear proof that it was a correct statement of the legal situation and such proof was not forthcoming.

In responding to Dodd's argument, Berle agreed that the great industrial managers and those who control large scale enterprises, function more as "princes and ministers of industrial government than as promoters or merchants", this would justify the assumption of social responsibility. "But it is theory not practice."[4]

Berle warned against weakening their responsibility to shareholders except for "a clear and reasonably enforceable scheme of responsibility to someone else." Otherwise managements would simply become absolute, and there would be no accountability. He pointed out that with the spread of share ownership and indirect interest in security through institutions, a large section of the population would be affected if "the fund and income stream upon which this group rely are irresponsibly dealt with." (Page 1368)

It may be that the law will eventually consider the shareholder equally with other groups, or it might be that shareholders will be given a primary right to residual income, but subordinated to other claims of society.

> "Meanwhile as lawyers we had best be protecting the interests we know, being no less swift to provide for the new interests as they successively appear." (Page 1372)

Berle had previously stated in his great work with Means, that the corporation had ceased to be a private business device and had become an institution "and that the passive shareholders had surrendered the right that the corporation should be operated in their sole interest."[5]

Managers had become a "neutral technology" whose task was to balance "a variety of claims by various groups in the community and assign to each portion of the income stream on the basis of public policy rather than private cupidity." (Page 355)

In effect the disagreement between the two Professors amounted to the absence of machinery for enforcing a community demand upon the business enterprise as a social institution. Some years later, Dodd expressed the view that business obligations towards labour had been implemented by means other than treating business managers as fiduciaries for employees.[6] It had been achieved by granting labour specific statutory rights which business corporations were bound to implement and encouraging the development of collective bargaining in order that employees may bargain on equal terms with managers. Dodd drew a distinction between the fiduciary obligation owed by a trustee to a beneficiary which is an obligation to administer the trust fund so as to secure the largest possible return and the obligation owed by a modern corporation to employees which amounted to an obligation to give recognition to specific statutory claims.

Corporate managers might assume that a certain suggested course of action would increase earnings of shareholders, that such a course of action would possibly have no tendency to produce the sort of unfavourable public reaction which might injure the corporation as a profitable enterprise, and that the pursuit of that course of action in the interests of shareholders would violate no rule of law nor contractual rights of any person, including managers themselves. Given these conditions, they ought to pursue that course of action according to orthodox trusteeship principles. But he saw no similar duty to pursue a course of action that would enable the corporation to benefit its employees by raising wages.

By the same analysis, Dodd regarded claims for consumer interests in the corporate institution on the basis of trusteeship as no less a misnomer than trusteeship for employees. Consumers had acquired new statutory rights and had strengthened their legal position against corporations. " To label this relationship a trust, however, was to lawyers as discredited a thesis as that which held corporate capital as a trust fund for creditors." (Page 546)

In summary, therefore, what is the essence of this classic dialogue? Both were agreed that the modern corporation had added a new dimension to economic life and one that did not follow the rules of classical economics. Their joint concern was to utilise this new institution for the general welfare. Berle put forward the idea of trusteeship for shareholders to deal with new relationships. This principle is generally accepted today (in the U.S. and U.K.) and has in subsequent years been strengthened by securities legislation. Dodd argued, however, that corporate managers should assume wider responsibilities and he found reassurance in the U.S. Government's intervention in the 1930s.

In 1954, Berle conceded that:

> "Modern directors are not limited to running business enterprises for maximum profit but are in fact and recognised in law as administrators of a community system."[7]

What is the machinery for implementing this community responsibility? Berle's work indicates that management is controlled by public consensus and he stresses the value of corporate conscience. To his critics Berle argues:

> "Things being as they are, I am unabashed in endeavouring to seek the best use of a social and legal situation whose existence can neither be denied nor changed."[8]

The problem is one of degree. Certainly, as far as company law is concerned, in most of the jurisdictions in the U.S. there is no legally enforceable duty to protect the interests of employees, consumers or the public, which bind corporate managers. The remedy lies in the public consensus, promptings of the corporate conscience and continued development of legal rights against business enterprises, as Dodd envisaged.

As Kaysen comments:

> "No longer the agent of proprietorship seeking to maximise return on investment, management sees itself as responsible to stockholders, employees, customers, the general public and perhaps most important, the firm itself as an institution ... Its responsib ilities to the general public are widespread; leadership in local charitable enterprises, concern with factory architecture and landscaping, provision of support for higher education and even research in pure science to name but a few." (1957 page 311)

Although the concept of corporate managers as fiduciaries of the public interest has achieved fairly wide acceptance in the U.S.A. by legal and economic writers, and the business community, it has had less impact on the courts, with perhaps the exception of cases concerning charitable contributions.[9] There has been little attempt to transform vaguely defined notions of responsibility into a measure of accountability on management in respect of groups other than shareholders.

2. The United Kingdom

Similarly, in the U.K. company law has resisted adapting to a view of the company as an institution with clearly defined social and economic responsibilities to groups other than shareholders. There has been no significant change in the legal definition of company interests. The interests of the employees and of the nation "would not seem to me to form part of a true legal definition of the interests of the company."[10]. This contrasts with the law of public corporations, as Gower recognised some years ago:

> "It recognises openly what the public company is coming to recognise tacitly, that an enterprise should be run for and on behalf of the public as a whole and not merely for the benefit of a small section of it represented by the shareholders."[11]

The traditional legal framework regulating company affairs and setting the priority of company operations towards the interests of the "owners" has tended to mask the reality of corporate activity in the U.K. For the most part, a managerial approach is adopted in the running of companies. Such an approach visualises the directors as standing at the point of convergence of a number of interests involved in the firm. As Seymour outlines:

> "A company must serve the public not only for survival but because a moral obligation lies on it. Because the people connected with it - the shareholders, directors, management, supervisors, operatives - live through the community and are morally responsible to make a return to the community in the form of goods and services at competitive prices to the best of their skill and energy.

> There can be no question that any one of these three major purposes is more important than the other; they are the three legs of a tripod supporting the existence and success of a business, and each of them must be rigid if the business is to prosper."[12]

At the same time, it must be stressed that:

> "The task of the board is, in normal circumstances, so to conduct its business as to make the maximum continuing profit."[13]

The Editor of the Investors' Chronicle told the Jenkins Committee that:

> "In my own philosophy, any company which forgets that it has three equal interests to serve ... will be failing in its duty ... and it seems to me to be sterile to rank the claims of any one of these interests above those of the other."[14]

In 1971 a survey of directors and managers in the U.K. revealed that 87% agreed that it is unjust for executives to act in the shareholders' interests alone, and 85% rejected the view that whatever is within the law is acceptable.[15] Such views have been reflected in the policies and pronouncements of the leading employer and management groups. The British Institute of Directors views directors as having duties "to employees, customers, and creditors as well as in some degree to the state."[16] The C.B.I. acknowledges that a company, like an individual, must be recognised as having functions, duties and moral obligations that go beyond the pursuit of profit and the specific requirements of legislation.

> "We think that the Government might consider, as part of their doctrine of wider disclosure and general legislative

> encouragement for companies to recognise duties and obligations arising from the company's relations with creditors, suppliers, customers, employees and society at large, and in so doing to strike a balance between the interests of the aforementioned groups and between the interests of these groups and the interests of the proprietors of the company."[17]

The last Conservative Government White Paper on company reform recognised that company directors should discharge their social responsibilities as well as protect their shareholders' legitimate interests. The boards of companies and managements have a -

> "Manifest obligation towards all those with whom they have dealings and none more so than the employees." [18]

The proposed Bill would have created a duty on directors to have regard to the interests of employees. (clause 53)

The Bullock Report also recommended as a preliminary to giving worker seats on the board, that all directors should continue to be required to act in the best interests of the company, but that in doing so they should have regard to the interests of the company's employees as well as its shareholders.[19] Both the Labour Party and Governments have accepted such a change as a minimum requirement of company reform.[20]

3. Changing Patterns of Responsibility

What then are the reasons behind these claims for redefinition of corporate responsibility from such diverse sources as the C.B.I . and the Labour Party? There is no doubt that part of the answer must lie in disenchantment with public ownership as a means of effecting industrial democracy and the search for new ways of effecting public control over private industry.

Another factor is the increasing professionalisation of management and improvement of professional education and training. Managers today derive their standards of business conduct from outside bodies and companies are unable to dictate policies automatically without taking account of the influence of external forces. Indeed, changing patterns of workers' education, greater unionisation and changing technology make it imperative that there be greater involvement and participation at all levels in the corporate structure.

> "As management becomes more professional and as trade union officials become more sophisticated in economics, the Board can be expected to be under more and more challenge from its subordinates and from those negotiating with it across the table."[21]

During the last twenty-five years the senior managements of large companies have, as a result of the rapid technological change and fluctuations in the economic climate, become more aware of the need to be more responsive to change if they are to remain profitable. They are likely to encounter investment decisions which radically affect the lives of thousands of workers and it is becoming increasingly difficult to deny a right for employees to have their interests taken into account and indeed represented.

Such attitudes may be justified in terms of increasing social responsibility or on grounds of democracy. Whatever justification one accepts, the trend represents recognition of the reality of the position of the workforce in a company and the changing vision of business in the community from private property to public partnership.

There is no doubt that the relatively poor performance of the U.K. economy since the war, as against the rapid economic growth of other Western European nations, has brought the organisation and role of business in the community under increasing scrutiny. It has hastened support for the view that, in order to solve national economic and social problems, companies should be subjected to a degree of control as will make profit seeking accord with the Government's overall strategy, business more responsible to society's needs, and answerable to those whose lives are affected by it.

Such observations take us beyond simply tinkering with the definition of directors' responsibilities. Whether company law admits it or not, management's role in the modern enterprise is to balance conflicting interests. As the Biedenkopf Commission acknowledged:

> "In every company there are structural and objectively necessary conflicts of interests. In the first place, there is the conflict concerning wages, in the second place the necessary conflict between measures taken by the company and the interests of workers in the maintenance of jobs."

Such conflicts characterise corporate activity despite the fact that company law chooses to view the business enterprise as a private one governed by and on behalf of the people who own it.

The reality is that business enterprises' obligations to groups outside the shareholders have been recognised and implemented for many years. This has been achieved not by altering the duties of directors and treating them, in Berle's terminology, as fiduciaries for the employees, or the community, but by the imposition of a basic floor of responsibilities and rights bestowed upon the converging groups in the enterprise. These rights have been granted by a continuation of legislative standards underpinned by voluntary bargaining by trade unions, consumer bodies or Government agencies bargaining on behalf of consumer interests. At the same time fundamental changes have taken place in the attitudes, expectations and therefore role and function of those who participate in the corporate enterprise.

Today, we have come to expect full employment, social security, an increasing standard of living, and have accepted the changes in government, management and technology which support these expectations. At work, for instance, employees are today less ready to accept work organisation and discipline. Traditional managerial prerogatives have weakened and there is pressure for more control by individuals over their work. Action has begun on obtaining a better fit between jobs and abilities, better job design and work restructuring, flexible timing, greater job mobility.

Considerable strides have been made through employment protection legislation, on protection against unfair dismissal, redundancy, rights for female workers, time off for trade union or other socially acceptable reasons.[22] Employees have almost lost the uncertainty inherent in the contractual model and much progress has been made in recognising that the employment relationship is more in the nature of a status relationship.

Some nations have progressed much further along this path, for example, the German Works Constitution Law 1972 imposes a duty on employers and works committees "to have regard to established scientific findings on the humanisation of work structures." (Section 90)

With security of employment and social security, there now appears to be a search for additional measures that will safeguard continued stability, opportunity and control at the workplace. In all sectors of society, there are moves for a shift in the distribution of power. The rise of the consumer movement and the changes in the employment relationship typify this shift. Greater advantages are being bestowed upon those that were formerly lower down in the power scale.

Another significant change, referred to in an earlier chapter, has been the institutionalisation of corporate enterprise, acceptance of the notion of a company being an entity interacting with other groups.[23] This has tended to diffuse power, make its exercise a matter of bargaining. At the centre is the executive or management, those who operate the enterprise and from them emanates a series of relationships with employees, consumers, suppliers, government and the local community. Management is required to negotiate at each point an arrangement satisfactory to both participants, bearing in mind their bargaining position in respect of other groups. It is management's basic task to review each arrangement in relation to the others, and blend them into a coherent form that enables the system to operate efficiently as a whole.

Over the last few years what has been termed "managerial prerogatives" have been gradually eroded. In 1964 one U.S. judge recognised that there were certain decisions totally reserved to management which at most were open to consultation with employees, they represent the very "core of entrepreneurial control".

> "Decisions concerning the commitment of investment capital and the basic scope of the enterprise are not in themselves primarily about conditions of employment, though the effect of the decision may be necessary to terminate the employment ... those management decisions are fundamental to the basic direction of a corporate enterprise or which impinge indirectly on employment security should be excluded from that area. Nothing the court decides today should be understood as imposing a duty to bargain collectively regarding such managerial decisions, which lie at the core of entrepreneurial control."[24]

Today there are fewer areas for action in which management is left free from constraints imposed through bargaining procedures or the law. In respect of the workforce literally anything may become a matter of bargaining and there is a strong tendency throughout Western Europe away from what used to be called joint consultation to joint regulation through collective bargaining or statutory codetermination. In West Germany workers have seats on the company boards. In Italy the Fiat workers have set an example of how collective bargaining may be extended to give workers greater regulation over strategic decisions. In the U.K. collective bargaining has traditionally been the most accepted medium for worker involvement in corporate life.

> "There runs through the history of industrial development the continuous thread of opposition to the exercise by management of an unrestricted power to treat a worker as either a commodity or a servant whose duty is to do neither more nor less than carry out his master's bidding. The balance of advantage enjoyed by the employer has been reduced as the strength of collective bargaining increased. Through the control of entry and the way they did their work, they were able to temper the authority of management."[25]

The great achievement of collective bargaining was that it:

> "Did not only help to drive a better bargain with their employers ... its great and enduring social achievement has been to create a secondary system of industrial citizenship parallel with and supplementary to the system of political citizenship." [26]

Collective bargaining in the U.K. has not, however, been geared to influencing actual decision-making at company level other than the crude response of after the event industrial action. The industry wide nature of bargaining has dramatically limited the scope of collective agreements.

More recently, attempts have been made by Labour Governments, influenced by the union movement, to use the law to stimulate more effective collective bargaining and establish new procedures. The Employment Protection Act was a significant break with the traditional abstentionist philosophy of the law in the field of labour relations. It seeks to support trade unions and collective bargaining through formal and legally reinforced machinery. In a sense the Act represented the beginning of a new law of industrial democracy, albeit at a level below the board, based on the single channel of participation and communication through trade unions.

There have been parallel developments in the field of consumer protection, community development and protection of the wider public interest by Government intervention in the private sector. In recent years a sophisticated statutory framework has been constructed to protect and promote the interests of consumers and redress the inequality of bargaining power between large-scale corporate manufacturers and trader and individual consumer. In the absence of effective representation and a bargaining agency, a Government Department and an Office of Fair Trading has been established to oversee the legislation, offer guidance to manufacturers and traders on how to meet their legal and moral obligations, represent the interests of consumers.

Potentially, the most significant development of recent times in the context of corporate responsibility and accountability, has been the growing involvement of Government in private industry. In particular, the use of the limited company device for public purposes. In the last decade the main feature of Government policy has been its increasing intervention in private enterprise through the provision of finance and acquisition of shares, whether this be by the exercise of Ministerial discretion, special legislation or independent bodies such as the National Enterprise Board or the Scottish Development Agency. So far the relationship between Government and private industry has been, with notable exceptions, broadly at arms-length, but the potential for utilising this form of Government influence over corporate decisions in the wider interest of the community, is far-reaching.

Inevitably, it involves questions concerning the accountability not only of corporate officers, but of Government and improving the mechanisms for exercising greater control over Government finance.

A good example of the potential degree of Government influence was the memorandum explaining the precise relationship between the Government and the Rolls Royce 1971 Co.Ltd.

> "It is the wish of both parties that the board
> of the company should as far as possible operate
> as though it were the board of a privately owned
> company established under the Companies Acts;
> and it is not the Government's intention as sole
> shareholder to concern themselves with day to day

> running of the company or to diminish in any way the responsibility of the board for the conduct of the company's affairs. The Government will expect the company to act commercially and to earn a commercial return on its capital employed."[27]

When Rolls Royce was transferred to the N.E.B. the same sentiments were expressed, but the company's plans are now subject to agreement with the N.E.B. whose approval is also necessary for capital expenditure of £5m or over.[28] Their approval must also be sought for acquisition of share capital of a company above a certain level or the disposal of shares. In addition, the company's social responsibilities are set out in terms of the need to locate investment expansion in development areas, promote worker participation and ensure observation of counter inflation policy in wage bargaining.[29]

These developments take the notion of corporate responsibilities and accountability down hitherto uncharted avenues. Clearly, a major problem is the extent to which private companies, wholly or partly owned by state agencies, can be used as instruments of Government policy. For example, there might be pressure on British Leyland to buy machine tools from specific British manufacturers in defiance of commercial considerations and there was a request to Rolls Royce to cancel contracts with the Chile Government.

All these developments have taken place largely under a legal framework, the foundations of which have remained unchanged since the nineteenth century and which principally rests on notions of private law. Thus we have for instance the anomalous position of Government directors who cannot look after the interests of the public, but must think in terms of the shareholders. Their position is therefore regarded as having little impact in monitoring the Government's stake.[30]

In the preceding paragraphs we have seen that in spite of the limitations of company law over the years, the responsibilities of management towards groups other than shareholders has been gradually recognised and widened by the external forces of a combination of voluntary bargaining, Government policy and legislation. This trend has been hastened by changes in attitudes over work, education and training of those involved in the corporate structure.

The fact is that even if directors' duties are widened to take account of responsibilities to employees and the public, those who run the company are still in company law only accountable to the shareholders. To borrow a term from Germany, we shall still be dealing with a company law rather than an enterprise law. As Nikisch observed, company law in capitalist nations views companies not as an enterprise but operating an enterprise. This is reflected, for instance, in the view of the Institute of Directors who clearly regard the shareholders as the company: employees and others are "arms-length" groups.

> "There is no doubt that the duty to the company is all embracing and overrides all others ... Almost in the same breath a second question poses itself, if this decision is good for the company, is it good or bad for the shareholders,

> the owners of the company? It is their investment for which the director is responsible. He is there as a representative of the shareholders' interests."[31]

It could be argued that the present dated framework should be replaced with a corporate structure that contains effective machinery for representation of all those whose interests are closely tied up with the enterprise. The next reform must be on the internal machinery of corporate government, (as opposed to external imposition of standards), in accordance with the "democratic imperative" that "those who will be substantially affected by decisions made by social and political institutions must be involved in the making of these decisions."[32]

Decisions about production, investment and employment are largely concentrated in the hands of top management. The traditional U.K. method of collective bargaining has so far failed to achieve for workers any effective participation. In as much as the Employment Protection Act attempts this, it does so only on a procedural basis and then only below board level. The rights bestowed upon workers and unions and the corresponding obligations placed upon management, are purely procedural, a duty to disclose, engage in prior consultation on redundancy and negotiate. As one writer points out, they -

> "are not being used to affect the balance of bargaining power as long as the procedural proprieties are observed."[33]

In so far as collective bargaining promotes democracy at work, it does so in a defensive manner. Its reach is inadequate to cover the process of corporate planning being confined, in the context of the U.K., to "bread and butter" issues such as wages and hours and based on conflict rather than co-operation.

Likewise, in respect of Government intervention and private enterprise, emphasis has been placed on making Government accountable, for which at least there are traditional mechanisms, albeit inadequate. There is, however, no procedure by which limited companies can be held directly accountable. As Ganz acknowledges:

> "Public accountability is to and through the Minister." (1977 page 107)

Footnotes - Chapter Four

1. Hutton v. West Cork Railway Co. (1883) 23 Ch D 654 at 672
2. Berle, A. Corporate Powers as Powers in Trust 1931 1049
3. Dodd 1932 1147
4. Berle For Whom are Corporate Managers Trustees: A Note 45 HLR 1365
5. Preface to Modern Corporation and Private Property 1932
6. See Dodd M. 9 U.Chic. L.Rev. 538, 1942
7. Forward to The Corporation in Modern Society at XII Mason (ed) 1960
8. Ibid
9. See for example Smith Manufacturing Co. v. Barlow Supreme Court of New Jersey 98A 2d 381 (1953)
10. Inspector's Report into Savoy Hotel Case HMSO 1954
11. Gower 1969 page 240
12. J. Seymour 1954
13. Lord Cole 'The Future of the Board Reproduced in Taylor Top Management p.6 1968
14. Minutes of Evidence to Company Law Committee p.49
15. S. Webley British Businessmen's Behaviour 1971
16. Guidelines for Directors 1975
17. Responsibilities of the British Public Company page 9
18. Company Law Reform Cmnd 5391 para 3
19. Cmnd 6706
20. See The Community and the Company 1974 and Companies Bill 1978 clause 46
21. Footnote 13 at p 95
22. See Employment Protection Act 1978
23. See for example Abrams M. Changing Values in Society - Social Pressures on Business - Administrative Staff College (1974) Sheppard H.L. 'Where Have All the Robots Gone?' New York (1172) Fogarty M. 'The Place of Managers in Industrial Democracy' Confederation of Executive Organisation (London) 1975

24. Fibreboard Corp. v. N.L.R.B. (1964) US 346, 379

25. Clarke et al Workers' Participation in Management in Britain 1973

26. Marshall - Sociology at the Crossroads and other Essays 1963 p 98

27. H.C. Debs. 874 Col. 389 Written Answer June 4 1974

28. Rolls Royce has recently been withdrawn from N.E.B. control

29. See White Paper 'The Attack on Inflation' Cmnd 6151 and see Guardian 5th June 1976

30. H.C. Debs. 107 1975-76 Q 2154-5

31. Institute of Directors 1975 page 13

32. E.E.C. Green Paper 1975 p 99

33. Anderman - The Employment Protection Act ~~1976~~ 1975 p 5

CHAPTER FIVE

EMPLOYEE REPRESENTATION - EXPERIMENTS IN EUROPE

1. Rationale

The primary motive for changes in company law must be to make corporate controllers more accountable for the exercise of their powers and extend influence in the enterprise to those whose lives are directly affected by it. Clearly all employees participate in an enterprise by exercising their labour and skills but as we have observed the legal framework denies an effective voice for employees in the policy making bodies that allocate resources within the institution. Although, through the system of collective action and the development of practices designed to achieve control over performance of work and creation of basic rights in respect of employment, workers have achieved a measure of participation in the corporate framework, the nature of industry and very framework within which it operates is incompatible with a condition in which, as Dawe argues:

> "men can regain control over essentially man-made institutions and historical situations." (page 218)

In contrast to the pre-industrial period the modern worker with the increased concentration and centralisation of decision making at work has become disenfranchised. As Mills acknowledged they became trapped:

> "They sense that within their everyday worlds they cannot overcome their troubles, and in this feeling they are quite often correct. What ordinary men are directly aware of and what they try to do are bounded by the private orbits in which they live; their visions and their powers are limited to the close up scenes of the job, family, neighbourhood; in other milieux they move vicariously and remain spectators. The the more aware they become, however

> vaguely, of ambitions and of threats
> which transcend their immediate locales,
> the more trapped they seem to feel." (1959 page 3)

Industrial democracy is seen as a means of involving workers more in decisions, recognising that as providers of work they should participate in decisions and inevitably assume some responsibility alongside the nominated management who derive their authority from the owners capital.

Democracy at work is by no means a new idea. It was an important part of early theories of socialism. Mill regarded it as an inevitable development in the evolution of the enterprise. Later the Webbs saw the development of collective bargaining as the primary source of industrial democracy in their classic work on Industriay Democracy, Trade Union Structure and Functions. (1902).

In the foregoing chapter we touched upon the need for extending accountability in the enterprise and involving the workforce more in the decision making process. The arguments for such changes are based upon a number of propositions.

First, they are seen as a means of improving industrial relations within individual enterprises as a consequence of decisions being made jointly with the workforce. As the authors of the E.E.C. Green Paper argued:

> "Difficult problems of industrial relations
> will be easier to solve properly, fairly
> with a minimum of wasteful confrontation
> if there are mechanisms which involve those
> closely affected in the process of finding
> solutions." 1

Such an argument implicitly accepts a unitary view of industrial relations in the enterprise in contrast to collective bargaining on the pluralistic pattern, as prevails in the U.K. Such a system openly recognises that management and workers' interests are essentially at variance.[2]

Much related to this argument is the view that participation is the most appropriate solution to the problems of alienation in modern industry and would thus result in increased productivity and improved efficiency. Sociologists cannot agree on the precise relationship between "motivation" and economic efficiency but as Barakat remarked:

> "We are repeatedly told that alienation of man from society, social organisation and/or himself is one of the dominant conditions and modes of life of modern times." (page 7)

Greater involvement in decision making and more control over the environment in which they operate has often been put forward as a solution to this problem. As Blumberg argued:

> "there is scarcely a study in the entire literature which fails to demonstrate that satisfaction in work is enhanced or that other generally acknowledged beneficial consequences accrue from a genuine increase in workers' decision making power." (1968 page 127)

On the other hand if the CBI is to be believed, the time involved in operating participative management decisions might possibly impede economic efficiency.[3]

A third argument in support of increased participation in the enterprise decision making processes is based on the notion of social justice. As the E.E.C. Green Paper acknowledged:

> "those who will be substantially affected by decisions made by social and political institutions must be involved in the making of those decisions." (page 99)

Why should the shareholders have the exclusive right to direct capital and labour? As a Norwegian Labour Minister declared at an ILO symposium:

> "Workers participation is based on fundamental concepts of justice ... the ordinary worker invests his labour and ties his fate to his place of work. For this reason he has legitimate claim to have a share in influencing various aspects of economic policy." 4

In addition to these very strong arguments there is the political question. A prominent feature of recent Labour Party policy has been the degree to which its economic policies have been formally backed or acquiesced in by the labour movement in return for the implementation of legislation extending the influencing of trade unions.

In addition to the social, economic and political arguments favouring greater participation, the U.K's membership of the E.E.C. and the experience of different forms of participation in the member states has given added impetus to the debate. As the Bullock Report (Cmnd 6076) recognised:

> "it is worth emphasising that the U.K. is not stepping out of line with European countries in introducing board level representation." (Ch 6 para 41)

Indeed the Report quotes extensively from the industrial democracy experiments in Sweden and Germany. In many respects, however, the authors of the Report overemphasise the success of the European experiments suggesting at one point that the German economic miracle is attributable to the co-determination policy.[5]

> "If the study of comparative law teaches anything, it is that it is impossible to separate the effect of the law from that of an infinite number of other social variables and thus laws and institutions quite often cannot be transplanted from one nation to another." [6]

With that warning in mind, however, some benefit may be gained by an examination of the different forms of participation practised in Europe and some observations made on management structure and the extent of worker involvement in the enterprise in the member states. After only a brief examination, the first observation that comes to mind is that there is far from a consensus on the best method of achieving greater worker participation. Of the nine members of the EEC only five have employee representatives on company boards. That includes the Netherlands which simply allows employees to participate in the appointment of independent members to the supervisory council (road van commissarissen) . Of the others, West Germany and France have a system of two-tier boards whilst Denmark and Luxembourg operate on the single tier board structure.

In respect of the extent of employee representation this too varies considerably. Thus in France two employees sit on the administrative council in a consultative capacity; in Denmark two employees sit on the board with full participative rights and in Germany there is now equal representation of employees with shareholder representatives on supervisory boards.

2. E.E.C. Proposals

During the last decade developments in respect of industrial democracy have not only taken place at a national level in Europe but the European Community itself has provided significant contributions to promoting the concept.

The enthusiasm by the community for promoting worker participation can be viewed from two angles. First there is the obvious need for a common market for companies with common rules. Under the prevailing arrangements companies are incorporated under the separate laws of the member states and the considerable divergence between these different laws represents a check to economic activity within the community as a whole. Harmonisation of company laws would therefore ultimately promote greater commercial activity and favour the establishment of a common market.

In addition to the need to harmonise the diverging national laws of member states, employee participation is seen as a basic objective of the Community. The Commission sees it as a primary function to take note of trends in member states towards reforming basic social institutions such as the business enterprise and to take account of new developments.

The Commission's Green Paper cited the growing awareness of the need for institutions which can respond effectively to the need for change in the economic environment, technology and structural changes which the functioning of the European Community itself will cause. As the Commissioner responsible stated:

> "democratic societies can only meet these challenges by involving those concerned in the process of finding solutions which most can understand and accept even if that acceptance is, understandably enough in certain cases, reluctant. In societies like those of the Community, with their high standard of education and expectation, the managers of enterprises cannot expect to implement strategic economic decisions without adequately involving those who will often be most substantially affected, namely the employees of the enterprise. The alternative is clear: social confrontation to an unacceptable degree which may even threaten the democratic foundations of our societies. Such confrontations will arise in one of two ways: either as an immediate response to change which those concerned do not understand; or as a consequence of the collapse of enterprises which could not be changed to meet the challenges of the time, since no adequate machinery existed for implementing changes which those concerned could understand and accept. The member states have a clear and common interest in trying to tackle these problems together rather than alone ..."[7]

The Commissioner sees participation by employees on company supervisory boards as the primary means for a continuous involvement by employees in the strategic decisions of companies. This is not to say that the Commission does not recognise other forms of participation such as collective bargaining. But it argues that collective bargaining most frequently takes place at a level at which influence of a company decision is restricted. At plant level shop stewards or works councils tend to have limited pre-occupations and perspectives whereas at industry level bargaining is remote and tends to depend on bargaining power. Representation on company boards is seen as complementary to these other means of achieving influence, adding a new dimension to employee involvement and a new institution for providing information, consultation and the opportunity to influence decisions.

The Commission aims to realise its goals by two methods. First the adoption of a directive harmonising national company laws, the Fifth Draft Directive of 1972.[8] Second is the proposed Statute for a European Company.[9]

(a) Draft Fifth Directive

The Draft Directive enables member states to choose between two models broadly based on the West German and Dutch systems. In the first model the appointment of the members of the supervisory group is made partly by the general meeting of the shareholders and partly by the employees. The members appointed by employees should account for at least one third of the total membership of the board. The second model is based on the Dutch reform in 1971 which introduced into company law a notion which represented a change in philosophy away from the company as means of profit maximisation run in the sole interest of shareholders to that of an enterprise in the economic order of the state. The enterprise is required to look after the interests of providers of capital, labour and the community. This "harmony model" requires large companies to adopt two tier boards, the top tier consisting of one third elected by shareholders, one third elected by the employees and the other third co-opted by the other two groups in such a way that each has a right of veto against proposals by the other if it finds their nominations unacceptable. In that instance the decision whether the veto has been exercised for good reasons goes to a committee of the Dutch Social Economic Council.

Since the Draft was issued the community has enlarged and new discussions and consultations have taken place. In 1974 the Council adopted its social action programme expressing the political will to adopt measures to "progressively involve workers or their representatives in the life of undertakings in the community."[10]

Interest was further sustained by the Green Paper 'Employee Participation and Company Structure' which adopted a more flexible approach than in 1972. The authors realised that a sufficient degree of convergence in the field of industrial democracy could only be achieved after a considerable period and that a first step would be the creation of minimum standards as to company structure, with the emphasis on flexibility.

The Commission discussed the basic principles that member states contemplating participation schemes must consider.

(i) Whether all employees should be able to participate in the processes whereby representatives are appointed and (or) whether representatives should be appointed through trade union organisations.

(ii) Proportional representation was suggested in order to ensure a degree of representation for minorities;

(iii) Members of supervisory boards should owe a duty to the enterprise as a whole and therefore have regard to the interests of both shareholders and employees.

(iv) The possibilities for employees not to be represented on the company board if a majority of the employees wish to do so.

The Commission introduced much needed flexibility by the proposal for a transitional period:

> "Accordingly, consideration must be given to the possibility of providing, in an amended Fifth Directive, that those Member States which cannot immediately adopt mandatory employee participation in supervisory boards, should be free for a transitional period to release all or certain categories of the companies concerned, from the obligation in question, but should impose upon those companies which do not choose to implement employee representation on the board, an obligation to adopt a system based on an institution representing the employees at enterprise level." (1972 page 3)

The most acceptable course of action remains the two tier board with employee representation on the supervisory board. However, for states unable to adopt this system, other avenues would be open such as the creation of an enterprise council at company level consisting of employees. Such councils would have wide powers of information and discussion with management, on economic matters including expansion and closures. It was not proposed, however, to give the council any power of approval or veto.

The Commission even goes so far as to sketch out the four different arrangements which the amended Fifth Draft Directive will attempt:

> "Accordingly, during the period in which the dualist and the one board system may co-exist, in a particular Member State, there might be four alternative structures available to the company: the dualist system with employee representation on the supervisory board; the dualist with a transitional arrangement for employee participation; the one board system with employee participation on the board; and the one board system with a transitional arrangement for employee representatives." (Page 46)

(b) Statute for a European Company

The proposal for a legal framework for the European Company has been the subject of much discussion and debate since the idea was first put forward by Professor Sanders in 1960. Inevitably there are significant differences between the fifth directive and the proposed regulation because where the directive lays down board objectives leaving options for member states, the regulation once adopted by a company as its legal form is more detailed and uniform. Obviously the Statute must contain regulations on employee representation or some companies might be tempted to elect to register under the European Company rather than stricter national laws.

The Commission put forward its first proposal in 1970. This contained three ways of representing employees' interests within a company.

(a) A European Works Council

(b) Two tier board

(c) The possibility of conducting collective agreements between the European Company and the union representatives within the undertaking.[11]

The supervisory board would have one member representing the employees for every two members appointed by the general meeting. The employee representative would not be directly elected by the employees but by the members of representative bodies (works councils) set up under national law. The European Parliament put forward several amendments to the proposals which were finally presented again by the Commission in May 1975.[12] These proposals provide for the election by employees of a European Works Council within any company which has establishments in more than one member state. This council will have powers to represent the interests of employees in consultation with the board of management which must submit a quarterly report on progress to the council and inform it of any event of importance. The council will be entitled to receive the same communications and documents as shareholders. Any decision in respect of recruitment, promotion and dismissal of employees, the terms and computation of provisions for social facilities and holidays may only be taken by the board of management with the agreement of the European Works Council, with provision for arbitration in the event of deadlock. (Art 119/123)

The European Company will have a management board responsible for running the company and a supervisory board responsible for supervising, appointing and dismissing the management board. The management board is required to keep the supervisory board informed on the conduct of business and submit important policy decisions for authorisation. All members of the supervisory board would have equal duties and rights in respect of information. As regards the composition of the supervisory board, after much argument a compromise was arrived at which combines the Dutch and German models. Representation would be one third shareholders, one third employees and one third members co-opted by the two groups who are independent and represent general interests. Employees in all the establishments of the company within the community elect an electoral college in accordance with the principles applicable to elections to European Works Councils and at the same time as those elections. The electoral college then elects employee representatives on the supervisory board.

The members of the final third will be co-opted by the shareholders and employees with a two thirds majority of votes and eligible candidates must represent general interests possessing the necessary knowledge and experience and not directly depend on either the shareholders or employees.

(c) Opinion in Europe

Opinions differ radically on the notion of employee representation on company boards. These differences of opinion are not simply between employer and employee groups but within the two groups there are widely differing views.

Employers for the most part are reluctant to surrender their traditional managerial prerogatives and freedoms. The Union of Industries within the European Community (UNICE) rejected[13] the 1970 proposal of the Commission for a European Company on the basis that it did not correspond to social reality in the member states, and the 1975 proposal on the grounds that the shareholders' interests would be insufficiently represented. In response to the Green Paper, UNICE were opposed to the adoption of Community legislation which would establish the long term objective of employee representation on company boards. Their preference is for a more flexible approach establishing a Community principle of "constructive dialogue at the level of the enterprise", but leaving member states free to develop their own system in accordance with national needs and developments.[14]

Some of the trade unions, particularly those in France and Italy which are strongly influenced by Marxist doctrine, reject employee participation outright since it seeks implicitly to integrate employees with the capitalist system which they are pledged to radically alter. Other unions, as we shall see, particularly in the U.K., foresee representation on company boards as likely to compromise their collective bargaining role.

At the European level a compromise has been achieved within the European Trade Union Confederation (ETUC) which generally supports the Green Paper, although the ETUC felt that the method by which representatives should be appointed to boards should be left to national legislatures. In February 1978 the Economic and Social Committee agreed almost unanimously that employee participation is a desirable evolution in a democratic society and that a flexible approach should be taken. In particular they supported the introduction of the dualist system on an optional basis and company level representative institutions, where participation on the board is not possible.[15]

The policy of employee representation on company boards is very much bound up with political considerations. As suggested earlier where there are influential trade unions with a Marxist philosophy such as in France, Italy and Belgium, employee representation has little support. For example in Belgium one of the biggest trade unions, the FGTB has made it abundantly clear that it will not entertain any development which would integrate workers and unions into the capitalist system. A resolution carried at a 1971 Extraordinary Congress clearly illustrates this position:

> " ... unions must maintain constant pressure on management decisions without ... sharing responsibility for them."[16]

In countries where the trade unions are more closely identified with political parties in the social democratic tradition, worker participation and particularly board membership, tends to be well established or at least recently introduced. Thus it has been introduced into three Scandinavian countries recently (Sweden, Norway (1972), Denmark (1973)); in the Netherlands (1971) - in Luxembourg (1974), and in Austria. The U.K. and Ireland formerly relied on collective bargaining and the conflict model of industrial relations to effect worker involvement in the corporate framework. However, membership of the E.E.C. and changes in the attitude of some trade unions has brought about a reconsideration of traditional patterns of behaviour and has stimulated a significant debate on industrial democracy. By far the most influential factor in any debate on employee representation as a means of achieving industrial democracy has been the experience of West Germany. It is therefore worth examining their co-determination laws in some detail.

3. West Germany

Germany's century of experience with supervisory boards and fifty years with statutory works councils has strongly influenced discussion within the Community. The system is based on a long established formal distinction between a supervisory board and a management board. Indeed a common misconception is that the two tier board was introduced exclusively to accommodate employees on company boards.[17] In fact the two tier structure was introduced by legislation in 1884 and 1870, in the interests of efficient management and more effective shareholder control not as a mechanism for giving workers a say in company decisions. The policy of co-determination that emerged from the allied reconstruction of the post war German economy was therefore based on the existing unique two tier system of corporate government.

The Co-determination Acts of 1951 and 1976 and the Works Constitution Acts of 1952 and 1972 constitute the most wholesale attempt in post war Europe to change organisational structures and internal enterprise behaviour by way of legal norms. A unique experiment and one that perhaps owes its success,at least in part , to the peculiar circumstances which prevailed at the time it was conceived in the late 1940s. For some observers it is not too much to say that co-determination constitutes a "progressive jump in the history of highly industrialised European society."[18]

Since legislation in 1937 (Aktiengesetz), now the Stock Corporation Act 1965, German company law has been based on a mandatory division of functions between the general meeting of shareholders (Hamptversannaulung), a supervisory board (Aufsichsrat) and a managing board (Vorstand). Aside of the impact of worker directors, the system is based on the shareholders electing members of the supervisory board (S.B.) (S 119(2)) who in turn appoint the managing board (M.B.). The general meeting cannot direct the M.B. in respect of business policy and they have no power to dismiss members of M.B. who can only be removed by the S.B. for justifiable reasons. These include a vote of no confidence by the shareholders in the M.B. unless it is obviously arbitrary and if the S.B. does not act on the vote they may be removed by the shareholders by a majority of three quarters of those voting (S 103). This system may be contrasted with U.K. framework where, theoretically at least, the shareholders have the power to alter management's terms of reference as enshrined in the Articles and to remove the directors on a section 184 resolution. German management is thus more formably insulated from the members.

The central feature of co-determination in Germany is employee representation on supervisory boards and therefore its precise powers and relationship with other corporate organs is of vital importance. Under the terms of the 1965 Act, management is solidly vested in the management board. "The board of management shall direct the company as a matter of its own responsibility" and this includes policy making (S 111(1)). The legislation expressly protects the management board role and function and precludes management powers being bestowed upon the supervisory board (S 114(4)). That subsection coupled with the limited powers of the members to dismiss members of the management board without cause gives the management in German companies a considerable degree of autonomy. The supervisory boards have no direct executive power apart from the power to appoint members of the management board every five years. Its role is confined to receiving and approving annual accounts[19], receiving reports from the management board on past and future activities at their periodic meetings and to request any information on any aspect of business, examining the company's books, or calling a meeting of the shareholders if the interests of the company demands it. (S 110(3)). The most striking feature of the relationship between the two boards is that the supervisory board is essentially a mechanism for keeping the shareholders and the employees informed. The only area where the supervisory board has a specific veto power is in respect of any kind of transaction which they decide by a majority vote may only be entered into with its consent but this provision must be viewed in the context of the express prohibition on the supervisory board from participating in management decisions and the management boards' rights to take any matter to the shareholders who may overrule the supervisory board by a three quarters majority.[20]

The system of co-determination which was grafted onto the existing two tier structure applies in different respects to three types of company.

(i) All companies with at least five employees are subject to the general Works Constitution Law 1952 and 1972. This requires the formation of works councils in each firm or in independent units of a company, for example, separate production units; the formation of works councils committees for certain specific tasks; facilitation of council meetings during work hours. In firms with more than three hundred employees at least one works council member can work full-time on council matters and this increases with the size of the firm up to eleven. There must be quarterly works assembly meetings during working hours at which outside trade union representatives may be present and the formation of a mediating body is required for determining conflicts between the works council and management.

The meetings of the works councils with management are expressly intended to deal with contentious issues "with the serious intent to reach agreement".[21] Council approval is required on issues involving piece work and other remuneration schemes, training programmes, extraordinary dismissals. The council is also entitled to receive information on dismissals and major plans affecting the company's technical or commercial activities.[22] In respect of board membership the council may nominate, in some instances together with a recognised union, employee representatives to sit on the supervisory board.

(ii) In companies with more than five hundred employees the Works Constitution Act 1952 requires that one third of the members of the supervisory board be elected by the employees. The functions and responsibilities of the supervisory board remain unchanged under the general company law. Clearly the shareholder representatives are in a strong position always being able to outvote the employee directors.

(iii) Since the Co-determination Act 1951 companies in the coal and steel sector of industry employing more than one thousand workers are required to establish a supervisory board on which there is equal representation between shareholder and employee representatives plus one independent member nominated by agreement. A procedure is provided for resolving deadlock through a conciliation panel and finally to a labour court. In 1956 this system was extended by the Co-determination Extension Act, to holding companies of industrial groups more than half of whose business is in coal and steel. In that case representatives of employees are elected by an electoral panel covering the employees of each company in the group. Unlike the position in other industries the employee representatives are selected not only from the works council but unions recognised within the company.

In addition a works director of labour and personnel (Arbeitsdirektor) must be appointed as a full-time member of the management board and his appointment must be acceptable to the employee representatives. This director has statutory responsibility in respect of industrial relations and social matters such as health and safety at work, pensions and leisure.

This particular institution was intended to ensure that industrial relations issues were not pushed aside in the preparation and formulation of corporate policy.

(iv) Under the Co-determination Act 1976 the system of employee parity with shareholder representatives on the supervisory board in the iron and steel industry was extended to all companies employing more than two thousand employees. The supervisory board consists of twenty members, ten from each group. However, because of political pressure, it was agreed that only three of the employee representatives should be directly linked to the unions and of the other seven one should be from staff and middle managers (leitende Angestellte). The property rights of the shareholders are preserved by the fact that the chairman of the supervisory board has a casting vote and he cannot be selected without the consent of the shareholders.

This provision was included to meet the argument that otherwise the legislation would be a breach of German constitutional law (the Grundgesetz) which expressly protects the fundamental right of ownership.[23]

These recent proposals have sparked much criticism, in particular from employers who have argued that a:

> "company must be managed according to the laws of economic efficiency, not the principle of political compromise." [24]

4. Norway

In Norway employee representatives have been appointed to the boards of large state-owned enterprises since 1948 but the extension of such representation to the private sector is only a recent development. In 1968 the Government set up the Eckhoff Committee to look into "democracy in economic life." It reported in 1971 and put forward three different schemes one of which, the so-called Aspengren and Hansen scheme, was adopted by the Labour Government and formed the basis of legislation in 1977. The basis of the scheme was the introduction of a board of representatives into the structure of companies with more than two employees. The board consists of at least twelve members, one third selected by the employees and two thirds by the shareholders. The board is responsible for electing the management board and it represents the final authority in respect of major investment policy and any decision resulting in major changes in or a redistribution of the workforce.

The reasoning behind the legislation was essentially political rather than based on a desire to give workers a feeling of greater participation or involvement. Indeed a survey by Thorsrund and Emery found that the existence of worker directors in the state industries added very little to the workers' feeling of participation. The rationale of the legislation was that:

> "it was a breach of true and genuine democracy that important decisions which to a high degree have a decisive influence on the situation of the individual and his family and also the enterprises future as such, should be taken in bodies whose only one interest in the enterprise, namely the interests of the owners of capital, is represented." [25]

5. Sweden

Worker directors were introduced in a trial Act in 1973. This legislation gave employees of limited stock companies or co-operatively owned concerns with at least one hundred employees, the right to appoint two directors. The new system is very much linked to the trade union movement inevitably so since 90% of all company employees are organised in unions belonging to the L.O. blue collar organisation or T.L.O. white collar federation.

The local union organisation appoints the directors. If they cannot agree the two unions with the largest number of organised employees in the company select one each. If more than four fifths of the employees belong to the same local union organisation it can appoint both employee directors. By February 1975 the unions had claimed and obtained board representation in 80% of companies covered by the Act.[26]

A permanent Act came into force in 1976 which lowered the number of employees from one hundred to twenty five thus increasing the number of companies covered to around 8,000. An amendment to the companies legislation required that for a board decision to be valid, all directors should, as far as possible, have the opportunity to take part in discussing the matter and all should have sufficient material available to them to be able to take a decision.

The recent legislation represents a radical change of attitude on the part of the unions in Sweden rather similar to that of the U.K. unions. In the past both the L.O. and the T.L.O. were satisfied with the system of collective bargaining as a means of influencing decisions.[27] The legislation is viewed with scepticism by the employers who see the unions' attitude as a departure from their traditional pragmatism. A particular cause of concern amongst employers was that the Riksbank (central Bank) has adopted the habit,when presented with an application to invest abroad,of inquiring whether the company worker directors have approved the investment. The implication being the possibility of worker directors exercising a veto over foreign investment, although so far it has been no more than inquiries by the bank with no follow up.[28]

A particular significant concession has been the abolition of Article 32 which formed one of the rules of the employers' associations and was included in all collective agreements. The Article preserved the employers' right to freely hire and dismiss workers, to supervise and allocate work and to employ workers who were not union members. This principle had been accepted by the Swedish Labour Court but was reversed by the co-determination legislation with a new Article 32.

> "The parties to a collective agreement on pay and employment conditions must also, if the union side so requests, reach collective agreements on co-determination for employees in matters concerning the conclusion and cancellation of employment contracts, the supervision and allocation of work or other aspects of management."

The legislation additionally reinforces the unions' influence by imposing on the employer "a primary right to negotiate". Before an employer decides on any important change in his operations, "he shall on his own initiative summon to negotiations and negotiate with the trade unions to which he is bound by a collective agreement."

In practice therefore a Swedish employer cannot take any major decision without having negotiated the matter first, it must be pointed out, however, that the employer is entitled to take his decision by himself if negotiations do not lead to agreement.

The new legislation requires the employer to keep unions continually informed on financial and production development within the company. It bestows upon trade unions the right to inspect company books and accounts and other documents and in certain circumstances the right to veto the hiring of subcontractors.

It is too early to assess the new balance of power between management and unions in Sweden but undoubtedly their system represents the most radical and far reaching in Europe combining traditional patterns of collective bargaining with worker directors. As in the U.K., Sweden has a strong tradition of collective bargaining and to that extent co-determination has been left for negotiation between employer and unions. Trade Union representatives on company boards are in many respects regarded as a supportive to the collective bargaining process.

6. Netherlands

In the Netherlands the trade unions have been slow in recognising the value of co-determination and have not applied any strong pressure for legislation. In company law there has, however, been a move away from the notion of a company as a fixed contractual relation between shareholders and management exclusively, with the employees simply selling their labour. Employees are now recognised as having a considerable interest in the enterprise and as having a right to take part in the plural community of interests.[29] Legislation applies to companies with over one hundred employees and capital in excess of 10m gilders. These companies must establish a supervisory board which must consist of at least three members who are not connected with the company as shareholders, workers or trade unionists. Nominations may be made by the shareholders'assembly, management, works council or the supervisory board itself. Both the shareholders assembly and the works council can veto appointments if they consider a candidate to be inadequately qualified or if the balance of the board will be upset by the appointment. The Board has power to appoint and discharge managers after informing the shareholders assembly. It also makes important management decisions on share issues, investment above a certain level, amendments to the constitution, dismissal of workers and radical changes in working conditions.[30]

Rights of enquiry available in the past only to shareholders have now been extended to trade unions. Subject to the consent of the works council a trade union that has grounds for suspecting that the company is being mismanaged may apply to the courts with a request for an enquiry. In 1971 the merger code was revised and it made it compulsory for the public authority to be notified of any mergers involving enterprises employing more than one hundred workers. Management are required to notify the union before any agreement is signed and submit information on the reasons for the merger and likely social and economic consequences. Despite the fact that this right of enquiry and the merger code are not directly related to any notion of co-determination they are indicative of the legislative policy and principles which have given rise to greater employee influence on the composition of boards. They represent part of a process described by Zanderland as "the end of subordination".[31]

7. Lessons from Europe

Clearly as Batstone recognised in his report for the Bullock Committee (Cmnd 6706):

> "The introduction of worker directors is so recent in many countries that no reliable data on their actual performance are available." (page 9)

When the new legislation was introduced in West Germany after the war considerable expectations were raised. Some saw co-determination as a method of extending democracy to the workplace and bestowing upon workers a sense of dignity and individual worth. As Clegg asserts:

> "Neither the allies nor the unions wished to see the coal and steel industries at the disposal of their former owners. They thought the system of worker directors would provide effective restraint and, in particular, would prevent the wealth of those industries being used to back a revived nationalist movement as it had once been used to support Hitler. Similarly, they both wished to erect a barrier against the concentration of power in coal and steel by the amalgamation of undertakings; and they believed that worker directors, with their personal interest in undertakings, would constitute a more effective barrier than shareholders ... In addition the unions were anxious to maintain the unity of the movement ... the main danger being a rift between the socialist and catholic unions ... The traditional political object of the socialist - nationalisation - was unacceptable to orthodox

> catholics, co-determination was in line with their notions of industrial harmony and collaboration and at the same time compatible with the socialist aim of increasing the power of the working class ..." (1976 page 95)

Employers and financiers predictably viewed the legislation with fear and scepticism arguing that it would result in declining efficiency, a withdrawal of investment capital and the erosion of the competitive spirit inherent in the free enterprise system.

As pointed out earlier some have attributed Germany's post war success to co-determination and on that basis the experiment must be viewed as a resounding success. The Bullock Committee implied as much:

> "The fact that the West German and Swedish economies, despite differences between the social philosophies of the two countries, have been among the most successful in the world - not least in avoiding industrial conflict which has cost Britain so dear - has not escaped notice." (Ch 3 para 13)

However, Sweden's economic success can hardly be attributed to co-determination since it had only existed three years when the Committee made its investigation. Many would argue that skilful economic management, competitive markets, absence of Government interference, tight control of money and low rates of interest, are more likely to be the reasons behind Germany's progress.

In so far as board level representation of employees is concerned in Germany it must be stressed that it exists in a corporate framework which strictly limits its power and ability to influence corporate planning. Most of the supervisory board decisions in reality amount to no more than confirming management policies and approving corporate reports. The supervisory board can refer back but in the last analysis management can appeal over its head to the shareholders, its role therefore appears mainly co-ordinating and advising rather than a controlling function.

The Biedenkopf Commission set up in 1968 to review the co-determination policy illustrated the dominant role of management.

> "It was constantly stated that only in exceptional circumstances did controversy arise in supervisory board meetings over management investment proposals; as a rule the individual member of the board has neither technical ability nor the time to examine the calculations which are attached to the substance of investment proposals."
> (Part III para 62)

The Report particularly emphasised that only in exceptional cases are proposals to take a decision contested in the supervisory board and that unanimous votes are reported to be the rule rather than exception. (para 36) This might in part be attributable to the fact that the legislation requires all members of the council to co-operate for the good of the enterprise and this has been interpreted to the effect that council members are not primarily responsible for particular interests.

Co-determination had, however, led to management plans being put under greater scrutiny, particularly in respect of their effect on employees. Of particular significance is the conclusion that the degree of prior consultation was much higher in the coal and steel industry where there is parity representation than in companies where management could rely on the built in majority of shareholders.[32]

It has often been claimed that important issues are worked out on sub-committees on which employee representatives were under represented. The Commission again found that in the coal and steel industry employers were adequately represented but in other companies committees were often structured to favour the employer and information was restricted. Indeed the general consensus was that employee influence on those boards was much more limited, a conclusion which was an important stimulus to the 1976 legislation. (para 36).

Overall perhaps the most significant finding of the Commission was that very formal structures for co-determination had resulted in the development of an informal network of communication between management and employee representatives at all levels. With greater consultation on a far wider range of issues than could be expected in view of the supervisory board's limited powers.

In the complex of formal and informal patterns of communication and behaviour in the German corporate structure it may be impossible to come up with one reason why the employee representatives have had limited visible influence on company policy making but there is no doubt that the very limited powers of the supervisory board is a significant factor. A way round that problem would be to include worker representatives on the management board and in this respect the experience of the personal director in the coal and steel industry may be of interest. In filling this position the initiative is with the employee representatives, although according to the Commission, no candidate has been nominated against the wishes of management. Potentially the personal director is in a strong position to exert his influence for the benefit of employees. (Para 96) However, his potential influence is constrained by the impact of law and custom requiring him to act as a manager not a negotiator. He is expressly required to carry out his managerial function in the best interests of the company as a whole and under a duty not to reveal confidential information or company secrets. Thus, although chosen by the employees, he is subject to considerable pressures on his loyalty.

The co-determination legislation is so framed as to preclude the personal director from operating exclusively to represent the interests of employees. It ensures simply that employee interests are taken into account in so far as is consistent with the overall pattern of decision making. Most personal directors have resolved any conflict by operating within the framework of the law and functioning as a responsible manager rather than worker agents.

In practice, although the legislation does not lay down the functions of the personal director his activity is confined to social and personnel affairs. He has no direct role in financial or production matters. Within the limitations of this role, however, his presence has undoubtedly resulted in the anticipation of the social ramifications of decisions and mitigation of the detrimental effects of many decisions on the workforce. The labour director has been conspicuously most successful where they have been able to win the trust and acceptance of other board members. In cases where they have not been able to do so they have been isolated and their influence considerably diminished.[33]

In so far as the co-determination experiment could operate in the U.K., a major factor would be the relationship between traditional patterns of collective bargaining and the worker directors. The Commission, however, found that in Germany co-determination at plant and supervisory board level had not interfered with established collective bargaining procedures. In fact in the coal and steel sector, management and unions had tacitly agreed to support the two systems by making sure that the same people were not involved in both systems. There must be some doubt, however, as to whether this could be maintained in view of trade unions tendency to extend the nature and scope of bargaining. Undoubtedly, German unions have tended to use co-determination as a means of obtaining more information on corporate activity and performance rather than as a means of becoming involved directly in the process of management. Indeed the legal constraints in the German system would not permit any other role.

It is in this area that we can perceive the danger in viewing the German model with a view to its operation in the U.K.

Co-determination is a complex institution and its transfer to the U.K. would not simply mean electing worker directors but would involve a substantial change in the system of industrial relations. Such changes would have to be hastened by legislation rather than the traditional voluntarist approach of the U.K. Co-determination can quite clearly only be discussed and evaluated within the conceptual legal and institutional framework within which it operates.

For example, German trade unions operate within a constitutional framework that strictly delimits their activity and contrasts sharply with the U.K. system of labour law. Whilst it is true to say that in Germany management, by its control of corporate policy has retained effective control of decision making even in these sectors where the employees have parity representation with the shareholders, according to Adams co-determination has nevertheless provided:

> "for the smooth evolution of industrial change. In the post war period numerous technological innovations, mergers and shutdowns have been introduced in the iron and steel industry ... These changes have, for the most part, been carried out smoothly and without disruption or notable psychic stress. Worker representatives on supervisory boards and works councils have been able to negotiate the pace and conditions under which the changes take place. As a result workers needs have been given high priority from the outset." (1977 p14)

Thus, on the whole,"co-determination is functioning well enough in spite of several flaws."[34]

As Adams points out, above all

> "it has demonstrated the capacity to find solutions to major organisation problems

> before they evolve into hardened stand
> by one side or the other." (1977 page 21)

The same author argues that as a result of a continual institutionalised contact and exposure to issue of joint concern:

> "representative s of labour and management
> have come to trust and co-operate to a much
> greater degree than was thought possible." (page 21)

Indeed the key to the success of the German system is co-operation rather than the conflict which lies at the root of the U.K. industrial system.

8. United Kingdom Developments

In the U.K. attitudes towards employee representation on company boards have changed considerably over the last ten years. Employers and trade unions were previously united in their outright rejection of any form of employee representation on company boards. Employers considered it an invasion of traditional property rights and an erosion of management independence. Whilst trade union officials have traditionally treated any alternative schemes to collective bargaining as an undesirable duplication of the channels of representation only likely to weaken union influence and employees' willingness to join a union.

Potentially the post war nationalisation programme of successive Labour Governments has been the most interesting development in the field of industrial democracy, creating opportunities for experiments with different forms of industrial democracy. The TUC were, however, exceedingly cautious and followed the views expressed by Herbert Morrison when introducing the London Transport Bill in 1930 that board members of publicly owned industries should be selected on the basis of competence for the job rather than as representatives of the workers concerned. Some years later the TUC in their interim report on post war reconstruction re-affirmed their support of this view, although they did suggest that:

> "experience gained in the collective organisation of labour is a strong qualification for board membership." 35

Trade unions officers appointed to the boards of nationalised industries should, however:

> "surrender any position held in, or formal responsibility to the trade union."

In consequence there was very little deviation from the more traditional forms of industrial democracy based on collective bargaining and it is only fairly recently that experiments in employee representation have begun.

The late 1960s saw a change in attitude from the labour movement as a result of the deliberations of a Labour Party working group chaired by Jack Jones. The group found it impossible to come up with a recommendation for industrial democracy and considered that different issues were involved in the public and private sectors. They did, however, arrive at a number of vague conclusions. First, workers have the right to determine their economic environment by participation in a widening range of decisions within the firm and that the recognition of that right and means to secure it, must be a matter of urgency. Second, workers'participation must be closely identified with the trade union organisation and representation. Third, that industrial democracy must be developed on the basis of a single channel of representation. The committee envisaged a significant extension in the participation of workers' in decisions affecting their jobs whilst at the same time offering no threat to trade union authority since the new procedures would be firmly based on existing trade union structures.[36]

The Donovan Report in 1968 which was mainly concerned with collective bargaining, made very brief reference to workers participation in management. The overall majority conclusion was that appointment of worker directors would expose the holder of such an office to an intolerable degree of strain and would inhibit the development of efficient collective bargaining. (Cmnd 3623 para 997)

Further interest in worker directors was stimulated by the 1972 EEC Commission proposal suggesting a common standard for legislation relating to joint stock companies in all member states and proposals for a European Company.

In 1977 the basic principles adopted by the Jones Committee were somewhat extended in the TUC Interim report on industrial democracy prepared for the annual congress. This report was introduced by the General Secretary who clearly asserted that the:

> "TUC had an emerging and developing policy for giving workers a greater amount of control over the industries in which they worked."[37]

The main TUC proposals were contained in the 1974 Report on Industrial Democracy. By that time the TUC felt that collective bargaining, even if expanded, would not bring workers influence effectively to bear upon matters of vital concern to them. It enabled them to exert only a limited influence over company policy on details of new enterprises, locations and prospective takeovers and mergers. The Report envisaged that employee representation on the board should be a legal right which a recognised and independent trade union may demand. Such representation would be through trade union machinery with 50% of the seats on the board occupied by employee representatives.

The TUC recommended the revision of company law since they saw the present system as reflecting a conception of management's responsibilities to capital and labour that is outdated in the present economic and social system. They argued that the law should be altered to reflect the essentially joint interest of labour and capital in the enterprise by placing a statutory obligation on companies to have regard to the interests of employees as well as shareholders.[38] Originally, the TUC favoured the two tier system with employee representation on the top tier but more recently they have argued for a reconstituted form of the traditional unitary board with overall authority ultimately to overrule the shareholders on certain issues.[39]

The TUC argue that their proposals would create a new basis of consent in industry to replace traditional machinery by establishing a forum for agreement on a framework of policy within which management could act. As the Fabian Society observed in support of the proposals:

> "if it is true as we believe that our prospects of economic recovery depend largely on industry then the need for a new basis of consent becomes even more vital. In many companies and industries, it will not be possible to carry through the necessary investment and re-organisation programmes unless the employees themselves are involved." [40]

Predictably the TUC see employee representation as being effective only if the trade unions have direct control over the appointments, as opposed to the use of works councils or direct elections by workers. The unions in the U.K. are, however, by no means in complete agreement over the question of industrial democracy and more recently annual congresses have thrown into stark relief the concern that the unions have over the maintenance of existing channels of union representation. In 1976 the Engineering Union sought to draw the distinction between trade union participation in management in public and private industry, giving support only to the former. The General and Municipal Workers sought a more flexible approach widening the options on types of legally backed participation, whilst on the other hand the EEPTU expressed open hostility to the General Council's commitment to participation on policy making boards.[41] The lack of any real consensus is therefore the main feature of trade union debates on industrial democracy.

This was strikingly illustrated by the reaction of the union movement to the Bullock Report. The General Secretary saw the proposals as genuinely consistent with TUC policy whilst the AUEW and EEPTU, two of the largest unions, opposed the proposals and even the GMWU expressed serious reservations.[42]

In conclusion therefore it is true to say that as far as the U.K. trade unions are concerned, any commitment to extending the influence of employees in companies is restricted to those forms that are based on the existing organisational structure of the unions and this explains the very limited range of participation practices that have received official approval.[43]

Not surprisingly, the Labour Party strongly favours industrial democracy linked with union machinery:

> "We consider that behind the TUC conditions is a rationale of fundamental importance which should guide the Labour Party in its approach, namely that trade union participation at board level must be a supplement to and not in any way detract from, the trade union position in collective bargaining." [44]

On its return to office in 1974, the Labour Government was committed by the terms of its manifesto to a policy on industrial relations reform which included legislation to promote industrial democracy through union machinery. In response to a private member's bill sponsored by Giles Radice which gained some Parliamentary support, the Government agreed to appoint a committee of inquiry under Lord Bullock. Its terms of reference clearly reflected the very powerful industrial and political influence of the union movement and it was no surprise that a majority came down in favour of employee representation through union machinery. In fact there emerged two schools of thought. The academics and trade unionists who signed the majority report and the minority industrial representatives who favoured a more limited approach. (Cmnd 6706)

The central proposals of the majority was that the boards of companies with 2,000 or more employees should consist of equal numbers of employees and shareholder representatives, with a quota of independent members providing the balance. The trade unions were given a central role in the scheme since the whole process could only be triggered off by a request for a ballot from an independent trade union representing more than 20% of the workforce. All employees would be allowed to vote but in voting they would have no knowledge of who the directors might be or from whom they would be chosen. In the event of a favourable ballot, arrangements for the selection of representatives would be made by a union committee (J.R.C.) representing all independent and recognised trade unions in the company. The representatives would be employees of the company and not full-time trade union officials and would be introduced on to reconstituted unitary boards. The majority rejected the two tier board in favour of the present structure. The unitary board would be able, as at present, to delegate certain of its functions to lower boards or management committees, but to ensure that the reconstituted board retained overall control the legislation would spell out areas where responsibility for a decision must rest with the board.

The minority report favoured a more gradual and flexible approach modelled on the German system with two tier boards and one third representation on the top tier for shareholders, employees and neutral interests. The minority took exception to the majority's reliance on trade union machinery and the disenfranchisement of non-unionists. They therefore recommended the creation of a statutory obligation to negotiate structures for industrial democracy at plant level on the same lines as German Works Councils.

As already observed the unions' reaction to the Bullock Report was divided. The EEPTU and AUEW were generally opposed to the whole notion of worker directors whilst the unions such as the TGWU and ASTMS fully endorsed the proposals.

Predictably the CBI were united in their condemnation:

> "The proposals would fundamentally change the free enterprise system, damage the morale of managers, discriminate against non-union employees and have a disastrous effect on overseas investment in this country."[45]

The Institute of Directors condemned the proposals on the basis that:

> "neither industry nor democracy would benefit from bringing political methods and the conflicts of collective bargaining into the board room."[46]

Generally speaking, the attitude of management towards the notion of participation has been one of mistrust. In so far as management has encouraged greater worker involvement, it has been inclined towards consultative rather than participative experiments. For the most part:

> "employers and their spokesmen have evinced deep mistrust as to the value of participation, particularly in integrative forms, such as the appointment of worker directors though they reflect a widespread belief in prior consultation with workers on matters which concern them."[47]

The representative bodies of management and the Conservative party have indicated that they would be willing to redefine directors' duties enabling them to take account of the employees' interests but their ultimate long term responsibility would still be to the shareholders.

The Conservative party, BIM and the CBI have all unequivocally rejected the compulsory representation of employees on company boards. They also reject the notion of two tier boards preferring the traditional U.K. system. They see supervisory boards as an unnecessary and potentially damaging complication in a country where, in their contention, shareholders get their protection from an active market rather than discretionary intervention. Both the CBI and the BIM see an increase in the number of non-executive directors as the best method of broadening companies responsibilities within the single board system. Indeed the CBI do point out that there is nothing to prevent companies electing worker directors if they so desire.

The CBI stated in their evidence to the Bullock Committee that employee representation at board level will not normally be a suitable form of participation. They did not, however, completely rule it out but preferred the more flexible voluntary approach:

> "It is vital that employers and employees retain freedom of action to develop a form of participation which can reflect their wishes and the structure of their particular organisation . A standard system applied to all companies, large or small, centralised or decentralised, could not possibly be suitable to meet the needs of employees and companies ...
>
> A fundamental principle, therefore, on which proposals for greater employee involvement in company affairs must be based is that participative arrangements must be sufficiently flexible to accommodate the various forms of participation already in operation successfully, and to the satisfaction of all parties in a number of companies."[48]

The CBI's central proposal is the participation agreement. This provides for the parties to devise a scheme to fit their own circumstances. It allows for flexibility and experiment but only within a framework of criteria. The proposed criteria includes:

(a) There must be no conflict with collective bargaining and recognised arrangements;

(b) and no interference with the executive function of management or its responsibilities for discharging its third party obligations;

(c) agreements must be ratified by a majority of all employees in a secret ballot;

(d) not more than one third of the directors should be elected by the employees;

(e) the legal rights of shareholders should not be impaired;

(f) the full responsibility of all directors for the whole enterprise should not be diluted.

The main forms of industrial democracy in the CBI view should be, however, below board level with greater encouragement for the development of consultative works councils to operate alongside collective bargaining arrangements linked to top management by the designation of a director as convener of a company-wide employee council.

In the context of this discussion on the rationale, scope and relative merits of experiments in employee representation and proposals in the U.K., it is necessary at this stage to discuss the likely impact of such proposals on U.K. company law and practice.

Footnotes - Chapter Five

1. Employee Participation and Company Structure - E.C. Bulletin Supp 8/75 page 9.

2. See Fox A: Industrial Sociology and Industrial Relations Res paper 3 for Royal Commission on Trade Unions and Employers Associations.

3. C.B.I. Evidence to the Bullock Committee March 1976

4. International Labour Review 1976 Jan - Feb.

5. See pages 25 and 50.

6. O.K. Freund and B. Hepple 1972 page 60

7. Preface to Employee Participation and Company Structures 1975

8. Oct. 9 1972 J.O. 1972 C 131/149

9. See Sanders 1969

10. Leaven 1974 p 185

11. See O.J. 1970 C 124/1

12. Amended proposal for a statute for European Company Bulletin 4/75

13. UNICE Report on the European Company 1970

14. UNICE 1976

15. See Financial Times Feb. 1978 and ETUC 1978

16. Quoted in Walker K. 1974 35

17. See Written Evidence of the Economist to the Company Law Committee Cmnd 1749 258-260

18. Dirks, W. quoted in Wilpert B. Research on Industrial Democracy: The German case 1975

19. S 170. If they are rejected the decision is then placed in the hands of the shareholders' meeting.

20. S 111(4) Although not widely used. See Davies 1975 281

21. See S2 Works Constitution Act 1972 and Ramm T. 1972 and Robertson, J.C. 1973 p 749

22. Ibid S 102

23. See Financial Times Nov. 25 1978

24. Erdman 1972

25. Norwegian Ministry of Labour Press Release, Oslo October 1971 See also Emery and Thorsrud 1970 and Goss 1973

26. See Geiger 1976 and Balfour 1976

27. See Bouvin 1977

28. See Financial Times July 1977

29. See Vander Meers S. 1973

30. See Structure of Public and Private Companies Act 1971

31. Albeda W. 1973 p 69

32. Schedule 3 Table 9

33. See Fuernstenberg 1969 and Fogarty 1964 page 184

34. Hartman p 19

35. TUC Interim Report on Postwar Reconstruction 1944

36. The Labour Party 1967

37. See Guardian Report TUC Annual Congress 1973

38. TUC Industrial Democracy Annual Report by the General Council 1974

39. See TUC Evidence to the Bullock Committee 1976

40. See Fabian Society Workers in the Boardroom Fabian Tract No. 441 1976

41. See TUC Annual Report 1976

42. See Financial Times September 1976; Financial Times 4th January 1977

43. See TUC Evidence to the Bullock Committee 1976

44. The Labour Party Report of a Working Group May 1974

45. See The Times 27th January 1977

46. Institute of Directors Press Release on the Bullock Report January 1977

47. Clarke et al 1972 p 179

48. See Written Evidence to Bullock Report April 1976

CHAPTER SIX

COMPANY LAW AND EMPLOYEE REPRESENTATION ON COMPANY BOARDS

The representation of employees on company boards would have a profound effect on corporate law and practice in the U.K. Some argue that the notion of employee representation could be accommodated within the present framework with the minimum of change by making employee directors accountable directly to the corporate owners. The Stock Exchange in its evidence to the Bullock Committee asserted that:

> "Legitimate claims for a greater degree of involvement by employees in their companies can be met without making fundamental changes to the structure of company law." [1]

Employee representation would be acceptable provided that it was:

> "Subject to the overriding right of shareholders as owners of the company to remove any director at any time." (Section 14)

However, it might be argued that if the experiment in industrial democracy is made in earnest then it must necessarily accord with democratic principles. This would involve direct representation of the employees with a strong chain of corresponding accountability to the employee directors constituents, the workforce. Considerable changes in traditional company law and practice would therefore be needed to facilitate employee representation and it is here that we encounter the real problems inherent in experiments on the lines of the Bullock majority proposals. The essential problem facing the law makers is how to enshrine principles of industrial democracy and extend the influence of the workforce in a legal framework whilst permitting shareholders the exercise of proprietery rights over their investment in the company and its management?

Some might argue that it is not possible to reconcile the interests of shareholders and employees and the only solution is to institutionalise the inherent conflict between the two groups as in collective bargaining. The Bullock Committee assumed that it is possible, indeed such an assumption was forced upon them by their terms of reference. The central question asked of the Committee was how employee representation should be extended to the board room not whether it should be or whether it could be effectively combined with traditional collective bargaining.[2]

It is intended to examine the impact of Bullock type proposals on the functioning of the traditional concepts of company law.

1. Directors' Duties

No. 2 [illegible]

Two issues are involved in respect of the duties of directors and employee representation. The first has for the most part already been resolved, that is, a redefinition of the interests which the directors may lawfully consider in carrying out their duties. The U.K. has retained the traditional formulation that the directors must act in good faith for the benefit of the company and the company is defined in terms of its owners. As already observed, however, the Bullock Committee recommended that:

> "all directors should continue to be required to
> act in the best interests of the company, but that
> in doing so they should take into account the interests
> of the company's employees as well as its shareholders."
> (Ch 8 para 38)

2 interpretations of this are made by .... ? see Sealy (2) 1011/12

Such a change in the law has support from both the CBI and past and present Tory Governments.[3] A clause similar to the above was included in the Companies Bill 1973. The precise effect of such a change, however, is by no means certain. Arguably the new definition would simply bring the law into line with the realities of modern business, the director must take account of employee interests if only for the fact that a contented workforce is in the interests of shareholders. It may be argued, however, that if the law has defined the company directors responsibilities in terms of the employees as well as the shareholders then responsibilities carry a corresponding degree of accountability. Does the wider definition of directors' broad responsibilities to employees give the employees a right to call the directors to account, to challenge their action as being contrary to the express duty to have regard to their interests? Would such a definition involve us with "the bizarre prospect of the shop-stewards'handbook needing a section on the rule in Foss v. Harbottle?"[4] Does it give employees a right to challenge, through the courts, the action of the directors in so far as their interests have not been properly considered?

Much of the confusion is attributable to the modern practice to use terms like duty, obligation or similar verbs such as oblige, bind or compel in several different contexts. As one writer has commented in an analysis of power and duty in the law of trusts:

> "the failure to recognise that terms (such as those above) may be and are used in different senses has operated to produce conceptual blockages at crucial stages in the development of the law."[5]

It is submitted that there is a similar danger in the context of directors duties and employee interests. There is no doubting management's assertion that they accept a degree of responsibility towards employees but they are primarily and directly accountable to the shareholders and this fact is no less relevant if the shareholders hardly ever choose, or are unable to, call management to account. The expression 'obligation' in this context has been used loosely, accepting that responsibility to groups other than shareholders carries no corresponding accountability.

It is the problem of accountability that lies at the root of the whole discussion on the role and function of corporate activity in contemporary business. Trends in recent years in legislation and developments in public opinion have sought to tighten the accountability of managers and directors in the absence of effective action by or on behalf of shareholders. The fundamental problem is when one translates vague expressions of responsibility the breach of which has hitherto carried social or industrial consequences, into legal obligations that are meaningless without the provision of effective mechanisms for enforcing the duty. This may be done by the legal action, the election of employee representatives on to company boards, or expanding disclosure requirements. Simply widening the definition of directors duties and giving employees a right to challenge management may in fact give support to irresponsible management in that a widened definition may make it much more difficult to enforce corporate managers duties by legal action because it would allow the directors to argue that particular decisions that are challenged, are a permissible compromise between different interests within the enterprise. It has, for example, been observed that a similar provision in German law often serves as a shield for managers against the protests or law suits of their shareholders. In particular, if the definition were drawn so wide as to include the public interest "it is apt to be used as a cloak for managerial self interest or at best a source of self deception."[6]

A second and related problem in this context is the precise nature and extent of the legal duties and responsibilities on a reconstituted board. Are they all to have the same duties or are the directors completely free to pursue the interests of their constituents, irrespective of the company's wider interests? The TUC raised fears when they commented in their Report that it is pointless to give employees a right to representation and then require them to behave like any other directors:

> "Equal responsibility does not give identical responsibility ... the primary responsibility of union members would be to their constituents: they would be worker representatives on the board rather than worker directors." (1973 page 46)

It is surely unreal to place employee representatives under precisely the same duties as the shareholders representatives. German authors criticising their own system point out that the employees:

> "... are elected to the board to control and regulate the policy of the enterprise in the name of the members ... take the case of a strike ... must they abstain from all activity showing sympathy for the very group which they represent."[7]

4) where stated that : see OGDEN, SG Nov. 1982 SOCIOLOGY V.16 No.4
p 552.
for TUC attitude to director duties

The Bullock Committee opted for the princ iple of collective responsibility of directors. All directors should have the same legal duties and liabilities, that is, to act in the best interests of the company defined in terms of the workforce as well as the shareholders.[8] They argued that to create different standards would detract from the principal objective of the exercise, that of co-operation, and it would not be conducive to the efficient management of the company. But what precisely is meant by the expression "acting in the best interests of the company"? It is a vague expression that often arises in company law, in particular in respect of alteration of the articles, as a means of glossing over class disputes. As one learned judge observed:

> "the benefit of the company as a corporation cannot be adopted as a criterion which is capable of solving all the problems in this branch of the law." [9]

In the words of Lord Wilberforce:

> "This formulation bona fide in the interests of the company is one that is relevant in certain contexts of company law ... on the other hand (it may) become little more than an alibi for a refusal to consider the merits of the case ..."[10]

Essentially it depends upon how one sees the company as an entity. Kahn Freund poses the question, is the new structure built in the land of collective bargaining on the pluralistic pattern and based on conflict, or is it built in the land of company law on a unitary pattern? (1977 page 75) In other words, is the reconstituted board going to be merely an extension of collective bargaining into the board room where the two prominent interests groups confront each other representing their constituents? On the other hand are the board members meeting not as representatives of two irreconcilable interest groups but as individuals charged with the duty to consider the interests of the company as a self perpetuating entity, quite distinct from the groups from which it comprises and which has interests which extend beyond any of its component groups.[11]

The Bullock proposals might be said to represent a compromise between the two structures. They have been described by one of the signatories to the majority report as being based on the notion of a "conflictual partnership".[12] In the words of the Report:

> "The new concept of a partnership between capital and labour in the control of companies will supersede the idea that a company and its shareholders are one and the same thing." (Ch. 8 para 26)

But are they? A view of the joint interests of capital and labour is dependent upon what one sees as the primary objective of corporate activity. If the profit motive is dominant then it is difficult to see how the so called interest of the company will not almost always be indistinguishable from shareholder interests. It has, for example, been suggested that:

> "the company's interest may be opposed to those of the workers in a sense in which they cannot be opposed to those of the shareholders nor, for that matter, those of creditors." [13]

For example, if a dispute arises between the shareholders the majority group pushing for more investment and another group arguing for greater dividend, whichever loses, an interest of the shareholders will be advanced since the result will be either an increase in dividend income or in the long term in an increase in the value of the shares as a result of the investment. If, on the other hand, there develops a conflict between shareholders and employees over the introduction of new technology resulting in redundancies, the new technology is in the interests of the company and the employees are pursuing purely sectional interests, as are the losing group of shareholders in the first example, except the employees are dismissed and do not benefit in any tangible sense from the change.

This analysis assumes that the maximisation of profit is the primary objective of corporate activity. It has been argued that this is increasingly not the case and that corporate controllers may quite legitimately pursue other goals in addition to profit maximisation and by doing so take action which is in the "interests of the company" but which is not in pursuit of any shareholders interest.[14] Cited in support of this view are the observations of the CBI's Wilkinson Report (1973) and their support for legislative encouragement for companies to recognise wider obligations to groups other than shareholders. Such observations, however, always carry the implicit proviso, only in so far as such objectives are consistent with the long term profitability of the company. This is perhaps justifiable in that as Vag^{h}ts asserts:

> "Once the profit maximising conception of the corporation is abandoned it is not easy to construct an attractive and logical new framework to guide and legitimate management." (1966 page 48)

It seems therefore inevitable that to operate in the best interests of the company, however much of a balancing operation is performed at board level, will ultimately expose the employee representatives to an intolerable degree of pressure and bring them into direct conflict with their constituents. This is highlighted in the context of industrial action and membership of corporate organs. In West Germany, for example, members of works councils must exercise their powers in the interests of the plant and they are therefore not entitled to organise or participate in industrial action since such conduct is contrary to the broad duty to co-operate. As Simitis observes:

> "The integrational function of the concept becomes thus evident. Participation is tolerated but not as an instrument exclusively designed to safeguard the expectations of workers. The link between participation and the plants benefit dissociates the representatives from the workers and transforms them into special kinds of managers." (1975 page 12)

The Bullock Committee recognised the dilemma that faced employee representatives but, it is submitted, did not offer any explanation as to how it should be dealt with.

> "But at times there is bound to be conflict; instances are likely to include arguments about the priority to be given to maintenance of employment levels. There will be cases where the re presentatives of employees or shareholders argue for the predominance of their own interests. But no one will be in breach of his duty for arguing a specific case at board level... It would be unreasonable and unrealistic not to expect the employee representatives of the workforce to argue strongly at board level for the interests of their constituents. Indeed one of the objectives of putting them on the board in the first place is to make sure that the employees' voice is heard, at the very highest level of the company." (Ch 8 para 39)

There would, however, be no change:

> "in the law which at present prevents the mandating of a director to vote in a particular way. We are quite clear that an employee representative would be in breach of his duty if he voted in a particular way solely because of the instructions of his trade union. He must be a representative free to express his opinions and to reach his own conclusions about which policies will work for the greater good of the company not a delegate told how to vote by his constituents." (Ch.8 para 40)

In the event of the employee representative being mandated he would be obliged to disclose this to the board and not vote:

> "... an employee representative who finds that an instruction to take industrial action amounts in effect to a mandate on him to vote on the matter in a particular way should, on normal principles of company law, be obliged to declare this to the board and abstain from voting on it." (Ch.10 para 57)

Assuming that the board dealt with issues such as industrial action and collective bargaining,and this is more likely under the Bullock style reconstituted board than under the two tier system, the situation is fraught with difficulty for the employee director who is duty bound to consider wider "corporate interests". In particular strikes are a good example of the obvious priority that would be given to corporate interests. In West Germany on the rare occasions that such matters have come before the courts they have tended to shy away from any definite position. In 1955 the metal workers went out on strike and one of the employee supervisory council members played an important part in urging the workforce to strike and he became chairman of the strike committee, in particular playing an active part on the picket line. The lower court found that the director was in breach of his duty to the company since he was required to act for the good of the company and not represent special (workers) interests. Both the lower court and the Court of Appeal recognised the difficult situation that the employee was placed in and drew the somewhat artificial distinction between active and passive support. A director may withhold his services but not in any active way such as picketing or any other open support of the strike. The Court of Appeal even asserted that employee representatives participating in a strike would not be entitled to exercise their functions.[15] It appears that the court did not consider why the company's best interests are so patently contrary to those of the workforce. It might be argued for example that the refusal to negotiate with workers might equally be contrary to the corporate interest.

Again what is described as being in the company's best interests is identical to the interests of the shareholders. As Simitis acknowledges:

> "Hence any attempt to transform the company's best interest into the main guidelines for the activities of worker representatives must lead to serious conflicts. Not the company but the workers interests were the point of departure of all discussions on participation." (1975 page 13)

The problem would seem to be, should employee representatives be placed under a duty to try to reconcile conflicting interests and somehow arrive at a solution or should the issue be resolved by allowing the representatives to represent their constituents in the real sense of the word.

The Bullock proposals were centred on employee representation through trade union machinery. The representatives would not be full-time officials but shop stewards and by defining the directors duties as if the employees and the management were operating under unitary terms of reference the inherent conflict between shop stewards and their collective bargaining role and board membership is disregarded. This was largely why a majority of the Donovan Commission (Cmnd 3623) rejected the idea of worker directors:

> "Such an office might expose its holder at times to an almost intolerable strain when decisions unfavourable to the workers had to be taken because they were in the interests of the company as a whole. A concurring vote might be unavoidable if he is to do his duty as a director and yet could easily be misunderstood and misinterpreted. The result might be to open a gap between the workers and worker director which it would be extremely difficult thereafter to bridge. In effect he would cease to represent them." (1968 page 258)

Traditionally, trade union representatives, whether shop stewards or full-time officials, are not elected to represent their members by weighing up all the arguments and making a decision independent of their members. The whole machinery of trade unions is geared so that the demands and aspirations of the members are communicated to the representatives.[16] Unions expect that the representatives will carry out their instructions and the same would surely be expected of the board room representatives. If they are not seen to carry out their members' instructions their credibility would be seriously damaged and they would simply become alienated from their constituents, by-passed in favour of the full-time officials. The resulting frustration would surely defeat the object of the exercise.

The only way to bridge the sort of gap that Donovan referred to would be to develop strong channels of communication between representatives and constituents which is the central feature of trade union organisation. The union official is always in a position of strength through being able to consult his members by convening a meeting and seeking authority. Employee directors, however, though they may be shop stewards, are not trade union officials. They will have no direct line to their constituents but will simply report to the Joint Representative Council of all the unions and access to members will very largely be dependent upon the officials in whom authority is usually vested to convene full meetings.[17] Thus, if friction and conflict do develop between directors and trade union officials, the directors are in a vulnerable position.

These observations clearly reflect the view that any approach to relations between the management of business enterprises and labour which ignores the divergency between their interests is doomed. As the great architect of the Australian system of compulsory arbitration recognised:

> "the war between the profit maker and the wage earner is always with us". [18]

In other words the conflict between those who argue for higher living standards in the present against those who argue for more investment is a permanent feature of the system. The only interest that management and labour arguably have in common is that conflicts should be institutionalised, regulated by formal procedures .

> "It is, however, sheer utopia to postulate a common interest in the substance of labour relations. The conflict between capital and labour is inherent in an industrial society and therefore in the labour relationship. Conflicts of interest are inevitable in all societies." [19]

To that extent legislation on employee representation, if it is to be realistic, must explicitly recognise that directors elected by workers should be able to act in the furtherance of interests of the workforce.

2. Confidentiality

There is no doubting the need for all board members to keep in touch with those who elected them by reporting back to them on specific issues, indeed, this represents one of the fundamental pillars of U.K. company law.[20] It is of particular importance in the context of employee representatives on company boards with the vital need to develop strong channels of communication between the directors and their constituents. Any rational approach to the problems of modern business enterprise and relations between the workforce and management is linked to a better knowledge of the company's financial resources.[21] If the employees are to obtain the benefits of board membership and be able to effectively contribute to corporate success, it is important that their representatives be in a position to pass on information to their constituents.

Traditional rules of company law are not, however, geared to encourage this process. The law is notoriously vague and coupled with the fact that the representatives must always be asking themselves whether the information contravenes their duty to act in the best interests of the company, places them in an unenviable position.

Considerable anxiety was expressed over the TUC's comment that:

> "...worker representatives should not be unnecessarily hampered and restricted in reporting back by narrow requirements of confidentiality." [22]

The Bullock Committee regarded it as:

> "essential to the success of board level representation that employee representatives should be in close touch with their constituents. They must make it their regular job to report on what the board is doing or proposing to do. They must be able to take soundings before a matter comes up to the board so that they can accurately reflect the views and feelings of the employees to their fellow directors. If they are prevented from doing so they will become isolated from those they represent and may even be regarded with suspicion as the agents of management." (Ch 8 para 49)

In many instances confidentiality in the context of employee representation presents no more of a problem than under the present arrangements. Employee directors are no more a risk than shareholder representative directors in the context of unauthorised disclosure to competitors or disclosure of corporate information for personal gain.

> "Individual employee representatives are no more likely than existing directors deliberately to leak confidential information to competitors or price sensitive information to speculators."
> (Ch.8 para 53)

Employers are increasingly, as part of the process of collective bargaining and under statutory provisions, revealing confidential information to trade union representatives during negotiations. The problem however becomes acute in those areas where the confidential information has a direct impact on the interests of the workforce such as plans or factors relevant to collective bargaining or plans to re-allocate or close down plants and the emotive issue of redundancies. In these cases the employee representatives are unlikely to regard the need to keep such information as secret as being in the interests of the company in terms of their constituents. Indeed this represents rather more of a problem under the Bullock proposals than under the West German system where the problem is avoided by the separation of management functions from strictly supervisory functions. The Bullock proposals, however, allow for representation on a unitary board which can be expected to be dealing with major issues such as resource allocation and which therefore may lead to problems over the disclosure of information coming to employee representatives at board meetings. This is particularly so in view of the express intention of some trade unionists supporting employee representation at board level to use it as a means of extending the influence, scope and effectiveness of trade union bargaining power. In other words under the pluralistic model rather than the unitary pattern the problem in respect of confidential information becomes more acute.

The Bullock Report recognised the problems that employee representatives would be faced with and difficult conflict of interest that might arise although they did not make any proposals for change. Experience in Sweden and Germany where satisfactory systems of reporting back have been developed, showed that breaches of confidentiality as a result of board level representation were very rare:

> "Most companies had devised a satisfactory and workable system for deciding what was confidential before employee representatives on the board reported back to their constituents ...Our visits to Sweden confirmed our view that the best rules of confidentiality are those which are devised within each company at board level. It is much more desirable that within certain legal limits the board should work out what is confidential in a particular circumstance, than the law should try to prescribe what shall happen in every case." (Ch.8 para 57-58)

Bullock style representatives are likely to encounter more problems than their European counterparts largely because of the rejection by Bullock of any formal split between managerial and supervisory functions, their reliance on voluntary regulation is therefore understandable. It may be that shop stewards elected to company boards would prefer to avoid too olose an association and involvement in company financial affairs in the context of collective bargaining, since it could prejudice the union position in wage negotiations at plant level and inevitably involve the stewards in some degree of responsibility for the decisions arrived at. In this event the problems of confidentiality might be reduced to manageable proportions. This may also explain the unions' initial preference for the two tier board structure where membership of a supervisory board would not inhibit their collective bargaining role.

One particular problem is that if company boards are allowed to formulate their own categories of confidentiality it bestows upon them considerable discretion. It would necessarily involve legislation allowing the board to decide by a majority vote what information is to be treated as confidential in effect, allowing the directors to prescribe their own duties. Coupled with the necessary restriction on the shareholders right to commence action complaining of a breach of duty by a director in releasing confidential information, it may be argued that this gives too much unsupervised power to the directors.[23]

3. Board Structure

Until the Bullock proposals, it had been assumed that employee representation on company board necessarily involved the introduction of a two tier board structure. The initial proposals from the TUC seemed to be prepared in terms of a two tier system and even those groups who came out opposed to both worker directors and two tier boards accepted that introducing the former necessarily meant acceptance of the latter. Such a system was to be broadly based on the German model where the law requires a rigid distinction of functions and responsibilities between a management board responsible for the overall management of the company, operating within constraints set by the supervisory board with responsibility for overall strategy. The introduction of such a system into the U.K. would obviously be a considerable legal innovation. On the other hand, a close examination of the present unitary system reveals that it is not so far removed from the continental model.

The present companies legislation says very little as regards the distribution of functions and responsibilities between the main organs of a company, the general meeting and the board of directors. Apart from certain major constitutional decisions, such as alteration of the articles or the memorandum, the broad distribution of powers and functions is matter for the articles. In practice the board are usually invested with a very wide measure of responsibility for the management of the company which in turn may be delegated to committees. Indeed in many of the large companies it is the small committee of executive directors that takes the decisions, the full board merely being the legitimising institution rather than the decision making one.

There is no clear cut distinction between the functions of a board of directors and those of management but it is plain that on U.K. boards, directors, although responsible for management in terms of the law, are in many respects unable to exercise management functions. A British Institute of Management survey in 1972 found that 70% of the companies in the survey had some sort of management conference or committee meeting regularly to look at the overall affairs of the company.

> "The pattern varied enormously, but a broadly typical situation would be for the full board to meet monthly and form a committee of the senior executive to meet more frequently. Sometimes, junior executive directors and senior managers would attend the management committee, occasionally a non-executive director would be a member ... In addition the executive directors would usually work on the same floor and frequently lunch together so that in many companies the "management committee" would in fact be in continuous session, regardless of its regular meeting times." (page 3)

These committees have certain powers delegated to them by the board, for example, to decide capital expenditure up to a certain fixed ceiling and the B.I.M. report pointed out that it is at this level that the "horse trading" between executive directors and the different sections of the company was carried out, compromises are arrived at and corporate priorities roughly established. At board level these decisions are formally endorsed and any outstanding issues are resolved. In the final analysis the role of the board is a function of the size of the enterprise.

> "It was hard to establish what a board actually did and this obviously has a bearing on size." (BIM 1972 page 3)

Any examination of the role of company boards in the U.K. would reveal a very diverse picture, such a picture is inevitable bearing in mind the adaptability and flexibility of the corporate model as developed in the U.K. The functions of the corporate boards depend on a variety of factors including the history and traditions of the particular company, sales, profits and cash flow, employees, the scale, diversity and spread of its operations, the pattern of ownership and the form of organisation and management control. There is no doubt, for example, that as the external equity increases management tends to become divorced from ownership, and as this process continues and the company expands corporate policy and planning is devolved downwards from the board. The power to take significant decisions thus shifts from owners to managers.

The Industrial Participation Association pinpointed a number of different corporate structures in their evidence to the Bullock Committee. These ranged from smaller companies with a board consisting of executive managers firmly involved in all aspects of company policy and affairs, to the completely decentralised groups with a holding company board appointing senior managers and allocating resources but leaving operating policy to its subsidiary boards.[25]

Within the larger corporate institutions there is great diversity. Guest Keen and Nettlefords Ltd., for example, operate a policy based around decentralisation and aimed at promoting local autonomy with little direction from the centre. They operate a four tier board structure which is made up of 140 boards in the U.K. and 583 directors. At the apex of the system is a holding company board, GKN Ltd., below that the two boards of GKN (Overseas) Ltd. and GKN (U.K.) Ltd. and below these are 13 sub group boards in the U.K. and 137 U.K. company boards and divisional boards.[26]

E.M.I. produced a detailed breakdown of the functions of its main board, which included:

(a) Ensuring the executive functions are properly performed through monthly meetings to review the results;

(b) Undertaking an annual review of the budget for the forthcoming year;

(c) Devising the five year plan;

(d) Formulating group policy with regard to Government relations, public relations and international affairs;

(e) Taking investment or divestment decisions;

(f) Approving half yearly and annual accounts and the reports to the shareholders;

(g) Appointing and reviewing the remuneration of executive directors.[27]

Below the board there exists, however, a diverse and complicated system of corporate operations:

> "Generally speaking, the legal corporate organisation - that is, the conduct of businesses by subsidiary limited companies - does not necessarily correspond with the substantive business or management structure. Thus one business may include the activities of several companies; alternatively, a business may not be represented as a separate company at all; only as a division of a company whether the parent company or a subsidiary of the parent. The Boards of Directors of wholly owned subsidiary companies within the EMI group do not therefore have the same functions as the parent board: some of these Boards do function as a management committee, but others have no more than purely legal functions."
>
> (Para 9)

The legal framework assumes a downward line of authority from shareholder general meeting through the board to management groups and committees. In some respects, however, corporate structures and decision-making pattern is best viewed in reverse of that picture. In reality it is management that controls the shareholders meeting and the board. The shareholders are either unable or unwilling to involve themselves in the company meetings and elections. The directors are elected at the general meeting but they usually owe their seats on the board to the small group of executive directors who nominate the other directors and wield the proxy machinery. If therefore the majority directors are dependent upon the managing director, chairman and executive, they are in no position to function as supervisors or controllers of management. Rodiere described the German supervisory board as being:

> "an honorary gathering of distinguished people neither capable of nor inclined to exercise any real control even though charged in law with supervising the activities of the managing board." 28

If employees are to be represented on company boards it is important therefore that such a body has an effective hold on corporate decision-making and strategy and cannot be by-passed. In other words that corporate decisions are a direct responsibility of the board. However, it is quite apparent that the very complexity and diversity of corporate structures in the U.K. is likely to frustrate and work against such proposals. In a sense the practicalities of modern business work against vesting such responsibility in one place.

> "It is often not possible to say that one man or one body of persons has responsibility for a decision or policy." 29

The Bullock Committee even recognised that:

> "The extent to which a main board exercises detailed control of policy is inevitably limited. It cannot exercise detailed influence over every aspect of the company's affairs and it is largely reliant on the proposals and policies put forward to it by management." (Ch.7 para 23)

Indeed management, including the executive directors, are able by the use of various strategies to effectively manipulate their boards. Such devices are largely based on information control. Pahl and Winkler observed that the:

Who else said this?
IV your intro,

> "standard expectation of most of our directors was that the board collectively does not decide or even seriously discuss anything." (1974 p 109)

They set out to examine whether in reality the holders of formal corporate authority actually made decisions:

> "To be sure the final yea or nay at a board meeting may be seen as the decision point, and may so appear in corporate histories ... But the board actions we observed are better interpreted, we feel, merely as ratifications of decision made earlier or elsewhere, sometimes by much more junior men, about which the board had no practical alternative. The distinction between "making" and "taking" decisions is relevant. Boards of directors are, we feel, best conceived as decision taking institutions, that is, as legitimising institutions rather than as decision making ones." (1974 p 110)

(a) Two Tier or Unitary

In the context of employee representation on company boards the issue of the precise role and function of the board is inevitably central. Indeed the Bullock Committee devoted considerable space to discussing the board's relations with corporate management since, if the experiment is to have any chance of success it is vital that the new board be the effective locus of management power. Central to the debate over the choice between two tier board or unitary board is the concern expressed by the protagonists of "employee participation" that the organ chosen as the main channel of participation be specifically charged with the functions in which it is desired that the employees be able to participate.[30] The problem is summarised in the TUC's observation that on the one hand they would wish to see employee representatives relieved of any responsibility for day to day management but on the other hand ensure that they participate in setting and achieving basic corporate objectives.[31] It would therefore be necessary to develop a framework which safeguards and strengthens the ability of non-executive directors to exert influence and share effective control whilst at the same time maintaining a sufficient degree of ?
of recognising management right to manage ?
freedom for management.

Such a balance may be accomplished by the introduction of a two tier system based largely on a supervisory board. As indicated earlier, initially at least, this system was favoured by the TUC in particular because they saw it as a means of acquiring the benefits of participation whilst retaining a sufficient degree of independence and credibility to pursue a collective bargaining role. might not appeal to them and A majority of the Bullock Committee[32], however, recommended a modification of the present unitary system. They argued that a two tier system would create difficult problems for the law in defining the respective functions of the two boards. Unless the system ? – [illegible] not to all companies to which [illegible] [illegible] ? applied to all companies the law would be operating two separate structures depending not on suitability but simply the size of the workforce. The Committee argued that to adopt the two tier system would simply frustrate employee participation, as it necessarily involves the placing of restrictions on the ability to influence policy decisions. (Ch.8 para 7 – 8)

It is apparent from the study of the West German two tier system that such an arrangement creates a very rigid allocation of supervisory and management functions. In effect the decisions in which the employees have the most interest are not made or even discussed at supervisory board level.[33] In Germany this may not be so important to employee interests since there is a sophisticated chain of participation which stretches back via the works councils to the individual worker. The Bullock Committee, however, made no precise recommendation for a formal "substructure of participation", it was therefore far more important to ensure that the body on which the employees are represented is vested with ability to affect decisions.

Many disagree with the principle of this act, CBI's response to Gov. Con. Doc. p.23.
IoD's " " " " "
Press Release p2.

Essentially the type of board structure depends upon the rôle that is given to employee representatives. Under a two tier system the function of the supervisory board is strictly limited to supervision at arms length, whilst under the unitary system the board may reserve certain powers to ensure that they can exercise greater control over the direction of corporate objectives. The Bullock Committee favoured the latter approach, retaining the unitary board structure with a clear definition of its role and function. In order to ensure that important decisions were not made elsewhere company law would specify certain areas where the right to take a final decision would rest with the board of directors. The attributed functions of the board comprise. :

(a) Winding up of the company.

(b) Changes in the memorandum and articles.

(c) Recommendations to shareholders on dividends.

(d) Changes in the capital structure of a company.

(e) Disposal of a substantial part of the undertaking.

(f) Allocation and disposition of resources to the extent not covered in (c) to (e).

(g) Appointment, removal, control and remuneration of management whether members of the board or not, in their capacity as executives or employees.
(Ch.8 para 18- 19)

Such a system would undoubtedly represent an improvement over the present system in as much as the theoretical model visualises the "board as an integral part of the corporate management structure", which . is plainly unreal. However, it must be questionable whether the seven fairly elementary reserved functions would ensure that real influence on the conduct of business strategy would be retained. In effect the reconstituted board would be likely to be treated as a supervisory board with its role restricted to the "attributed functions" and delegating to management committees those decisions that most affect employees.

On the other hand it may be argued that to go much further would result in management by negotiation which would hardly be conducive to efficiency. Such an observation illustrates the fundamental dilemma facing the architects of any new system of corporate government, how best to draw the line between management and corporate controllers or supervisors. Expressed another way, to what extent are non-executive directors representing an interest group, to be given powers of veto over management decisions. This is where the two tier system has merit in that it draws a clear line between the respective roles of the representatives of capital and labour and management. Whilst enabling the representatives to maintain control over the overall objectives of the enterprise it also gives formal protection and recognition of management's distinctive function. As Fogarty asserts:

> " A major advantage of two tier boards is that they can be used to mark off clearly and unmistakably the role of the three major components of a company government: the ultimate constituencies of shareholders, employees or the public interest; the supervisory committee of watchdogs for those interests, and the executive directors whose business is not merely to administer the firm but to act in the fullest sense as its leaders." (1975 p 64)

There would be nothing to prevent supervisory board directors from becoming involved in the substructure committees provided that they accepted that responsibility for the decision at that level rests ultimately with management. The evidence from the USA on the role and effectiveness of non-executive directors on audit committees bears this out.[34]

The supervisory board is seen as deciding the general policy of the company, dealing with major issues. Its role would be advisory and it would lay down guidelines within which management may operate, giving express consent on certain reserved issues but not being involved in management as such. In particular consent would be required for the closure of a plant, major organisational or structural changes or joint ventures.

In addition, there is no doubt that giving employees seats on the supervisory boards which meet less frequently would minimise the difficult conflicts of interest that the representatives are likely to encounter.

Apart from the representation of employee interests, supervisory boards have advantages for the shareholders, in particular the investment institutions. Lester observed:

> "The great advantage of banks taking large equity stakes in industrial companies is that a close relationship is easier to achieve. Through the continental supervisory board, the senior management can be changed much more readily than in this country, as the changes at Volkswagon have demonstrated. Less drastic action is also made easier. The conclusion in Fraser's view (deputy chairman of Lazards and chairman of the

> City Capital Markets Committee) is that supervisory boards are needed in British companies to give major shareholders real power." (1975)

The choice between unitary or two tier board is dictated by the need to ensure that the "top board" on which the representatives sit, does possess real rather than theoretical power. Moreover, both unions and management seem to agree that there is an area properly to be designated as pertaining to day to day managerial functions and that this should be the responsibility of a designated board rather than diffused through a series of committees sub-delegated by a one tier board of directors.

4. Shareholders - Property Rights

The impact of a system of employee representation involves more than the election of employees on to company boards. Indeed under the present legal framework it would be possible to have employees elected to the board either by direct election or nomination of a trade union representative, simply by a term in the articles of association. The object of any experiment in industrial democracy, however, is the direct involvement of employee representatives in corporate decision making and a corresponding share in power by the employees. If the exercise is to be credible the decisions taken by the representative body must be incapable of being overturned or modified by the shareholders meeting. In effect this means a radical departure from the principle that forms the very foundation of company law, that of ownership and the un-

No : see [illegible] p(2) [illegible]

fettered exercise of the rights attached thereto. Ultimately control of the company, in law, resides with the owners or shareholders, the consequences of the experiment in employee representation would involve a considerable step towards what has been described as the "socialisation of private capital".[35] In the view of the Bullock Committee one of the weaknesses of the European experiments is that:

Do the council draft consider this?

> "... they have introduced employee representatives on to boards without also considering how the powers of the shareholders are affected; an d the result of this has sometimes been a reduction in the effectiveness of employees involvement at board level." (Ch.8 para 26)

The Committee recommended considerable changes in the legal rights of the shareholders although, in practice, the changes reflect the present reality of relations between boards and the general meeting. The shareholders mee ting would retain the right to approve or reject the reconstituted board's proposals in certain specified circumstances. These would be changes in the company's constitution, winding up changes in capital structure, fixing dividends, disposing of part of the undertaking. The right to convene a meeting for the purpose of considering resolutions in those areas would be the exclusive right of the board, but the shareholders meeting would retain the right to decide whether to pass the resolution or not. In effect therefore the shareholders would be unable to initiate a change of policy in those areas without the approval of the board and to that extent it restricts the basic right of ownership, the exercise of control.[36]

The Bullock Committee pointed out that the changes are not as far reaching as they might at first appear. The law would in fact reflect current practice in larger companies. The validity of these observations is borne out by Midgleys investigation; he observed that:

> "shareholders, as a body, are passive and apathetic about their rights and responsibilities." (1975 p 54)

The effect of the Bullock proposals would be to bring the:

> "law into line with reality, rather than reducing any real power or valuable rights that shareholders possess." (Ch.8 para 29)

This somewhat naive assumption by the Committee is open to considerable doubt. There is surely a vast difference between having rights and not choosing or being able to exercise them to great effect, and having such rights completely removed. Shareholder apathy or acquiescence may be explained by the fact that they perceive under the present arrangements that the board of directors and management, having similar attitudes and expectations, can be relied upon to act wholly in their interests. Such perceptions would radically change with the representation of employees on the board and explicit recognition and consideration of employee interests. Bullock style proposals reduce shareholders control over the board almost to the level of creditors. What is less clear, however, and this is the question that the Committee gave scant consideration to, is the precise results of changing the structure of property rights in terms of economic performance.

The majority commented that:

> "it seems to us (as it did to most witnesses) that to regard the company as solely the property of the shareholders is to be out of touch with the reality of the present day company as a complex social and economic entity, subject to a variety of internal and external pressures in which the powers of control have passed from the legal owners to professional management."
> (Ch.6 para 2)

Aside of such observations the Committee did not attempt to analyse the precise implications arising from the change in property rights which is the inevitable result from the introduction of employee representatives. It is easy to observe that ownership has become divorced from control, to an extent the consequences in respect of economic and financial performance are predictable but that represents no argument for the further diminution of property rights. Shanks comments that:

> "... one of the disturbing features of the majority Bullock Report is the impression it gives that its proposals are in the mainstream of European thinking and that they have a kind of "wave of the future"inevitability about them, especially in the context of our membership of the European Community ... We have to come to terms with co-determination in some form or other, but we should adopt an otherwise unsatisfactory model because we misread the European experience."[37]

What is more to the point is, however, that for better or worse, most of the different models of industrial democracy in Europe tread a careful line between the provision of machinery allowing employees to participate and influence decisions whilst at the same time keeping to a minimum any further attenuation of property rights. Indeed as observed earlier, the West German system of supervisory boards was first introduced to strengthen the exercise of shareholders control over the managers of their property. It might indeed be argued that the gradual erosion of the owners ability to exercise control over modern corporate management and the failure of the institutional investors to assume any controlling interest, has roughly coincided with the decline in the economic performance of private enterprise in the U.K. , what Allen called the British disease.[38] Those with the greatest incentive to secure the efficient operation of industry, the recipients of the "residual rewards", have been in no position to exert influence because of diffused ownership, minimal impact that one shareholder may have and the massive rise in the costs of exercising effective control. If therefore the ability of the recipients of the residual rewards to scrutinise management behaviour and performance is further reduced, the effect might be a further reduction in efficient operation. The answer might therefore lie either in underpinning the authority and rights of the traditional recipients of the residual rewards or replacing them from some other source. In other words, the only effective way to make industry more efficient if society insists on giving workers representation on corporate boards is to give them equivalent rights in respect of residual rewards. To a certain extent this was the basis of the Swedish Meidnar plan put forward by the Swedish unions in 1976.[39] It was proposed that they should share in the fate of enterprises through a special fund

[illegible] as, p28.

over which they would eventually gain a controlling interest.

One of the paradoxes of the Bullock majority report is that although they argue for a reduction in shareholders' property rights in order to prevent joint decisions being unilaterally overruled, the shareholders in fact retain the right to veto certain decisions, in particular, to impose borrowing limits on the board. The retention of such rights surely runs counter to their central argument which, if carried to its logical conclusion, would necessitate the complete removal of the shareholders' overall control of the board.

The Bullock Committee's concern was exclusively in the area of the representation of employee interests at board level, which necessarily imposes restraints on the shareholders' ability to exert control over corporate performance and conduct of management. This, however, is only one aspect of the debate on corporate accountability. In a sense it solves one problem but leaves unresolved the vital issue of the monitoring of management performance. There is no guarantee that the employees and their elected representatives will be able or concerned to render management accountable except in so far as it directly concerns employee interests. It is this question to which we must next direct attention.

Footnotes - Chapter Six

1. The Stock Exchange Evidence to the Bullock Committee section 14 1976

2. See Preface to the Bullock Report Cmnd 6706

3. See Companies Bill 1979 clause 46

4. See Wedderburn and Davies 1977 197, 199

5. Harris, J.W. 1971

6. Vaghts 1966 46

7. Quoted in Labour Party Green Paper 1974 p 16

8. Chapter 8 para 35-40

9. Peters American Delicacy Co.Ltd. Heath (1939) 61 CLR 457, 481

10. *Ebrahimi* v. *Westbourne Galleries Ltd.* [1973] AC 360, 381

11. See Schmitthoff 1975

12. See Wedderburn & Davies 1977 p 198 footnote 3

13. Kahn Freund 1977, 77

14. See for example Ansoff 1969, Morris 1967, Elliott J. 1978

15. Simitis 1975, 12

16. See Clegg H. 1972 Boraston etc. 1975

17. See Bullock Report Ch.9 para 45-47

18. Higgins, M.B. A New Province for Law and Order p 1 1974

19. O. Kahn Freund 1977

20. See Chapter 8

21. See for example Clark et al 1972

22. TUC 1974

23. This is perhaps where an audit committee might play a useful role See later chapter 7 p 222

24. See Chapter 2

25. Industrial Participation Association 1976

26. Guest Keen and Nettlefold Evidence to the Bullock Report 1976 p 7

27. EMI Evidence to the Bullock Report 1976

28. Quoted in Batstone &. Davies 1976 p 57

29. Bullock Report Ch.7 para 25

30. See Batstone and Davies p 18-27 and 53-56

31. See TUC 1974 para 1(ii)

32. Ch.8 para 11-20

33. See Chapter 5

34. See Chapter 7 p 222

35. Davies P.L. New Statesman 18 February 1977

36. See Bullock Report Ch.8 para 26-34

37. Shanks M. Workers on the Board: are we misreading the European Experience? The Times 15th February 1977

38. Allen: The British Disease Hobart Paper IEA Paper 67

39. See chapter 5 p 120

CHAPTER SEVEN

COMPANY BOARDS - INSTITUTIONAL CHANGES

It has already been pointed out that in view of the increasing scale of corporate activity giving rise to the emergence of a managerial class, power no longer resides with the shareholders or, arguably, even the board of directors as a whole,but with the executive management. Modern company boards are for the most part legitimising institutions having no real influence over corporate strategy except perhaps in a negative sense. These observations not only have a profound effect upon the proposals to elect employee representatives to the board, they also represent a much wider threat and present a considerable challenge to society in terms of accountability.

The traditional model gives the proprietors the vital task of monitoring the board of the directors to whom the management of the company is delegated. It is argued that shareholders have manifestly failed to exercise control over management and if their ability is diminished by the further attenuation of their ownership rights who will monitor management? If the board is in future to be a political arena based on a 'conflictual partnership', who performs the necessary function of corporate watchdog or supervisors?

It must be stressed that this is not an internal problem. We have already noted that because of the institutionalisation of the business enterprise, society demands the imposition of standards of behaviour and performance in the conduct of business that reflect the increasing awareness of the power of business. Any institution with such widespread and fundamental effects is for practical purposes a public institution and as such should be subjected to new forms of public accountability and the imposition of more effective institutional restraints designed to prevent and deter corporate mismanagement and abuses. It might be argued that market mechanisms provide the most effective check on corporate activity that company reformers are advocating should be provided by the law. In the capital market the investor may eliminate inefficiency by ultimately causing a change in corporate control or denying capital, whilst in the product market inefficiency is eliminated through business failure. Both, however, are extreme and largely inappropriate methods of effectively regulating corporate performance since considerable slack is tolerated before corrective action is considered.

1. Importance of the Board

In chapter six we examined the role of the board in the context of employee representation and drew evidence in particular from the Bullock Report. We found that modern company boards play a limited role in corporate decision making, they were represented as decision taking rather than decision making bodies. Galbraith observes:

> "The men who now run the large corporations own no appreciable share of the enterprise. They are selected not by the shareholders but in the common case by a Board of Directors which narcissistically they selected themselves."
>
> (1971 p2)

Galbraith was one of the foremost proponents of the theory that the direction of a company is not set by the board nor even executives who sit on the board but by what are termed the technostructure, a notion that:

> "embraces all who bring specialised knowledge, talent or experience to group decision making. This, not the management, is the guiding intelligence - the brain - of the enterprise. There is no name for all who participate in group decision making or the organisation which they form. I propose to call it the technostructure."
> (1971 page 191-192)

Eisenberg, in an important series of studies, contrasts the 'received legal model' of the company where the board selects officers, sets policy and generally manages corporate business, with the working model, in which the board performs none of these functions. Indeed, the proposition that the board do not manage has never been seriously doubted amongst students of business, particularly in the U.S.A. In 1945 Baker observed of the U.S. system:

> "under the system of directorates which has developed in this country among large listed companies, directors are unable to manage corporation in any narrow interpretation of the word. Directors do not and cannot direct corporations in the sense of operating them."
> (page 12)

It is often argued that boards have important functions in respect of corporate strategy and policy making, indeed this represents the primary motive behind employee representation at board level, giving the workforce the power to influence policy. Some studies have implied that the formulation of business policy is tantamount to exercising an overall managerial role but this is not borne out by practice or the great weight of academic investigation. Baker's report from the Harvard Business School in 1945 pointed out that important policy decisions on marketing, finance, production and personnel were invariably conceived and confirmed by executives below board. In addition, in respect of issues such as the preparation of budget, collective agreements and new products, the board's role was confined to the receipt and consideration of after the fact reports.

In the same year Gordon concluded that there was no evidence to suggest that the boards of larger companies either initiated decisions on specific issues or broad policy. Recognising the approval function as opposed to initiating activities, it was found that:

> "even with respect to approval, many boards in these large companies are almost completely passive." (page 90)

The final approval usually being bestowed by the managing director, finance committee or similar small group of executives.

The findings of Pahl and Winkler in 1974, the BIM study in 1972 and Tricker in 1978, much later in the U.K. correspond with the earlier American experience.

Perhaps the most revealing recent study, once again in America, was by Mace in 1971. He depicts directors as passive, friendly advisers to management. Only occasionally asking incisive questions or attempting any critical evaluation of management performance. In 1977 Mace reaffirmed his view in testimony before the SEC, asserting that the situation in his consideration had not changed dramatically since his study.[1]

Some of the comments made by directors to Mace are illuminating:

> "We get a little advice from the outside board members, but the management runs the company. The board rubber stamps the action of management and the board members are there to mollify the outside stockholders." (1971 page 15)
>
> One president stated it succinctly: "I would never take a capital appropriation request to the board. What in the world would they know about it." (1971 page 44)
>
> The vice-chairman of a large eastern company stated: "Except for the selection of the chief executive officer, the board is basically a non-decision making body." (1971 page 48)

The reality is therefore that despite the company law texts telling us that the business of the company shall be managed by the board, there is considerable doubt as to the precise functions attributed to the directors. The only firm conclusion is that in the larger enterprises directors as a board do not manage the company .nor for that matter would it be a practical possibility.

That is not to say, however, that company boards can be dispensed with or to give support to the "mushroom concept of a good director". That is, allow the managing director to treat directors as "mushrooms".

> "Put him in a damp, dark place, feed him plenty of horse manure and when his head rises up through the pile to get attention or ask a question cut it off quickly and decisively."[2]

The need is to clarify and strengthen the role of the board within the corporate structure. This is necessary not simply to meet internal pressure in terms of overall corporate efficiency but external forces from society. If the limited liability company is to continue to form the bedrock of our economic enterprise it must be built on public confidence and central to this objective is the board of directors imposing some degree of accountability on management as a precondition for public support.

The problem has been described as one of legitimacy. As Mason expresses it:

> "We are all aware that we live not only in a corporate society but a society of large corporations. The management - that is the control - of these corporations is in the hands of, at most, a few thousand men. Who selected these men, if not to rule over us, at least to exercise vast authority, and to whom are they responsible? The answer to the first question is quite clearly: they elected themselves. The answer to the second, at best, is nebulous. This in a nutshell constitutes the problem of legitimacy."
> (1959 page 5)

Drucher points out:

> "The danger is that business managers do not have social legitimacy and do not know it ... Legitimacy in this context means the corporation's right to go on doing that which it has been doing for decades ... businesses right to set prices has been controlled by Government advertising is more strictly regulated. Consumer groups have become more articulate and better organised. Even professional groups normally allied with the corporations are acting up." (1946 page 8)

In the U.S.A. fears over corporate accountability and legitimacy have been prompted largely by the growing size and diversity of companies, rendering them more remote. There has also been considerable public disquiet created by recent frauds and company collapses which have focused attention on the corporate system. The creation of very powerful agencies such as the Equal Opportunities Commission, Federal Opportunities Commission, Federal Trade Commission and Environmental Protection Agency, in addition to the now well established Securities and Exchange Commission , have also encouraged questioning of the credibility of companies in society. The disclosures that followed on the collapse of the Penn Central[3] represents a perfect example of the failure of the role traditionally and formally attributed to the board of directors. The board had manifestly failed to monitor management and an SEC study[4] revealed that a seat on the board was looked upon rather more as an honour than an active responsibility in the business sense. The company directors required and received only limited information and board meetings were very formal and the only occasions when the directors made contact. The study concluded that there was a total failure to create any procedure including the provision of regular information on the company's finances, sufficient to enable the board to comprehend what was happening.

As often observed in preceding chapters, similar fears have been expressed in the U.K. and calls made for the development of new forms of corporate legitimacy based on a broader role of the board in stimulating greater accountability. So far the debate has concentrated on the extension of democracy into the board room as the means of making companies more accountable, it is only fairly recently that other avenues and possibilities have been canvassed. It may be that the cries for greater accountability have been prompted by different motives from those in the U.S.A. but they call for moves in the same direction. U.K. governments have tended to use companies either through voluntary action or legislation or offering incentives, as a support to government policies on employment, incomes, prices, competition and consumer affairs and in doing so the role of the company in our society has been increasingly questioned. If private industry is being used by Government as a tool in economic policy and is receiving massive amounts of financial assistance and other support, then the issue of corporate accountability will inevitably be raised. The CBI observed in their report on the responsibility of public companies that:

> "Within its own fields of knowledge, skill, geographical concern and financial capacity, a company has the duty to be responsive to the movement of informed public opinion ... A company may have few or many points of contact with the public interest. Assuming that there are many, it will not be enough for one executive, even the managing director, to assume a responsibility for the subject. More widely dispersed responsibility and authority will be required with the board setting the tone:
>
> (i) to be aware of the points at which the company does or may touch aspects of the public interest;

> (ii)to ensure that managers and specialists take account of this;
>
> (iii) to make due provision for this in forward objectives, policies, plans and financial budgets, and for performance to be monitored;
>
> (iv) by progress reports, internal and external, to show that the right balance is kept between what is desirable and what can be afforded."
>
> (1973 p 23-24)

Although business failures and scandals have not been on the same scale as in the U.S., Department of Trade Reports have steadily established a pattern sufficient to cause widespread concern over the role of directors and company boards. The most recent revealed:

> "imprudence, short sightedness and concern only for a short term profit on the part of individual directors." [5]

in respect of a loan of £5.2 million which was not even discussed at board level in the company involved.

Clearly any clarification of the functions and any new role attributed to the board must recognise the inherent limitations on its capacity as an institution to exert influence in respect of policy and strategy. There can be no benefit in clinging on to the present fiction in respect of large companies that directors manage the business. The vital task for the board, as the CBI report implicitly recognises, is in rendering management accountable and effectively monitoring their performance. If a restructured or reconstituted board (with or without employee representation) can perform that function and be seen to be active then much will have been achieved. Such a role is envisaged under the American Bar Association's Model Business Corporation Act which was changed from:

> "the business and affairs of a corporation shall be managed by a board of directors"

to

> "the business and affairs of a corporation shall be under the direction of a board of directors." 6

The authors of the draft justified the change on the following basis:

> "Many commentators have recently voiced concern that (the language requiring that the business be managed by the board of directors) may be interpreted to mean that directors must become involved in the detailed administration of the corporate affairs. Before the advent of the so called "outside director" it was not unreasonable to expect the board to be actively involved in the corporation's business; however, with the development of board participation by individuals not otherwise actively involved with the corporation: any such expectation can no longer be viewed to be reasonable. Indeed, such involvement is clearly neither practical nor feasible insofar as today's complex corporation other than perhaps the closely held corporation is concerned ... to adapt to current corporate life the revision provides that the business and affairs of a corporation shall be managed under the direction of a board of directors." 7

It may be argued that one of the effects of continuing to attach such importance to strategic and policy making functions of the board has been to distract boards from carrying out functions that they may be equipped to carry out with some degree of practical credibility, such as monitoring management.

2. Limited Role of the Board and its Membership

From much of the discussion research and analysis in U.S. and to a lesser extent in the U.K., it is fair to conclude, in the words of Drucker:

> "in reality the board as conceived by the law-maker is at best a tired fiction. It is perhaps not too much to say that it has become a shadow king. In most of the large companies, it has in effect been deposed and its place taken by executive management." (1954 p 178)

To a great degree such a development is inevitable in view of the size and complexity of modern companies and the corresponding restraints that it imposes on the boards. For example, in 1967 an American survey by Conference Boards[8] of 454 manufacturing and mining companies found that the boards of 45% met no more than six times a year and 76% no more than 12 times a year. A survey by Heidrick and Struggles three years later of 474 industrial companies produced broadly similar findings. In the U.K. a BIM survey in 1972 of 200 companies found that about 65% met monthly whilst 23% met less frequently. Only 7% of the boards met more often.

With these figures in mind assuming that the average board meeting lasts for three hours (probably much less) most company boards meet no more than 36 hours in a year during which time they are required under the "received legal model" to manage the company and formulate business policy. As Eisenberg concludes:

> "... it is obvious that by reason of time constraints alone the typical board could not possibly manage the business of a large publicly held corporation in the normal sense of that term. Such businesses are far too complex to be managed by persons who put in the equivalent of five to ten working days a year. Furthermore, the same imperative precludes the board making business policy. In a complex organisation concerned with complex choices, policy cannot be developed on a part-time basis." (1975 p 379)

Much related to the restraints placed on a board in terms of time is the problem of receiving reliable and relevant information in order to arrive at a meaningful decision. The same American surveys show that only 17.3% sent directors manufacturing information before a meeting, 21% market information and 11% no information at all. Of the executive management questioned 20% argued that directors' access to corporate plans and data should be restricted. In a British survey of non-executive directors by Tricher one respondent stated:

> "I doubt very much that most non-executive directors are given sufficient information concerning the running of the business to enable them to form a view." (1978 p 50)

Given the fact that the board as a separate institution has no access to staff in order to assist in collation and evaluation of information, except the executive management, they are wholly dependent on executive as to the amount, quality and make-up of the information they receive. Indeed, observations recorded by Mace seemed to suggest that it was bad corporate manners "and not in accord with professional courtesy to ask challenging questions and seek information." (1971 p 54)

> "It need hardly be added that this kind of power over information flow is virtually equivalent to power over decision." 9

Problems of time and limited access to information place obvious obstacles on the ability of the board to carry out those functions that the legal model has traditionally attributed to it. More significant, however, in the context of illustrating the importance of the board's role and its direct dependence on the executive is an examination of the studies relating to the composition, selection and tenure of directors.

The most significant factor in the composition of boards both in the U.S.A. and the U.K. is the extent to which the board includes individuals directly dependent or linked to executive management in some manner. Usually a majority of the seats on the board are held by executive directors. In the survey by Heidrick and Struggle 49.8% of the industrial companies had boards where the executive directors held 50% or more of the seats and 55% in a further study in 1970.[10]

It is hardly surprising that inside directors would not challenge the managing director or their colleagues at board level bearing in mind their dependence in terms of promotion and career prospects within the hierarchy. Indeed, arguably, it is impossible for executive directors to exercise any degree of critical analysis of performance since the logical outcome of any adverse conclusion as to performance is that management be replaced. Mace's study revealed similar sentiments:

> "It is hard to believe", said one president "that an inside officer as a member of the board is responsible for evaluating the management of a company which he, among other board members, has delegated to the chief executive officer for whom he works. That is the dilemma, and that is where the conflict begins."
>
> "The vice president inside director type is in a very precarious position at a board meeting. He just cannot say anything in disagreement with his boss, so what he usually does is sit quietly and wait until he is called upon to speak. He's got to walk such a tightrope! He must be sure that nothing is said or implied which would be offensive to the senior management of the company."
>
> (b) "If you watch what happens at board meetings, you will observe that any questions are asked by outside directors and never by insiders. And it is a little bit like a tennis match - if a questioning outside director is at one end of the board table, and the president ~~is~~ at the other end, the question and response results in all eyes moving in unison to whoever is speaking."
>
> (a) "Insiders don't ask questions or raise issues at board meetings because their points of view and contributions have all been expressed at meetings of management prior to the board meeting..." (1971 p 119-121)

Reliance on the executive may also extend beyond inside directors to those outside that sit on the board as a result of the favours of the chairman. They may be lawyers, accountants, bankers, suppliers or persons similarly tied in a business sense to the corporate management.[11] Surveys in the U.S.A. indicate that 20% to 25% of outside directors of the larger companies are either lawyers or bankers and that of the remainder most are "psychologically tied to the chief executive by friendship, former colleagueship, or both."[12]

In the more limited BIM study, of those boards that had non-executive directors, they were usually in a minority of one quarter to one third. The investigation revealed that out of the 166 companies with non-executive directors, 22 of the most recently appointed had been executive directors of their company for at least 10 years or more. Indeed the survey found that the most common type of background for non-executive directors were:

" - retired executive directors of the company (82 companies)
- family or historical connections with the company (66)
- member of the legal profession(63)
- merchant banker (60)
- other banker or financier (52)
- accountant (45)
- technical specialist (37)
- substantial shareholder (35)
- politician (26)" (1972 p 10)

The authors of the survey observed that:

> "the true objective outsider seemed to be a rarity." (p 12)

As regards the actual selection and tenure there is little evidence of real independence on the part of those outside directors not connected in some way to the management. It seems that in the U.S.A. directors are most frequently selected and hold office at the favour of the chief executive, not the board. The major consideration in selection ~~is~~ is: the individual concerned likely to fit in and agree with management or is he likely to "rock the boat."

> "Don't be surprised or disappointed" one president said "if you find that most outside board members are known to be non-boat rockers, what would you do if you were president? you control the company and you control the board. You want to perpetuate this control. You certainly don't want anyone on your board who even slightly might be a challenge or a question to your tenure, so you pi ck personal friends with prestige, there is an aura of stability, character and integrity. You sure as hell are not going to ask Ralph Nader or Lowis Gilbert or - what's the name of that woman who is so unpleasant at shareholders' meetings?

> The retired chairman of a medium sized company in the mid-west stated: "In the companies I know, the outside directors always agree with management. That's why they are there. I have one friend that's just the greatest agreer that ever was and he is on a dozen boards. I have known other fellows that have been recommended to some of the same companies as directors, but they have never gotten anywhere on the list to become directors. Because if a guy is not a yes man, he is an independent thinker, then they are dangerous to the tranquility of the board room. Company presidents are afraid of them - every damn one of them". 13

Once a friendly director has been taken on the board the chief executive is able to ensure that the directors always remain friendly by the threat of removal from the board. Although theoretically it is the shareholders who remove directors, in reality, just as the managing director can ensure the election of friendly non-executive directors, so he can also ensure that they are removed or at least not re-nominated when their period of office expires. Indeed in the Heidrick and Struggles survey (1971) 37% of the corporations reported that they had "fired" non-executive directors.

Mace concludes:

> "Also communicated to, and generally accepted by, directors was the fact that the president possessed the complete powers of control. Those members of the board who elected to challenge the president's powers of control were advised usually outside the board meetings, that such conduct was inappropriate or they were asked to resign." (1971 p 80)

Again, board room practice in the U.K. bears a close relation to the U.S.A. The BIM survey drew the conclusion that outside directors are mostly appointed under command from the chairman or chief executive. It appeared from the interviews conducted that a significant factor in the choice of a director was that he should have "a pleasant and co-operative personality" and be "compatible with the board as a team". As the report concludes:

> "It is logical, too, to suppose most chairman are unlikely to suggest the appointment of a non-executive director who will seek to remove them."
> (1972 p 13)

A point of great relevance lies at the root of the observation of one chairman interviewed who conceded that the U.K. system:

> " of company control failed to spot bad management easily and get rid of it quickly largely because the executive directors in many companies, particularly the chairman, were effectively appointing judges in their own cause when selecting their non-executive directors. Most chairman conceded that this did happen elsewhere although not in their own company."
> (1972 p 13)

Tricker records the view of one director to the effect that:

> "Directorships are awarded by the patronage of the chairman and it is hard to deny the reality of the statement, although the implications that patronage produces poor results would have to be questioned." (1978 p 50)

One respondent commented that:

> "The tendency is for a chairman to appoint people well disposed to the company and himself." (p 50)

3. Non-Executive Directors

Reference has already been made to the U.S. Bar Association's revision of the Model Business Corporation Act requiring that the affairs of a corporation be managed under the direction of a board but the problem of corporate accountability cannot be solved by simple legal definitions. What is meant by direction? What institutional changes will be required for the board to effectively comply with such a duty in terms of monitoring management? Under the present arrangements the law gives companies a considerable degree of flexibility in respect of corporate government and structures but if new institutional checks are to be introduced some of that flexibility must be sacrificed. In addition the courts will be required to take a far more active role in requiring and encouraging directors to discharge their duties. The present rules in the U.K. are a positive disincentive to directors to play an active role in monitoring management, the fewer meetings they attend the lower the duty imposed upon them.

In the U.S.A. this process has already commenced. As a result of the work of academics like Mace, focusing attention on the role of non-executive directors, and the publicity surrounding recent corporate collapses, experiments are taking place in making the board a more effective institution. At the same time the courts, traditionally always more prepared to question business managers than their U.K. counterparts have been underpinning such changes by encouraging litigation against directors for mismanagement and imposing higher duties. As Schaeftler acknowledges:

> "In the past, a great number perhaps the bulk, of derivative suits (i.e. minority shareholder actions) involved the classic breaches of fiduciary duties; self dealing, conflict of interest, secret profits, waste of corporate assets and the like. But today in the mid-1970s management is much more likely to be charged with negligence, mismanagement and careless administration than to be accused of fraudulent misuse of the company." (1976 p 139)

Non-executive directors have begun to demand more information and the introduction of effective procedures that will enable them to monitor management's performance and assist in the detection of corporate frauds, illegal payment and slush funds that have become a feature of business news in the U.S.A.

Most of the proposals for reform of board structure and corporate accountability particularly from the U.S.A., have centred on the role of the non-executive directors. This concentration may be justified on the basis that executive directors have a very clearly defined role and responsibility in the management of the company which thus precludes them from performing with any degree of credibility and objectivity any task other than management.

One of the most radical proposals of recent years was that of Goldberg's in 1972. His idea sprang from the circumstances surrounding his resignation from the board of TWA on the grounds that he had been denied a staff and budget with unlimited access to company records. Goldberg argued that given these limitations, he was unable to discharge effectively his legal responsibilities as a director.

In his proposals Goldberg recognises the wide divergence between the legal model and reality of board practice. The board cannot:

> "... acquire more than a smattering of knowledge about any large and far flung company. The ... board is relegated to an advisory and legitimising function that is substantially different from the role of policy maker ... contemplated by the law." (1972 p3)

It is therefore:

> "difficult, if not impossible, for the most dedicated director to have much impact on policy decisions." (page 3)

The result is "justifiable criticism and legal recriminations." The most satisfactory method of rectifying the situation, according to the Goldberg model, is therefore to create:

> "a committee of overseers of outside directors that would be generally responsible for supervising company operations on a broad scale and make periodic reports to the board." (page 3)

Such a committee would have the authority to appoint a staff of experts to assist them in their surveillance of management and in addition skilled consultants such as financiers and accountants to provide an independent source of advice for the board. Indeed the staff:

> "would be responsible only to the board and would be totally independent of management control ... and would look into major policy questions and report to the committee and through them to the board as a whole before decisions are taken on management recommendations." (page 3)

Unlike most of his contemporaries, Goldberg seeks to make board room practice correspond with the legal model rather than the less ambitious task of re-defining the "received legal model" to give the board more limited tasks that they can better achieve. The result would be to "re-assert the position of the board as a focal point for creative policy input for corporate decisions." (page 4)

There is no doubting the logic of Goldberg's proposals if we proceed on the basis that the board of large companies are managerial institutions, putting into effect business policy. However, what in effect would be the result of the application of this model?

Most would argue that the proposals are impractical, over elaborate and would result in nothing more positive than the addition of another tier of bureaucroacy whose function would be to retrace or "second guess" management but without the responsibility for results which attends management decisions. In Eisenberg's words the board staff:

> "could normally be expected only to decide again with much more limited facilities and feel for the business and at the price of additional expense and time - issues which management and the corporate staff have already once decided. If the conclusion of management and the corporate staff are the same, nothing will have been gained for this price. If they differ, it is far from clear how the

> board will choose between them. In short, the proposal would add a further and unnecessary level of decision making to corporations which already tend towards over bureaucratisation: would add immediately to the difficulty of running the corporation's business; and would produce a wholly undesirable diffusion of responsibility as among the executives, the shadow staff, the overseeing committee and the board itself." (1975 p 390)

The Goldberg proposals are essentially aimed at underpinning the director's role of managing the corporation. It may be argued, however, that it creates as many legal dilemmas as it eliminates.

> "If a conflict among staffs arose, some comfort could be taken largely in the boards having considered all viewpoints and its conclusion thus should not ordinarily be questioned by a court under the business judgment rule. But the directors would also have to consider ... the comparability of the quality of the outside staff with the inside group, the possibility that a dissident stockholder would claim that because of a disclosed adverse report the board knew or should have known the investment would turn sour, or that confronted by conflicting views the board did nothing when it should have taken advantage of a golden opportunity." [14]

It must be clear from the introductory remarks to this chapter that given the present size and diversity of corporate activity the role that legal theory attributes to the board of policy making as an integral part of management is fictional and unworkable. Given that Goldberg's view of bringing into line practice with legal theory is unworkable, the only alternative would be to modify the legal model giving to the board or independent directors, functions that they are able to perform and which recognise the inherent limitations of modern boards within the corporate structure. For example, it has been argued that the primary priorities of the board are to provide criticism, constructive advice and counsel for management.[15] This may be so but it hardly represents a function essential to the enterprise. It may be that independent directors are lawyers, accountants or bankers and in that capacity they may have something constructive to offer management but nothing that cannot be obtained from the company's own professional advisers.

Company boards have by law and practice traditionally been required to perform an authorising function in respect of important corporate activity such as mergers or other constitutional and structural change. Indeed a central part of the Bullock proposals ensuring that employee representatives were able to influence decisions was the proposal that certain areas be reserved specifically to the board. Aside of such considerations, however, the authorisation functions may have a useful purpose in that the very existence of a review procedure of management plans is likely to ensure the proposals are prepared with care thus provoking a more measured reasoned decision process. As one U.S. executive comments:

> "the board buffers and protects the chief executive and provides him and his subordinate management with a sheltered and supportive environment in which to function." [16]

Again, however, the point must be stressed that the board's ability or indeed willingness to review management decisions is strictly limited in that they are dependent for information on the proposals from those that formulate them. It is therefore arguable that this authorising cum review function is best performed at an earlier stage, as in practice it generally will be.

Eisenberg concludes that:

> "for most or all practical purposes the last real authorisation level is the office of chief executive. Thus, aside from the potential check it provides in conflict of interest cases the boards authorisation function, like its advice and counsel function, is of limited importance." (1975 p 393)

Another function that is increasingly being seen in terms of a more prominent role for company boards is as a vehicle for allowing interest groups to influence or exert control over decisions. We have already discussed this at great length in the context of European experience and proposals in the U.K. for employee representation. There is no doubting the value of experiments in Europe in bringing to the attention of corporate controllers matters of particular relevance to interest groups in the decision making process. Aside, however, from the symbolic value of employee representation at board level there is no concrete evidence to suggest that it gives employees a more effective voice that the obvious alternative of collective bargaining or indeed that such representatives would be more likely to be concerned with management accountability or particularly well equipped to challenge the executives. In any event as we have already observed few decisions are made at board level.

From the employee's point of view involvement at a lower level by collective bargaining or membership of a workers council, where decisions are actually made, is of more benefit.

A major danger in using the board exclusively as a vehicle for allowing different groups to influence policy is that it will convert companies into quasi political institutions. Blumberg argues that such developments:

> "would transform that board into a political institution, a microcosm of the community. All the directors would become, in effect, special interest representatives (whether for an outside group or for stockholders) working to satisfy their particular constituents. The problem of conflict of interest for the individual board members would be replaced by the problem of conflict among the directors. It is extremely doubtful that such a board could manage a corporation effectively. Board decisions would involve shifting alliances between constituent groups with log rolling deals (for the exchange of support for respective proposals) all of which would lead to a condition described by Beardsley Runl decades ago as "gangsterism". (1973 p 47)

Indeed, it is possible that in view of the different patterns of corporate government and industrial relations that exist in the U.S.A. and U.K. from those in Europe that the present preoccupation with employee representation will bring about greater recognition and promote more independence in respect of board membership than actually result in the representation of various interests at board level.

In terms of the function for which the board is best equipped to perform in that there is no effective alternative the modest, though indispensible one is that of monitoring management's performance. It is this function that Eisenberg first gave prominence to:

> "A corporate organ comprised in significant part of non-executives can rarely either manage the corporate business or make business policy ... There is, however, one cluster of critical functions which such an organ is optimally suited to perform,selecting, monitoring and removing the members of the chief executive's office. It therefore follows that the primary objective of the legal rules governing the structure of corporate management should be to ensure effective performance of that cluster of functions - if possible without precluding the board from playing additional roles if it so chooses." (1975 p 402)

The centrepiece of Eisenberg's model is the non-executive directors; it is they who should possess the effective power to appoint the managing director or chief executive, monitor his performance and remove him should he prove unsatisfactory. He stresses that this limited role is the only method of bringing the legal model into line with what is realistically effective.

The restoration of the basic right to appoint and dismiss to where it traditionally rested would give the non-executive directors effective power to monitor performance of management.

> "Under a monitoring model therefore the role of the board is to hold the executive accountable for adequate results (whether financial, social or both) while the role of the executive is to achieve such results. Of course, the board cannot perform this task without regard to policy.Objectives must be set, explicitly or implicitly, against which to measure management results and the selection of the objectives will partly depend upon the

> directorsbroad notions of policy and will interact with the question of what business policies are suitable for that particular firm."[17]

Indeed, a special sub-committee of the U.S. Bar Association on Company Law interpreted the Model Business Corporation Act as placing responsibilities on directors to establish basic corporate objectives, to select senior executives, to ensure the recruitment of competent managers, and to monitor the performance of the enterprise and its managers. In support of this they recommended that a majority of the board be persons independent of management in order to ensure the integrity of the monitoring function.[18]

(a) Role and Function

At the outset it is important to recognise that whilst outside directors have a very significant role to play in rendering companies more responsive, aware of the community in which they operate and imposing higher standards of corporate accountability, there are limits to their responsibility within the corporate framework. Given the pressure placed on directors with a clearly defined monitoring role they may be tempted to advance one stage further from a supervisory role to actually interfering with management by substituting their own judgment for the executive's judgment. Such a development must be resisted, non-executive directors clearly have no place in any part of the management structure of the company, if this is misunderstood there would be a weakening of the notion of personal accountability amongst the executive directors and the result would probably be management by committee which would be detrimental to the whole decision making process and ultimately to corporate growth. It is precisely for this reason that Goldberg type proposals for a private staff for the directors in order to analyse decisions should be avoided. Such a move would inevitably increase the likelihood of directors interfering with management.

An additional danger to be aware of is the attitude of non-executive directors. Non-executive directors must be deterred from assuming an adversary attitude to management which their newly defined supervisory role may encourage them to adopt. Their function simply implies an ability to be vigilant, to subject management to questioning in the joint effort to secure what is in the best interests of the company.

(b) Appointment and Independence

Obviously if the principal role of non-executive directors is monitoring then the basic criterion for board selection must be their ability to contribute to the various monitoring exercises. This includes having sufficient time available to devote to the inevitable research involved and attendance at committee meetings. They must also be seen to be independent of management. Both current law and practice on both sides of the Atlantic at present makes little attempt at securing independent directors. Most directors have some link with the managing director and management of the company and their presence on the board is often at the pleasure of the managing director.

The central problem is therefore achieving a sufficient degree of independence in order to give credibility to the efforts of the directors in monitoring management whilst at the same time ensuring that the best qualified individuals are available, bearing in mind the secondary functions of board membership such as providing counsel and advice. The retired executive may be appointed as a non-executive director but it is likely to impair his objectivity and in effect, his judgment. At the same time it is precisely his experience that makes him of value to the company. Such individuals may therefore sit on the board but not as an independent member. The same would apply to those directors that have a business relationship with the company either as banker, accountant, lawyer or supplier. Such persons may have considerable talents and offer much to management in terms of counsel and advice but as monitors of management their objectivity is questionable.

In view of the present practice and attitudes that prevail, electing independent directors will be a difficult goal to attain. One important step in creating the right climate and promoting the necessary degree of independence might be the selection of outside directors by a nominating committee composed wholly of outside directors. Such a committee would liaise with management, in particular, the managing director, about the possible appointments but would not be bound to adopt management nominees.[19]

In this respect legislation has an important role to play although arriving at a workable definition of independence presents the drafters with a problem.

> "... the definition of independence must be rigorous. Specifically, any person who is an executive of the corporation or who has a professional relationship or business dealings with the corporation, any close relatives of such persons, must be treated as not independent ... Be independent in fact as well as form, and must have effective power to select and remove the members of the chief executive's office." [20]

Arguably in order to achieve these objectives the independent directors must be in a majority on the board and be in control of the proxy machinery:

> "...the power to nominate directors on the boards' behalf and to spend corporate funds and devote corporate facilities towards the election of such nominees is vested exclusively in the independent directors. Since control of the proxy machinery carries the de facto power to select and dismiss the executives whoever has that control has ultimate control over the company. At present, the power to select and dismiss directors is typically vested in the chief executive. Since the full board has control of the proxy machinery and since the chief executive usually dominates at least a majority of the board, he can effectively remove any single board member who opposes him by wielding his power over the board majority to prevent the directors renomination. A director who would otherwise oppose the chief executive will therefore normally either remain silent or resign, unless he can somehow himself mobilise a majority control, which is rarely possible." [21]

Such a system would mark a considerable departure for companies in both U.S.A. and the U.K. where hitherto outside directors have been in a majority. In the U.S.A. the idea of treating the independent directors as a separate corporate organ has already been implemented in the context of investment management of mutual funds. The Investment Corporation Act 1940 requires that a number of the board of directors be independent, that is, that within the preceding two years before appointment, they must have had no business or professional relationship with the company or its principal management officers. In addition the legislation provides that the contracts between the investment adviser and the fund, the principal underwriter and the fund be approved by a majority of the funds independent directors present at a meeting called specifically to consider them. The directors must request and evaluate, and the adviser must furnish all information reasonably necessary to evaluate the investment advisory contract.

The New York Stock Exchange requires directors who are:

> "independent of management and free from any relations which could interfere with the exercise of independent judgment as a committee member." 22

Aside of the benefits of introducing a new legislative code, the courts could play an influential role in encouraging companies to appoint independent directors. In the context of a statutory definition of directors' duties in the U.K. and reform of section 210 the courts could use their powers to require the appointment of independent directors. In a recent derivative action in the U.S.A. the settlement stipulated a number of changes to the company board. These included that the size of the board be increased by the addition of four new directors approved by the court as qualified "by virtue of their independent experience, integrity and ability". Six per cent of the board should be independent outside directors, defined as follows:

> "any person who (i) is not an officer of the company; (ii) has not individually received from the company in any of the preceding four years or is not proposed to receive in the next year in excess of $25,000 for services rendered or from the sale of material; and (iii) is not associated with a company or firm which in any of the four preceding years received or is not presently proposed to receive in excess of one per cent of its gross sales from transactions with the company..."[23]

The company also agreed to create aboard nominating committee made up of independent directors to nominate all candidates for directors on the board's behalf.

4. Other Institutional Changes

Given that the monitoring function is to be the principal function of independent directors, how may law and practice be changed to underpin this difficult function? What other institutional changes are necessary?

It is beyond argument that a board of directors that consists entirely of executive directors is undesirable and that checks and balances should be built into the system in order to monitor management performance. This is necessary in terms of the protection of shareholders' interests and the wider community interest in securing the maximum utility from resources. Such changes will not, however, be easy. In the U.S.A. the process has already begun, stimulated by a combination of judicial action, business failures, public opinion and the work of the SEC. In the U.K. the mood is more cautious and management less willing to admit new machinery to represent outside interests and impose more accountability in the board room. There is no doubt that management will struggle to retain the self-perpetuating hold they have on corporate affairs. As Turner observed in his study of the birth of British Leyland in 1971:

> "What lessons can be drawn from the chronicle of its creation? It provides, to begin with, a number of graphic illustrations of the truth that, in business in general and mergers in particular, it is the self-interest of the key personalities involved - not the interests of the shareholders or even the company itself - which often dictates events. Where will they fit into the new hierarchy? Will their power and prestige be diminished or enhanced? Nor is this in any way surprising, once we dismiss from our minds the image of the chairman and their aides like to project. It is a rare and selfless man who, having attained power after years of competitive struggle and hard work, is willing to yield it up because of some more general benefit."

(a) Professional Directors?

The term "professional director" has been used to describe someone whose full-time employment is serving as non-executive director on the boards of companies. It is argued that such individuals bring to the boards the talents and expertise that they have acquired over the years. Interest in the notion of professional directors has not, however, been enthusiastic. In the U.S.A. over 88% of the companies in the Heidrick and Struggles survey (page 10) reported that they had no interest in using professional directors and it is difficult to see how they may be introduced by legislative reform since it would be impossible to define precisely what is meant by the expression "professional" director. Could it be, for example, that potential professional directors will be required to pass an examination in business administration as suggested in the U.K. Parliament?[24]

The tradition in the U.K. was to appoint to the board someone whose name would be an asset to the company and give it a sense of respectability, such as a Peer, but who would in terms of expertise and meaningful involvement, add nothing but social graces. Chamberlain observed in 1962:

> "In England where they have a 'profession' known as company director, the boardroom life is popularly regarded as a cushy sinecure." said Lord Boothby, a life peer, in a reflective moment.
>
> "If you have five directorships it is total heaven, like having a permanent hot bath ... No effort of any kind is called for. You go to a meeting once a month in a car supplied by the company, you look grave and sage, on two occasions say 'I agree' say 'I don't think so' once and if all goes well you get £500 a year."
>
> (Page 109)

Rubner is rather more cynical:

> "When scrutinising the composition of the boards one must perforce conclude that many of the members are not to be taken seriously. The appointment of 'guinea pig' directors originated in Britain where nobles, drawing fees in guineas, lent their names to corporations in order to dupe the public to whom the presence on the board of a member of the aristocracy symbolised business acumen and/or respectable

> management. The credulity of the public has declined and aristocrats only have limited publicity value nowadays. Television personalities and sportsmen (and the present writer would add some well known politicians) are now grilled for director tasks for which they often have no competence."
> (1965 page 77-74)

More recently, however, perhaps inspired by some notable revelations in Department of Trade reports, the CBI and management groups have advocated strengthening the role of non-executive directors.[25.]

(b) Full-time Directors

Another development in the U.S.A. is the idea of appointing all or some members of the board as full-time directors with no management responsibilities. For example, Texas Instruments has one full-time board member recruited from the executive officers and who is relieved of management duties. Apart from the Chairman and President, the Officer of the Board is the only insider on the board and he is involved in developing procedures, policy and reviewing personnel performance at board level. Under the scheme the Officer of the Board retires at 55 and becomes a General Director. The Company stipulates that the criterion for appointment to either of these posts is the individual's ability to bring to the board a "dispassionate point of view". As part of the process of training, directors are expected to take directorships outside the company in order to gain experience.[26]

Although these appointments have some benefit in terms of the individual director having the time to perform his duties there must, however, be doubts over their objectivity bearing in mind their close relationship with the management of the company.

(c) The Committee System

In the U.S.A. and to a lesser extent the U.K., company boards are coming to rely more heavily on committees as a means of fulfilling their responsibilities in terms of management performance. This trend is likely to accelerate, particularly in the U.S.A. in view of the American Bar Association's Model Business Corporation Act which allows a director to rely on information and reports presented by a board committee on which he does not serve if he reasonably believes that the committee deserves his confidence. If the amendments were adopted in state laws it is hoped that it would make it possible for companies more readily to appoint members with particular expertise and involve them in specialised work assigned to the various committees.[27]

The Committee system is not by any means a novel organisational form. Under the traditional model which sees the board as a policy making body most of the important decisions are made, compromises reached and priorities established in management and finance committees of the board. However, the committee system is now being adopted as an instrument for effecting the new attitude towards the role and function of company boards as the "corporate conscience" with the creation of audit committees and community responsibility committees.

For example, General Motors is operated on the basis of a committee system consisting of six standing committees - Finance, Executive, Audit, Public, Policy and Nominating - the last four made up entirely of non-executive directors. The executive committee, which is directly responsible for management functions, consists of executive directors and the finance committee which sets the limits within which management decisions may be made, had equal representation between executive and non-executive directors.

The Conference Board Report 1973 found that a large number of the 855 companies studied operated a system of committees at least consisting of audit, finance and executive committees. It seems that such a system enables recurring problems to be given continuous attention rather than being treated on a "one-off" basis.

It also enables the company to obtain the maximum benefit from the individual talents and expertise of non-executive directors. In a committee, for example, a director may be more inclined to take the initiative.

A particularly important factor, if non-executive directors are to be effective, is the supply of information. Leech and Mundheim observe:

> "the operation of a committee makes it necessary to institutionalise a flow of information to the board."

In addition:

> "it requires a conscious judgment on whether or not to supply the committee with a staff. Although the staff members will normally be people regularly employed by the corporation, there w ill be occasions when the staff work will be supplemented by the work of outside experts." (1976 page 1809)

(i) Public Responsibility Committees

A recent addition to the standing committees that some major U.S. corporations are establishing is the public responsibility committee. This represents a positive response in terms of mode of operation and accountability to the growing pressure for responsible social performance. The objective of such committees is to bring to the attention of management delicate and complicated social issues which full-time boards could not normally have the time to consider. In Harvard Business School Research project 35 companies in the U.S.A. were found to have responsibility committees examining such issues as occupational safety and health, charitable contributions, product safety, environmental problems, community relations and consumer affairs.

> "We believe that public responsibility committees are a good idea. They offer an answer to the need of corporations to deal more effectively at the top management level with a range of new social and political demands for which existing organisational structures may not suffice ... Our judgment is that over the next few years the number of public responsibility committees will grow as corporations realise that board level response to more governmental regulation and increased demands from various sectors of society is necessary."[28]

Such a committee would have a vital role in producing and evaluating data in resoect of social accounting.[29]

(ii) The Audit Committee

It is generally believed that audit committees are a recent North American device, a passing fad designed by boards and auditors to allay public fears over the credibility of financial disclosures and criticism of corporate accountability by the state agencies. In fact it seems that committees, in some form or another have been with us for many years.

> "Great Western Railway: Report of the Audit Committee
>
> The auditors and Mr. Deloitte attended the committee and explained the various matters connected with the Finances and other departments of the railway which explanations were highly satisfactory.
>
> The committee consider the auditors have performed their duties with great care and intelligence and therefore confidently recommend that they be continued in office."

Paddington Station, Benjamin Lancaster, Chairman,
2nd February 1872.

The S.E.C. was the first significant organisation to recommend audit committees although their initial suggestion in 1940 did not meet with much enthusiastic response. It was not until the much publicised business failures of the 1960s and accompanying concern over corporate accountability that the idea was taken up on a large scale. Now over 80% of public corporations in the U.S.A. have established such committees and the New York Stock Exchange requires all listed companies to have one. The S.E.C. endorsed the Stock Exchange's requirement arguing that it represented the most effective and constructive response yet to the need for more effective corporate measures against "questionable payments".

Audit committees are an important response to the demands for greater corporate accountability from two angles. First, from the non-executive directors point of view they provide a vehicle with defined powers and procedures enabling the independent directors to pursue issues of concern. Second, they underpin the work of the independent auditor by providing him with a vehicle in which to meet the enlarged responsibilities that are being placed upon him, particularly by the U.S.A. business community.

In 1970 a study by Mantz and Newman suggested that in broad terms the U.S. companies expect their audit committee to:

1. Review the work of the independent auditor
2. Review the auditors experiences with management, the scope of the audit work and the co-operation the auditor received from financial management and the internal auditing staff.

These expectations have grown and contemporary practice demands that the audit committee look more closely at the companies internal control systems, taking a more positive role rather than reacting to a given situation. In a more recent study Mantz and Newman suggest other activities that committees undertake:

discuss the adequacy of staffing for the internal audit;

organisation and independence of internal audits;

review the accounting principles and practices followed by the company;

> discuss the effectiveness of procedures to prevent conflicts of interest or improper payments. (1976)

Although the procedures differ widely from company to company in the U.S.A. the general pattern would appear to be that the audit committee meets with top management representatives, the independent auditors and the head of the internal audit department. At this meeting they discuss the scope of the internal and external audit and the impact of any recent developments on the company's accounting practice and policies. A second meeting is held to discuss the completed audit before publication. Often the committee will meet separately with the independent directors.

All audit committee members are given a written agenda in advance of meetings and background information. In addition the committee carries out a continuous review of the co-ordination between external and internal audit and in particular the procedures followed by the external audit.

Mantz and Newman considered that the type of committee that exists in large U.S. corporations may be the prototype of the kind of monitoring committee that they and their contemporaries such as Eisenberg favour.

> "However care should be taken to ensure that its agenda and operations are not controlled by the chief executive officer. Functions of the committee should be at least three fold: to recommend independent auditors to the board, to review the intended scope. In addition some audit committees review the processes of the managements inside audit of its own accounts. The audit committee should consist, ideally, of

> outside directors only and should be a small, effective working unit. Although it is desirable for some members of the audit committee to have financial or accounting training or experience, it is of greater significance that the members of the committee appreciate that financial statements are designed to communicate rather than obfuscate. An individual who has curiosity and an impatience with obscurity would be a useful member."
> (1970 page 1815)

The danger of playing such a role is that the audit committee may become too involved in management although it has been suggested more recently in the U.S.A. that audit committees be directed to review management policy decisions, criticising policies that prove ineffective. In effect the committee would be carrying out management performance audit. Such a role would inevitably have a profound effect upon the present pattern of management, their role and responsibilities in practice and in law.

There is no doubt therefore that whatever the precise functions of audit committees in the U.S.A. they have grown in importance

> "... an idea and a mechanism which had been available for many years but used by relatively few companies, has within the space of a few short years been recognised and adopted by the great majority of large U.S. corporations." [30]

> "Far from a passing fad, the audit committee has now become a vitally important cog in the corporate machinery." [31]

On the wider scene the Accountants International Study Group organised by the professional bodies in the U.K., Ireland, Canada and U.S.A. recommended in 1977 that !

> "All publicly owned corporations should establish an audit committee consisting principally of outside directors with an outside director as chairman, setting aside part of its meetings for discussion between the outside directors and the external auditor." (page 12)

In Canada by 1970 three basic areas of concern had emerged in the context of corporate government. First, public concern over the credibility of financial information, performance of directors in discharging their duties, the effectiveness of the auditors in securing the reliability of published information. Second, company directors were concerned over the statutory definition of their duties and the increased likelihood of derivative actions as a result of legislative changes. Third, the auditors concern over their role and the increased expectations of society as to the audit function.

These areas of concern were particularly highlighted by the Lawrence Committee report in 1967; the recommendations of the Canadian Institute of Chartered Accountants Special Committee on Shareholders' Audits 1968; the report of a Royal Commission into the collapse of the Atlantic Acceptance Commission Ltd. 1969 which argued that the financial collapse could have been avoided by establishing an effective audit committee; and the Report of the Special Committee to Examine the Role of the Auditor by the Canadian Institute of Chartered Accountants in 1978.

In 1970 the Ontario Business Corporation Act required public companies in Ontario to establish audit committees, Section 182(1) Audit Committee -

"The directors of a corporation that is offering its securities to the public shall elect annually from among their numbers a committee to be known as the audit committee to be composed of not fewer than three directors, of whom a majority shall not be officers or employees of the corporation or an affiliate of the corporation, to hold office until the next meeting of the shareholders.

(2) Chairman - The members of the audit committee shall elect a chairman from among their number.

(3) Review - The corporation shall submit the financial statement to the audit committee for its review and the financial statement shall thereafter be submitted to the board of directors.

(4) Hearing of auditor - the auditor has the right to appear before and be heard at any meeting of the audit committee and shall appear before the audit committee when required to do so by the committee.

(5) Idem - Upon request of the auditor, the chairman of the audit committee shall convene a meeting of the committee to consider any matters the auditor believes should be brought to the attention of the directors or shareholders.

(6) Right of the auditor to be heard - The auditor of a corporation shall be entitled to attend and be heard at meetings of the board of directors of the corporation on matters relating to his duties as auditor."

The enormous growth in the number and powers of audit committees throughout North America gives some indication of their potential utility in providing an effective monitoring device underpinning the role of outside directors. It must be stressed, however, that the motives behind the rapid increase in the number of committees, particularly in the U.S.A. are to some extent motives of self-preservation by directors rather than enhancing the efficiency of management and promoting greater corporate accountability. Tricker quotes from one New York observer:

> "The director here is on the defensive. The advent of litigation has led to high indemnity insurance premiums and unnecessary self-protection and checking by directors ...Though the audit committee has become vital, there are outstanding questions on its composition, particularly what constitutes real independence and on its constitution; is it appointed by the Chairman and the Chief Executive? Is its role to be an independent check on management? What is the balance between being management's ally or its adversary? Are they really cost effective?" (1978 page 61)

5. Independence in the British Boardroom

Would the experiments in North America with the increased use of non-executive directors and audit committees be successful in the U.K? There is no doubting the need for more effective monitoring of corporate affairs, enough evidence has built up over the last few years from Department of Trade reports.

Rhys Williams M.P., a notable and persistent advocate of the benefits of a greater independent element in boardrooms, summed up the problem admirably:

> "There is a serious weakness in British company law. The supervisory elements in the joint stock company do not have enough strength. Therefore the curative function which should be carried out within the joint stock at the start of its troubles, if it is going into a bad patch is largely ineffective. We find that companies are allowed to become worse over a period of years before recognising that they have a serious problem. When the shareholders, the public, the Government or management recognise that there is a grave problem to be tackled, all too often it is too late. As a result there are dreadful disclosures in the newspapers and shocks for the economy when companies suddenly collapse like a tree which has rotted from the inside but given no sign at the outside that it is losing its health." 32

Charles Villiers expressed similar sentiments in 1971:

> "I believe that the Government cannot afford to see resources handled in a careless or inert way. The whole nature of business has become professional, competitive, rather ruthless and quite different to the imperial and Commonwealth heritage. It will become tougher still as we lower our barriers against the Europeans. In this situation we have to ask if our system of board members, executive and non-executive, if our arrangements for monitoring company results, if our practice of control by shareholders is adequate for the task of shifting unsuccessful management, and of finding better replacement before catastrophe overtakes the concern. My own belief is that we need to bolster up the function of the non-executive director and provide an independent tribunal to which shareholders can complain about management performance. This would be in line with the practice of other successful industrial countries and I doubt if we shall indefinitely get away with the utterly relaxed, even slack system we have at the moment." 33

Unlike the U.S.A. the major source of criticism has not come from judicial action and academic comment but Department of Trade Inspectors' Reports and has been aimed at directors and auditors.

The following are some examples of their revelations:

> "During the inquiry it became apparent from the evidence of Sir Denys Lawson and other witnesses that he had come to consider the group as his own property notwithstanding the substantial interest held by outside shareholders ... It seems to us that, in fulfilment of his duty of care in the company's affairs, a non-executive director should apply to the problems before the Board a conscientious and independent standard of judgment, free of involvement in the daily affairs of the company. When such directors are mere "yes men" to the chairman they fail to fulfil their function." 34

In their investigation into the affairs of Hartley Baird Co. in 1973, the Inspectors criticised the board for failing to exercise "control over Mr. Dalgleish, its chairman, who purported to enter into some highly unusual transactions". The directors "failed in their obligation to the company to ensure that (certain) debts owing to Hartleys .... were paid."

> "It was Mr. Caplan who ran the L.& C. Group. Mr. Caplan's sway over the other executive directors was absolute. They were always ready to do his bidding, subordinates did not question his decisions. For them no other authority was needed. He was the company ... There appear to have been no formally laid down accounting procedures within the L & C Group. The system of internal control contained a number of shortcomings and weaknesses, the most serious of which was the lack of any clear

> definition of authority for major transactions. A lack of management information made it difficult for the L and C directors to make the necessary contribution to the working of the group." 35
>
> "Mr. Young the managing director had a markedly optimistic approach to the business and we think that that undoubtedly influenced his fellow directors sometimes to the extent of clouding their judgment on matters that require a more cautions approach ... We found that formal Board meetings when called were normally at short notice and for such purposes as to formalise legal documents or to adopt decisions which had been taken already at informal gatherings of the directors mentioned in the previous paragraph. In our view none of the directors can be absolved of blame for allowing the continuation of a position where the board of Court Line acted largely as a rubber stamp; the overall management of Court Line was throughout inadequate and it was in any event never supported by the necessary financial control." 36

Finally, in the report into Dowgate and General Investment Co., "imprudence, shortsightedness and concern only for a short term profit" are attributed to the directors who "did not even discuss this loan at board level". (1978) Inspectors have been equally scathing in their criticism of the role of auditors in these firms.[37]

This succession of critical analysis reveals the complete absence of any effective independent machinery for rendering management more accountable for its decisions, particularly in those companies dominated by a strong personality. To some extent the problem could be alleviated by a new definition of directors' responsibilities in respect of the management and direction of companies. At present it is based on obscure and outdated case law which simply adds to the confusion and uncertainty. Such uncertainty is well illustrated by the reports into Lowson Group and London and Counties Securities where the responsibilities of directors, including non-executive directors, were interpreted as being far more onerous than is generally understood from the case law.

The greater use of non-executive directors and committees of the board is therefore seen as a means of meeting these criticisms of corporate government. A series of Bills introduced by Sir Rhys Williams in each session of Parliament since 1969, have sought to stimulate debate and interest about the health of U.K. corporate law and practice. He has unsuccessfully sought to introduce into company law the requirement that "major public companies" appoint no fewer than three non-executive directors and an audit committee. Internal organisational reform would be encouraged by the requirement of companies caught by the proposals to produce data and estimates for the board in respect not only of the company's past performance but of its current performance and the future course of business.

Under the proposals an audit committee would consist of three non-executive directors and meet at least twice a year. It would be charged with the duty of scrutinising all financial statements to be published by the company and commenting on them if they felt the need to. The committee would also make recommendations to the shareholders on the appointment of auditors and to the board on remuneration of auditors. Central to the proposals was the requirement to publish a statement in each accounting reference period to the effect that their reports have been properly considered by the board.[38]

Although the particular proposals may be criticised in that no attempt is made to actually define the term non-executive director and make independence of management a key factor, they would ensure that investigations would take place into issues that, under the present system, tend to develop into areas of conflict and suspicion and which lead to the sort of public wrangles highlighted in Department of Trade reports.

If one factor was to underline the basic objectives of the proposal to introduce strong audit committees, it is that of strengthening the role of the board as a fiduciary body by reinforcing the responsibilities of the members and in the process educating board members in financial matters. The benefits in terms of more effective organisation and greater accountability are considerable. For example, in addition to underpinning the role of external auditors, the outside directors might wish to use the committee as a means of questioning the levels of expense accounts of the executive directors rather than risk a major confrontation with the management,or in determining conflict of interest policy for company personnel.

The Governor of the Bank of England sees the audit committee as a "lightening conductor for trouble, as a body that would spot trouble before it arrives." The Governor quoted the standard work in the U.S.A. on auditing which sees the committee as forcing:

> "both auditor and management to take a more aggressive approach towards solving problems that they might otherwise be inclined to learn to live with." 39

As was said in the Companies Bill Standing Committee :

> "... we see that an audit committee will provide a forum for dealing with the whole question of audit, internal controls and matters of this sort within the main board but on a much more continuous and regular basis. Clearly these matters are always the responsibility of the main board, but with an audit committee we see it as an advantage that these matters will be continually and on a regular basis, received and studied." 40

The problems raised by the institutionalisation of modern companies are not simply problems involving the recognition of claims by the workforce for greater representation. It involves a much wider problem in terms of society and the use of resources. Indeed, all the interests converging within an enterprise have an interest in institutional changes designed to render corporate controllers more accountable and monitor managements. Such institutional changes as we have just examined, ~~but these~~ will not in themselves be sufficient. They must be underpinned by further changes in the law and legal policy. Such changes centre on the role and function of disclosure and accounting systems and the audit.

Footnotes - Chapter Seven

1. SEC Hearings on Corporate Suffrage Washington D.C.
   (Sept.30 1977) Statement of M.C. Mace
2. Connors 1973 p4
3. See Daughen and Binzen 1971
4. SEC The Financial Collapse of the Penn Central Company
   Report August 1972
5. Report of the Department of Trade Inspectors into Dowgate and
   General Investment HMSO 1979
6. American Bar Association 1974 Addendum B 143
7. See Business Lawyer 1975 501, 504-5
8. Bacon J. 1967
9. Eisenberg 1975 p 380
10. Smith 1970 p 49-50
11. Smith 1970 p 48-49
12. Bacon J. 1967 p 49
13. Mace 1971 p 99-100
14. Blough 1973 p 470 Mace 1971
15. Blough 1973 p 470
16. Heineman - What Does and Doesn't go on in the Boardroom
    Fortune Feb. 1972 157
17. Eisenberg 1975 p 399
18. See Corporate Directors Guidebook 32 Business Lawyer 5 1975
19. See Leech & Mundheim 1976
20. Eisenberg 1975 p 408
21. Eisenberg 1975 p 408
22. See Tricker 1978 p 48
23. Civ No. 74 1453 F.C. D. Cal Nov. 23 1974
24. Committee Stage Companies Bill 1978 6th March 1979 and
    Financial Times 7th March 1979
25. C.B.I. 1973

26. See Vance 1968 at p 198; Leech & Mundheim 1976, 1807

27. See 30 Business Lawyer 1973 1504

28. Harvard Business Review Magazine June 1977, 40, 60

29. See Chapter 8

30. Farrell 1976 p 10

31. Foster July 1976 p 24

32. Companies (No.2) Bill Standing Committee 29th June 1976 Col. 43

33. See Financial Times 5th November 1971

34. Department of Trade Inspector's Report into Lowson Group 1976

35. Department of Trade Inspector's Report into London and Counties Securities 1975

36. Department of Trade Inspector's Report into Court Line Ltd.

37. See Chapter 8

38. See Companies Bill 1978 Standing Committee F 7th December 1978 Col 75

39. Financial Times 29th November 1978

40. See footnote 38 col 75-76

CHAPTER EIGHT

DISCLOSURE, ACCOUNTING AND THE AUDIT

1. A Disclosure Philosophy?

Since 1908 legislation in the U.K. has required companies to disclose progressively more financial information in terms of particulars lodged with the Registrar of Companies and publication of annual accounts. It can hardly be said, however, that these requirements are consistent with any basic philosophy of corporate accountability or aimed at underpinning arrangements for monitoring management. Indeed, as Morris observed:

> "unfortunately few attempts have been made in Britain to determine the objectives of disclosure in financial statements." (1974 page 70)

Disclosure of financial information is justified in terms of a vague notion that it represents the price of limited liability and as a basic report to the shareholders on a stewardship function by directors.

Since the early legislation that gave birth to the limited liability company subsequent changes in respect of the disclosure provisions have evolved from three discernable forces. First, major business scandals and failures that have prompted legislation under pressure from public opinion. Second, the greater public interest in company accounts as a result of more widespread ownership of shares, development of a capital market and growth of institutional investors. A third, and a much more recent force, the seeds of which were sown in the Companies Act 1967 requiring disclosure of charitable and political contributions, is the increased pressure to disclose information for the general economic and social good.

The first Companies Act was the Joint Stock Companies Act 1844 and it is clear from this Act that the early inclinations of the Government were towards disclosure. The Act enabled business organisations to obtain the fundamental attribute of corporate personality by simple registration and instructed each director to deliver accounting reports periodically to independent auditors and present a balance sheet to the shareholders. Indeed the enthusiasm of the Board of Trade for full disclosure extended to a clause calling for a half yearly profit statement which was eventually dropped by the House of Commons. Later legislation prescribed the form that accounts must take but the 1856 Act abandoned compulsory accounting and auditing requirements for most companies, a state of affairs that continued until the 1900 Act. This move and the absence of any more sophisticated disclosure requirements may largely be explained by the general presumption of the era in favour of laissez faire. In addition the tendency amongst lawyers was to regard the new form of business enterprise as a mere extension of partnership, the financing of which was largely internal and the origins of which were embedded in freedom of contract between individuals. In effect the law and lawyers did not regard incorporation by registration as a favour of the state, in the same way as they did incorporation by special charter. In general therefore the law and judicial policy was concerned to prevent fraud, In the absence of bad faith and so long as the actions of the directors can be seen to be in the interests of the company the courts would not interfere.

A consistent preoccupation of the law was a concern for creditors, partly attributable to the prevailing view of companies as extensions of partnerships, early legislation was concerned to verify the existence of the original capital and up until the 1948 Act the law concentrated on the balance sheet, neglecting the profit and loss account. At the same time the judiciary elevated the capital maintenance concept to a pinnacle of judicial concern.

In general, legislation up to 1929 tended to be a reaction to specific scandals rather than based on any grand design. Thus the failure of the Royal British Bank in 1856 led to the Joint Stock Banking Act 1858 and the Prevention of Fraud Act 1857. A spate of insurance company failures was followed by the Life Assurance Companies Act 1870 and the collapse of the City of Glasgow Bank in 1878 was immediately followed by the Companies Act 1879. In addition the Royal Mail case in 1931 had a profound impact on corporate accounting practice and brought about some improvements in the meaning of net income statements. In between these events the Companies Act 1900 made the annual audit compulsory and the 1907 Act required the annual filing of a balance sheet. There was no requirement to publish a profit and loss account until the 1929 Act. The attitude of the times towards financial disclosure was aptly summed up by Buckley LJ in Newton v. Birmingham Small Arms Co.[1] when he maintained that a balance sheet could be as uninformative as the directors might desire so long as it did not show the financial position to be better than it was.

In 1925 the Board of Trade appointed the Company Law Amendment Committee chaired by Wilfred Greene to undertake a full review of the Companies Acts.[2] In evidence to the Committee both the English Law Society and the Institute of Chartered Accountants in England and Wales (ICAEW) expressed their satisfaction with the prevailing disclosure requirements.[3] Most directors they asserted, were basically honest and the caution sometimes displayed in respect of disclosure was in most instances prudent, since it was undesirable from the point of view of the company to make a mass of information available which could be used by competitors. This somewhat complacent view was further reflected in the observations on the use of secret reserves,by the Law Society:

> "The provision of a secret reserve is for very many companies a sound business policy and of the greatest advantage. It would not be in a company's best interests that it should have to indicate that it has in one year drawn so much from reserve to meet an increase in the price of raw materials, etc. and that next year it has put so much back into reserve to restore it to a 'safe' figure. Transactions of this nature are necessary to meet fluctuations in trade and if disclosed the indications afforded as to the course of the company's business would be carefully

> scrutinised by competitors ... too much disclosure should not be insisted on and the greatest possible freedom should be allowed to those responsible." (Cmnd 2657 Appendix P chap. 14 p 18)

The Committee revealed their thinking in the Preliminary to the Report:

> "The system of company law and practice in force in England and Scotland has been gradually evolved to meet the needs of the community at large and the commercial community in particular. We consider that in general it fulfils this object in a highly satisfactory manner. It is a system well understood by those who have to deal with it, it has stood the test of years, and in our opinion should not be altered in any manner of principle except where alteration is imperatively demanded. The evidence satisfies us that the great majority of limited companies both public and private are honestly and conscientiously managed ... We are further satisfied that the abnormal conditions prevailing during and since the war have been largely responsible for some of the matters which have given rise to unfavourable public comment, and we are of opinion that the return to more normal conditions will tend to eliminate certain unsatisfactory features which have shown themselves in recent years." (Page 4)

The findings of the Committee reflected this somewhat self-satisfied view. They accepted that ICAEW's objectives to keep additional legislation on disclosure of accounting regulations to a minimum and seemed to suggest that profitability stimulates honesty among the business community. The Report recommended that a balance sheet and profit and loss account be presented to members before the meeting. They did not, however, propose any rules in respect of auditors' qualifications or specify what the profit and loss account should include.

The Companies Act 1928 and Consolidating Act 1929 broadly followed the Greene Committee.

> "On the whole the Act was regarded as a sound one reflecting the best professional practice ..."[4]

By the imposition of very general obligations in respect of reporting the legislation left a great deal of scope for concealing the results of corporate activity. For example in a leading article in the Accountant the editor declared that it will:

> "thus be possible to issue a so called profit and loss account ... in which the amount of depreciation is understated so that shareholders may even be kept in ignorance as to whether any such provision has been made."[5]

The Act did, however, bring some benefits. For example in the accounts of Bovril Ltd. for the year ended December 1928 £3m out of £6m appearing on the assets side of the balance sheet were covered by the expression "Goodwill, trade marks, freehold and leasehold properties and interest in associated companies, Government stock etc." The 1929 balance sheet, however, revealed that 80% of this item was made of intangible assets.[6]

Towards the end of the 1920s it became clear, however, that contemporary disclosure law and practice was under challenge. At a meeting of Marconi's Wireless Telegraph Co. in 1929 Dr. O'Brien, chairman of the Association of Marconi's shareholders, declared:

> "I have no hesitation in saying that the auditors certificate is no guarantee whatsoever that everything is right with the company ..."[7]

In particular, the practice of accumulating secret reserves was being challenged. This was a practice deeply embedded in the conservatism of contemporary business practice; it enabled management to retain reserves in excess of amounts appearing in the balance sheet. It was a policy that received judicial blessing in Newton's case and at least implied acceptance of the Green Committee, indeed in 1933 according to Samuel it was:

> "one of the cornerstones of modern company finance"(page 269)

With the emergence of the profit and loss account in the 1930s as the principal accounting report it became clear that secret reserves provided considerable scope for distorting the profit and loss account by understating or overstating profits from one accounting period to another.

> "The covering up of profit and loss figures by the inclusion of extraneous items of unstated amounts is always a matter to be deplored. Shareholders should have presented to them a profit and loss account which leaves no doubt as to the actual result of the year's operations, and such items as 'Balance from trading account after crediting claim for repayment of income tax and transferring £13,500, from advertising reserve, £11,943 (in the accounts of R.& J. Hill Ltd. for the year to 31 March 1929) should find no place in the accounts of a public company."[8]

The Royal Mail case in 1931 starkly exposed the inadequacy of contemporary accounting practice and the need for reform. By using secret reserves the accounts of the company gave no indication of the forthcoming financial collapse. A prospectus issued by the company had stated that profits had been earned over a period of years without disclosing that the company had for several years been suffering large losses on its trading, dividends were paid out of abnormal wartime tax refunds. The accounts of the company were audited by an eminent international firm of accountants and prepared in accordance with accepted accounting practice which at that time confined the auditor to the balance sheet.

The controversy over the Royal Mail case marked the beginning of a process of reassessing the hitherto pre-eminent doctrine that:

> "secrecy is a necessary adjunct of commercial success." [9]

and much greater stress being placed on the profit and loss account as an instrument of financial accountability.

> "From the investor's standpoint the moral of the RMSP Co. case is the necessity for the amendment of the company law so as to make compulsory the issue to shareholders of fully detailed and unambiguous profit and loss accounts." [10]

This process continued within the accountancy profession until the Cohen Committee (Cmnd 6659) reported and the subsequent Companies Act 1948, embodying changes that owed much to the lessons of the Royal Mail case. This was arguably the first major reform of company law and particularly financial reporting that was not a specific reaction to a corporate failure or scandal, but based on a reasoned policy and concern for the needs and rights of shareholders. The Cohen Committee founded their report on the benefits of full disclosure for shareholders and potential investors and in doing so implicitly laid to rest the predominantly nineteenth century notion of a company's affairs being primarily a matter of contract among the shareholders.

> "The Companies Acts have been amended from time to time to bring them into accord with changing conditions but if there is to be any flexibility, opportunities for abuse will inevitably exist. We consider that the fullest practicable disclosure of information conveying the activities of companies will lessen such opportunities and accord with a wakening social consciousness." (page 3)

The 1948 Act, which still represents the basic framework, required greater disclosure in respect of the profit and loss account, consolidation of subsidiaries, disclosure of trading companies reserves, directors' interests and a strengthened status for auditors. Subsequent legislation has simply served to underpin the basic framework conceived by the Cohen Committee and created by the 1948 Act.

In 1962 the Jenkins Committee on Company Law Reform (Cmnd 1729) reported. In the context of corporate disclosure and by contrast to developments in the U.S.A., however, its proposals were conservative. The Economist,for example,described the report as "emphatically a technicians' report ... a meticulous job well but undramatically done."[11]

Baskin wrote that:

> "Financial information in Great Britain ... still tends to be regarded as within the exclusive province of a select few - perhaps an appendage of the club philosophy. The public is supposed to regard access to information as a privilege not a right." (1964 page 7)

Loss, the American academic, referred to the Report as "a conservative document by American standards".

> "Even if all of its recommendations were adopted the amount of required disclosure would lag behind the standards set in the U.S. after the Federal Securities legislation in 1933."[12]

Gower, a member of the Committee, summed up their attitude aptly:

> "We were essentially a group of technicians, and not people who regarded ourselves as competent to rethink the broad aspects of where the modern company fits into the whole social context. Perhaps we ought to have been, but we are not. Had that been what the Government wanted they would have appointed an entirely different committee. We therefore assumed that our role was to make recommendations for making the Companies Act and the Acts better than they are at the moment. And with that rather humble role we went ahead." [13]

The Report consequently made little reference to rights and interests beyond traditional ones and did not either make proposals aimed at increasing the effectiveness of the shareholders ability to monitor corporate management or render companies more accountable in terms of a wider public interest. It was proposed to extend the disclosure requirements unless the directors considered it to be harmful to the company's interests.[14] The authors of the Report did not however answer the fundamental question as to whether disclosure in the company's interests could nevertheless be to society's interest. Disclosure was regarded more in the nature of an irksome restriction than a necessary part of a framework of corporate accountability to society.

A regrettable feature of the Report and of U.K. company law in general is the absence of any clear statement of aims and objectives. There was no explicit statement as to why disclosure is regarded as a necessary feature of company law or whose interests it is designed to protect. It was described in the Report simply "as a right in principle".

The legislative requirements are underpinned by a system of self regulation in respect of corporate securities centred around the Stock Exchange but in so far as the rules on disclosure are concerned the pattern is the same. They aim to give shareholders information centred on the balance sheet and profit and loss account in accordance with the Exchange's overall objective to run an orderly market. The only body that vaguely represents the public interest is the Department of Trade which has power to investigate companies and require corporate officers to produce reports and accounts. The Department has however limited powers in respect of corporate regulation. It may issue statutory instruments clarifying or extending the Companies Acts, but it does not have the same rule making and interpretative role as the SEC in the U.S.A. There is, for example, no routine examination of corporate reports. The Companies legislation does give the

Department a wide discretion in respect of the appointment of inspectors and,as we have seen, it is these investigations that have revealed the need for more effective institutional checks and balances against corporate mismanagement.

2. Disclosure - The American Approach

The architects of the legal framework in the U.S.A. recognised the fundamental role of disclosure in the scheme of things and notable academics had perceived its value from the outset. Berle and Means in their work demonstrating the separation of the control of large companies from their ownership argued that two approaches should be adopted to influence directors' conduct, stricter application of fiduciary principles and expanded disclosure requirements.[15]

Professor Ripley recognised in 1926 that:

> "stockholders are entitled to adequate information, and the state and the general public have a right to the same privilege." (Page 165)

At the time that the SEC was created in 1934 it was made abundantly clear that the Commission's work was to influence the conduct of corporate controllers by the requirements to disclose information. Brandeis, for example, noted in 1913 that:

> "Sunlight is the best disinfectant: electric light the best policeman." [16]

William Douglas, who played a prominent role in advising the Roosevelt administration on its legislative programme, declared that:

> "... publicity alone can accomplish much - not publicity in the sense of registration in some dusty file in Washington or in some state capital but publicity in the sense of direct and unequivocal statement in the periodical reports to stockholders... That simple expedient will go far as a corrective of conditions which have been constantly recurring in our history. Its prophylactic effects will equal in importance any other single measure which can be adopted."
> (1934 page 1323-24)

The SEC was established in 1934 with the task of administering the whole framework of corporate regulation in the U.S.A., functioning as a quasi judicial, quasi legislative and administrative body. By contrast to the U.K. legislat~~ion~~ure the American legislat~~ion~~ure required companies to report directly to the SEC and the legislative delegates to the Commission considerable rule making power. In particular the power to make and prescribe:

> "... the items or details to be shown in the balance sheet and the earnings statement, and the methods to be followed in the preparation of reports, in the appraisal or valuation of assets and liabilities, in the determination of depreciation and depletion, in the differentiation of recurring and non-recurring income, in the differentiation of investment and operating income, and in the preparation, where the Commission deems it necessary or desirable, of separate and/or consolidated balance sheets or income accounts ..." [17]

In the Wheat Report, a Disclosure Policy Study in 1969, the Commission's philosophy of disclosure was expressed as follows:

> "The emphasis on disclosure rests on two considerations. One relates to the proper

> function of the Federal government in investment matters. Apart from the prevention of fraud and manipulation, the draftsmen of the '33 and 34' Acts viewed their responsibility as being primarily one of seeing to it that investors and speculators had access to enough information to enable them to arrive at their rational decisions. The other, less direct consideration rests on the belief that appropriate publicity tends to deter questionable practices and to elevate standards of business conduct." (Page 10)

A former chairman of the SEC acknowledged the vital role that disclosure plays in America by elevating corporate standards and sensitivity:

> "In other words disclosure restrains because of sensitivity to public reaction, caution about response to the dissident shareholder and the possibility of legal action." [18]

Thus it can be seen from these observations that the U.S.A. had a much more clearly defined and articulated policy on disclosure in the context not only of the individual shareholder's 'right to know' but also in terms of using disclosure to elevate the standards of business conduct and responsibility of business to society in general.

3. Disclosure and Accounting - A European Perspective

As already observed, one of the principal objectives of the European Communities common industrial policy is:

> "the creation of a unified business environment involving the harmonisation of company law and taxation, and the creation of a community capital market." [19]

In its efforts to achieve this objective the Commission has embarked on a programme of company law harmonisation designed to implement Art. 54(3)(g) of the Treaty of Rome which calls for 'the co-ordination of the safeguards required from companies in the Member States to protect the interests both of members and third parties'.

After a lengthy period of discussion, compromise and re-drafting the programme has started to gather some momentum and British company lawyers and accountants are, within the next two years, likely to feel the full impact of our membership of the Community. So far four directives have been approved with another four and a draft regulation for a European Company Statute in the pipe-line. The First Directive was enshrined in s.9 of the European Communities Act 1972 and had little impact on U.K. company law apart from modifying the ultra vires rule. Parliament is at present in the process of amending company law in order to comply with the Second Directive which aims to regulate the formation of companies and the maintenance and alteration of capital.[20] The Third Directive deals with mergers and is expected to have only a limited effect on existing U.K. practice. Sometime this year the Government has promised a major Bill dealing with the outstanding issues of company reform and including the changes to U.K. company law following publication of the Fourth Directive on company accounts. Adoption of the proposed Seventh Directive on group accounts which complements the Fourth Directive, is expected to take place this year.

In the ~~foregoing~~ following paragraphs it is intended to examine the different accounting systems in Europe, problems of harmonisation, and the impact of the Directives on accounting provisions of the Companies Act in the context of the wider discussion on corporate accountability and the disclosure philosophy. In the same way as there is no such thing as European company law, there is no common European accounting system. The techniques, standards, quality and the status of the accountant varies from country to country. Perhaps the most prominent feature of accounting in Europe is the extent to which the U.K. and Ireland have the most highly developed profession. For example, the U.K. and Ireland have approximately one professionally qualified accountant for every 800 of the population, whereas the original six members of the Community have one for every 4,300.[21] The explanation for this is attributable to a variety of reasons based on different economic policies and social background, but undoubtedly one of the major factors is the more sophisticated and highly developed capital market in the U.K. Public interest has tended to focus on corporate accountability in terms of investor protection and on the notion of stewardship, with the consequent emphasis placed on the disclosure of financial information independently checked by auditors. The particular disclosure philosophy which lies at the heart of U.K. company law has fostered a strong accountancy profession which has been permitted to develop its own standards and rules under the legal requirements of truth and fairness in reporting.

By contrast, however, in most European countries the emphasis has always tended to be on form rather than substance. In terms of the law a more rigid and prescriptive tradition prevails which consequently leaves less to judgment, calling for a knowledge of the law rather than a highly trained accountant. The European approach would be to prescribe how a particular problem would be dealt with in the statute, whereas in the U.K. it is largely left to the accountancy profession operating within a flexible framework of conventions and rules.

A prominent American international accountant argues that there are four types of accounting systems: accounting within a macro-economic framework; the micro-economic approach to accounting; accounting as an independent discipline; and uniform accounting. The problems inherent in any harmonisation programme of the accounting laws and practices of Europe are apparent by the very fact that examples of at least three of those systems exist in one form or another in Europe. France and Germany are regarded as good examples of uniform accounting, where reports and information are produced according to a standard format. Netherlands is a good example of the micro-economic system in which accounts and reports are produced in terms of the efficiency of the firm as a unit or going concern. The U.K. is an example of accounting as an independent pragmatic system which relies less on legalistic restraints and prescription and more on professional standards and self-regulation.

A further difference between U.K. practice and Europe is the different methods of raising capital. In West Germany, for example, the preference is for debt capital raised on a short term basis from banks and in terms of financial reporting and the law this explains the strong tendency towards creditor protection. In the U.K on the other hand, the traditional preference is for equity capital from private shareholders and the institutions. This explains the sophisticated and highly developed capital markets in the U.K. and the pre-occupation with shareholder protection, publicity and the disclosure philosophy. Indeed, it was estimated in a survey from the Institute of Chartered Accountants in England and Wales[23] that the number of quoted companies, market capitalisation and equity turnover in the U.K. were all greater than the combined totals in West Germany, France, Italy, Holland Belgium.

In addition, in countries such as Germany which have a strong tradition of legal regulation, greater Government intervention in the context of corporate control and an effective and prominent role for institutions such as banks, there is a considerable degree of conservatism in accounting that is not so prevalent in the U.K. This is typified in the legal provisions on compulsory build up of 'legal reserves' from profit to 10% of capital, prohibition on revaluating fixed assets and special provisions for reserves in order to meet such eventualities as price rises, losses in value and other risks.

Finally, in most of the European nations the revenue authorities have a substantial influence on the preparation of accounts in that items cannot be claimed for tax purposes unless they are incorporated in the official company accounts.

Thus, in harmonising financial reporting and accounting practices all these differences will make for difficulties in the formulation of a framework that will carry credibility within the different systems. Different systems inevitably breed different attitudes and values. The company law practitioner and accountant operating in a bureaucratic environment with inflexible rules and a rigid statutory framework would find a system based on the U.K. model operating through requirements imposed by professional bodies and other self-regulating machinery and a flexible legal framework, totally alien. By the same token a system of reporting that is based on a vague concept of truth and fairness would mean nothing to the continental practitioner.

Another significant difference concerns the consolidation of accounts. U.K. law has for many years required holding companies to publish group accounts combining the information contained in the separate balance sheets and profit and loss accounts of the holding and its subsidiary companies.[25] The rationale of this requirement is the realisation that group organisation provides a useful framework within which to perpetuate deception, fraud and give a false impression of solvency. Consolidation is not, however, a universal practice throughout Europe and even in those countries that require consolidation, quite often different definitions and practices are adopted that reflect the different priorities and patterns of financial and legal development. This is perhaps one of the areas somewhat chauvinistically described by Benson when he commented that U.K. accounting, 'is in the lead by a large margin'. (page 758) Indeed, many large companies operating in Europe have found the need to produce consolidated accounts, particularly if they require a U.K. Stock Exchange quotation. For example, Ciments Lefarge, a French company with considerable world-wide group sales, did not produce consolidated accounts until it obtained a Stock Exchange quotation in 1972. The company announced its intention to publish consolidated accounts showing a true and fair view, a notion unknown to French law, whilst at the same time retaining French methods of presentation.

Looming over all these differences of approach is the debate over inflation accounting, a debate that has caused much disagreement within the U.K. accountancy profession and over which there is little consensus in Europe. The French Government have rejected proposals on inflation accounting and the West German Government were so hostile to the notion that agreement on the Fourth Directive, which opens the way for Governments to introduce it, was delayed. The British Government has welcomed the profession's attempts to introduce a system of inflation accounting but as yet no E.E.C member Government has produced a standard practice on it.

Despite the many differences in attitude, law and practice, between the Member States, there remains a strong impetus towards harmonisation. This is so because harmonisation does not imply complete uniformity between nations, but a gradual reduction of the magnitude and number of differences. Indeed, Trigg argues that complete uniformity would be harmful, it would result in a lack of individuality and independence.

> "I venture to suggest that the profession through the world is looking for unity, it is not necessarily looking for uniformity. In my mind, uniformity is a backward step, and unity a forward step." (1967 page 303)

The harmonisation programme brings one considerable advance in that the motives and objectives of the disclosure provisions are clearly spelt out. The preamble to the proposal for a Fourth Directive declares that:

> "At the present moment, considerable differences exist in the Member States as regards the legal requirements governing both the structure and content of companies' annual accounts. The parties that the companies have to furnish are plainly at variance both qualitatively and quantitatively from one country to another. This situation may be prejudicial to the fusion of national markets into a common market operating as an international market. The idea of the Common Market implies that all companies having the same legal form can work in the Community under comparable legal conditions. It is a question of equality of opportunity as regards the law. Otherwise, competition in the different Member States between companies having the same legal form

> will continue to be distorted artificially.
>
> Persons who intend to establish relations with companies in other Member States or who have already done so, have the greatest interest in being able to obtain sufficient and comparable information concerning the assets, financial position and results of such companies. At present the annual accounts of companies established in different Member States are far from being comparable, partly because the nomenclature in use in the different Member States for the items in balance sheets and profit and loss accounts is often totally different. In most cases the reader of a balance sheet, while being quite familiar with the structure of the accounts and the terminology employed in his own country, is not able to analyse the annual accounts of companies in other Member States. These circumstances might be enough to stop anyone from taking the risk of forming commercial ties with these companies.
>
> The differences that exist between national laws as regards presentation of accounts can also provide a reason for companies - in choosing where they will establish themselves - to choose a country where the requirements in this matter are not stringent.
>
> Finally, these differences may also be prejudicial to the rational orientation of capital investment in the Community to the extent that investors are not in possession of sufficient comparable information to take their decisions in full knowledge of the facts. This is particularly true as regards purchase of shares in companies in other Member States." [26]

4. The Second Directive

Although the Fourth and Seventh Directives will have the most impact on the law in respect of company accounts, the Second Directive does introduce certain concepts which do not exist in the U.K. and which highlight the different approaches of the

U.K. and continental practice. These relate to the calculation of distributable profits, an area that under U.K. law has been a source of some conflict between the courts and standard accounting practice.

The principle upon which the present law is based stems from the capital maintenance concept enshrined in the dicta of Lord Herschell in Trevor v. Whitworth.[27]

> "The capital might be diminished by expenditure upon and reasonably incidental to all objects specified. A part might be lost in carrying on the business operations authorised. Of this all persons trusting the company are aware and take the risk. But they have a right to rely and where intended by the legislation to have a right to rely on the capital remaining undiminished by any expenditure outside those limits, or by the return of any part of it to the shareholders."

From this developed the principle that "dividends must not be paid out of capital and that dividends must only be paid out of profits."[28]

The courts have developed, over the years, a number of rules as to what constitutes distributable profit in the legal sense, although for the most part the judicial attitude has been largely based on the familiar concept that in the absence of bad faith and so long as the directors are acting within their powers, the formulation of distributable profit is a commercial decision. Indeed, by contrast to the approach taken by other Member States the British attitude is that:

> "... all that is left, and very judicially and properly left, to the commercial world. It is not a subject for an Act of Parliament to say how accounts are to be kept; what is to be put into a company account; what goes into an income account, is left to men of business.
>
> The Company Acts do not require the capital to be made up if lost ... I cannot find anything in them which precludes payment of dividends so long as the assets are of less value than the original capital. It appears to me that the proposition that it is ultra vires to pay dividends out of capital is very apt to mislead, and must not be understood in such a way as to prohibit honest trading." [29]

The rules that dividends can only be paid from profit were satisfied by the courts adopting an economic concept of capital rather than a legal one centred on capital as ownership interest. They were able to comply with the basic principle by distinguishing between fixed and circulating capital.[30]

> "Perhaps the shortest way of expressing the distinction which I am endeavouring to explain is to say that fixed capital may be sunk and lost, and yet that the excess of current receipts over current payments may be divided but that floating and circulating capital must be kept up, as otherwise it will enter into and form part of such excess, in which case to divide such excess without deducting the capital which forms part of it will be contrary to law." [31]

Indeed the somewhat over-enthusiastic application of this distinction has at times led to serious criticism from the accountancy profession. In many respects what rules have emerged from the cases have largely been outpaced by concepts of what accountants would reasonably regard as profits available for distribution. There has developed a gap between what profits can be regarded as distributable in law as opposed to those which are regarded as distributable in the business sense. As Gower acknowledges, in practice "the courts abdicated almost completely in favour of accountants and their business clients." (1969 page 116)

Clearly, few would argue with the basic rule of law and commercial prudence that dividends cannot be paid if this would result in the company being unable to pay its debts as they arise. It is, however, difficult to justify a practice that permits a distribution of profits without provision being made for loss of or depreciation of fixed assets, a practice that offends against the basic accounting conventions of prudence and continuity of the business enterprise. It is, nevertheless, permissible in law.[32] By the same token the courts have been reluctant to impose rules in respect of accumulated deficits. In Amonia Soda Co. v. Chamberlain it was held that a company was under no obligation to make good capital which had been depleted by accumulated deficits in the past before paying a dividend out of profits in a new accounting period. Similarly, it would not be regarded as good practice to distribute unrealised appreciation in value of a company's fixed assets, although the English courts appear to permit this.[33] The different attitudes of the English and Scottish courts in this respect reflect different sides of a balancing line between the unfettered observance of accounting conventions and commercial freedom. The Court of Session[34] considers that an estimated increase in the value of fixed assets could not form the basis of a dividend payment. Lord President Clyde based his judgment on the accounting convention of prudence; the unrealised profit on the fixed capital might never materialise and the company would be placed in difficulties. His decision: "accords with the uncontradicted evidence in this case of the practice amongst chartered accountants."[35]

Within the twin constraints of prudence and commercial solvency U.K. courts have given considerable economic freedom to companies in their dividend policy. To a certain extent this must be so since the methods by which profits of a particular company are to be calculated depends on a variety of circumstances which may vary widely as between one company and another. In addition the calculation of net distributable profit for an individual accounting period gives so much scope to the internal accountant, in particular in respect of subjective accounting decisions on depreciation and stock valuation, that it would be impossible under the present legal framework for the courts to take a more interventionist stance in this area.

The policy of the Second Directive reflects the less flexible continental approach in respect of corporate accounting. Article 15 dealing with distribution of dividends declares that:

> "(a) Except for cases of reductions of subscribed capital,no distribution to shareholders may be made when on the closing date of the last financial year the net assets as set out in the company's annual accounts are, or following such a distribution would become, lower than the amount of the subscribed capital plus those reserves which may not be

> distributed under the law or statutes ...
>
> (c) The amount of distribution to shareholders may not exceed the amount of the profits at the end of the last financial year plus any profits brought forward and sums drawn from reserves available for this purpose less any losses brought forward and sums placed to reserve in accordance with the law or statutes."

Subject to a number of conditions, investment trust companies will be exempt from the provisions.

The Companies Bill 1979 seeks to implement these provisions. In future, both public and private companies will not be allowed to make a "distribution" except out of profits available for distribution, that is, accumulated realised profits, which have not been capitalised less accumulated realised losses not previously written off against realised profits. Unrealised profits will not be permitted to be applied in paying up debentures or amounts unpaid on unissued shares. (Clause 39)

The Bill defines a distribution as meaning every type of "distribution" of a company's assets to members in cash or otherwise, except issues of fully paid bonus shares, redemption of preference shares, the reduction of share capital and distribution of assets on a winding up. "Profits" and "losses" are taken to refer to both revenue and capital profits and losses . (Clause 45(2))

In respect of public companies the Bill further provides that a distribution may only be made where the company's net assets will be, both before and after distribution, not less than the aggregate of its called up share capital and its "undistributable reserves". (Clause 40(1)) The expression "undistributable reserves" refers to the share premium account, capital redemption reserve fund, the amount by which the company's accumulated unrealised profits so far as not previously utilised exceed its accumulated unrealised losses, in so far as they have not previously been written off, and reserves which are undistributed under the provisions of the Memorandum and Articles. (Clause 40(2)).

Clause 41 contains rules for investment companies listed on the Stock Exchange which are certified by the Secretary of State to meet certain conditions.

The accounts to which reference is to be made when deciding the level of permitted distributions will generally be the last audited accounts filed at the Companies Registry. If the auditor's report is not "an unqualified report" the auditors must, however, state "in writing, whether, in their opinion, that thing is material for the purpose of determining ... whether that distribution would be in contravention of the relevant section." (Clause 43)

Auditors will, therefore, have the additional burden of deciding whether the financial effect of a qualification is to reduce the realised profits and/or distributable reserves of the company to such a level that the distribution would be contrary to the provisions.

Where an interim dividend is concerned, reference will also be made "to such interim accounts as are necessary to enable a proper judgment to be made as to the relevant items." In respect of public companies, interim accounts must be filed at the Companies Registry and they must be "properly prepared ... for the purpose of determining whether that distribution would be in contravention" of the sections. (Clause 43) The Labour Government's Companies Bill 1978 had required interim accounts to be audited (clause 42), but this proposal was not included in the 1979 Bill on the basis that it would be both time-consuming and expensive and would, in effect, deter companies from paying an interim dividend.

Where a distribution is made in contravention of the provisions, shareholders will be liable to repay the distribution if they knew or believed that it was in contravention of the provisions.

The net effect of the new legislation will be a considerable erosion of the traditional flexibility that the law has permitted in dividend policy. The measure of profit is not concerned with the difference between capital and revenue, but with the notion of realisation. There can be no distribution from unrealised profits, and companies must make good past realised losses before a distribution can be made. Such rules are clearly in line with existing accountancy practice, in particular Statement of Standard Accounting Practice 2 (SSAP), Disclosure of Accounting Policies, which refers to the notion of prudence specially requiring that profits should not be anticipated but should be recognised by inclusion in the profit and loss only when realised.

But when, in practice, does profit become realised? The legislation gives no guidance in this respect and it remains a matter ultimately to be decided by the courts. In the past they have indicated that profit becomes realised when it has been "ascertained and earned".

> "The statement of principle that a profit may not be anticipated means no more than that you may not in making your computation bring in, in year one, a sum which you may, with whatever degree of certainty, anticipate will be earned in year two." [36]

There are, however, possible areas of conflict between accounting practice and judicial attitudes. For example, companies that are involved in long-term contracts may take profit in the accounts during the term of the contract, rather than waiting for completion. Indeed, part of SSAP 9 deals with contracts where the related activity takes place over a period that is longer than twelve months, such as construction, and in these circumstances a company should bring into its earnings a proportion of the anticipated profits on a contract as the work is carried out. When is the date of realisation? Is it the date when the final payment is made? Or, for example, the date when an architect or surveyor's report is received confirming that a section of the work has been completed and part of the profit may be recognised?[37]

One immediate effect of the new provisions on distributable profit is likely to be an increase in the practice of showing distributable and non-distributable reserves separately in the balance sheet.

The new rules on interim dividends are also likely to force some companies to re-think their policy in this area. Under the present framework the payment of interim dividends is a prime example of the non-interventionist policy of the law, payment of interim dividends has been less trouble than final dividends. This contrasts with the more rigorous policy adopted amongst other Member States. In West Germany, for example, interim dividends are permitted only after the end of the financial year, subject to severe restriction and their payment requiring the consent of the Supervisory Board.[38] In Denmark and France, interim dividends are not even permitted.

The effect of the legislation on current U.K. practice will be that if payment of an interim dividend contravenes the sections regulating distributions, additional accounts must be prepared. (Clause 43(8)).

5. The Fourth Directive

The provisions contained in the Fourth Directive on company accounts represent the cornerstone of the harmonisation programme. The original draft was first submitted in 1971 before the enlargement of the Community and after five years of consideration by a working party under the German accountant, Wilhelm Elmendorff. The proposals were consequently heavily influenced by the German and French systems of law and accounting, and "quite noticeably permeated by concepts that seem to have been borrowed from German stock corporation law."[39]

In particular, the prescriptive nature of the original draft owed much to the German Stock Corporation Law 1965 (Aktiengesetz), with a creditor orientated approach and a conservative tax based system of law and accounting. The flexible U.K. concept of published accounts showing "a true and fair view" was to be subservient to the prescriptive continental approach.

U.K. influence was first felt in 1971 when the Groupe d'Etudes (EEC Accountants Study Group) invited representatives from countries that had declared their intention of joining the Community to join it in discussing the proposals. Two memoranda were later submitted to the Commission which argued for considerable changes to be made to the proposals and which reflected considerable U.K. influence. This influence has gradually been extended and the final version represents something of a success for the U.K. negotiators bearing in mind that the original framework was conceived at a time when the U.K. had no voice within the Community.

From an initial position of subservience, the requirement for accounts to give a true and fair view now overrides all other considerations. (Article 2) Where application of the Directive would be insufficient to give a true and fair view, additional information must be providedand, in exceptional cases where the application of a provision of the Directive is incompatible with a true and fair view, the provision must be departed from with an explanation for the reason and effect of such departure.

The Directive has three fundamental effects on U.K. law and practice. For the first time it prescribes compulsory lay-outs or schemes, for balance sheets and profit and loss accounts. Second, the Directive divides companies into three groups, varying the disclosure and audit requirements for each group. Third, it introduces statutory "valuation rules" which must be observed in drawing up company accounts and which in the U.K. have hitherto been left to the professions and business community to develop.

Under the present law in the U.K. legislation specifies that certain information must be disclosed and for particular types of undertaking such as building societies and industrial assurance companies, the lay-out of the accounts has been prescribed. Any attempt, however, to extend this to all companies has been sharply resisted. The Cohen Committee argued that:

> "...the diversity of companies is such that it is doubtful whether standard forms of accounts would be practicable and in any event we fear that standard forms might restrict further progress in the technique of conveying information through the published accounts." (Cmnd 6659 para 97)

The great advantage of standard formats, particularly in the context of the E.E.C., is that it does permit greater comparability thus assisting investors, analysts and economists in arriving at more realistic and accurate decisions and forecasts about companies. This argument might, however, carry more conviction but for the fact that it will be open to companies within the terms of the Directive to value their assets on different bases, comparability will in this respect be more difficult.

The Directive will require legislation to prescribe the lay out for company balance sheets. (Article 8) This may be either the traditional horizontal presentation or a vertical lay out, but whichever is chosen its format must be rigidly followed; the order may not be varied although the inclusion of additional information is permissible.

In most cases it will simply be a matter of requiring greater detail than under the present U.K. legislation. The Directive does, however, include some classifications that would be completely new to the U.K. such as the requirement to supply separate debtor and creditors in terms of those that become due and payable within one year and those after one year. In accordance with recommendati ons in the Green Paper, "'The Future of Company Reports'[41], the U.K. Government propose that in respect of (a) bank loans and overdrafts, (b) inter-group indebtedness and (c) other groups borrowings, an analysis must be provided, broken down into amounts payable on demand, those payable in one year or less but not on demand, and those payable in more than one year but less than five years.[42] This will represent a considerable improvement for users of accounts over the present arrangements where they are unable to assess the timing of the repayment of corporate borrowings.

The profit and loss account may similarly be in either the horizontal or vertical form and the prescribed lay out must be followed as rigidly as that of the balance sheet. In addition, the profit and loss account may be presented either on the basis of the type of expenditure, for example, wages, depreciation, materials, etc., similar to an added value statement; or according to the type of operations, for example, cost of sales, distribution costs, administrative expenses, etc.[43]

The rigidity of this approach is mitigated in two respects. First, there is the overriding concept that the accounts must show a true and fair view. Thus, if to follow the standard format would result in the presentation being inaccurate, unfair or likely to mislead, it may be departed from. Second, the disclosure rules are linked to the size of the company. The Directive permits Member States to exempt small and medium sized companies from various of the disclosure requirements. (Article 47) A medium sized company is one which does not exceed the limits of two of the three following criteria:

Balance Sheet Total	£2,640,000
Net Turnover	£5,280,000
Average number of employees during financial year	250

The limits for small companies are:

Balance Sheet Total	£660,000
Net Turnover	£1,320,000
Average number of employees during financial year	50

The U.K. Government is therefore presented with the option of following these exemptions, setting lower limits (but not upper limits) or electing to treat all companies alike. If the exemptions are adopted small companies will be required simply to publish an abridged balance sheet and notes to the accounts. There will be no need to publish a profit and loss account, annual report or auditors' report. The exemption in respect of medium sized companies extends to the publication of an abridged balance sheet, profit and loss account and notes to the accounts. They will not be exempt from the requirement to produce an annual report and auditors' report.[44]

Perhaps the most significant innovation in terms of the law and philosophy of accounting regulation in the U.K., is the establishment of "valuation rules" or general accounting principles to be followed in the preparation of accounts. (Articles 32-33). As already pointed out, at present the law is based on the true and fair view concept underpinned by the provisions of Schedule 8 of the 1948 Act. Questions of accounting principles have been left exclusively to the profession.

Section 7 of the Directive lays down the basic principles which at present are the foundation of U.K. accounting standards; the going concern concept, consistency of valuation principles from year to year and valuation on a prudent basis. Departure from these basic principles is permissible only in very exceptional circumstances and these must be explained in the notes with an assessment of the effect of the departure on the accounts.

On the face of it therefore the principles upon which accounts are to be based are those currently used in the U.K. The important factor, however, is that they will in future be required to be enshrined in legislation and this may mean some loss of flexibility, with more emphasis being placed on strict interpretation of the rules rather than their spirit. As Renshall observed:

> "Once a rule has hardened into a statutory formulation the approach to its interpretation changes profoundly ... the tendency now will be to delimit it by reference to the strict meaning of the words which may produce unexpected shifts of interpretation." (1978 page 47)

The valuation provisions are soundly based on traditional historical cost principles but they do allow Member States the power to permit or require revaluations on a replacement cost basis or some other method designed to take account of inflation. The legislation will require to define the contents and limits of the different valuation methods, the rules for their application and the details must be disclosed in the notes. (Article 33) The absence of this derogation would obviously have thwarted the current efforts by the U.K. profession to introduce a system of inflation accounting and indeed frustrated the extension of the present dual approach combining historical cost with revaluation of fixed assets.

Historical cost may not, however, be abandoned completely in that the amount of any difference from historical cost must be shown as a Revaluation Reserve which may not be distributed unless it represents gains actually realised; although it may be capitalised by the issue of fully paid up bonus shares.

(a) Fixed Assets

Under U.K. law it has never been obligatory to provide for depreciation or replacement of fixed assets. In practice, however, accounting prudence has dictated that companies do set aside each year an amount which can be ultimately used to replace fixed assets at the end of their useful life. The Directive, however, will require companies to write off 'systematically' the value of fixed assets over their useful economic lives. It is not intended to specify what the useful economic life of an asset is, it will simply be a matter of the directors' discretion, accounting practice and overriding principle of truth and fairness. The expression 'systematically' implies that the directors will remain free to select the method of depreciation which is appropriate to the circumstances of the company. (Article 35)

(b) Intangible Assets

The Directive requires that research and development costs, formation costs and goodwill must be written off over a period of five years. No distribution of profits can be made unless the amount of the reserves available for distribution and profits is not at least equal to the amount of research and development and formation costs that have not been written off. Member States may allow departures from this rule in exceptional cases.

In the U.K. it is intended that this requirement be introduced to a limited extent and the present accounting practice be retained. This will mean that research costs (other than fixed assets) will normally be written off in the year of expenditure and only development cost may be deferred. In exceptional cases, as for example might appear in the aerospace industry with development over a long time scale, development cost may be written off over a longer period than five years and the restriction on distribution suspended.

It is particularly important that provision be allowed for writing off goodwill over a longer period than five years. In some instances a company may carry a considerable sum in goodwill, for example amalgamation, to require this to be written off within five years may place an undue strain on corporate profitability. Goodwill may therefore be written off for a period which does not exceed its useful economic life. It may be that the Government will eventually follow the North American practice of stipulating a maximum period of forty years for writing off goodwill.

(c) Stocks

Stocks form a sizeable class of assets on a balance sheet and the basis of their valuation is therefore an important decision in terms of the overall picture presented by the accounts (Article 39.40). U.K. legislation does not state the basis on which stocks are to be valued preferring it to be dealt with by the accountant taking into consideration the differing circumstances and conditions under which companies operate. The Directive whilst laying down the general rules does preserve the flexibility in choice of valuation method which the present U.K. system allows.

In respect of stocks of goods of the same category or which otherwise cannot be distinguished from one another the Directive permits three methods of valuation and despite the fact that one of them is regarded as inappropriate for the U.K. because it results in the cost of the stock being calculated at less than its actual amount, there is no proposal to limit the choice of valuation methods in the U.K.[45]

(d) Notes to the Accounts

The Directive lays down certain supplementary information to be included in notes to the accounts, most of which is already required in the U.K. either in the accounts or directors' report. This includes such things as securities issued during the accounting period, an analysis of turnover in terms of geographical area in addition to business activities, number of employees and directors' emoluments (Article 43). This transfer of information from the directors' report to the accounts is significant in that the amounts disclosed will now fall within the scope of the audit.

In addition the Directive requires disclosure of the total amount of financial commitments not included in the balance shset in so far as it is of assistance in assessing the financial position. This means that in addition to the present requirement to disclose capital commitments[46], companies will be required to disclose any other material contracts which create financial liabilities. This may, for example, include commitments in respect of the acquisition of goods and services at some future date.

The Directive also requires further information in respect of any security over the company's liabilities. At present only the fact that liability is secured need be stated whereas the Directive will require more precise detail on the nature and form of the security.[47]

6. The Seventh Directive

One of the major criticisms levelled at the Fourth Directive from the U.K. professional bodies was that it did not deal with group accounts, a subject already dealt with under U.K. legislation. This was to be left to a separate but complementary Directive. The Draft Seventh Directive on group accounts was first submitted by the Commission to the Council in May 1976 and it was hoped that agreement on the Fourth Directive would speed up work on it.

It has since 1948 been recognised under U.K. law that whilst running a business in the form of a group with a number of separate subsidiaries bring economic and commercial benefits, it may also be used as a device for misrepresenting the financial position and solvency of the parent or its subsidiaries. Parent companies are therefore required to prepare group accounts of itself and all companies over which it has a power of control, whether or not it chooses to exercise such control[48].

As already indicated the requirement to publish group accounts is not widespread in Europe. In France and the Netherlands, for example, there is no requirement to produce consolidated accounts, although many large groups choose to prepare them. In West Germany a German group holding company must prepare group accounts consolidating the profit and loss accounts and the balance sheets of all dependent companies in its group with its own accounts. Indeed, the process of consolidation is set down in greater detail with rigid rules on the structure, form and content of the group accounts, a system which contrasts with the U.K. where much of the detail is left for the profession to determine[49].

In so far as the Draft Seventh Directive lays down technical details in respect of the methods and techniques of consolidation it is relatively uncontroversial, although predictably there is less flexibility than the present U.K. arrangements. The details contain a number of points that have provoked adverse comment from companies and accountants in the U.K., in particular the original proposal that consolidated goodwill be written off over a maximum period of five years. However, in accordance with similar provisions in the Fourth Directive the proposal has been amended so that goodwill on consolidation must be written off over a period not exceeding its economic life.

In the introduction to the proposals the Commission[50] declares that the purpose of group accounts is principally the same as for the accounts of individual undertakings, to give a true and fair view of the assets, liabilities, financial position and results of the group. The larger economic unit of the group is seen as a single entity for the purposes of group accounts, replacing the individual and legally separate member undertakings.

The proposals essentially distinguish between subsidiaries which must be consolidated using the parent company concept and associated companies. The definition of an associated company broadly follows the U.K. model, an undertaking over which another exercises, directly or indirectly, a significant influence. To assist in the practical application of this rule:

> "an undertaking is presumed to be associated
> with another undertaking if it holds 20% or
> more of the capital, or of votes attaching to
> the shares issued by that undertaking" (Article 1)

The rationale for extending coverage to include associated companies is that the exercise of significant influence creates a special relationship between a group and the associated company. It is provided, therefore, that the profits and losses realised by the associated company must be reflected in the valuation of the group undertaking's shareholding (Article 17).

Although the definition of an associated company is consistent with U.K. practice, the definition of a group under the terms of the Directive follows German practice. Under U.K. law the definition of a group is simple, precise and objective. It rests on the power of control which exists if a holding company holds more than 50% of the equity share capital of another, or otherwise controls the composition of the board of directors of that company[51]. By contrast the original version of the Draft Directive defines a group in terms of an economic unit as existing when a dominant undertaking exercises in practice its influence over other undertakings to the extent that all undertakings are managed on a central and unified basis. An amended version has to a certain degree brought the definition nearer to British practice but the basic philosophy is still expressed in terms of economic rather than legal criteria. Article 3 now states that:

> "... a dominant undertaking and one or more undertakings dependent on it shall constitute a group if the dominant undertaking exercises in practice its dominant influence to the effect that all such undertakings are managed on a unified basis by the dominant undertaking."[52]

The expression "unified basis" is not defined but clearly ownership or control are not the only elements. The key to the expression would seem to be the existence of a directing body or spirit rather than central ownership. The explicit objective is to recognise the economic reality in the group as an economic unit behind a collection of legally autonomous undertakings. The problem, however, is that although it has a sound philosophical base it does not possess the simplicity and objectivity of the U.K. formula and, indeed, in practice its interpretation and application may raise problems in the U.K. Under the definition, dominant influence can exist in the absence of legal ownership, thus in the U.K. it could be that certain companies which under present legislation are not regarded as groups because of the absence of legal control may be classed as a group under the unified formula. Alternatively, companies which at present are obliged to produce consolidated accounts may, under the draft proposals, be excluded from the group because they are not under unified management. ICI in evidence to the House of Lords Select Committee[53] on the European Communities expressed the view that they did not manage on a unified basis either their overseas subdidiaries or their non-wholly owned subsidiaries in the U.K., consequently the nature of their consolidated accounts would be significantly changed by the Directive.

Consistent with the economic philosophy behind the provisions is the fact that a dominant undertaking of a group may be in some form other than a limited liability company. The only proviso is that at least one member of the group must be a limited company incorporated in a Member State. If this requirement re-appears in the final version of the Directive it is likely to create problems in the U.K. in that if a partnership manages a limited company, a group relationship will subsist and consolidated accounts will be required even though there is under present law no obligation placed on partnerships to prepare and file accounts.

A further requirement that would represent a departure for U.K. companies is the need to prepare consolidated accounts of a horizontal group dominated by an undertaking registered outside the E.E.C. For example, if a company in the U.S.A. has subsidiaries in the U.K., Italy and France, the (sister) subsidiaries form a horizontal group within the E.E.C. and consolidated accounts would be required even though none of them had any control over any other. Problems are foreseeable in this respect particularly as regards the domestic law of the individual States. U.K. law could not, for example, compel a German company to give details to its U.K. sister subsidiary for the purpose of publishing consolidated accounts. Such accounts would in fact be difficult and costly to prepare.

Similarly, under the terms of the Directive consolidation would have to be prepared of each sub-group level without exception. Bearing in mind the detailed requirements of the proposals this again would represent a considerable burden. The practice in the U.K. is to exempt sub-groups. In Germany there exist similar exemptions where the parent company guarantees their debts.

The extent of this requirement is illustrated by the following:

2 : Germany
3 : France
4 : Holland

Company 1 : U.K.

B : U.K.
C : Italy

Company A : Japan

In terms of the draft and working on the assumption of unified management, consolidated accounts would have to be published in respect of Company 1, 2, 3, 4, sub-groups 2 and 3, and horizontal group B and C.

In response to the criticism levelled at this aspect of the proposals they have now been amended in order that Member States may exempt undertakings from horizontal and sub-group consolidations provided that a number of conditions are fulfilled. These are that:

(1) the annual accounts of all undertakings forming part of the sub-group must be drawn up, audited and published in accordance with the terms of the Directive:

(2) the group consolidated accounts must be drawn up, audited and published in accordance with the Directive;

(3) all shareholders of the dependent undertaking must declare each financial year their agreement,

(4) the dominant undertaking must agree to guarantee the commitments of the dependent undertaking;

(5) the exemption must be disclosed in the notes to the group consolidated accounts;

(6) the shareholders' agreement and the guarantees by the dominant enterprise must be filed, in the U.K., with the Registrar of Companies.

If full group or sub-group accounts are to be prepared under the proposals normally all undertakings must be included. The one exception to this is where the omission of an undertaking from the consolidated accounts would only be of minor importance for the purposes of group accounts and in terms of true and fair view criteria. This will not be permitted, however, where several undertakings are of minor importance but taken as a whole area of importance in representing a true and fair view of the group's position. The auditor is specifically required to concern himself with any omission from the consolidation and explanation of the reasons must be provided in the notes to the accounts.

It is expected that agreement on the Seventh Directive will be reached some time this year and there is no doubt, judging by the relative success of the U.K. lobby over the Fourth Directive, that a compromise will be achieved over the central question of what amounts to a group. It is widely anticipated that a working compromise will emerge between the 'economic entity' approach based on unified management of the present draft and the more legalistic definition centred on control which is favoured in the U.K. and the International Accounting Standard 3 on groups.

7. Green Paper - Accounting and Disclosure

In September last year the Government published 'Accounting and Disclosure'- A Consultative Document', (Cmnd 7654) laying out how U.K. company law is to be amended in order to accommodate the requirements of the Fourth Directive. This document heralds a significant change of course in terms of the legal framework regulating companies by abandoning the unitary approach in which all companies are treated equally. Hitherto all limited companies, regardless of size, have been required to disclose the same detailed financial information. The Green Paper follows the model of the Directive by proposing a three-tier structure for companies with different disclosure requirements for large, medium and small companies.

The approach of the Government in implementing the Directive is:

> "that companies should be given the maximum flexibility permitted by the Directive to present information in a manner suitable to their particular circumstances. It is also intended to use the basis of classification of companies, included in the Directive as a means of relieving the proprietors of small companies from necessary disclosure and so to bring about a

> much greater distinction between the disclosure requirements of large and listed companies on the ona hand and small companies on the other". (Page 11)

The Three tiers will be:

> Top Tier - all companies listed on the Stock Exchange and other large companies which exceed two of three criteria:
> turnover of £5 million;
> balance sheet total £2.5 million;
> average number of employees 250
> Middle Tier - all public companies not included in the top tier and all private companies which do not fall within either the top or bottom tier.
> Bottom Tier - small private companies which do not exceed two of three criteria;
> turnover of £2,300,000;
> balance sheet tdal £650,000;
> average number of employees 50. (page 1)

Companies in the top tier will be required to disclose further information on short-term borrowings, leasing arrangements and pension commitments. In addition they will be required to provide a statement of the source and application of funds in their accounts. They will not, however, be required to disclose additional non-financial information as proposed in the Labour Government's Green Paper.

Companies in the middle tier will be permitted some concessions in the amount of detail in their accounts. The major thrust of the proposals, however, is in offering greater privacy to smaller companies. Two options are suggested for consideration:

(1) Take maximum advantage of the concessions permitted by the Directive;

(2) Retain the existing legislative requirements for drawing up accounts for use by the company and shareholders, taking advantage of concessions under the Directive in respect of publication of accounts.

8. Accounting and Management

Accounting standards and the role of accountants is central to the disclosure philosophy. If managements are to be more effectively monitored and companies made more accountable there must be some mechanism for measuring performance, some common yardstick. Success or failure must be judged according to a standard which is objective, consistent and inevitably numerical. Hence the importance of accounting principle and the role of accountants in verifying information.

Under U.K. company law the production of financial information is the primary responsibility of the executive directors. It is they who are responsible for selecting the accounting principles upon which the financial statements are based, not the external auditors. This gives the executive a considerable degree of flexibility in manipulation of accounting principles and final figures. Indeed the U.K. system is noted for its flexibility based on the central requirements that directors must ensure that the annual accounts display a "true and fair view".[54] This vague notion is the overriding legal objective on which the external auditor is required to report and as we have seen because of the success of the U.K. negotiators, it now represents the cornerstone of the EEC programme for harmonisation of accounting provisions.

The U.K. legislation makes no attempt to define truth and fairness and on the rare occasions that it has received judicial scrutiny it has simply been equated with generally accepted accounting principles. The effect is that the expression has become meaningless. As Chambers asserted:

> "the words truth and fairness have become mere formulae; because there are many true and correct statements of the state of affairs of a company." [55]

Indeed, in so far as it is a basis for making economic decisions, a profit and loss account drawn up on the historical cost basis cannot reflect the truth when it uses a fluctuating standard, cash, as its unit of measurement. The Sandilands Report on Inflation Accounting in 1975 stated that:

> "according to the estimates of the Government statistical service, stock appreciation in 1974 amounted to nearly 50% of the gross trading profit of companies." (Cmnd 6225)

The Report went on to observe that "the problem of stock appreciation has become so serious for British industry that something must be done to remove this distortion from company profits."

Thus the whole framework of corporate financial information rests on generally accepted accounting principles as selected and interpreted by the executive. It might be argued that the profession should seek to impose consistency, we have seen that there are conventions soon to be embodied in the law, that similar items should be treated in the same manner from year to year, otherwise it would be difficult to make a proper comparison of corporate results. The public interest however demands not simply consistency within individual companies but across the board in order to compare one company with another. Such a requirement is frustrated, however, by accounting principles which allow different bases of measurement which cannot yield comparable results. The obvious example is stock valuation where there are a number of alternative bases, all of which are acceptable despite the fact that each one is likely to produce a different result.

Chambers provides evidence for this by showing that:

> "the number of possible methods, or sets of rules, for obtaining the aggregate amount of the assets of a company which has commodity stocks, three classes of fixed assets and ... three classes of security investments is 108 x 24 x 48 = 124,416. And this is only a conservative estimate, which, by considering alternatives implicit in some of the rules such as those for depreciation, could be increased at least tenfold." (1969 page 186)

In examining a limited number of procedures and rules that form generally accepted accounting principles, Chambers illustrates the large number of combinations possible and explodes the illusion that the virtues of the traditional model are its objectivity and certainty.

Does general acceptance therefore necessarily provide the most effective criteria for the provision of information upon which to base a judgment on corporate activity and accountability?

> "General acceptance suggests a rut. What is done is not necessarily right just because it is done." 46

In the words of two American accountants:

> "The development and regulation of accounting theory and practice is basically the result of ad hoc expedients, largely distorted by the very corporations whose affairs are being accounted for." 57
>
> "General acceptance ... tends to mean anything goes". 58

For example, in the Department of Trade investigation into the Court Line collapse in 1978 the Inspectors, in the chapter on accounting, refer to the extent to which Court Line relied on "off the balance sheet" financing by means of leasing for nearly £38 million of its aircraft purchases. The inspectors considered that in view of its volume such financing should have been revealed. It was, however, pointed out that no accounting standard had been produced on the subject of disclosure of obligations under leases and that there are no U.K. company law requirements. The question might be posed to that comment, what of the much praised truth and fairness criteria?

> "In our view the amounts involved were material and should have been disclosed, together with

> information about the payment pattern of the Tristar leasing charges. Both the directors and Robson Rhodes (the auditors) stated that they would have had no objection to including the information by way of note if this had been proposed but nobody made the suggestion." (para 566)

It is suggested therefore that the institutional role of the accountant is fundamentally compromised since it is impossible to:

> "expect objective reporting from an institutional structure which combines power of selection of accounting principles by the very managers whose activities are being accounted for, wide discretion in making that selection and auditing of that selection by persons hired and fired by the very managers who make the selection. As long as management rather than the accountant is empowered to make discretionary choices on any competing accounting principles, such choices will often lack soundness and will invariably lack objectivity." [59]

An illustration of this power was highlighted again by the Inspectors in the Court Line investigation:

> "It appears to us that whenever there was doubt about the possible methods of application of accounting practices, Court Line chose the method which reacted most favourably on the profit of the year.
>
> We do not believe that this happened by accident. We believe it to be a deliberate decision of management. This finding is denied by Mr. Bond and Mr. Makin (directors with responsibility for accountants).
>
> It was suggested to us that Court Line were not unique in their optimistic accounting practices and that there were many other companies whose accounts have been criticised for optimism. Whilst this may be true, in our view it in no way absolves the directors of Court Line." (Para 696)

The following exchange from the U.S.A. illustrates the extent of the illusion:

> Chairman (of a practising Law Institute Panel) "let us assume that a company has a lot of decisions to make on accounting principles and that in each case the company adopts a more liberal method or the one that is least acceptable. Do you think that while each of these might have been generally accepted accounting principles, in the aggregate they can so distort the financial statement that you would not be willing to give an opinion that they fairly present the financial condition of the company?"
>
> CPA: "I think that is like being a little bit pregnant; there is no such thing. I think what you do in a case like that would be to take a deep breath, swallow hard, and sign the certificate. You might try to persuade management that your feeling is that they should not use all of them because of the danger of creating what might be considered a distortion. Under the present rules of the game, if they insist on doing it, you have no alternative." [60]

9. The Auditor - Watchdog in Need of New Teeth?

It is generally accepted that the role of the auditor is to act as a professional "watchdog". The following represents perhaps the clearest expression of their contemporary role and function.

> "No one would deny that the function of the auditor in lending credibility to financial statements, has been growing in importance, rapidly and steadily, over the last fifty years. Such financial reports are relied on heavily by investors, creditors, security analysts, Government and others. The role of the auditor in lending credibility to these financial statements is vital in establishing and maintaining confidence in the capital markets. Without such confidence the whole basis of our capitalist system would be destroyed. Thus, the

> continuing importance of the auditor's role is not in dispute." [61]

Lee expressed similar sentiments:

> "Company auditing is concerned with the creation of belief and confidence in the financial accounting information which describes the use made of economic resources within a company over a stated period of time. By giving an expert and independent opinion upon the company's annual financial accounts, the auditor attests to the latter's credibility on behalf of the shareholders who rely upon this formal substantiation taking place, prior to making use of the information in their investment management activities." (1970 page 292)

The same author sees the notion of a company audit as an exercise in power and responsibility. Management are given the legal responsibility to publish financial information annually in order to fulfil their stewardship duties. In order, however, to prevent manipulation of the results the auditor is the counter balance to management, with a responsibility to assess the reported information and report on it.

In the U.K. legislation has sought to define the responsibility placed on the auditor and underpin their independent status. They are for example allowed to attend and address the general meeting at which their appointment must be specially considered each year. Under the 1967 Act the auditor is required to state clearly if adequate books and records have not been maintained or if they have not been able to obtain all necessary information from the directors. The 1976 Act in particular was aimed at strengthening the status of the auditor by preventing auditors resigning without making formal statements of any circumstances which they consider should be brought to the notice of shareholders or creditors. In addition they were given the right to requisition an extraordinary general meeting and circulate statements to the members.[62]

The origins of the more recent provisions are traceable to the results of the Department of Trade investigation into Pinnock Finance. In this case the auditor of the finance company, after taking legal advice, resigned because of failure to extract satisfactory explanations in respect of the conduct of the company and its directors. The retiring auditor was replaced by a former employee of Pinnock Finance who duly issued approved reports on the accounts covering the previous auditors period of office and subsequent four years until the company collapsed with losses of £8 million. In his letter of resignation to the board the auditor spelt out precisely the reasons for his resignation which included disregard of exchange control regulations, overstatement of investment assets and failure to meet the group's own advertised gilt edged investment base criteria.

The Board of Trade Inspectors were quick to conclude that had the original auditor completed his audit and indicated in his report the areas which concerned him, the company's trading activities might have been curtailed and the loss to the public avoided.

Under the present law a retiring auditor who discovers malpractice cannot quietly resign, he must bring his discoveries to the attention of the members and creditors.[63] Despite these changes, however, auditors have in recent years been increasingly under pressure as a result of adverse publicity in Department of Trade reports and criticism over their role and function. Speaking on the public responsibility of accountants, Sir Henry Benson, industrial adviser to the Governor of the Bank of England and himself an accountant, has commented:

> "I am no prophet of doom, but I cannot refrain from uttering the warning that neither the public nor Governments will be complacent unless a radical improvement takes place in the near future." [64]

This is but one example of a considerable body of criticism against the accounting profession, particularly in respect of their role as auditors of the accounts of limited companies. Headlines such as the following have become frequent in business journals:

> Auditors: "why the watchdog needs a closer watch";[65]
> "call for sanctions against below standard accountants";[66]
> "rocket for profession from fraud squad chief." [67]

A succession of Department of Trade reports have been severaly critical of the part played by auditors in business failures or improper activities. The following are some examples:

> "We further find that (the auditors) acted without reasonable skill and care in advising ICFC in respect of the updated profit forecast. The auditors of Roadships did not "after 1969 ever achieve the standard of independence necessary

> for a wholly objective audit ... It follows that they were unable to judge accurately the extent and depth of the tests and other procedures that they should have adopted to gauge how far the companies books of account reflected accurately the company's financial position." [68]

> "The auditors were responsible for part of the overstatement by acting without reasonable skill and care in the conduct of their audit." [69]

> "It is our view that it was the auditor's duty to test Mr. Rowlands retrospective expense claim by reference to the evidence available to them. This was an enormous claim by any standard of judgment. The claim was submitted for the specific purpose of dealing with Mr. Rowland's overdrawn personal accounts which Lohrr o had been advised were unlawful in terms of section 190 of the 1948 Act. This was a matter which we drew to Mr. Butler's (the auditor) attention and the attention of both firms of auditors in January 1975 before the expense claim was made. Having regard to the size of the claim and the circumstances surrounding its preparation we believe that both firms of auditors were on notice to exercise particular care in dealing with the matter. It is our view that the auditors did not do so." [70]

> "We noticed a number of errors where the auditors had failed to follow items through in the course of the audit and to see that agreed and necessary provisions were included in the accounts." [71]

The Inspectors in the London and Capital Group investigation recalled an early observation of Mr. Stonehouse's when giving evidence in Melbourne:

> "He made what then seemed to us a cynical observation that the auditors had taken part in a gavotte ..."

> "We are driven to the conclusion (in regard to the 1973 accounts) the auditors were thoroughly slipshod in dealing with material matters. They told us that they thought the responsibility lay with the lawyers." [72]

It may be argued, and not without some justification, that the general impression created in the public eye of the profession is less than "true and fair" but the necessity to achieve some perspective does not excuse the glaring examples of incompetence revealed in the reports. Some of the reports point to mitigating considerations and there is no doubt that in the last resort much depends on the personality of the individual auditor and his ability to stand up to the directors on important issues. There are cases where the auditors are exposed as amazingly gullible individuals only too willing to accept, without qualification, the explanations of the directors. Another feature of the inspectors' observations is that the particular company being investigated is often dominated by one all powerful individual whose personality tends to obscure the dubiety of the explanations and information he gives to the auditor. Such a situation clearly prevailed in the investigation in the 1960s into theFire Auto and Marine Insurance Company and more recently Slater Walker Securities, Lonrho and London Capital Group.

What chance do the shareholders have when they are saddled with gullible auditors and a man such as described by the inspectors in the London Capital investigation:

> "Mr. Ston ehouse was a sophisticated and skilled confidence trickster. His pleasant manner and fluency, as well as his apparent grasp of affairs, were the most potent weapon in his armoury." [73]

What is particularly disturbing, however, is that a frequent complaint against auditors is that they failed "to follow items through in the course of the audit"; "Work has been inadequately performed and working papers have omitted to record what work was in fact discharged." Since it must be assumed that most company boards do not set out with the aim of deceiving shareholders, such shortcuts by the auditors, though unjustifiable, may have little impact. But when the directors do set out quite deliberately to mislead the members and deceive the public such errors become more significant. Indeed the number and frequency of the published failures must inevitably give rise to the question, how many remain to be discovered?

It might therefore be argued that the general standards of auditing are inadequate. This is a question that has very much occupied the minds of the professional bodies for several years. Auditing practices have been tightened up and more thorough procedures are becoming standard. Sophisticated and well-tested check systems have been developed and many large firms take the view that "a good audit involves far more than checking the books." [74] However, even in the biggest firms it seems that such procedures are not infallible, as evidenced in the criticisms of the auditors of Scottish and Universal Investments Ltd. in failing to detect an unsecured loan of £4.2 million.

The answer to the problem goes much deeper than simply improving auditing standards and guaranteeing access to information. Modern technological developments, in particular the widespread use of computers, have presented auditors with considerable problems. In the U.S.A. for example, the electronic data processing industry has acknowledged that it is exceedingly difficult to detect fraud in which computers are used as the main tool of the crime. In a study on computer crime Whiteside quotes from the president of a New York bank who expressed little faith in the notion that the profession can improve its ability to detect computer crime in the making.

> "Auditors seldom find a loss ... they may confirm it after it happens." [75]

A computer security firm observed that:

> "The beautiful thing about computer crime is that if you are intent on committing one you can always make column A equal column B for the accountants." [76]

As Brown comments, unlike the manual systems in a computerised system:

> "... the form, content and accessibility of records frequently are such that the auditor is unable to follow a single transaction completely through the system ... The system is sufficiently complex so that if an auditor of the computerised books of a large corporation is to be truly independent in his examination, he would have to bring with him for the auditing process not only his own team of computer specialists, but even his own computer."
> (1975 page 40)

It is clearly outside the ambit of this study and indeed the expertise of the writer, to discuss at length the accountants function as auditor in terms of the techniques and procedures.

We may, however, be legitimately concerned with auditing standards.

Compulsory audits have been required of companies continuously since the Companies Act 1900 and it was only in 1978 that the professional bodies made any attempt to lay down definitive minimum standards. Previously accountants have only had a series of guidance statements to assist them in their audit function as opposed to standards in the sense of a yardstick against which to measure the performance of accountants.

This issue may be examined from three angles, competence of auditors, independence and performance.

(a) Competence

If published financial statements are to carry any credibility the person entrusted with the task of auditing those statements must be competent to do so. Such competence is most readily apparent if the person holds a recognised professional certificate of competence. Legislation seeks to ensure this by requiring auditors to be members of one of the four recognised accounting bodies.[77] It must therefore be assumed that those who possess a professional qualification have received sufficient training in the theoretical and practical aspects of their chosen branch. Whether of course they possess the right personal qualities in terms of an inquiring mind and strong personality is another matter.

(b) Independence

Assured that the auditor appointed is competent to carry out his statutory and contractual obligations those for whom he carries out the duties must be convinced that he will give an honest and unbiased opinion of the financial statements. U.K. law makes some attempt to secure the independence of auditors in that legislation vests appointment of the auditor in the hands of the shareholders. Such appointment must be discussed and voted on each year at the annual general meeting. The legislation also provides that they may not appoint incorporated companies, employees of the company or of any company within the same group, or partner of any officer or employee of the company.[78] Although far from satisfactory these provisions are at least preferable to the position in the U.S.A. where:

> "by law and largely by practice, the selection, tenure and dismissal of an accountant is entirely in the hands of the management. Moreover, management is not hesitant to use this power. During the eighteen month period of November 1971 to April 1973 there were approximately 400 changes among the corporations which must file Form 8-K; with the S.E.C. and during the period of January 1973 to June 1974, there were approximately 700 changes. At least 10% of these changes and almost certainly more were made against a background of disputes over accounting principles."[79]

The accountant's dependence on management for his tenure when combined with management discretion in selecting among competing accounting principles and the

> "low standards set by the accountants for determining whether a given principle is generally accepted, result in an almost irresistible pressure on the accountant to go along with management principles. The accountant can swallow his convictions or he can qualify his opinion, or he can resign. Usually the latter two courses are one and the same, the pressure is considerably augmented by the fact that if an incumbent accountant does back out, a more flexible auditor can always be found." [80]

Even although shareholders in the U.K. do have exclusive rights to appoint auditors there is still a need to ensure that the auditor is not unduly influenced by management or his own interests in the company. This is especially so in view of the declining influence of shareholders' voting power and the control over meetings that the executive are able to exert.

Until recently, the question of financial involvement between a company and auditor has not been of serious concern. Unlike the U.S A. it has never been regarded as improper that the auditor should hold shares in the company. The absence of such concern in this respect may be explained by the emphasis on the auditor as agent of the members and his function in overseeing the stewardship role of management. Share ownership is consistent with such a role as indeed U.K. law once recognised by requiring auditors to hold shares. The nature and balance of corporate government has changed, however, and this somewhat naive view has given way, particularly in the U.S.A., to a view that the auditor must be independent of all parties. This accords with the increased awareness of the appearance of independence and is consistent with the trend in the U.S.A. towards monitoring corporate social responsibility.

The U.K. Accountancy Bodies have produced statements in respect of professional independence but such statements are only intended as guidelines and there must be strong doubts about whether the professional bodies have the necessary determination to enforce them. The guidelines tend to consist of vague aspirations resting on the auditor using his own judgment in particular situations. Thus, for example, the English Institute of Chartered Accountants Independence Paper states:

> "Professional independence is a concept fundamental to the accountancy profession. It is essentially an attitude of mind characterised by integrity and an objective approach to professional work. A member in public practice should be, and be seen to be, free in each professional assignment he undertakes of any interest which might detract from objectivity."
> (1979 para 1)

It is suggested, for example, that a practice should not derive too great a part of its professional income from one client and should endeavour to ensure that the recurring fees paid by one client does not exceed 15% of the gross fees of the practice. (para 4) The guidelines also recognise that:

> "Financial involvement with a client may affect objectivity. Such involvement can arise in a number of ways of which a shareholding in a company upon which the practice is retained to report is a typical example." (para 7)

It is often suggested that independence is purely a state of mind and cannot be defined beyond vague guidelines and in terms of situations where the auditor prejudices his independence. On the other hand it might be argued that independence in this context has two elements, the substantive and the appearance. In the first instance it relates to the objectivity of the individual auditor in terms of his state of mind. This is developed and guaranteed by personal qualities such as strength of character and professional integrity and may not necessarily be achieved by legislation or rules. The appearance of independence is, however, of equal importance in terms of preserving and improving the credibility of the auditors' function in the eyes of the public. Independence in this respect is rather like justice, it must not only be accomplished but must be seen to be accomplished.

Cook, a former chairman of the S.E.C. emphasised the former aspect of independence:

> "The independent accountant must combine the impartiality of a judge with the right sense of responsibility of a fiduciary. Though hired and fired by management, he must divorce his mental processes from any bias in their direction when making accounting judgments. Such a standard of professional conduct must be maintained if the auditor's certificate is to be more than a snare and a delusion and the public obligation of the accountant satisfied." [81]

On the other hand, Axelson asserts that "independence has an external as well as internal dimension. Because the auditor's independence must be accepted by the third parties who rely on his certificate it must be apparent as well as real."

(1963 page 54)

In the U.S.A. therefore the professional bodies have tended to stress "intellectual honesty" and independence of mind, the S.E.C. have, however, underpinned these statements by more explicit regulations and rulings. Annual reports are required to be filed with the Commission and in lieu of government examination of each financial statement the certificate of an independent accountant is required. Cook asserted in 1950:

> "I believe that the duties inherent in furnishing such a certificate impress upon the auditor a fiduciary obligation towards the public as well as toward the client if full confidence ... is to be maintained." [82]

The S.E.C. rules therefore state:-

> " (b) The Commission will not recognise any certified public accountant or public accountant as independent who is not in fact independent. For example, an accountant will be considered not independent with respect to any person or any of its parents, its subsidiaries, or other affiliates (1) in which, during the period of his professional engagement to examine the financial statements being reported on or at the date of his report, he or his firm or a member thereof had, or was committed to acquire, any direct financial interest or any material indirect financial interest; or (2) with which, during the period of his professional engagement to examine the financial statements being reported on, at the date of his financial statements, he or his firm or a member thereof was connected as a promoter, underwriter, voting trustee, director, officer, or employee, except that a firm will not be deemed not independent in regard to a particular person if a former officer or employee of such person is employed by the firm and such individual has completely dissociated himself from the person and its affiliates and does not participate in auditing financial statements of the person or its

> affiliates covering any period of his employment by the person. For the purposes of Rule 2-01 the term 'member' means all partners in the firm and all professional employees participating in the audit or located in an office of the firm participating in a significant portion of the audit.
>
> (c) In determining whether an accountant may in fact be not independent with respect to a particular person, the Commission will give appropriate consideration to all relevant circumstances, including evidence bearing on all relationships between the accountant and that person or any affiliate thereof, and will not confine itself to the relationships existing in connection with the filing of reports with the Commission." [83]

Thus if a partner in an accounting practice sits on the board of directors of a company but deliberately refrains from participation in the audit the S.E.C. has taken the view that the accounting firm could not be considered independent. Even where a partner in a practice resigns from a directorship in the financial year under audit, the Commission consider that his firm could not be considered independent even although the accountant had not participated in any respect in the firm's audit of the company.[84]

In South-Eastern Industrial Loan Company the particular company was part of a group system with which the accountant involved was actively associated, performing numerous tasks for the group such as "arranging for renewal notes, extending maturity and payments, arranging for refinancing, insurance and printing of stationery, passbooks and stock certificates and distributing funds to various subsidiaries in payment for loans." The Commission concluded that the accountants:

> "close identity with financial destinies and his personal concern with the managerial policies of the system and its distressed customers were in conflict with the duties of an independent accountant." [89]

It may be argued that the provision of other services such as consultancy work compromises the accountant's independence. Doubts have been expressed in the U.S A. about the propriety of the independent auditors furnishing extensive "management services" including advice as to functional re-organisation and personnel affairs. How can auditors be effectively independent if they are auditing their own work? Schattke and Sm ith conducted a survey in the U.S.A. and concluded that:

> "the provision of management services and auditing for a single client is an undesirable practice. Perhaps C.P.A. or chartered accountant firms should be prohibited from providing dual services."

The A.I.C.P.A's Committee on Professional Ethics considered the propriety of furnishing tax and management advisory services to their audit clients and concluded that as long as services consist of advice and technical assistance, there was little likelihood of a conflict. If the accountant actually made management decisions on matters in respect of the company's financial position or results of its trading operations

> "it would appear that his objectivity as independent auditor of the company's financial statements might well be impaired." [86]

A former chief accountant of the S.E.C. argues that the accountant who performs management services should keep two questions in mind:

1. Am I remaining an adviser to management and not entering the decision-making area?

2. Am I sure that the audit of the financial statements will not involve checking any such work?[87]

In general therefore the approach both in U.S.A. and U.K. tends to be pragmatic. The English Institute of Chartered Accountants Independence Paper simply declares that:

> "Whilst it is right that members should provide for audit clients, other services beyond performing the audit, nevertheless care must be taken not to perform executive functions or to make executive decisions. These are the duties of management. In particular members should beware lest, in providing such services they drift into a situation in which they step across the borderline of what is proper." (1979 para 22)

This is in sharp contrast to France where rules of independence are extremely detailed and restrictive. Licensed auditors work exclusively as commissaire aux comptes and are forbidden to offer other services to a company. Charged with the public duty of inspection they must be, and be seen to be, wholly independent. It is argued, however, that such a system does not produce a good audit because the accountants who are carrying it out are persons who are not widely experienced in the profession itself and are not in the larger partnerships with a wide range of facilities and experience available.

The approach in the U.K. seems to rely heavily, as in all aspects of independence, on the accountant's own discretion rather than the application of rigid professional and statutory norms.

(c) Performance

If a satisfactory audit is to be accomplished the work must be properly planned and closely supervised. An audit is centred on gathering information and evidence which the auditor uses in forming a view of the accounts. Such information may be gathered in a number of ways, by actual confirmation with third parties, discussion with management or vouching of documents supporting a transaction. Whatever method is adopted, however, each opinion must be fully supported. If the auditor does not meet the necessary standard in the performance of his audit he may be in breach of his obligations to the company.

A feature of the recent Department of Trade reports is that improper management and dubious activities have remained undetected by auditors. In this respect it may be that society's expectations of what an audit should involve and the accountant's traditional perception of an audit no longer accord. This is particularly so in respect of the detection of corporate fraud and error. Originally this was the primary objective. As Bourne observed in 1887:

> "The object of an audit is a two-fold one, the detection of fraud where it has been committed, and its prevention by imposing such safeguards, and devising such means as will make it extremely difficult of accomplishment even if the inclination is in that direction." (page 330)

This formula was modified in view of the fact that it placed impossible burdens on auditors to the extent that the auditor was expected to investigate the possibility of the existence of fraud and error only if his suspicions were aroused when following routine auditing procedures. This raises two important questions, first, the difficulty of deciding at what point suspicions are sufficiently aroused to justify further investigation and action. In this respect there is evidence to suggest from U.K.D.T.I. reports and American case law that what they regard as grounds for reasonable suspicion is not the same as what the auditors consider as reasonable grounds. For example, in a study of Australian private shareholders by Beck in 1973, 93% of those questioned expected the auditor to assure them that no fraud had been perpetrated by corporate officers. Second, and related to the first point, are routine audit procedures able to reveal grounds for suspicion? The Adams Committee in Canada argued:

> "Although auditors can gain reasonable assurance of detecting errors or frauds that would materially mis-state the financial statements, there is an unavoidable risk that some fraud and, to a lesser extent, some error may remain undetected. This is inherent in the nature of audits which have to be cost effective. Audits generally involve testing samples rather than checking every item, examining evidence that is seldom conclusive and generally relying on internal controls that may be circumvented by fraud or collusion ... Unless auditors have reason to suspect management's integrity it would be unrealistic to hypothesise about and search for all the ways in which they might have been misled."
>
> (1977 Section D4)

On the other hand, the observation of an investment analyst on the performance of the auditors in the case of Equity Funding, a U.S. insurance fraud are illuminating:

> "A frequently heard comment after the Equity Funding scandal became public was that "routine audit procedures are not designed to detect fraud". If routine audit procedures cannot detect 6400 phoney insurance policies, $25m counterfeit bonds, and £100m missing assets, what is the purpose of audits." (Accountancy January 1977)

Cases in the last decade in the U.S.A. have stimulated the profession to review their role particularly in respect of corporate fraud. The most notable has perhaps been the Equity Funding failure which resulted in the formation of a Special Committee of the American Institute of Certified Public Accountants to report on the adequacy of auditing standards with particular emphasis on fraud. The Committee challenged the audit profession to improve procedures in order to detect material frauds.

> "In this respect it seems clear that the auditor has an obligation to discover material frauds that are discoverable through application of customary auditing procedures applied in accordance with generally accepted auditing standards. The auditing profession should ... continue to improve the efficiency of customary audit procedures to the end that probability of discovery of material frauds continues to increase within the limits of practicability." (1975 page 40)

In the U.S.A. the courts have in effect been saying to auditors even where the audit was conducted in accordance with professional practice, the auditor may still be held to have failed to perform a proper audit. In United States v. Simon[88] the auditors were indicted under the Securities Exchange Act for failing to verify and report sufficiently on the disclosure of a number of loan transactions. The auditor had failed to go beyond books and records of the company in order to verify the uncertainty of recovery and security of a loan. Eight expert accountants were called and testified that the audit was conducted in a manner consistent with standard practice and generally accepted accounting principles. The auditors were nevertheless convicted, a decision that was later affirmed on appeal. In his judgment, Judge H.J. Friendly clearly indicated that it may not be sufficient for auditors to follow accepted practice if to do so does not fairly reflect an accounting transaction. The Chairman of the S.E.C. described the effect of the Simon case in the following terms:

> "The court established that it is not enough to merely adhere to rules, even if they are generally accepted principles or standards ... an accounting report has to reflect pertinent information which those who prepare it have, or in due diligence, should obtain, whether or not the disclosure of that information is required by specific generally accepted principles or standards." [89]

The courts and the S.E.C. in the U.S.A. have therefore required accountants to significantly increase their control over the financial statements and accounts that they are required to certify and stimulate the development of more realistic standards that will meet the demands of society for a more effective audit in terms of revealing corporate fraud, major errors and irregularities. Apart from the observations of D.T.I . inspectors which have undoubtedly encouraged the profession to at least examine the possibility of developing audit standards, British courts have preferred for the most part to rely on self regulation by the profession. Auditors are required to carry out such checks and verifications as professional practice demands, but the courts have made no attempt to exert greater influence on the role of the corporate auditor.[90]

In view of the attitude of the judiciary it is a matter of concern that the U.K. professional bodies have failed to take action against their members who have acted less than diligently or in contravention of accounting practice.

> "British accounting bodies have yet to discipline one chartered accountant, finance director or auditor for failing to comply with accounting or auditing standards." [91]

Under pressure from the Government the three main accountancy bodies in England and Scotland set up the Cross Committee to review internal disciplinary powers and procedures. The committee suggested that a distinction be drawn between what is described as private interest cases where poor workmanship by an auditor is a matter of concern to the client who employed him, and what is termed public interest cases where an auditor's incompetence affects others. In the first instance it is open for the client to sue on the basis of the clearly defined legal relationship. In the second instance it is far more difficult for a member of the public who claims that they have suffered loss as a result of bad workmanship of auditors revealed, perhaps by Department of Trade Inspectors, to find a legal peg on which to hang a claim.[92]

> "In these circumstances it can be argued with force that the image of the profession requires that the accountancy bodies should themselves not only take but be seen to take some action in the matter." (Page 5)

The accountancy bodies recently accepted the recommendations of the Grenside Committee to extend accounting bodies' disciplinary procedures on a joint basis to cover all cases where inefficiency or incompetence by accountants affects the public interest. Disciplinary action is to be taken against accounting firms for the first time, with the possibility of unlimited fines. The joint scheme is to be financed by a levy on all accountants. The Committee propose lay representation at all levels in the new disciplinary machinery. In an attempt to reduce the incidences of unsatisfactory professional work, there is to be stricter control over the issue of practising certificates and the creation by each body of a practice advisory service from which accountants in trouble could seek help and guidance.

As the Grenside Committee argued, implementation of the proposals is:

> "an essential step to remove the erosion of public confidence in the profession which has been going on for the past few years." (1979 page 24)

This is in sharp contrast to the position in the U.S.A. where the volume of pressure exerted by the courts and S.E.C. has resulted in the accountants being far more concerned about achieving minimum standards and being seen to discipline those that depart from such standards. In particular the S.E.C. with its three basic functions of rule making, adjudicating and exercising disciplinary functions in respect of the profession, has played a vital role in focusing attention on the role and function of auditors.

The Cohen Commission in 1977 considered that the increase in litigation in the U.S.A. against auditors, whilst disturbing to the profession, had been an important factor in inducing greater concern over substandard performance and is an effective mechanism for making auditors answerable to those affected directly or indirectly by their work.

These observations might be borne in mind in the context of the U.K. professional bodies attempt to lay down standards and institute effective disciplinary machinery since:

> "... in a free society no institution vital to the public interest can maintain a claim to legitimacy if its affairs are shrouded in secrety."[93]

10. Disclosure - A Philosophy?

Under the present legal framework there is clearly no general and unqualified right to information about the affairs of a company. The law tends to view the disclosure philosophy in terms of a stewardship report to the shareholders. Indeed in 1965 the ICAEW[94] actually sought counsel's opinion on the object of audited accounts and was informed that such accounts were to assist shareholders in exercising their control of the company by enabling them to judge how its affairs have been conducted. As indicated earlier, however, it remains an open question as to whether accounts prepared under the present principles, conventions and policies, actually achieve that somewhat modest objective.

In more recent years, however, acknowledgment of the broader responsibilities of corporate entities has led to suggestions that the scope and content of corporate reports be extended to reflect a wider accountability of corporate controllers in addition to underpinning existing requirements designed to assist in the monitoring of management activity. In the U.S.A. the S.E.C. has recently been criticised for taking too narrow a view of its role. For example, Schwartz argued that company law should be concerned not only with protection of shareholders but also the public interest. He contended that there was a legitimate public interest in learning of the "social performance of public companies" and a wider view of disclosure would bring significant advantages in this respect.

> "Shareholders need pertinent information about the impact of corporate decisions, and not just for the purpose of being able to decide whether earnings or stock prices will be affected. Rather, since the shareholders' position in management's election is what legitimises management's power, shareholders should be able to make decisions on

> the basis of adequate information before they make themselves part of the process. Institutions that are concerned with public welfare should be especially mindful of this relationship.
>
> There is also a great indirect value involved in the disclosure of this kind of information. Disclosure can work like a market mechanism. The disclosure of unflattering information imposes a cost - the cost of embarrassment - which might quickly turn into the cost of consumer relation. To avoid paying that cost, companies would have to change the facts required to be disclosed should they be embarrassing. Thus, disclosure would lead to the employment of more blacks, the abatement of pollution, or the production of safe automobiles so as to avoid recall." (1971 page 37)

Although there is no legally recognised obligation placed on companies either side of the Atlantic to disclose information simply because of their size or power, Schoenbaum has detected a movement in that direction:

> "In recent years a new policy basis for corporate disclosure has emerged. Its scope is not yet clear and it has not yet received formal recognition in the law, but its significance cannot be underestimated. This is the idea ... that disclosure has a role in regulation corporations as major power centres of our society. Acceptance of this wider role of disclosure to any degree is to say that there is a direct relationship between corporate disclosure under the securities laws and corporate responsibility. The novelty of this view should be emphasised. It would mean that disclosure is not merely investor-oriented but society-oriented. The efficient allocation of capital resources is secondary to the ethical and moral aspects of disclosure - and ethics and morality encompass more than merely restraining over-reaching by insiders. The heart of the problem is getting at the impact of corporate behaviour on society, not only as to its financial affairs, but also in the areas of civil liberties, the environment, health, safety and consumer rights." (1972 page 578)

In many respects in the U.S.A. business has already recognised that disclosure "should relate to the social influences of business and its responsibility to society" and there is in the S.E.C. a body well suited to fulfil a more active role in this context. Schoenbaum continues:

> "... the addition of society-oriented disclosure rules to present Securities and Exchange Commission regulations need not involve a departure from the principle of profit maximisation or require the acceptance of a totally new concept of corporate duty. It would merely be a recognition of the fact that the large corporation is not a private and autonomous institution, but is a community asset which is public in its conduct, its mores and its impacts. The basis of increased disclosure is simply that although a corporation exists to maximise profits, society has a right to be informed of the undeniable public impact of its actions.
>
> Greater corporate disclosure requirements would have two important effects. First, corporate decisions which have a societal impact would be more open to public view. There would be increased debate among the public and among the corporation's shareholders concerning many decisions. Shareholder and public opinion would act as a check on management and stimulate executives to higher ethical standards regarding public interest matters. ... A second result of increased disclosure would be to expose those areas of corporate behaviour which cannot be reformed internally, but which must be dealt with through government action and legislation. The theory here is that disclosure is the least restrictive form of regulation in that it provides an incentive for self-reform. But there will be matters which can be corrected only through direct action by government. Disclosure would provide a basis for knowing when new laws are needed and, just as important, when they are not needed." (1972 page 578)

See [illegible]!

In the U.K. the debate over the value and scope of disclosure has been much less sophisticated than in the U.S.A. Perhaps the most significant was the publication in 1975 of the Corporate Report by the Accounting Standards Steering Committee (ASSC). The Report considered that:

> "the fundamental objective of corporate reports is to communicate economic measurements of and information about the resources and performance of the entity, useful to those having reasonable rights to such information." (para 3.2)

The Report considered that there is a basic responsibility on every economic entity to report publicly where its size rendered it significant, that is, the entity had at its command human or material resources on such a scale that the results of its business have significant economic implications for society. This responsibility to report arises on the basis that:

> "Just as directors of limited companies are recognised as having a stewardship relationship with shareholders who have invested their funds, so many other relationships exist ... economic entities compete for resources of manpower, management and organisational skills, materials and energy, they utilise community owned assets and facilities. They have a responsibility for the present and future livelihoods of employees and because of the independence of all social groups, they are involved in the maintenance of standards of life, and the creation of wealth for and on behalf of the community." (1975 para 1.3)

The Report drew on the observations of the CBI Report in 1975 which argued that Government policy on disclosure should seek to encourage companies to recognise duties and obligations arising from the companies' relations with groups in society. The authors conducted a survey of corporate objectives amongst the chairmen of three hundred of the largest U.K. listed companies and the majority view of those that replied (166) was that their primary objective was to make a profit for the benefit of a number of groups and this could only be achieved if sufficient attention was paid to the particular interests of each group. The majority view rejected the notion that the maximisation of profit was the primary responsibility. The Report concludes therefore:

> "Business enterprises can survive only with the approval of the community in which they operate and they have an interest in revealing information which displays how differing interests are being balanced for the benefit of the whole community."
> (para 4.29)

If short term profit maximisation is not the exclusive objective of modern companies why therefore encourage the users of corporate reports to believe it is by elevating the notion of audited annual profit to such a paramount position? Especially when it is clear that the calculation of annual profit is subject to so many variables, uncertainties and so easily manipulated. Surely if society is encouraged to evaluate the performance of companies on the basis of short term criteria, management will also tend to concentrate on short term results. In addition if companies have responsibilities to other groups besides the shareholders why does the format of accounts continue to imply otherwise?

The traditional balance sheet and profit and loss account form of presentation therefore seem now inadequate in the context of the wider and more comprehensive range of responsibilities that is expected and demanded of modern companies since it fails to convey a comprehensive picture of economic activity.

Any new standards of disclosure, whether aimed for shareholders or a wider audience, must inevitably be expressed in monetary terms and there is no reason why the expression "profit" should be disregarded so long as it represents profit in a wider context than short term profit as expressed in traditional current accounts. It may be expressed as profit in terms of a strong financial condition to the benefit of all concerned with the enterprise which results from the efficient use of the communities limited resources, not exclusively the ability to re-invest or pay a dividend for the benefit of the "owners". Indeed there is some evidence to suggest that contemporary boards regard themselves as being required, in producing a profit, to strike a balance where relations within the enterprise interact, between a reasonable level of income for the workforce, return for the shareholders, research and development in the interests of the internal groups and society.[96] Acceptance of such a view of profit inevitably means refashioning the disclosure philosophy to reflect the new and wider view of corporate objectives in terms of financial accounting and recognition of new forms of social accounting.

This could mean changing the basis of financial accounting from the traditional profit and loss account to net value added. This involves measuring profit in terms of the wealth that the company has been able to create by its own efforts. Instead of profit representing that which is left after all other claimants except the members have been accounted for, added value looks at the company's turnover as being the:

> "result of other people's work, namely the raw materials, products and services which the company has purchased from outside, and in part the result of the efforts of the company's workforce and use of its physical and financial resources. This latter part is the value added by the company, and can therefore be expressed as turnover less goods and services purchased from outside." [97]

Since this method concentrates on the notion of profitability in a much broader context than the narrower shareholders margin, it represents a much more realistic yardstick for judging whether companies have met their various responsibilities, a better report in terms of overall corporate accountability, a useful tool in the monitoring of management performance.

The Labour Government 1974-79 favoured recognition of wider corporate responsibilities in terms of disclosure and in addition to a statement of added value proposed a number of changes. Some were included as a result of the Fourth Directive and were also included in the present Government's proposals, in particular greater disclosure relating to research and development expenditure, transactions in foreign currencies, short term borrowings, leasing and revenue commitments, and greater disaggregation. These may be viewed as an extension of the traditional U.K. disclosure philosophy in terms of the stewardship role of corporate boards and to that extent represent a welcome addition to the present requirements. The Fourth Directive however and the present Government implicitly rejects disclosure in terms of recognition of wider respohsibilities.

In both the Corporate Report and the Labour Government's Green Paper (1977 Cmnd 6888), it was proposed that companies be required to produce an employment statement including information about its workforce and manpower policies. As the authors of the Corporate Report acknowledged:

> "Nothing illustrates more vividly the nineteenth century origin of British company law than the way in which employees are almost totally ignored in the present Companies Acts and in corporate reports. The 1967 Companies Act introduced a requirement for companies with more than 100 employees to state in the directors' report the average number of employees per week and the aggregate remuneration paid. This modest requirement barely does justice to the role of companies as the life support systems for millions of people.
>
> Economic entities are concerned with the use of monetary material and human resources. As employers they are accorded a position of trust by their employees who look to the entity for employment security and prospects. In our view this relationship carries with it a responsibility to report to and about employees.
>
> Employment prospects affect whole communities and society looks to employers (and employees) to maintain certain standards of conduct. Economic entities therefore also have a general responsibility to report employment information to the community at large." (Para 6.12 to 6.14)

Both reports therefore recommended that companies should present employment reports setting out such things as:

- numbers joining and leaving the company during the year, possibly showing school-leavers separately, also those retiring and made redundant.
- employment and training policies of the company and its subsidiaries in the U.K., including information about education and training of those under 19.
- unions recognised by the company for collective bargaining purposes and a short statement of the collective bargaining arrangements.
- employment participation arrangements.
- numbers of man-days lost per year as a result of industrial disputes within the company.
- pension and sick pay arrangements.
- numbers of disabled people employed, and a short statement of how company personnel practices cater for those who are disabled.

In addition the Corporate Report suggested that a statement of corporate objectives should be published. This would include a statement of management policy and philosophy and medium term strategic targets set in certain policy areas, as steps towards implementing that policy. These might be in such areas as profitability, investment, employment, consumer affairs, environmental issues.

In the context of this wider view of disclosure it has also been suggested that some form of social accounting be introduced. The authors of the Corporate Report stated:

> "We believe that social accounting (the reporting of those costs and benefits, which may or may not be quantifiable in money terms, arising from economic activities and substantially borne or received by the community at large or particular groups not holding a direct relationship with the reporting entity) will be an area of growing concern to the accounting

> profession and one in which it has an opportunity to help develop practical reporting techniques." (1975 para 6.46)

Social accounting was pioneered in North America on the assumption that if business has wider responsibilities, as expressed in the work by Berle and Means and subsequent academics, there is an obvious need to measure and evaluate performance of these responsibilities. As Epstein asserts:

> "Without measurement there can be no assurance of progress towards corporate social responsibility goals, there can be no evaluation of the cost effectiveness or efficiency of alternative social investments ... there can be no comparison of companies and industries ... and there can be no criterion for corporate decision making in the interests of social responsibility." (1976)

This involves the disclosure of a wide variety of information in addition to the proposals in the Corporate Report. For example, in the U.S.A. 85% of the Fortune magazine 500 industrial companies made social responsibility disclosures in their 1975 reports.[98] In 1974 the National Association of Accountants Committee (NAAC) on Accounting for Corporate Social Performance suggested that such disclosure should cover four basic areas (a) Community involvement, (b) human resources, (c) physical resources and environmental contributions and (d) product or service contributions.

Modest proposals along these lines were put by the last Conservative Government in their recommendation that there be a duty on "companies to report to shareholders on specified parts of the company's response to the social environment." (Cmnd 5391 para 58). The Companies Bill 1973 which followed proposed to authorise the Government to require companies to include in their annual reports a wide range of information about their employee relations competitive practices, relations with consumers and their impact health and safety of the public.

In recent years there has grown up a number of self appointed auditors of corporate social accounts. In the U.K. for example Counter Information Services was formed some years ago and has published a series of reports critical of industries and individual companies social performance. In addition Social Audit Limited has been formed as a public interest group devoted to disclosing information about the performance of business enterprises.

They argue that business information should cease in principle to be confidential and in addition to items on which regular reports are required:

> "the most effective solution ... would be to give the public a statutory right of access to all company information, except where there is a good cause against: personal records, trade secrets and the like would clearly need to be excluded." [99]

Bodies such as Social Audit frequently operate without the consent of the company and in many cases although clearly independent of the enterprise are open to the charge that they are not objective, having selected a company primarily because it was viewed as socially irresponsible and therefore out to make a case against it.

In North America social audits have been carried out not by external pressure groups but the institutional investors before deciding to place their investment portfolios. For example, during the proceedings of the 1968 General Council of the United Church of Canada it was suggested that as an investor the church had a responsibility to see that profits were earned by those companies in which it held investments, in a socially responsible manner (see Brooks 1977). In the U.K. it is evident that some of the trade unions with considerable investment portfolios are using some non-financial criteria when considering whether to buy or sell shares in companies.

Clearly the notion of social accounting and social auditing as a legal responsibility is some way off. To some such disclosures are of doubtful merit either too expensive or amounting to nothing more than a:

"vague and pious statement of self approval." (Midgley 1975)

However, there is no doubt that in the immediate future legal obligations to disclose the type of information as envisaged in the Corporate Report and the Labour Government's Green Paper, provide a very effective machinery for underpinning institutional changes in corporate government and management, rendering them more accountable and monitoring their performance. In recent years the value of disclosure has been in doubt largely because of the absence of any philosophical foundation, except that of stewardship. The credibility of financial information and those that verify such information has suffered in recent years as a result of Department of Trade revelations and the growing awareness of the power of corporate controllers. As we have seen, based on the vague notion of truth and fairness and with so many different methods of valuation and calculation, annual accounts are a "complicated hotch-potch" which can be easily manipulated to meet short term objectives.

It is submitted that the most immediate improvements in raising the level of corporate responsibility and performance can be made by using disclosure to underpin institutional changes such as the wider use of non-executive directors and audit committees. For example in 1977 the Advisory Committee on Corporate Disclosure recommended to the S.E.C. that the Commission adopt:

> "a package of disclosure requirements that, taken as a whole, will strengthen the ability of boards of directors to operate as independent effective monitors of management performance and will provide investors with a reasonable understanding of the organisation and role of the board." [100]

In particular it is suggested that such disclosure requirements in the U.K. should concentrate far more on board organisation and procedures rather than substantive decisions. For example, future legislation could require companies to provide the following information.

First, companies should be required to disclose information about individual nominees for directorships and in particular his affiliations, relationship with management and the fees proposed to be paid to him. Second, it seems reasonable to suggest that a crude indication of whether the directors are performing their duties properly may be given by their attendance record and the length of each directors' meeting. Similar information might also be provided in respect of committees of the board. Third, companies should be required to disclose the procedure used to select board members and the criterion for selection. In their study of non-executive directors Leech and Mundheim considered that the selection of outside directors by a nominating committee composed wholly of outside directors was vital:

> "in creating an environment conducive to an independent attitude on the part of outside directors ... Although the nominating committee should consult with the chief executive officer about possible board candidates, the committee should not feel bound to adopt management candidates." (1976 page 1830)

Such requirements should benefit the company in terms of matching corporate need with board vacancies. As Heller observed:

> "what steps should a company take to make sure that the proper people are serving on its board of directors? Special criteria should be developed and tailored to the needs of the individual company.
>
> Once the specified criterion for company boards have been developed and agreed upon, the present composition of the board should be analysed and evaluated. A programme must then be developed to recruit to fill identified needs and to develop a strategy for retiring board members whose future contributions are likely to be limited." (14 Cal.Mangt.Rev. Spring 1972 24, 28)

A third requirement should be a requirement to produce a statement on the resignation of directors similar to the statement by auditors that there is nothing that should be brought to the attention of the shareholders. Such a requirement would greatly increase the role and importance of the individual non-executive director, discourage management from frustrating their legitimate expectations or undermining their authority.

11. A New Breed of Watchdog

Inevitably, widening the objective and scope of corporate disclosure will mean a more active role for auditors. In any event the effect of the Fourth Directive will mean that much of the information hitherto contained in the Director's Report will, in future, be included in the annual accounts and thus fall to be audited. Such a review of the role of auditors would be necessary in any case in view of the discussion earlier which must draw us to the conclusion that the notion of an audit and the role of auditors as perceived by the profession is out of line with society's expectations. In the U.S.A. the courts and the S.E.C. and in the U.K. the Department of Trade Inspectors and the financial press, are confronting auditors already facing increasingly complex business problems with the widespread use of computers, with standards much higher than those set by the law or the profession.

In the context of corporate accountability auditors are intermediaries between the controllers and the recipientsand users of financial information. If, therefore, the objectives and scope of disclosure requirements are to be widened in order to meet the demands for greater accountability and assist in the more effective monitoring of management, the role of the auditor is central. It means a much wider involvement in company affairs beyond that of the traditional attest function, working closely with the audit committee in monitoring management.

Indeed, the Cohen Commission in the U.S.A. on Auditors' Responsibilities recommended a break from the obsolete limited concept of the auditors link with only a client's annual financial statements and extension of the role to a flexible and timely association.

This would involve in addition to the annual financial statement:

> ": the effectiveness of internal control systems:
> : the process of preparing quarterly financial information:
> : consistency of other financial information in the annual report with the financial statements:
> : the adherence of company personnel to its policy statement on corporate conduct."

The report accepts as reasonable society's expectations of auditors that they should provide "some surveillance over management and detection of fraud." In this respect there is evidence to support the view that as a necessary part of this reappraisal of the auditing function smaller companies should be relieved of the obligation to prepare a full scale audit and the revised audit should be aimed exclusively at large and quoted companies.

Small companies in the U.S.A. have never been obliged to have a full scale audit and both Australia and Canada fairly recently dropped the audit for small companies, subject to the approval of the membership. Instead of the audit, companies simply have a review which does not involve seeking independent verification of the accounts but rather relies on the statements of the executive. A review account would consist of:

> "(a) enquiries concerning financial, operating, contractual and other information received in response thereto;
>
> (b) comparison of current and prior period financial information and considerations of the reasonableness of financial information and other inter-relationships;
>
> (c) discussions with responsible client officials concerning information received and financial statements." [101]

Clearly, any reappraisal of the auditing function would involve considerably more cost which would be both intolerable and impractical for small companies and there is much in favour of the adoption of a review system for such companies where the members agree to it. It would always, of course, be open to either the members or a creditor or potential creditor, such as a bank, to demand a full external audit. In support of the argument for relieving small companies from the audit it is suggested that in such companies the audit differs from that in larger companies, in that it is more difficult for the auditor to obtain corroborative audit evidence since there are fewer internal controls. Too much reliance has to be placed on management representations and in the absence of controls the auditor is himself required to undertake substantive testing. The net result is that the audit is both an undue waste of expertise, resources and time. In addition if new standards are introduced it will simply mean that the frequency of qualifications will increase thus reducing the overall impact and credibility of reports and qualifications.

Against this there is what Sherwood calls the safety belt argument:

> "There is no doubt that the statutory audit, like the safety belt, will not prevent all disasters. It is, at its best, necessarily an imperfect piece of equipment for controlling the limited company, but like the safety belt it should reduce the risk of injury to all those who are involved with the company's business, whether shareholders, directors, employees, or creditors." (1979 page 55)

Whichever course is adopted, the role of the auditor in the larger enterprises must be radically changed towards a more meanintful policing function with the powers, protection and independence consistent with such a function. In addition auditors will be required to verify the information and reports on a company's social performance which may mean the auditor dealing far more with subjective assumptions than they have hitherto been concerned with. To some accountants this may be a distasteful function, on the other hand over time industrial and professional standards will doubtless emerge on these aspects of social accounting, as did standards on financial accounting. In any event, it is accepted that accountants will be required to accept this subjectivity far more if inflation accounting is introduced. In addition it is not beyond the bounds of possibility that auditors might be required to certify information intended for Government use such as that their clients have not broken official income limits or that productivity deals with the workforce are self-financing.

Footnotes - Chapter Eight

1. (1906) Ch 378, 387
2. Cmnd 2657
3. Greene Committee Appendix AA and Appendix P
4. ICAEW 1966 p 75
5. Leading article Accountant Vol. LXXXII 1929, 313, 314
6. Accountant Vol. LXXXII 1930, 231
7. Quoted in Accountant Vol. LXXX 1929, 750
8. Accountant Vol. LXXX 1929, 718
9. Accountant Vol. LXXXV 1931, 313, 314
10. Accountant Vol. LXXXV 1931, 269
11. The Economist 23rd June 1962
12. Loss "The Protection of Investors" S.African Law Journal Vol.80 1963, 67
13. Report of the International Law Conference, David Davies Institute and British Institute of Comparative and International Law, July 1962 p 75
14. See for example paras 397, 375, 122
15. See Chapter 4
16. Brandeis 1913, 92
17. Securities Act 1933 S19(a) and Securities Exchange Act 1934 S 13(b)
18. Cary 1962 p 411
19. Commission of the European Communities, Industrial Policy and the Community, November 1972-73
20. Companies Bill (HL) 1979
21. Lee 1973 63
22. Mueller 1967
23. ICAEW 1972
24. Stock Corporation Law 1965 S150
25. Companies Act 1948 S150

26. Commission of the European Communities Proposal for a Fourth Directive on the Annual Accounts of Limited Liability Companies. Supplement to the Bulletin of European Communities 12th November 1971

27. (1887, 12 App Cases 409, 415

28. Bond v. Barrow Haematic Steel Co. (1902) 1 Ch 353, 365

29. Lee v. Neuchatel Asphalte Co. (1889) 41 Ch D 1, 21

30. A Distinction originated with Adam Smith and modified by J.S. Mill. " We may follow Mill in distinguishing circulating capital which fulfils the whole of its office in the product on which it is engaged, by a single use, from fixed capital which exists in durable shape and the return to which is spread over a period of corresponding duration:" Marshall Principles of Economics 8th ed. 1938, 75

31. Verner v. General & Commercial Investment Trust (1894) 2 Ch 239, 266

32. See footnote 29

33. Dimbula Valley (Ceylon) Tea Co.Ltd. v. Lawrie (1961) 1 AER 769

34. Westburn Sugar Refineries Ltd. v. IRC (1960) TR 105

35. Ibid

36. Willingdale v. International Commercial Bank (1977) Ch 98

37. See Green Paper 'Company Accounting and Disclosure' 1979 Cmnd 7654: Although the principle has been enshrined in SSAP2 for some years and has not given rise to controversy, its incorporation into law may cause some re-examination of practices in certain cases, such as the treatment of differences arising on the translation of foreign currencies

38. Stock Corporation Law 1965 Section 59

39. Niehus 71

40. See Companies Act 1948 Eighth Schedule

41. Cmnd 7654 1978

42. See Green Paper 1979 Cmnd 7654 para 24-25. Also Companies Act 1948 Schedule 8, para 8(1)(a)

43. Section 4 Art 22

44. See Articles 11, 27, 47, 49, 53

45. See Green Paper, p.39-40. The three methods are first in last out (FIFO) which assumed that items bought first have been sold and quantities in hand represent the latest purchases; last in first out (LIFO) which is the calculation of the cost of stocks and work in progress on the basis that the quantities in hand represent the earliest purchases or production, and the average cost method representing a compromise between the other methods by taking an average price calculation by dividing the total cost of units of stock by the total number. The LIFO method is not regarded as appropriate in the U.K. See SSAP 9 'Stock and Work in Progress'.

46. See Schedule 8, para 11(6)

47. See Schedule 8, para 8(9)

48. Section 154(1)

49. Stock Corporation Law 1965 S329-330

50. Journal of European Communities, Vol.19 C 121, 26th June 1976

51. Section 154(1)

52. Amended version of the Seventh Directive, 12th December 1978

53. House of Lords Select Committee on the European Community 1978-79

54. Companies Act S149

55. 1969 p 12

56. Cowan 1965 , 10

57. Miller 1964, 44

58. Ladd Contemporary Corporate Activity and the Public 1963, 164

59. Eisenberg 1975, 427

60. Quoted in Eisenberg 1975, 431

61. Stamp and Morley: Accounting Principles and the Public 1963, 164

62. See Companies Act 1967, S14, Companies Act 1976 S 13-17

63. Ibid

64. The Guardian 21st April 1977

65. Investors' Chronicle 27th February 1976

66. Financial Times 14th May 1973

67. Accountancy Magazine 25th May 1977

68. Department of Trade Report on Roadships 1976, 256

69. Ibid

70. Lonrho 1976, 652

71. London and Counties Group 1977

72. London Capital Group 1977

73. Ibid

74. The Times 2nd March 1978

75. The Sunday Times Business News 30th October 1977

76. Ibid

77. Companies Act 1976 S13(1)

78. 1948 Act S161 as amended by 1967 Act S2

79. Eisenberg 1975, 425

80. Ibid

81. Quoted in Rappaport para 26.1 1972

82. Ibid 26.10

83. S.E.C. Regulation S-X Rule 20-1 1972 revision

84. See Rappaport para 26-23

85. 10 S.E.C. 617 (1941)

86. AICPA Committee on Professional Ethics Opinion 12

87. Barr A. Accounting - Changing Patterns Nov.11 1957 quoted in Rappaport para 26.12

88. (1968) CCA Fed.L .Report 92511 U.S. Dis.Court SDNY

89. Casey W. The Partnership between the Accountancy Profession and the S.E.C. Address before AICPA 2nd October 1972 quoted by Eisenberg, 432

90. See Re Kingston Cotton Mills (No.2) (1896) 2 Ch 279, Fomento (Sterling Area) Ltd. v. Selsdon Fountain Pen Co.Ltd. (1958) 1 WLR 61; Re Thomas Gerrard and Son Ltd. (1968) Ch 455.

91. Financial Times, May 1976

92. See Arenson v. Arenson (1977) AC 405 HL and on the auditor's duty to investors see Hedley Byrne & Co.Ltd. v. Heller (1964) AC 465 HL

93. Mintz and Cohen 1976, 598

94. Council of ICAEW 1967

95. Schoenbaum 1972

96. See for example Webley S. 1971 and 1972

97. See Future of Company Reports 1977 Cmnd 6888

98. See Social Responsibility Disclosure 1976 Ernst & Ernst, Cleveland.

99. Social Audit No. 216

100. S.E.C. Advisory Committee on Corporate Discolsure
May 1977

101. Canadian Institute of Chartered Accountants Handbook
S 8100 1976

CONCLUSION

This study has attempted to trace the growth of corporate power and influence in society, in the context of the legal framework and functioning of legal concepts. Attention has been focused on two related issues. One the response of the law to the institutionalisation of the corporate enterprise and changing patterns of responsibility. Two, the need to improve existing and devise new methods of rendering corporate controllers more accountable, monitoring performance more effectively.

The modern business enterprise was conceived during the industrial revolution in response to the demands of the capitalist for a flexible unit within which to operate his business and minimise risk. Limited liability was welcomed as a means of harnessing the aggregations of capital to the benefit of all. As company law developed alongside the law of contract it embodied the same values of freedom, equality and self regulation. The idea was that there was no need of state interference except to check fraud, the force of the market and freedom of contract would be sufficient.

Thus, within a conceptual framework resting on the pillars of private law the limited liability enterprise was permitted to flourish. Vast aggregations of capital vested the capitalist with considerable power but since the use and disposition of the property from which they derived such power was based on private law, the legislature did not seek to temper such power except in the case of obvious or blatant financial abuse. Renner's work vividly outlined how the legal institution of property, whilst maintaining its formal continuity, underwent a profound change and Berle and Means took the analysis one stage further in their examination of the separation of ownership from control in modern companies. They were among the first to plot the rise of private collective capital and argue that it had created a major problem of legitimacy, a problem that has since become more acute with the growth of financial institutions and further alienation of the individual from control of property. Institutionalisation of the company set problems for society which have yet to be resolved. As Prais observed in 1974:

> "Limited liability has now led to the evolution of an all embracing group of "Juggernaut Companies" ... It is the task of 20th century, a task requiring social engineering on an equally imaginative scale, to set constraints on the growth of such companies so that a workable and efficient economic framework may survive." [1]

Traditional channels for rendering corporate controllers accountable to their owners have proved increasingly fictionalised with the growing apathy amongst shareholders. Indeed, the foundations of the modern enterprise have changed from democratic to bureaucratic. Company law has been slow to respond to the changing pattern of corporate ownership and control and calls for greater responsibility, particularly in refusing to admit that corporate bodies have obligations beyond those dictated by private law. Nevertheless, changes in the attitudes of management, workers, consumers and their representative bodies and government policy, have created a framework of voluntary and statutory checks and balances which serve to restrain and delimit corporate activity.

There remains, however, a vital and often ignored distinction between corporate responsibility and accountability. Institutionalisation has brought a call for the recognition not simply of vaguely defined responsibilities to groups other than the shareholders but a wider accountability in terms of the ability to not only challenge corporate decisions but participate in them. In Europe this has manifested itself in the growth of employee representation on company boards which is seen in varying degrees as a means of effecting industrial democracy, as an answer to the problem of alienation and in terms of social justice.

However, an examination of the European systems and evidence, in particular from West Germany, reveals that despite the somewhat extravagant claims, an objective evaluation of European experience so far, leads one to the conclusion that co-determination has had a fairly limited impact on decision making in European companies. As Batstone observed in his report for the Bullock Committee in 1976:

> "But two conclusions can fairly easily be reached: first, worker directors have generally had little effect on anything, and, second and consequently, they have certainly had no catastrophic effect on anything and anybody." (page 35)

A further conclusion is that the merits of the German co-determination policy and experiments in Scandinavia are as much in the system of below board participation and the organisation of management structures so that workers have a higher degree of autonomy in working groups about the way their immediate working environment is organised.

The influence of the European experiments and membership of the Community stimulated interest in the U.K., particularly from some sectors of the labour movement which had hitherto been hostile or indifferent to such experiments. There has however been little consensus on the method of attaining industrial democracy, rights and duties of the representatives or indeed the broad objectives. Trade unions see it as largely a means of strengthening their own position whilst others see it as a means of diffusing trade union power. The analysis in chapter six revealed that representation of employees on company boards would have a profound effect on company law and present formidable problems for the individuals concerned. In particular they would be exposed to considerable pressure and conflict in a scheme based on the Bullock proposals. The representatives will be taken from a background of collective bargaining and trade union influence and required to sit on a board weighing up all the arguments to arrive at a decision in the overall interests of the company, independent of their members. This however ignores the traditional role of the union shop steward who is always expected to carry out his members' instructions. The proposals assume that the actors in the theatre of collective bargaining based on conflict can automatically assume a role at least partly based on co-operation and partnership. As a trade union representative on the board of the British Steel Corporation observed:

> "The conflict comes home to you when you're at a meeting with trade unions and management there. You're trying to get a point across when someone from the shopfloor challenges you as to which side you're on, but there's no way you can forget that you're a trade unionist first." [2]

In the U.K. there already exists a system, albeit somewhat rusty, of institutionalised conflict resolution in collective bargaining. The introduction of what amounts to a secondary system of conflict resolution alongside the existing machinery would, it is submitted, only serve to generate confusion and muddle decision making within an enterprise. It would, in effect, create a court of appeal against conflicts already resolved or a source of friction in respect of conflicts to be resolved through collective bargaining. In any event conflicts would never be resolved at board level if, as the T.U.C. contend:

> "unions would always be free to oppose management policies." (1975)

In a study of the British system of industrial organisation and the history of labour management relations one is drawn to the inevitable conclusion that the traditional concepts of company law as they function at present, would not be an appropriate framework upon which to construct a system of industrial democracy. It is submitted that the better approach would be to build on the system of collective bargaining to give workers a greater involvement in decisions and at the same time maintain the distinct loyalties and responsibilities of management and union representatives. The protagonists of employee directors invariably overlook the fact that company boards are operating within a market economy still based on capitalism and such boards cannot afford to ignore commercial considerations whatever the nature of ownership or structure and membership of the board. In any event we found evidence to suggest that company boards do not for the most part, decide major issues with which the workers have a legitimate interest, they are no more than legitimising institutions which are better playing a monitoring role.

Indeed, from chapter seven it is clear that the most urgent issue in terms of company law and corporate accountability lies in a review of the role of the board and institutional changes designed not so much to allow groups to be represented on the board, as to encourage a more questioning and effective monitoring role on the part of boards. In particular it is submitted that such a role might best be accomplished by a two tier system of corporate government which institutionalises the two distinct roles of management and supervision. Communication between the two boards could then be assisted by statutory committees such as audit committees, designed to foster closer links between external auditor and the non-executive directors and thus promote more effective monitoring of management's financial performance. The evidence from chapter seven suggests that there is a need for much more independence in the monitoring of corporate performance and some hope might be derived from the most recent published survey on the appointment of non-executive directors by the Bank of England.[3]

The financial institutions could play an important role in this respect and there are signs of an awakening conscience from within their ranks, in particular, there is much merit in the suggestion for a body set up by the Institutional Shareholders Committee to which independent directors would have access.

Such institutional changes must however be underpinned by a more rigorous disclosure policy. In chapter eight we have traced the somewhat piecemeal and complacent development of disclosure in the U.K., based on the vague notion of truth and fairness behind which it has been possible to perpetrate a multitude of sins. Although the programme of harmonisation may bring advances in terms of common standards and the abandonment of the unitary approach to the regulation of companies, the benefits in terms of more effective monitoring are marginal.

Chapter eight reveals the need for a review of the relationship between external auditor and corporate management in terms of independence, performance of the audit function and selection of accounting principles. The nature and scope of corporate disclosures must increase with the growing demands for,and recognition of, greater corporate accountability. This will inevitably mean the wider involvement of auditors in company affairs. In addition it must surely mean that new rules and standards on corporate disclosures will be entrusted to some form of company law enforcement commission with appropriate statutory powers similar to the S.E.C.

Footnotes

1. A New Look at the Growth of Industrial Concentration
   Oxford Economic Papers July 1974

2. Bank J. and Jones K. Worker Directors Speak 1977
   Gower Press p 47.

3. The survey shows that over 50% of the Times 1,000 list of companies have three or more non-executive directors, an increase from 33% on a similar survey by the Bullock Committee (See Cmnd 6707 p 62).
   The proportion of companies with no such directors correspondingly fell from 25% to 12%. Since the survey found that the size of company boards has not changed significantly, this would suggest that non-executive directors have been increasing not only in number but also proportionately.
   Bank of England Quarterly Bulletin Vol.19 No.4 1979

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