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Corporate Governance and Board Independence

by

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Abstract

In recent decades, board independence has become high on the agenda of corporate governance reform, resulting in a dramatic change of composition and structure of boards of publicly traded companies. Debate nevertheless continues: the inefficiency of independent directors has been regularly explored by commentators, and the current financial crisis appears to reinforce the doubts about the contribution of board independence. In this thesis, the author stands with independence proponents, firmly backing the movement of encouraging more independent directors to join the boards of listed companies. However, this thesis intends to bring a more systematic analysis, which many previous academic studies have ignored, to a number of questions, e.g. what specific functions are expected of independent directors; how these functions can fit with the unitary board structure; why independent directors are seen as an inherent demand of corporate governance; whether they can be compatible with other governance mechanisms; how their value can be better appreciated; and how mainstream company law is applied to independent directors. On the other hand, the author accepts some critical findings about the difficulties which independent directors face in practice. In response, the author offers a series of solutions, which critics have rarely mentioned, for the purpose of eliminating those obstacles. In general, this dissertation seeks to fuse together two sides of academy, i.e. the advocates and critics of independent directors, and chart a course through which independent directors can better serve the goal of improving the system of corporate governance.

INTRODUCTION

Since the 1970s, "corporate governance" has been a popular term for the academy of company law. In its narrow meaning, as classically defined by the Cadbury Report of 1992, corporate governance refers to "the system by which companies are directed and controlled".[1] In other words, it is about how the internal structure of the company should be constructed and how the relationship between the board of directors, management and shareholders is to be organised. Definitely, a successful company must be run under a well-structured system, with a view to ensuring cooperation and a reasonable division of power and authority between participants with no one party given a monopoly on all the powers. Certainly, such a balanced regime is what a classical model of corporate governance strives for:[2] shareholders invest their money into the company in return for stockholding along with voting power, by which they can select directors to form the board; with the board in charge of the power of business control as a top organization within the internal hierarchy; the senior officers are hired by the board to serve the purpose of daily management, and if necessary, the board may delegate some of its power to these managers.

Within this system of corporate governance, it is clear that a good firm depends on many smart and honest business professionals at all levels. There is no doubt that intelligence and integrity are the most important characteristics of management. However, in recent decades, some high-profile scandals and failures of large companies, e.g. the incredible crash of Barings Bank and the notorious collapses of Enron and WorldCom, which have generally been attributed to a poor regime of internal control and slackness in detecting financial problems at an early stage, remind us of certain drawbacks within the traditional system. In some incidents,

[1] *Cadbury Committee Report on the Financial Aspects of Corporate Governance* (Gee, 1992), para. 2.5.
[2] In this thesis, the scenario of corporate governance specifically refers to the governance of public companies whose shares are traded on the stock market, e.g. London Stock Exchange.

these collapsed companies were criticised for blindly ignoring "red flag" signals prior to the occurrence of the scandals, due to a lax monitoring system within their organisations. It may be argued that, if the system could be tightened up and appropriate reviews could be undertaken, similar tragedies, or at least some of them, could be avoided. In this sense, corporate governance lost its purpose in these events, because it failed to work as a "firewall" to insulate the company from potential risk, or act as a "brake" when the company was being driven on the wrong track.

The Proposal of "Board Independence"

In response to the above problems, the academy has long attempted to offer proposals designed to eliminate irresponsible behaviours while retaining the confidence of the industry. Many proposals have thus been put forward for discussion by commentators setting out their visions on the future development of corporate governance. In all those agendas to reform the incumbent system of corporate governance, the board of directors has been thrust firmly in the spotlight. To be sure, it is necessary to mention here that the formation of corporate governance is a complicated mixture of multifarious factors in relation to business-running. Within all the parts, the board of directors is only one piece of the picture. However, given the fact that the board has been traditionally recognized by law as the leadership body of the company, it is not strange that a great extent of attention is intensely focused on those holding seats in the boardroom.

It is suggested that an effective board could be very beneficial for both the purposes of promoting business performance, i.e. ensuring the prosperity of the company, and also improving internal integrity by rendering the management more accountable and rooting out potential abuse of corporate powers. In the modern age, however, the contributive role of the board may be offset by certain factors. In the unitary board structure prevalent across the Atlantic, as senior offices are appreciated for their

contribution to the company, they may sometimes receive an invitation into the board as a reward, and then be enrolled as an executive director. By recognizing their professional kill and business talent, the board would usually delegate authority to these executive directors in charge of primary management. As a result, when the executives gradually dominate the boardroom, the board may finally fall to be merely a prolongation of the management, rather than a superior body which should be empowered to objectively keep an eye on the delegated management. Therefore, in a situation where the management power grows quickly at the expense of the shrinking of the board's role, the board would become more powerless to monitor, question and confront management.

In order to regain a balance of power-sharing and ensure that any individual does not autocratically control the board, the academy has placed its emphasis upon the group of "non-executive" or "outside" directors. In fact, the term "non-executive director", or, in US terms, "outside director", is not a brand-new title. It refers to those directors who are not incumbent members of the management and are not generally detailed to carry out the function of business running. Given that they sit outside the inner group of executives, the presence of non-executive directors can be possibly treated as a counteractive force against the domination of management. Thus the board can still, at least to a certain extent, resist the assimilation by the management and keep its self-existent position. In accordance with views set out in the Higgs Review,[3] an effective board, which should embrace an idea of power equilibrium, may normally require a balanced composition of executive and non-executive directors.

During the discussion of contribution of non-executive or outside directors, one particular characteristic has long received greater attention: independence. The

[3] Derek Higgs, *Review of the Role and Effectiveness of Non-Executive Directors* (Jan. 2003), 4.2: "In the unitary board structure, executive and non-executive directors share responsibility for both the direction and control of the company. The benefit of the unitary board, strongly supported in consultation responses, is the value of executive knowledge within the board, alongside non-executive directors who can bring wider experience."

proposal is indeed a call for "board independence", which means that independent non-executive or outside directors should dominate the board instead of executive directors. Put another way, if the theory of corporate governance does want the board to be a leadership organ which is different from the executive team, non-executive or outside directors must be less influenced by the management's philosophy and retain their objective judgments. In this sense, under most situations, the group of "independent directors" is actually what the reform wants. Such a requirement has been commonly recommended by market rules, for example, the UK Corporate Governance Code (in place of the Combined Code) states that non-executive directors, who meet a defined standard of "independence", should compose a majority of the board, and moreover, they should be able to actually control a number of core sub-board committees. Consequently, "the independence of the board" is a central topic in modern theories of corporate governance.

A Note on the Credit Crunch

In the midst of writing this thesis, an unprecedented financial crisis occurred. This "plague" quickly spread over the planet and cruelly hit the global economy. Amidst this crisis, the banking industry in the UK is certainly a poor victim. The government found itself with no choice but to rescue them by the injection of billions of pounds of taxpayers' money. Reluctantly picking up the bill, the public angrily questioned: why did banks make overly bold decisions or fanatically financed their business through takeovers without carefully evaluating potential risks? Later, when it was revealed that one former bank head, who many held responsible for the massive losses of his institution, could still be entitled to his pension of nearly £700,000 a year, the public was furious. When it was further disclosed that banks sought to distribute billions of pounds as bonuses to their senior staff, the public viewed it as absolutely unacceptable since it appeared that those banks, which had received significant public funds to keep them afloat, were now using the taxpayers' money as

"reward for failure".

In all these events, the board was often the target of the irritated public. People asked in anger: why did the boards fail to constrain the over-ambitious and risk-taking management? Why did the board design excessive remuneration packages which were criticized as disproportionate and "short-termist"? If it is suggested that the board should be in a position to oversee the performance of management, where were the independent directors when we expected them to play a key role in this regard? All these emotional questions can be summarized as a criticism against the system of board independence. It may suggest that independent directors failed in their responsibilities, or at least, they did not carry out their functions effectively.

All these allegations provide us with a proper opportunity to carefully review the system of "board independence" in a practical paradigm. A number of serious questions should be seriously considered: what should independent directors do?; how can they effectively fulfil their roles?; what are the obstacles that stand in the way of their efficiency?; what can be done to remove these barricades? It is certainly a mission of this thesis to answer them.

Research Boundaries

Before discussing detailed components of "board independence" in following chapters, here, the author intends to make clear at first that the research of this thesis is exclusively based on the structure and circumstance of corporate governance in the UK and US (as representatives of Anglo-Saxon system), where the "separation of ownership and control" (a conception which will be analyzed in following chapters) and the single board system are common features. Since this thesis is finished in the land of UK, the research on a local basis can be understandable. And given the fact that the US shares a similar system and symptom and both jurisdictions are relying

board independence as a prescription, reference to American development is somewhat necessary.

However, it is necessary to bear in mind that there is not only one corporate governance system around the world. Although a strong performance of financial markets in London and New York has given rise to a popularity of Anglo-Saxon corporate governance model, it is still merely a group within the universe of corporate governance systems.[4] A distinct model, which takes root in Continental Europe (e.g. Germany) and spreads to many other countries (e.g. Japan), represents an opponent of Anglo-Saxon system. In this model, ownership structure is concentrated rather than dispersed, and responsibilities of management and leadership are separately arrangement to two boards rather than combined in a single board.[5] Thus, it is questionable whether board independence, as a solution to the problems of corporate governance in the Anglo-Saxon system, may be smoothly applied to and equally efficient in a system where conditions are significantly different.[6] Answering this question and providing compatible proposals deserve a systematic study,[7] but it is not within the content of this thesis. It is neither the intention of the author to compare two models so as to judge the superiority of each one. All in all, readers should not misunderstand what the author discusses in this thesis as a "one-fit-all" system.

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[4] See Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Corporate Ownership around the World*, The Journal of Finance, Vol.54, No. 2, Apr. 1999, 471-517.

[5] See *e.g.* Petri Mäntysaari, *Comparative Corporate Governance: Shareholder as Rule-Marker* (Berlin: Springer, 2005), Ch. 5-6; Eddy Wymeersch, *"A Status Report on Corporate Governance Rules and Practices in Some Continental European States"*, in Klaus Hopt et al., *Comparative Corporate Governance – the Status of the Art and Emerging Research* (Oxford: Oxford University Press, 1998), at p.1078.

[6] This question has been seriously raised in some developing countries, for example China, which traditionally implanted German corporate governance model, but currently is under influence of Anglo-Saxon system to introduce independent directors. See *e.g.* Yihe Zhang, *Review and Reconstruction: Functional Complement between Systems of Supervisory Board and Independent Directors*, in *Contemporary Law Review* (China), Vol.5, 2003, at 22.

[7] Some development in European Union has been made by the High Level Group report during the Communication "Modernising Company Law and Enhancing Corporate Governance in the European Union – A Plan to Move Forward". See *"Final Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe"* (Brussels, 4 November 2002).

The Structure of the Thesis and Research Issues

As the title of this thesis suggested, the system of board independence is the core topic of the research. In order to understand it, we must have a clear thought about its development in history. Chapter one thus starts as a review on this issue. It considers a number of critical questions: Is non-executive or outside directors, or as currently called, "independent directors", an original component of corporate governance since the company was created as a business form? If not, when were these directors introduced into the company, and what was reason for their introduction? For which purposes were they expected to serve, and are these purposes unchanged at all times during the development of the notion of board independence? More importantly, by reviewing historical development across the Atlantic, Chapter one is supposed to find out whether, in chasing the goal of board independence, two countries, the UK and US, were through the same way and under the same impetus. If there was a difference, what are the factors of causing it? These considerations help us better understand the regulatory frameworks as what will be discussed in next chapter.

In Chapter two, two different regulatory frameworks are posted in front of us: a statutory model in which board independence should be regulated by the law and the industry only has the option to follow the orders and rules made by authorities; and a self-regulatory system where the industry is allowed to play as a rule-maker and rule-enforcer and the law is averse to interfering with the discipline of the market. A conventional wisdom is that corporate governance should be exclusively placed under either framework: regulated by law or regulated by the industry itself. However, the author intends to explore whether there is a new method by which advantages of two models can be added together and both side effects can be minimized.

After a reasonable regulatory framework is established, a number of new questions

arise and much research still remains to be undertaken. Some of the most important topics are outlined below:

First of all, it is essential for us to consider which roles independent directors are supposed to play. It is overwhelmingly supported by commentators that the monitoring function is the primary job of independent directors. However, in the unitary board structure prevalent in Anglo-Saxon countries, where there is only one board to represent the company, there is a worry that an over-emphasis on control may not properly reflect the general role of independent directors. Designating independent directors the sole task of monitoring might confine their participation in board performance, and deprive the company of their potential contribution to the prosperity of business. It is thus analyzed in Chapter three what multiple roles independent directors should play in serving the board, and how these roles could be compatible with the unitary board structure.

Secondly, it is reasonable to bear in mind that changing the board system is only one of many potential measures of corporate governance reform. It should not be viewed as an exclusive solution to the problems that we face in the modern age, e.g. the over-confidence of management and the irresponsibility of the company's leaders. In the face of a number of different proposals designed by intelligent scholars for the purpose of resolving current corporate governance problems, it is questionable whether reforms that focus on improving the board's independence are really indispensable, and cannot be replaced by other means which may possibly be more effective and efficient, for example, by increasing the activism of shareholders or strengthening the self-correction mechanisms of the stock market. By way of a detailed analysis, Chapter four is designed to answer this doubt. Moreover, this chapter also reviews a derivative proposal of board independence, i.e. an idea to install a pure independent board by removing executive directors (other than CEO)

out of the board. It is interesting to see whether such a radical change can bring additional benefit to the efficiency of board dynamics.

Thirdly, discussion of the topic of independent directors cannot avoid the following question: are independent directors in practice effective? While the inclusion of independent directors might in theory be beneficial in creating a sound and responsible system of corporate governance, such a goal might be damaged by obstacles arising in practice that may adversely impact upon the willing and ability of independent directors to carry out their functions. Certainly, the reform on board independence would become meaningless if directors failed to avoid such pitfalls of practice and were thus unable to undertake an effective performance. Therefore, in Chapter five, an analysis is necessary to specifically review practical performance of independent directors and identify any problem. Possible solutions are also offered in this chapter.

Finally, it is important to review the issue of legal liability of independent directors. Given that in modern times, large companies have a significant influence on the economy and the whole community, it is reasonable for society to expect these corporate entities to be governed by responsible and diligent businessmen, rather than amateurs with insufficient knowledge and diligence. As a reflection of such public expectations and against a backdrop of increasing regulation of different aspects of the directorial role, the courts have raised the expected standard of the duty of skill and care. Certainly, against a background of rising standards, it seems to be obvious that the possibility of directors' exposure to legal liability would similarly increase. This may then lead to a fear amongst independent directors that accepting such posts may put them in a risky position, and thus potential candidates would be scared away. In tackling the conflict between more rigorous duties and a growing panic within the community of independent directors, Chapter six first refers to

empirical research to disclose the current state of directors' legal risks, and secondly, examines the development of the law in setting up the rules as they are applied specifically to independent directors. Through a review of the case law, this chapter provides a clear summary on what legal rules independent directors should comply with and how they can ensure that their behaviour falls in line with those requirements.

Research Methods

Many research issues are explored in this thesis, but in general, they can be summarized into two core questions: first, why are independent directors necessary in the spectrum of corporate governance? Second, how can their performance be improved to match their significance? In relation the first question, a library based doctrinal approach is applied in the research. Since the conception of "corporate governance" has been accepted by mainstream academy of company law, a great number of commentators have contributed their original thoughts into this area. All their works reveal how a corporate governance system should be reasonably shaped. Based on a systematic summarization of them, it enables this thesis to draw a conclusion about how, in a structural view, board independence becomes a natural part of modern corporate governance.

As for the second question, a different methodological approach is adopted. Library based doctrinal approach may explain the theoretic rationality of a specific structure of corporate governance, when most commentators give their affirmation and support to this system. However, a perfect theory on the paper does not always mean a successful system in practice. Governance practices are, by nature, dynamic and behavioural, since they emphasize on interactions between different parties in the company. Even in the same structure, people may act totally differently due to their philosophy, cognitive bias and mental pressure. Improvement in performance of

independent directors will require change related to patterns of behaviour. The dependence of the overall quality of corporate governance on behavioural issues thus suggests that the research of effectiveness of the working of independent directors should be orientated toward the discipline of behavioural economics. Therefore, this thesis pays more attention to those factors which stood in the way of activity of independent directors, and test relative measures about how board dynamics can be adjusted to boost incentive of independent directors and smooth obstacles of communication.

Summary

In sum, although increasing the number of independent directors on company boards has become a common feature of the market, many questions, as preliminarily listed above, still remains unanswered. In response, the purpose of this thesis is to undertake a clear review of the system of independent directors. The author expects that such a systematic review can finally contribute clarification to the topic of board independence.

CHAPTER ONE

HISTORICAL REVIEW OF INDEPENDENCE OF DIRECTOR

Before entering deep inside the discussions and debates around the independence of the corporate board, this thesis will begin with an historical introduction. Interestingly, academic researchers have historically paid less attention to this area. By contrast, they have tended to focus their attention on such questions as: what should the independent directors do about corporate governance; and can such directors do their work effectively? It is often taken for granted that independent directors have a meaningful role in the corporate governance system, and will be in such a position because they were created for such a purpose. In order to clarify this subjective assumption, it is helpful to paint a brief but clear picture of the real origins and development of the creature of “independent directors” (or whatever similar terms might be used, such as “outside” directors, “non-employee” directors, “non-executive” directors, etc.). Through the exploration of history, we might find it surprising as to how independent directors were created, and how they became to be accepted by the business industry and the whole community. But prior to the description of their historical development, it is worth noting that, independent directors are also equal members of the company board, and thus it is not only unnecessary but also unrealistic to analyse them in isolation from the board of directors as a whole. Consequently, the following section is not just confined to the sole development of independent directors, but broadly, the whole evolution of the board of directors.

1. The Origin of Directors: Pre-1844

The term "director" was first formally used in the 1694 charter of the Bank of England, describing the members of a governing board of the joint-stock bank.[1] At the end of the 17th century, this word regularly replaced other titles such as "assistants" or "committeemen", which were commonly applied to the group of officers elected by the fellowship in regulated companies, or early joint stock chartered companies. The East India Company, as an example, changed the term "committeemen" into "directors" in 1698 to describe those people in charge of the business.[2]

There is a great temptation to trace the history of the board of directors to the period of "regulated" companies (i.e. essentially companies in which members traded independently under the companies' franchise, and subject to the by-laws and general orders of the companies[3]), or even earlier, to the time of craft gild or guilds which existed and prevailed in England in the later middle age.[4] Indeed, it has been a long history for the merchants in Europe to use the collective governance by a body of representative -- a similar form of organisation as the board of directors in the modern corporation. As early as in the 15th and 16th centuries, the gild moved toward the use of boards of assistants, by retrenching the traditional governance of the guild through meetings of the entire membership.[5] In the case of the Company of Merchant Adventurers, one of the earliest English companies engaged in the overseas

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[1] Ronald Ralph Formoy, *The Historical Foundations of Modern Company Law* (Sweet and Maxwell, 1923), p. 20-21. *See also* W. R. Scott, *Constitution and Finance of English, Scottish and Irish Joint Stock Companies to 1720*, vol. 1, (Cambridge University Press, 1912), p. 339.

[2] Cyril O'Donnell, *Origins of the Corporate Executive*, 55 Bulletin of the Business Historical Society, Jun 1952, vol.26, at 63-64. However, there were still some companies insisting on using the traditional term for a long time. The Hudson's Bay Company titled the officers "committemen" until 1884, and employed the word "directors" in 1912 charter supplement.

[3] Franklin A. Gevurtz, *The European Origins and the Spread of the Corporate Board of Directors*, (2004) 33 Stetson Law Review 925, at 942. See also Ronald Ralph Formoy, *supra.*note 1, p. 4.

[4] M.Schmitthoff, *The Origin of the Joint-Stock Company*, (1939) 3 U. Toronto L. J. 74, at 79-93.

[5] Franklin A. Gevurtz, *supra.* note 3, at 948. See also Lujo Brentano, *On the History and Development of Guilds and the Origin of Trade-Unions* (Burt Franklin, 1870), p. 151-152, 194-195.

trade,[6] Henry VII granted a charter to the company in 1505 by giving it an exclusive privilege on trade abroad,[7] and on the other hand, requiring it to be governed under a certain and formal basis, i.e. by a Governor and twenty-four assistants elected by the merchants overseas.[8] Some latter charters of the regulated companies, such as the Russia Company, the Eastland Company and the Levant Company, clearly followed the same pattern, providing a governing board to be in place.[9]

However, this thesis will not be concerned with tracing the story back to the Middle Ages. The reason for refusing to do so is simple, that is, even if the organisations which people developed for certain purpose have some kind of similarities, it does not necessarily mean that they have a common basis with the modern company. The governing body of the regulated company is not synonymous with the board of a modern company, although they both share the conception of collective action and decision. In nature, the regulated company was little more than "a development of the local gilds" with the monopoly to trade in certain areas.[10] Every member of it was conducting operations on his own behalf, rather than subscribing money into a common fund for the business to be run by the company as a separate entity. The governing board of it was nothing remotely like a board in the current corporate context. Under most circumstances, the function of the governing boards in the regulated company was to resolve disputes among merchants and to enact ordinances for the regulation of the company's members.[11] Thus it is fair to conclude that the board in a regulated company hardly existed to play any modern roles as we nowadays expect a board to carry out.

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[6] P. Griffiths (sir), *A Licence to Trade: The History of English Chartered Companies* (Ernest Benn, 1974), at 9-12.

[7] However, for the balance of the arguments between Merchants Adventurers and its rivals, the charter compelled the company to open its membership to any Englishmen who paid a fee.

[8] Griffiths, *supra*. note 6, at 10.

[9] Cyril O'Donnell, *supra*. note 2, at 60, 63; George Cawston, *The Early Chartered Companies (A.D. 1296-1858)* (Arnold, 1896), at 61; John P. Davis, *Corporation: A Study of the Origin and Development of Great Business Combinations and of Their Relation to the Authority of the State*, vol. 2 (Knickerbocker Press, 1905), p. 90-91.

[10] F. W. Dendy, Records of the Merchant Adventurers of Newcastle-upon-Tyne (Surtees Society, vols. XCIII and CI), vol. II (1899), p. i.

[11] George Cawston, *supra*. note 9, p. 249-251..

It is unclear when exactly the joint stock trading companies in England evolved into the corporate model that can be associated with a modern corporation. However, while the East India Company finished such an evolution, we find two remarkable differences from the regulated companies. First, voting rights began to depend on the amount each member invested in the permanent joint-stock; and second, the individual member lost the right to trade on their own or in particular groups.[12] As a result, it was the company itself running the voyage and trading, and thereby it was the board selected by the members that took charge of the governance of the company. From this point, the board employed one role commonly described in textbooks of company law, i.e. to manage the affairs of the company. By implication then, the directors, no matter what specific title they might have held at that time, should act in the form of a group, to collectively make business decisions for the best interest of the company representing the members as a whole.

From all the above factors, it is clear that, though the regulated company is widely regarded as the precursor of the modern company, the idea of the corporate board as a management organ never existed in the regulated company, but did not appear until the joint stock company traded on its own account instead of the individual members. Moreover, it is possible to infer three conclusions from this information. At first, the actual powers exercised by the directors (or "assistants", or "committeemen" typically used in the early corporate charters) are very ambiguous.[13] There is no clear and common understanding with respect to what the officers should do, and how they should do it. All these puzzles were left to the members to work out, or maybe, they allowed the directors to decide in certain circumstances. Secondly, derived from the first conclusion, there is no specific distinction or division of the powers and responsibilities among the directors. The only distinguishable difference

[12] Franklin A. Gevurtz, *supra*. note 3, at 944.
[13] Cyril O'Donnell, *supra* .note 2, at 65.

is between the "Governor" and the directors. There is no doubt that, in most of the charters, the "Governor" is placed at the top of the governance structure to handle the day-to-day business of the company, and the directors were expected to work with the "Governor" in running the company,[14] and in some cases, to choose the "Governor" from among themselves.[15] But there are few cases in which one can say that there is any power which a given director is responsible for. In the modern company, it has, for example, "non-executive" directors, "financial" directors, or "public policy" directors. In the past, such specification did not exist. Finally, it is less likely that the board in the early age of joint stock companies appeared, in any sense, to monitor the performance of the management on behalf of the investors - a function which is highlighted in the debate of modern corporate governance reform.[16] Taking account of the structure of the companies at that time, it is easy to understand why the monitoring role was not seen as a priority. In most situations, the directors were those who held the most substantial ownership interests in the company,[17] and in effect, they were running the business for their own benefit. There is a strong motive for them to vigorously operate the company's affairs and carefully protect themselves from corporate failure. In other words, in the early era, the boundary between the role of "directorship" and "management" was obscure and rarely distinguished. It was common for 18th century directors to exercise some powers, which in the modern corporate view, should be attributed to the managers, rather than directors. Consequently, the demand for monitoring the management hardly existed, or probably, never occurred in the early days of business organisation.

Provided that there was no urgent call for monitoring by directors, and it was common sense among businessmen that they relied on a small group of parties, named as "directors", to run the company for the interests of all members subscribed

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[14] George Cawston, *supra*. note 9. *See also* P. Griffiths, *supra.* note 6, at 74.
[15] Cyril O'Donnell, *supra.* note 2, at 67.
[16] For the discussion of directors as monitor, see the Chapter 3 of this thesis.
[17] Cyril O'Donnell, *supra.* note 2, at 64.

to the enterprise, it seems reasonable to say that, the idea of independent directors cannot find its origin in this early commercial age. It is unimaginable for people at that time to be selected as directors for reason other than to cooperate with the "Governor" (today we might provide a more fashionable title such as "Chief Executive Officer") for the management of the company. It might be extremely unacceptable for a director to have a seat in the boardroom paying tribute to more than pursuing business aims. People selected directors in the joint stock company, because they believed these men could and should lay their heads together, and give the best judgements requisite and profitable for the company. They thought that directors could consciously commit the management only when they were the major investors of the company and thus there was a strong identity between their interest and corporate profitability. The correlation among management, directorship and ownership results in the proposition that, in such a corporate structure, specific directors as monitor or an outside resource[18] should be not only unnecessary but also superfluous. From the late-seventeenth-century to eighteenth century, we witness an age of appearance and development of the board of directors associated with the modern idea of the business corporation, but not the origin of an independent force inside the boardroom.

2. The Popularity of the Company: Until 1990

2.1 The Popularity of the Company as a Business Form

Great Britain was, of course, not the first country to set foot in foreign trade, but it has been the most successful player in this area for a long time. Behind the glory and prosperity, the profiles of those joint stock companies were prevalent. The empire

[18] It is not very possible at the early time of joint stock company that the members of the company would select a non-member to be the director, although today this is a common practice for company to choose an outside director, who may have no any shareholding of the company on which he seats.

expanded its colonies and threw its influence all over the world, through the actions and businesses of the joint stock companies.[19] It seems true that the commercial model of joint stock companies was one of the pillars of British economic success, and the landmark of the early capitalist society.

Hail for the great contribution by these joint stock companies is beyond the purpose of my thesis. But we should bear in mind that the achievement did affect the public impression of the businessmen. In the early middle age, the merchants, as the middlemen in the economic circle, were despised by the scholars, who held the belief that it is immoral for a man to profit by selling goods made by others, because every article had its just price "for which it was the right that the owner of the ware should exchange it".[20] People came to change their prejudice and tended to view those men who were committed to directing the voyage as respectable and courteous rich gentlemen. The phrase "joint stock company" became synonymous with "grace-and-favour" and profitability, because all of them received the Royal charter or were incorporated by private Act of Parliament, and thus monopolized the cargo trading on certain shipping routes or geographic areas. It is human nature that, if something is well-off, everyone would try to pursue it. The "joint stock company" provides the perfect example. More and more men assembled together and formed enterprises on a joint stock basis, even if some of them did not, or could not, get a charter from the Crown or a special Act of Parliament. In one way, the growth of the number of companies actually advanced the business development and trade progress. On the other hand, evil often comes with good. The public trust was clearly a seedbed for villainy and depravity. While the South Sea Bubble inevitably burst in 1720, most people, who at one time used to imagine the purchasing of shares as an easy way to fortune, woke up to the fact that the price of the stock could not stop

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[19] Of course, we cannot forget the great contribution of other commercial combinations, such as regulated companies. Most of the early big trading companies were this form of companies, although some of them traded with a joint stock.

[20] W. Cunningham, *Growth of English Industry and Commerce*, I, (Cambridge University Press, 1885), p.252.

from going down and down, and finally being valueless.[21] The subsequent Bubble Act[22] reflected a need across the nation for a stringent constraint on free stock transfer and opening books of subscription. However, partly because of the ill-conceived and incoherent phraseology of the Act, it became a dead-letter provision and few cases were reported under it. Unsurprisingly, immorality and cheating under the name of "the company" were never eliminated.

In order to get things back on the right track, the Parliament thought it time to pass a new Act to encourage those honest joint stock companies and protect the vulnerable public against fraudulence. The year 1844 stands out in English history as the beginning of a new period for both law and commerce. The Joint Stock Company Act,[23] passed on September 5 of this year, is a herald of the free age for incorporation. It was no longer necessary to make a special application to the Crown, a company could automatically be constituted by registration on the condition that it provided certain information about itself. After the availability of limited liability by 1855 Act, the first statute entitled as Companies Act appeared in 1862. From then, the incorporated company, as a form of industrial organisation, was no longer the mysterious privilege of certain people or the only favourite son of the Parliament or the Crown. Everyone was allowed to found his own enterprise by the name of company and on the basis of transferable share, only if he paid some fee to finish the registration and complied with other requirement of regulation.

All these facts inevitably led to companies gradually becoming the preferred business vehicle. The idea of "limited liability" provided people with a brand-new vision about how to invest in businesses with risk but also protection from losing their personal wealth. The law was creative here in treating the company as a body with

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[21] For more detail of the South Sea Company, *see* Ronald Ralph Formoy, *supra.* note 1, p. 23-29.
[22] 6 George I, c. 18 (1720), formally entitled as "An Act to Restrain the Extravagant and Unwarrantable Practice of Raising Money by Voluntary Subscriptions for Carrying on Projects Dangerous to the Trade and Subjects of this Kingdom".
[23] 7 & 8 Vict, c. 110 (1844).

separate personality, and thus equal to natural persons from a legal perspective. That means a company with a legal personality is distinct from the people who created and actually run it.[24] The advantage of corporate personality is clear: for a limited liability company, after the investors have donated their money into the funding pool of the company, they have satisfied their duty as shareholders in company law. They are no longer liable for the debt and failure of the company, because it is then the company, with separate identity, who bears the final risk. Members of the company can only be called upon to pay the full price of their shares, and thus the worst result is they will lose all their investment in a collapsed company. Creditors of the company cannot seek recompense from shareholders' pockets.[25] Due to the benefit of the solid shield of "limited liability", there was a clear increase in the number of the registered companies.[26] Although there were deep emotions in the second half of nineteenth century which asserted that it seemed immoral to limit the liability of businessmen for the debt they incurred, thus "making life easy for business rogues",[27] the trend proved unstoppable and the coalition between companies and limited liability was seen as solid business sense. Even if some "decent and honest" men insisted on the tradition that gentlemen do not limit their business liability, this refusal became to be seen as more and more old-fashioned and obstinate.

2.2 The Separation of Ownership and Management

The popularity of the company is not just a victory of one business form, but furthermore, it should be regarded as the triumph of a certain model of business

[24] Lord Macnaghten made his point firmly in *Salomon* case that, "[t]he company is at law a different person altogether from subscribers to the Memorandum and, although it may be that after incorporation the business is precisely the same as it was before, and the same persons are managers, and the same hands receive the profits, the company os not in law the agent of the subscribers or trustee for them." *Salomon v. A Salomon & Co Ltd* [1897] AC 22, at 51.

[25] Of course the law has made certain exception to the principle of "limited liability" in order to prevent fraud and abuse of rights. The rule of "lifting the veil" is a common example to discourage unfair practices.

[26] Geoffrey Todd, "*Some Aspects of Joint Stock Companies, 1844-1900*", in *The Economic History Review*, Vol.4, No.1 (Oct. 1932), at 46-71.

[27] Alex Rubner, *The Ensnared Shareholder* (Macmillan, 1965), p. 15.

operation structure. Due to the success, the company is more capable of persuading the public to contribute their saving into it. Most of these investors are not professional businessmen, but only average men in the street who have no specific idea about business running or management. Therefore, the shareholders, in theory the owners of the company, are gradually separated from management, and the directors, instead, assume control over the company. The distinction between ownership and leadership has mostly been due to the rapid growth of corporate scale. When thousands of individuals become the members of a company by purchasing its shares, it is highly unlikely that all the business should be decided through a fully democracy model, i.e. a general meeting of all shareholders, in an annual basis. It is neither realistic to frequently organise additional shareholder meetings to deal with unexpected events as they occur. Consequently, it is inefficient to pass and disperse control over the business into the hands of every individual shareholder. Furthermore, it is worth noting that, the interference of shareholders with the management has generally never been encouraged in company law. In the view of law, the ownership and management should be definitely distinguished and treated in different ways.[28]

On account of these facts, a smooth and agile reactive management structure naturally required that discretion to concentrated in the form of an inside institution in charge of policy-making and business-running. To serve this purpose, the shareholders should choose certain senior officers and authorize them to make judgements about the day-to-day running of the business, only leaving the general meeting the power to approve or decline activities pertaining to the most important issues, such as reductions of capital and takeovers. So boards of directors appeared,

[28] It is absolute that, unless in some exceptional circumstances, the shareholders cannot bypass the board of directors to directly interfere with the management. See *Shaw & Sons (Salford) Ltd v Shaw* [1935] 2 K.B. 113, CA, per Greer L.J. at 134: "A company is an entity distinct alike from its shareholders and its directors. Some of its powers may, according to its articles, be exercised by directors, certain other power may be reserved for the shareholders in general meeting. If powers of management are vested in the directors, they and they alone can exercise these power…[Shareholders] cannot themselves usurp the powers which by the articles are vested in the directors any more than the directors can usurp the powers vested by the articles in the general body of shareholders."

as inside institution, to take charge of managing companies' affairs on behalf of shareholders. The division between shareholders and directors means that members of company cannot directly interfere with corporate activities at their will. So the main way for shareholders to influence the corporate management is normally by their power to select and remove directors.

2.3 A Deviation from Legislative Purpose

It is interesting that early corporate legislation did not actually require companies to have directors.[29] But there was a strong assumption that it might be the common practice to run a company through the board of directors, and every company should have such a structure. By reference to the purpose of the enactment of early Companies Acts, it is understandable why this presupposition was popular. The Company Act was not made from scratch and "the company" was not an invention of law-makers. It might be better regarded as a procedure in which legislators tried to "formalize" or "codify" a decent and successful business model. Certainly, given the success in trading, the East India Company and other high-profile trading companies were exactly famous examples of this model that the Parliament preferred as a reference in producing the law. Because all these companies had been under the management of the board, it is simple to relate the board structure to an indispensable prerequisite. Thus the intention was for such a structure to be followed and a company without a board would be implausible. This idea was immediately shared by the courts in their judgements. It was held that as an artificial legal person, the company "could only act through directors".[30] The words of Jessel M.R. usefully sum this up: "[directors] are really commercial men managing a trading concern for the benefit of themselves and of all the other shareholders in it."[31] All the above

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[29] Stephen W. Mayson et. al., *Mayson, French & Ryan on Company Law*, 2005-2006 edn. (Oxford University Press, 2006), p. 460.
[30] *Ferguson v Wilson* (1866) LR 2 Ch App 77, at 89-90.
[31] *Re Forest of Dean Coal Mining Company* (1878) 10 Ch. D. 450, at 452

factors suggest that the power of management was vested in the board, and there seemed to be still no clear distinction between the board of directors and management. Moreover, it also dropped a hint that the early position of directors was probably incompatible with any notion of "independence" or "non-executives", which were predicted on a distance from operation of corporate affairs. At least in eyes of the law, the directors were mostly designed for running the business.

However, reality began to slightly depart from the thoughts of the members of Parliament and the courts. The assumption of identity between the board of directors and management might only be possibly remained in those small and medium-sized companies, in which directors seem to be familiar with the companies' affairs and capable of controlling the daily running of the businesses. In large public companies or even multinational corporations, it is highly doubtful whether this could be the same case. In an organisation with thousands of employees at varied levels and numerous divisions around the country or even across the border, concentrated direct control appears to be illogical and impossible. An institution which simply meets on a monthly or quarterly basis is not wholly qualified to serve the role of efficient management. Delegation is thus necessary. The board has to delegate a significant part of its managerial power to some "executive" directors, who can work on a full-time base and quickly deal with any emergent events. Moreover, even those "executive" directors in charge must further sub-delegate their authority to some subordinate officers, because it is unrealistic for one man to reach every corner and angle of the business of a giant company. In this sense, a pyramid structure of management hierarchy is inevitable in a large company. The managerial role, which the company law bestows on the board of directors, has been gradually ripped off the board. In the vision of big companies, a managing board is more like a fabricated illusion, rather than a practical conception. The board of directors has been materially deprived of the managerial role, leaving it with a vacuum of proper function and

authority.

3. An Age that Directors Do Nothing: Evidence in the First Half of the 20th Century

Although the law insists on the management by directors at all times,[32] the gap between legal principle and commercial practice had not been narrowed. As stated above, the boards of directors in large companies had no longer been able to directly control over daily businesses. Management was the stuff of those "executives" and senior managers, not that of the board as a whole. When a corporation was dominated by one person or a small group whose power was undisputed, outside representatives were frequently invited to sit on the board for certain non-management purposes, usually for the purpose of industrial interlocking or propaganda. Whatever their specific purposes, normally, these directors were "expected to speak only on their subject and otherwise to listen to the boss expounding policy".[33] Mostly, "executive" members of boards and senior managers simultaneously were very reluctant to allow other directors to dispute the running of the company; and "fortunately", those "non-management" or "non-executive" directors rarely did so, because they had no such an interest. The normal schedule was such outside directors to join the board meeting only several times a year, in return for a fee (normally one guinea per meeting), accompanied by a free lunch. Thus one writer gave them the visual title of "guinea-pig directors".[34] In sum, a significant number of directors became to lose their role of active participation in corporate governance. A division in the boardroom became visible: power often

[32] Although ostensibly, the Companies Act does not set up such a requirement, in fact, the model set of articles for a limited company does include the provision. In the *Draft Model Articles of Association for Private Companies Limited by Shares*, Article 2(1) makes it clear that: "The directors' functions are: (a) to manage the company's business; and (b) to exercise all the powers of the company for any purpose connected with managing the company's business". A similar provision can also be found in the *Draft Model Articles of Association for Public Companies*. This endorses the invariable attitude of the legal policy.
[33] Alex Rubner, *supra.* note 27, p. 74.
[34] Horace B. Samuel, *Shareholders' Money* (Sir Isaac Pitman & Sons, Ltd., 1933), p. 111.

came to lie not with the whole board but with a segment composed of “executive” or “managing” directors, while the rest had little to do and their responsibilities only seemed to be attending periodic board meetings.

The passivity and indifference of some directors was regarded as an accursed shame by some critics. The word “ornamental” or “decoration on the Christmas tree” was used to condemn such directors for acting as no more than window-dressing. As Samuel remarked, an alarming situation in the early 20th century arose with the use by British companies of “financial gigolos” as directors for a two-fold function: “Their names act first as the bait by which the public is induced to acquire the shares of the Company, and, secondly, after the Company has formed, as a means of preserving confidence.”[35] In the words of Rubner:

> “When scrutinizing the composition of the boards one must perforce conclude that many if the members are not to be taken seriously .The appointment of guinea-pigs originated in the 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 symbolized business acumen and/or respectable management. The credulity of the public has declined, and aristocrats only have a limited publicity value nowadays. Television personalities and sportsmen are now grilled for director-tasks, for which they often have no competence.”[36]

One notable example of this unfortunate tale was found in a newspaper advertisement, quoted by Samuel, that “A Titled Gentleman is invited to communicate with a progressive company with a view to installing him as a director.

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[35] *Ibid.*
[36] Alex Rubner, *supra.* note 27, p. 73.

Write A., Box 10, 161."[37] Certainly, this farce was not confined to the UK. Across the Atlantic, we could easily find another version of such absurdness. A lot of film stars and retired Generals entered the boardroom of large American corporations, and treated the directorship as an insignia for their honorary status.[38] In dealing with corporate affairs, they easily let themselves be pushed around by the power-bosses in their midst, because most of them lacked necessary business knowledge and experience, and on the other hand, they did not think it was their responsibility to manage the company (even if the law said they should do so). Consequently, as was expressed at that time, "the board has become more and more a legal fiction in practice...and in many cases has been deposed by operating management",[39] and more frequently "executive committees are usurping the rights of directors".[40]

The companies themselves were continuing to appoint directors for non-managerial purpose. One of the main reasons was that, they needed celebrities as directors to promote the profile and image of the companies. A large board composed of many famous people would be readily accepted as the equivalence of good management and future profitability.[41] Moreover, the board became used as a reservation set by companies for dumping some "useless" people.[42] If someone was deemed unhelpful for business operations, but the company still wanted to remain his prestige, a compromise could be to place him on the board to appease his pride. Of course, it was not always the case that the "guinea-pig directors" adorned the company board. Sometimes businessmen with ability and experience took on the role of directors not solely for monetary reasons. In British and American companies, it became common to invite specific representatives onto the board, normally senior executives from

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[37] London Daily Telegraph, Oct. 4th.
[38] Alex Rubner, *supra.* note 27.
[39] L.D. and J.J. Gilbert, *Report of Stockholder Activities during 1958*, New York, 1959.
[40] L.D. and J.J. Gilbert, *Report of Stockholder Activities during 1959*, New York, 1960.
[41] Certainly some writers had questioned this suspect link between celebrities and corporate performance. They maintained that "honorary directors may only bring prestige but not increased dividends". See L. D. Gilbert, *Dividends and Democracy* (American Research Council, 1956).
[42] Alex Rubner, *supra.* note 27, p. 74.

other companies with which the company had close relationships and community of interest, e.g. the client firm, the bank and the major supplier.[43] Such interlocking directorships were mostly "courtesy-appointments",[44] not for the purpose of management. Although these directors normally had more sufficient and competent knowledge of business-running than those "guinea-pig directors", the situation was still similar that such directors rarely bothered "executives" like an active watch-dog barking at every moment.[45] As one commenter has humorously noted, the chief executive officer of the company, and in some cases the perpetrator of a fraudulent promotion, would "speak a few slow words...always indicative of triumph, and then everybody would agree to everything, somebody would sign something, and the 'Board'…would be over."[46]

In sum, a general theme running throughout the critical literature in the first half of the 20th century was that directors so often failed to attend to their duties of obedience, diligence, and loyalty to the corporation.[47] In practice, many boards were little more than a formal ratifying body for the decisions of management. It is weird that, at least in those large companies, while successive companies legislation always put the board as an integrated body on the top of corporate governance structure to discharge the most important function of a company, often directors were gradually deposed by the chief executive and senior managers, and simply become a "non-executive" audience in the boardroom leaving everything to be decided by only one or a small number of colleagues. Their important functions were largely removed. In many cases they could be eliminated and almost no one would realize it.

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[43] *Ibid.*

[44] *Ibid.* It is described, at that time, executives of banks were "frequently appointed directors to endow the client with prestige…"

[45] Alex Rubner made an interesting point in his book, suggesting that the British companies preferred adopting an attitude "to regard the board as a harmonious governing unit which must appear united to the outside world, and to the shareholders". Under this expect, it was usual for British companies to "appoint to their boards full-time directors who are mostly employees of the company with departmental responsibilities and expect their part-time directors to open their mouths as little as possible". See Alex Rubner, *supra.* note 27, p. 75.

[46] Anthony Trollope, *The Way We Live Now* (Trollope Society, c1992). First published in 1875.

[47] I. Maurice Wormser, *Directors – Or Figures of Earth?* 1 Brooklyn L. Rev. 28 (1932), at 7.

Nowadays, amidst the ongoing debate about how to make non-executive or outside directors active in their responsibilities, it is interesting to find that their predecessors used to do little in the past. Even if those directors were chosen as outsiders, they were rarely independent in practice.

4. Independent Directors as Actor in Corporate Governance: The Change in the Late-Twentieth-Century

4.1. Continuation or Change?

4.1.1 Arbitrary Management and Obedient Directors

In the second half of the last century, a much more complicated situation arose. It is not easy to provide only one exclusive description of what was happening during this time. For most contemporary writers, the ridiculous early 20th century tale never disappeared, but in fact deteriorated with large-scale development of giant public companies. "Decoy duck" directors[48] – whose only function was to give the investors a feeling of security and respectability – were too often found in boardrooms.

This failure of directors to discharge their responsibility was relentlessly disclosed by the media. Corporate collapses and market fraud were always in the headline of the newspapers. Behind all the scandals, those indifferent directors fell under the spotlight. They approved every proposal from the management without hesitation, even if the decision might finally be at the expense of the shareholders, in theory whose interest they should protect. In an investigation into one high profile scandal by the then Department of Trade, it was found that "[t]he non-executive directors did

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[48] Joseph W. Bishop, Jr. *Sitting Ducks and Decoy Ducks: New Trends in the Indemification of Corporate Directors and Officers*, 77 Yale L. J. 1078 (1967-1968).

not sufficiently recognise that directors should behave as reasonably conscientious persons, aware of their responsibilities to investors and the fact that investors are rightly on them, and that they must be very careful in placing their reliance on others."[49] A similar discovery was made on the other side of Atlantic. When the Penn Central, one of the most famous American large companies, went into bankruptcy, a SEC staff study of Penn Central revealed the following about the board's failure to monitor the management of the corporation:

(1) a seat on the board tended to be viewed as an honour, not as an active business responsibility;
(2) the directors sought – and received – only limited information;
(3) board meetings were formal and typically the only point of contact between directors;
(4) there was a failure to establish procedures (including a flow of adequate financial information) to permit the board to understand what was happening.[50]

It is possible to summarize every corporate collapse into one version of the story: an over-confident and uncontrolled Chief Executive, and a group of lazy and indifferent directors.

To vouch for the above points, the literature of Professor Mace provides us with a brief picture of relevant issues. His findings can be divided into two categories. At first, it was noticed that many boards, and in particular the non-executive/outside directors, generally did not:

(1) establish company objectives, strategies or board policies, however defined. Do not allocate company resources except in a perfunctory way;

[49] London & County Securities Group Ltd.; a report by inspectors appointed by the Department of Trade: HMSO, 1976, para 15.09 and 15.10.

[50] "*The Financial Collapse of the Penn Central Company*", Staff Report of the Securities and Exchange Commission to the SPECIAL Subcommittee on Investigations, House Committee on Interstate and Foreign Commerce, Aug. 1972. Other examples could be found in a series of court cases in the US, e.g. in *Escott v. BarChrise Construction Corp.*, 283 F. Supp. 643 (S.D.N.Y 1968), outside directors had failed to fulfil their "due diligence" responsibilities in connection with the preparation of a prospectus for a public offering of securities.

(2) do not ask penetrating or searching questions in or out of board meetings;
(3) do not select the president;
(4) do not evaluate or measure the performance of the president except in broad, general terms, and therefore;
(5) are not really very much involved and do not really represent the owners of the corporation – the stockholders. [51]

By contrast, the directors only do the following:

(1) they serve as source of advice and counsel to the CEO;
(2) they serve as some sort of discipline for the president and his subordinates – they know that periodically they must appear before a board made up largely of their peers and give some sort of accountability for stewardship;
(3) the board acts in a crisis situation, if (a) the president dies or became incapacitated; (b) the leadership and performance of the president is so unsatisfactory that a change must be made.[52]

In large publicly held companies, the president, or Chief Executive, has *de facto* powers of control and he decides what he wants the board to do and not do.

4.1.2 Changes in the Boardroom

However, it is over-cynical and not objective to continue this observation with such pessimism. Some positive changes did happen in this time, or even prior to the 1950s. Directorship were no longer seen to be mere "honorariums", but started to become a major responsibility, which required the service of professionals.[53] Most were introduced in response to the corporate scandals and academic concern that arose during the 1920s-1930s.[54] Interestingly, nearly all of them appeared in the US. The debate about corporate governance resulted, in part, in the enactment of the basic US

[51] Myles L. Mace, *Directors: Myth and Reality* (Harvard University, 1971), p. 43.
[52] *Id.* p.13.
[53] Ira M. Millstein, *The Professional Board*, 50 Bus. Law. 1427 (1995), at 1429.
[54] William O. Douglas, *Directors Who Do Not Direct*, 47 Harv. L. Rev. (1933-1934).

federal securities laws.[55] The legislations imposed strict and specific duties on the directors of public companies listed on the Stock Exchange, mostly requiring them to verify the accuracy and integrity of certain statements which should be made public to the investors. Thus those "passive" directors had to be cautious before signing their name on any document, and carefully think about whether their unconditional approval would constitute an offence against the federal law. The Securities Exchange Commission, the federal government agency, was viewed, in the eyes of the businessmen, as an unmerciful hunter ready to target any gentlemen in the boardroom, though in most cases only the directors in a troubled company were the unlucky guys. At the suggestion of one counsel, if the non-management/outside directors wanted to remain safe, they should keep an eye on corporate affairs and check the statements which needed their signature, or else just quit or do not accept such directorships.[56] Furthermore, as early as the 1920s, some corporations had created audit committees composed of outside directors to improve the acceptability of their financial statements. The audit committee typically selected the outside auditing firm, reviewed the results of the audit, and in effect certified that the audit was conducted independently of management.[57] Therefore, at least, the directors did have something to do, even if they were still usually the allies or "dummies" of the management.

4.1.3 The Investment Company Act of 1940

In addition, one development deserves special attention. In 1940, the US Congress enacted the Investment Company Act[58] in order to provide broad relief against such widespread abuses as inadequate capital structures, fraud on investors, theft from

[55] Securities Act of 1933, ch. 38, 48 Stat. 74, and Securities Exchange Act of 1934, ch. 404, 48 Stat. 881. For the detail and background, *see* Philip A Loomis, Jr. & Beverly K. Rubman, *Corporate Governance in Historical Perspective*, 8 Hofstra L. Rev. 141 (1979-1980), at 165-171.
[56] Thoma G. Meeker, *The Outside Director – Advice to My Client*, 24 BUS. LAW. 573 (1968 – 1969).
[57] However, in some instances, these outside directors had close financial or personal ties with management, and thus would not have qualified as being "independent" under today's standards. Their objectivity is doubtful.
[58] Ch.686, tit. I, 54 Stat. 789, as amended, 15 U.S.C. §§80a-1 to -52 (1970).

fund treasuries, and insider dealing in loan and security transactions, which were prevalent in the industry during the 1920s and 1930s,[59] and to raise the level of confidence that could be placed in investment companies by investors, especially those having relatively small amounts of money to buy securities.[60] The Act provides that a certain portion of the board of directors of the fund consist of persons who are not associated with the adviser or principle underwriter, and the contracts between both the investment adviser and the fund and the principal underwriter and the fund must be approved by a majority of the fund's independent directors.[61] The statutory definition of persons who qualify as independent directors excludes anyone with a financial or other material interest in the investment adviser or principal underwriter.[62]

In fact, the Investment Company Act of 1940 seems to be an alien in legal history given the fact that no other company legislation specifically regulated the composition of the board and set up a prerequisite for someone to be director. But taking account of the corporate nature of these mutual funds, it is understandable why it was deemed necessary for the law to require an additional internal check in the company. The most distinctive feature of the mutual fund industry is its externalization of management. Unlike a typical corporation, a fund generally has no employees of its own. Its officers are usually employed and compensated by the fund's investment adviser, which is an independent external entity that provides a full range of clerical services in addition to managing the assets of the fund. Due to this unique structure, conflicts of interest can arise between a fund and the fund's investment adviser because the interests of the fund do not always parallel the interests of the adviser. Such a "close relationships" clearly calls for a firewall to

[59] *Brown v. Bullock*, 194 F. Supp. 207, 244-45 (S.D.N.Y), affd., 294 F.2d 415 (2d Cir. 1961).
[60] Larry D. Barnett, *When is A Mutual Fund Director Independent? The Unexplored Role of Professional Relationships Under Section 2(a)(19) of the Investment Company Act*, 4 DePaul Bus. & Comm. L.J. 173 (2005-2006), at 159.
[61] 15 U.S.C. §80a-10.
[62] 15 U.S.C. §80a-2(a).

protect the interest of the fund shareholders by making the independent directors the "watchdogs" over the fund's operations.[63] It is the first time, in history, that the outside directors were vested with certain power to influence the corporate decision-making, and essentially, the characteristic of "independence" from the management is added to the conception of outside directors. The legislators, the judges, and the public investors explicitly expected those independent directors to be actively involved in the corporate governance, not just play as a silent symbol without any meaningful function. It is suggested that the board should avoid being completely equal to management, and it should assume a role of supervision in corporate governance.

However, it is notable that the Investment Company Act of 1940 is only a specific Act for specific group of companies. From an international perspective, moreover, an emphasis on investment company directors is not universal in law; other countries do not uniformly require, or even permit, boards of directors for their mutual funds.[64] For a long time, the passivity of non-executive/outside directors continued, and the evolution and reform on the corporate governance was extremely slow.

4.2 The Debate in the US

The period from 1970s to 1980s was a time of business and social transition. Some internal changes happened in the large public companies' boardrooms. It was believed that the CEOs and directors were increasingly sensitive and concerned about their responsibilities, largely attributable to the activities of the SEC.[65] In the observation of one writer, the manner in which large publicly held corporations were

[63] See *Burks v. Lasker*, 441 U.S. 471, 485 (1979): "Congress entrusted to the independent directors of investment companies…the primary responsibility for looking after the interests of the funds' shareholders."
[64] Wallace Wen Yeu Wang, *Corporate versus Contractual Mutual Funds: An Evaluation of Structure and Governance*, 69 Wash. L. Rev. 927 (1994).
[65] Myles L. Mace, *The Changing Role of directors in the 1970s*, 31 Bus. Law. 1207, (1975-1976), at 1208.

being governed had in fact become different from the tradition.[66] The trend to having outsiders on boards continued, and there was an increased acceptance of the need for outside directors.[67] More companies tended to use the committee form to deal with certain issues, especially in relation to audit, compensation of management, and nomination of directors.[68] There also had been changes in the attitudes of the directors, in particular to their due diligence requirements. The outside directors did know that it was no longer a good excuse for them to escape penalties by alleging a lack of actual awareness of corporate operation. More of them tried to ask questions and get answers, make audit committees meaningful and not symbolic, and insist on reading proxy statements, annual reports and quarterly reports prior to issuance.[69] In other words, those directors were trying to be somewhat "independent" and keep a safe distance from management.

Accordingly, the board of directors of the publicly held corporation was drawing substantial attention from both the government and scholars. The disclosure of illegal or questionable payments made both overseas and improper political contributions in the home country by publicly held corporations,[70] and highly publicized corporate financial scandals, all spurred the SEC to rethink the role of outside directors. It was felt that most evils during the 1970s attributed to the exercise of unbridled power by

[66] Marshall L. Small, *The Evolving Role of the Director in Corporate Governance*, 30 Hasting L. J. 1353 (1978-1979), at 1356-1362. See also Noyes E. Leech & Robert H. Mundheim, *The Outside Director of the Publicly Held Corporation*, 31 Bus. Law. 1799 (1975-1976), at 1807-1811.

[67] National Industrial Conference Board, Corporate Directorship Practice (1967), at 6; Corporate Directorship Practice (1973), at 2; The Board of Directors (1977), at 84. However, among those non-executive or non-management directors, most of them were retired officers, who would not be treated as "independent" in the modern sense.

[68] In 1940, the SEC first publicly recommended that every corporation establish a committee of non-officer board members whose responsibilities would include selection of the independent auditor and supervision over the audit engagement. (SEC Report on Investigation: In the Matter of McKesson & Robbins Inc. 5 (1940), summarized in Release N. 19 (Dec. 5, 1940); in SEC Accounting Series Releases 26, 30 (1948). The New York Stock Exchange required listed companies to have audit committees after June 30, 1978, (New York Stock Exchange Company Manual A-29; 2 NYSE GUIDE (CCH) ¶2495h (1977). And the sixth annual study of boards of directors by Korn/Ferry International, an executive search firm, disclosed that 71% of the 143 companies in its survey either had nominating committees with non-management majorities or planned to create them. Wall St. J., Fed. 15, 1979, at 7, col. 1.

[69] Myles L. Mace, *supra.* note 65.

[70] SEC Report on Questionable and Illegal Corporate Payments and Practices, 94th Cong., 2d Sess. (Comm. Print 1976), submitted to the Senate Comm. On Banking, Housing and Urban Affairs on May 12, 1976; Senate Selected Comm. On Presidential Campaign Activities, Final Report, S. REP. NO.981, 93rd Cong., 2d Sess.446 (1974).

the Chief Executive Officer, and in order to counteract this uncontrolled force, it was deemed necessary to introduce an internal oversight into the board, where the corporate decisions were made. The Commission had come to rely on outside directors to promote some of its own regulatory objectives. In some situations it required the formation of committees of outside directors,[71] sometime newly chosen, to direct investigations and report to the full board, with the expectation that the board would remedy past wrongdoings and bring proper procedures to prevent recurrence.[72] In the statement of Roderick Hills, then chairman of the SEC, it was held that "the most important job we [the SEC] have to do is create a truly independent character on those boards of directors, both from a remedial standpoint, when we found the problem, and from a perspective standpoint."[73] His successor, Harold Williams, was without question another ardent proponent of the role of the independent outside director in corporate governance.[74] There was a growing expectation that outside directors would perform their roles with increasing diligence, and keep an eye on the management of the companies. The voice for more participation of outside directors in corporate governance also found an echo in the academy and business community.[75] Overall, at this moment, the main proposal called for outside/non-executive directors to fulfil one central function: monitoring.[76] The logic is not difficult to understand: since the performance of the management

[71] Homer Kripke, *The SEC, Corporate Governance, and the Real Issues*, 36 Bus. Law. 173 (1980-1981). It is held that the Commission was aiming for making proposals to reconstitute the board of directors. One factor of what the SEC supposed to achieve concerning corporate governance was, to assure that independent members of the board of directors would act as checks on, or as monitors over, actions of management, and to press for recognition of independent directors as the ultimate source of power in a corporation

[72] *SEC v United Brands Co*., CCH Fed. Sec. L. Rep. ¶ 95,420 (D. D.C. Jan 27, 1976); *SEC v Mattel, Inc.,* [1974-75 Transfer Binder] CCH. Feed. Sec. L. Rep. ¶94,807 (D. D.C. 1974).

[73] Corporate Rights and Responsibilities: Hearings Before the Senate Comm. On Commerce, 94th Cong., 2d Sess. 316-317 (1976).

[74] H. Williams, *Introduction – Symposium on Corporate Governance*, 8 Hofstra L. Rev. 1 (1979). More description of the view of Williams, *see* Irwin Borowski, *Corporate Accountability: The Role of the Independent Director*, 9 J. Corp. L. 455 (1983-1984), at 455-460.

[75] Melvin Eisenberg, *Legal Models of Management Structure in the Modern Corporation: Officers, Directors and Accountants*, 63 Calif. L. Rev. 375 (1975); Noyes E. Leech & Robert H. Mundheim, *supra.* note 66; Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. Pol. Econ. 288 (1980); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. Fin. Econ. 305 (1976); Robin Marris & Dennis C. Mueller, *The Corporation, Competition, and the Invisble Hand*, 18 J. Econ. Literature 32 (1980).

[76] Melvin Eisenberg, *id.* at 438; Noyes E. Leech & Robert H. Mundheim, *supra.* note 66, at 1803-1806.

should be watched, people need someone as watchers; the most ideal candidate is an outsider who is not an employee of the company, and thus can retain an independent and objective perspective; so outside directors with independence characteristic are the appropriate monitors.[77]

However, the major attention in the US to independent outside directors' role in monitoring gradually gave way to another proposal. As Professor Brudney remarked, "the emphasis of reformers had shifted considerably to the left – to the mechanism for making corporate management socially responsible."[78] This abdication reflected the change of public view with respect to corporate impact on our lives. Corporate governance was no longer just a "business" problem, but became a social issue. Concerns such as environmental pollution, energy crises, poor quality of products, and secret payments to politicians both home and abroad, had become well-known to everyone in the street, even those who held no stock of any company. It was thought that the large corporation, like an individual citizen, should have a certain social responsibility, and the directors, as controllers of the activities of the company, should also be responsive to a broad range of interests, not simply confined to wealth-maximization for shareholders.[79] For achieving such a "socialist" goal, many embraced the notion of "outside" or "independent" directors as an effective weapon against those "irresponsible" corporate activities that brought on damage to the employees, clients, or even the whole society. It became a belief that, these directors, who should be loyal to specific constituencies other than shareholders, could influence the corporate policies and decisions so as to reduce the social cost of

[77] Of course, this reasoning is over- simplistic; and it has long been the target of criticism from the scholars. I will exam the debate in the latter chapter 5.

[78] Victor Brudney, *The Independent Director – Heavenly City or Potemkin Village*?, 95 Harv. L. Rev. 597 (1982), at 603-604.

[79] R. Nader, M. Green & J. Seligman, *Taming the Giant Corporation* (Norton, 1976); C. Stone, *Where the Law Ends* (Waveland Press, 1975); Donald E. Schwartz, *Towards New Corporate Goals: Co-Existence with Society*, 60 Geo. L.J. 57 (1971). Harvey J. Goldschmid, *The Greening of the Boardroom: Reflections on Corporate Social Responsibility*, 10 Colum. J. L. & Soc. Probs. 17; Philip I. Blumberg, *The Role of Corporation in Society Today*, 31 Bus. Law. 1403 (1976); All these ideas can be traced back to the debate in 1930s, between E. Merrick Dodd, *For whom Are Corporate Managers Trustees?* 45 Harv. L. Rev. 1145 (1932), and A. A. Berle, *For whom Corporate Managers Are Trustees*, 45 Harv. L. Rev. 1365 (1932). See Joseph L. Weiner, *The Berle-Dodd Dialogue on the Concept of the Corporation*, 64 Colum. L. Rev. 1458 (1964).

externalities, such as pollution and public health, and to improve social programs, such as donations to libraries and other public sectors, as well as to curtail any unlawful activities, such as "questionable" payments abroad, and even positively try to alter the law, through politics or court action.[80]

Of course, if this "socialist" model of corporate governance did come true, it could bring great benefits to our society. However, an inevitable side effect of this shift of emphasis was that, the focus of the debate had been totally changed. People abandoned the proposal of how the independent director could effectively monitor the management to help improve the decision-making process, but ardently argued about whether the corporate entity should have a social responsibility, and if so, how much of this was enough; for whom independent outside directors should be responsible; how the proper directors could be selected for protection of the interest of certain constituencies, say, the employees, consumers, or broadly, the public interest.[81] It is hardly surprising that such controversial questions drew an endless disputation, and no consensus could easily be reached, even among those proponents of corporate social responsibility. Certainly, any radical proposal required for a fundamental structural reform in corporate governance drew the clear resistance of the business community, because of a fear that traditional directors and senior managers might be kicked out of the future corporations, or the way in which companies should be run would be significantly altered.[82] In addition, it seemed that the contemporary government and most politicians did not share the most radical

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[80] David L. Engel, *An Approach to Corporate Social Responsibility*, 32 Stan. L. Rev. 1 (1979); Russell B. Stevenson, Jr., *The Corporation as a Political Institution,* 8 Hofstra L. Rev. 39 (1979).

[81] Noyes E. Leech & Robert H. Mundheim, *supra* note 66, at 1828-1929; Alfred F. Conard, *Reflections on Public Interest Directors*, 75 Mich. L. Rev. 941 (1977), at 951-952; Philip I. Blumberg, *Reflections on Proposals for Corporate Reform Through Change in the Composition of the Board of Directors : "Special Interest" or "Public" Directors*, 53 B. U. L. Rev. 547 (1973); P. L. Davies, *Employee Representation on Company Boards and Participation in Corporate Planning*, 38 Mod. L . Rev. 254 (1975); C. Stone, *supra.* note 79, at 160-171, 159-160, 178-180; Cyril Moscow, *The Independent Director*, 28 Bus. Law. 9, (1972-1973), at 11-12.

[82] The Business Roundtable represents a good example. It is a group concerned with the corporate governance program, composed of people who are the chief executive officers of major American corporation. It has long been regarded as a conservative body, which successfully rejected proposals by radical reformers. *See* The Business Roundtable, *The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation*, 33 Bus. Law. 2083 (1978).

views of the corporate responsibility lobby on corporate governance reform, even though they all accepted that corporate behaviour in the US ought to be reviewed.[83]

As a result, "corporate responsibility" radicalism was almost extinguished in the 1980s, and the "modest" reformists, usually those representatives or sympathizers of the corporate world, regained dominance. Basically, it was agreed that there was an inherent demand for reform of corporate governance. But such a reform was mere improvement, from "good" to "better"; not a revolution, which means from "wrong" to "correct".[84] Furthermore, it was acknowledged that the board should at least in some ways remain "independent" from management so as to work as an objective institution for judgement, rather than letting itself become a "yesman" to management. Nevertheless, all the above factors should be based on a self-determination ground without the intervention by the government or the imposition of any other uniform rules. Their position was that the change should rely primarily on internal reform through the introduction and popularization of independent directors, and "insofar as possible without government mandate".[85] Few drew the conclusion that it might be necessary to give government a major role to accomplish the objectives of a revitalized board.[86]

By the time of emergence into the 1990s, calls for fundamental board revolution almost died out, and the "anti-intervention" or "self-regulatory" group appeared to be the final winner.[87] They turned into the major spokesmen of the corporate governance program. They were convinced that most of the problems relating to

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[83] The Corporate Democracy Act of 1980, which proposed to increase participation of shareholders and outside directors, inform the community affected by the corporate activities, and protect employee right, failed to be enacted in the Congress. H.R. 7010, 96TH Cong., 2d Sess.

[84] See Kenneth E Kendall & Julie Kendall, *Good and Evil in the Chairmen's "Boiler Plate": An Analysis of Corporate Visions of the 1970s*, Organization Studies 14(4), 1993, 605-626.

[85] William C. Greenough & Peter C. Clapman, *The Role of Independent Directors in Corporate Governance*, 56 Notre Dame L. 916 (1981), at 916.

[86] However, Irwin Borowski, *supra* note 74, at 456, advocated that the courts and government agencies play a leading, but carefully limited role, in creating a framework of standards and rules for independent directors.

[87] However, of course, the "anti-intervention" group later faced great challenge in the 21st century due to the enactment of the Sarbanes–Oxley Act. The author will discuss this topic in following Chapter 2.

corporate governance could eventually be fixed by the effort of the industry on its own, mainly through an effective system of independent outside directors and other measures. Some statements of principle or guidebooks were produced by this group, with the hope that the businessmen in the boardroom would be conscious of, and automatically comply with the recommendations inside.[88] All in all, it seems to be an unavoidable trend in the US that, independent outside directors, as an important impetus of corporate governance, had been common in the boardroom, and occupied the majority or exclusive status in the audit, compensation, and nominating committees. Despite meeting opposition,[89] the notion was widely accepted by most.[90] A non-employee director from the outside world and with no business or material tie with the management, became the basic definition what we thought about the "independent" directors.

4.3 The Development in the UK

4.3.1 The Initiation of Non-Executive Directors

Although we have spent a significant amount of time describing the situation in the US, we may also be curious about what was happening simultaneously in the UK, which shares a similar corporate system with its Americans counterparts. In fact, it is very difficult to answer this question, partly because there was no loud voice at that time in relation to the topic of "corporate governance". Indeed, a nearly blank period is exhibited in front of us. Unlike the situation on the other side of Atlantic, large public companies seemed to be under negligible public pressure seeking to regulate the corporate "evil". The first clear proposal for the renaissance of non-executive

[88] Committee on Corporate Laws, ABA, *Corporate Director's Guidebook*, 1994, 49 Bus. Law. 1247 (1994); The Business Roundtable, *Statement on Corporate Governance* (1997).
[89] Homer Kripke, *supra.* note 71; Daniel R. Fischel, *The Corporate Governance Movement*, 35 Vand. L. Rev. 1259 (1982); Victor Brudney, *supra* note 78; Christopher S. Axworthy, *Corporate Directors – Who Needs Them?* 51 Mod. L. Rev. 273 (1988).
[90] In most of the statements by the Business Roundtable, it is confirmed that the practice of introduction of independent outside directors has been commonly adopted in many leading corporations in the market.

directors was from the Confederation of British Industry (CBI), an industrial association. The report of the Company Affairs Committee of the CBI (The Watkinson Report) published in 1973, concluded that:

> "[T]he inclusion on the board of public companies of non-executive directors is highly desirable. Non-executive directors can make a valuable contribution by reason of their ability:
>
> (a) to bring to bear an independent and entirely objective and detached approach to policy matters;
>
> (b) to give the board the benefit of their knowledge and their experience in other areas over a wide field of activities.
>
> By virtue of the fact that, unlike executive directors, non-executives are not closely involved in the day-to-day affairs of the company, they are in a better position to see the company as a whole and to take a critical view of it."[91]

Moreover, the CBI held the non-executive as the most favourable, yet not the only, choice to benefit the British industry, because their inclusion was expected "not only to secure the benefit described [above], but also to demonstrate clearly to shareholders and to people outside the company that these benefits are being secured."[92]

This idea received some support from the government. The Government White Paper on The Conduct of Company Directors agreed, in 1977, that "non-executive directors can bring to the board a breadth of knowledge and experience which the company's own management may not possess. Even more important, they can increase the

[91] Company Affairs Committee, Confederation of British industry, *The responsibilities of the British public company: final report of the Company Affairs Committee*, Part IX, at 37-38

[92] *Id.*

element of independence and objectivity in the board decision-making, not being involved in day-to-day management they are able to take a detached look at the way in which the company is being run and at its medium and long-term policies. They should provide independent supervision of the company's management."[93] Several years later, the idea was picked up again by another group. This is the well known PRO-NED (Promotion of Non-Executive directors), another industrial-background organisation sponsored by the Bank of England, the CBI, the Stock Exchange, and other City institutions.[94] As the title suggested, the aim was to promote the recognition of the importance of non-executive directors. In its booklet on the role of the non-executive director,[95] it was explained:

> "The purpose of appointing non-executive directors is to provide the board with knowledge, expertise, judgement and balance which may not be available of the board consist only of full-time executives…[Executive directors'] day-to-day responsibilities may be confined to a limited part of the business. It is unrealistic to expect them also to exhibit the detachment and wider experience that can be brought to bear by a non-executive director from outside…Thus the essential advantage of non-executive directors is that they bring a fresh and wider view to board discussion and decision taking."[96]

It is clear that British industry itself played an initiatory role in the modern development of non-executive directors. By contrast, the American corporations

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[93] The Conduct of Company Directors: White Paper, Cmnd. 7037, HMSO November 1977 and The Companies' Bill, 1977 (Bill 38); To Appoint Non-Executive Directors and Audit Committees in Major Public Companies (Bill not pursued on change of government).

[94] The Sponsors of PRO-NED: Accepting House Committee; Bank of England; British Institute of Management; The Committee of London Clearing Bankers; The Committee of the Scottish Clearing Bankers; Confederation of British Industry; Equity Capital for Industry Limited; Finance of Industry plc; The Institutional Shareholders' Committee; The London Stock Exchange.

[95] The Promotion of Non-Executive Directors, *Role of the Non-executive Director: a booklet prepared for PRO NED*, February 1982.

[96] *Id.*

were pushed into accepting independent outside directors by external forces, such as the government, the academy, and pressure groups, and it seems to be true that public opinion compelled, more or less, businessmen to adopt certain defensive measures to protect themselves and ease the anger around the country. Many corporations introduced the outside directors to address the concern, and thus implied that the "problem" has been solved. However, British industry chose a self-oriented way to proceed with limited outside influence. They embraced the idea of "non-executive" directors not because the public screamed at them, but for the reason that they thought there was a necessary internal demand.

4.3.2 Governmental Reports in the 1990s

The 1990s should be seen as a memorable decade for the development of "non-executive directors". Two important government reports were published in this time, that is, the Cadbury and Hampel Reports. Before the analysis of them, it is worth noting that the economic background has entirely varied from the 1960s-1980s situation. The British economy regained its energy and strong pulse against the backdrop of "Thatcherism" in the 1980s. Privatization, reverse of the post-war nationalization, re-injected into industry the competition and innovation which are both essential necessities for an efficient market. The revival of industry allowed companies to comfortably rethink their position and experiment or accept some proposals of "corporate governance" that in the past, they viewed as less of a priority. Such self-examination is partly reflected in the Cadbury Report.[97]

Originally, the Cadbury committee was convened to review the corporate financial system, mainly regarding issues of audit and accounting, in response to several market scandals which had resulted in the unaffordable unlimited liability for

[97] Report of the Committee on the Financial Aspects of Corporate Governance (London: Gee, 1992).

auditors and accountancy firms involved. However, the Report did not restrict itself to such a narrow remit, but interestingly, covered the broad topic of "corporate governance". It was suggested that the inclusion of "non-executive" directors, as one of the recommendations by the report, could significantly benefit companies, by providing necessary objectivity in the boardroom, and useful advice which otherwise the executives might lack.[98] Thus it made the principal recommendation that the majority of non-executive directors should be independent.[99] In contrast to the frosty reception received by the PRO-NED report, the Cadbury Report was widely accepted by industry and most of its principles and recommendations are still today held up as a measure of good practice. It became a yardstick against the standards of "corporate governance", and materially influenced views expressed in later academic studies and government reports. The Hampel Report, the successor of Cadbury, arose six years later in 1998.[100] With a few modifications, the Hampel committee inherited and endorsed most of the propositions of Cadbury. Once again, a new Combined Code was issued to cater for the demand of introducing better practices into the industry. While we now commonly laud the achievements of these Reports, it is meaningful to note that, even if all committees were initiated by government agencies, the major sponsors behind each Report were city institutions with industrial backgrounds.[101] This factor indicates a basic point, that is, British industry has never lost its dominant and leading role in the development of corporate governance and influence on the notion of "non-executive directors".

However, compared with the early-age conclusions of PRO-NED report, we can find two significantly different features in the Cadbury and Hampel reports:

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[98] Cadbury Report, para. 4.10, 4.11.

[99] *Id.* para. 4.12,

[100] COMMITTEE ON CORPORATE COVERNANCE: FINAL REPORT, First published January 1998. Before the Hampel Report, another government review, Greenbury Report, also, in part, dealt with the issue of "non-executive" directors, by proposing that the remuneration committee in every listed companies should consist exclusively of non-executive directors with relevant experience and independence.

[101] The Hampel committee's sponsors are the London Stock Exchange, the Confederation of British Industry, the Institute of Directors, the Consultative Committee of Accountancy Bodies, the National Association of Pension Funds and the Association of British Insurers.

First, it was mentioned in these two Reports that "non-executive" directors can provide some kind of oversight,[102] a function which was not clearly referred by PRO-NED and other earlier reports. In the period from the 1970s to 1980s, the potential benefit of introducing "non-executive" directors was normally seen as inviting fresh minds into board dynamic or offering some bright advices. Monitoring was never a main objective at that time. But in the Cadbury report, supervision was regarded as a domain in which "non-executive" directors can play an important role. Such a difference of vision on the functions of "non-executive" directors may be partly because the setting up of Cadbury Committee was against the background of market scandals and the original purpose of this Report was to find a path to confront fraudulent activities. In this sense, the introduction of "non-executive" directors seemed to be a possible solution to internal monitoring.

Second, in the Cadbury report, it was the first time that the characteristic of "independence" was emphasized.[103] Earlier reports like PRO-NED did not explicitly pay attention to the independence of "non-executive" directors, probably because it was thought that "independence" might cause a division in the boardroom which could finally harm the efficiency of board. This philosophy seemed not be shared by the Cadbury and Hampel reports. An over-united board came with the danger that the management might function with no monitoring or control inside the corporate system. The result could be especially disastrous when those uncontrolled people were running businesses controlling billions of pounds of the funds of others. Such a risk was clearly known to the government, as well as the industry itself, in the 1990s due to high-profile market scandals. "Non-executive" directors independent of

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[102] Cadbury Report, para. 4.5: "The first [important contribution of non-executive directors] is in reviewing the performance of the board and of the executive." And para. 4.6: "The second is in taking the lead where potential conflicts of interest arise".

[103] Cadbury Report 4.12: "An essential quality which non-executive directors should bring to the board's deliberations is that of independence of judgement. We recommend that the majority of nonexecutives on a board should be independent of the company".

management were deemed to be promising to overcome this problem.

Consequently, the Cadbury and Hampel reports made a big step forward by proposing the introduction of "non-executive" directors, who should be independent and in charge of monitoring. At this moment, corporate governance reform in the UK moved into a new modern era: "reforming the board to be more independent from management".

4.3.3 The Difference of Impetus

When the idea of "board independence" became more acceptable in the UK, resonance with the corporate governance system in the US occurred. However, although both Americans and Britons met together at the same end, they travelled down different paths. As stated above, it seems clear that the renaissance of non-executive directors in the UK was due to the self-demand of industries, different from the situation in the US that corporate governance reform was driven by external forces. This slight distinction of impetus has rarely been noticed by scholars. However, in the opinion of the author, this phenomenon may partly explain why, in relating to board independence, corporate governance models across Atlantic are somewhat different. Before exploring this point, it is somewhat necessary to analyse why the British industry accepted the notion of "non-executive" directors on its own initiative, rather than under the push from public pressure.

A reasonable explanation is possibly because of the inherent predicament of British economy. UK economic system was seriously affected during the Second World War, and post-war recovery was slow and costly.[104] Certainly, detailed description about historical problems and reasons of then economic difficulty is beyond the purpose of

[104] Alan Sked & Chris Cook, *Post-War Britain: A Political History*, (Sussex: John Spiers, 1979), p. 27-28.

this thesis.[105] To briefly sum up, British industry was the victim of long-term stagnation and enervation of the market.[106] Sadly, since the first half of the 20th century, UK was also losing its competitive capacity and market share in the global competition. It was a disappointing fact that the British industry had fallen downwards into the bottom of the race in the developed world, overtaken by competitors of Japan and West German. Thus, in order to get out of this hardship, UK industry had a strong demand for corporate governance improvement so as to promote business performance and competitive capacity. For such a purpose, it was held by the British industry that they must take certain measures to adjust to the changes in the world economy and market. The problem, as industry suggested, was that British directors were too conservative and small-minded to be innovative and aggressive. In order to overcome this obstacle, the introduction of fresh talent, by the inclusion of non-executive directors, was naturally necessary. With the help from these talents from outside world, it was believed that the performance of companies could be effectively improved. Under this background, the notion of "non-executive" directors in the modern sense resurrected and was voluntarily embraced by British industry.

The internal requirement of change led UK industry to initially propose a reform based on the renaissance of non-executive directors. This momentum heralded two differences from the development of independent outside directors in the US:

First, the reform was, more or less, immune from some "cacophonies". By comparison, as discussed above, a visible phenomenon in the US during corporate governance movement in the 1970s was that many lobby groups tried to use the agenda of "corporate governance" to achieve a number of different objectives,

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[105] As one writer suggested, the economic problems facing Britain in the 1960s and 1970s were due to the special economic vulnerability which lay in the long period of relative economic decline began in the last quarter of the 19th century. See David Marquand, *The Decline of Post-War Consensus*, in POST-WAR BRITAIN, 1945-64: THEMES AND PERSPECTIVES (Pinter, 1989), p. 6.

[106] Alan Sked & Chris Cook, *supra* note 105, p. 290-291.

generally described as “corporate social responsibility”. For example, some argued that the introduction of outside directors should be a guarantee of protecting the interest of employees and consumers. The others proposed that the adoption of board independence could be used to tackle bothering social issues like pollution and corruption. At the end, all these incompatible suggestions drove the reform to an extreme, by characterizing outside directors as an omnipotent savior (but in fact, it would be unrealistic for outside directors to be such almighty). Fortunately, such an endless debate did not happen. British industry explicitly made it clear that what they designed to achieve through “non-executive” directors was to help UK companies survive in global competition and regain their prosperity, rather than to resolve all social problems by single proposal. In the eyes of the author, this less ambitious perspective actually saved British corporate governance reform from a US-style controversy as for the relationship between outside directors and social interests. More importantly, it helped British industry save a decade to catch up the reforming steps of the US from behind and finally become a leader, together with the US, in shaping the system of board independence today.

Secondly, the major influence of British industry in proposing the introduction of “non-executive” directors makes corporate governance reform in this area more self-regulatory-oriented. By contrast, reforms in the US were more driven by the authority (for typical examples, the enactment of Investment Company Act of 1940 and actions initiated by the SEC). Such a progress emphasized the benefit of compulsory force, but inevitably, it left a gap between administrative direction and industrial flexibility. However, in the UK, in initiating the plan during 1970s-1980s, the industry itself had a great voice in deciding where the reform would be going. Corporate participants were more involved in considering the roles of “non-executive” directors and forming a proper regime that could be acceptable and efficient in operation. Fortunately, this tradition has been retained in following development of

British corporate governance development so as to construct the system on a more self-regulated foundation (through "comply or explain" approach). This secures a balanced compromise between regulative purpose and industrial reality, which may bring benefits of efficiency and flexibility.[107]

In sum, although both the UK and US jumped into the pursuance of board independence in the second half of the 20th century, situations across Atlantic were not exactly the same. Britons set out to make this needed reform resulting from the industry's own initiative, while Americans were somewhat under varied public pressures and administrative influences. This difference of impetus finally contributed to a difference of corporate governance development relating to board independence: compared with the US system, the British reform has been more focusing on self-regulation and industry's inherent demand. These features might explain why, although starting reform much later than the US, British corporate governance model can still claim to be a global leader in the 21st century.

4.4 Conclusion

The historical review of the evolution of the directors discovered a natural difference between the reality hundreds of years ago and the current consideration with respect to those at the top of modern corporations. Historically, ownership and directorship had been firmly tied together when major shareholders took seats in the boardroom. Moreover, there is no doubt that, no clear classification of functions existed in the early joint-stock companies, and the directors were all treated, by law or common sense, as the equivalent of management. In one sense, the "trinity" of shareholder, director and manager was an obvious feature of corporate governance in the early age. However, when companies became large and more complex in their structure,

[107] The author will reach the details in following Chapter 2.

the separation between ownership and leadership was inevitable, and then the group of "directors" divided into two groups. One of them composed of professional full-time executives in charge of the major business of companies. The other had fallen down to be just silent and indifferent players on the board. The traditional system of "trinity" was thus over.

This division made the board more and more rely on management, and gradually allowed the management to often become too strong to control. The loss of balance in corporate governance certainly attracted significant concern. Reform was called upon on the system so that a certain level of monitoring could be maintained inside the companies. The board was requested to be more responsible for this role. Due to this understanding, "outside" and "non-executive" directors were selected as the candidates for such a task. However, as stated in the chapter, it was found that "outside" and "non-executive" were historically not created for the role of monitoring. At the very start, they were put into the board for purposes such as promotion of legitimacy and credibility, or facilitation of close relationships among different companies. At this time their role was not typically strongly related to the supervision function. They usually fell into being the "dummy" of the powerful Chief Officer and senior management. As a solution to this problem, it became necessary to systematically change the definition and understanding of those directors. In response, a new qualification was imposed on the "outside" and "non-executive" directors, that is, they were required to be "independent" from management, rather than being in coalition with management. A key lesson we learned from human history is that, if someone has to keep an eye on the others, he must at first be "independent". Being "independent" may not be the end for being modern "outside" and "non-executive" directors, but of course it is an important beginning.

To deliver such a system of board independence, a trend, as observed in this chapter, is the prevalence of self-regulation supported by business industry itself. Most corporate participants accepted or even ardently embraced the notion of independent directors. But equally they stringently resisted intervention of the government through tough and detailed regulation, which they argued would be unnecessary and counterproductive. Their victory was recorded in the form of the statements issued by Business Roundtable in the US, and the significant Reports in the UK. However, due to some appalling scandals in the stock market, the self-regulatory model has increasingly faced great pressure and challenge in the 21st century. The author will explore this topic in the following chapters.

CHAPTER TWO

THE REGULATION ON INNDEPENDENT DIRECTORS: CODIFICATION OR SELF-REGULATION

The debate about how to promote the independence of the board, between self-regulation and "hard law" through government intervention, has been revisited in the current century. To render membership of the board, i.e. outside and non-executive directors, a more objective and independent position, some commentators have suggested that it should be left industry itself to institute reforms, finding a way to a new age of corporate governance. External compulsory forces would not be welcomed, because the imposition of compulsory rules may not bring about effective and voluntary compliance.[1] It is implied that this opinion for self-regulation gained more support in the last two decades of the 20th century, especially from the business community.

However, after some disastrous tragedies in the securities market, especially the current crisis in banking sector, confidence of the effectiveness of self-regulation model has been seriously damaged. Some writers were, in fact, astonished and disappointed at the optimism and naiveté of the proponents of self-regulation, who believed that industry would automatically fix the problem, and a regime without

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[1] Melvin A Eisenberg, *Corporate Law and Social Norm*, 99 Colum. L. Rev. 1253 (1999); Adam C. Pritchard, *Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers*, 85 Va. L. Rev. 925 (1999); Stephen J. Choi, *Regulating Investors Not Issuers: A Market-Based Proposal*, 88 Cal. L. Rev. 279 (2000); Stephen J Choi, *Law, Finance, and Path Dependence: Developing Strong Securities Markets*, 80 Tex. L. Rev. 1657 (2002); Stephen J. Choi & Jill E. Fisch, *How to Fix Wall Street: A Voucher Financing Proposal for Securities Intermediaries*, 113 Yale L.J. 269 (2003); Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 Yale L.J. 1521 (2005); Richard C. Nolan, *The Legal Control of Directors' Conflicts of Interest in the United Kingdom: Non-Executive Directors Following the Higgs Report*, in John Armour & Joseph A. McCahey, *After Enron: Improving Corporate Law and Modernising Securities Regulation in Europe and the US* (Oxford: Hart Publishing, 2006), 367.

legal force could largely stop such improper activities.[2] In the view of those sceptics, codification of binding legal rule should be the first choice for corporate governance reform. In their views, the purpose of the inclusion of independent directors can only be achieved through specific regulation, when the law can make it clear about how the board should be structured, what standard of independence the directors should follow, and what roles the independent directors should play. The legal measures can promote certain minimal standards for directors, and because of the possible adverse consequences to the directors who fail to meet these minimal standards enlist the self-interest of the directors in doing their job. Such a codification model will offer these directors a guarantee to effectively discharge their functions, because they can use the law as a weapon and excuse to persuade over-powerful management to accept their involvement in corporate governance. In this chapter, the author will examine whether this codification proposal is capable of truly making a positive difference.

1. The Historical Background

The "severe winter" of the US stock market in 2001-2002 made a lot of self-regulation supporters pipe down, and interventionist arguments came to prominence again. After the revelation of a series of scandals involving irregular accounting procedures bordering on fraud, Enron, one of the world's leading energy companies and "America's Most Innovative Company",[3] stood at the verge of infamy and debacle. Its shares plunged from over $90.00 to $0.30, immediately leading to an unprecedented and disastrous event in the financial world. While the

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[2] Saleem Sheikh, *Non-Executive Directors: Self-Regulation or Codification*, Comp. Law. (2002), Issue 23(10), 296-307, at 296. See also Robert Prentice, *Whither Securities Regulation? Some Behavioral Observations Regarding Proposals for its Future*, 51 Duke L.J. 1397 (2002); Iain MacNeil & Xiao Li, *"'Comply or Explain': Market Discipline and Non-Compliance with the Combined Code"*, in *Corporate Governance*, Vol. 14, No. 5, Sept. 2006, 486-496 (concluding that the Combined Code, under the self-regulatory regime, could be integrated into mainstream company law).

[3] Named by *Fortune* magazine for six consecutive years, from 1996 to 2001. Moreover, Enron was on the *Fortune's* "100 Best Companies to Work for in America" list in 2000.

investors were still gape-mouthed, the company filed for bankruptcy on December 2, 2001, becoming the largest contemporary corporate failure in America.[4]

Ironically, in similarity to Enron's slogan "Ask Why?", the public cannot stop asking why this famous company suddenly collapsed without any premonition. The truth is that, for a long time, Enron had been trying to cover up its financial problems by systematically planned accounting fraud, such as overstated earning and the transfer of losses to "offshore" affiliated entities. In the midst of such abject deceit, there was a clear failure of the board to carry out its responsibilities.[5] The board, especially the audit committee, which has long been regarded as the most important internal control system, turned a blind eye to the wrongdoings of the management. Interestingly, most members of the board, other than those participants of the fraud, were in fact all "independent" outside directors, according to the then-existing standard of the stock exchange requirement.[6] However, it was subsequently disclosed that all these "independent" directors had a certain financial relationship with the CEO or the company, for example, some of them were representatives of charities which received significant donations from Enron, or consultants serving the company for a well-paid compensation.[7] Such financial ties do not mean they were absolutely not independent, but it is reasonable to question whether they would bring any serious oversight role into the company. In the congressional hearings, it was reported that: "[Enron] represents a colossal failure of virtually every mechanism that is supposed to provide checks and balances on which the integrity of our capital markets depends. And in that system, the board of directors is supposed to provide the first line of

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[4] For a detailed history and examination of the causes of the fall of Enron, see, *e.g.* William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 Tul. L. Rev. 1275 (2002).

[5] Of course some outside "gatekeepers" also did little to detect the improper management activities, such as the auditors, rating agencies, and investment analysts. See John C. Coffee, Jr., *What Caused Enron? A Capsule Social and Economic History of the 1990s*, 89 Cornell. L. Rev. 269 (2004); Jonathan R. Macey, *Efficient Capital Markets, Corporate Disclosure, and Enron*, 89 Cornell L. Rev. 394 (2004).

[6] Marianne M. Jennings, *A Primer on Enron: Lessons from A Perfect Storm of Financial Reporting, Corporate Governance and Ethical Culture Failure*, 39 Cal. W. L. Rev. 163 (2003), at 200.

[7] Staff of Permanent Subcomm. on Investigations of the Senate Comm. on Governmental Aff., 107th Cong., The Role of the Board of Directors in Enron's Collapse (Comm. Print 2002), at 51-52.

defense by overseeing the conduct of management".[8]

The public was enraged at the irresponsible behaviour of the whole corporate governance system in Enron. The call for action was quickly received by Congress, the SEC and the Stock Exchanges. In late May and early June, NASDAQ and NYSE both announced that they would adopt some additional corporate governance listing standards in order to maintain investors' confidence. NASDAQ proposed to tighten the definition of "independent" directors, and prohibited any major payment, other than for board service, to the independent directors or their family members.[9] The NYSE followed the recommendations of its Corporate Accountability and Listing Standards Committee, including a requirement for a majority of independent directors on the board under a stricter standard of "independence", and all core committees, i.e. compensation, nominating, audit, solely composed of independent directors.[10] On the other hand, under the public assault, American corporations also tried to retrieve their reputation and appease worried investors. The Business Roundtable was the main voice from the industry. In its *Principles of Corporate Governance*, published on May 2002, the group paid tribute to the success of the US capital market, and only lightly referred to the trouble, by saying "while there have been exceptions to the overall record of success, generally the system have worked very well."[11] Not surprisingly, the Business Roundtable repeated the strategy of self-endorsement which was adopted in the last century, with the hope to avoid any stringent response from the law-makers. It insisted on the belief that "the most effective way to enhance corporate governance is through conscientious and

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[8] Financial Collapse of Enron Corporation: Hearing Before the Subcomm. On Oversight & Investigation of the Comm. On Energy & Commerce, 107th Cong. 7 (2002), available at http://energycommerce.house.gov/107/action/ I07-88.pdf

[9] Press Release, NASDAQ, Nasdaq Submits First Round of Corporate Governance Rule Changes to the SEC; Announces Plan for Additional Issues for Review This Month, (June 5 2002), *available at* http://www.nasdaq.com/newsroom/news/pr2002/ne_section02_121.html

[10] News Release, NYSE, NYSE Board Releases Report of Corporate Accountability and Listing Standards Committee - Group Makes Recommendations To Help Restore Investor Trust and Confidence, (June 6, 2002) *available at* http://www.nyse.com/press/1044027444876.html. The complete content of recommendation *available at* http://www.nyse.com/pdfs/corp_govreport.pdf.

[11] The Business Roundtable, Principles of Corporate Governance (2002), at ii, *available at* http://www.brtable.org/pdf/704.pdf.

forward-looking action by a business community that focuses on generating long-term stockholder value with the highest degree of integrity”.[12] What is more, it implied that regulation or codification should be not necessary because “[n]o law or regulation alone can be a substitute for the voluntary adherence to these principles [the statements recommended] by corporate directors and management and by the accounting firms retained to serve American corporations.”[13] It might be the case that, if the Enron scandal was just an individual corporate collapse without any domino effect, the self-regulation proponents would successfully pull through as they did in the public debate in 1970s.

However, in the aftermath of Enron, a new scandal arose. This time it was WorldCom, once the United States’ second largest long distance phone company. On June 25, 2002, the company announced that it had overstated its earnings by more than $72 billion during the past five quarters, primarily by improperly accounting for its operating costs. Just one month later, it filed for bankruptcy, which led to, in place of Enron, the largest corporate failure in American business history. The flood of the WorldCom scandal instantly shattered all “dikes of containment” that had been built up by the self-regulation group.[14] This time, the public and Congress clearly were tired of the changeless “sweet words” and had no continuing patience to wait for the corporations themselves to slowly and unconcernedly reform their behaviour and just pick up the proposals which they preferred. As a result, American law-makers passed the Sarbanes-Oxley Act of 2002 without significant hesitation and opposition from within the Congress and Senate.[15] In fact, since the purpose of the enactment was aimed at curtailing the accounting fraud that occurred in Enron and WorldCom, the Sarbanes-Oxley Act looks more like a specific act relating to accounting, rather than

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[12] *Id.* at v.
[13] *Id.* at iv-v.
[14] R. William Ide, *Post-Enron Corporate Governance Opportunities: Creating a Culture of Greater Board Collaboration and Oversight*, 54 Mercer L. Rev. 829 (2002-2003), at 54.
[15] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in sections of 11, 15, 18, 28, and 29 U.S.C.). The Act was approved in a big majority by the House by a vote of 334-90 and by the Senate 99-0.

a reform bill for corporate governance generally. However, it did significantly affect the corporate operation structure, by indicating the significance of an independent audit committee (comprised of independent directors) and effective internal control system that the board should be responsible to. Obviously, "the 2002 Reforms deepen the American Corporate Governance system's reliance upon independent directors who (in this ideal conception) feel accountable only to the corporation and its stockholders."[16] In a sense, the Act could be treated as a form of codification with respect to independent outside directors.

The shock wave of Enron and WorldCom soon spread across the Atlantic. The British capital market was permeated by an atmosphere of fear even if no similar scandals had happened in the City of London. It seemed to many commentators that the American-style, financial statement fraud might possibly take place here, and thus there was a necessity to review the modern corporate governance system in UK. As a response, the (then) DTI announced a review of the role of and responsibility of the non-executive directors, with the expectation that an effective system for non-executive directors could promote the integrity of the market and improve the long-term performance of the company. On January 20, 2003, the independent report, well-known as the as the 'Higgs Review', was published by Derek Higgs.[17] In this important report, the self-regulatory tradition was held in special favour again. The basic idea is that self-regulation is preferable to legal regulation. A reform based on "best practice", rather than compulsory legislation, is more suitable and acceptable for the British industry. According to those insisting on a self-regulation approach, the tough intervention by codification is less likely to happen in this country, because the British stock market has long enjoyed and been used to a system of self-review and –improvement, and there is no evidence to suggest that such a system would face

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[16] William B. Chandler III & Leo E. Strine, Jr., *The New Federalism of the American Corporate Governance: Preliminary Reflections of Two Residents of One Small State*, 152 U. Pa. L. Rev. 953 (2003), at 962.
[17] Derek Higgs, Review of the Role and Effectiveness of Non-Executive Director, January 2003.

material risk of collapse in the future. Thus the majority of industry gave a welcome to the Higgs Review. However, some writers have still debated both whether such a voluntary compliance system can achieve the ideal purpose of the reform, and also whether the denial of specific legislative reform is reasonable.[18] Typically, they contend that "while self-regulation is the preferable method for ensuring the proper functioning of the NED role, partial statutory regulation of NEDs ought to be put on the statutory agenda to ensure NEDs are fully aware of their obligations and to store confidence in investors and other stakeholders who deal with companies with a clear message that NEDs are discharging their duties effectively as guardians of the company's best interest."[19]

2. Is Codification The Only Choice?

Before exploring the debate between self-regulation and codification, it is necessary to begin with a fundamental question: why in general is codification deemed necessary? In general, there are two possible reasons: first, that there is no existing law available in a specific area, or the current law is not adequate to meet modern changes; and second, particular benefits are exclusive to codification and cannot be achieved by other methods. Interestingly, we may find that neither explanation is adequate to justify the action of crafting specific legislation for the independence of directors. The author will now exam these two factors respectively:

2.1 Is The Law Absent?

2.1.1 General Duties on All Directors

Apparently, it is not easy to give a single conclusion to this question. It would not be

[18] Saleem Sheikh, *supra.* note 2.
[19] *Ibid*. at 296.

the truth to say that the law had been completely silent. Of course, the notion of "independent directors" is not a term that has been recognised in specific legislation such as the Companies Acts.[20] But we must bear in mind at first that, no matter what titles the directors hold, they are equal members of the board. As a director, in general, they thus assume the duties set out by the law. Certainly, it would be false to suggest that company law has never been acquainted with the duties of directors. The case of *Re City Equitable Fire Insurance Co.*[21], for example, had framed that all directors owe an obligation of skill and care, that is, they need to serve the company with their best knowledge and full diligence.[22] *Dorchester Finance Co. Ltd v. Stebbing* [23] and other following cases[24] did raise the standard of duties of skill and care to a relatively higher bar in response to the improved corporate governance.[25] On the other hand, the law made it clear that the directors owe to the company the duty of loyalty as fiduciaries. In the words of Chadwick L.J., "it follows from the principle that directors who dispose of the company's property in breach of their fiduciary duties are treated as having committed a breach of trust that a person who receives that property with knowledge of the breach of duty is treated as holding it upon trust for the company. He is said to be a constructive trustee of the property."[26] Normally, the fiduciary duties of directors could be divided into the following sub-groups in detail:[27]

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[20] However, it is necessary to note that, although there is no specific statute in this area, independent directors are given some recognition in the case law.

[21] [1925] Ch. 407.

[22] However, the level of requirement on duties of skill and care was highly a subjective test that is not rigorous to directors, particularly those non-executives. As Romer J. said, "a director need not exhibit in his performance of his duties a greater degree of skill than may reasonably be expected from a person of his knowledge and experience." *Re City Equitable Fire Insurance Co.* [1925] Ch. 407, at 428. But now this bar has been significantly promoted to a combined standard, primarily based on an objective standard. See section 174 of the Companies Act 2006: A director of a company must exercise reasonable care, skill and diligence that would be exercised by a reasonably diligent person with "(a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company, and (b) the general knowledge, skill and experience that the director has."

[23] [1989] BCLC 498.

[24] *Norman v. Theodor Goddard* [1992] BCC 14; *Re D'fan Ltd* [1993] BCC 646; *Re Westlowe Storage & Distribution Ltd (In Liquidation)* [2000] BCC 851.

[25] Finch, *Company Directors: Who Cares about Skill and Care?* 55 Modern Law Review 179 (1992) ; see also S. Worthington, *The Duty to Monitor: A modern View of the Director's Duty of Care*, in F. Patfield (e.d.) *Perspectives in Company Law:2* (Kluwer, 1997), at p.181.

[26] *J.J. Harrison (Properties) Ltd v. Harrison* [2002] 1 BCLC 162, at 173.

[27] P. L. Davies, *Gower and Davies' Principles of Modern Company Law* 8th e.d.n. (Sweet & Maxwell, 2008), at

(1) that the directors must remain within the scope of the powers which have been conferred upon them;[28]

(2) that the directors must act in good faith to promote the success of the company;[29]

(3) that the directors must exercise independent judgement;[30]

(4) that the directors must not put themselves in a position in which their personal interests conflict with their duties duty to the company.[31]

Currently, all these duties and also the duty of skill and care are codified in Companies Act 2006 with clear phrasing to ensure certain minimum standards of behaviour from directors.[32] For an outside or non-executive director to be independent, it does not mean that he could get away from the above legal regime of duties. As the men and women who serve the company, they are certainly not allowed to misuse their power. When they are requested to contribute their knowledge and diligence to the company, they should know that the duties of skill and care have been imposed upon them. Reforms on corporate governance have never changed the way that an independent director must embrace these duties. But on the contrary, he or she should firmly learn all these duties at heart. In this sense, it is important to realize that the law is always present with respect to the duties of directors. The doubt remains, however, as to whether there is really any necessity for specific legislation referring to the responsibilities of independent non-executive directors.

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p.497.

[28] *Harward Smith Ltd. v. Ampol Petroleum Ltd* [1974] A.C. 821. See section 171 of the Companies Act 2006.

[29] *Hutton v. West Cork Railway* (1883) 23 Ch. D. 654; *Re Smith & Fawcett Ltd* [1942] Ch. 304; *Regentcrest Plc (in liquidation) v. Cohen* [2001] 2 B.C.L.C. 80. See section 172 of the Companies Act 2006.

[30] *Cabra Estates Plc v. Fulham Football Club* [1994] 1 B.C.L.C. 363. See section 173 of the Companies Act 2006.

[31] It is useful to divide the "no conflict" principle into three categories when the specific rules implementing the principle vary according to different situations: (1) self-dealing transactions: *Aberdeen Railway v. Blaikie* (1854) 1 Macq. H. L. 461, HL Sc. See section 177, 182, 197-214 of the Companies Act 2006; (2) exploitation of the company's property, information or opportunity: *Regal (Hastings) Ltd v. Gullier* [1942] 1 All E.R. 378, *Industrial Development Consultants v. Cooley* [1972] 1 W.L.R. 443, *Bhullar v. Bhullar* [2003] 2 B.C.L.C. 241. See section 175 of the Companies Act 2006; (3) receipt from a third party of a benefit for exercising directorial functions in a particular way: *Industries and General Mortgage Co. Ltd v. Lewis* [1949] 2 All E.R. 573, *Logicrose Ltd v. Southend United FC Ltd* [1988] 1 W.L.R. 1257. See section 176 of the Companies Act 2006.

[32] Chapter 2, Section 170-177.

2.1.2 A Distinction of Scope of Duties

When we found that the duties of independent directors could be equally regulated under existing law, it is interesting to question why some commentators think that a clear borderline should be drawn between the roles of different directors.[33] If it is the fact that the law does not deliberately impose different duties on different groups of directors,[34] then in what way might the law differentiate between different directors in respect of certain duties? In fact, such an expectation derives from a confusion concerning the nature and scope of the legal duties. In sum, all directors' responsibilities are essentially the same, but the scope of their duties is variable. As an analogy, a pharmaceuticals company and a baker both assume legal liability, under the general principle applicable to goods quality, if they fail to provide safe products (medicine or loaf) to their consumers. The foundation of this guarantee is not significantly different. In order to fulfil the safety promise, the pharmaceuticals company must establish a well-equipped lab and recruit qualified chemists and staff, and carefully test their product and evaluate the result of experiments before any new pill can be sold in the market. If the company failed to do all the above things with due diligence, it might be held to have violated its duties if the medicine consequently is proven to be dangerous to human health. But by contrast, the public may rarely expect the baker to invest an equal amount of money and effort in quality control procedures, as the pharmaceuticals company does, before he can sell a piece of bread. In other words, even if the nature of the legal duties is unalterable, the burden on different people to perform their responsibility depends on internal and external factors and thus it might produce a virtual image that people in different position have different duties. This is exactly the case for the directors.

[33] Saleem Sheikh, *supra.* note 2.
[34] *Dorchester Finance Co. Ltd. v Stebbing* [1989] BCLC 498.

Suggested by different titles held by different directors, of course, independent directors are not doing the same works as those of executives. Currently, a popular view is that, "when executive directors are in charge of running the business, non-executives are responsible for monitoring company affairs".[35] If we agree that the detailed functions of independent directors should be distinct from executives, then certainly the legal view on directors' duties would vary according to this difference of functions. The Combined Code also confirmed the view that the scope of directors' duties should be analyzed against their specific role within the company. According to the Code: "although non-executive directors and executive directors have as board members the same legal duties and objectives, the time devoted to the company's affairs is likely to be significantly less for a non-executive director than for an executive director and the detailed knowledge and experience of a company's affairs that could reasonably be expected of a non-executive director will generally be less than for an executive director. These matters may be relevant in assessing the knowledge, skill and experience which may reasonably be expected of a non-executive director and therefore the care, skill and diligence that a non-executive director may be expected to exercise."[36] This proposition was also endorsed by the judicial view. In *Equitable Life Assurance Soc'y v. Bowley*,[37] it was held by the court that, "[t]here is a considerable measure of agreement about the duty owed in law by a non-executive director to a company. In expression it does not differ from the duty owed by an executive director but in application it may and usually will do so."[38]

[35] The author will analyse the details of independent directors' roles in Chapter 3.
[36] The Combined Code (June 2008), Schedule B, para. 1.
[37] [2003] EWHC (Comet) 2263, [35]-[41], (2004) 1 B.C.L.C. 180.
[38] *Ibid.*, at 188-89. See also in *Re Cont'l Assurance Co. of London Plc*, [2001] B.P.I.R. 733, 850 (Ch.) ("I accept that the managing director of a company...has a general responsibility to oversee the activities of the company, which presumably includes its accounting operations. But I do not think that those responsibilities go as far as to require the non-executive directors to overrule the specialist directors, like the finance director, in their specialist fields.").

2.1.3 A Vacuum in the Law

As stated above, despite owing duties of the same nature, the law did traditionally take a different view on the scope of the duties for different groups of directors. This really causes a difficulty in answering the question: "is the law absent?" In fact, it is a two-side story.

First of all, it is not true that independent non-executive directors can get totally nothing from the general statement of directors' duties expounded in the Companies Act 2006. Putting the case law and the Companies Act 2006 together, a relatively clearer picture has been drawn in front of non-executive directors. "[The passage of the Companies Act 2006] is in itself a very important development, not only because the basic duties are now set by Parliament rather than by the courts but because the relative clarity of the duties will inevitably lead to even more focus on how directors executed their office when things go wrong."[39] Simultaneously, the authority of courts has been retained and reaffirmed in interpreting what the duties in the Companies Act 2006 actually mean. Section 170(4) provides that "the general duties shall be interpreted and applied in the same way as common law rules or equitable principles, and regard shall be had to the corresponding common law rules and equitable principles in interpreting and applying the general duties". Compared with the old-aged system which was traditionally monopolized by the case law and dominated by obscure rulings of courts, the regime now has moved to a more transparent and understandable legislative base in which principles consolidated by the Act run in the first place, leaving courts to work out specific applications of rules firmly under these principles.[40] Such a system is certainly a positive step forward, bringing beneficial clarification on the area of directors' duties. Independent

[39] Editorial, *Woe to the Inactive Director*, Comp. Law. 2008, Issue 29(6), 161, at 161.
[40] Such an arrangement is also explicitly declared in section 171(3) of the Companies Act 2006: "the general duties are based on certain common law rules and equitable principles as they apply in relation to directors and have effect in place of those rules and principles as regards the duties owed to a company by a director."

non-executive directors, of course as well as other directors, can learn from the enactment of the Act that now the law has a higher expectation on them. This strong message carries a salutary effect on corporate governance in the UK by spurring directors on to seriously re-consider their responsibilities, since in the opinion of the author, the law-making process is more easily capable of catching the eye and igniting resonance of the public than a bundle of reported cases which would only be circulated in several legal journals and familiar to a small group of professionals. In one sense, the provisions of c.2 of the 2006 Act form a firm groundwork in shaping the corporate governance system of independent directors. If it is suggested that the law is completely "silent" or "absent" in guiding the development of independent directors, it would certainly be a false accusation.

However, if referring to differences between executive and non-executive directors, to be honest, the law has not sought to answer this question. The case law has recognized that there is a difference in terms of the scope of their duties, but it never formulates a comprehensive conclusion about where the boundary is. The Companies Act 2006 provides a general chapter of directors' duties, but it does not intent to reach the details relating to how independent non-executive directors should do their jobs. In this sense, the law is "absent" in telling all the things and the scope of duties may still remain elusive. In short then, how can the general principle be flexibly applied to different cases and different directors? How should the functions of independent directors be viewed against the general requirement? Thus it leaves a "vacuum" so that specific regulation could be invited to fill in the blank. Corporate governance may be open to an idea of making a law, outside of the general Companies Act, applicable to only a particular group of directors (i.e. independent non-executives in all publicly traded companies[41]), which can comprehensively

[41] Technically, this could be referred to those directors of a company whose shares are admitted to trading on a UK "regulated market", a notion widely adopted by the Financial Services and Markets Act 2000 and other Rules in regulating financial services.

target issues such as who can qualify as independent directors, what such directors should do, and what is their working model. A feasible proposal might be to codify and detail the Higgs Review.[42] Although there is currently no clear sign of legislation movement in this direction, in theory, we can still be open-minded to such a proposal at this stage, and then move to a following analysis to see whether this kind of codification is viable.

2.2 Is the Benefit of Codification Evident?

2.2.1 The Benefit of Further Clarification

As stated above, the author suggested that a “vacuum” in the law means a possibility of codification in relation to specific regulation of independent directors. There is no doubt that codification can make obscure legal language more intelligible for those people to which the law is aimed. Those who become company directors may have no clear understanding of their duties under the law, since the rules were scattered about in the decisions in individual court cases over several centuries. Businessmen, unlike legal professionals, have little interest or time to sift through the morass of the legal judgements in the area to ascertain their duties. Thus codification could make the law “consistent, certain, accessible and comprehensible”.[43] Directors might find a statutory statement of their duties more useful than principles derived from cases. Clarity and accessibility are arguably key benefits of codification.

Those supporting codification of board independence on account of the benefit of clarification might have a good point here: the Companies Act 2006 only builds a basic framework of principles to clarify the nature of duties, and these principles set out in quite general ways might in practice mean little to independent directors. For

[42] See Iain MacNeil & Xiao Li, *supra.* note 2.
[43] Department of Trade and Industry, *Company Law Review*, March 2005, para. 3.3, at 20.

example, in mentioning the duty of skill and care, the Act emphasizes that the standard should be carefully measured against “the functions carried out by the director in relation to the company”,[44] what do the words exactly mean to a non-executive director in a big bank who chairs the audit committee? The Act seems incapacitated to function as a guidebook to directors. So further clarification appears to be needed, and the proponents of codification believe that this can be provided by a specific legislation regulating all angles of independent directors’ works.

However, it is doubtful whether such a specific elaboration of the roles and responsibilities of “independent” directors could achieve a purpose of offering further clarification. Those supporters may be right that the Act is concise, but clearly, they miss other sources of “soft” regulation which are currently taking the job of formulating details of corporate governance in the UK: the Combined Code (now changed to the title “the UK Corporate Governance Code, hereinafter referred as “the Code”). The Higgs Review is a historic achievement in British history of corporate governance, by reviewing the importance of non-executives and conceiving of great suggestions to improve the system. The new-version Code almost entirely absorbed all recommendation of the Higgs Review. It presents a number of reasonable views and workable measures in respect of independent non-executive directors. It is hard to conclude that specific legislation can pronounce both spirit and substance of the Higgs Review in a more articulate way than what the Code does. It would also be irrational to think that codification, through repetition of contents of the Code, could provide further clarification which we might desperately dream of.

Moreover, unlike the case law principles that directors fail to assuredly understand, business people may be quite familiar with the Code, because it is the basic guideline for those companies listed on the securities market. In the eyes of investors and the

[44] Section 174(2)(a).

business community, the Code provisions represent "best practice" that the companies are encouraged to comply with in order to advance their profile. It would be misleading to suggest that the content of the Higgs Review and Code is vague or over simple, or that special legislation would help enforce their provisions. Such a system has been working smoothly for nearly two decades, and we have witnessed a change of practice that publicly traded companies have re-structured their board to be more independent, by recruiting more non-executive directors.[45] No persuasive evidence available strongly supports a view that codification can bring more benefit than self-regulation to promote corporate governance practice.

2.2.2 The Benefit of Compulsive Force

Another benefit of codification is the statutory force of the law. It is argued that the legal system can provide strong investor protection and encourage the development of capital market characterized by the separation of ownership and control, "because a good legal environment protects the potential financiers against expropriation by entrepreneurs, it raises their willingness to surrender funds in exchange for securities, and hence expands the scope of capital market".[46] Unlike self-regulation that in effect emphasizes voluntary compliance and advisory direction, legislation is compulsory in nature and commands those subject to the relevant laws to act in accordance with the legal provisions at hands. If a person fails to abide by or act against such legal requirements, there would be a major risk of punishment by the law. This force is the most important reason why the legal system is indispensable in our society, and it makes the law fundamentally different from other social control systems of human behaviour, such as ethical and moral codes.

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[45] See HEIDRICK & STRUGGLES, INC., *Raising the Bar: Corporate Governance in Europe 2007 Report.*

[46] R.L. Porta, F. Lopez-de-Silance, A. Shleifer and R.W. Vishny, *Legal Determinants of External Finance*, 52 Journal of Finance 1131 (1997), at 1149. See also R.L. Porta, F. Lopez-de-Silance, A. Shleifer and R.W. Vishny, *Law and Finance*, 106 Journal of Political Economy 1113 (1998); R.L. Porta, F. Lopez-de-Silance and A. Shleifer, *Corporate Ownership Around the World*, 54 Journal of Finance 471 (1999).

The proponents of codification explicitly allege that legislation can compel higher standards of conduct in the boardrooms.[47] The view might seem to suggest that the reform on corporate governance should tend to opt for legal rules with clear statutory sanctions, rather than market-based regulation. It is also suggested that the threat of legal liability or even criminal sanctions may, through the medium of legal advice, have "a significant influence on behaviour in practice" and "concentrate the minds of directors".[48]

The author concurs with this point that legal force can of course introduce a strong signal that conduct must be in line with the requirements of the law. To a certain extent, improper and illegal activities might be deterred resulting from fear of sanctions. What we should expect from the law is that it could reduce the frequency of occurrence of harmful behaviour in the first place. This is what we might call its reductive goal.[49] However, it is worth noting that codification alone is no panacea. Behaviour will not change merely because of the existence of a written form of law. People choose to comply with the law mostly on the ground that they accept the social philosophy behind the terms of the provision, and believe that they are doing the right thing. A most successful legislation is the one which finds redolence in the community reflecting ways that those in society largely voluntarily act. In some situations, the measure of self-control is often a preferable solution to some of the most difficult and perhaps insoluble problems of social organisation.[50]

As a force for controlling companies, it is unclear and even doubtful whether the law can be an effective method just through the threat of penalty. In the Enron scandal, it

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[47] Saleem Sheikh, *supra*. note 2, at 305.
[48] See S. Deakin & A. Hughes, *Directors' Duties Empirical Findings – Report to the Law Commissions* (1999), available at: http://www.lawcom.gov.uk/files/study.pdf. However, some writers have taken a sceptical view here, by suggesting that criminal penalty might not be able to make a real difference on behavioural control. See Richard C. Nolan, *supra.* note 1, at p.381-382.
[49] C. Stone, *Where the Law Ends* (Waveland Press, c1975), p. 30.
[50] *Id*. p. 112.

is beyond question that those wrongdoers definitely knew they were carrying out immoral and illegal transactions, but the risk of legal liability did nothing to prohibit their behaviour. What contributes to this defiance might be the over-reliance on short-term profit and excessive risk-taking strategy. On pursuing a desired market performance, the management may be over ambitious and over confident so that they would lose any focus on regulation and duties in law. In such a situation, no laws, no matter how sophisticated their design can carry the burden of altering undesirable social behaviour alone.[51] So long as the underlying attitudes of "the culture of the corporation" are left untouched, some measure of resistance – of circumvention, disregard, and foot dragging – is inevitable.[52]

But on the other hand, market-based regulation may be more likely to embrace "social norms",[53] which can promote the self-awareness of directors about their responsibilities and the self-discipline in respect of their behaviour.[54] A system of corporate regulation tailored to the needs of modern business should, ideally, combine both forms of regulation and provide effective incentives to generate a culture of compliance. Thus law cannot bring change merely by itself, especially when resistance might possibly arise amongst those whom the law intends to regulate. Certainly, the aim of codification to improve corporate governance practice cannot be achieved without help from self-regulation, which is more likely to be accepted in the market.[55] In this sense, the benefits of compulsory force cannot justify a view that codification should replace self-regulation to promote corporate governance development.

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[51] David A. Skeel, Jr., *Icarus and American Corporate Regulation*, 61 Bus. Law. 155 (2005-2006).

[52] *Supra*. note 49, p. 228-229.

[53] The term "social norm" refers to "all rules and regularities concerning human conduct, other than legal rules and organisational rules". See M.E. Eisenberg, *supra*. note1, at 1255.

[54] A. Shleifer & R.W. Vishny, *A Survey of Corporate Governance*, 52 Journal of Finance (1997), at 749.

[55] Eilis Ferran, *Corporate Law, Codes and Social Norms: Finding the Right Regulatory Combination and Institutional Structure*, 1 Journal of Corporate Law Studies 381 (2001). See also Angus Young, *Frameworks in Regulating Company Directors: Rethinking the Philosophical Foundations to Enhance Accountability*, Comp. Law. 2009, 30(12), 355-361 (suggesting self-regulatory codes or rules as an intermediate level of regulatory mechanism relating ethical principles and the law).

2.2.3 The Limits of Codification

By reference to the evidence of those major scandals which occurred in the 21st century, it can be argued that self-regulation regimes do not formerly raise higher standards and bring forth best practice.[56] It may be spurious to suggest, however, that codification will be more effective than self-regulation. Acceptable, specific, and measurable standards of corporate performance are not easily established.[57] The law has long played a relatively minor role in the evolution of board structure and behaviour; market and other social forces are far more important.[58] Moreover, in most cases, the law cannot introduce best practice and mere compliance with the law does not necessarily make a good citizen or a good company, since "law seems most appropriate where it is used to enforce acceptable minimums (a morality of duty), rather than to force from each person what he is fully capable of (a morality of aspiration)."[59] The law sets minimum standards of conduct because in nature it is the general requirement for all actors in society, not only those large publicly held companies but also the small ones. The best practice which we reasonably expect the big companies to meet is unrealistic for all small- or medium-sized undertakings. By contrast, the "comply or explain" approach under self-regulation regime fully allows a particular company to build a corporate governance system which can better fit its own circumstance.

Even for a specific regulation merely applicable to certain listed companies, it is still questionable whether there could be a "one fits all" standard. Even if such a general

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[56] Christopher S. Axworthy, *Corporate Directors – Who Needs Them?* 51 Mode. L. Rev. 273 (1988), at 295.

[57] J. Bacon & J. Brown, *Corporate Directorship Practices: Role, Selection and Legal Status of the Board* (Board, 1973), at 21; Noyes E. Leech & Robert H. Mundheim, *The Outside Director of the Publicly Held Corporation*, 31 Bus. Law. 1799 (1975-1976), at 1824-1825.

[58] Melvin A. Eisenberg, *supra.* note 1. See also Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 Stan. L. Rev. 1465 (2006-2007), at 1488-1490 (suggesting that reputation concern provides another sort of stick or carrot that could enhance director independence).

[59] Lon L. Fuller, *The Morality of Law*, rev. ed. (Yale University Press, 1969).

standard did exist, it is less likely to include the stricter requirements of "best practice", which is common for some large companies to fulfil but difficult for others to completely observe. The compromise between the minimum standard and best practice would finally lead to the result of a lower requirement when compared with the recommendations and principles of the self-regulation model.[60] Thus the legislation cannot really advance standards.[61] In addition, in some situations, a uniform legislative standard may even exacerbate the problem of "inflexibility".[62] Furthermore, it was explained that "[n]ot the least difficult problem here is the development of a social mindedness hitherto sadly lacking both among business men and their legal advisers."[63] Such social awareness cannot, however, be created by statute alone.

Furthermore, we should also bear in mind that the course of codification is the combination of cost and benefit. Certain disadvantages are inevitable when legislation is used as the method to control the conduct of human beings.[64] As one writer has remarked, "regulation has often proved clumsy and ineffective."[65] There is clearly a trade-off to be made between clarity and flexibility. The more detail the statute provides, the more complicated the legal structure would be; the more specifically the statute regulates, the more difficult it would be to achieve its original

[60] Of course, the law can copy the model of "compliance or explain", which is commonly used in the Code, in order to achieve the effect of flexibility. However, this not only renders the law a mirror version of the self-regulation form, but also makes the notion of mandatory legal force, the major benefit and advantage of codification, obsolete.

[61] But interestingly, by contrast, market-based self-regulation may in some cases establish tougher standard than those set out by the general law. See H.E. Jackson & E.J. Pan, *Regulatory Competition in International Securities markets: Evidence from Europe in 1999*, 56 Bus. Law. 653 (2001).

[62] For example, it was found that rule of defining independence in the Sarbanes–Oxley Act may be too tight in some ways, barring the best candidates because of relatively minor affiliations. For instance, SOX treats Warren Buffett as a "conflicted" member of the audit committee of the board of Coca-Cola, Inc., because he controls companies that do business with Coke. See Edward Iwata, Business Say Corporate Governance Can Go Too Far, USA TODAY, June 24, 2004, at 1B.

[63] William O. Douglas, *Directors Who Do Not Direct*, 47 Harv. L. Rev. 1305 (1933-1934), at 1307.

[64] Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. Corp. L. 1 (2002-2003), at 3 ("The laws are likely to have significant costs, including perverse incentives of managers, increasing distrust and bureaucracy in firms, and impeding information flows. The only effective antidotes to fraud are active and vigilant markets and professionals with strong incentives to investigate corporate managers and dig up corporate information.")

[65] Lewis D. Solomon, *Restructuring the Corporate Board of Directors: Fond Hope – Faint Promise?* 76 Mich. L. Rev. 581 (1977-1978), at 581.

purpose. Legislation is not the goods on the shelf in a supermarket that is immediately available so long as we would like to buy it; codification is otherwise a time-consuming political course full of arguments and debates in the legislative body. Given the "time-lag problem", it might need several years for a statute to be passed by which time the social situation may be significantly different from before and thus renders the law out-dated. By contrast, the cost of self-regulation is relatively small so as to make possible a frequent review of the whole system, and then keep the model up to date according to the changing circumstances of the business world.[66]

Finally, even if law-makers can be responsive to the cries of the public and community in time, it is questionable whether it is possible to make a well-conceived and straightforward legal bill in a short time.[67] Unlike uncomfortable shoes which you can throw away at any time, it is never easy to get rid of unreasonable legislation.[68] Self-regulation, nevertheless, has little risk of this problem. In nature, self-regulation is modest reform, not so ambitious as law-making generally strives to

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[66] By comparison, dramatic regulatory interventions by lawmakers have only stepped in after a major scandal produced public outrage. See David A. Skeel, *supra*. note 53, at 156; See also Larry E. Ribstein, *Bubble Laws*, 40 Hous. L. Rev. 77 (2003) ("Constituents and politicians panic when scandals dominate the press, then they become overly complacent in times when few corporate scandals have received recent attention.")

[67] It was suggested by historical evidence that "crisis legislation comes with no guarantee". See David A. Skeel, *supra*. note 51, at 169-172. See also Roberta Romano, *supra.* note 1 (implicating that the Sarbanes-Oxley Act is an example of poorly-considered legislating in the immediate aftermath of a public scandal or crisis, unable to resolve the ills of the market).

[68] For example, the Sarbanes-Oxley Act, the landmark of modern codification, has been under a serious attack on the basis of the cost it imposed on business, placing American corporations at a competitive disadvantage with foreign firms and driving businesses out of the United States. See Henry N. Butler & Larry E. Ribstein, *The Sarbanes-Oxley Debacle: What We've Learned; How to Fix It* (Jun. 2006), available at: http://ssrn.com/abstract=911277; Peter Iliev, *The Effect of SOX Section 404: Costs, Earnings Quality and Stock Prices* (May 2007), available at: http://ssrn.com/abstract=983772. See also Nathan Wilda, *David Pays for Goliath's Mistakes: The Costy Effect Sarbanes-Oxley Has on Small Companies,* 38 J. Marshall L. Rev. 671 (2004); Ginger Carroll, *Thinking Small: Adjusting Regulatory Burdens Incurred by Small Public Companies Seeking to Comply with the Sarbanes-Oxley Act*, 58 Ala. L. Rev. 443 (2006-2007). But *cf.* Robert Prentice, *Sarbanes-Oxley: The Evidence Regarding the Impact of SOX 404*, 29 Cardozo L. Rev. 703 (2007-2008).

And the criticism also came from Congress, such as congressman Ron Paul who contended that SOX was an unnecessary and costly government intrusion into corporate management. In an April 14, 2005 speech before the U.S. House of Representatives, Paul stated, "These regulations are damaging American capital markets by providing an incentive for small US firms and foreign firms to deregister from US stock exchanges. According to a study by the prestigious Wharton Business School, the number of American companies deregistering from public stock exchanges nearly tripled during the year after Sarbanes-Oxley became law, while the New York Stock Exchange had only 10 new foreign listings in all of 2004. The reluctance of small businesses and foreign firms to register on American stock exchanges is easily understood when one considers the costs Sarbanes-Oxley imposes on businesses. According to a survey by Korn/Ferry International, Sarbanes-Oxley cost Fortune 500 companies an average of $5.1 million in compliance expenses in 2004, while a study by the law firm of Foley and Lardner found the Act increased costs associated with being a publicly held company by 130 percent." The speech is available at http://www.house.gov/paul/congrec/congrec2005/cr041405.htm

be.[69] Self regulation is more acceptable to the business community so as to avoid being a thorn in the industry's side.

2.2.4 Conclusion

All in all, any proposal of codification must carefully consider the balance between its limits and probable benefits, i.e. in what direction might the law influence business practice. If specific legislation cannot induce a more obvious improvement than the recommendations and principles embodied in the self-regulation regime, codification might lead to no more than just a little deterrence and promoted awareness. Simultaneously, the cost of inflexibility and the risk of poorly structured statute might in practice outweigh any such benefits. At the end of the day, it may be business industry and society in general that bears any negative impacts of codification. Certainly, such a result is not what the public wants in the first place.

3. A Hybrid Model: The Combination of Self-Regulation and Public Control

3.1 "A Haven for Self-Regulation" to a Hybrid Model

As in the words of one writer, Britain has long appeared to be "something of a haven for self-regulation" for a wide range of activities including securities market and corporate governance.[70] The necessity of self-regulation usually arises in the case of market failure where external intervention is demanded but conventional public regulation is deemed a costly method of solving the problem.[71] Self-regulation enjoys certain advantages over public regulation as the costs for the formulation and

[69] Larry E. Ribstein, *supra.* note 65.
[70] R. Baggot, *Regulatory Reform in Britain: The Changing Face of Self-Regulation*, 67 Pub. Amin. 435(1989), at 438.
[71] Anthony Ogus, *Rethinking Self-Regulation*, 15 Oxford J. Legal Stud. 97 (1995).

interpretation of standards are lower because of a greater degree of expertise and knowledge of practices within the relevant area than authority agencies. In addition, there are savings in costs of timely amending rules, and administrative costs can be internalized in the market activity rather than relying on huge public funding borne by taxpayers.[72] Thus in the modern commercial environment and powerful capital market, it is obvious that market-based regulatory solutions are playing an important role. It is said that market-based self-regulation "has become the primary mechanism for the allocation of resources. As a result, the participants in the market have become holders of power and agents of governance".[73]

However, "a heaven of self-regulation" does not mean that public control plays no role. It is better to bear in mind that market-based self-regulation and certain public regulation are in nature compatible and interdependent, and it is simply not sensible to rule out one from the other.[74] To clearly understand the potential in the combination of self-regulation and public intervention, it is necessary to first briefly describe how the self-regulation regime is enforced in UK as an example:[75]

> Corporate governance here usually achieves its aims through the use and prevalence of Code on Corporate Governance. Such Codes were, in the beginning, especially private sector initiatives, responding to both private and public concerns, as well as to the risk of government intervention in outstanding questions of corporate governance. Enforcement of the Code was left to market regulators, first to the private body (the London Stock Exchange) and later, to a state agency (the United Kingdom Listing Authority).[76]

[72] *Ibid.* at 97-98.
[73] R.M. Lastra & H. Shams, *Public Accountability in the Financial Sector*, in E.V. Ferran & C.E. Goodhart, *Regulating Financial Services and Markets in the Twenty-First Century* (Hart Publishing, 2001), at 165.
[74] B.R. Cheffins, *History and the Global Corporate Governance Revolution: The UK Perspective* (Mar. 2001), available at: http://ssrn.com/abstract=262805.
[75] Richard C. Nolan, supra. note 1, at 370-371. In 1970s, the SEC's in US also proposed a prospective of "voluntary" action (close to the regime mode of self-regulation). See Homer Kripke, *The SEC, Corporate Governance, and the Real Issues*, 36 Bus. Law. 173 (1980-1981), at 189-102.
[76] The transfer of function was made by the Official Listing of Securities (Change of Competent Authority)

> Certainly the Code is not a legislation with compulsive force. But the regulatory body set the Listing Rules with which a company listed on the London Stock Exchange must comply, and one of the obligations of the Listing Rules is that the listed company must either follow the Code or explain why not (so-called "comply or explain" rule).[77] This is the condition which a company must agree in order to be traded on the stock market.[78] And failed to comply with the Rules may also lead to painful result. Statutory powers had been authorized to the Listing Authority to enforce the Rules:[79] (1) power to suspend or expel shares from trading;[80] (2) power to publish non-compliance (so called "name and sham");[81] (3) power to fine a non-compliant company;[82] (4) power to fine a director of such a company.[83] Thus, the creation and enforcement of codes of corporate governance in the United Kingdom are complex mixture of private and public action. There is, nevertheless, a clear trend of greater state involvement over time.

Therefore, we now witness a governance regime by administrative bodies, such as the SEC, DTI and UKLA (the United Kingdom Listing Authority), under the authority of certain legislations, with certain powers to regulate corporate governance, responding to both private and public concerns. The methods of investigation and civil action of these government agencies have been some of the main weapons to target inappropriate behaviour in the market. The stock exchanges and also individual companies trading on the securities markets all know that their activities are under the scrutiny of these supervisory bodies. On the other hand, since general legislation may be too inflexible and costly, the task of proposing and reviewing

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Regulation 2000.
[77] Listing Rules, r. 12.43.
[78] *Ibid.* r. 1.1.
[79] See Financial Services and Markets Act 2000, s. 77, 78, 91-94; Listing Rules, r. 1.15, 1.19, 1.8, 1.9.
[80] Listing Rules, rr. 1.15, 1.19.
[81] *Ibid.* r. 1.15.
[82] *Ibid.* r. 1.8.
[83] *Ibid.* r. 1.9.

specially designed rules applied in the market might be the function for a government agency, rather than Congress or Parliament. These organisations often placed the pressure of reform on industry, through the way of making relevant rules, or more informally, some “recommendation”.[84] It is suggested that, in fact, stress from government agencies provides the major impetus to self-regulation.[85] Additionally in some situations, these specific organisations are even the main proposer and advocator of corporate governance reforms. For example, the SEC has long been a firm backer of the notion of “independent outside directors”.[86] The hand of the DTI can easily be found behind all three important Reports on corporate governance in the UK. The effort of government agencies should ensure that self-regulation is not merely a tricky game by businessmen to blur the argument about corporate problems, or just a self-serving program for the interest of the companies.

As observed above, it is found that the corporate governance regime has long been under a mixed system where market-based self-regulation and public regulation are combined as complex and hybrid regulatory tools.[87] In fact, in some situations, there is no clear dividing line between regulation by the market and regulation by the state.[88] A significant part of self-regulatory rules and codes were private sector initiatives, and on the other hand, the state provided legal backing, by supplying

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[84] The previous Combined Code and new Corporate Governance Code made by the Financial Reporting Council, absorbing most proposals of governmental reports (Cadbury and Hampel Reports, and Higgs Review) are “soft law” designed to influence the corporate governance system of industry. In America, the Securities and Exchange Commission, under the authorization of the Securities Act, is the federal agency empowered to make rules to regulate the stock market.

[85] It should be noticed that “although they (those ‘recommendations’, ‘best practice’ and stock market rules) are not mandates, because no legislature or court actually requires them, they are good models and one may defy them with some peril. If a corporation gets into trouble, one can say, ‘If they had an auditing committee, or a nominating committee, or outside directors, or had they performed in a truly monitory manner, these things wouldn't have happened,’ … That is progress.” See Donald E. Schwartz, *Genesis: Panel Response*, 8 Caedozo L. Rev. 687 (1987), at 690.

[86] Since the 1970s, The Commission had come to rely on outside directors to promote some of its own regulatory objectives. Both then chairman of the SEC, Roderick Hills, and his successor, Harold Williams, are the supporters of independent outside directors. Williams made explicit his program for reforming the Board of Directors: The directors should all, except only the chief executive officer (CEO), be independent of management, i.e., not officers or employees and not "suppliers" like bankers and lawyers. The CEO should not be the chairman of the board, so that he should not control the board's agenda. See Harold M. Williams, *Corporate Accountability and Corporate Power* (Oct. 24, 1979) (a paper presented at the Fairless Lecture Series, Carnegie-Mellon University, Pittsburgh).

[87] Eilis Ferran, *supra.* note 55.

[88] A.C. Page, *Self-Regulation: The Constitutional Dimension*, 49 Mod. L. Rev. 141 (1986).

enforcement mechanisms that market-based self-regulation might otherwise be lacking.[89] Such an arrangement makes the combination of self-regulation and public control possible.

3.2 The Reasons for a Hybrid Model

Why has the corporate governance system traditionally relied on a hybrid form of regulation, rather than leaving everything to be decided by the market alone? It is certainly because the feature of public control has certain advantages in shaping the system of corporate governance.

While we argued that complete public control was not realistically capable of resolving all inherent problems in the market, it is also unsafe to solely rely on self-reform by the industry alone.[90] As is the order of nature, any course of evolution is not very fast and acute, especially when the dominant force of transformation is by the people whose interest would be affected by such evolution.[91] It is unlikely that in general executives of the top would be willingly to voluntarily call for the introduction of a system which restricts their own performance. In most situations, uncontrolled powers would generally be favoured by those in control of large companies, and frequently, resistance against monitoring would occur in the business community.[92] As some writers have mused, self-regulation would become no more than a smart mask worn to cover up the depravity in the companies, and the inclusion

[89] *Ibid.*, at 382. See also J. Parkinson, *Evolution and Policy in Company Law: The Non-executive Directors*, in J. Parkinson, S. Gamble and G. Kelly, *The Political Economy of the Company* (Hart Publishing, 2000), at 261.

[90] Frank B. Cross & Robert A. Prentice, *The Economic Value of Securities Regulation*, 28 Cardozo L. Rev. 333 (2006-2007).

[91] Some evidence can be gleaned from the empirical research, which reported that the stock exchange itself was very reluctant to impose meaningful disclosure requirements on its member firms and did so only under "intense governmental pressure". See Allen Ferrell, *The Case for Mandatory Disclosure in Securities Regulation Around the World* (Sept. 2004), available at http://ssrn.com/abstract=631221, at 29, 34; Jonathan R. Macey & Maureen O'Hara, *Markets to Venues: Securities Regulation in an Evolving World*, 58 Stan. L. Rev. 563 (2005-2006), at 578-580 .

[92] Management has traditionally been reluctant to share its authority, and tried to minimize the role of board in corporate governance. See J. Bacon & J. Brown, *Corporate Directorship Practices: Role, Selection and Legal Status of the Board* (Conference Board, 1975), at p.6-12. See also Myles L. Mace, *Directors: Myth and Reality* (Harvard University, 1971).

of independent directors might simply be seen as a way to invite their associates into the boardroom.[93] It is thus hard to comment that a self-regulation system entirely on the industry's own initiative may ultimately achieve the goal of building up a responsible corporate governance system, which is in accordance with the general desire of the investors or, broadly, the whole community.[94] Unless there is strong pressure imposed upon them, directors are more apt to do the least they can, or even refuse to accept any changes to their behaviour.

Historical lessons might also prove that the real force to push for directors to rethink their roles, under most circumstances, emanates from the outside world, for example, pressure by government agencies or the cries of the public. In the *Ensnared Shareholder*, Rubner noted that:

> "No less important in our days is the taming of the company beast by the financial press and the stockholders' organisations. These rarely unveil breaches of the Companies Acts, but – playing upon the sensitiveness of the managerial oligarchy – castigate directors' behaviour as "unfair" or "improper". These, of course, are social evaluations which have no basis in law and yet may prove as effective in restraining directors as an official warning from the SEC or the Board of Trade."[95]

More importantly, in facing with new challenges within the market, there is an increasing demand and necessity of reforming. The feature of public control of the hybrid model may allow market regulators to duly step in and initiate proposals, rather than dogmatically waiting the industry to work out plans by itself (as discussed above, it has been seen that directors are usually hesitated to call for a radical

[93] Victor Brudney, *The Independent Director – Heavenly City or Potemkin Village?* 95 Harv. L. Rev. 597 (1981-1982). See also A.C. Page, *supra.* note 88, at 163; Eilis Ferran, *supra.* note 55, at 402-403.
[94] J. Fishman, *A Comparison of Enforcement of Securities Law Violations in the UK and US*, 14 Co. Law 163 (1993).
[95] Alex Rubner, *The Ensnared Shareholder* (Macmillan, 1965), p. 21.

change). For example, in this crisis year of Credit Crunch, the Financial Reporting Council (FRC), a regulatory agency in the UK, is keen on leading a new reform in response to the financial crisis. After carrying out a review of the impact and implementation of the Combined Code of 2008,[96] the FRC launched a consultation on its proposals to reform the UK's Corporate Governance Code.[97] In the words of its press notice, the FRC firmly declared its intention to "take into account those lessons of the recent financial crisis that are relevant to all companies" so as to ensure the Code to reflect changing governance concerns and practices and economic circumstances. In one sense, this might show that regulatory intervention can be a prompt momentum to put corporate governance reform forward.[98]

3.3 A Hybrid Model and Board Independence

In the area of shaping the system of board independence, the author suggests that a hybrid model is perfect for this purpose. First of all, unlike rules of reporting and accounting standards, which are primarily placed on a basis of mandatory requirements and legal obligations, the system of board independence is on a more complicated ground. Board independence is not merely a minimum standard that listed companies should normally make at least half of board members financially independent, but it emphasized the characteristic of "best practices", i.e. independent mind, diligence, willingness to be active, a critical attitude and objective judgement. All these factors mean a goal which rules are encouraging and expecting, rather than requiring. It is hard to see how traditional law-making, in simply setting out general principles at minimum standards, can match this goal. Moreover, it is necessary to

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[96] 2009 Review of the Combined Code: Final Report, December 2009, available at: http://www.frc.org.uk/images/uploaded/documents/2009%20Review%20of%20the%20Combined%20Code%20Final%20Report.pdf

[97] Consultation on the Revised UK Corporate Governance Code, December 2009, available at: http://www.frc.org.uk/images/uploaded/documents/Consultation%20on%20the%20Revised%20Corporate%20Governance%20Code.pdf

[98] FRC launches proposed reforms to the UK Corporate Governance Code, , FRC PN 287, 01 December 2009, available at: http://www.frc.org.uk/press/pub2175.html

note that board independence is more about "business culture". As analysed above, a self-regulation approach is the preferable method than tough laws alone to achieve the aim of influencing the culture toward a bright direction. Primarily sharing features of self-regulation, a hybrid model is capable of fulfilling these roles of promoting "best practices" and heralding culture-change.

On the other hand, the nature of reform of board independence does request certain public control on the front line. It is sensitive that board independence is a progress affecting boardroom dynamic. As long as the agenda of reform is at the hand of industry itself, there is a risk that directors would like to stand on the status quo and be reluctant to consistent review on the system. This carries a side effect that supply of reform might run behind demand. In order to break this "inertia", flesh impetus, i.e. public control, should be injected into the program. Regulatory agencies can be a leading force in initiating proposals of improving efficiency of board independence. Moreover, a general principle that the Code itself is subject to periodic reviews by the FRC can effectively put the reform of board independence on a more continuous and regular basis so that provisions can be updated in due course. Thus a hybrid model, emanating advantages of public control, is certainly fit for such a purpose.

It has been seen that a hybrid model can offer benefits of both self-regulation and public control. However, a further question might be how to strike a reasonable balance between these two approaches. Should the system be more regulatory-orientated? Or should it stay on the favour to self-regulation? Traditionally, the latter, i.e. an inclination to market discipline and self-correction, seems to be a popular view and regulators in the UK used to believe in the efficiency of self-regulation.[99] Nevertheless, such a philosophy encounters an unprecedented

[99] Such a market-based regulatory belief was implicitly confessed in the Turner Review, made by the FSA in response to the global banking crisis. See para. 2.7(1). Although it is worth noting that this Review only discussed about the FSA's past approach in regulating banking sector, this attitude may still represent the general philosophy of British regulators in dealing with issues of corporate governance.

financial crisis, which indicates, at least, the mishap of regulatory approach in preventing and controlling market risks. In such a circumstance, there appears to be an implicit signal that regulators would like to promote their profile in shaping the system of corporate governance.[100] Regulators are intended to deepen their involvement in evaluating efficiency and contribution of independence directors against the backdrop of current crisis. The publication of the Walker Review,[101] the review on the Combined Code and the achievement of the new Code all suggest that regulators are taking a more active attitude to review the system of board independence, and regulatory forces are raising within the hybrid model. It is not exactly unambiguous whether this change of pendulum would lead the system to a primarily regulatory-based state, or whether it would be the herald of making a tough rule for independent directors. But in the near future, as long as the system of board independence is retained in the regime of "best practices" in the Code, it is hard to foresee a radical change of internal dynamic in this hybrid model. Perhaps now regulators may prefer to more closely watch the effort of industry in striving to catch up with "good corporate governance", and give some pushes if the industry failed to keep up with the expectation of progress. However, there is still no signal of swinging to a dogmatic strategy of whipping all companies into the corral of "board independence" by using hard laws or regulations.[102]

4. Conclusion

In the above parts of the chapter, it was explored that, although enacting new legislation is attractive for most legislators and the public, codification is rarely a

[100] Such a strategy can also be reflected in the ambition of the Tuner Review, which suggested that the FSA should adopt a more systematic and consistent regulatory approach.
[101] *A review of corporate governance in UK banks and other financial industry entities: Final recommendations*, 26 November 2009 (a report partly reviewing the performance of non-executive directors in financial industry).
[102] At least, this philosophy has long been ensured by the Code itself that the purpose of the Code is to encourage voluntary compliance, rather than compulsorily force compliance like what a Regulation or Rule does. See the Corporate Governance Code 2010, Preamble 2: "The Code is not a rigid set of rules. Rather, it is a guide to the components of good board practice distilled from consultation and widespread experience over many years."

perfectly rational idea in shaping the system of independent directors. By contrast, self-regulation can retain many positive momentum of reform. However, the author suggests that the self-regulation system must remain under the scrutiny of certain external forces, in order to guarantee the proper orientation of reform. This direction should emanate from government agencies and also be in accordance with the demands and understanding of industry. Such an arrangement is not to replace the central role of the market in breaking the path of development of independent directors, but more accurately, to act as a supporter and guider. Government agencies should encourage industry to insist on the usage of those directors for improving the corporate governance system, rather than introduce an indistinctive "one fits all" rule and force all different companies to adopt an inflexible standard.[103] They should direct the basic principle applied to the independent directors, but allow industry and companies to decide what is most advisable to meet their own demands and ensure that their practice is within the proper guiding principles set forth. This combined form of self-regulation and government direction offers the benefit of flexibility and self-motion from the former, and on the other hand, the advantage of mandatory force and external oversight from the latter. Consequently, a hybrid regulatory model is more preferable than codification in shaping the future of board independence.[104]

[103] See William B. Chandler III & Leo E. Strine, Jr., *supra.* note 16.

[104] However, we should be cautious: promoting self-regulation in the area of independent directors does not mean that stricter intervention by governmental regulation is not necessary in other areas. The author shares the view that, in certain issues pertaining to the market, such as anti-fraud controls and information disclosure, the regulatory rules should be tightened and the authorities should play a more active role, especially when current systematic financial crisis has imposed significant questions upon the little activism of authorities. See Jonathan R. Macey & Maureen O'Hara, *supra.* note 91 ("We propose that a better structure for securities regulation would allocate to firms decisions regarding the internal operations of securities trading and assign to the SEC decisions relating to the overall market. Thus, regulation of listing and delisting, which define access to the U.S. capital markets, are better handled by the SEC, while decisions regarding trading system capacity are handled more effectively by the market itself. We also would transfer oversight and monitoring of trading practices to the SEC, reflecting our belief that the incentives of exchanges are not compatible with the policing of these activities.")

CHAPTER THREE

THE ROLE OF INDEPENDENT DIRECTORS IN CORPORATE GOVERNANCE

After the discussion in the above chapters, we have realized how the government tried to exert an influence on the industry's understanding about corporate governance. Three governmental reports, i.e. the Cadbury Report, Hampel Report and Higgs Review, intended to impress the value of independent non-executive directors on publicly held companies, and persuade them of the necessity of reforming their boards. Certainly, to a certain extent, the government did achieve its agenda, as the proportion of non-executive directors has been rising and, at least ostensibly, the board has become more independent than was the practice in the past. However, due to the restriction of their length, these reports could only put forward their conclusions with limited in-depth exploration. It was hard for them to bring all relevant details into the papers. Thus there was little general and systematic analysis about how exactly the multiple roles of directors should be played and why non-executive directors, who are encouraged to be independent, should take these responsibilities.

In response to this problem, it is now the right time for us to return to academic research to look for answers. It is essential to go in to particulars of theories relating to the material role and function of the board and its independent directors. In this chapter, the author will begin with an examination of the general function of the board of directors in corporate operations,[105] and then examine the role of independent directors by comparison with the board's work. It is important to check

[105] By insisting on the unitary board structure in the UK legal system, it has been emphasized many times that both insiders and independent directors are equally seen to be members of the board, and therefore, any investigation of their role should be naturally included in an analysis of the general function of the board.

to what extent these directors take part in various key functions of the board, and why they are capable of playing an effective part in all such matters. After these analyses, it may be straightforward for us to have a clear and proper perspective of the topic.

1. The Functions of the Board and its Independent Directors

Before referring to the role of the specific group of independent directors, the board as a whole should be the starting point of the study. In modern corporate governance development, an undeniable trend is that, the board, as the head of company, is required to play a more important and active role. It is believed that "the expansion of the board's role increases the demands on directors' time, on their need for information about and in education in the business, and on their level of 'professionalism'".[106] Thus directorships nowadays leave no room for "amateurs". Given this fact, it is thus an important subject of this chapter to respectively review the contribution of the board on corporate governance.

In modern companies, especially large enterprises of enormous capital size, it might be rare case for the board to play one simple role. On the contrary, its functions could normally be very complicated and multifaceted. The board may commonly assume different jobs in diverse kinds of companies, and it is not unusual that, even in the same company, the board would not play the same role in every stage of its growth. For example, the working style of the board when the company is on the high speed of development is extremely dissimilar from that on the moment of corporate financial crisis. In the former case, the board is definitely under less pressure and more inclined to leave significant discretion to management. Therefore, it would probably not adopt a very proactive approach to the company's affairs and it is very

[106] Ira M. Millstein, *The Professional Board*, 50 Bus. Law. 1427 (1995), at 1428.

likely that the performance and influence of the board would be difficult to perceive. By contrast, the circumstance of the latter is the reverse. When the company was in financial difficulties, the board would perhaps frequently be required to take an aggressive and active attitude to interfere with the company's operation. In order to rescue the company or lead it back onto the right track, the board may have to use its power to remove the management, when it is deemed that it cannot meet its expectations. If necessary, the board may even replace the management as the primary organisation with responsibility for the corporation's business. However, despite the complexity and variety of board functions, it is still possible for us to summarize the board's roles into three parts: the oversight role, the advisory role and the relational role.

1.1 The Managerial Role: A Myth for Modern Board

First of all, it is very frequently assumed that the board should manage the company if there is no contrary provision set out in the constitution of the company. This notion can be traced in many publications, as a form of common sense recorded by the writers.[107] Certainly, the implication is in part due to the provision of the *Draft Model Articles of Association for Public Companies*,[108] a default standard form of articles of company, suggesting that directors should "shall manage the company's business", subject to the Companies Acts and the articles.[109] Despite the fact that the law in fact reserves the ground of flexibility, and some writers also try to remind

[107] See Janet Dine, *Company Law* 5th e.d.n. (Palgrave Macmillan, 2005), p.152-153; Brian R. Cheffins, *Company Law: Theory, Structure, and Operation* (Clarendon Press, 1997), p.39, 95; John H. Farrar & Brenda Hannigan, *Farrar's Company Law* 4th e.d.n. (Butterworths, 1998), p.304, 329; J. E. Parkinson, *Corporate Power and Responsibility: Issues in the Theory of Company Law* (Clarendon Press, 1993), p.56.

[108] Article 2(a).

[109] A similar statement can also be found in the Model Business Corporation Act, made by American Bar Association, before the revision of 1974, which required that "the business and the affairs of a corporation shall be managed by a board of directors." Now, the provision, §8.01, of the new version of Model Business Corporation Act in US now provides that " All corporate powers shall be exercised by or under the authority of the board of directors of the corporation, and the business and affairs of the corporation shall be managed by or under the direction, and subject to the oversight, of its board of directors, " See Committee on Corporation Laws of the American Bar Association, Model Business Corporations Act with Revisions Through 1974, Addendum B at 139. Delaware's General Corporation law was similarly amended in 1974. See DEL. CODE ANN. Tit. 8, § 141(a) (Supp. 1977).

readers that in practice managerial power will often be devolved to groups or individuals below board level,[110] it seems to be a trite mark that the board is the managing "brain" in control of all material conducts of a company.

However, unfortunately, modern academic studies found little evidence to support the view that, especially in large publicly held corporations, the board has been effectively adopting such a managerial position. As early as the 1930s, it was disclosed by William Douglas that the laziness and passivity of the board had reached an extremely unacceptable end where some directors paid little attention to the corporate operation and completely allowed themselves to be the marionette of the executives and senior management.[111] In 1945, it was the finding of Robert Gordon that in many large American corporations, the boards were in fact in a dispensable role. There was little or no indication that the boards of large companies managed on either specific or broad policies in relation to financial and non-financial matters.[112] In most cases, the boards merely amounted to an organisation for approving the decisions of management, being deprived of the function of initiating any corporate policy. It was also found that "even with respect to approval, many boards in these large companies are almost completely passive", and that the final approval function was usually exercised by the chief executive with informal advice from some executive directors or senior managers.[113] Even later in the 1970s, the unsatisfactory performance of the board continued apace. Professor Mace reported that the boards in general did little in the way of business-running. Usually, the board may tend to serve as the source of behind-the-scenes counsel to the Chief Executive or merely exert some sort of "discipline".[114] It seems to be self-evident to conclude that, in modern corporate governance, the boards of large publicly held corporations

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[110] See B Pettet, *Company Law* 2nd e.d.n. (Longman Law Series, 2005), p. 147; Brian R. Cheffins, *supra.* note 3, p.95-96.

[111] William O. Douglas, *Directors Who Do Not Direct*, 47 Harv. L. Rev. (1933-1934).

[112] R. A. Gordon, *Business Leadership in the Large Corporation* 2nd e.d.n. (University of California Press, 1961), p.128-129.

[113] *Ibid*. p.131.

[114] Myles L. Mace, *Directors: Myth and Reality* (Harvard University, 1971), p. 13, 43.

rarely, if ever, performed the management function.[115]

Actually, it is not difficult to understand why the board of directors became increasingly unable to carry out management functions of large companies. While, for the sake of maintaining satisfactory financial growth, a company may have to employ thousands of employees and expand its business to a broad market, it is nearly impossible to suggest that the board can by itself resolve all issues, no matter how important or insignificant, derived from the corporate operation. It may have no choice but to authorize certain individuals as responsible for the everyday running of the business, who are usually not at the board level. Corporate operating procedure is pyramidal in form: at the base are the employees in the office or factory, whose jobs are to work under the instruction of junior managers of departments; at the next level are the senior managers in charge of difference divisions or branch, who normally are selected by the board or Chief executive, and empowered to arrange the daily affairs of specific parts of corporate management; and at the pyramid's apex is the corps of officers, who "have some discretion but in general are deemed to execute policies formulated by the board." [116] In most circumstances, directors do not and cannot directly manage or discipline all junior managers and staff; the senior managers carry out this function and take judgements in this sense on their own.[117] Thus the board, as the head of company, can only influence this corporate system by considering the most important policies and then sending its voice downwards to the senior managerial level below.

Nevertheless, even as the top body in the corporate hierarchy, the board is rarely able to fulfil its roles entirely.[118] The executive directors in the board, who are the

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[115] Melvin A. Eisenberg, *The Board of Directors and Internal Control*, 19 Cardozo L. Rev. 237 (1997).
[116] J. Baker, *Directors and Their Functions: A Preliminary Study* (Boston, 1946), p.12; R. A. Gordon, *supra* note 8, p.79-90.
[117] M. A. Eisenberg, *The Mordenisation of Corporate Law: An Essay for Bill Cary,* 37 U. Miami L. Rev. 187 (1983), at 204
[118] Ira M. Millstein, *supra.* note 2, at 1435.

insiders of the company and commonly take the position of senior management, are normally the main protagonists in setting up the company's policies, because they are usually business professionals with great experience and are more familiar with the circumstance of the company. Their knowledge and skill give them good credit in shaping the policies of the company. Thus it became more likely that many business decisions were made through in-house discussion within the management team, and then ritualistically ratified by the full board just as a formality to meet procedural requirements.[119] John C. Baker found that major corporate policies were usually formulated by the executives and not even formally discussed in the board meeting, and sometimes the board would only receive the after-the-fact reports for consideration.[120] The natural reluctance to share its authority has also encouraged the management to minimize the board's participation in corporate governance,[121] with the board of directors often reduced to an "impotent ceremonial and legal fiction" only for the sake of appearances and to satisfy the requirements of the Companies Acts and the company's articles.[122]

The impotence of the board has been observed by both academic theories and empirical findings. Certainly, the board has difficulty managing the business of the company in the broad sense. However, it is interesting to see how such a conclusion could be compatible with the suggestion by the Higgs Review that the board is collectively responsible for the direction and leadership of the company.[123] Are the terms "direction" and "leadership" synonymous with "management"? Ostensibly, there seems to be little difference between all these words. But in a proper understanding, the author does not agree that the implication of the Higgs Review should refer to a management role of the board. The meaning of "management" is

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[119] R. A. Gordon, *supra.* note 8, p.116-146.
[120] J. Baker, *supra* note 12, p.131-132.
[121] J. Bacon & J. Brown, *Corporate Directorship Practices: Role, Selection and Legal Status of the Board* (Conference Board, 1973), p. 6, 10, 12.
[122] P. L. Davies, *Employee Representation on Company Boards and Participation in Corporate Planning*, 38 Mod. L. Rev. 254 (1975), at 263; Drucker, *The Bored Board*, 1 Wharton Magazine 19 (1976).
[123] Higgs Review, Suggestion Code principle A.1 and provision A.1.1.

more properly seen as controlling the company's affairs on a continuous basis. The board, nevertheless, cannot provide such a service, because all members may only gather together for meetings several times a year. By contrast, the term "leadership" suggests a position of superiority within an institution and an ultimate control on business. In other words, the board is the top internal body holding power above the management. Such a control, through "leadership", should be appropriately regarded as the function of monitoring, which will be discussed below.[124] As for the suggestion of "direction", there is a slight difference from the sense of "management". While "management" gives emphasis to actions as "doers", "direction" appears to be more like guidance as "advisors". In this sense, the board is to be counsel of setting the company's strategy and making important decisions. This role is recorded as the advisory function, being explored in the later part of this chapter.

1.2 The Oversight Role: An Undeniable Job of the Board and its Independent Directors

Obviously, to a great extent, it is not possible for the managerial role to be the main responsibility of the board. Corporate management must be based on a daily and continuous ground so that major policies and decisions can be properly reviewed and modified in due course to meet realities and market changes. The board thus might only play a very limited, though not wholly useless, role in the business-running, particularly in large companies. However, this fact does not amount to a conclusion that the board cannot have any influence on the operations of the company. There might be some functions other than management which are entirely fitted for the board. For a long time, writers have been arguing that the board should be expected to fulfil the oversight or supervision role in corporate governance. Although the

[124] In fact, the Higgs Review also took this view, by suggesting that leadership should be provided "within a framework of prudent and effective controls which enable risk to be assessed and managed". See *Ibid.*

board, on the one hand, has come to be deprived of the capacity to manage the corporate business, its role might be, on the other hand, stressed in another way and have a different focus. The board, as the head of company, should keep an eye on the performance of the executives and senior managers.

Certainly, this oversight role is not a new concept unknown to law and business practice. In the words of Lopes L.J, the board of directors can act as "watchdog or bloodhounds".[125] This role is implied by the law in many instances, for example, it is required by Companies Act that certain transactions and actions must be reviewed and then approved by the resolution of directors.[126] Therefore, even if the board is not the body to formulate company's policy, it still gets the chance to oversee the proposals from management, and no further movement is allowed to be taken unless the board accepts the opinions of executives or senior managers and nods its head in agreement. In this way, the management is under scrutiny and cannot run the company wholly at its pleasure.

1.2.1 Why is Monitoring Important in Corporate Governance?

First of all, it is important to start the analysis by wondering why the monitoring should have its necessary place in the regime of corporate governance. In any case, double-check would be redundant if the monitoring could be automatically internalized within the smooth running of business. For a sole trader, there is no need to institutionalize an extra internal body to keep an eye on the management, because the business owner would certainly take care of his business.[127] But for the corporate

[125] *Re Kingston Cotton Mill Co.* (No. 2) [1896] 2 Ch. 279, at 288.

[126] *E.g.* s.175 of Companies Act 2006, in dealing with directors' duty avoid conflicts of interest, the involved director might need to get proper authorisation by the board of directors.

[127] Of course, in the external spectrum, there are still a number of parties who would carefully review the performance of those sore traders. For example, creditors may worry about whether interest and principal debt will be paid on schedule, and thus have an incentive to observe the behaviours and financial status of the debtor. Tax departments, e.g. HM Revenue & Customs, have to ensure that correct tax is paid at the right time, and thus may keep an eye on the acts of business traders.

form, it is a different story. In order to properly understand this argument, it is helpful to begin the discussion by examining the comparison between bond holders and shareholders. Suppose that a firm is seeking to finance itself from the market, there are usually two ways of doing so: by issuing debentures or new stocks. By buying those bonds, the holders fund the company and at the same time acquire certain legal rights as conditions. In the event of failing to meet repayments on schedule, debt-holders will exercise preemptive claims against the assets in question. In the case of liquidation, debt-holders will then realize recovery in the degree to which the assets of the company still remains. Based on these instruments, the bond holders get a protection on their interest. Thus normally, the law does not award them any additional default power of interfering with the management of the company.

By contrast, the use of equity as an alternative financial instrument leads to a different mode of governance. Compared with debt-holders, the property rights of shareholders are relatively in a position of lower priority. The equity holders only have a residual claim right to the firm in both earnings and asset-liquidation respects. There is no schedule for the company to repay shareholders, which means that they cannot "cash in" their investment unless they sell their stocks to someone else. Such an arrangement normally puts shareholders in a disadvantageous position. The only possibility that shareholders can get a better investment return than debt-holders is that, the company turns in a good business performance and earns a lovely profit. A good performance usually means a mounting up of stock price, which gives shareholders a great chance to realize the value of their investment; and a great earning means a considerable dividend, although we must bear in mind that the company is not compulsively required by the law to share its profit with shareholders. When such gains are on a higher level than returns of debentures, investors would certainly show more interest in purchasing stocks. However, shareholders understand that the good performance of the company may normally result from good

management. As they contribute their savings to a publicly held company, there would certainly be a worry whether their money would be properly allocated and injected into profitable projects by the management, whom shareholders may have little contact with. If corporate governance repeats the model of the debenture, by suggesting no power of control, people would of course be seriously hesitant at choosing stocks as an investment instrument. Due to this reason, for the purpose of attracting equity investment,[128] the system of corporate governance has to award shareholders with more power to balance their weak status of the residual-claimant and to calm their worry. So in return, the system of corporate governance empowers shareholders to get involved in internal affairs and obtain certain control over the company. Therefore, the control power, termed "monitoring", turns to be an indispensable feature of corporate governance.

1.2.2 Why the Board is a Suitable Monitoring Body

As stated above, monitoring is important in corporate governance. Shareholders rely on this control power in many ways. A common example is that, a board of directors is created by election of shareholders, with superior authority: (a) to assess internal performance of the management on a timely basis, (b) to decide on management compensation based on their performance; (c) to replace the management if their performance is disappointing, (d) to verify financial statements of accuracy, (e) to authorize audits in depth for purposes of management integrity.[129] It is suggested that the board arises endogenously and serves as a credible instrument to review the managers' performance and reduce the risk of poor management on behalf of shareholders. In the opinion of the author, the adoption of the board of directors as a

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[128] Certainly, for the interest of the company, equity as a financial instrument has its own advantage than debenture. Because equity-based investment contracts for the duration of the life of the firm, the company bears less pressure on its finance, compared with the compulsive demand of repayment of debt. In some ways, the cost of financing by issuing stocks could be lower.

[129] Oliver E. Williamson, *Corporate Boards of Directors: In Principle and In Practice*, J.L.E. & O. 2008, 24(2), 247-272. See also Eugene Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J. L. & Econ. 301 (1983).

monitoring instrument is an essential part of "the Deal of incorporation".[130]

When the board is expected to play a role of monitoring, it is a key question for us to ask, why it is important for the board to evolve as a curb upon the power of the executives and management. If shareholders prefer to keep an ultimate control as a weapon to protect their investment, why do they not exercise this power by themselves, but rather create a body as proxy, i.e. the board of directors, to achieve the purpose of monitoring? In response to this doubt, the answer may be that, in practice, shareholders are unable to monitor. To qualify as a part of corporate governance, members of the company must act collectively in the form of the shareholders' meeting. But normally, the meetings are summoned annually and poorly attended, partly because shareholders find it hard and troublesome to travel to company meetings.[131] Furthermore, only a limited number of management's proposals will be referred to the general meeting for a vote and resolution. The range for shareholders to supervise the management is thus very limited in company law. Undoubtedly, such weak control rights are not sufficient for shareholders to timely exercise *de facto* monitoring.

In modern corporate governance, the problem of the impotence of shareholders has deteriorated because of the structural character of industries and stock markets of US and UK. Ownership structure in large publicly held companies has made the relationship uneasier between the company and its shareholders. As noted by Berle and Means in their historic work *The Modern Corporation and Private Property*, this particular structural phenomenon is known as "the separation of ownership and control". The development and prosperity of the securities market encouraged many individuals to invest their savings in the heavy buying of companies' stocks. By

[130] The meaning of "the Deal of incorporation" refers to a collective description of all agreements within shareholders, by which they contract for incorporating or investing a business.
[131] See Kenneth Midgley, *Companies and Their Shareholders: The Uneasy Relationship* (The Institute of Chartered Secretaries and Administrators, 1975); Donald B. Butcher, *Reform of the General Meetings*, in Saleem Sheikh & William Rees e.d.n., *Corporate Governance and Corporate Control* 2nd (Cavendish, 2000).

undertaking empirical research into 200 large American corporations, Berle and Means observed that, as the size and capital of companies increase, the shareholding structure became significantly diluted in the hands of tens of thousands of individual investors, who resided in different geographical locations.[132] One of consequences of this ownership deconcentration was that the influence of shareholders on business decision-making process was inevitably reduced, because none of the individuals held enough stock to comprise a majority in voting in shareholders' general meetings. Moreover, due to the great complexity of modern business and urgent demand for managerial efficiency, it was highly unlikely that a large corporation could be effectively run on a fully democracy model, i.e. general meetings of inexperienced shareholders. Thus it became reasonable to assume that the responsibility of management should be delegated to senior officers of the company, who have professional skill and knowledge to run the business in a proper way.

During this separation of ownership and control, a clear risk arose that senior management might become negligent or even commit self-serving transactions to benefit themselves at the expense of the company and its shareholders. A serious question here is how we can make sure that the management cannot easily abuse its power. As discussed above, shareholders treat ultimate control as an important condition in exchange for their monetary subscription. When the power cannot be guaranteed and the management can easily escape from control, the interest of investors in purchasing stocks would reduce.[133] Even if it has been revealed that such a control would never be exercised on a direct basis by shareholders, they do still expect the existence of some monitoring instruments to back up their confidence. However, on the other hand, although shareholders favour monitoring in mind, they rarely do anything to achieve this goal in real life. To a certain extent, shareholders

[132] Adolf Berle & Gardiner Means, *The Modern Corporation and Private Property* (Transaction, c1991).

[133] The significant slump of the stock market following the uncovering of large market scandals partly confirm the suggestion that the willingness of investors could be heavily weakened, if they doubt the integrity of the management and market.

are closed to the notion of expending their energy on advancing active monitoring. In reality, shareholders may have not enough incentive to monitor or influence the decision of management, because the expectation of most shareholders is merely to benefit from the share price difference. By following the "Wall Street rule", they can freely vote with their "feet" through selling stock and exiting the company, if the management seems unsatisfactory and the company is underperforming in the market.[134] This can be termed as "rational apathy".

Even if some individual shareholders did have the motive to challenge, they might find themselves impotent in face of the unruly management, because their shareholding is wholly inappreciable compared with the total stock of the company. While unsatisfied shareholders may try to assemble together as a group to swell their voice, the apparent difficulty is that such a coalition is never easy because in the large publicly held companies, there are thousands of shareholders widely spread in different geographical locations, often anonymous to each other and most of them are those who lack the incentive to be involved in the corporate affairs. Even if ideally, the shareholders could constitute a force against the management, company law itself provides them with only limited options to assert their interest[135]: firstly, they may be entitled to stop some of management's proposals; however, most decisions regarding the corporate operation are made at the board meeting without the necessity to be proposed on the general meeting; secondly, the shareholder can bring an action against the management if they think the conduct is not within the best interests of the company, or unfairly prejudicial to their interests,[136] but normally, it should be

[134] See Soderquist & Vecchio, *Reconciling Shareholders' Rights and Corporate Responsibility: New Guidelines for Management*, Duke L.J. 819 (1978) (suggesting that it is obvious that the average stockholder does not think of himself as a partial owner of the corporation, but as an investor free to move into and out of the corporation without loyalty, simply as a holder of an investment contract with different attributes from that of the bondholder).

[135] Sometimes, the securities law against collusion may even prohibit hinder shareholders from contacting and associating with each other. See George W. Dent, Jr., *Corporate Governance: Still Broke, No Fix in Sight*, 31 J. Corp. L. 39 (2005-2006), at 55-56.

[136] Companies Act 2006, s.994, although in practice only normally available for shareholders in private companies. See *Re Blue Arrow plc* [1987] B.C.L.C. 585.

borne in mind that legal proceedings are costly, time-consuming and uncertain. If, in the perfect assumption, shareholders did succeed in their monitoring, activist members may find that they would suffer from a new problem of "free-riding". If we supposed that the efforts of monitoring could promote the performance of the company, the result would possibly reflect an increasing of company's asset value, usually in the form of rising stock price, a benefit which can be shared by all shareholders, no matter whether they had devoted any contribution to monitoring. In other words, passive members can easily rely on the efforts of activists without doing anything. This existence of "free-riding" may certainly weaken the will of activists to monitor, leading to a circle that everyone expects the action of others, but in fact no one would take the first step. Encumbered by all these restrictions, in the circumstance of modern corporate governance, shareholders rarely take part in active monitoring in a direct basis.

Therefore, it is reasonable to conclude that the control power of shareholders has been reduced in real life. The incapacity and indifference of shareholders toward controlling management may suggest that it is not feasible to solely rely on the power of shareholders in corporate governance to review the performance of management. The solution then, though by no means a simple one, is to find a body in the company which can represent the interest of shareholders, and fulfil the role of oversight on behalf of the shareholders. The shareholders thus may rely on the work of their representatives rather than directly supervise the performance of management at every moment.[137] In other words, the oversight of management and corporate affairs in general had to be delegated to a representative group, i.e. the board of directors. Shareholders' expectation of control can thus be realized.[138] Furthermore, such a delegation may be helpful to the efficiency of monitoring.

[137] In the opinion of some writers, the board should work as the representative of investors, and then fulfil its role through appointing management and supervising their performance. See Paul W. MacAvoy & Ira M. Millstein, *The Recurrent Crisis in Corporate Governance* (Palgrave Macmillan, 2003), at p.7.
[138] Because the cost of installing a board as monitoring mechanism is paid by all shareholders, the problem of "free-riding" is also resolved.

Compared with the shareholders who may lack enough time, experience and knowledge, the board, which is more often related to the business of the company, could gain a significant advantage in all these characteristics. As the statement in the report of Department of Trade suggests, "the lesson is that a company needs a board that can be providing an independent check on its executive, that is fully and fairly informed of the group's affairs, that is in a position to monitor the actions of the executive and that, in consequence, is in a position in the event of some unexpected happening...to give shareholders an immediate and convincing account of the situation."[139] It is suggested that in some ways, the board should play a central role in the oversight and supervision.

1.2.3 The Independent Directors as Supervisor

As stated above, due to the widespread dispersion of stockholding and passivity of individual shareholders, it was claimed that the "professional" management thus actually controlled the company and came into a position with very little questioning and scrutiny.[140] Thus in theory, the board, as custodians of the interests of stockholders, would be in the position, not for the purpose of managing the enterprise, but rather with the object of supervising those who formulate the policies under which the business is to be conducted. In fact, this is not an idea difficult to understand. But why has the academy long paid little attention to the role of the board in monitoring the management? By carefully reviewing the works of many commentators, it is found that there has been a wide-spread misunderstanding among some of them, which makes commentators downplay the role of the board. A number of studies did not make a clear distinction between "the board" and "the management", by simply suggesting that the board is synonymous with the

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[139] Lonrho Ltd.; a report by inspectors appointed by the Department of Trade: HMSO, 1976, para 12.136

[140] A. Berle & G. Means, *The Modern Corporation and Private Property* (Harcourt, 1968), p. 110; see also Alfred D. Chandler, Jr., *The Visible Hand: The Managerial Revolution in American Business* (Harvard University Press, 1977).

management,[141] or the board is a formality body controlled by the management.[142] In this view, if management performance must be under scrutiny, the board would certainly not be a proper candidate as monitor, because the gatekeepers are in fact those who should be watched.[143]

To a certain extent, such an understanding is not totally incorrect. In the structure of the unitary board,[144] it comprises both executive and non-executive directors. Of course, the Chief Executive always has a seat in the boardroom. In some cases, he or she is also the Chairman of the company and thus the leader of the board. Senior officers of the management team may be invited onto the board, and thus be directors. To be sure, given those advantages of the management in business knowledge and information control, senior officers do sometimes have a great influence on the board's operation. However, the author suggests that some commentators make a critical error of treating the board and the management as the same. In the above discussion, we have found that, in a large corporation, it is no longer realistic for the board to manage the company on a timely basis. In most circumstances, the board delegates average managerial power to the Chief Executive and other senior officers. In this sense, as a feature of modern corporate governance, we witness not only "the

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[141] Both Berle and Means ignored the different attributes between directors and management officers in their works.

[142] See e.g. Lucian A. Bebchuk, *The Case for Increasing Shareholder Power*, 118 Harv. L. Rev. 833 (2005); Lucian A. Bebchuk & Jesse Fried, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation* (Harvard University Press, 2004); Charles M. Elson, *Director Compensation and the Management-Captured Board – The History of a Symptom and a Cure*, 50 SMU L. Rev. 127 (1996); Barry Baysinger & Robert E. Hoskisson, *The Composition of Boards of Directors and Strategic Control: Effects on Corporate Strategy*, 15 Acad. Mgmt. Rev. 72 (1990).

[143] Other than the belief that the board is comprised or controlled by the management, another opinion, which leads to some commentators' looking down on the role of the board, is that, the board is thought as having little incentive and capability to fulfil the function of monitoring. These factors would be specifically discussed later in Chapters 5 and 6.

[144] In some Continent European Countries, like German and France, the corporate governance system is a bit different from that in UK and US. The Supervision Board, acts as an internal monitoring institution and a managing board, which only comprises executive officers, takes charge of the business-running of the company. For a discussion of the European corporate governance difference relating to the one-tier and two-tier board systems, see Ruud A. I. van Frederikslust, James S. Ang & P. Sudi Sudarsanam, *Corporate Governance and Corporate Finance: A European Perspective* (Routledge, 2008); Sigurt Vitols, et al., *Corporate Governance in Large British and German Companies: Comparative Institutional Advantage or Competing for Best Practice* (Anglo-German Foundation for the Study of Industrial Society, 1997). However, any proposal for a two-tier board system to be introduced into the UK has long been firmly resisted by the academics and business alike, partly due to belief in the superiority of the British one-tier board system and the allegation of ineffectiveness of the German supervision board system. See the Hampel Report (1998) and Higgs Review (2003).

separation of ownership and control", but also "the separation of the board and the management". Thus the proposition is not well-grounded that there is no difference between the board and the management. On the other hand, even if it is a part of the fact that some boards are controlled by the management, it is still narrow-minded to believe that such a phenomenon can never be changed or improved. Efforts might certainly be made to release the board from the dominance of the management, and reform it to truly be a monitor. The author's point is not that the control of the management can easily be resolved, but only that it is too pessimistic to conclude that the board would never be able to exercise effective oversight of management.

In accordance with such an understanding, when the monitoring function of the board is to be effectively performed, then, one pre-condition must be achieved, that is, the board must be in a position of independence and objectivity so that it can undertake meaningful monitoring. In this sense, taking the control or dominance of the board away from the executive management would be the first step of this agenda. For such a purpose, it is ridiculous to expect a board to seriously play this role if the executive holds a majority of seats in the boardroom. Therefore shareholders need someone else, not a member of the insider group but with the power to partly counterweigh the influence of the management. Independent directors appear to be suitable candidates. When independent directors constitute a substantial force in the boardroom, there would be a possibility that the board could minimize any improper influence and control from the management. For this reason, the trend of increasing the independence of the board should be affirmed and encouraged. The composition of the board must ensure that certain directors, especially those independent from management, can formally and actually dominate the board membership, and that these directors should certainly play an essential role in the supervision of management.[145] Consequently, in some senses, including more independent directors

[145] Ira M. Millstein & Paul W. MacAvoy, *The Active Board of Directors and Performance of the Large Publicly Traded Corporation*, 98 Colum. L. Rev. 1283 (1998), at 1292-1293.

is naturally compatible with the board's role of supervision.[146]

1.2.4 "Strategic Monitoring" and "Management Monitoring"

In the eyes of some writers, supervision by independent directors can normally be classified into two groups: "strategic monitoring" and "management monitoring".[147] The "strategic monitoring", on the one hand, is that even if the independent directors do not formulate the policies, they should still actively participate in board meeting discussions in order to prevent any fatal mistakes in decision-making due to the cognitive biases or over-confidence of executive management. For such purposes, these directors must carefully review the grounds of argument enumerated by management before supporting the submitted proposal, and try their best to provide necessary advice for redress or improvement. In fact, there is an evident range of this "strategic monitoring" in common with the advisory role of directors, which would be discussed later, and the meaning of the two conceptions largely overlaps. It might thus be prudent to comprehensively examine this particular issue at length in the next part of this chapter, which will focus on the counsel function of independent directors in relation to the work of board. On the other hand, "management monitoring" means that in specific cases, the board or the group of independent directors might be entitled to review the decisions and conduct, previous or current, of management, and possibly take a judgement against management and force it to change its mind or behaviour. This form of supervision has long been the central topic of research in corporate governance. It is also known as "conflicts monitoring", which focuses on preventing managers from opportunistically pursuing their own interests rather than

[146] See Hillary A. Sale, *Independent Directors as Securities Monitors*, 61 Bus. Law 1375 (2005-2006). Recently, the courts also have drawn attention primarily to the monitoring function of independent directors: "It is arguable...that a company may reasonably at least look to non-executive directors for independent judgement and supervision of the executive management". See *Equitable Life Assurance Society v. Bowley* [2003] EWHC 2263, at 41.
[147] Lynne L. Dallas, *The Multiple Roles of Corporate Boards of Directors*, 40 San Diego L. Rev. 781 (2003), at 808.

the interests of shareholders.[148] Unlike "strategic monitoring" or advisory functions permeating the whole process of decision-making and corporate operation, "management monitoring" may only appear in certain circumstances. It is worth noting that "management monitoring" gives the independent directors a position superior to management in that their decision would be the final determination and the management must comply with this ruling and governance. Thus "management monitoring" is very important in corporate governance.

1.2.5 Monitoring in the Conflict of Interest

One obvious example of "management monitoring" is in the case of conflict of interest. For instance, as fiduciaries, executive directors must not place themselves in a position in which there is a conflict between their duties to the company and their personal interest.[149] Any contract involving a danger of conflict of interest would possibly be held as void or voidable. Subjective to this "no conflict" principle, the rule is in particular applied to the exploitation of the property, information or opportunity as far as the interest of the company is concerned.[150] Traditionally, the common law had set up a strict prohibit inhibition in this regard by holding that directors cannot be allowed to use any corporate asset or opportunity unless the dealing is approved by the shareholders in general meeting. It is not surprising that this old rigid attitude was not acceptable to the business community because those strict requirements are inconsistent with business practice and would unnecessarily stifle commercial activities which might benefit the society and public.

By realizing this difficulty, the law has changed to a more permissive perspective to

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[148] See Robert A.G. Monks & Nell Minow, *Corporate Governance* 4th e.d.n. (John Wiley & Sons, 2008), at p.223, Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 Stan. L. Rev. 863 (1991).
[149] Section 175(1), Companies Act 2006.
[150] Section 175(2).

this issue. Departing from the traditional requirement, modern company law theories, alternatively, turns to a more open-minded stance on this issue, by holding that in certain situations, the conducts might not constitute the breach of legal duties as long as it can meet the requirement of "independent approval", which in certain cases means the approval by disinterested directors. Following the proposals of the Company Law Reform Group,[151] the Companies Act 2006 now provides that, if the constitution of a public company includes provisions enabling the board to authorize the matter, the board would have the authority to approve the transactions in relation to dealing with the company or use of corporate opportunity, as long as the interested directors, including those who are under the influence of the interested directors, are disqualified from the voting on the decision in the board meeting.[152] The "independence" of the board in reviewing these issues is thus very important to the validity and legitimacy of the judgement. The role of independent directors is essential in this area of "management monitoring".[153]

However, in situations where self-interested transactions are expected to recur, it is necessary not to lose sight of the fact that the differentiation between insider and independent directors is solely for the purpose of "institutionalizing" the objective decision-making system.[154] There is no valid evidence to prove that independent directors may have any inherent advantage or other qualities that make them better able than executive directors in monitoring the operation of the business enterprise.[155] Furthermore, because of their limited acquaintance with corporate affairs or excessive reliance on information provided by the management, there is no

[151] Company Law Reform, Draft Bill, Part B, Chapter 1, B6 (4)(b)(c), (5).

[152] Section 175 (5), (6). A similar position could also be found in US Model Business Corporation Act §8.62(a)(1) – (2) (2005).

[153] Richard C. Nolan, *The Legal Control of Directors' Conflicts of Interest in the United Kingdom: Non-Executive Directors Following the Higgs Report*, in John Armour & Joseph A. McCahey, *After Enron: Improving Corporate Law and Modernising Securities Regulation in Europe and the US* (Hart Publishing, 2006), 390-396.

[154] Marshall L. Small, The *Evolving Role of the Director in Corporate Governance*, 30 Hastings L. Rev. 1353 (1979), at 1395.

[155] There is no doubt that, according to legal regulation, executive directors are also entitled to participate in deciding the matters regarding the conflict of interest, if they are not involved in the self-interested transaction and they are not under influence from those interested directors.

guarantee that independent directors can in every case detect or prevent the self-dealing of executive management. The role of independent directors in monitoring should be largely appreciated, but the effect of such supervision should not be overly exaggerated as omnipotence. The only result that independent directors are able to achieve is to make an examination as to form, rather than the substance of any particular transaction. In a sense, the oversight can, at least, eliminate the obvious surface danger of conflict of interest, in structure leaving no one in the board in a position without any limit and control, making it hard for management to abuse their powers. It is unreasonable, however, to expect these directors to be a cure-all able to resolve all problems.

1.2.6 Monitoring in the Audit Committee

Another type of "management monitoring" is not usually required in law, but is more commonly embodied in business practice and market self-regulation, especially the Code in the UK. In most of these circumstances, such oversight is achieved in the form of a specific committee of the board. In modern corporate governance, it is generally accepted that the organising of board committees is beneficial to the effectiveness of the work of directors. A committee completely or largely composed of independent non-executive directors might, to the great extent, exclude improper influence from executive management that would possibly damage objectivity and independence of the judgement. Furthermore, the committee format provides independent directors with a helpful platform where they are able to discuss the concerned issue objectively and honestly among themselves. In practice, it is strongly recommended by market rules or even certain statutes (for example, the Sarbanes-Oxley Act of 2002) that non-executive or outside directors, who meet a certain standard of "independence", should occupy a majority, or the whole, of the composition of the committees, and their dominance must be ensured in the

operation of committees.

Among these sub-board committees, the financial committee plays the most important role in "management monitoring", because it is in the core position to review the material performance of the management. The lesson learned from the scandals of Enron and other collapsed companies is that corporate financial reports are the most significant basis for the market and investors to build up a sound understanding of the operation of the company and to observe in advance the difficulties of the company and failure of management. On the other hand, management might find it more difficult to secretly benefit themselves at the expense of the company if the financial reports made by them were under the strict scrutiny of independent directors. Therefore, before financial reports can be submitted for the external review and confirmation of the company accountant and auditor, it is necessary to establish a system of internal control by institutionalizing the financial committee as the firewall against any potential danger of self-interested transactions and other improper or illegal conduct. Even a *pro forma* review here is likely to inhibit practices which cannot stand even superficial scrutiny, and promote extra care and caution in the preparation of the report.[156] Thus even if the function of the audit committee cannot be described as omnipotent, its existence is still very necessary in corporate governance and the role should be rightly recognized.

Audit committee has been an important topic of corporate governance regulation across the Atlantic, especially since the catastrophic collapses of Enron and other big names in 2002. Following the enactment of the Sarbanes-Oxley Act, in the UK, the Financial Reporting Council (FRC) appointed a group, chaired by Sir Robert Smith, to launch a review, "Audit Committees - Combined Code Guidance" (known as

[156] Providing the management with an organ to which they are accountable, even in form, may dissipate a part of danger that the executive management would openly add fake or vague information into the financial report in order to mislead the investors.

Smith Guidance).[157] Both of these regulatory efforts firmly insisted that an important solution to potential manipulation of financial statements by the management should rest with the audit committee,[158] i.e. a well-structured and effective audit committee constitutes an essential defence against corporate malfeasance of misstatements and audit malfunction. As the Smith Guidance suggested, the primary role of audit committees is "to ensure the integrity of financial reporting and the audit process by ensuring that the external auditor is independent and objective and does a thorough job, and by fostering a culture and an expectation of effective oversight".[159] Furthermore, in some situations, the audit committee may play a wider role in "ensuring that the company has sound internal financial control systems and systems for the control of non-financial risks" and "underpinning the assurance that boards give to shareholders of the integrity of the company's audit and internal control processes".[160] To achieve such an aim, undoubtedly, the audit committee must stand in an objective position even at a higher level of independence than the board in general. In these days, it is strictly required that all members of an audit committee must be independent non-executive directors, who are encouraged to have "significant, recent and relevant financial experience", and more desirably, have a professional qualification of accountancy.[161] To make sure that the committee functions in a truly independent climate, the management are not allowed to be present at its meetings, unless they are invited to attend a particular meeting or a particular agenda item. In sum, the audit committee is an exclusive land of independent directors where the management cannot put their hands in.

[157] The report was first published in 2003 and updated in 2005 (titled as "FRC Guidance on Audit Committees"). A new edition of the guidance was issued in October 2008, in which a limited number of changes have been made.
[158] The comparative studies on audit committees in US and other countries could be found on Appendix III of Smith Guidance 2003.
[159] Smith Guidance 2003, Background report, para. 7.
[160] Smith Guidance 2003, Background report, para. 8 and 9.
[161] Smith Guidance 2003, Proposed guidance, 3.1 and 3.16; 2008 Guidance on Audit Committees, para. 2.3 and 2.16.

However, expectation and reality may not always converge. It is believed that audit committees are very important as there could be considerable benefits in "increasing the level of assurance against catastrophic failure and gross malfeasance", and, more generally, in offering improvements on corporate governance.[162] But on the other hand, such a conclusion sounds like no more than a good wish, rather than a secure promise. First, the function of the audit committee is limited. Although named as "audit committee", it is clear that it does not carry out day-to-day monitoring and conducting of audits. All these functions belong to the others. For example, it is the responsibility of the management to prepare financial statements, and it is the job of internal and external auditors to exercise auditing. The audit committee should not cross the line of allocation of responsibilities, seeking to take control of everything. In a proper understanding, the committee is serving narrowly as a kind of "discipline" in ensuring that there is a proper system and all parties are doing their job seriously.

Secondly, the authority of the audit committee is limited. It is important to bear in mind that audit committees should not go beyond the principle of the unitary board. Audit committees must be independent, but only in the sense that members must be independent of the executive management. Members of the committee are not independent of the board.[163] Thus the committee should not be regarded as enjoying a superior authority above the board, and there is no way to suggest that the board would be bound by findings of audit committee, or the committee is entitled to force the board to follow any of its conclusions. "Any disagreement within the board, including disagreement between the audit committee's members and the rest of the board, should be resolved at board level".[164] In other words, the findings of audit committees are not final judgements until formally endorsed by the board in its own name.

[162] Smith Guidance 2003, Background report, para. 6.
[163] Smith Guidance 2003, Background report, para. 20.
[164] 2008 Guidance on Audit Committees, para. 1.5.

Thirdly, the ability of the audit committee is limited. Even if the Smith Guidance emphasized sufficient timing of works and continuing communication with key people in the company's governance, a main working model of periodic meetings may still struggle to meet all workload, especially when members of the committee are merely part-time, non-executive directors. Even if the Guidance tried to convince that all necessary resources should be available for the committee to undertake its duties, there is no guarantee that every issue would be carefully explored in detail. Ironically, the harder an audit committee worked, the more exhausted it would be.

Finally, the active attitude of audit committees is limited. In general, the Smith Guidance favoured a smooth communicating style, "a frank, open working relationship" and "a high level of mutual respect".[165] Although it agreed that, in some cases, a robust attitude is necessary for putting wrong things right and the committee's members should be ready to deal with difficult situations, the Report had to admit that such an expectation may be unrealistic, given that the committee might feel it difficult to put its judgement against the "expert" views of the management and the auditor.[166] Here the only suggestion to be drawn is a compromise that, the solution to difficulties in reality may largely depend on the personal quality of the committee members, i.e. their independent mind, sufficient knowledge, tough attitude and persuasive skills.[167] But none of these characteristics could be clearly interpreted in any written formula or assessed by a uniform standard. It is also questionable how many independent directors do really have the above merits.

[165] 2008 Guidance on Audit Committees, para. 1.7.
[166] Smith Guidance 2003, Background report, para. 13-15.
[167] Smith Guidance 2003, Background report, para. 16.

In accordance with the supposition above that the audit committee has its inherent limits, it is interesting to wonder why regulatory efforts still think the committee as a key to resolving improper performance in corporate governance. In response to this question, the analysis needs to focus on two points. First of all, the audit committee is intended to target one basic problem, i.e. who should monitor the monitor. In the corporate hierarchy, senior management and internal auditors constitute the most important safeguard against any potential trouble within the company, and the external auditor is an extra firewall to detect matters missed by the management, and in some situations, to uncover wrongdoings committed by the management themselves. But who should review the works of these monitors? In absence of any audit committee, when the management has prepared financial statements, the only following procedural requirement is to receive the verification by the board, in which senior officers are present and have substantial influence. Certainly, the board as a whole, compromising both executives and non-executives, are not fit to serve as an independent and objective body to keep an eye on the monitors. On the other hand, the commitment of the external auditor could be improperly affected, if it keeps a close relationship with the management and relies on the management for future engagement of services.[168] Given all these factors, it is natural to require an independent institution to step in as the "discipline" over those monitors. Therefore an audit committee, completely composed of independent directors, is suitable to ensure the integrity of financial statements and monitor the effectiveness of the internal audit. The independence of external auditors can be secure if they are required to be primarily accountable to an independent audit committee. In order to eliminate any improper influence upon the external management, it is appropriate to re-allocate to the audit committee the responsibilities of reviewing the external auditor's objectiveness and the effectiveness of its audit process. In sum, in building

[168] As of the independence of auditors, see A. Anandarajan, G. Kleinman & D. Palmon, *Auditor Independence Revisited: The Effects of SOX on Auditor Independence*, I.J.D.G. 2008, 5(2), 112-125; Lesley Bolton, *Auditor Independence: What Investors Think*, Accountancy 2007, 140(1369), 94-95.

a sensible system of internal monitoring, it is necessary to create an independent audit committee to gain assurance that all those monitors, who are in charge of daily monitoring, do not go beyond their duties. It would be difficult for such a role to be undertaken by other internal institutions.

Secondly, although the audit committee can only serve as a *pro forma* review of the integrity of financial statements and to achieve such a purpose may largely depend on the robustness and personal characteristics of committee members, the effort of appreciating the contributions of the audit committee should not be played down. It still needs to be conceived that the raising of matters on the audit committee is beneficial for promoting a culture of good corporate governance. As the Smith Guidance notes, "the work of the committee should however go beyond catching inappropriate reporting or inadequate auditing. Rather its work should be more pervasive and seek to build into the organisation a culture of compliance and fair reporting, an environment in which issues are openly discussed and resolved before they become matters of real concern."[169] In fact, tough regulation has usually been a useful weapon to tackle vicious misstatements, but it cannot remove all problems solely by *ex post* penalty or threat of penalty. As discussed in Chapter 2, it has been found that the law has its own limit, and normally, compliance of regulation needs the support of mental recognition and voluntary abidance, which mostly result from cultural norms and community environment. The existence of an independent audit committee can remind the management to be cautious of preparing financial statements, and impress upon the internal and external auditors the importance of independent and objective auditing. It aids development of a working climate in which any suspicion or sign of trouble could be openly put forward to the concern of an independent body at an early stage, before drifting towards a crisis. In this sense, building a strong audit committee can to a large extent help the implementation of

[169] Smith Guidance 2003, Background report, para. 12.

regulation, through offering improvements of the culture of the company on a wider front.

1.2.7 Conclusion and Caution

Consequently, while the board is in charge of its function of oversight, the directors, especially those independent from executive management, are expected to play an important role as supervisor in reviewing the performance of the company. It is not suggested that in every moment independent directors might have to act in a radical manner against the management, but in certain situations, for example, when the management is seeking to exploit company benefits, there is undoubtedly a case for a tough attitude. The meaning of the oversight role is to establish a certain form of control in the corporate structure to counteract continually expanding managerial power and reduce the opportunity for management to arbitrarily abuse their power. However, it is worthwhile to bear in mind that the increasing independence of the board should not be confused with an idealistic understanding that a monitoring function can completely eliminate all problems in corporate governance.[170] The review by independent directors is mostly as to the form of the management behaviour under examination, but not the substance of decisions and conduct of management. The monitoring function of independent directors thus must be recognized in an objective and appropriate way.

Furthermore, it is also crucial for independent directors to realize that "monitoring must begin with results, but it cannot end there".[171] Certainly, statistics, e.g. profit levels, as an ideal index of business running, can suitably reflect managerial performance. If companies earn a high profit in the financial year, the work and

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[170] G. H. Roth, *Supervision of Corporate Management: The "Outside" Director and the German Experience*, 51 N.C.L.Rev. 1369 (1973), at 1381-1382.
[171] *Ibid*, at 399.

ability of executive management would often be affirmed and praised, and other directors would find it hard to openly question the judgements of those “talents”. This is a kind of common sense in the business community. Directors should not be so narrow-minded, however, to merely focus their attention on past success or ostensible performance of the management. Excellent outcomes may flow from a dominant position in the market, or from a windfall; on the other hand, a temporary deficit or business loss might be an acceptable cost due to heavy start-up costs or investments, which did not bear fruit at the outset but will reap a great harvest in the future. Even though the amount of profit may be sizable, it should still be compared with market expectations and the former history of corporate financial performance. In this sense, in “management monitoring” and the use of supervisory powers, the concept of monitoring for results thus does not preclude an objective review of the nature of managerial performance, “either accepting as satisfactory a level of performance which falls short of the applicable objective, or criticizing as unsatisfactory a level of performance which exceeds it”.[172]

1.3 The Advisory Role: Can the Board and its Independent Directors Help Promote the Performance of the Management?

As stated above, the role of oversight should be regarded as the most essential function of the board in corporate governance. However, the board has other roles to play. It was found that “the changing attitudes toward the board of directors” have gradually been appreciated by the market.[173] An inevitable change has invaded the boardroom in that directors have begun to carefully reconsider their role and come to resist being wholly controlled by the management.[174] Company boards have increasingly attempted in certain situations to infuse its own will into the

[172] *Ibid.*
[173] Noyes E. Leech & Robert H. Mundheim, *The Outside Director of the Publicly Held Corporation*, 31 Bus. Law. 1799 (1975-1976).
[174] Change Invades the Board Room, FORTUNE, May 1972, at 156, 158.

policy-making and operation of the company.[175] Even if the power of specific daily management and formulation of policies still lies in the hands of management, the board can in another way impose its influence by the role as counsel for the management.[176] This is not a fresh idea. It is traditionally held that in the corporate operating structure, the Chief Executive establishes the business goals and strategy, and then the board might "accept his proposals, adding, perhaps, some friendly advice".[177]

Why is the board expected to have its own influence on decision-making processes of the company? This may be partly due to the belief that, the board, as a team or group, can work better than any one individual in directing the company. It is found that, in some circumstances, the board of directors, in a group-working model, might achieve a better result in deciding certain important issues, especially when the topic of discussion is complex and decisions difficult to reach.[178] Peer group decision-making may engender more effective decisions than individual decisions.[179] Thus the board is encouraged to play a more important role in shaping business decisions. Furthermore, it is suggested that some of "knowledge assets", which are related to a company's competitive advantage, may "reside, or be created, in the boardroom".[180] A model of the board as "a team with members having

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[175] See Ira M. Millstein, *The Evolution of the Certifying Board*, 48 Bus. Law. 1485 (1993), at 1488.

[176] R. Gordon, *supra* note 8, p. 135-137.

[177] Lewis D. Solomon, *Restructuring the Corporate Board of Directors: Fond Hope – Faint Promise?*, 76 Mich. L. Rev. 581 (1977-1978), at 610

[178] M. Bainbridge, *Why a Board? Group Decisionmaking in Corporate Governance*, 55 Vand. L. Rev. 1 (2002).

[179] Robert J. Haft, *Business Decisions by the New Board-Behavioral Science and Corporate Law*, 80 Mich. L. Rev. 1 (1981-1982), at p.9-14: "The evidence shows that peer groups produce better solutions to problems than do individuals working alone. With some dissent, the evidence also supports the proposition that peer groups perform better than the best individual in the group". This is the "assembly bonus effect" that the tradition mode of CEO-dominated board cannot enjoy.

[180] Alice Belcher & Till Naruisch, *The Evolution of Business Knowledge in the Context of Unitary and Two-Tier Board Structures*, J.B.L. 2005, Jul, 443-472. The term "knowledge assets" is described as one of specific valuable resources for the company which are rare and hard to imitate or be purchased. This knowledge-based view has been summarised as follow: "[t]he knowledge-based view of the firm views a firm as a knowledge-creating entity, and argues that knowledge and the capability to create and utilize such knowledge are the most important source of a firm's sustainable competitive advantage. Knowledge and skills give a firm a competitive advantage because it is through this set of knowledge and skills that a firm is able to innovate new products/processes/services, or improve existing ones more efficiently and/or effectively. The raison d'être of a firm is to continuously create knowledge." See I. Nonaka, R. Toyama & A. Nagata, *A Firm as a Knowledge-creating Entity: A New Perspective on the Theory of the Firm*, [2000] Industrial and Corporate Change 1-20 at 1.

complementary skills and differing roles" may assist in the creation or development of business knowledge, especially when the board is running in a cooperative and harmonious fashion.[181] Given these values of the board, it is important to appreciate its contribution. The board should be a proper working place where all directors are collectively responsible for promoting the success of the company. For such a purpose, there is a need for the executives to listen to opinions from their non-executive colleagues, in order to obtain helpful advice. In fact, an honest and frank discussion in the board meeting might also help the directors, in particular outside or non-executive directors, to understand the purpose and intention of management. So directors can bring their own experience and knowledge, which the management might lack, to reinforce the feasibility of major policy and direct the strategy of the company.

The role of the board acting as a consultant can be seen as a completely distinct function from that of monitoring. It is questionable, however, whether there is a borderline between these two roles, or if there is any overlap with reference to the oversight and advisory position of the board. In a sense, the function to give counsel is probably better seen as just a different form of monitoring.[182] Of course, one of the very meanings of supervision is to deter and stop the deliberate self-interested behaviour of management that may cause harm to the company's interests, or on the other hand, to remove the top officers if their performance is so unsatisfactory that it is the best option to select new leadership and management. However, it would be rare for matters to be so bad that the board must adopt a radical approach in fulfilling the oversight role. In most cases, the operation of the company is smooth and relatively peaceful in which the performance of management is generally seen as acceptable. Certainly, it does not mean that the Chief Executive and senior managers

[181] Alice Belcher & Till Naruisch, *ibid*.
[182] Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 Geo. L. J. 797 (2000-2001), at 803 ("Maybe the service function is better seen as just a different form of monitoring, to compensate for the cognitive biases - as opposed to the deliberate self-interest of the managers and their organisational culture".)

are infallible in their work. If management always made the best choices, there would be no necessity to call for the board to support them or review their works. However, such perfect circumstances are not realistic in practice. Like anyone else, the management might commit some kinds of error or fault resulting from defective judgement, deficient knowledge, or carelessness;[183] their decisions may in general be correct and feasible but on occasion they may miss some slight but important factors. "Good corporate actors can make bad decisions when placed in certain situations. They can do so without guilt, however, because self-serving biases allow them to rationalize their behaviour to maintain self-esteem".[184] All these mistakes do not necessarily amount to bad faith of management, but are simply caused by the cognitive biases of the managers and their organisation culture.[185] On the other hand, it is not uncommon that the management might not be able to realize their weakness, because it is part of human nature that people are usually inclined to treat their ideas as the best without any question, and may be reluctant to check whether there is some defect in their own reasoning. By discussions in the boardroom, directors, who are not the members of management that devised and submitted the proposals, may have a chance to review the suggestions of management from an objective view, and easier detect any limitations or flaws which are not noticed by the management in the formulation of policy. The advisory function could then also be referred to as the "strategic audit" role of the board.[186] In this circumstance, there is no doubt that the board is playing its oversight role in such a situation for the purpose of detecting management's cognitive bias and avoid them being too self-reliant and narrow

[183] See Jayne W. Barnard, *Narcissism, Over-Optimism, Fear, Anger, and Depression: The Interior Lives of Corporate Leaders*, 77 U. Cin. L. Rev. 405 (2008-2009); Joan MacLeod Heminway, *Personal Facts About Executive Officers: A Proposal for Tailored Disclosures to Encourage Reasonable Investor Behavior*, 42 Wake Forest L. Rev. 749 (2007), at 768-771.

[184] Marleen A. O'Connor, *The Enron Board: The Perils of Groupthink*, 71 U. Cin. L. Rev. 1233 (2002-2003), at 1238.

[185] Donald C. Laangevoort, *Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (and Cause Other Social Harms)*, 146 U. Pa. L. Rev. 101 (1997).

[186] Gordon Donaldson, *A New Tool for Boards: The Strategic Audit*, Harv. Bus. Rev. (Jul. - Aug. 1995), at 99; see also National Association of Corporate Directors, *Report of the NACD Blue Ribbon Commission on the Role of the Board in Corporate Strategy* (September 2000); The Conference Board, *The Corporate Board: A Growing Role in Strategic Assessment* (1996), at p.12 (noting that 51% of respondents reported that their boards had a greater role in strategy than three years earlier, and nearly 49% reported that their board is "actively engaged in the choice of strategic options).

minded. By giving some necessary advice, the board is able to correct any weaknesses within the management and promise that the policy made by management can to the largest extent be reasonable after a careful and thorough consideration. In this sense, the advisory role of the board could be viewed as the prolongation of the function of oversight.

1.3.1 The Independent Directors as Counsel

It is urged that directors need become an active participant in the decision-making process. However, in the spectrum of advisory function, there is a division of responsibilities between executive and independent directors. Unlike executives, independent directors have less involvement in the formulation of policies. Their role is more suitably described as advisor or counsel, rather than leading policy proposer. Their role is not to construct the main body of corporate strategy, but support the Chief Executive and other executives to run the business by providing advice to reinforce and improve the decisions of management. In some case, it may also be necessary for the independent directors to "act as arbiters in disagreements among internal managers",[187] making the board act as the "top-level court of appeals of the internal agent [labour] market."[188] The experiential research found that in practice, a considerable amount of directors' time is spent "advising the CEO, a task that, while not as dramatic as replacing him, enable them to play what many consider to be their key normal duty."[189] In the reports of the Business Roundtable, an organisation composed of leaders of large American corporations, it was confirmed that a key element of the board's role is "providing advice and counsel to management".[190] Given this fact, it is follows that independent directors should seriously assume this

[187] Eugene F. Fama & Michael C. Jensen, *supra.* note 25, at 315.
[188] *Ibid.*
[189] J. W. Lorsch & E. Maclver, *Pawns or Potentates: The Reality of America's Corporate Boards* (Harvard Business School Press, 1989), p. 64.
[190] The Business Roundtable, Statement on Corporate Governance (1997), at 6.

responsibility in the fulfilment of advisory functions.

The role of counsel could also be very important during the moment when the company is performing badly. If there was a common feeling among the market that the corporate operation could not meet expectations and the management should be liable for the downturn, independent directors in the board of the company would usually feel under pressure. The possibility of aggressive movement by investors and the potential danger of a take-over bid might force these directors to act quickly before those unhappy shareholders began to take steps to reorganise the board.[191] They would be keen on offering their advices and persuading the management to take necessary actions of improvement, or even in certain rare situations, suggesting a fundamental change of the management team.[192] Thus, in this sense, they are encouraged to treat their advisory powers more seriously to help the company out of the trouble. Today, in an investor-oriented stock market, it is very unlikely that, when the company performs poorly, the board and its independent directors would do nothing, say nothing, leave the share price to slump, and let the company fall into a real crisis. There is a clear incentive for independent directors to play their advisory role in supporting the company in difficulties.

1.3.2 Two-Level Advisory Process

Obviously, the advisory role might introduce certain benefits into a corporation's operating and strategy-making processes. In running an economic organisation with complicated structure and hierarchy, the form of a committee is actually a more efficient way than narrowly relying on a single-man leadership.[193] As stated above,

[191] Compared with the individual stockholders, the institutional investors, with a considerable shareholding, have more incentive and capacity to challenge and defeat the board, by the proxy-voting battle, or changing sides in favour of the take-over bid.
[192] Melvin A. Eisenberg, *Legal Models of Management Structure in the Modern Corporation: Officers, Directors, and Accountants*, 63 Cal. L. Rev. 375 (1975), at 398.
[193] Jonathan P. Charkham, *Keeping Good Company: A Study of Corporate Governance in Five Countries*

it is not reasonable in reality for a large company to be run by only the Chief Executive, and the existence of autocracy in the corporate governance is undesirable, since single-person leadership might become characterized by over-confidence and short-sighted utilitarianism.[194] The group working model in corporate governance thus helps the Chief Executives overcome their inherent weaknesses and establishes a favourable mechanism of feedback and communication, which might ultimately make a positive contribution to the promotion of long-term corporate interests.

However, it might be questioned why the Chief Executive might seek advice from the board, or more specifically, from independent directors, rather than simply engage external business institutions as counsel. In part, the reason might be that the Chief Executive is only allowed to receive certain advice through the resource of the board, and other institutions are unable to provide such information and knowledge.[195] On the other hand, if external institutions were hired by the Chief Executive to provide advice, a similar relationship as between superior and subordinate may come to exist, and the opinions of this institution would be analogous to suggestions from lower ranks in the corporate hierarchy. But the board is the place where its members can acquire equal status with each other for balanced conversation and discussion. This is somewhat similar to the conception of parliament democracy, in which the balance of power and share of authority can be maintained, and the benefit of group decision-making is also achieved. It may be expected that such an arrangement would in part make Chief Executive openly and seriously consider the opinions of others. Only when members of the board are on an equal footing with each other, can the benefits of group working and the function of advisory assistance be reached.

(Oxford University Press, 1994), p. 361.

[194] See Donald C. Langevoort, *supra.* note 81, at 823-824.

[195] For example, some Chief Executives in the business community might refuse to serve other companies unless they are guaranteed a membership in the boardroom.

Of course, even if the advisory function of the board is appreciated, it may be claimed that independent directors are not the only members of the boardroom to offer those advices. The senior members of management may be included in the board and then come to be directors. Their position in the boardroom enables them to enter the office where they can equally communicate with the Chief Executive and deliver their opinions in an open way. Given the fact that executive directors have a better idea about the business and company's affairs, their opinions might be equally, or even more helpful for formulating proper policies. Therefore, ostensibly, it seems rational that executive directors, like their non-executive/outside colleague, can also act as counsel in the board, and the introduction of independent directors to meet the advisory role might seldom be required. But in fact, this suggestion may not reflect reality. It is not fair to say that executive management can completely replace independent directors as a counsel source.

In fact, the author suggests that there should be two levels of advisory process within the corporate governance system, where different parties of the management and directors can respectively make their contributions. One of the levels is in initiating policies, when advice and proposals are welcomed in drafting an original plan; the other is in approving policies, when critical and supportive ideas are encouraged to review the feasibility and detect possible problems. The senior management may normally play their role in the first level. As members of the management team, senior officers would be keen on offering advices in their best knowledge and convey their concern to the Chief Executive, because none of them would expect a failure of the project and thus damage their reputation as business professionals. To be sure, in this stage, the advisory panel within the management team is part of the managerial function. Thus in the course of initiating policies, the management, rather than the board and directors, are actually the main actors of providing advice.

However, policies must be formally approved before they can be executed. This is the work of the board and its directors. In a proper understanding, the advisory role at this level may be like a "second reading", even if the management has already consulted all team members at the stage of formulating policies. At the stage of approval, it is beneficial for directors to give advice from angles different from that of management, and raise questions that might be missed in shaping the proposals concerned. It is thus questionable whether senior management, while acting as directors, can also effectively perform the role during approving policies, since they cannot offer a vision from outside of management team. Or they may be merely reluctant to take a critical view, because they may subjectively believe that their original plan is watertight. In a situation where the board is largely or exclusively composed of executive directors, the two levels of advisory process may largely overlap, and the role of the board in advising the Chief Executive simply amounts to a repetition of views expressed by management in initiating policies. Certainly, this is not fit with the purpose of two-level advisory process.

Consequently, in a system where advisory processes are allocated on two levels, the counsel role of independent directors is very important in the stage of final discussion and approval of policies.[196] This should not be confused with the advisory service of the management team in initiating policies.

1.3.3 Independent Directors as Arbiters

Other than approving policies, the board and its independent directors also play an advisory role, sometimes called the "service" role,[197] at another stage of corporate

[196] Certainly, in certain cases, independent directors might be psychologically unwilling to bring their thoughts into the board meeting in order to avoid embarrassing management. And moreover, they might suffer pressure from the management to stop them from active supervision. These problems would be discussed latter in Chapter 5.

[197] Donald C. Langevoort, *supra.* note 81, at 802.

governance. In certain significant situations, the board must make decisions by itself, rather than delegate the discretion to management. For example, the board has to decide how to allocate profits and fund of the company, whether to start a new business or to reach out to a fresh market, or whether to accept a take-over bid offer or else resist it and determine how to defeat the hostile predator. Undoubtedly, all these decisions are very important for the company, relating to the future of the enterprise. In this process, the board and independent directors are not expected to simply assist the management formulate policies, but by contrast, they need to actively participate in the process and form a view on policy formulation at a board level.

However, a key question here may be why should the board decide these matters? Is it reasonable for a board mainly composed of independent directors, who are outsiders, to make such decisions? Or provided that the management comprises business professionals more familiar with the working of the company, would it be more rational for the management, not the board, to decide the fate of the company? On the face of it, we might be inclined to agree with the latter. This praise for management superiority is termed "managerialism". It treats the corporation as a bureaucratic hierarchy dominated by professional managers.[198] By dint of managerialsim, the management are regarded as business actors with autonomous power to pursue what they think are "the best interests" of the business. Thus, when important decisions have to be made, the judgement should be in the hands of the management, and the board, on the other hand, should only be a kind of figurehead to affirm the ideas of the management.

Nevertheless, such an assumption should not be accepted as a dominant corporate

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[198] Alfred D. Chandler, Jr., *The Visible Hand: The Managerial Revolution in American Business* (Harvard University Press, 1977); William W. Bratton, Jr., *The New Economic Theory of the Firm: Critical Perspectives from History*, 41 Stan. L. Rev. 1471 (1989).

governance model at every stage. When certain issues have to reach the board level for final judgement, the author suggests that ultimate control should no long rest with the management. Normally, proposals waiting for judgements before the board are relating to the interests of different parties. In this sense, it is not uncommon that these interests would conflict with each other. A typical example is the collision between shareholders and the management. For instance, in the scenario of a tender offer, the preferences of the two groups may not always be the same. In the target company, shareholders might tend to prefer a sale of the company due to the fact that a premium might be offered significantly above the market share price, but the management might resist the offer because in their view the merger would not serve the "long-term" interests of the company. In taking such business decisions, it may not be sound to merely rely on the belief of "managerialism", which is predicated on the notion that the professional management would automatically take superior decisions than shareholders.[199] On the other hand, in the bidding company, a similar collision might also occur. The management might launch the takeover simply due to their inherent inclination to expand the "enterprise empire" at any cost.[200] However, shareholders might suspect that such an expansion does not serve the purpose of efficiency and profitability,[201] or shareholders might worry that the management would paying too much for acquisitions, bringing a significant side-effect on the company's financial reserve and exposing the company to potential risk.[202] Given all

[199] As discussed above in this chapter, the cognitive bias of the management might in some ways counteract their proper perception and full awareness, leading them to be too near-sighted and over-defensive. The objective judgement of the management may also sometimes be affected simply by their "superiority complex", ignoring demands and expectations from other groups. Furthermore, there is also the prospect of directors' personal interests affecting their resistance to a bid, because of their fear of losing their position in the company after takeover.

[200] See Mark J. Roe, *Modern Politics and Ownership Separation*, in Jeffrey N. Gordon & Mark J. Roe (e.d.), *Convergence and Persistence in Corporate Governance* (Cambridge University Press, 2004).

[201] For example, RBS's strategy of aggressive expansion primarily through acquisition, especially the takeover of ABN Amro, had been seriously criticized, and eventually proved disastrous leading to the near-collapse of RBS in 2008. See The Independent, The rise and fall of 'Fred the Shred', available at: http://www.independent.co.uk/news/business/analysis-and-features/the-rise-and-fall-of-fred-the-shred-960336.html; Guardian, RBS record losses raise prospect of 95% state ownership, available at: http://www.guardian.co.uk/business/2009/feb/26/rbs-record-loss.

[202] An example could be found in the controversial takeover contest between Cadbury and Kraft. When the management of Kraft are desperately keen on purchasing Cadbury, even by raising the bid price to historical 18.9 billion dollars, a serious accusation has been raised by Kraft's largest shareholder, Warren Buffett, criticizing that the company overpays for acquiring Cadbury. See BBC, Warren Buffett attacks Cadbury takeover, available at:

these factors, the management is not always an objective judge in deciding everything.

As a response to this issue, some commentators have claimed that shareholders should otherwise be responsible for taking such decisions.[203] On the face of it, such a proposition appears viable. As capital subscribers, shareholders usually invest their savings in the company based on an expectation that they will receive a substantial return in the future. So when a decision can be significantly related to the development of the company, of course, shareholders should be given more discretion, because they may have the strongest incentive to promote the interests of the company, and finally the value of their investment. Certainly, in accordance with traditional ownership scholarship, shareholders are the owners of the firm. It seems logical to assume that such an ownership includes a property right, and shareholders can exercise the power of ultimate control due to this ownership.[204] However, the author disagrees with the suggestion that the most essential responsibility of corporate decision-making should be transferred from the board to shareholders. Although the law and most of academy has firmly accepted shareholder wealth maximization as the proper norm of corporate governance,[205] it does not follow that shareholders are entitled to take control of decision-making at every stage. In other words, shareholder cannot be given carte blanche to judge certain important issues.

The reasons of shareholders' incapability can be analyzed through three angles: firstly, as stated above (and also would be discussed in the next Chapter), shareholders in a large corporation are dispersed with trivial stockholding, and thus they might be indifferent to company's affairs. In front of "managerilism", shareholders might succumb to the proposal of management; or even if they do not

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http://news.bbc.co.uk/1/hi/business/8470622.stm.

[203] Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 Va. L. Rev. 675 (2007).

[204] See Melvin A. Eisenberg, *The Conception That the Corporation Is a Nexus of Contract, and the Dual Nature of the Firm*, 24 J. Corp. L. 819 (1999).

[205] Companies At 2006, section 172(1).

favour the proposal, they might give up resisting. Secondly, there is a risk that, in some cases, shareholders may have an incentive to pursue their short-term interest, but disregard the long-term perspective of business development.[206] For example, while in relation to a company's annual profits, shareholders might usually anticipate a high dividend, but by contrast, the company might intend to keep more money within its fund in order to re-invest into business or contribute to other areas for the purpose of future prosperity. It is not absolutely reasonable to suggest that such a claim of shareholders would always be good for the company.

On the other hand, it is necessary to realize that theories of company law reject the notion of shareholders' direct or indirect decision-making control. We must bear in mind that the company is a business form different from a partnership. Within a typical partnership, all partners bear unlimited liability, but at the same time they have great power in running the business and obtain ultimate control on nearly all important issues. Part of the reason for such an arrangement is because partners must be concerned about their own interest. If the business is poorly managed and finally fails, all partners may have to share responsibility for business liabilities and meet these from their personal wealth. Thus normally, partners are deeply involved in the decision-making process of the partnership. However, the corporate form, with a large and fluctuating membership, requires a more elaborate system to allocate the controlling powers. It is worth noting that, as a consequence of incorporation, a company has been conferred with the privilege of separate personality, which means that a company is a legal entity distinct from its members. This principle was supported by the House of Lords in *Salomon v. Salomon & Co.*[207] A legal consequence of the company's separate personality is that shareholders normally enjoy the advantage of limited liability, which means they do not need to expose their personal assets to companies' liabilities. The worst result would only be losing the

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[206] Iman Anabtawi & Lynn Stout, *Fiduciary Duties of Activist Shareholders*, 60 Stan. L. Rev. 1255 (2007-2008).
[207] [1897] ac 22.

money they invested in the company. A condition in exchange for this advantage, however, shareholders have to give up the power of control over the business. Accordingly, they create the board of directors and delegate the decision-making control to it.[208] So it is the board and directors, not shareholders, who have *de jure* rights in determining essential issues.[209] Shareholders are merely left with limited power in limited incidents (usually relating to structural changes of the company, e.g. altering the articles, restructuring the board, and merger/acquisition).[210] Such an allocation of power is in accordance with the requirement of proper balance between liability and decision-making control, which reflects the core feature of difference between partnership and company.[211] Partners are entitled to significant control but exposed to unlimited liability; shareholders are deprived of the control but protected by the shield of limited liability. If shareholders were offered great access to decision-making processes, it would certainly lead to a radical change of the system, causing a disproportion in liability and power. The balance could thus be broken.

In order to explain the obvious side-effect of shareholders' increasing control, let us go back to the analysis of the traditional model of the company: in the corporate form, delegation of control helps ensure that none of the participants (i.e. shareholders) in the enterprise can exercise too much control over factors that affect the outcome for the other participants.[212] Unlike the case in partnerships, shareholders do not need to

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[208] In legal principle, it is the company, as an artificial person, who has the power and legal status to decide how to run the business and how to distribute the property. But in fact, as an economic organisation, a company is never a real person who can make decisions by himself. It is the aggregation of natural persons. In the words of Lord Reid, it "must act through living persons, though not always one or the same person." *Tesco Supermarkets Ltd. v. Nattrass* [1972] AC 153. In similarity to lots of other social undertakings, the company has a systematic pyramidal structure for the allocation of human resources, in which an internal institution should be created to stand in top position to lead other people to achieve certain objectives. Thus, in the view of company law, the board of directors is such a body.

[209] Of course, in the case of a small company, the distinction between shareholders and directors are often an illusion, for they are in practice the same (or nearly the same) people. But in a large publicly held company, tow groups are clearly different.

[210] However, it is absolutely necessary to mention that, in practice, such an analysis might be relevant to large public companies, where a clear division of power is visible. In many small or medium-sized companies, the difference of decision-making between shareholders and the board might be usually vague, because there is normally an overlap between these two internal organisations.

[211] Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 Va. L. Rev. 247 (1999).

[212] Margaret M. Blair, *Reforming Corporate Governance: What History Can Teach Us*, 1 Berkeley Bus. L. J. 1 (2004), at 13.

base their investment on trust in other members, but only rely on the business perspective and capability of the board. This makes it easier to make credible commitments with the company and other shareholders. If such a delegation is removed, potential investors would inevitably be cautious, because they may have to consider the willingness of current shareholders to cooperate with them. Given the fact that in a large company there are tens of thousands members resident in different places, it is extremely difficult for any contacts and confidence to be built. Investors would certainly worry about the risk that they cannot judge the managerial quality within the company through a single body (i.e. the board of directors), but have to consider the general intelligence of most members (which would certainly be impossible to evaluate). All these factors may reduce the interests of investment in the stock market. Therefore, shareholder decision-making control is not fit for the purpose of the corporate form.

If we argue then that neither the management nor shareholders should be completely empowered to take decisions of fundamental importance to the company, then we might conclude that the board may be the only candidate to take the responsibility.[213] Actually, the board may act as "arbitrators" in reaching those very sensitive decisions. When an issue involves different demands of different parties, it may be prudent to refer it to an internal arbitration tribunal.[214] Thus a board composed of a majority of independent directors may be an appropriate place for such a purpose. Independent directors are neither members of the management team, nor spokesmen for shareholders.[215] They may be able to stand in an objective position so that it is

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[213] Lynn A. Stout, *The Shareholder as Ulysses: Some Empirical Evidence on Why Investors in Public Corporations Tolerate Board Governance*, 152 U. Pa. L. Rev. 667 (2003-2004), at 685 ("To address this problem of mutual opportunism, corporate team members prefer to cede control over both the firm and their sunk-cost, team-specific investments to an outside party that is not itself a residual claimant and thus lacks any direct incentive to take advantage of team members. This outside party is the board of directors.")

[214] Only when the issue is in nature a legal argument, it should then to submitted to the court, as an external tribunal, for judgement.

[215] It is very important to bear in mind that the standard of "independence" in the Higgs Review and Code does not merely mention "independent of the management", but also refer to directors who should not "represent a significant shareholder". See the UK Corporate Governance Code 2010, B.1.1.

possible for them to review issues by an impartial manner. In this sense, the board and its independent directors are the best arbitrators to resolve arguments between the management and shareholders.

Moreover, independent directors are in an objective position, but they are not out of touch with the management and shareholders. In a unitary board structure, executive and independent directors are both present in the board. They are collectively responsible for the direction of the company, and share the role of leadership. This provides independent directors with an understanding of the expectations and propositions of senior management, and the executives also have an opportunity to explain their considerations to independent directors. At the same time, it is also necessary to bear in mind that, even though shareholders in practice rarely take direct action against management and the board, they are still able to exert influence over the board in various ways. In an investor-oriented stock market, the board cannot ignore the desire of shareholders.[216] The threat of shareholders exiting the company *en masse* and resultant slump in share price may persuade independent directors to take shareholders' discontent seriously. Therefore, independent directors are not arbitrators who are indifferent to those issues referred to them. To ensure that their reputation as business professionals and objective arbitrators would not be damaged, independent directors must determine to make the best decision in every moment. In sum, empowering the board and independent directors with an arbitration role is to best service the purpose of settling internal conflicts typically between shareholders and management, and making objective decisions that can to the largest extent combine their contributions to business prosperity.

[216] According to A.4.1 of the Code, "[t]he board should appoint one of the independent non-executive directors to be the senior independent director. The senior independent director should be available to shareholders if they have concerns which contact through the normal channels of chairman, chief executive or finance director has failed to resolve or for which such contact is inappropriate."

1.4 The Relational Role: A Bridge between the Company and Outside World

We have examined two major functions of the board in corporate governance, i.e. the oversight and advisory function, which can be normally regarded as the most central roles played by the directors. Both roles are well recognized in academic research and business practice. However, this is not the end of discussion, and it is not proper to conclude here that there is no other function the board can carry out in the running of company. Commentators often focus on the responsibilities of the board with a view emphasized on the internal sphere of the company, that is, the relationship among directors, shareholders, and management. But it is worth noting that in society, the company is not an isolated body without any contact with the outside world. In the running of a business, the company must interact with external parties, and influence, or be influenced, by the community. In such a case, the board is one of the bodies in the company which can fulfil the role of connecting the company with the factors outside. In some ways, the board can be reasonably seen as a "bridge" through which the company can communicate with the external world in order to build up a harmonious relationship between these two sides.

This relational role of the board is that, by using board memberships, the corporation acquires resources that enable it to decrease the uncertainty of its environment, thus increasing its chances of survival.[217] These resources include advice, coordination with its external environment, information access and exchange, support through identification with the corporation, status and legitimacy within relevant

[217] The justification of the board's relational function is based on the analysis of "team production" theory, which observes that it takes more than shareholders' money to make a corporation. Executives must invest skill and creativity, employees must put in time and effort, and local governments may offer tax breaks and specialized infrastructure. Moreover, shareholders are not the only financial investors in the firm; creditors often provide funding as well. Corporate production accordingly is a form of team production involving the inputs of many team members. It is argued that the mediating function (as the center of nexus of contracts to deal with demands from different interest groups) is the model which more appropriately describes the role of the board. See generally Margaret M. Blair & Lynn A. Stout, *supra.* note 107; Lynn A. Stout, *Bad and Not-So-Bad Arguments for Shareholder Primacy*, 75 S. Cal. L. REV. 1189 (2002), at 1195; Lynn A. Stout, *supra.* note 109, at 680.

communities, and monitoring and control. The board's effective performance of some of these relational roles requires the presence of a combination of inside directors and outside directors.[218] It has been argued that board should be "mediating hierarchs" who enjoy ultimate control over the company's assets and outputs and who balance conflicting claims of various constituencies, partly due to the implication that the directors may have to a certain extent altruistic motives and thus are trustworthy in playing the judging role.[219]

Although it is fair to question that in some situations the board may use the relational role in a somewhat rhetorical sense and to advertise its community engagement but with less material meanings, this role should still be important, because, at least, it has been confirmed by the law that external factors other than merely shareholders' expectations are also important for the long-term success of the company,[220] and it is helpful for maintaining a healthy and responsible profile of the company. Consequently, the relational role should be recognized as one of the functions of the board, especially in large public companies with a close relationship and interaction with the external field.

1.4.1 Arguments about "Social Responsibility"

As the board is expected to make itself a "bridge" between the company and other external groups, a serious question would inevitably be raised, i.e. whether this means that the company should assume a "social responsibility". It seems sound to suggest that the company might tend to be socially responsible through the relational functions of the board. For example, when the public are not satisfied with the

[218] Lynne L. Dallas, *The Relational Board: Three Theories of Corporate Boards of Directors*, 22 J. Corp. L. 1 (1996-1997).
[219] Margaret M. Blair & Lynn A. Stout, *Director Accountability and the Mediating Role of the Corporate Board*, 79 Wash. U. L. Q. 403 (2001).
[220] Section 172(1), Companies Act 2006.

company's environment policy, a "warm-hearted" board may patiently hear the discontent of people and respect their views. Then the board can directly change the policy or indirectly persuade the management to improve their performance.

It is interesting that, in the words of Henry Manne, the controversy of corporate responsibility recurs periodically in historical thought, which is part of a tradition of popular mistrust of large-scale business enterprise.[221] It has been widely agreed that large companies "have long since become, for better or for worse, the most effective 'private' forces to do both widespread good and widespread harm."[222] Due to this nature, the attitude of the public toward those business tycoons is usually very complicated and ambivalent. On the one hand, it is normally appreciated that industry in the form of a company is the very touchstone of modern capitalism, which can effectively aggregate substantial capital for investment, promote efficiency of production for manufacturing, and create employment for the community. On the other hand, there is a latent dread inside public opinion that, as the size of companies continuously becomes bigger and bigger, they will finally grow up as "commercial monsters" with uncontrollable economic power that may exploit the community in order to meet the unbridled aims of profit-maximization.[223] All these factors invited an academic re-examination of the role of the company in

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[221] Henry G. Manne, *The Myth of Corporate Responsibility*, 26 Bus. Law. 533 (1970).

[222] Christopher D. Stone, *Where the Law Ends* (Waveland Press, c1975) at xii.

[223] One writer feared that, due to its considerable economic power the unruly large company, in the hands of a small group of elites, could induce great damage towards the public and community:

"The stealings and slayings that lurk in the complexities of social relations are not deeds of the dive, the dark alley, the lonely road, and the midnight hour. They require no nocturnal prowling with muffled step and bated breath, no weapon or offer of violence…The modern high –powered dealer or woe wears immaculate linen, carries a silk hat and a lighted cigar, sins with a serene soul, leagues or months from the evil he causes…

…The hurt passed into that vague mass, the 'public', and is there lost to view. Hence it does not take a Borgia to knead 'chalk and alum and plaster' into the loaf, seeing one cannot know just who will eat that loaf, or what gripe it will give him…The owner of the rotten tenement house, whose 'pull' enables him to ignore the orders of the health department, foredooms babies, it is true, but for all that he is no Herod.

Often there are no victims. Of the crazy hulk sent out for 'just one more trip' meets with fair weather, all is well. If no fire breaks out in the theater, the sham 'emergency exits' are blameless. The corrupt inspector who O.K.'s low-grade kerosene is chancing it, that is all. Many sins, in fact, simply augment the risk. Evil dose not dog their footsteps with relentless and heart-shaking certainty. When the catastrophe does come, the sinner salves his conscience by blasphemously calling it an 'accident' or an 'act of God'." See E. A. Ross, *Sin and Society* (Houghton Mifflin 1907), at 9-12.

modern society.[224] Some writers argued that in view of their enormous influence and resources, the large corporation could and should bear extra responsibility more than just pursuing profit.[225] Such a radical claim also received advocacy from the business world.[226] It was suggested that, since the corporation is an institution that has such significant impact on those groups, other than shareholders, "whose lives and fortunes are vitally affected by corporate operations",[227] the function of the board is not, as the law has traditionally stated, to be singly responsible for the interests of the shareholders, but more broadly, to balance different claims of the various constituencies, of whom shareholders constitute only one group.[228] To achieve this proposal, a fundamental reform of the function of the board may be necessary, and thus more radically, in order to enforce the role of the board as "guardian" of "social responsibility", some commentators even called a re-organisation of the board, by allowing non-shareholder constituencies to select their representatives to participate in the corporate decision-making process.[229]

At the same time, aside from the academic debate, some people also tried to change the whole system in a practical way. A number of militant socialists devoted

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[224] W. Hutton, *The State We're In* (Vintage, 1996, c1995); J. Plender, *A Stake in the Future – The Stakeholding Solution* (Brealey Publishing, 1997); *Your State at Work: TUC Proposals for a Stakeholding Economy* (TUC, 1996); P. Ireland, *Company Law and the Myth of Shareholder Ownership*, 62 Mod. L. Rev. 32 (1999). This thought was also shared by the political party. See *Vision for Growth: A New Industrial Strategy for Britain* (Labour party, 1996).

[225] In the 1930s classic debate between Professors Dodd and Berle, it was a core question whether the corporation and its management owe any duty towards the larger public. Even if there is no clear line drawn for an accurate answer, they both agreed that to a certain extent, the shareholders, who are traditionally regarded as the sole beneficiary of the company, should not be the only constituency in the consideration of the board. See E. Merrick Dodd, Jr., *For Whom are Corporate Managers Trustees*, 45 Harv. L. Rev. 1145 (1931-1932); E. Merrick Dodd, Jr., *Is Effective Enforcement of the Fiduciary Duties of Corporate Managers Practicable*, 2 U. Chi. L. Rev. 194 (1934-1935); A. A. Berle, Jr., *Corporate Powers As Powers in Trust*, 44 Harv. L. Rev. 1049 (1930-1931); A. A. Berle, Jr., *For Whom Corporate Managers are Trustees*, 45 Harv. L. Rev. 1365 (1931-1932).

[226] In 1929, Owen D. Young, then President of General Electric professed that the Board owed an obligation as trustee not solely to shareholders, but also to employees, consumers, and the general public. See Statement of Oven D. Young, in 1929, quoted in W. Cary, *Cases and Materials on Corporations* 4th ed. (Foundation Press, 1969), p. 239-240.

[227] P. I. Blumberg, ELI. Goldston & G. D. Gibson, *Corporate Social Responsibility Panel: The Constituencies of the Corporation and the Role of the Institutional Investor*, 28 Bus. Law. 177 (1973) (remark of P. I. Blumberg).

[228] Lynne L. Dallas, *Working Toward a New Paradigm*, in Lawrence E. Mitchell, *Progressive Corporate Law* (Westview Press, 1995), p.35-66.

[229] Phillip I. Blumberg, *The Role of the Corporation in Society Today*, 31 Bus. Law. 1403 (1975-1976). See also J. E. Parkinson, *Corporate Power and Responsibility: Issues in the Theory of Company Law* (Clarendon Press, 2002), at. p.408-422.

themselves to a contest against so-called “irresponsible” management through the proxy fight. The most famous event was the well-known Campaign GM, in which several young “corporate guerrilla fighters” bought 12 shares of the General Motor Co. and then asked for the inclusion of their “public interest” proposals into the proxy statement, calling for a broadening of the board to change the board structure and introduce representation of special interest groups -employees, consumers, suppliers, dealers or the public generally.[230] In addition to General Motors, many other companies in the US faced proxy contests in 1971-1972.[231] Even if in the end, almost all these proposals were defeated by rejection from financial institutions and inevitably received only minor welcome from the shareholders, it is evident that the campaigns successfully drew public attention towards the corporation as a prime target responsible for social problems, and led to a continuous and ardent discussion during the decade. The core of this debate is summed up perfectly by the words of one writer, “whether the nineteenth-century legal framework for governance of aggregations of capital in corporate form, which in the twentieth has produced the phenomenon of a self-designating and self-perpetuating management with considerable power to accumulate capital apart from the public capital market, and with wide and unreviewable discretion with respect to its use, is appropriate today for an industrial democracy.”[232]

The proposals, which viewed the board’s role as a “bridge” to be a shortcut to the aim of “social responsibility”, are persuasive. Nowadays business professionals at least seem more likely to stand up for social needs and not merely strive for

[230] Discussed in detail in D. E. Schwartz, *The Public Interest Proxy Contest: Reflections on Campaign GM*, 69 Mich. L. Rev. 419 (1971); See also D. E. Schwartz, *Towards New Corporate Goals: Co-Existence with Society*, 60 Geo. L. 57 (1971-1972).

[231] American Tel.&Tel. Co., Notice of Annual Meeting and Proxy Statement, Mar. 3, 1971, at 12-13; Gulf Oil Corp., Notice of Annual Meeting and Proxy Statement, Mar. 25, 1971, at 8; Honeywell, Inc., Notice of Annual Meeting and Proxy Statement, Apr. 2, 1971, at 8; Ford Motor Co., Notice of Annual Meeting and Proxy Statement, Apr. 7, 1972, at 20-21; Jewell Companies, Inc., Notice of Annual Meeting and Proxy Statement, May 15, 1972 at 10-11; American Tel.& Tel. Co., Notice of Annual Meeting and Proxy Statement, Apr. 19, 1972, at 13-15. Each of the proposals included representatives of other groups as well as employees in the proposal to broaden the composition of the Board.

[232] John J. Gibbons, *Governance of Industrial Corporations in an Industrial Democracy*, 31 Bus. Law. 1393 (1975-1976), at 1400.

profit-maximization.[233] In practice, as well in accordance with morality, companies have become more socially sensitive and responsive to certain non-commercial demands. Corporations are thus "asked to participate in certain activities, or to refrain from others, because of the alleged morality or immorality of the conduct involved or because of its significance to the local community, the nation or the international society".[234] Moreover, the fast expansion of corporate economic power has shaken the deep belief that the company is merely a private sector body established solely for business reasons. Some writers began to challenge the role of large corporations in modern capitalism as simply an economic institution, and proposed that it is an analogy of the "public" sector with some political and social implication,[235] because "modern conditions require companies to accept social responsibilities".[236] The public, or semi-public features of the company implicate the similarity with the most well-known example of the public institution, i.e. the government. It is common sense in a democratic society that the citizen must have final control, through the voting rights, over government, since the performance of it would undoubtedly imposes a great impact on everyone in the society. So similarly, the public should have a voice to be heard while their destiny is being influenced by large corporations. Furthermore, in most situations, if there is a choice between resolving social problems by external or by internal means, society ought surely to choose the latter. The suggestion of corporate social responsibility certainly offers the possibility of overcoming such troubles without imposing any external costs on the community. An industry system can *ex ante* prevent some wrongdoings at the outset, when the companies are more sensitive to their "social responsibility" owed to the community.

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[233] Lewis D. Solomon, *On the Frontier of Capitalism: Implementation of Humanomics by Modern Publicly Held Corporations – A Critical Assessment*, in Lawrence E. Mitchell, *Progressive Corporate Law* (Westview Press, 1995), p.281-313.
[234] Phillip I. Blumberg, *The Politicalization of The Corporation*, 51 B.U. L. Rev. 425 (1971), at 433.
[235] S*upra.* note 125.
[236] Minutes of Evidence, Company Law Committee, HMSO, London, 1960.

1.4.2 Confusion between Shareholder and Stakeholder

Indeed, the advocacy of "social responsibility" imposed great pressure upon the relational function of the board, rendering directors facing difficult choices between the interests of shareholders and stakeholders.[237] When the board is required to consider all internal and external factors together into its decision-making, directors may inevitably ask themselves what matters they should be primarily concerned about. When the board is trying to connect the company with its outside world, directors must determine how far they can properly go beyond the traditional line of company law. In other words, in playing its role as "bridge", the board must decide whether it should still firmly comply with the classical rule of setting shareholders' interest as the priority, or whether it should treat the interests of stakeholders equally to those of shareholders. It is still unclear "how the traditional economic role of the corporation in a capitalistic society - maximization of profits for the benefit of shareholders - can be reconciled with what appear to be increasing societal demands…"[238]

If the board sees its relational role in term of the stakeholder model, certainly, a long-time principle of company law must be overcome. This doctrine was enshrined by the decision in *Hutton v. West Cork Railway Company*,[239] where the directors of the company, in the process of being wound up, tried to pay the employees for their loss of jobs, as a mere compensation and gratuity, but finally, this proposal was denied by the court and held as *ultra vires*. Bowen L.J. said: "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

[237] Here the term "stakeholder" refers to non-shareholder groups, for example, consumers, employees, suppliers, and more widely, the general public. Thus a "stakeholder model" suggests that the company should not merely consider the sole interest of shareholders, but pay attention to a broad range of expectations of different parties. See P. Ireland, *Corporate Governance, Stakeholding and the Company: Towards a Less Degenerate Capitalism?* 23 Journal of Law and Society 287 (1996).

[238] A A Sommer, *Corporate Governance: Its Impact on the Profession*, Journal of Accountancy, Jul. 1980, 50, at 52-53.

[239] (1883) 23 Ch D 654.

as are required for the benefit of the company."[240] The case makes clear that no objective can be achieved unless it is good for the shareholders. Despite this, the case was not intended to wholly inhibit the board from taking other factors into account. However, other relationships can merely be considered to implement and reinforce the benefit of shareholders in the situation that they are not in conflict with the interest of members. Thus under the common law position the board was not allowed to overtake and outstrip the fundamental rule of company law, even if it is with a proper and selfless motive.

Of course, the appearance of theory of "social responsibility" has posed certain challenges to the traditional rule of superiority of shareholders' interest. However, there are still a number of obstacles in the ways of achieving the goal. First, it is questionable whether the relational function or "social responsibility" is the only solution to resolve the externalization problem of corporate costs, such as pollution. Certainly, specific statutes have been enacted in those areas to stop irresponsible companies to, for example, from piping sewage into rivers, emitting smoke into the air, or indulging in bribery at home or abroad.[241] This legislation reminds companies that they have duties at law not to act in socially irresponsible ways, or the companies concerned and officers may face significant civil claims and criminal penalties. It may be fair to suggest that, if legislation can effectively detect misconduct and enforce penalties, this may be more effective than simple reliance on a good sense of "social responsibility". Second, it is also clear that, in a market which is becoming more and more consumer-oriented, voluntary embracing of "social responsibility" may be less relevant than pressure from consumers and the

[240] *Ibid.* at 673.
[241] For example, as a result of SEC investigations in the mid-1970s finding that over 400 US companies had made questionable or illegal payments in excess of $300 million to foreign government officials, politicians, and political parties, the US Congress enacted the Foreign Corrupt Practices Act of 1977 to bring a halt to the bribery of foreign officials and to restore public confidence in the integrity of the American business system. In UK, as for the legislation to control pollution, currently it is controlled under a specific statutory scheme found in Part IIA of the Environmental Protection Act 1990, as inserted by the Environment Act 1995, and other 'rules' found in regulations and statutory guidance.

public to discipline the company, making it becoming more sensitive to the impacts of its behaviours. Irresponsible companies are more likely to be penalized when they are "named and shamed" in the media, and unhappy consumers may turn their back on such companies. Furthermore, it can be argued that companies have also learned that public discontent is often more powerful than rigid governmental regulation.[242] Third, there is some ambiguity regarding the definition of "the interests of stakeholders". The meaning of the "public interest" might to a certain extent be unclear without reference to any particular standards and guidelines. For example, to keep obsolete plants open or stop cutting jobs may assist employees or the community, but they may also lead to loss of productivity, loss of competitive position, and ultimately destruction of the shareholders' rights. One must question whether this result serves "social responsibility". Finally, even if it were possible to resolve all the above problems, there may still be uncertainty about the way that interests of social and economic groups affected by the corporation could effectively and feasibly be given equal attention in the corporate decision-making process. Any reform with the intention to "politicalize" the board into a body required to balance all kinds of claims, would very likely become a "nightmare" for corporate industry, because a board with diverse objectives may lead to endless arguments among those representatives holding entirely antithetical opinions, and more seriously, the company itself might become confused as to what its main purpose of business was.[243] While the intense disagreement grows and each member tries to persuade the representatives of other constituencies, the quality of decision made by the board turns up to be lower. Consequently, linking the relational function with the idea of "social responsibility" or "stakeholder model" may not be able to bring any benefit to the effective performance of the board.

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[242] Homer Kripke, *The SEC, Corporate Governance, and the Real Issues*, 36 Bus. Law. 173 (1981), at 206.

[243] E. Norman Veasey & Christine T. Di Guglielmo, *How Many Masters Can a Director Serve? A Look at the Tensions Facing Constituency Directors*, 63 Bus. Law. 760 (2007-2008).

1.4.3 The Solution of Companies Act 2006

As discussed above, it is not reasonable to suggest that the relational role of the board should wholly embrace the notion of "social responsibility". The expectation that the board should stand more in line with the interests of all non-shareholder parties is somewhat unrealistic. However, it is not correct to conclude that relationships between the board and stakeholders are absolutely unvalued, and the law should completely ignore the fostering of such relationships. Lawmakers should understand the point that large corporations are closely related with the outside world, and thus it is necessary to make a suitable response. Not surprisingly, trends in this sense have been found in the development of legal rules since the 1980s.[244] In particular, the issue of how stakeholder interests could be accommodated in shareholder-centric company law regime, became a particularly controversial topic in the Company Law Reform debate proceeding the new Companies Act 2006. In reaching a final conclusion, an approach, which is described as "enlightened shareholder value" approach, was adopted in the CLR proposal. In the Companies Act 2006, it is hence provided that:

> A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to—
>
> (a) the likely consequences of any decision in the long term,
> (b) the interests of the company's employees,
> (c) the need to foster the company's business relationships with suppliers, customers and others,
> (d) the impact of the company's operations on the community and the

[244] To a certain extent, the Companies Act has appreciated the importance of employees' interest and arranged certain, but very limited, place in the law for the directors to consider the employees' demand as well as the interest of shareholders. See s.309 and 719 of Companies Act 1985.

environment,

(e) the desirability of the company maintaining a reputation for high standards of business conduct, and

(f) the need to act fairly as between members of the company.[245]

Obviously, this provision has a significant effect on the debate. On the one hand, the shareholders' interest is endorsed in a more definite form that the "success of the company" is closely connected with the "benefit of its members as a whole". Thus the best interest of the company is at the end equal to the collective interest of the shareholders. On the other hand, the relationship between directors and stakeholders is formally clarified that the non-shareholder interests should be necessarily considered. It is suggested that such a relationship is very important to the prosperity of a company, and amongst the provision, there is a self-evident implication that the board should and must keep a close tie with groups other than shareholders because it is the indispensable way to ultimately promote and maximize the interest of members as a whole.[246] Furthermore, it is worth noting that the preference of shareholders' interests is unshakable even if the directors are given more discretion to take account of other factors for making their decision. In other words, the relationship is not in nature a legal duty that the directors bear responsibility in law towards those stakeholders, and thus the relationship is only allowable or capable of being maintained if it is not contrary to the directors' duties to the shareholders.[247] The relationship with "social accountability" is more likely regarded as a secondary outcome derived from primary goal of pursuit of shareholders' interests, when the improvement of such relationships may be good for the members of company.

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[245] Section 172 (1).
[246] See Mohammed B. Hemraj, *Corporate Governance: Rationalising Stakeholder Doctrine in Corporate Accountability*, Comp. Law. 2005, 26(7), 211-214; James McConvill, *The Separation of Ownership and Control under a Happiness-Based Theory of the Corporation*, Comp. Law. 2005, 26(2), 35-53.
[247] This proposition was criticised by commentators as "toothless tokenism", because "a right without a remedy is worthless". See M. McDaniel, *Bondholders and Stockholders*, 13 J. Corp. L. 205 (1988).

So far, the philosophy embraced by the Companies Act 2006 might be regarded as an affirmation of the relational function of the board. It firmly reminds the board that, in promoting the success of business, directors should attempt to link the company with its external circumstances in a harmonious climate. Unlike the role of monitoring, the regulation in this sense does not set up a rigid rule here by requiring the board what it should do and how to do it. There is no exclusive standard to prohibit directors from doing something, but on the contrary, an encouragement of best corporate practice and a call to adopt deemed appropriate behaviours.[248] The intention of s.172(1) is not to make any radical revolution contrary to the traditional shareholder-favour doctrine, but more appropriately, it is better regarded as a supplement of the legal principle, persuading the court to be more open-minded on the issue of directors' duty to promote the interest of shareholders. The judges are thus encouraged to take a broader perspective in reviewing the validity of decisions of the board. Some business decisions could be justified in law that, even though in the previous view, the shareholders get no benefit in short-term, the long-term success is still ensured when the company can keep a harmonious relationship with all its constituencies. For example, as one commentator suggested, shareholders might feel "happy" when they regard their companies as more "social responsible".[249] This psychological "happiness" might as well be viewed as a component of shareholders' interest and long-term success of the company, even if the evidence of economic benefit is at first sight weak. Consequently, s.172(1) provides a wide discretion for directors to carefully figure out the extent of the relational function of the board under the background of legal principle of "the best interest of the company". Directors would be more comfortable to value the board's role as "bridge", based on the suggestion that their decisions are justified in accordance with the purpose of the Act. Although

[248] It seems obvious to say that the law in this sense draws similarities with public education, rather than imposing legal requirements that the directors must owe their duties to groups other than shareholders. It turns out to be more like a booklet with the incentive to tell those businessmen how to successfully run their companies. It can be seen as a smooth persuasion rather than a radical revolution.
[249] James McConvill, *supra.* note 142.

s.172 seems to be solely a statement with no strong enforceable mechanism,[250] it can still make a great difference on how the board plays its relational role.[251]

1.4.4 The Independent Directors as Communication Link

In the above part of this chapter, the author has examined the role of the board as a relational "bridge". In sum, a relational board can "assist the corporation in forging relationship with various stakeholders and others in its social environment".[252] Now, it is interesting to delve deeper into this issue to explore how independent directors can fit themselves in this general function of the board.

Certainly, it is necessary for us to bear in mind that, appreciating the value of relationships between the company and stakeholders is not just a task of any specific group of directors. The responsibility is taken by the board as a whole to ensure that all factors relating to business success are carefully considered and assessed. For those in charge of large companies, they might have already realized that the prosperity of the company is based on the multi-contribution by a number of constituencies. The introduction of the "enlightened shareholder value" approach may not suggest a radical departure from their current beliefs and practice. There is no sound evidence to suggest that senior managers have poor ability and knowledge to understand all those key factors.

However, management could sometimes unconsciously or deliberately miss the point the more that their own compensation becomes linked to share price. There is temptation that management might emphasize too much day-to-day share

[250] Andrew Keay, *Section 172(1) of the Companies Act 2006: An Interpretation and Assessment*, Comp. Law. 2007, 28(4), 106-110, at 110 ("Perhaps the main point to note is that there does not seem to be any framework in place to ensure that directors are held accountable for their decision-making process".)
[251] For a more detailed discussion of rationale and criticism of s.172, see Ji Lian Yap, Considering the Enlightened Shareholder Value Principle, Comp. Law. 2010, 31(2), 35-38.
[252] Lynne L. Dalleas, *supra.* note 114, at 3.

performance but relatively downplay the long-term development of the company. The increasing of capital value does promote shareholders' benefit in the short-term, but there can be a risk in the future that the long-term perspective would be damaged.[253] The strategy of chasing high short-term profits may satisfy investors, but it is wondered whether such measure may be achieved through sacrificing others' interests. Therefore, independent directors, whose compensation is not related to the stock performance, are encouraged to play the role of offsetting the boardroom climate which may overly put much concentration on short-term promotion of capital. It is thus important for independent directors to remind their executive colleagues that, as an objective judge in business decision-making processes, they should take a balanced view between short-term value and long-term success (as s.172 requires), as well as fairly take account of the interest of both shareholders and other constituencies.[254]

Furthermore, literature typically identifies the contribution of directors, who are from groups of outsiders, in achieving the goal of the "bridge strategy". It is argued that these directors provide the company with access to a network of contacts that may be useful in gathering resources.[255] Given the fact that independent directors usually have their main career in other businesses, it is not unusual that in some cases, the company might be tempted to invite people into its board due to the consideration of their background or profession. For example, the interlocking of directorships, affiliating the company with financial institutions, may help the company access capital. Moreover, in many circumstances, the fulfilment of the relational function relates to how to promote the profile of the company. As in the words of one executive, "the board is part of the image of the company. The calibre and stature of

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[253] The current credit crunch is a good example. In the past few years, financial institutions strived to produce huge profits with the effect that their stock prices spiralled through high-risk transactions on financial derivative products. In short term then their performance was strong, but when the crisis erupted, the companies had to pay for their excessive risk-taking, and finally the shareholders and employees became the victims of the failure of business.

[254] Giles Proctor & Lilian Miles, *Corporate Governance* (Cavendish Publishing, 2002), at p.194-196.

[255] L. Johnson et. al., *Board of Directors: A Review and Research Agenda*, 22 J. Mgmt. 409 (1996), at 428.

the outside board members, both just as names and as people circulating in the business community, contributes to the image of the company. When I look at a company, I look at who is on the board …. The type of people on a board does, in a series of informal and intangible ways, have a good deal to do with what the character of a company is. Is it a respectable and conservative company, or is it highly speculative? The investing public, you know, really care who is on the board".[256] To be sure, if the public has to valuate two different types of board, i.e. an insider-based board or independent-majority board, they would generally favour the latter. A board with a characteristic of independence certainly gives the outside world an image, although there may be no strong supportive evidence from such an assumption, that the company is run in a proper way and would be more careful about the interests of stakeholders. Therefore, independent directors are to a large extent indispensable in playing the board's relational function.

1.4.5 The Relationship with the Stock Market

Usually, as in the analysis above, the relational function is referred to relationships between the company and stakeholders. While the introduction of independent directors is generally seen as a part of the "bridging strategy" of mediating,[257] it seems interesting to wonder whether stakeholders are the only parties that benefit from this function. It is noteworthy that, as far as the publicly held company is concerned, the firm must be concerned about its profile and performance on the stock market, as well as on the retail and manufacture spheres. The reason is easily to understand: the company relies on the market for financing, in form of either equities or bonds.[258] There is no doubt that the company may expect that the market could

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[256] Quoted by Myles Mace in his book, *Directors: Myth and Reality* (Harvard University Press, 1971), at p.16.

[257] Lynne L. Dallas, *supra.* note 114, at 10; S.A. Zahra & J.A. Pearce, II, *Boards of Directors and Corporate Financial Performance: A Review and Integrative Model*, 15 J. Mgmt. 291, 301 (1998) (referring to it therein as the strategic contingency perspective). See also Lynne L. Dallas, *Two Models of Corporate Governance: Beyond Berle and Means*, 22 U. Mich. J. L. Rep. 19 (1988), at 91-94.

[258] Of course, in normal situations, access to capital markets is the major reason why a company would like to be

appreciate it as a business institution with a robust governance system. Moreover, certainly, the market and investors would view some companies as attractive if they think the firms are built and run in a good structure of corporate governance.[259] In this sense, the author suggests that a proper relationship between the company and stock market is actually necessary, and the market should also be an important party whom the relational function should work on.

The relationship between the company and investors is of course always complicated and variable. In judging a given company, investors may analyze it against a number of standards and by reference to various pieces of information, e.g. business perspectives, market share, cash flow and profit margin. Some investors might also pay certain attention to the structure and composition of the board. The emphasis on the board may arise because of two factors: first, given the fact that the board is the leading body of corporate hierarchy, the market usually obtains an image of internal governance only through the profile of the board;[260] second, investors know that they get all critical disclosures from the board, because it is the duty of the board to verify the accuracy of those public statements. So if the board does matter in the minds of potential investors, it is common to claim that, while as the recipients of great capital from the public, these publicly held companies should be governed by effective, or at least appropriately structured, boards. What kind of board could be

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listed on stock exchanges, even if it must at the same time sacrifice the privacy of financial status and follow strict rules of frequent information disclosure.

[259] Some institutional investors, e.g. public pension funds, do like to set up their own standard for "good corporate governance", and try to rank companies according to their vision. It is common that the independence of the board is usually treated by these institutions as an important guideline to judge a particular company (through rating system). See Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 Bus. Law. 921 (1999), at 954; David Zaring, *Best Practices*, 81 N.Y. U. L. Rev. 294 (2006), at 297-298.

According to a 1996 McKinsey survey of investors, two-thirds of those surveyed were willing to pay more - on average 16% more - for a well-governed company, all other things being equal. See Robert F. Felton et al., *Putting a Value on Board Governance*, 4 McKinsey Q. 170, 170-71, 174 (1996). "Well-governed" meant: (i) a clear majority of outside directors; (ii) the presence of truly independent directors with no management ties; (iii) directors possess significant stock holdings, and are paid, to a large extent, with stock; (iv) formal evaluation of CEOs and directors; and (v) the board responds to investor requests.

[260] For example, by looking at the career record and biography of board members (including senior managers), investors may have a general understanding about the managerial style of the company, and then decide whether the company is worthy for investment.

conceived as "effective"? Investors may again face a choice, similar to that, as discussed above, in relation to stakeholders, i.e. a board dominated by the management, or a board which can at least in theory embrace the feature of independence? If this decision has to be made, undoubtedly, a board, in which independent directors constitute a substantial force, would be the preference. In this sense, the principal role the independent directors are asked to play is to maintain the confidence in the market. The inclusion of independent directors implies that a well-organised system of corporate governance has been set up, the company is thus being run in a proper path and the interest of investors would be seriously respected. Therefore, it is important for independent directors to occupy a vital role in assuring investors that "the governance process has integrity",[261] and the managers "are complying with the legal duties, regulatory requirements, and ethical imperatives associated with the operation of a public company."[262] By achieving this, confidence in the securities market is capable of being preserved.

Certainly, it is not true that the market would unconditionally favour independent directors. There is no secure promise that, by organising the board in a certain manner, the company would automatically be successful in its business. In some ways, the appearance of independent directors is mostly able to psychologically satisfy the investors that some measures, which are subjectively believed to amount to "good corporate governance", have been implemented. But does this mean that the relational function of independent directors is without any sensible meaning? The author thinks it is not sound to quickly deny any contribution. The term "confidence" is a description of a complex mental characteristic. A good example of this is the disaster of the collapse of Enron and WorldCom that became widely recognized by the public during the 2002, and the aftershock of "the events of 2002 represented

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[261] E. Norman Veasey, *An Economic Rationale for Judicial Decisionmaking in Corporate Law*, 53 Bus. Law. 681, (1998), at 688 (quoting William T. Allen, *Independence, Integrity and the Governance of Institutions*, Speech to the National Association of Corporate Directors Annual Meeting 7-8 (Oct 27, 1997)).

[262] Brian R. Cheffins, *Company Law: Theory, Structure, and Operation* (Clarendon Press, 1997), at p.96.

unprecedented levels of both the number and the size of companies involved."[263] The scandals caused a drastic impact on the securities market, by leading so many Americans to doubt the integrity of the financial organisations and the whole system.[264] The atmosphere of mistrust led to a market panic, and inevitably resulted in a downturn in stock market of which recovery was difficult in the short-term. In response to investors' concerns, American lawmakers enacted the Sarbanes-Oxley Act. As one of the important provisions in the Act, independent directors are regarded as a major method of internal control against the misstatement of financial reports, which has been targeted as the main contributory factor in the scandals of Enron and WorldCom. The message send from the legislation is that certain improvements have been made to remedy the defects of the market.

Interestingly, across the Atlantic, although there was no directly comparable scandal on the scale of those in the US and scant evidence to suggest the possibility of such large-scale improper behaviour in the near future, the British government also tried to maintain the confidence of the market by releasing a consultation report, the *Review of the Role and Effectiveness of Non-Executive Directors* (in short, "the Higgs Review").[265] In the review papers, it clearly reinforced the values of independent non-executive directors. The bulk of the Higgs Review's findings were imported into the Combined Code. In sum, it is suggested that, through these reform, confidence could be maintained in the market.

The reason for seeking to bolster confidence is not difficult to understand.

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[263] John A. Weinberg, *Accounting for Corporate Behavior*, Econ. Q., Summer 2003, at 18.
[264] The proportion of audits in the US who expressed very little confidence" or "no confidence at all" in the "financial industry" almost doubled from 19% in January 2002 to 35% in July 2002. During the same period, the proportion having "a great deal of confidence" in the financial industry declined from 10% to 5%. See Hart and Teeter Research Companies, Roper Center Public Opinion Online, Dec. 7-10, 2000, available at LEXIS accession no. 0376547 (Pubic Opinion Location Library or Public Opinion Online database); Hart and Teeter Research Companies, Roper Center Public Opinion Online, Jan. 18-21, 2002, available at LEXIS accession no. 0397267 (Pubic Opinion Location Library or Public Opinion Online database); Hart and Teeter Research Companies, Roper Center Public Opinion Online, July. 19-21, 2002, available at LEXIS accession no. 0411854 (Pubic Opinion Location Library or Public Opinion Online database).
[265] Derek Higgs, published in January 2003.

Confidence is actually the foundation of the securities market, because it is presumed by participants in financial relationships as a prerequisite to group life and to economic prosperity.[266] Investors may hesitate at investing if they feel that the market safeguards have failed. Available research indicates that, in modern society, the level of trust is positively correlated with the size and robustness of the financial sector, i.e. an increase in trust benefits the financial sector, otherwise, a decrease in trust may harm it.[267] Thus the collapse of the market usually occurs when trust disappears. Because the performance of stock market has a major impact on the general economy,[268] the damage to the market might infiltrate society as a whole. To a certain extent, one of the factors relating to the stability of the stock market is how to retain strong confidence among investors. In order to obtain this confidence, reform of corporate governance system can be seen as important. It is common sense to perceive that better corporate governance is a touchstone of better business performance.[269] In the meaning of "good corporate governance", the introduction of independent directors would easily be presumed by investors as some form of improvement. Consequently, the relationship between the company and the market is promoted through the appearance of independent directors, when investors are assured that the system has been reformed and thus their confidence is maintained.

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[266] Francis Fukuyama, *Trust: The Social Virtues and the Creation of Prosperity* (Free Press 1995), at p. 9, 47.

[267] César Calderón *et al.*, *Development and Efficiency of the Financial Sector and Links with Trust: Cross-Country Evidence*, 51 Econ. Dev. & Culture Change 189 (2002); Paul J. Zak & Stephen Knack, *Trust and Growth*, 111 Econ. J. 295 (2001), at 307-311; Daina C. Mutz, *Social Trust and E-Commerce: Experimental Evidence for the Effects of Social Trust on Individuals' Economic Behavior*, 69 Pub. Opinion Q. 393 (2005).

[268] "The Nation's capital markets play a critical role in our domestic economy by creating jobs and expanding business… The success of U.S. securities markets is largely the result of a high level of investor confidence in the integrity and efficiency of our markets." See Senate Comm. on Banking, Housing and Urban Affairs, Private Securities Litigation Reform Act of 1995, S. REP. NO. 104-98, at 8 (1st Sess. 1995), reprinted in 1995 U.S.C.C.A.N. 679,687.

[269] However, it does not mean that in every case, a better corporate governance structure could certainly produce the success of a company. Many empirical studies found no close relationship between corporate governance and corporate performance. See Niamh Brennan, *"Boards of Directors and Firm Performance: is there an expectations gap?"*, in *Corporate Governance*, Vol. 14, No.6, Nov. 2006, 577-593.

1.4.6 Authorities Using Independent Directors to Reach its Agenda

On the one hand, the authorities may use the introduction of independent directors as an effective measure to achieve its own regulatory agenda and try to influence the development of corporate governance. It is interesting, however, that the authorities can also be seen as a major party involved in the communication of relationships. For large publicly held companies, other than interacting with the stock market, their performance is also under the scrutiny of government bodies or agencies with the authority to make and enforce market rules. Where serious wrongdoings or fraud is detected by the authorities, they may well launch an investigation into the company's affairs.[270] If it were convinced that the company and its officers did commit any improper conduct, the authorities would certainly have a strong motive to actively correct identified problems in corporate governance.

However, given the fact that the authorities are not the true owners of the companies, they cannot directly decide how the business should be run and how the company should make a specific judgement in any particular situations. In general, apart from imposing huge fines against the company for regulatory breaches, occasionally, the authorities may tend to influence the internal system of decision-making through indirect interference.[271] For example, the authorities might order, by civil action or other methods,[272] that the company makes an adjustment on the structure of the board, requiring it to include a majority of independent, non-executive/outside directors. Alternatively, the authorities may require the company to convene a specific committee, mainly or exclusively composed of independent directors, to

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[270] For example, after the crisis of Enron began to unfold in 2001, SEC announced that it was investigating several suspicious deals struck by Enron, pronouncing that "some of the most opaque transactions with insiders ever seen". Under the pressure of investigation and market panic (the share price of Enron fell to $20.65, down $5.40 in one day on October 22), chairman and CEO of Enron admitted, "We will cooperate fully with the S.E.C. and look forward to the opportunity to put any concern about these transactions to rest." See Floyd Norris, Where Did the Value Go at Enron (sharp drop in stock price), The New York Times, col. 5 (Oct 23, 2001).

[271] Hillary A. Sale, *Independent Directors as Securities Monitors*, 61 Bus. Law 1375 (2005-2006) (suggesting that the SEC is using independent directors as securities monitors in the information-forcing-substance disclosure model that the SEC has used to achieve improved corporate governance).

[272] See the case of *SEC v. Mattel, Inc.*, *infra.* note 169.

carry through an internal investigation. In the eyes of the authorities, a board dominated by independent directors may be seen as an effective weapon to fight against misconduct in corporate governance, because it is expected that those directors would take an objective perspective in the best interests of the company. Equally the company might accept the introduction of independent directors as feasible way to cooperate with the instructions of authorities. While resistance to the authorities' proposals for change may not be a shrewd move, since it may be seen as a negative signal, the company would be reluctant to allow the authorities to "arbitrarily" interrupt its business. Thus indirect interference on the board's structure might be a reasonable compromise, because the company can still keep most of its discretion, and the amendment would not radically overthrow the whole corporate system. As a result, in this sense, independent directors play an important role to communicate the relationship between the company and the authorities, when the authorities do not want to lose control on corporate governance and the companies do not want to fail the authorities.

In practice, using independent directors to act as a bridge with regulators is a credible idea. It is not surprising that the SEC, which holds responsibility for regulating American securities markets, has long been the major ardent advocator for the inclusion of independent outside directors as a path for the improvement of corporate governance. In several cases of investigation and direct actions against companies involved in breach of market and legal rules, the SEC attempted to use the introduction of independent directors as a part of its action to resolve identified problems. An important example is the 1970s case, *SEC v. Mattel, Inc.*,[273] in which the SEC reached a settlement with the companies concerned involving the provisions of restructuring the board to consist of a clear majority of independent directors. In the *Mattel* case, the company committed violations of the SEC's antifraud and

[273] SEC. REG. REP. 94,807 (D.D.C. 1974).

reporting-disclosure requirements. Ultimately, the case terminated in a consent decree, which required the company to appoint several additional unaffiliated directors, who should be approved by the SEC and the court, in sufficient numbers to constitute a majority of the board. The company also agreed to maintain an executive committee consisting of three or more members, but based on the precondition that a majority of it should at all times be composed of those additional directors.[274] It is obvious that the SEC intended to treat independent directors as an "ideal carrier" to embody the companies' willingness to improve the decision-making processes. On the other hand, because those directors are not public officers directly accountable to the authority, the SEC can to a certain extent avoid getting too deeply involved in substantial corporate management and excessively interfering with private business. Simultaneously, re-organising the board helps companies convince the authorities that they are attempting to remedy their problems. In sum, in terms of the relational role as a communication link, independent directors are designed to become a measure to put the expectations of both the authorities and companies together. Therefore, even if it might be suspected that the practice of including independent members is far more a kind of modality rather than making any real practical difference, the communication role should not be completely excluded from the spectrum, since the movement has helped the authorities to realize their agendas and encouraged the industry to appreciate the notion of independent directors.

1.4.7 Independent Directors and Legal Rules

In some ways, the law may prefer the introduction of independent directors and endorse the decisions of these directors.[275] The courts have long been reluctant to

[274] See Mattel Posts 27% Drop in Earnings and Adds Seven to Its Board, Wall St. J., Dec. 17, 1974, at 6, col. 2.
[275] Notes, *Propriety of Judicial Deference to Corporate Boards of Directors*, 96 Harv. L. Rev. 1894 (1982-1983) (the courts' deference to the decision by independent directors in dealing with the cases regarding corporate governance). But *cf.* Walter Werner, *Corporate Law in Search of its Future*, 81 Colum. L. Rev. 1611 (1981) (questioning propriety of judicial deference to decision by so-called independent directors).

interfere too much with the operation of corporate affairs, and generally have clearly expressed their willingness to respect judgements of those running the company.[276] As stated by Lord Davey in *Burland v. Earle*, [277] "[i]t 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."[278] The court may be very careful to avoid substituting its own decisions for the opinions of business professionals, because it is not the proper body with specific knowledge and experience in the commercial area.

However, it does not mean that the law should completely give up its jurisdiction. Certainly, in some cases, participants in the company may refer the arguments to the courts for judgements. For example, if the shareholders were not satisfied with a decision of the management and thought that their interest was damaged, they might sometimes have the motive to bring legal proceedings against the corporate officers,[279] by the way of derivative action.[280] The court might thus need to decide whose claim it should accept. Due to the tradition of philosophy of unwillingness to interfere with business decision-making, the court would not like itself to be the place of resolution to corporate affairs, and it may establish certain "floodgates" in order to filter in advance cases coming before the court.

One of the modern ways to do so is through the requirement for pre-review by independent opinions, normally from the independent directors. This practice can be

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[276] *Foss v. Harbottle* (1843) 2 Hare 461.
[277] [1902] AC 83.
[278] *Ibid.* at p.93.
[279] However, it is the truth that, for shareholders of listed companies, in most situations, it is far more convenient to simply exit the company by selling their shares. See the analysis in Chapter 6.
[280] Section 260-264, Companies Act 2006, providing that a member of a company may bring a derivative claim against an actual or proposed act or omission involving negligence, default, breach of duty or breach of trust by a director, and such a claim must apply to the court for permission to continue.
Of course, in British company law, shareholders can bring an action based on the statutory remedy in section 994 of Companies Act 2006 against unfair prejudice. But for shareholders in a public company, the remedy is not easily available. See *Re Blue Arrow plc* [1987] BCLC 585.

found in the judgement of *Zapata Corp v. Maldonado*,[281] made by the Delaware Supreme Court. In the *Zapata* case, minority shareholders intended to bring a derivative action against officers of the corporation. In response to this move, the board of directors formed an independent sub-committee to conduct a proper inquiry into allegations of shareholders and review the substance of the derivative action. Subsequently, when the sub-committee reached a conclusion in favour of the decision of the board, the company anticipatively brought a pre-trial motion in order to dismiss the derivative action, and finally, it succeeded. The Court held that the shareholders did not have an indefeasible right to bring the action. It was followed that, in deciding upon shareholder litigation, it is necessary to have regard to the conclusions of the sub-committee of the board. Thus given the facts of this case, the action was struck out. The rule has been followed by several successive US cases in which the claims of shareholder litigation were turned down.[282] It was held that, in justifying shareholder litigation, the support of independent directors is required as pre-condition, unless the plaintiff alleges specific facts that create a reasonable doubt either that a majority of the directors are disinterested and independent of the alleged wrongdoers or that the challenged transaction was otherwise a valid exercise of business judgement. In other words, the plaintiff must allege an improper motive or conflict of interest, showing the transaction to be so egregious on its face that it cannot be regarded as a valid business decision.[283] Thus if shareholders failed to convince the court of the feasibility of the allegation, a court will review the board's decision under the business judgement rule, that is, so long as the committee is independent and uses adequate procedures, the court will defer to its recommendation and the case will be dismissed.

A similar issue also appeared in front of British courts. In *Smith v. Croft (No.2)*,[284]

[281] 430 A 2d 779 (1981).
[282] Grobow v. Perot, 539 A.2d 180, 186 (Del. 1988).
[283] Levine v. Smith, 591 A.2d 194, 205-06 (Del. 1991).
[284] [1987] 3 All ER 909.

minority shareholders alleged various improprieties committed by the directors, who were also majority shareholders with about 63 percent shares, including an *ultra vires* transaction of excess remuneration and unlawful financial assistance for the purchase of the company's shares in breach of s. 151 of Companies Act 1985. Confirming the decision in *Prudential Assurance Co. Ltd. v. Newman Industries Ltd and others*,[285] Knox J was satisfied that there was a *prima facie* case based on breach of s.151, and the claim was for fraud on the minority and therefore lay within "the proper boundaries of the exception to the rule in *Foss v. Harbottle*".[286] Knox J conducted further analysis, however, and decided that the court should look at the view of the "independent shareholders", i.e. the "views of the majority inside a minority" as to whether they supported the derivative action. On ascertaining that 21 percent of voting shareholders did not want the action to continue, the Court struck it out.

On the surface, the conclusion reached by Knox J is somewhat different from the judgement across the Atlantic in *Zapata Corp v. Maldonado*, because in *Smith v. Croft (No.2)*, the court had regard to the opinions of shareholders, independent of both plaintiffs and wrongdoers, rather than to consider independent views in the board. But in fact, both conclusions are not significantly distinct. As Knox J said, "[u]ltimately the question which has to be answered in order to determine whether the rule in *Foss v. Harbottle* applies to prevent a minority shareholders seeking relief as plaintiff for the benefit company is, 'Is the plaintiff being improperly prevented from bringing these proceedings on behalf of the company?' If it is an expression of the corporate will of the company by an appropriate independent organ that is preventing the plaintiff from prosecuting the action he is not improperly but properly prevented and so the answer to the question is 'No'."[287] Ostensibly, the British court

[285] [1982] Ch 204.
[286] [1987] 3 All ER 909, at 914.
[287] Ibid. at 955-956.

primarily identified the general meeting as being the "independent organ" which could be entitled to decide the issue on behalf of the company as to the desirability of derivative action. However, essentially, the conclusions of two judiciaries are not totally incompatible. The expression of "appropriate independent organ" used in *Smith v. Croft* did not exclude the possibility of identification of an independent committee as such a body, and sufficiently, in certain proper cases, it would be reasonable to bring the idea of *Zapata Corp v. Maldonado* to the UK, by extending the interpretation to a sub-committee of board.[288] Therefore, it is not surprising to foresee a scene that, when the board is faced with a derivative action which it saw as inappropriate, it might form an independent sub-committee to look into the allegation and review evidence provided by the unsatisfied shareholders. The committee would reach a conclusion, either by its own investigation or through the commission of specialist investigators such as accountants, and then issue a report of whether or not to back the claim of shareholder litigation. If the committee preferred not to continue the litigation, it might call for the termination of the derivative action. Provided the court were satisfied that the sub-committee was truly unaffiliated with the officers engaged in the alleged wrongdoing, and the opinion of this sub-committee was honestly independent, it may be well that the court would treat the committee as an appropriate independent organ within the *Smith v. Croft* principle, and thus strike out the derivative action.[289] This principle may be necessary, especially for cases involving large publicly held companies, because "the practicalities of identifying the independent group among thousands of shareholders would probably prove insurmountable",[290] and thus the independent views of a sub-committee of the board might be a reasonable alternative for the purpose of legal doctrine.

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[288] B. Petter, *Company Law* 2nd e.d.n. (Pearson Longman, 2005), p.225.

[289] It is important to refer to section 263(3), which provided that in considering whether to give permission to continue a derivative claim, the court must take into, in particular - (e) whether the company has decided not to pursue the claim. Thus, if it is possible that the refusal of a sub-committee to pursue a derivative claim may, in proper cases, be regarded as the decision of the company. By considering this fact, the court may dismiss the application of continuing derivative claim. However, we must notice that the sections also provide that the views of independent shareholders should be taken into account. Therefore, it is not reasonable to conclude that the findings of the independent sub-committee would always automatically accepted by the court.

[290] *Supra.* note 183.

Furthermore, even if a derivative action were accepted by the court as meeting all the preconditions or disclosing a *prima facie* case, independent directors might still turn up as a possible remedy to correct the misdeed in the company and satisfy the plaintiff shareholders. An example can be found in an American case, in which the parties finally came to a settlement. *Springer v. Jones*[291] was a derivative action against the officers of Northrop Corporation on the ground of illegal political contributions, and a class action against corporation itself based on violations of the proxy voting rules. According to the provisions of the settlement, it was required that the company must introduce a series of changes to the structure of the board, including, first, to increase the size of the board by adding four new directors, who should be approved by the court as qualified in terms of independence, integrity, ability and experience; second, to make sure that 60 percent of the board, certainly covering those four new directors, must be "independent outside directors", in accordance with specific standards;[292] third, no lawyer who serves as (or is associated with a law firm serving as) outside counsel to Northrop can be a director; in addition, the corporation must reconstitute its executive committee so that seven of its eight members, including its chairman, are independent outside directors, as defined. Obviously, the central part of the settlement focuses on the directors who are independent of the management and not financially reliant on the company. By promoting the independence of the board, shareholders may feel satisfied that their demand had been met. The court may also be less worried, because such a settlement ensures that there is no danger of the court encroaching upon the "business judgement" rule. The only role of the court in the settlement was to control the appointment of new directors according to the standard of independence. As a result,

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[291] Civ, No. 74-1455-F (C.D. Cal. Nov. 23, 1974).

[292] The "independent outside director" is defined to mean one 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 presently proposed to receive in the next year in excess of $25,000 (other than fees as a director) for services rendered or from the sale of material; and (iii) is not associated with a company or firm which has in any of the four preceding years received or is not presently proposed to receive in the next year in excess of one percent of its gross sales from transactions with the Company.

the law generously places its credit on the introduction of independent directors. The courts regard the practice of structural change of the board as one feasible option of remedies in resolving the problems of corporate governance. It is also a signal that, due to the recognition of the law, independent directors could be trusted, when they can appropriately meet the requirement of independence. The companies are, therefore, encouraged to embrace the idea of independent directors for the purpose of legally justifying its decisions in controversial matters.

2. Conclusion

Generally speaking, it is very rare that the board of a company would only play one single role in operating the business. As in the words of one commentator, "boards are expected to perform multiple roles, with the effective performance of these roles requiring different types of directors. Some boards perform some roles better than others, depending on their composition."[293] It is a fact that in different types of companies, boards are expected to fulfil diverse functions in order to meet certain demands in the distinct stages of their business cycle. There is no absolutely accurate rule to guide the work of the board about what it should do in every particular case. The multiple roles of the board mean that it might have different focuses and emphases in different specific circumstances. In practice, the board has its own flexibility and it is extremely difficult to make a generalization here. However, in theory, it would still be helpful to provide an overview here about the "effectuation of any meaningful functions [the board] can perform, and particularly any functions it is uniquely qualified to perform".[294] As the author discussed in this chapter, as management and policy-initiating are beyond the board's reach, three clusters of functions remain: reviewing and supervising the performance of the management;

[293] Lynne L. Dallas, *supra.* note 43, at 815.
[294] Melvin A. Eisenberg, *supra.* note 88, at 391.

providing advice and counsel to the management in a modality by which persons other than executives can be formally represented in corporate decision-making process; and acting as a body to correspond and communicate with specific groups of interest and the external world.[295]

Following the analysis of the general functions of the board, a systematic examination on the specific roles of independent directors is necessary. In order to ensure that the board can appropriately discharge its responsibilities in leading the company, it is important to recruit a strong combination of different groups of directors in the unitary board structure. In normal practice, the principal contribution of independent directors may be their role in the strategy-making process by providing sensible advice and helping the management formulate more feasible proposals, since in most situations the executive management accepts the introduction of independent directors on the ground of the expectation that they can help offset their cognitive bias and weakness. However, the responsibility of independent directors in advising management should be compatible with the function of monitoring. In a circumstance of "separation of ownership and control", non-executive or outside directors, who are able to remain independence, have long been regarded as an important internal control force to counteract increasingly expanded managerial power. Given the fact that they are expected to be objective and independent, it is suggested that these directors are perfectly placed in a position where the performance of the management is under their scrutiny. Basically, these two above functions, the advisory and monitoring roles, are the central elements in the roles of independent directors.

Apart from the above two functions, the third cluster of independent directors' roles

[295] Similarly, it was summed up by Jonathan Johnson that, the board should play three roles in the corporate governance, that is, the role of control, service, and resource dependence. See J. L. Johnson et al., *Boards of Directors: A Review and Research Agenda*, 22 J. Mgmt. 409 (1996).

are of critical importance to large public companies in practice. It is stressed that the success of big business may rely on external factors, such as the consumers, employees, and capital markets. Furthermore, it is common that the performance of these corporations is often under the observation of both the authorities and the law. In order to maintain a harmonious relationship with its various stakeholders, the company must actively or unconsciously communicate with all these parties on a frequent basis. For the achievement of this relational function, independent directors are normally regarded as an effective measure as a communication link between the company and external parties. Although to a certain extent, the function as communication link seems not to be as perceptible or meaningful as the monitoring and advisory roles, it should not be underestimated or ignored. It is necessary to bear in mind that, only when the company can foster smooth relationships with the outside world, will long-term business success be effectively achieved.

CHAPTER FOUR

COMPETING MECHANISMS IN CORPORATE GOVERNANCE: INDEPENDENT DIRECTORS, INSTITUTIONAL INVESTORS AND MARKET FORCES

In Chapter three, three major functions of the board were examined, and it was specifically discussed how independent directors could fit within these roles. Certainly, some of the ideas are not fresh thoughts in theories of corporate governance. In fact, many companies have already made great strides in restructuring their boards to follow the reform. Great numbers of independent directors have now been invited on corporate boards,[1] and these directors have increasingly showed their willingness to act independently of the management.[2] In one sense, the days of the wholly inactive or passive director would seem to be numbered.

However, even if this change to board structure and dynamics appears to be promising, some commentators have long challenged the ascension of independent directors by arguing that in practice, there are other competing alternatives which can replace independent directors as a shortcut to pursuance of the aim of better corporate governance. For example, it has long been argued that institutional shareholders and the stock market may both effectively exercise the function of supervision - a role which advocates of independent directors have suggested should

[1] According to a survey launched by Heidrick & Struggles, "Corporate Governance Report 2009: Boards in turbulent times", it was found that in Europe, the proportion of independent directors has risen to 45%, significantly outweighing the proportion of other groups.
[2] See Heidrick & Struggles, "10th Annual Corporate Board Effectiveness Study2006-2007": ninety percent (90%) interviewed directors say that their boards behave independently of management to a great or very great extent", and "eighty-two percent (82%) of them report, 'CEOs have less control over their boards' to at least some extent, with 49% indicating this has happened to a great or very great extent".

fall upon the board.[3] To accentuate this proposition, the current financial crisis seems to be strong evidence that our endeavours in decades to promote board independence failed to either stop management from taking too much risk or curb spiral increasing of executive remuneration.

The author accepts that corporate governance is a complicated nexus with many factors. Appropriate reform of corporate governance may depend on the effects of different measures, and the workings of the board and independent directors cannot be the only instruments deployed in this task. However, the author's proposition in this chapter is not to reject other measures, but to consider whether these measures are really competing against the prevalent model of board independence and whether any single mechanism is solely capable of relieving the pain of corporate governance in this turbulent moment.

1. Institutional Investors and Shareholder Activism

In a situation of "the separation of ownership and control", a realistic issue is how to tackle the problem of "agency costs",[4] i.e. how we can minimize the cost resulting from shirking by the management.[5] By classifying executives as agents and shareholders as principals, scholars working in this model are mainly concerned about how to discipline the management to be more accountable.[6] Although it was admitted that to a certain extent "agency costs" are pervasive but inevitable,[7] commentators suggested that such costs can still be partly internalized and controlled,

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3 Daniel R. Fischel, *Corporate Governance Movement*, 35 Vand. L. Rev. 1259 (1982), at 1265.

4 See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. Fin. Econ. 305 (1976); Eugene F. Fama & Michel C. Jensen, *Separation of Ownership and Control*, 26 J. L. & Econ. 301 (1983).

5 Shirking is defined as not only deliberately cheating, but also negligence, incompetence and even honest mistake. See Michael P. Dooley, *Two Models of Corporate Governance*, 47 Bus. Law. 461 (1992), at 465.

6 Barry D. Baysinger & Henry N. Bulter, *Race for the Bottom v. Climb to the Top: The ALI Project and Uniformity in Corporate Law*, 10 J. Corp. L. 431 (1985), at 436 ("[the] modern corporation…presents a nearly perfect example of an agency relationship: individuals with delegated authority (agents) exercise that authority on behalf of others (principals) for a fee").

7 Roy Radner, *Hierarchy: The Economics of Managing*, 30 J. Econ. Literature 1382 (1992), at 1405-1407.

either by reaching contracts designed to refrain agents from shirking,[8] or by setting up some mechanisms to detect and punish shirking. Furthermore, a multi-layer internal control system may usually be in the place to ensure that no one can easily escape scrutiny and be slack in his or her duty. In a branching corporate hierarchy of a large corporation, monitoring is normally diversified while the operating activities tend to be devolved down to different divisions and levels. In practice, junior managers in each operating unit take responsibility for monitoring individual staff. In turn, middle-level managers are delegated with the authority to assess the performance of their subordinates while the work of final review reaches the senior officers of the company. Such a system is certainly efficient, because, by breaking the whole monitoring into discrete segments, it makes it possible for a monitor to more intensely focus on a limited part of the task. But finally, the question is who should keep an eye on the senior management?

This uncertainty in relation to the ultimate accountability of senior executives has been discussed above in Chapter three, described as "who should monitor the monitor?" In the opinion of the author, it is suggested that the responsibility be delegated to the board of directors, which should act as a brake and supervisor over senior management. This solution, as some writers have termed it, is called "director primacy".[9] However, some critics have started to challenge the idea by arguing that there may be better resolutions to this problem. Professor Bebchuk proposed his perspective on corporate governance, by claiming that shareholders should be given more power of control over both monitoring and operation of the company's affairs.[10] In accordance with his proposition, the model of "director primacy" is not

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[8] For example, principals may award higher wage to agents if they did finally keep the promise of preventing from shirking. See Jensen & Meckling, *supra.* note 4, at 325-326.
[9] Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 Nw. U. L. Rev. 547 (2002-2003).
[10] See Lucian A. Bebchuk & Jesse Fried, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation* (Harvard University Press, 2004); Lucian A. Bebchuk, *The Case for Increasing Shareholder Power*, 118 Harv. L. Rev. 833 (2005) [hereinafter Bebchuk, *Increasing Shareholder Power*]; Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 Va. L. Rev. 675 (2007) [hereinafter Bebchuk, *Shareholder Franchise*].

correct in shaping the future of corporate governance. As a result, "shareholder activism" should replace independent directors as an alternative solution to the problem of "agency costs".

1.1 The Rise of Institutional Investors

Since the second half of the 20th century, the circumstances of securities market have dramatically changed. Institutional investors have replaced individual shareholders as the dominant force in the market.[11] Each of them might hold an appreciable amount of shareholding in publicly held companies, and in aggregate, the majority of equity of such companies is probably in the hands of these institutions.[12] Along with their increases in shareholding, institutional investors have appeared of late to pay more attention to the performance of their portfolio companies. When the performance of companies has been unsatisfactory or the management has made unpopular decisions, at times financial institutions have not hesitated to express their fury by challenging the management and even forcing the CEO to leave his post.[13]

Indeed, it is not uncommon to suggest that investors, as residual claimants of firm productivity, might have sufficient incentive to act as monitors, if they realized that the success of their monitoring could positively affect the company's residual income (i.e. increasing the value of shareholders' investment).[14] When institutions acquire a large bundle of stock, the liquidity of investment also begins to wane as they are less likely to walk away from an underperforming company by selling their shares on the

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[11] L. Roache, *CEOs, Chairmen and Fat Cats: The Institutions Are Watching You*, 27 Co. Law 297 (2006), at p.300.
[12] *E.g.* Jennifer S. Taub, *Able but Not Willing: The Failure of Mutual Fund Advisers to Advocate for Shareholders' Rights*, 34 J. Corp. L. 843 (2009) (suggesting the occurrence of "an Intermediation Revolution" when the majority of equities are owned by institutional investors).
[13] More recent stories is that in 2004, Walt Disney was forced to restructure its leadership after a major revolt by its shareholders, see BBC News, *Shareholder Revolt Stuns Disney*, March 4, 2004, available at: http://news.bbc.co.uk/1/hi/business/3528103.stm.
[14] Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 Am. Eco. Rev. 777 (1972), at 781-783.

market.[15] Any large-scale trade in the stock would result in an unpredictable effect on the general market, and impose a significant transaction cost on the investor. Since illiquid investors are "trapped" in the company, they may be more concerned about the performance of the company, because this directly relates to their investment interest. Thus due to "self-interest", their willingness to act as monitors of corporate performance would grow.

Equally, institutional investors do not lack "disciplinary" power when they are not satisfied with the management. The threat of shareholder revolt, either in the form of defeating a management proposal in the general meeting or lobbying the board to sack the CEO, is a strong warning to those boards whose performance cannot meet expectations. It has been found that, nowadays, institutional investors have shown their ability to collectively organise to overcome the traditional problem faced by individual shareholders of "free riding" and inter-shareholder communication deficiencies. By forming alliances or through the services provided by professional agencies, institutions have tried to act together and coordinate their responses so as to form a majority voice to impose pressure on the management. For example, in the US, the corporate governance industry has significant influence on votes of investors through services like proxy voting recommendations and governance ratings. The market leader Institutional Shareholder Services (ISS) has been described as "a decisive advisor in a number of major corporate events", when most of big institutional investors are its clients and a part of them choose the arrangement of automatically adopting ISS's voting recommendations.[16] Therefore, far removed from an era of "rational indifference" of individual shareholders, the management should now be aware of the fact that they are being increasingly watched by institutional investors.

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[15] John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 Colum. L. Rev. 1277 (1991), at 1287-1289.
[16] Paul Rose, *The Corporate Governance Industry*, 32 J. Corp. L. 887 (2006-2007), at 899-903.

Inspired by the growth of "institutional activism", some critics have doubted whether in a world of rising influence of institutional investors, independent directors are the best candidates to hold the management accountable.[17] Given that we are now living in a "shareholder-centric" model where shareholders' interest has been praised as the priority of corporate governance, why not directly empower shareholders to take more steps into the decision-making process rather than indirectly install independent directors as a proxy? Compared with the reliance on independent directors to "self-correct" the mess of their executive colleagues, the notion of supervision by shareholders seems to be more promising, since investors are ultimate beneficiary of the corporate governance system. Based on this belief, scholars have suggested that shareholders should be given more power of control over both monitoring and operating the company.[18]

This proposition is also partly endorsed in the UK by the Combined Code (now titled as "the UK Corporate Governance Code"). The famous "comply or explain" regime is considered to be a "shareholder-enforced" system,[19] by which investors have an opportunity to register their reaction. Given the important position of institutional investors in the market, it is not surprising that the Code specifically sets up a section in relation to them, by requiring institutional investors to duly evaluate companies' governance arrangements and seriously use their powers.[20] In this sense, the corporate governance system is mainly enforced by institutional investors through the market framework, i.e. the "voice or/and exit" paradigm[21] ("holding" shares to exercise voice or/and "selling" shares to express dissatisfaction). Although such an arrangement is different from radical proposals of directly empowering institutional

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[17] See Bebchuk, *Increasing Shareholder Power*, *supra.* note 10; hereinafter Bebchuk, *Shareholder Franchise*, *supra.* note 10.
[18] *Ibid.*
[19] Jennifer S. Taub, supra. note *12*, at 863.
[20] The UK Corporate Governance Code (June 2010), Schedule C.
[21] Photis Lysandrou & Denitsa Stoyanova, *"The Anachronism of the Voice-Exit Paradigm: Institutional Investors and Corporate Governance in the UK",* in *Corporate Governance*, Vol. 15, No. 6, (Nov. 2007), 1070-1078.

investors, the system still puts great credit on them. Institutional investors are presumed to be the constructors of corporate governance.

1.2 Obstacles in the way of Shareholder Activism

Advocates imply that shareholders' activism could be strong enough to usurp the supremacy of the board in corporate governance. However, it is suggests here that, although the increasing influence of institutions may herald a promising future of shareholder democracy, it is still too early to conclude that institutional activism can eliminate the ills of the corporate governance system. The weakness lies in both the incentive and ability of institutional investors, even if it is true that financial institutions have done much better than individuals in both areas.

First of all, the motives of institutional investors could be negatively affected by a number of factors. For example, when some institutional investors simultaneously provide financial services or solicit pension plans from their portfolio companies, potential conflicts of interests have long been criticised by commentators as a factor possibly forcing these institutions to shut their mouths and succumb to the management.[22] Amongst institutional investors, conflicts could happen between different groups, and some investors may not use their powers to pursue an exclusive goal of maximizing shareholders' wealth.[23] More importantly, there is an undeniable risk that institutional investors may suffer from myopia problems in that they focus too much on short-term profit, and thus force managers to concentrate on performance of the share price rather than the long-term development of the company.[24] Referring to the crisis of Northern Rock, it was suggested that

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[22] Adrian Cadbury, *Corporate Governance and Chairmanship: A Personal View* (Oxford University Press, 2002), at p.205. *C.f.* Gerald F. Davis & E. Han Kim, *Business Ties and Proxy Voting by Mutual Funds*, 85 J. Fin. Econ. 552 (2007), at 568.

[23] See Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. Rev. 561 (2006), at 590; K. A. D. Camara, *Classifying Institutional Investors*, 30 J. Corp. L. 253 (2005), at 242-250.

[24] See Roberta S. Karmel, *Should a Duty to the Corporation Be Imposed on Institutional Shareholders?*, 60 Bus.

institutional investors should be partly blamed, because they "too often drive executives to those very excesses of risk which end in tears."[25]

Secondly, subjectively, institutions may have no real incentive to care too much about how the company is running its business. As a strategy to limit risk, institutions typically diversify their investment through holding equity in many companies simultaneously as a portfolio package. Moreover, many institutions are short-term traders or invest in the markets through passive index funds. Thus, the cost of corporate governance failure in one particular company could be minimized, but the costs of time and resources to undertake effective activism might not be completely compensated.[26] Requiring institutional investors to devote fund and energy in tracing good corporate governance seems to be incompatible with the behavioural model of rational institutional investors (who would rather sell the shares than hold on to exercise voice).[27] In sum, a large number of institutions still prefer to view themselves as simply "pure investors" in the market rather than activists.[28] Their interest is embodied in the movement of share price and general market climate, not mainly in monitoring and running the company's business. In response, the regulation (including the Walker Review) is willing to take a step forward to tackle this problem by requiring institutional investors to disclose their voting patterns and explain its use of ownership powers,[29] with the expectation that transparency and

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Law. 1 (2004), at 7-8, 19; John C. Coffee, Jr., *What Caused Enron? A Capsule Social and Economic History of the 1990s*, 89 Cornell L. Rev. 269 (2004), at 271.

[25] A. Hilton, "Why non-execs failed to rein in risk-taking at Northern Rock", Evening Standard , September 20, 2007.

[26] Roberta Romano, *Institutional Shareholders and Corporate Governance in the US*, in Geoffrey Owen et al., *Corporate Governance in the US and Europe: Where Are We Now?* (Palgrave MacMillan, 2006), at p.55.

[27] See Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. Rev. 601 (2006), at 629-633; Olin Kramer, *Pay Without Performance: The Institutional Shareholder Perspective*, 30 J. Corp. L. 773 (2005), at 774-775.

[28] Leo E. Strine, Jr., *Toward a True Corporate Republic: A Traditionalist Response to Bebchuk's Solution for Improving Corporate America*, 119 Harv. L. Rev. 1759 (2006), at 1765.

[29] According to section 1277-1280 of the Companies Act 2006, the Treasury or the Secretary of State has a reverse power to make provision by regulations requiring institutions to provide information about the exercise of voting rights. See also the Walker Review (*A review of corporate governance in UK banks and other financial industry entities: Final recommendations*, Nov. 2009), Recommendation 22 (suggesting that "fund managers and other institutional investors should disclose their voting record, and their policies in respect of voting should be described in statements on their websites or in another publicly accessible form.").

pressure from ultimate beneficiaries may indirectly discipline institutions to engage with corporate governance of their investee companies. Although a requirement of disclosure may make institutional investors more morally difficult to remain inactivity in exercising their voting powers, it is still not clear how far the authority is ready to exercise the regulatory power, or whether such a disclosure can really stimulate the incentive of institution investors to commit to governance.[30]

Thirdly, it is necessary to bear in mind that, inevitably, institutional investors face practical difficulties in achieving the goal of monitoring.[31] Shareholders are not insiders who are privy to the internal affairs of the company in a timely fashion. In short, they are less familiar with the business than directors. Even if, by careful analysis, institutions could glean a better understanding of the company's affairs, most of the information they would receive would still be "second-hand", that is, the resource of information largely relies on *ex post* disclosure by the company. This dependence on information represents an obstacle in the way of institutional investors' efforts. So in practice it is hard for institutional investors to discover governance problems in advance and make an *ex ante* response. Even when the most diligent investors are able to detect early warning signs of managerial problems, it seems that typically they are not generally inclined to speak out the truth in public. On the contrary, the investors would more likely keep this finding secret, and smoothly sell their stockholdings before others catch the wind of dangers. At least, exposing the reality can only cause a plummet of share price and bring no benefit to the honest. Consequently, even though institutional investors enjoy great influence, it is arguable whether they are really capable of wielding monitoring powers.

Finally, referring to the "comply or explain" system adopted in the UK, the

[30] The Government did express its support on this reverse power, but it decided to first wait and see how the market revolves before actually exercising its regulation-making authority. See HL Debs, vol. 682, col. 787, May 23 2006 (Lord Sainsbury).

[31] Bernard S. Black, "*Shareholder Activism and Corporate Governance in the United States*", in Peter Newman, ed., *The New Palgrave Dictionary of Economics and the Law* (Palgrave MacMillan, 1998), vol.3, at p. 459-465.

efficiency of regime is to a certain extent suffocating due to all these above factors. It was found that institutional investors were not showing enthusiasm for confronting non-compliers, but were rather inclined to judge the issue of corporate governance by the financial performance of companies.[32] Non-compliers could be forgiven if the performance was substantially good. Failure to comply with the Code only seems to be a relevant allegation when poor performance is looming. Such a utilitarian attitude could blatantly distort the dynamics of "shareholder-enforced" system. Institutional investors are not keen to join an active dialogue of corporate governance, but dive into a simple approach of "comply or perform". If the proposal is that institutional investors could be the Messiah of corporate governance, this reality might then fail those fervent supporters of shareholder activism.

1.3 Shareholder Activism and Independent Directors

The theory of "shareholder activism" has long regarded itself as a rival model against the idea of board independence, and it is confident that empowering shareholders, especially institutional investors, can herald a shift away from reliance on independent directors. However, as examined above, "shareholder activism" might face its own limits and difficulties. In fact, shareholders, who are willing to actively exercise their powers, will usually find it difficult to become actively involved in corporate affairs simply by their own efforts. In other words, they need to rely on the board and directors. This is because company law generally rejects the proposition that shareholders should have a direct and consistent control over the company's business. The courts have no longer followed the old-aged principle that the directors should unconditionally follow the order of shareholders as dutiful servants,[33] but varied to a modern view that, as long as the articles of association have clearly vested

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[32] Iain MacNeil & Xiao Li, *"'Comply or Explain': Market Discipline and Non-Compliance with the Combined Code"*, *Corporate Governance*, Vol. 14, No. 5 (Sept. 2006), 486-496.

[33] The proposition that the general meeting was the supreme organ of the company with ultimate control over the board was found in *Isle of Wright Railway v Tahourdin* (1883) 25 Ch. D. 320, CA, at 329.

material powers in the board, the shareholders cannot interfere with the exercise of those powers through the general meeting.[34] This doctrine was clarified by Greer L.J. in *Shaw & Sons (Salford) Ltd v Shaw* as follows:[35]

"A company is an entity distinct alike from its shareholders and its directors. Some of its powers may, according to its articles, be exercised by directors, certain other power may be reserved for the shareholders in general meeting. If powers of management are vested in the directors, they and they alone can exercise these power…[Shareholders] cannot themselves usurp the powers which by the articles are vested in the directors any more than the directors can usurp the powers vested by the articles in the general body of shareholders."

It is thus clear that the separation between ownership and control is not only a practical phenomenon in the market, but also, against the backdrop of the applicable law, a natural arrangement. Moreover, such a model is also fit with the "team production" theory proposed by Professors Blair and Stout.[36] It was suggested that a public company could be appropriately understood as a team of members (including shareholders as capital provider, managers as professional skill provider, and workers as labour provider, etc.) who make firm-specific investments in the corporation with the goal of producing goods and services as a team (i.e. team production). Because in the team members' interests could contradict each other and agency costs might be incurred during the production process, a board, mainly composed of outsiders (i.e. independent directors), is necessarily demanded as a "mediating" body.[37] Shifting powers from the board to shareholders may cause a radical change to this "team production" system, and destroy the "mediating function". As a result, trust among

[34] *Automatic Self-Cleansing Filter Syndicate Co v Cuninghame* [1906] 2 Ch. 34, CA; *Quin & Axtens v Salmon* [1909] 1 Ch. 311, CA, [1909] A.C. 442, HL.
[35] [1935] 2 K.B. 113, CA, at 134.
[36] Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law,* 85 Va. L. Rev. 247 (1999).
[37] Margaret M. Blair & Lynn A. Stout, *Director Accountability and the Mediating Role of the Corporate Board*, 79 WASH. U. L.Q. 403 (2001).

team members would be ruined and cooperation might be difficult.[38]

Based on this "team production" approach, it is necessary for us to reconsider the role of institutional investors in corporate governance. The belief in "shareholder-centric" perspective does not justify a proposal of depriving the board of its powers. Given the fact that activism is facing a number of practical obstacles, institutional investor may better change their strategy. It is more proper to regard themselves as architects and examiners, rather than executives who have to devote consistent energy to evaluate substance of every important decision.[39] The focus of institutional investors should be on shaping a rational governance structure (e.g. to put more genuinely independent directors into the board, and require independent-director-only committees) and ensuring that such a system has been followed and exercised. As an example, users (investors) only need to install an Intelligence Software (good corporate governance system) into their computers (companies) and then the software would exercise functions with little interference. The only thing that users should do may just be routinely check the performance and update the system. Certainly, such an automatic tool is superior compared with a system where users have to manually carry out works step-by-step.

In some ways, the "comply or explain" approach of the Code is doing the right thing in accordance with the above suggestion. Institutional investors could exercise their voice in shaping the governance structure, especially when the Code recommends them to evaluate "particularly those (governance arrangements) relating to board structure and composition".[40] Companies should either accept a default model (in

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[38] Lynn M. LoPucki, *A Team Production Theory of Bankruptcy Reorganization*, 57 Vand. L. Rev. 741, 749 (2004), at 751. This view is also indirectly accepted by the European Parliament in announcing its concern that profit-chasing private equity institutions might destroy industrial relationships through overly active takeover and buy-out. See PSE Group in European Parliament (2007), *Hedge Funds and Private Equity-A Critical Analysis*. Report of the PSE-Group in European Parliament.

[39] However, this does not include some decisions which the Companies Act and other regulations expressly give the shareholders monopoly power to determine, for example, issuing shares and accepting a takeover offer.

[40] The UK Corporate Governance Code, Schedule C, Principle 2, Main Principle.

which board independence is the emphasis), or if a company decides to depart from it, shareholders should have an opportunity to consider the compatibility of this special "software" and decide whether they would pay for it. However, in reality, institutional investors usually fall into a "comply or perform" pit like an inexperienced consumer easily accepts the rhetoric of a software salesman without carefully thinking about the value of this software. Could such passivity be changed? The author believes that it can be improved. The proposal is to shift the system from "comply or explain" to "comply or vote": in relation to non-compliance of the Code, an advisory resolution should be required so that investors can count their reaction into ballot. Although it might not be clear whether institutional investors would act dramatically differently from their current utilitarian behaviours, such a "comply or vote" regime could promote the compliance of the Code (especially in promoting the roles and involvement of independent directors) and encourage institutional investors to take their powers more seriously (since voting triggers more serious explanation and evaluation, and institutional investors usually seek professional voting advices from corporate governance agencies). Such a system of voting also offers a more formal panel for institutional investors to ally their voice than a weak role of "comply or explain" which only relies on informal and private dialogue.

2. Market Force as Discipline

A commonly held view in market capitalism is that, if the market can self-resolve its own problems, there is no urgent need for interference. In accordance with this idea, the views of many corporate governance scholars are based on a belief that: when the corporate sector is "in trouble" (e.g. through "agency costs", or uncontrolled managerial powers) and the market seems unable to find a perfect solution by itself, a reform of corporate governance (either through the introduction of independent directors or promoting "shareholder activism") is necessary to resolve those

problems. However, it may be wrong to conclude that the market completely fails to resolve corporate governance problems.

2.1 Market as a Monitoring Agent

2.1.1 Motivation of Diligent Management

Independent directors (or "active" shareholders) are demanded because of the assumption that management does not perform effectively (either through shirking or committing self-serving transactions). However, if as supposed, the managers were seriously damaging the system, companies would not be able to survive and succeed in the market competition. If the managers were so irresponsible and incompetent, why is equity investment still an important investment vehicle today? It seems hardly convincing that the market is terribly "disfunctioning" and all top executives deserve to be sacked instantly.

Certainly, it is necessary to realize that, in many cases, even without the monitoring of the board or shareholders, the management may still have certain motive to do their best for the interest of the company. This incentive emanates from two factors:

First, subjective concern about their reputation, partly due to pressure from management labour market, might act as discipline to stimulate managers to perform well. Pursuance of success in terms of their personal career would of course be a strong incentive of the management to work harder. The management would earn a stealth "bonus" from labour market (e.g. receiving a job offer from another big company with increasing salary) if the company produced a strong performance under their leadership. On the other hand, they might worry that poor performance

could negatively affect their reputation as business professionals.[41] Also based on a "team production" perspective, executives are understood as providers of managerial skill and knowledge. Unlike shareholders who can diversify their investment to reduce risk, the intelligence capital contributed by managers is a firm-specific investment. Their career may be linked with the success of the company. Leading a company to failure would probably affect their chance of securing equivalent or superior managerial posts in the future. Furthermore, the performance of management is also closely watched by market agencies outside of the company, for example, securities analysts and rating agencies. Downgrading is certainly a hassle for underperforming executives.

Second, other forms of self-interest can persuade the management to be more diligent. Stock options have been thought to provide incentives to align management interests with those of the shareholders.[42] Nowadays, the remuneration package of many executives is equity-based, and usually, senior managers enjoy performance bonuses at the end of the financial year. Undoubtedly, if a company performs poorly, the management may not receive their bonus because of the failure to meet performance expectations. Since poor performance would usually lead to a dropping of share price, the equity-based remuneration package of executives will shrink, because the plummeting price may either make the stock option scheme less profitable or chop at the value of their stockholding. In this sense, the management would certainly realize that a proper route to promote their own interest is by performing diligently for their success of the companies.

By briefly reviewing market forces as discipline, even most decisive sceptics may have to admit that the market did, or at least, tried to provide some answers.

[41] Ira M. Millstein, *The Evolution of the Board*, 48 Bus. Law. 1485 (1993), at 1488.
[42] James R. Repetti, *The Misuse of Tax Incentives to Align Management-Shareholder Interests*, (1997) 19 Cardozo L. Rev. 697 (1997), at 701.

Managers are aware that, if they tried to "fool" the market, they would probably pay the price sooner or later. However, the question is whether these market mechanisms are strong enough to rule out all problems.

2.1.2 The Limit of Self-Discipline

Many cases, especially the current financial crisis, have proven that the market fails its role to curb all mismanagement and wrongdoings. It is extremely questionable whether fear of blotting career profile can completely be reliable as devices to keep management in line. Even such fear does exist, it is suggest that, occasionally, the pressure may distort genuine incentive into ambition and irresponsibility. Even without bad faith, some "pathologies" (e.g. narcissism, over-optimism, fear, anger, and depression) could drive executives to unreasonable managerial behaviours.[43]

Much worse, the market may even encourage irrational risk-taking and praise over-ambitious managers (as in the scenario of Northern Rock).[44] High "liquidity" of the stock market may lead investors to pay more attention on short-term financial performance than to robust risk management of their portfolio companies. In addition, in response to failure of management, the market may be keen to punish companies and managers *ex post*, but it may fail to detect or correct problems *ex ante*. For example, all rating agencies did not successful sniff out the potential danger of posed by subprime mortgage-backed securities and collateralized debt obligations,[45] but only rushed to downgrade bonds and securities after the bad news was broadcast.

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[43] Jayne W. Barnard, *Narcissism, Over-Optimism, Fear, Anger, and Depression: The Interior Lives of Corporate Leaders*, 77 U. Cin. L. Rev. 405 (2008-2009).

[44] Roman Tomasic, *Corporate Rescue, Governance and Risk Taking in Northern Rock: Part 2*, Comp. Law. 2008, 29(11), 330-337.

[45] See Jeffrey Manns, *Rating Risk after the Subprime Mortgage Crisis*, 87 N.C. L. Rev. 1011 (2008-2009); John Patrick Hunt, *Credit Rating Agencies and the Worldwide Credit Crisis*, 2009 Colum. Bus. L. Rev. 109; Richard E. Mendales, *Collateralized Explosive Devices: Why Securities Regulation Failed to Prevent the CDO Meltdown*, 2009 U. Ill. L. Rev. 1359 (2009).

It is also necessary to be cautious because although equity-based remuneration can to a large extent tie managers to the interests of the company, it cannot eradicate all dangers. There is a potential risk that, when a manager realizes that his gain from self-serving may be materially larger than his income from compensation, or his diligence may not significantly increase the level of his remuneration, the motive to toe the line may be offset. In order to maximize their self-interest in equity-based compensation, the management might have a strong incentive to try every manoeuvre, no matter whether it is sound for the business, to promote the share price in the short-term.[46] As Professor John C. Coffee revealed, a remarkable feature of Anglo-Saxon corporate governance scandals is that executives would hide the company's loss or reduction of profit, because of fear that failure to meet market expectations would let down investors and result in a drop of price as well as their income.[47] Furthermore, poor structure and procedure might further distort the incentive effect of compensation. Ill-structured remuneration packages may even stimulate the management to manipulation, for example, by "backdating" of stock option.[48] In addition, it has been strongly claimed by a camp of legal theorists that managerial power over the executive compensation process creates a market failure of excessive payment.[49]

2.2 Market for Control

2.2.1 The Threat of Take-Over

The market can stimulate the inherent incentive of managers to perform diligently. It can also act as a "punishment" system to penalize those who have failed to promote

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[46] Paul Milgrom & John Roberts, *Economics, Organization and Management* (Prentice Hall, 1992), at 436-437, 471.

[47] See John C. Coffee, Jr., "*A Theory of Corporate Scandals: Why the USA and Europe Differ*, in *Oxford Review of Economic Policy*, Vol. 21, Issue 2, 2005, pp. 198-211.

[48] See Cindy A. Schipani, *Who Can You Trust?: Backdating in the Executive Suite*, Comp. Law. 2008, 29(7), 196-207; M.P. Narayanan et al., *The Economic Impact of Backdating of Executive Stock Options*, 105 Mich. L. Rev. 1597 (2007).

[49] *E.g*. Bebchuk & Fried, *Pay Without Performance*, *supra.* note 10.

the interest of companies. Contrary to the suggestion of relying on independent directors to banish immoral and incompetent management, some commentators have embraced another control measure, i.e. the "market for control".[50]

Basically, the model of "market for control" accepts the existence of a risk that managers may shirk their duties, but argues that, in an effective stock market, the problem can be offset by mergers and/or acquisitions. It is contended that when the company is under the poor governance of "bad" management, such a predicament would soon be detected by the market (on the assumption that investors are well-informed). Investors would then register their reaction by selling shares, leading the stock price to dive. The price dropping may send two strong signals: first, a company in poor performance is attractive to a potential take-over, because the buyer can offer a bid at a relatively lower price to induce current shareholders to sell stocks to him; secondly, such a company is tempting, because the stock price may have fallen below its true value due to the poor management, and the buyer may believe that he can run the company back to prosperity and then gain from the recovery of share price. Given these factors, incompetent managers may be targeted by hostile tender offers. And if the taker-over succeeds, the new owner may usually remove the previous management.

In this sense, the "market for control" theory suggests that all managers are living in competitive circumstances, where "predators" linger in the market. The threat of being targeted by potential hostile bids reminds them that they must be diligently responsible for promoting the interests of the company so that the share price remains at a high level and aggressors can be dispelled. Therefore, it is assumed that the threat of "market for control" may replace the proposal of independent directors

[50] As for a classical theoretic analysis of "market for control", see Henry Manne, *Mergers and the Market for Control*, 73 J. Pol. Econ. 110 (1965). See also Edith S. Hotchikss & Robert M. Mooradian, *Vulture Investors and the Market for Control of Distressed Firm*, 43 J. Fin. Econ. 401 (1997).

as a consistent mechanism of holding managers accountable. Such a proposal has been welcomed by the government. In a departmental policy paper, it was stated that "[t]he Government believes that the threat of take-over is a powerful spur towards efficiency in the management of UK companies."[51]

2.2.2 The Limit of "Market for Control"

The doctrine of "market for control" may be seen as the final instrument of market discipline, when self-incentive is not sufficient to guarantee a satisfactory performance. However, it is not reasonable to ignore the possibility that the "market for control" may have its own flaws. It is questionable whether a wave of tender offers is truly beneficial for corporate industry. Obviously, many managers have disagreed with the efficiency-enhancing justification for hostile takeovers, instead seeing such activity as driven by control arbitrageurs looking for quick profits through the exploitation of stock market mispricing and other "quick-buck" strategies. Even worse, it has been argued that an active market in corporate control is itself a cause of inefficiency, because of the 'short-termism' induced in managerial time horizons.[52] In the academy, there has been great controversy about whether takeovers are in fact beneficial or not for the economy and corporate governance.[53] In sum, the benefit of the "market for control" for corporate governance is not so promising. As concluded by Julian Franks and Colin Mayer, "[t]he market for corporate control does not therefore function as a disciplinary device for poorly performing companies".[54]

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[51] *Mergers Policy. A department of Trade and Industry Paper on the policy and procedures of merger control*. (1988) at para. 2.27.

[52] See Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 Stan. L. Rev. 1465 (2006-2007), at 1522 (footnote omitted).

[53] See Sharon Hannes, *The Hidden Virtue of Antitakeover Defenses*, 24 Cardozo L. Rev. 1903 (2002-2003); Lynn A. Stout, *Do Antitakeover Defenses Decrease Shareholder Wealth - The Ex Post/Ex Ante Valuation Problem*, 55 Stan. L. Rev. 845 (2002-2003); I. Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 U.C.L.A.L. Rev. 561 (2006), at p.568.

[54] J. Franks & C. Mayer, *Hostile Takeovers in the UK and the Correction of Managerial Failure*, (1996) 40 J. of Fin. Econ. 163, at 180.

Furthermore, the effectiveness of the "market for control" can also be weakened by a number of "tricks" which are designed to defeat hostile tender offers. Known as "defensive strategies", these measures can be wielded by the management, who are reluctant to sell the company out, to make the bidder's movement more difficult and thus reduce their purchase interest.[55] Even if a takeover finally overcomes such resistance and becomes successful, an ill-structured service contract may entitle executives to generous termination payment and/or pension benefit (infamously known as "golden parachute"), creating "a reward for failure" which could definitely dilute the punitive effect on incompetent management. In addition, it is questionable whether the "market for control" can in practice consistently discipline the management. Certainly, to buy a publicly held company is never easy, mostly depending on sufficient cash flow, robust financial resources, and, of course, the attitude of shareholders of the bidding company. Especially in respect of large companies, their huge size and capital means that there are not many potential bidders who have an interest and capability to take over these giants. To a certain extent, such large companies are insulated from the "market for control". Even if a possible bidder does exist, in some cases, the transaction would meet the legal obstacle of competition law. Any merger between two large companies would normally raise concerns about the risk of monopoly and damage to market competition. There is thus a common requirement of governmental review on the potential impact of any merger deal.[56] This procedural handicap may reduce the interest of the buyer, and affect the efficiency of the "market for control". Although the current wave of "nationalization" may create a derivative of "market for control" (where the government plays a role of takeover bidder and usually a restructure of

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[55] However, in some countries like the UK, the management's discretion in taking defensive actions, such as Poison Pills, is under constraint. According to the rules of *Takeover Code* (drafted and exercised by The Panel on Takeovers and Mergers), the board is not allowed to initiate a defensive action without approval of shareholders. For more detailed discussion, see Paul L. Davies, *Gower and Davies' Principles of Modern Company Law* 18th e.d. (Sweet & Maxwell, 2008), Ch. 28, at p.961-1057.

[56] For a general discussion on European and UK competition policy, see Mark Furse, *Competition Law of the EC and UK* 6th e.d.n. (Oxford University Press, 2008).

management occurs after "nationalization"), it seems clear that such a phenomenon could only be temporarily contingency strategy which is not likely to be widely adopted.

2.3 Independent Directors as Supplement

As an external effort, market forces do have a positive effect on corporate governance. However, as discussed above, incentive schemes may stimulate opportunism or even deliberate manipulation, and "market for control" may not be important if there is no such an active market. The Subprime Mortgage Crisis is a live paradigm of market failure. But how is this relevant to independent directors? There are three possible angles of insight:

Firstly, the very lesson that we learn from the Credit Crunch is that the market is good at penalizing "losers" after the outbreak of crisis, but neither capable of diagnosing "symptoms" in advance nor willing to pull companies out of trouble. It is not the job of the market to tell a company how to build and retain a reasonable system of risk management, or how to clean up its mess after a great setback. Indeed, this is the agenda of the board, especially independent directors. The financial crisis of 2008 revealed poor risk management on an almost systemic basis throughout the industry. For a long time, risk management has been regarded as the primary responsibility of top management. Although the board has long been required to ensure that the company has established appropriate internal programs,[57] the focus has been narrowly cooped up in the area of accounting integrity and the direct involvement of the board in risk management has been limited (at least, the Code only calls the board to ensure the existence of internal control system and conduct regular review of the effectiveness of the system, rather than requires the board to

[57] The Combined Code (June 2008), C.2 (supplemented by the Turnbull guidance (*Internal Control: Revised Guideline for Directors on the Combined Code*, Oct. 2005)).

discharge the function of risk management). A culture of delegation means that risk management is placed in the hands of management, who may themselves be over risk-taking, and the board wholly relinquishes responsibility by generously trusting the management. Such an arrangement should be changed. Directors should not be allowed to "dispense with their own duty of stewardship to the company by wholesale delegation".[58] On the contrary, "it is the responsibility of the board to test and challenge [risky] proposals from management".[59] The ultimate control of risk management should be separated from the management, and continuing oversight must remain, especially in respect of risks that are of material importance. For such a purpose, the participation of independent directors is demanded and a specific risk committee, mainly composed of and chaired by independent directors, should be created (at least in certain business sectors).[60] By reviewing risk management reports (provided at appropriate intervals) from management, independent directors in this risk committee should be responsible for a number of "oversight matters": consistently reviewing crucial financial and business strategies, monitoring the relative performance of the company in enforcing these strategies, costing out potential risks, asking tough questions to ensure that management carefully considers their plans, and keeping the board informed about any material change of risks and ensuring that risk management system are sufficiently adjusted to real time. To implement this agenda, a list of "specific governance responsibilities", different from the general principle completed in the current Code, should be introduced into a new Code so as to provide detailed guidelines to directors about what actions they are expected to do in managing risk.

Secondly, independent directors should more commit to the process of awarding executive remuneration awarding. It is urgent for the remuneration committee, which

[58] Annabelle Yip, Risk Governance as Part of Corporate Governance, J.I.B.L.R. 2008, 23(9), 493-496, at 494.
[59] Speech of Hector Sants, the Chief Executive of FSA, made at the Building Society Association Conference on May 7, 2008.
[60] Such a proposal is recommended by the Walker Review in Chapter 6.

is another panel for independent directors to carry out their functions, to tackle this problem in negotiating service contracts and setting compensation. The committee should consider including long-term performance and proper risk management as a factor in director assessment and compensation. Independent directors, who might be immune from the management's instinctive pursuit of share-price increase (relating to stoke-option compensation) or expansionist agenda (provided compensation is relating to corporate size), should be encouraged to set multi-criteria on a broader perspective in assessing directors' performance, rather than simply considering single factor of gross return or profit-earning. On the other hand, if the allegation is true that excessive compensation is partly due to the influence of executives over the board, then out of question, a rational solution to this problem is to strength the roles of independent directors by pushing them further away from managerial power. Through disclosure of remuneration committee report, independent directors should expressly explain how they inject performance objectives and risk adjustment into the compensation structure and whether there is any framework (e.g. deferment and clawback) in place to adjust compensation in circumstances of mismanagement and misconduct so as to avoid future "reward for failure".[61]

Finally, it is important to realize that the board is the body to set the culture of the company as the "tone at the top".[62] Playing a "mediating" role in "team production" approach indicates that the board is responsible for smoothing any irrational inclination of insiders. If the management is immersed in a manic risk-taking mood, the board should remain objective to question, or at least remind, executives about whether a serious risk is looming, especially when the market is also joining the carnival of praising the career of CEOs. Given the rising influence of independent

[61] See the Walker Review (2009), recommendation 30 and 33.

[62] Organisation for Economic Co-operation and Development, *OECD Principles of Corporate Governance* (2004), p.60: "[T]he board has a key role in setting the ethical tone of a company, not only by its own actions, but also in appointing and overseeing key executives and consequently the management in general. High ethical standards are in the long term interests of the company as a means to make it credible and trustworthy, not only in day-to-day operations but also with respect to longer term commitments."

directors in the board, there is no doubt that they are the leading voice to counterbalance a culture of profit-pursuing-only. Independent directors must better understand their importance to the company's culture construction. Through their interactions with other board members and actors in the company, independent directors have the potential of setting a rational tone throughout the company, and steering the company safely through a market full of turbulence.

3. Pure Independent Board

The author has examined above some competing proposals against independent directors, which focus on external solutions. It was found that these external mechanisms are not the balm to all the pains suffered by corporate governance. Investors and stock markets are proper candidates to judge whether a company is successful or not, because we value the share price of a good business and discount that of a poor corporation.[63] Such external activities are not involved, however, in running the business.[64] Creating and developing a successful company is the responsibility of managers and directors. Standing on the apex of the corporate hierarchy, the board of directors plays an important role of internal control. The reform agenda of the introduction of independent directors is thus intended to promote the contributions of the board by retaining its objective position.

However, to a certain extent, the tradition of unitary board structure seems to be an

[63] The investor's primary concern is whether information regarding the risk of collapse is available at the time of the investment decision. In an efficient market this risk is incorporated in market prices, but it is questionable whether such effective and sufficient information is available. Certainly, in some cases, the market may fail to correctly price shares because of misinformation or ignorance of risk. For example, most investors did not detect the problems of Enron and WorldCom, and ironically, they even appreciated Enron as one of the most successful American corporations (Fortune named Enron "America's Most Innovative Company" for six consecutive years). See Stephen J. Choi & Jill E. Fisch, *How to Fix Wall Street: A Voucher Financing Proposal for Securities Intermediaries*, 113 Yale L.J. 269 (2003), at 273 ("analysts ignored serious indications of financial problems and continued to recommend Enron as an investment long after the company entered its death spiral.") More currently, few investors realized in advance the danger of the subprime mortgage crisis, the collapse of Lehman Brothers, and the meltdown of Fannie Mae & Freddie Mac, AIG and RBS.

[64] If investors do enjoy control of the business, they would prefer a form of partnership, rather than choosing a corporate form, which restricted their interference with the decision-making of the company.

obstacle in the way of board independence. As stated in Chapter one, it was observed that the board historically clings to the management, and in the early age, the line between managers and directors was not clearly drawn. Senior officers have long been entitled to have their seats in the boardroom, and in fact, independent directors are more like latecomers in the development of the board. The combination of traditional practice and modern reform makes the board today more similar to a bipartisan coalition, where both the management and independent directors are sitting in the same room. In some ways, it raises a question as to whether the feature of "independence" can be compatible with this mixed composition. Commentators have long expressed their worry and critique that the effort of independent directors would in practice often be offset by the influence of management.[65] For the purpose of resolving this problem, some of them proposed an idea of building a "pure independent board" or "super independent board", i.e. other than the Chief Executive, all other members of the board should be independent of the management.[66] In other words, most senior managers would be excluded from the board. According to their perspective, the benefit of this arrangement would be obvious: the management cannot launch an in-house lobby, and the independence of the board can to the largest extent be secured. In this sense, the theory of "pure independent board" is another competing mechanism, which simply call for more independent directors to be included into the board.

3.1 Pure Independent Board and Two-Tier Board Structure

The proposal of "super independent board" completely separates directors from the

[65] All these arguments about true independence of directors will be discussed in the following Chapter 7.

[66] See Noyes E. Leech & Robert H. Mundheim, *The Outside Director of the Publicly Held Corporation*, 31 Bus. Law. 1799 (1975-1976), at 1807-1811; C. Stone, *Where the Law Ends* (Waveland Press, 1975). Former SEC Chairman Williams has made explicit his program for reforming the Board of Directors: The directors should all, except only the chief executive officer (CEO), be independent of management, i.e., not officers or employees and not "suppliers" like bankers and lawyers. The CEO should not be the chairman of the board, so that he should not control the board's agenda. Harold M. Williams, Corporate Accountability and Corporate Power (Oct. 24, 1979) (a paper presented at the Fairless Lecture Series, Carnegie-Mellon University, Pittsburgh).

management. By squeezing senior managers out of the board, the overlap between directorship and managerial position is cleared up. On the face of it, this arrangement is somewhat similar to the two-tier board structure, which is popular in countries across Continental Europe. Although managers have no place on the board, the fact remains unchanged that they control the daily affairs of the company, and have responsibly for writing business plans and policies. The management team is thus an actual "executive board". On the other hand, because senior managers no longer take directorships, their status in the corporate hierarchy would inevitably be downgraded, which means that they are subject to the scrutiny of the board, rather than peers of independent directors according to current regime. Certainly, such a structure sends a clear signal that a pure independent board should play roles of reviewing the management and approving proposals initiated by managers. In other words, it is mainly a "supervisory board". In sum, the idea is a *de facto* two-tier board structure.

However, it is questionable whether such a semi-two-tier board can compatibly match the current system of the unitary board. British academics have long turned down any form of acceptance of division of the board,[67] and this attitude has also been firmly endorsed in several governmental reports.[68] It is suggested that, by working in the same board, both executives and independent directors can keep up a smooth communication and share information which is necessary for the board to do its job. At least, both groups of directors have to take part in the board meetings together, and thus it is less likely that each of them would isolate themselves from the other. Due to this fact, it is quite hard to expect that a systematic revolution would be welcomed in UK. Although such confidence in the unitary board structure is regarded by some commentators as simply based on a subjective belief that "our

[67] See Paul Davies, *Board Structure in the UK and Germany: Convergence or Continuing Divergence?*, 2 International and Comparative Corporate Law Journal 423 (2000), at 455 (concluding that "the German supervisory board continues to be a rather ineffective monitor, whereas the U.K. board has not only taken on the monitoring task formally but is better placed to discharge it effectively in practice.")
[68] *E.g.* Hampel Report, 1.4; Higgs Review, 1.7. More recently, see the Walker Review, 2.6.

system is better than yours",[69] a truth is still that there is no clear evidence to support a strong superiority of either model.[70]

Also in the author's view, a transition of board structure cannot possibly bring visible benefits. The cost of a radical change from the unitary board structure to a two-tier one is obvious. First, the cost would come from law-making. In accordance with the current legal system, executives' responsibilities are regulated by company law under the section of "duties of directors". If senior officers were placed outside of the board, provisions of the law would no long be applicable to these non-director managers. Unlike directors who owe duties to the corporation under company law, senior officers may only be bound by their contractual obligations included in service contracts. Of course, it is not acceptable that executives, who actually control the business, could easily escape the regime of company law. Then a feasible remedy is to make a new law, which can widen the regulatory coverage to all senior officers in the company. But given the fact that legislation may usually be time-consuming and slow in progress, it is definitely doubtful whether it would be sound to re-draft the act and build a brand new system when we are not even sure about its contribution.

Secondly, a radical change to the current system may also impose a cost upon companies. Driving executives out means that the company has to re-organise its board and re-constitute its leadership structure. How to recruit new independent directors to fill the board would really be a difficult task for all companies. The worry has been repeated that there is a material gap between demand and availability of qualified candidates.[71] Suddenly requiring a "pure independent board" could be a nightmare for the industry, at a time when companies struggle to find enough people to join their boards. A possible result would thus be that, in order to meet the

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[69] Klaus J. Hpot, *Modern Company and Capital Market Problems: Improving European Corporate Governance After Enron*, in John Armour & Joseph A. McCahery e.d., *After Enron: Improving Corporate Law and Modernising Securities Regulation in Europe and the US* (Oxford: Hart Publishing, 2006), at p.454.
[70] *Ibid.*
[71] This issue would be specifically discussed in Chapter 5.

requirements, companies would have to reduce their expectations and engage persons who are not exactly suitable for the particular need of a given company. Such a blind searching for independent directors can bring no benefit, but only harm to the business. Moreover, a model of "super independent board" bears a risk of assumption of "one fits all", setting up a uniform system for all types of companies, without considering their inherent differences. It is necessary to bear in mind that board composition is endogenous: different companies need different modes of boards. For example, as remarked by one commentator, "slowly growing firms may need more independent directors to control the conflict between managers and shareholders over what to do with free cash flow that cannot be profitably reinvested in the firm's core business".[72] Firm-specific characteristics may cause some corporations to require more extensive monitoring, and the importance of independent directors in monitoring is increasing. On the other hand, in other companies, they may rely on alternative mechanisms,[73] and call for greater recognition on the contributions of executive directors.[74] In this sense, absolutely requiring a "super independent board" may make corporate governance inflexible. Such a cost would certainly be resisted by the industry.

3.2 The Value of Insiders

It is implied by advocacy that a "pure independent board" is good for corporate governance, and by contrast, the presence of insiders, i.e. executives, are to a certain extent counterproductive. This notion is predicated on an overly-simple assumption that the management would always damage the efforts of independent directors. We might doubt whether such an allegation is well-grounded. For any board, it must

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[72] Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 Bus. Law. 921 (1998-1999), at 949.

[73] See Anup Agrawal & Charles R. Knoeber, *Firm Performance and Mechanisms to Control Agency Problems Between Managers and Shareholders*, 31 J. Fin. & Quantitative Anal. 377 (1996), at 379; Chenchuramaiah T. Bathala & Ramesh P. Rao, *The Determinants of Board Composition: An Agency Theory Perspective*, 16 Managerial & Decison Econ. 59 (1995).

[74] Jill E. Fisch, *Taking Boards Seriously*, 19 Cardozo L. Rev. 265 (1997-1998), at 285.

fully understand its limit: the board is not the body to initiate a policy or write a plan. During the board's involvement in reviewing proposals set out by management or participating in passing its judgement as "arbitrators", it may be most effective if the board include an interaction with a broader range of managers rather than just reading the papers submitted or listening to the sole explanation of the CEO.[75]

In the unitary board structure, the necessity of appearance of executive directors may be even more obvious. A fundamental principle is that directors must be collectively responsible for leadership of the company.[76] Thus executives share this responsibility. But by being excluded from the board, executives' role of leading the business is removed. Unlike in two-tier board structure in which the managing board lawfully takes control of company's affairs, in a unitary system, the "super independent board" would be the sole body of leadership. In other words, independent directors would mainly bear the burden of determining the fate of the company. It is extremely questionable whether these independent directors, who have less understanding of the company's status and are working on a part-time basis, could really take over responsibility without significant input from insiders. Therefore, in the unitary board structure, executives are needed when a single board is taking both jobs of leadership and supervision.

The potential value of having a reasonable number of executive directors in a unitary board is summarized by one writer as:[77]

> "One possibility is that an optimal board contains a mix of inside, independent, and perhaps also affiliated directors, who bring different skills and knowledge to the board.[78] A second possibility is that having a

[75] Ira M. Millstein, *The Professional Board*, 50 BUS. LAW. 1427 (1995), at 1435.
[76] See Higgs Review, 4.2.
[77] Sanjai Bhagat & Bernard Black, *supra.* note 72, at 950-951.
[78] Barry D. Baysinger & Henry N. Butler, *Corporate Governance and the Board of Directors: Performance*

> few insiders on the board may make it easier for other directors to evaluate them as potential future CEOs.[79] If the senior managers are on the board, they must attend, must vote, and are expected to speak. That could produce more extensive and different interaction with the board than if they are merely invited by the CEO, do not vote, may not be expected to speak, and could be disinvited by the CEO the next time if they say the wrong thing. Thus, merely inviting other senior managers to attend board meetings, as some advocates of supermajority-independent boards suggest, may not be a full substitute for having them on the board. Third, as Baysinger and Hoskisson argue, inside directors may be better at strategic planning decisions.[80] Fourth, there is a tradeoff' between independence and incentives. Most independent directors own trivial amounts of their company's shares, and hence have limited incentives to monitor carefully. Inside directors lack independence, but have their human capital and often most of their financial capital committed to their company.[81]"

It is emphasized that, as senior managers, executives make significant investment of time and effort in learning firm-specific knowledge, in order to do their jobs more effectively.[82] These people are more likely to make better decisions for the company than an outsider, even assuming equal levels of information relating to the decision at hand.[83] The efficiency of corporate leadership might be damaged if it occurs without

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Effects of Changes in Board Composition, 1 J.L. Econ.& Org. 101, 116 (1985).

[79] Righarid F. Vancil, *Passing the Baton: Managing the Process of CEO Succession* (Harvard Business School Press, 1987), at p.139; Michael S. Weisbach, *Outside Directors and GEO Turnover*, 20 J. Fin. Econ. 431 (1988), at 433-34.

[80] Barry Baysinger & Robert E. Hoskisson, *The Composition of Boards of Directors and Control: Effects on Corporate Strategy*, 15 Acad. Mgmt. Rev. 72 (1990).

[81] Brian J. Hall & Jeffrey B. Liebman, Are CEOs Really Paid Like Bureaucrats?, 113 Q.J.Econ. 653 (1998) .

[82] Stephen M.Bainbridge, *Interpreting Nonshareholder Constituency Statutes,* 19 Pepp L. Rev. 971 (1992), 1006-07. See also Jill E. Fisch, *supra.* note 74, at 272.

[83] Stephen M. Bainbridge, *A Critique of the NYSE's Director Independence Listing Standards* (June 2002), available at: http://ssrn.com/abstract=317121. At least some insiders are therefore needed on the board so the other directors can benefit from their expertise and experience. This is the main argument against the proposal that all directors be independent of management. Another arguments, of somewhat less force, are that inclusion of

contributions of executive directors. Furthermore, in the view of the author, the absence of executives may also have a negative impact on the productivity of independent directors. Independent directors may possibly become confused about their role: traditionally, they simply offered advice and guidance; but when executives are out and the management team becomes some kind of subordinate body under the authority of the "super independent board", independent directors would find themselves in a position of ordering the managers. Such a confusion may affect their intelligence of making the best decisions. In this sense, the presence of executives is a necessary feature of corporate governance in the unitary model.

3.3 The Effect on Mutual Relationships

When the management and board are separated, the corporate governance structure would be radically re-organised. Executives lose their position in the board, and the management team becomes an internal institution on a lower level of the corporate hierarchy. Independent directors solely assume the responsibility of leadership, and the "pure independent board" enjoys the authority to control material business. Executives and independent directors are no longer equals in status, but rather are transformed into a subordinate-supervisor relationship. It may be debated whether this change would have any material impact on the internal climate of a company. In fact, the author speculates that there might be possible negative results from such a paradigm shift in board structure:

First, if executives no longer took seats on the board, they may suspect that they have been removed of the ultimate authority. If, as they assumed, the scale of their involvement in this process is reduced, executives might decide that "it is the job of others" and care less about the tasks. When a project fails, executives could possibly

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senior managers on the board gives the outside board members exposure to potential valuable professional experience. See Michael S. Weisbach, *Outside Directors and CEO Turnover*, 20 J. Fin. Econ. 431 (1988), 433-34.

escape taking the blame, because allegations would first and mostly be levelled against the leaders (i.e. independent directors). Accordingly, executives might mentally rely on the board to make final decisions, and simply follow its orders without challenge or question. So they may become less committed to company's affairs, but more likely to shirk from duties.

Second, if executives have a strong desire of controlling the business, they might subjectively believe that they are the best candidates for the running of the company, and thus resist the authority of the board because they view the board members as less skilled and experienced than them. Perhaps based on a good faith notion that the company would be better governed under their intelligent hand, executives may try to bypass the board and do things by themselves, since they appreciate that it is more efficient and more beneficial for the good of the company. As a result, the "super independent board" may only receive after-matter reports and merely approve some proposals which have already been exercised by the management.[84] Certainly, this outcome does not serve the purpose of corporate governance reforms.

Third, the separation of the board and management may send a signal of distrust, creating an inharmonious climate within the company. Reducing the level of trust that comes from closer or less adversarial relationships may have unintended consequences. Although it is argued that division of works makes for the "greater clarity of roles and responsibilities" of different parties,[85] the author suspects that there is little convincing evidence suggesting a significant benefit to encourage more teamwork, especially when people have fewer opportunities to review matters and vote on decisions face-to-face. It is hard to promote mutual respect and open discussion between parties of a non-equal status. This problem can be worse in the

[84] Such a problems has commonly been suffered by the supervisory board in a two-tier board structure. See Paul Davies, *supra.* note 67.
[85] Alice Belcher & Till Naruisch, *The Evolution of Business Knowledge in the Context of Unitary and Two-Tier Board Structures*, J.B.L. 2005, Jul, 443-472, at 472.

unitary board structure, when executives may think they have been usurped in their leadership and most of their decisions have to be assessed by others before being put into effect. The management might treat the inferior position as a sign of doubt on their business wisdom.[86] Given the fact that a harmonious environment is beneficial for the success of a company, excluding executives from the board and downgrading their posts would certainly not serve the purpose of increasing trust and confidence.

4. Conclusion

The UK system for the corporate governance of listed companies has long been appreciated as one of the foremost examples of a model leading the prevalence of board independence. However, criticism against independent directors has never stopped since the day of their introduction. Competing mechanisms, including institution investors as activists and market forces as discipline, have been proposed to challenge the supremacy of independent directors. The financial crisis of 2008 provides us a live opportunity to review the efficiency of these alternatives. It was found in this article that both measures suffer their own obstacles and limits. In conclusion, it is suggested here that it may be wrong to describe institutional investors and market forces as competing mechanisms against independent directors. Institutional investors may better wield their activism through focusing on shaping proper governance structure (board independence as default rule, but allow departure through a "comply or vote" approach) of their portfolio companies, rather than onerously carrying out substantial checking and deciding. While market forces appear no so promising in face of the financial crisis, independent directors should be more demanded to supplement the market through strengthening their involvement in controlling risk, assessing remuneration and setting the "tone at the top".

[86] By contrast, this problem may be minimized in the two-tier board structure, in which the managing board is on an equal status with the supervisory board, and is solely responsible for business running.

However, we must also be cautious that the importance of board independence should not be interpreted as an absolute dominance of independent directors. Certainly, the proposal of "pure independent board" does have some merits, by increasing the effort of monitoring through a higher level of board independence. Nevertheless, it is questionable whether in a unitary board structure prevalent in Anglo-Saxon countries, this model can be fully compatible with the current system. Introducing a radical change would inevitably mean material costs, either for law-making or business practice. On the other hand, it can be argued that insiders do add some value to corporate governance. Driving executives out of the board may lead to a scenario in which the board might work less, rather than more, effectively. Finally, a model of "super independent board" may create unexpected consequences that are not likely to engender mutual relationships and a harmonious climate within the company. Consequently, the author concludes that, in accordance with the feature of the unitary board structure, a reasonable number of executive directors should be included in the board.

CHAPTER FIVE

Factors in relation to the Performance of Independent Directors: The Obstacles and Solutions

Certainly, the presence of independent directors is a necessary step to construct a board with more balanced power-sharing and more objective judgement-making, which is the touchstone of the general system of corporate governance.[1] In this sense, we should pay attention to investigating whether this indispensible part of corporate governance can function smoothly in fulfilling its purpose.

Unfortunately, the financial crisis of 2008 seems to suggest that the system of independent directors is still far from perfectness. We have to admit that merely introducing someone with no responsibility of management or from outside of the company cannot immediately and certainly bring the ideal system into practice. Mere ostensible change to the board is *per se* unable to make a great difference to the substance of the decision-making process. The title of independent directors does not guarantee their activity and diligence.

Some evidence, as discussed following in this chapter, suggests that, despite some obvious improvement in corporate governance in recent years (e.g. recommending a majority of independent directors, and adoption of special sub-board committees), there are still some obstacles in real life that hold up progress. Due to these obstacles, moves to achieve an integrated corporate governance system through the

[1] There are some empirical studies that support the proposition that presence of independent directors will have a positive effect upon corporate performance and management behaviour. However, no consensus has been reached about how significant this effect is, and some studies even implied the contrary. Generally, see *e.g.* Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance,* 27 J. Corp. L. 231 (2002); Laura Lin, *The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence*, 90 NW. U. L. Rev. 898 (1996).

introduction of independent directors might suffer some difficulties. Given this fact, we must understand that, introducing independent directors and retaining their majority in the board is only the first step to reach the inherent demand of corporate governance, but not the overall content of the requirement of constructing a well-organised system. To make the reform work effectively, it is necessary to look deep inside the board and ascertain what might encourage the directors to fulfil their promise in the system. In this chapter, the author will examine some current obstacles which stand in the way of improvement in the work of independent directors, and also review and suggest some solutions, which may actually influence the attitude and effort of independent directors in delivering an effective performance.

1. The Independence of Directors

To be sure, there is no absolute correlation between non-executive or outside directors and the prevalent language of “independent directors”. These two different terms of title should not be confused with each other. The scopes of definition imposed on them are not the same: the conception of “non-executive/outside directors” may only suppose that those members of the board are not drawn from the insider group of senior managers and they are not in charge of the primary responsibility of management; on the other hand, an extra requirement is placed upon “independent directors” that not only the directors are distinguished in duties from the executive management, but also they must avoid any direct or indirect relationship with the management, such as consanguinity or financial connection. In short, independent directors must fall within the category of “non-executive/outside directors”; by contrast, the non-executive or outside directors would not always meet the condition of “independence”.

However, in many places, the difference between these two concepts is not being clearly emphasized, but on the contrary, the term of "non-executive/outside directors" is usually closely linked with the proposal of "independence". It was found that, in the current reform of corporate governance, the requirement of "independence" of non-executive or outside directors has been a necessary consideration. It is obvious that, in order to make the board capable of making an honest review of the performance of the management or to provide objective counsel to the management, the feature of independence seems to be an important element to achieve such a purpose. It is not secure for some directors to assume this responsibility, if they were under the undue influence of management and cannot make their own decisions. The characteristic of "independence" may help them avoid unnecessary pressure and not be hesitant in a way that might obstruct the realization of supervision. Thus it is not uncommon to require that, in a sound-structured board, the independence of a significant part of board members would certainly appear to be an indispensable requirement.

1.1 The Definition of "Independence"

Certainly, to require the directors to be independent is not the end of the analysis. The question here is the meaning of "independence", and how a director can qualify as really "independent". When we call someone "independent", of course it is necessary to refer to a measurable standard. In plain words, the term "independent" suggests a status free from control of others in action or judgement, and identifies one who is capable of making decisions on their own. But the reality is not as simple as the definition given in the dictionary. As human beings living in the modern society, there are certainly many factors that can affect the discretion of a person. The broad and abstract sense of "independence" does not clarify this understanding. In this sense, the provision of clear guideline as to the meaning of "independence" is

apparently an important content of the reform of corporate governance.[2]

To preclude someone as "independent", economic and family ties are definitely a visible target which can be easily located and detected. Not surprisingly, to exclude independent directors from having business or material relationships either with the management or the company has long been the central topic of the debate since the last century. All kinds of proposals with the purpose of improving regulation were keen to shed their own light on this matter. Clearly, the criterion of "independence" has been consistently raised to be more and more rigorous. In the modern version of regulation, it is not uncommon that even a slight relationship may be identified to prevent a director from being qualified as independent. To take the UK Corporate Governance Code (the Code) as an example, after leaving the board to decide whether the directors could be affirmed as independent, it is provided following that certain circumstances should be crucial to the determination of the board:

- has been an employee of the company or group within the last five years;
- has, or has had within the last three years, a material business relationship with the company either directly, or as a partner, shareholder, directors or senior employee of a body that has such a relationship with the company;
- has received or receives additional remuneration from the company apart from a director's fee, participates in the company's share option or a performance-related pay scheme, or is a member of the company's pension scheme;
- has close family ties with any of the company's advisers, directors or senior employees;
- hold cross-directorships or has significant links with other directors through involvement in other companies or bodies;
- represents a significant shareholder; or

[2] Higgs Review, *para.* 9.7, p. 35 (Jan. 2003).

- has served on the board for more than nine years from the date of their first election.[3]

In general, it is found that the provision of the Code almost covers all possible situations involving economic or family relationships which affect the independent discretion of directors. To be sure, the guideline here is not a compulsive regulatory requirement, which all listed company must abide by. Certainly, the company may still appoint someone to be independent director even if the person does not wholly satisfy all the conditions specified above. The board could by itself regard the nominee as independent and only need to explain its reason for such a belief in the public report. However, the list of code provisions may retain a certain influence upon the common understanding of the range of "independence". There is an implication here that the existence of the relationships or circumstances above might lead to a clear doubt about independence. The companies would thus usually take the provision seriously and try to avoid being plagued by the suspicion of nominating some directors who are not truly independent. As a result, the specific listing of the provision actually constructs an applicable interpretation, which is understandable as the norm in daily practice.

Similar rules over the qualification of independence, which pay great attention to financial or material ties, can also be found in the American stock market. In the context of Manual of New York Stock Exchange (NYSE), the general guide is nearly the same as that of the Code that the appointed directors should have no material relationship, either direct or indirectly, with the company itself, and it is up to the board to affirm and identify the independence of its directors.[4] In brief, it is specifically regulated that a director is not independent if:

(i). The director is, or has been within the last three years, an employee of

[3] The UK Corporate Governance Code (June 2010), B.1.1.
[4] NYSE Manual section 303A.02(a).

the listed company, or an immediate family member is, or has been within the last three years, an executive officer, of the listed company.

(ii). The director has received, or has an immediate family member who has received, during any twelve-month period within the last three years, more than $100,000 in direct compensation from the listed company, other than director and committee fees and pension or other forms of deferred compensation for prior service (provided such compensation is not contingent in any way on continued service).

(iii). (A) The director or an immediate family member is a current partner of a firm that is the company's internal or external auditor; (B) the director is a current employee of such a firm; (C) the director has an immediate family member who is a current employee of such a firm and who participates in the firm's audit, assurance or tax compliance (but not tax planning) practice; or (D) the director or an immediate family member was within the last three years (but is no longer) a partner or employee of such a firm and personally worked on the listed company's audit within that time.

(iv). The director or an immediate family member is, or has been within the last three years, employed as an executive officer of another company where any of the listed company's present executive officers at the same time serves or served on that company's compensation committee.

(v). The director is a current employee, or an immediate family member is a current executive officer, of a company that has made payments to, or received payments from, the listed company for property or services in an amount which, in any of the last three fiscal years, exceeds the greater of $1 million, or 2% of such other company's

consolidated gross revenues.[5]

To be honest, even though some slight difference in detail of the definition is inevitable in two regulatory regimes across the Atlantic, there is no great gap between them in relation to the nature of so-called “independence”. The common intent of those rules is to restrict, or even exclude directors (especially in the US, having independent directors in audit committee is a statutory requirement under the Sarbanes-Oxley Act), who assume the position as independent member, from being related to the company or senior officers in any substantial ties.[6] As a result, it seems more likely to convince the stock market and investors that a director without those relationships can be more suitable to serve the purpose of independent review. At least, on the surface, there is a belief that the directors, who are separated from economic and family ties, may act more independently than those who have the existence of circumstances.

[5] NYSE Manual section 303A.02(b).

[6] However, in some recent US cases, there is evidence that actual independence especially measured in subjective willing and social ties, rather than merely financial interest, appears to be the new standard applied by the courts. See *In re Oracle Corp. Derivative Litig.* 824 A.2d 917 (Del. Ch. 2003). In Oracle, the company formed a special litigation committee, comprised of two Stanford University professors recruited for the committee by two of the defendants, to deal with the shareholder litigation against four Oracle directors (including CEO Larry Ellison) for breaching their duty of loyalty by engaging in insider trading. The committee engaged in a lengthy investigation of the plaintiffs' claims and produced a 1,100-page report that concluded that continuing the litigation was not in the corporation's interests. It then moved to terminate the derivative action. While the argument was brought before the court, the committee's claims of independence was rejected, and the court reached its conclusion despite the absence of the sort of financial dependence. Vice Chancellor Strine held that the committee had failed to persuade him that it was sufficiently independent to evaluate the merits of the litigation objectively. He found the committee members' ties to the defendants which centered around their connections to Stanford University. Both members, Joseph Grundfest and Hector Molina-Garcia, were Stanford professors and alumni. The defendants included Michael Boskin, a Stanford economics professor, and William Lucas, a Stanford alumnus who had contributed almost$16 million to Stanford. In addition, defendant CEO, Larry Ellison, had contributed more than$10 million to Stanford, and had negotiated with the school about a potential $170 million contribution to establish an "Ellison Scholars" program at Stanford. Vice Chancellor Strine then ruled that such extensive social and professional connections precluded any presumption that the committee would evaluate the plaintiffs' claims solely on their merits, untainted by collegial sympathy or institutional loyalty. He therefore concluded "this was a social atmosphere painted in too much vivid Stanford Cardinal red for the committee members to have reasonably ignored it. Summarized fairly, two Stanford professors were recruited to the Oracle board...and soon asked to investigate a fellow professor and two benefactors of the University." See Usha Rodrigues, *The Fetishization of Independence*, 33 J. Corp. L. 448 (2007-2008), at 464-484.

1.2 The Mental Independence

However, it is necessary to bear in mind that there is no firm equality between "non-interest" and "independence". Even if a director does eschew any material relationship and thus is non-affiliated, no guarantee can be made here to say that the person might of course be independent in mind.[7] For those regulatory rules on "independence", which greatly emphasize remaining a distance from business relationships with the company or senior officers, there is always a potential risk that even the directors completely independent of these relations can be mentally "non-independent", slacking in their duties and failing to bring a real challenge against the inefficiency or improprieties of management. The so-called "independent directors" thus needs some extra features more than just the independence of financial or family ties.

More radically, there is even a call that, for the purpose of satisfying the inherent requirement of corporate governance, the standard of "independence" should be replaced by another term, i.e. "autonomy",[8] which would be more suitable to describe both the objective state and subjective activity of directors. In plain terms, the word "autonomy" means the condition or quality of being self-directed. Compared with the current understanding of rules about an "independent" financial position, this idea places more emphasis on independence in mind or judgement. Under the ideal circumstance where directors are "autonomous", the criterion of being independent of business and material relationships is only the first step and prerequisite, rather than the whole context of the requirement; other than these objective conditions, the directors are expected to ardently contribute their knowledge to the best interest of the company and actively take part in the decision-making process and internal monitoring system. In short, the suggestion of

[7] It is important to remember that "directors must not merely be independent, but must act independently." See *Telxon Corp v. Meyerson* 802 A.2d. 257 (Del. 2002), at 264.

[8] Daniele Marchesani, *The Concept of Autonomy and the Independent Director of Public Corporations*, 2 Berkeley Bus. L. J. 317 (2005).

"autonomy" is in relation to the independence of state of mind, which is wider than the simple independence of position in business.

While it is thought that an efficient independent director should be independent of both finance and mind, unfortunately, the traditional regime of regulation is to a certain extent inefficient. No matter how the rules of independent directors are regulated or improved, one matter remains unchanged, i.e. it is for the board itself to determine whether or not the appointee can meet the standard. However, while allowing the board to decide the matter, there are always some risks: firstly, nomination of independent directors may turn to be a secret friend-seeking procedure *ex ante* and a "box-ticking" behaviour *ex post*. Because the board does not need to disclose in detail about how they find out proper candidates (the Code only requires a general disclosure of nomination procedures in the annual report[9]), friends or people with close social tie could be introduced through simply private contact (as long as the company gives a brief explanation of an external search consultancy nor open advertising has been used).[10] Then the board may comfortably announce its nominees for shareholders to approve and easily justify the independence of their "allies" by a routine check of the list of standards set by the rules.[11] In short, the genuine independence could be offset by a behind-scene interaction during pre-nomination stage. Secondly, the board, especially the executive management, might abuse the power of nominating and thus encroach on the matter of independence. For example, management may prefer to appoint someone who is in support of their philosophy or who would not take a tough attitude towards them; or the management would try to boycott active challengers by not supporting their

[9] The UK Corporate Governance Code (June 2010), B.2.4.

[10] This was partly confirmed by a survey of U.S. board members, in which directors confessed that the most important factor in deciding to join a board may not be the financial soundness of the company or the director's ability to make a contribution to it, but the identity of other board members. See Korn/Ferry Int., 22nd Annual Board of Directors Study (1995), at 31.

[11] Even the strictest rule cannot preclude the independent directors "from being a social friend of, or a member of the same clubs, associations, or charitable efforts as, the persons whose compensation or self-dealing transaction he is asked to assess", who can nonetheless meet 'independence' in terms of business ties. See Victor Brudney, *The Independent Director – Heavenly City or Potemkin Village*, 95 Harv. L. Rev. 597 (1981-1982), at 613.

re-nominating. In the situation where the management has significant voice in determining the position of independent directors, certain undue influences may clearly be drawn down to offset the activity and passion of those directors to honestly speak out their objective opinions, when they might fear that their fate is dependent on the likes and dislikes of management.[12] Due to these problems, independent directors cannot effectively achieve their responsibilities, even if they are deemed 'independent' according to the relevant regulations.

1.3 The Solutions

1.3.1 From Listing to Disclosure

First of all, the beginning step may always be to tighten the standard of "independence", by crafting a longer and longer list seeking to cover all elements that could influence this factor. We have witnessed the development of corporate governance in this area, from the embryo of independent directors in the Investment Company Act of US,[13] to the modern model restated in the Code or NYSE Stock Exchange Rules.[14] Such well-prepared provisions have promoted the notion of board independence. But on the other hand, we should understand that attempts to improve standards should never stop. It is inevitable that some slight factors could be missed. A good example could be found in the scandal of Enron, some of its independent directors seemed to be acting consistently with the "independence" standard of the time, as set against stock market rules or the common understanding of academy. However, on consequently reviewing the case, it was surprising to find out that some independent directors of Enron were in fact the members of a charity which received

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[12] As Jonathan Charkham, Director of PRO NED, has put it: "The power of appointment to the board is the fulcrum on which the prosperity of the company is balanced – not the structure of the board." (In a paper to a joint conference of the International Bar Association and The Institute of Chartered Accountants in England & Wales, London, 20th April 1983)

[13] See the description of Investment Company Act in Chapter One.

[14] *E.g.* for the development of the standard of "independence" in US, see Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 Stan. L. Rev. 1465 (2006-2007), at 1479-1483.

significant donations from Enron and its CEO every year.[15] In a suspicious view, such a relationship may taint the notion of independence, even if it did not fall foul of the rules. Thus there is always a possibility that the standard of "independence" today might need continuous review periodically, and rule-makers should be cautious to the practices that could be used by management to bypass the firewall to improperly influence the "independence" of directors.

However, measures designed to keep tightening the standard of "independence" have their own inherent weaknesses. Drafting skills would be tested in that it would be impossible to articulate every possible brake on independence that might occur in practice. The words used by rule-making would usually be abstract in order to retain some flexibility, facilitating the rules commensurate with different circumstances. Moreover, there is normally a lag of time between the development of practice and rule-setting. The rules would usually only be reviewed periodically, or after something happened which led to calls for reform.[16] Therefore, it can be said that the strategy of tightening the "independence" bar cannot offer a satisfactory answer all the times. The following question can then be posed: when the rule-makers feel helpless to produce an all-encompassing standard for the independence of directors, what measure could be picked to fill the void?

In answering this question, the response has long been drawn in the market rules, i.e. a full disclosure of status. It is not uncommon to learn that most rules, either

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[15] It was found that many directors receive side payments in the form of corporate philanthropy to their pet charities and consulting contracts, which can be termed as "low visibility sanctions" or "high visibility sanctions". See Jeffrey N. Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections*, 69 U. Chi. L. Rev. 1233 (2002). See also Faith Stevelman Kahn, *Pandora's Box: Managerial Discretion and the Problem of Corporate Philanthropy*, 44 UCLA L. Rev. 579 (1997) (researching the problem of corporate philanthropy (charitable donation)); Melvin A. Eisenberg, Symposium, *Corporate Conduct That Does Not Maximize Shareholder Gain: Legal Conduct, Ethical Conduct, the Penumbra Effect, Reciprocity, the Prisoner's Dilemma, Sheep's Clothing, Social Conduct, and Disclosure Corporate Philanthropy*, 28 Stetson L. Rev. 1 (2000).

[16] As a typical example, the authorities are calling for a thorough reform on the regulation of financial system in the aftermath of the global credit crunch. See BBC, US plans to rein in Wall Street, available at: http://news.bbc.co.uk/1/hi/business/7953772.stm; G20 'deal on global regulation', available at: http://news.bbc.co.uk/1/hi/business/7953772.stm

provided by authority or the market itself, normally leave the final discretion in the hands of the companies to decide on the issue of "independence" of directors, letting themselves judge whether their board members are serving on an independent basis. Under this regime, information about any relationship between the given independent director and the companies or its management, no matter how slight or significant, should be made public.[17] The companies should bear in mind the strict duty to disclose any relationship, existing or possible, which would reasonably bring about doubt or suspicion that the independence of directors could be in some ways affected. Thus if the publicly traded companies decide to follow the recommendations of "best practices" and want to enjoy a high profile of "integrity of corporate governance" through the introduction of independent directors, they should comply with obligation of disclosure to signal to investors that they are seriously complying with the rules. On the other hand, traditionally, the responsibility of fair disclosure is merely fall upon the company concerned. The annual report and nomination committee statement are the only measures to endorse the independence of directors.[18] The author, however, thinks that the directors themselves should also assume responsibility. It is suggested here that, when anyone is appointed as an independent member of the board, it is necessary for him to issue a letter, along with the consent to hold the office, declaring that, he has no existing relationship with the companies or its insiders which might lead to concerns about his independence, or if such a relationship did occur, he should make a comprehensive and clear statement to this effect. Furthermore, this requirement of disclosure should be set up on a continuous basis so that all independent directors should make these reports annually to self-verify their independence or disclose any material factor pertinent to their independent status.

[17] The Corporate Governance Code, B.1.1: "The board should identify in the annual report each non-executive director it considers to be independent. The board should determine whether the director is independent in character and judgement and whether there are relationships or circumstances which are likely to affect, or could appear to affect, the director's judgement."
[18] *Ibid.*; Financial Reporting Council, Good Practice Suggestions from the Higgs Report (June, 2006), p.9.

In addition, the author suggests that, in response to the “behind scene” problem at pre-nomination stage, the disclosure system could be improved to further promote transparency. Under the current regime, disclosure is only based on a systematic description model in relation to practices of nomination committee. The committee is only required to make a statement in the annual report generally about its working model (e.g. the composition of the committee, attendance of committee meetings, or whether external advice has not been used). However, such a system is obscure to investors about how a particular independent director is found and evaluated. In order to resolve this issue, the author proposes a supplementary system of disclosure on an incident-based model, in which disclosure is triggered in every nomination of new independent directors and information should be available to investors before appointment. In such a disclosure, the nomination committee should explain: how a candidate is found (through personal contract of incumbent board members, or through an external human resource agency), whether the nominee is the only candidate for appointment, whether and how the candidate has been interviewed, how the committee has assessed the capacity of candidate, etc.[19] By introducing this incident-based disclosure system, it is supposed that the transparency of current nomination procedure could be raised to a more up-to-date disclosure basis and help investors better assess nominees before appointment. Although it is still possible to informally solicit a friend to be an independent director (as long as this private contact is disclosed), such a disclosure would certainly encourage a more transparent and formal nomination, making it more difficult to form a “social-club” in the board. In short, such an approach is not only focusing on disclosure of whether the company has a proper nomination procedure, but also requiring the company to show how it properly used this procedure.

[19] Certainly, all these factors are not fresh ideas and already recommended as primary duties of nomination committee. For example, in the FRC’s “Good Practice Suggestions from the Higgs Report”, it is expressly said that the committee should “before making an appointment, evaluate the balance of skills, knowledge and experience on the board and, in the light of this evaluation, prepare a description of the role and capabilities required for a particular appointment.” However, these factors are not included into the dimension of annual statement of nomination committee.

1.3.2 The Nominating Power

As stated above, it can be observed that, in some cases, the management might have an undue influence on selection of independent directors. The impact of the management on the nominating process would be very likely to place a stress on independent directors particularly in achieving their role in reviewing the performance of management.[20] The consciousness of responsibility in monitoring may certainly be corrupted if their tenures in the boardroom seats are totally in the others' hands. Consequently, an effective reform requires not only recruiting the right person, but also eliminating the behavioural barriers that jeopardize the effectiveness of independent directors.

In response to this requirement, a first step may be to require the CEO to step away from the nominating proceedings. The nominating process needs to be more formal and transparent, i.e. the companies should install a nominating committee to consider possible candidates and determine appointments. Currently, it is encouraging to see that proposals in connection with the nominating committee have been widely adopted by the modern corporate governance reform. The Code makes clear that it is necessary to construct the nomination committee in the board, which is composed of a majority of independent directors,[21] and chaired by such a director or chairman of the board.[22] The purpose of this arrangement is to make the nominating of directors largely insulated from the interference of management and to introduce a balanced evaluation for those candidates. Therefore, when the objective standard written in the rules cannot cover the whole qualification for "independence" and the board is called

[20] This conclusion was also in part supported by empirical evidence suggesting that, if the CEO got involved in the election of directors, the independence of candidates would then be negatively influenced. See Anil Shivdasani & David Yermack, *CEO Involvement in Selection of New Board Members: An Empirical Analysis*, 54 J. of Fin. 1829 (1999).

[21] The Corporate Governance Code, A.4.1. See also NYSE, Inc., Listed Company Manual §303A.04-05 (2007).

[22] The chairman cannot chair the nomination committee when it is dealing with the appointment of a successor to the chairmanship.

to self-affirm the independence of its appointed independent directors, the presence of a nomination committee then becomes an essential measure to narrow the gap in practice.

Certainly, an independent-majority committee is helpful in curbing managerial power on nomination process. However, we should be cautious here that, such a nomination committee does not categorically prohibit the management from having any influence to name a candidate who he thinks is suitable for the job. Because executive can still retain some seats in the nomination committee,[23] it seems unlikely to completely cut managerial power from nomination. Thus undue influence from management is still a risk. In order to tackle this problem, it is suggested here that a counterbalance could be introduced into the nomination process. Given that the "shareholder-centric" camp has currently been a prevalent thought in corporate governance,[24] shareholders, especially institutional investors, should be given a chance to participate during the process of finding and nominating an independent directors. Under this proposal, shareholders should be allowed to recommend a candidate to the nomination committee for consideration (along with an explanation of reasons of recommendation and declaration of independence of this candidate from nominator), and before referring candidates to appointment, the nomination committee should set up a period of consultation to invite views of investors about the candidate concerned. In announcing the appointment of independent director, the nomination committee should prepare a statement to disclose: whether a nominate has been recommended by shareholders; whether this candidate has been chosen by the committee for appointment, and (if not) why the committee favours its own nominee rather than the shareholder candidate; whether the committee has respectively interviewed shareholder candidate and other candidates; whether there is

[23] Because the nomination committee is responsible for finding not only new independent non-executive directors, but also successive CEO and other executives, of course incumbent management should be allowed to consider and have a say on their succession.
[24] This is also affirmed by the Companies Act 2006 in section 172, which declares that the directors must "promote the success of the company for the benefit of its members as a whole".

any concern of shareholders during the consultation period and whether these concerns have been seriously considered by the committee. This proposal is aimed to encourage the involvement of shareholders and promote the transparency of procedure, rather than merely leave shareholders with a “yes” or “no” option in nomination and appointment. On the other hand, this proposal is different from the idea of direct interference of shareholders with nomination or a radical solution of shareholder-nominated directors.[25] The role of shareholders in this approach is only advisory by which they can help the nomination committee broaden its perspective and consider some issues that it might miss. The full discretion is still in the hands of committee in determining which candidate should stand for appointment (but imposing a requirement of disclosure on the committee). Therefore the fundamental dynamics of nomination would not be radically changed but only reinforced. Compared with the current model which only implies dialogue and engagement of investors on an informal basis, it is believed that this proposal can better formalize the involvement of shareholders and retain a more balanced structure in the nomination process.

2. The Active Performance of Independent Directors

By including more directors who are truly independent, the reform on corporate governance may reach its first agenda. But it is essential to bear in mind that an active board needs directors who are not merely independent, but who are as well accountable to the company and can add value to its operations.[26] An independent director would not necessarily be diligent just because he is independent, and neither would a board be active simply for the reason that it is mostly comprised of independent directors. In short, these independent directors are being asked for active

[25] *E.g.* Lucian A. Bebchuk, *The Case for Increasing Shareholder Power*, 118 Harv. L. Rev. 833 (2005).
[26] Ira M. Millstein and Paul W. MacAvoy, *The Active Board of Directors and Performance of the Large Publicly Traded Corporation*, 98 Colum. L. Rev. 1283 (1998), at 1297.

performance on the board.

However, directors had long been criticized for their passivity and indifference.[27] Although non-executive and outside directors have a long history, they were usually observed as "silent" in their performance and turned a blind eye to the conduct of management.[28] The character of "non-executive" or "outside" did not make them independent of the management, but made them independent of corporate operations, knowing little about business running, being indifferent to managerial performance, but echoing what the CEO said in board meetings. This passivity and ineffectiveness, if not changed, would render the whole proposal of introducing independent directors as meaningless. According to current researches, generally, there are many factors which might contribute to ineffective performance.

2.1 Short of Working Time

First of all, a problem may be that some independent directors, who are often executives in other corporations or institutions, find it hard to meet the demand for increasing time contribution to their work.[29] Even if today is not the day that people simply take the title of director as a trophy of reputation, the independent directorship is still a byword in many cases for those who already have successful careers in other places.[30] The task of "independent directors" is normally regarded as a part-time job, because the common sense is not that it can in fact be a full-time career. This feature is obviously in accordance with the realities of the market of

[27] Victor Brudney, *supra.* note 11, at 612.

[28] As for the traditional passivity of non-executive and outside directors, see the description of Chapter 1.

[29] Even with the additional duties imposed by Sarbanes-Oxley, independent directors spend an average of about 275 hours a year on their board duties. See What Directors Think, CORP. BOARD MEMBER MAG., 2005, at 14, available at:
http://www.pwc.com/extweb/pwcpublications.nsfldocid/870C33ACFC7C57C385256FA3007252CF/$fle/cbm-wdt-2005.pdf

[30] Take RBS as an example, all of its non-executive directors are currently taking a number of directorships or positions in other institutions. See information available:
http://www.rbs.com/about98.asp?id=ABOUT_US/OUR_BOARD#non_executive

resource for potential candidates for role of independent directors. Companies might more or less have a clear bias on choosing business participants, such as executives in other companies, to act as independent directors, possibly because the corporate industry might think that only those familiar with business affairs can carry out the work, or it finds it hard to seek enough talents to take on the directorships from human resources other than the group of business professionals.[31]

Indeed, it should not be suggested that it is a bad idea to nominate businessmen as independent directors. As a matter of fact, directors who are executives of other companies can in many ways bring great contributions to the corporation in which they serve. Given their positions of executives, they are familiar with corporate operations and have clear visions about business development. Such independent directors can possibly provide useful advice and review business issues from a sharp angle, and thus achieve the advisory role as discussed in the third chapter. However, the question may be posed as to whether they can suitably balance the time demand between their main career and part-time directorship. When they are required to be diligently responsible for their full-time job, will they be able to juggle this with their part time position? When modern corporate governance practice suggests independent directors do more than just participate in periodical board meetings, is it still probable to ask them to squeeze out more working time from their exhausting primary job? If independent directors do decide to act effectively, they should strike a proper balance in the division of time and energy.

Empirical evidence might point to poor performance of non-executive/outside directors in this area. It was estimated that, on average in 1980, directors might not spend more 13 hours per month in attending board and committee meetings and

[31] Spencer Stuart, *Board Leadership and Composition Becoming More Independent, 22nd Annual Spencer Stuart Board Index Reveals Board Changes* (Oct. 3, 2007), available at: http://www.spencerstuart.com/about/media/46/. In this survey, it was found that 33% of current directors are active CEOs, while many others are former CEOs and 21% of board members are now active or retired division managers. See also Gerald F. Davis et al., *The Small World of the American Corporate Elite*, 1982-2001 STRATEGIC ORG. 301 (2003).

preparing for them.[32] Although there has been a clear upward trend in the latter figure,[33] the level of participation in corporate affairs by independent directors is still limited, and there is no possibility to suggest that their time contribution could begin to reach that of executives. Moreover, some reports also indicate that the frequency of board meetings, though maintaining an upward curve, is not so high as to promise a continual review of business operations. In some countries of Europe, the average statistics show that the board even cannot guarantee one meeting per month.[34] Furthermore, there may be certain concerns about the self-interest of independent directors, i.e. the fact that they may receive only a modest compensation for their services may fail to offset the costs of time and energy required for their board work. In other words, there is a question whether the typical fixed payment for independent directors, can constitute a clear "economic stimulus" to encourage them to contribute their working time, which can alternatively be used for their primary job, into the independent directorships. This is particularly true given that their "full-time" activities may reap far greater financial rewards.[35]

2.2 Shortage of Knowledge and Information

The challenge to the effectiveness of independent directors can, on the other hand, be stem from the reason that they are not familiar with the company's affairs and lack of specific professional knowledge, especially when dealing with such matters as

[32] KORN/FERRY INTERNATIONAL, Board of Directors (1981), at 20. And it was also observed that outside directors spent from 3.5 to 4 hours in preparation of each committee and board meeting. See HEIDRICK & STRUGGLES, INC., Director Data (1980), at 4.

[33] Even if there is no specific figure revealing the time-commitment of independent directors, empirical statistics of average performance of directors on the whole may still be able to unveil important trends: KORN/FERRY INTERNATIONAL, The 34th Annual Board of Directors Study (2008) (suggesting that despite a reported decline in full board meetings, directors spend nearly twice the time on board matters today than they did 20 years ago).

[34] HEIDRICK & STRUGGLES, INC., Raising the Bar: Corporate Governance in Europe 2007 Report, at p.7, available at: http://www.heidrick.com/NR/rdonlyres/666FC928-1933-4F4B-B184-FBBE141313A9/0/HS_CorpGovEurope2007.pdf

[35] However, it is worth noting that the compensation level for independent directors has seen a significant increasing trend in recent years, and the gap between the compensation of executive and non-executive directors has been narrowed. Moreover, it also should be noticed that monetary stimulus is not the only motivating factor. Some subjective elements, such as prestige or invitation by friendship, might of course attract people from the external world, even if financially they may not necessarily rely on the compensation for the directorship.

complicated financial reports. Certainly, if the directors are supposed to independently consider the merits of management's strategy and business plans, then they should, at least, be able to understand necessary elements of the strategic-planning process and learn whether the factors have been properly accounted for in the plan.[36] But regular board meetings, normally monthly or quarterly, do not necessarily offer independent directors a sufficient basis for understanding the business of the company which they are serving. It is fair to suggest that directors may have to do more homework before taking part in the meetings and putting good questions to management. Independent directors, who are visible in the list of board members but have failed to gain a sufficient understanding of key corporate information, cannot be on average regarded as effective.[37]

Furthermore, the lack of expert knowledge in finance, accounting or other professional areas may also pose challenges for independent directors' monitoring and advisory functions. It is common that independent directors need to review and verify financial statements before being made public, or be responsible for some particular duties split from the general work of the board, e.g. risk management or public relationships. All these tasks make it important for independent directors to have at least a certain degree of skill to understand, for example, the documents which they are determined to sign, and the matters that they are supposed to handle. If those independent directors are not capable of discharging this role, it might be very hard for them to detect such problems before it is too late.[38]

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[36] Ira M. Millstein, *The Professional Board*, 50 Bus. Law. 1427 (1995), at 1434.

[37] See the discussion in Chapter one about those outside or non-executive directors in the early age who had no professional business knowledge but were recruited into the board for "decoration" because of their personal reputation and public profile.

[38] For example, in relation to the poor performance and tragic loss of HBOS, there is certainly a strong allegations were levied against its former boss, Sir James Crosby, in dealing with the personnel arrangement of the risk management unit. After removing the former risk manager, who warned the bank about excessive risk-taking, the then HBOS chief executive appointed a new director of risk who was "senior banker" but with no experience of risk or regulation. Although HBOS denied any wrongdoing and justified its decision by arguing that its risk control strategy had been endorsed by an independent consultation institution, it can be questioned whether it was a good idea to put someone with no relevant professional knowledge in such an important position. See BBC News, HBOS risk control 'dumbed down', available at: http://news.bbc.co.uk/1/hi/business/7892079.stm; Why did HBOS make risky loans?, available at:

However, even if independent directors with proper skill were recruited onto the board, and they did acquire necessary knowledge about the company, another element could still stand in the way for them to be effective. Poor performance may to a certain extent arise from ineffective access to information. It is not surprising that compared with the executive management who are in charge of daily operation of the business, independent directors are naturally at a disadvantage in obtaining key internal information in a timely fashion.[39] Of course, it is not fair to suggest here that independent directors are completely unable to find out the truth by their own efforts in information-collection.[40] But access and collection of information may continue to be a trouble for the directors, and usually, they rely on executives and other officers for information.[41]

Furthermore, an appropriate information system does not merely mean that directors should only acquire any vital information before holding a board meeting. Information feed should not be set on a periodical basis, but a continuous one. As in the words of Jonathan Parker J., "[d]irectors have both collectively and individually a continuing duty to acquire and maintain a sufficient knowledge and understanding of the company's business to enable them properly to discharge their duty as directors."[42] Independent directors should ensure they are continuingly informed, knowing exactly how the company is running its business. However, to do so would request that directors contribute more time and work on collecting and reviewing

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http://news.bbc.co.uk/1/hi/uk/8067356.stm.

[39] See HEIDRICK & STRUGGLES, INC., The 10th Annual Corporate Board Effectiveness Study 2006-2007 (finding that, although board members generally felt that they have enough information, they report receiving relatively little information about management practices and human capital management. Only 31% of the directors indicated that to a great or very great extent their boards have independent information channels that provide useful information about company operations and management practices).

[40] Nowadays, under the regulations of market rules, the company should provide its directors with important documents and reports, and all necessary information under their request. And empirical study did find out that, at least, directors might subjectively be satisfied with their information access. See HEIDRICK & STRUGGLES, The 10th Annual Corporate Board Effectiveness Study.

[41] See Lawrence E. Mitchell, *Structural Hole, CEOs, and Informational Monopolies: The Missing Link in Corporate Governance*, 70 Brook. L. Rev. 1313 (2005).

[42] *Re Barings (No.5)* [1999] 1 B.C.L.C. 433 at 489.

information. This would certainly put much pressure on independent directors' timetable. As stated above, the increasing time gap between full-time career and part-time directorship makes it more and more difficulty for independent directors to meet their demands.

2.3 Boardroom Dynamic

In some cases, even if all objective conditions, such as time contribution, professional knowledge and sufficient information, are satisfied, passivity and inefficiency may still arise. Independent directors might be encumbered by an inherent structural bias that leads them hesitate to question or argue. For example, when independent directors are drawn mostly from the group of business professionals, a group of like-minded people may be created.[43] Subject to psychological and social considerations, independent directors might find it hard to stand in an adversarial position against the management who has a shared identity and philosophy.[44] They may recognize some unreasonable behaviours of management and also their harmful potential, yet be unwilling to correct them, at least so long as the performance of management is still acceptable.[45] Ironically, in some situations, independent directors may even be keen to defend an incompetent executive, since the failure of a CEO impairs their own reputational capital (suggesting that they may have made an error of choosing a wrong leader).[46] Therefore, when both executive and independent directors are present on the board

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[43] Cass R. Sunstein, *Deliberative Trouble? Why Groups Go to Extremes,* 110 Yale L.J. 71 (2000), at 74-75; Cass R. Sunstein, *Group Judgements: Statistical Means, Deliberation, and Information Markets,* 80 N.Y.U. L. Rev. 962 (2005), at 966; Cass R. Sunstein & Reid Hastie, *Four Failures of Deliberating Groups* (Apr. 2008), available at: http://ssrn.com/abstract=1121400.

[44] Maximiliano González, Renato Modernell & Elisa París, "Herding Behaviour Inside the Board: an experimental approach", in *Corporate Governance*, Vol. 14, No.5, Sep. 2006, 388-405 (suggesting a "herding behaviour" inside a board of directors, when an individual director makes a decision imitating another's actions and ignoring his or her own private information, even if his or her information suggests a different course of action).

[45] Jayne W. Barnard, *Narcissism, Over-Optimism, Fear, Anger, and Depression: The Interior Lives of Corporate Leaders*, 77 U. Cin. L. Rev. 405 (2008-2009), at 426.

[46] Donald C. Langevoort, *Resetting the Corporate Thermostat: Lessons from the Recent Financial Scandals About Self-Deception, Deceiving Others and the Design of Internal Controls*, 93 Geo. L. J. 285, 307 (2004), at 310.

and work together, a cooperative climate is promoted, but a risk arises that things become too cosy and that supervision in effect breaks down.[47] Given that being an independent director often asks for sceptical views and questioning,[48] over-cohesiveness in the board may act against these important features.

2.4 "Groupthink"

An over-cohesive boardroom culture may also result from an unconscious influence of intra-group dynamics. Group working can bring benefits to decision-making processes, by offering different perspectives, generating fewer errors, and uncovering more mistakes than individuals.[49] Certainly, it provides support for the board's role in overseeing managers' plans. However, in the same group, people may usually find it easier to accept an opinion if other members are inclined to agree with it, or the leader of the group, who has a history of extremely successful judgement, initiated the idea.[50] People are normally willing to justify their decision principally on the premise that majority support for it was given within the group.[51] This phenomenon is called "groupthink", which can possibly be seen as a significant impediment to group deliberation.

Irving Janis, the creator of this theory, described groupthink as "a mode of thinking

[47] See Alice Belcher & Till Naruisch, *The Evolution of Business Knowledge in the Context of Unitary and Two-Tier Board Structures*, J.B.L. 2005, Jul, 443-472. See also Luca Enriques, *Bad Apples, Bad Oranges: A Comment from Old Erope on Post-Enron Corporate Governance Reforms*, Wake Forest L. Rev. 911 (2003), at 930.

[48] Jennifer G. Hill, *Deconstructing Sunbeam - -Contemporary Issues in Corporate Governance*, 67 U. Cin. L. Rev. 1099 (1999), at 1115-1116. The Higgs Review held that directors should be "sound in judgement and…have an inquiring mind. They should question intelligently, debate constructively, challenge rigorously and decide dispassionately. And they should listen sensitively to the views of others, inside and outside the board." See Higgs Review (Jan. 2003), 6.10. However, some writers argued that such a skeptical attitude might induce hidden costs which could damage intra-group dynamics and trust. See Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norm, and the Unintended Consequences of Independence and Accountability*, 89 Geo. L. J. 797 (2000-2001).

[49] Donald C. Langevoort, *ibid.*, at 782.

[50] When issues are surrounded by uncertainty and ambiguity, members are more likely to be influenced by the ideas and opinions of others. See Lynne L. Dallas, *The Relational Board: Three Theories of Corporate Boards of Directors*, 22 J. Corp. L. 1 (1996-1997).

[51] See Donald C. Langervpprt, *Organized Illusions: A Behavioral Theory of Why Corporations Mislead Investors (and Cause Other Social Harms)*, 146 U. Pa. L. Rev. 101 (1997).

that people engage in when they are deeply involved in a cohesive in-group, when the members' striving for unanimity overrides their motivation to realistically appraise alternative courses of actions."[52] Groupthink may cause groups to make hasty, irrational decisions, where individual doubts are set aside, for fear of upsetting the group's balance. Due to the effect of groupthink, it may lead cohesive boards to unconsciously generate shared illusions, hinder critical reflection, and avoid seriously scrutinizing managerial policy.[53] Under this influence, eight symptoms that are indicative of groupthink occur:[54] (1) Illusions of invulnerability or invincibility, which create excessive optimism and encourage risk taking; (2) collectively rationalizing the policy that had been made, and ignoring external warnings that might challenge the group's assumptions; (3) unquestioned belief in the inherent morality of the group, causing members to disregard the consequences of their actions; (4) stereotyping of those who are opposed to the group as weak, evil, disfigured, impotent, or stupid; (5) direct pressure on dissenters who question the group, describing them in terms of "disloyalty"; (6) self censorship of ideas that deviate from the apparent group consensus; (7) illusions of unanimity among group members that view silence is consistent as agreement; (8) self-appointed mind-guards to shield the group from dissenting information.

Certainly, such a phenomenon of "groupthink" may occur in the boardroom, as members could unconsciously back proposals which they think are right but may in fact be unreasonable. Based on "unanimity" through groupthink, independent directors might be restricted in their active performance when they are reluctant to express diverging opinions and question the behaviour of the management.[55]

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[52] Irving L. Janis, *Victims of Groupthink: A Psychological Study of Foreign-Policy Decisions and Fiascoes* (Houghton Mifflin, 1972), at p.9

[53] Marleen A. O'Connor, *The Enron Board: The Perils of Groupthink*, 71 U. Cin. L. Rev. 1233 (2002-2003).

[54] Before applying groupthink theory, however, three antecedent conditions need to be satisfied: (1) a cohesive group, (2) structural faults in the organisation (insulation of the group, lack of tradition of impartial leadership, lack of norms requiring methodological procedures, homogeneity of members' social background and ideology), and (3) provocative situational context (high stress from external threats, recent failures, excessive difficulties on the decision-making task, moral dilemmas).

[55] See Kath Hall, *The Psychology of Corporate Dishonesty*, Australian Journal of Corporate Law, Vol. 19, 2006,

2.5 The Solutions

2.5.1 Diversity of Directorships

If, as observed above, holding multi-directorships might be one barrier to an active performance, the straightforward answer would then be to limit the number that could be held concurrently. In fact in modern times, the holding of several directorships concurrently is rare. The market rules are also set against the practice of an executive officer sitting in another boardroom. The Code makes its recommendation clear that: "[t]he board should not agree to a full time executive director taking on more than one non-executive directorship in a FTSE 100 company nor the chairmanship of such a company."[56] Moreover, it is understandable that, ensuring enough time contribution should not be just an expectation for independent directors to voluntary follow, on the contrary, it should be a condition that independent directors are bound to comply with. In relation to the appointment of an independent director, the nominating committee should prepare an assessment of the time commitment expected. Availability of time needs to be one of the factors against which the nominating committee evaluates the candidates. As a result, the letter of appointment should set out the expected time commitment, and be made available for inspection by any person at the company's registered office during normal business hours and at the annual general meeting.[57] On the other hand, the potential independent director should also undertake that they will have sufficient time to meet what is expected of them. To endorse this assurance, they should fully disclose their other significant commitments to the board before appointment, together with a broad indication of the time involved, and the board should be timely informed of

268, available at: http://ssrn.com/abstract=946302; Michael B. Dorff, *The Group Dynamics Theory of Executive Compensation*, 28 Cardozo L. Rev. 2025 (2006-2007).

[56] B.3.3.

[57] B.3.2.

any subsequent changes.[58]

The current movement of corporate governance places greater time demands on independent directors, and busy bosses are no longer welcomed in these jobs. However, it should be noted that if executive directors are not recommended as proper candidates, industry may find it difficult to recruit candidates for the posts. This becomes a tough question for companies, especially in the current climate in which it may be more difficult to persuade "independent thinkers" to accept board seats.[59] In response, it is suggested that the company should broaden its vision of the source of talents as independent directors, and cast a wider net to find those diverse talents beyond the "usual suspects".[60] For instance, professionals not from non-business sectors can be considered as potential candidates. Diversity might be an appropriate solution to resolve the lack-of-director puzzle.

Furthermore, diversity of directorships can also produce some positive effects on the board performance by infusing fresh thoughts.[61] Studies on social psychology provide evidence that diversity may offer more independent thinking on boards because diversity directors may hold "outsider values." Thus diversity may promote board effectiveness as different experiences may lead to different perceptives and useful advice.[62] In the UK, a similar view was shared by the Tyson Report of 2003, which agreed with the advantages of recruiting an appropriate mix of individuals with different skills, experiences and knowledge.[63] It concluded that the board can benefit from the diversity of composition through the bonus of group-performance, extension of information-acquisition, and efficient response to a broader set of

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[58] *Ibid.*
[59] Emily Thornton & Louis Lanvelle, *It's Getting Tough to Fill a Boardroom*, BUS. WK., July 29, 2002, at 80.
[60] FRC, Good Practice Suggestions from the Higgs Report, p.9.
[61] Steven Rarnirez, *Diversity and the Boardroom*, 6 Stan. J. L. Bus. & Fin. 85 (2000).
[62] Patricia Hill Collins, *Learning From Outsider Within: The Sociological Significance of Black Feminist Thought*, 33 Soc. Probs. (Dec. 1986). *Cf.* A.S. Tsui, T.D. Egan & C.A. O'Reilly, III, *Being Different: Relational Demography and Organizational Attachment*, 37 Admin. Sci. Q. 1992, 549; C.A. O'Reilly, D.F. Caldwell & W.P. Barnett, *Work Group Demography, Social Integration, and Turnover*, 34 Admin. Sci. Q. 1989, 21.
[63] The Tyson Report on the Recruitment and Development of Non-Executive Directors (June 2003).

constituencies.[64] In addition, the mix of experience and backgrounds can also help promote "the independence of mind, the probing, challenging attitude, and the sound judgement characteristic of effective boardroom cultures and performance."[65] Moreover, choosing a director with relevant experience in a certain area to deal with that specific matter may be helpful to develop a proper policy and send a positive message to its important constituencies, such as the shareholders, consumers and employees.[66] We should recall that both factors are a proper reflection of the essential function of the board and independent directors, i.e. the role as communication link between the company and its surrounding world. Thus it seems sound to suggest that greater diversity among directors could be beneficial for reaching an effective board.

However, to be sure, the suggestion of diversity should not be overstated. The proposal is not an inflexible requirement that all companies need to unconditionally adopt. The diversity of directors should primarily serve the business purpose of the company. The important determinants of recruiting independent directors are factors such as the company's size and history, the makeup of its customers and employee populations, the extent of its participation in global markets, and its possible future strategies.[67] As in the statement of the Tyson Report, the company should begin its search for appropriate candidates by "articulating its specific board needs taking into account the composition of existing board members".[68] Furthermore, despite the potential benefits, there may be some accompanying side effects which may offset the advantages. A clear possible drawback is that, the independent directors, who are from non-commercial sectors, might have less understanding about the content of their job and responsibilities than those business insiders. If independent directors have little idea about information in front of them or the topic discussed by other

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[64] Tyson Report, part IV, p. 7.
[65] *Ibid.*, p. 8.
[66] *Ibid.*
[67] *Ibid.* part V, p. 9.
[68] *Ibid.*

members of board, it is likely that they would be easily tempted to follow the opinion of others and hide their ignorance (so as to exacerbate "groupthink").

To deal with this problem, the Code states that the nominating committee should carefully pick the candidate. The committee should convince itself that the candidate has the knowledge and skill, which can meet the needs of the company and carry out the roles of directorship, or at least, the committee should ensure that the candidate has the ability of improving his knowledge and skill to a level which is suitable for the job.[69] However, finding a person exactly perfect for every purpose might only be a fanciful expectation. In practice, it is extremely difficult to search for a "decathlete" director at the stage of appointment. Non-business professionals might still need necessary information so as to acquaint himself with the company and the board, and furthermore, might also be required to refresh or develop their knowledge. Therefore, the Code makes it clear in the Main Principle that, "all directors should receive induction on joining the board and should regularly update and refresh their skills and knowledge."[70] In detail, it is the responsibility of the chairman to ensure that "the directors continually update their skills and the knowledge and familiarity with the company required to fulfil their role both on the board and on board committees. The company should provide the necessary resources for developing and updating its directors' knowledge and capabilities".[71] Moreover, given the possibility that independent directors, who are not expert in business, may not be able to fully understand the complicated information in front of them, it seems reasonable and necessary to allow the directors to seek assistance from external resources. For this purpose, the Code agrees that "directors, especially non-executive directors, have access to independent professional advice at the company's expense where they

[69] B.2.2.
[70] B.5, Main Principle. See also B.4.1: "The chairman should ensure that new directors receive a full, formal and tailored induction on joining the board. As part of this, the company should offer to major shareholders the opportunity to meet a new non-executive director".
[71] B.5, Supporting Principles.

judge it necessary to discharge their responsibilities as directors",[72] and the companies, especially the chairman, should ensure that the directors have been "supplied in a timely manner with information in a form and of a quality appropriate".[73] To achieve the goal, it is also important to let the independent directors be properly staffed (e.g. full access to the services of the secretary of the company).[74]

To fulfil the principles of the Code, it is suggested here by the author that more disclosure should be triggered in nomination. When the company appoints an independent director beyond the "usual suspects", the committee should prepare a separate section of the annual statement to describe: whether this director has any business background or experience, if not, which specific professional knowledge is appreciated by the committee so as to justify the nomination; whether this director is chosen for the service of a particular sub-committee; what kind of introduction or training program has been adopted to help this director better acquire necessary business information; whether this directors is satisfied that he or she has been full-informed. Such a disclosure does not any new obligation on the company (because all these practices have already been endorsed by the Code), but it could certainly promote the current practice to a more formal basis and improve the transparency of the system.

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[72] B.5.1. Similar provisions are found in The NYSE Rules, which seek to reduce the boards' dependence upon managers for information by allowing these committees to control the hiring of outside consultants. By reducing independent directors' reliance on insiders for information, this requirement reduces the structural faults in decision making.

[73] B.5, Main Principle.

[74] B.5.2: "All directors should have access to the advice and services of the company secretary, who is responsible to the board for ensuring that board procedures are complied with. Both the appointment and removal of the company secretary should be a matter for the board as a whole". In addition, it was also suggested that independent directors should be able to access external legal advice while in exercising their responsibilities. See Geoffrey C. Hazard, Jr. & Edward B. Rock, *A New Player in the Boardroom: The Emergence of the Independent Directors' Counsel*, 59 Bus. Law. 1389 (2003-2004) (analyzing the need for special counsel for independent directors in some specific situations, such as MBO and special litigation committee); E. Norman Veasey, *Separate and Continuing Counsel for Independent Directors: An Idea Whose Time Has Not Come as a General Practice*, 59 Bus. Law. 1413 (2003-2004) (analyzing the importance of competent general counsel in corporate governance).

2.5.2 The Separation of Responsibilities of CEO and Chairman

An effective board requires independent directors who can overcome the cognitive biases within the company that prevent them from performing their monitoring role effectively. It is necessary to look further at the structure of the board and the allocation of work, rather than merely focus on the board's composition. The board, as a platform, should provide the independent directors with a comfortable condition for them to carry out an effective performance.

Academic studies indicate that, to overcome the pitfall of "groupthink" and maintain the benefit of group decision-making, certain conditions appear to be indispensable:[75] (1) the group consists of equal status peers, (2) the group has nondirective leadership, (3) members feel free to ask questions,[76] and (4) members have assigned roles in small task groups. Accordingly, to satisfy the terms of equal status and non-directive leadership, it is essential to ensure that power and information are not concentrated in one or two individuals in the boardroom. Traditionally, the practice prevalent in corporate industry is that the positions of CEO and Chairman were usually vested in the same person.[77] The identity of the CEO and Chairman might potentially threaten the independence and objectivity of the board when primary power is over-concentrated. The CEO/Chairman might possibly misuse his power to control the agenda of the board meeting and impose improper pressure on dissenting colleagues. In order to prevent this problem, it is suggested by the Code that, "the roles of chairman and chief executive should not be exercised by the same individual."[78] When the CEO takes the job of running the company's business, the Chairman, on the other side, should be responsible for leadership of the board,

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[75] Marleen A. O'Connor, *supra.* note 53, at 1243.
[76] Michael B. Dorff, *The Group Dynamics Theory of Executive Compensation*, 28 Cardozo L. Rev. 2025 (2006-2007) ("The key to combating groupthink is to introduce reasoned dissent into the discussion")..
[77] Marleen A. O'Connor, *supra.* note 53, at 1245.
[78] A.2.1. But this provision is with qualified exception that, "If exceptionally a board decides that a chief executive should become chairman, the board should consult major shareholders in advance and should set out its reasons to shareholders at the time of the appointment and in the next annual report." See A.3.1.

ensuring its effectiveness, as well as ensuring that directors receive accurate, timely and clear information, and constructive relationships are fostered between executive and non-executive directors.[79] Empirical studies have revealed that separating the position of CEO from the Chairperson of the board would reduce the CEO's influence over the board, thereby creating impartial leadership, which would then reduce the possibility of groupthink.[80] By transferring the power of mobilizing the board to someone other than management, it is expected that the board can be a place where independent directors would feel free to express their concerns and opinions.[81]

2.5.3 Working Model of the Board

A boardroom climate of free questioning and open discussion is easier said than done. There is some evidence that a board would turn out to be active when it is strengthened by certain procedures that facilitate its functions. Such procedural measures could be introduced into many places, such as sub-committee working model of the board, an annual meeting of indepednent directors without executive directors present, or periodic formal evaluation of the CEO and the performance of directors.[82] First of all, it is suggested that independent directors can perform effectively if they are embedded in an appropriate committee structure.[83] This would

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[79] A.3.

[80] See, e.g. Robert A.G. Monks & Nell Minow, *Corporate Governance* 4th e.d.n. (Blackwell Publishing, 2008), at 242-243. *C.f.* James A Brickley et. al., *Leadership Structure: Separating the CEO and Chairman of the Board*, 3 J. Corp. Fin. 189 (1997).

[81] It has also been found that such a trend of separating management from board leadership is being embraced by American corporations. Although unlike the principles of the Code, there is no clear recommendation in market rules to encourage a formal separation between the CEO and Chairman, the idea of a "lead director" (who leads the independent directors) and "presiding director" (required by NYSE listing guidelines, who leads one or more meetings of the independent directors) represented a compromise in practice to separate power over management from power in the boardroom. According to public filings, about 96% of the boards of S&P 500 companies had a lead or presiding director in 2008. See Joseph J. Penbera, What Lead Directors Do, Jul. 1, 2009, available at: http://sloanreview.mit.edu/the-magazine/articles/2009/summer/50403/what-lead-directors-do/; Tammy Whitehouse, How To Raise A Lead Director In Post-Sarbanes Era, Feb. 28, 2006, available at: http://www.complianceweek.com/article/2344/how-to-raise-a-lead-director-in-post-sarbanes-era.

[82] Ira M. Millstein & Paul W. MacAvoy, *The Active Board of Directors and Improved Performance of the Large Publicly Traded Corporation*, 98 COLUM. L. REV. 1283 (1998), at 1314.

[83] April Klein, *Firm Performance and Board Committee Structure*, 41 J. L. & Econ. 275 (1998), at 300.

let independent directors perform the functions which they may best serve.[84] In modern time, the importance of sub-committees, especially the audit, nominating and remuneration committees (along with a risk committee discussed in Chapter 4), are highlighted by market rules and legislation.[85] Secondly, in order to encourage more frank discussion about the performance of the management, it is beneficial for the rules to empower independent directors by recommending them to meet at regularly scheduled meetings without the presence of the management and to publicly designate someone out of the senior managers to chair these sessions.[86] This provision may in some parts address the reluctance of independent directors to confront the management face-to-face by asking tough questions. Thus, they may find it easier to assess managers behind closed doors.

When some independent directors are not very inclined to undertake the monitoring work, there must be some stimulatory methods put in place to encourage or even force them to do so. Some commentators refer to this as "the role of devil's advocate", and recommend formalizing the role through rotating the position of devil's advocate.[87] According to this strategy, in each board meeting, one director is randomly chosen to begin the discussion and throw questions to management. The purpose of this arrangement is to break the deadlock when no one is willing to question. In the next board meeting, the role of devil's advocate would be transferred to another director to share the burden. Therefore, at least in the form, independent directors can view such robust questioning as a normal procedural requirement for reviewing managerial performance, without the fear that the management might view their questioning as distrust or some kind of assault.

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[84] Richard C. Nolan, *The Legal Control of Directors' Conflicts of Interest in the United Kingdom: Non-Executive Directors Following the Higgs Report*, in John Armour & Joseph A. McCahey, *After Enron: Improving Corporate Law and Modernising Securities Regulation in Europe and the US* (Oxford: Hart Publishing, 2006), at p.369.
[85] *E.g.* the Corporate Governance Code, B.2.1, D.2.1 and C.3.1.
[86] A.4.2. "Regularly scheduled executive sessions" (meeting without senior management present) are now required by the NYSE listing requirements. See NYSE, Inc., Listed Company Manual §303A.03 (2007).
[87] See Marleen A. O'Connor, *supra.* note 53, at 1304-1306; Jayne Barnard, *Institutional Investors and the New Corporate Governance*, 69 N. C. L. Rev. 1135 (1991), at 1170.

Finally, it is important to bear in mind that effective performance cannot be achieved without a reviewing system.[88] The procedure of periodical performance evaluation may introduce some incentives toward independent directors. The Code has already recognize this importance of performance evaluation, by requiring the board to undertake a formal and rigorous annual evaluation of its own performance, including its committees and individual directors, and to state in the annual report how such performance evaluation has been conducted.[89] However, the current evaluation system is simply based on a self-check model which entrusts the directors to review the performance of themselves and colleagues. This may lead to a risk of formalism and adulation. In order to counteract this negative trend, the author recommends that an independent consultant could be hired by the nomination committee (with consulting major shareholders in advance) to conduct the review or verify the evaluation as a supplement to self-assessment. This employment should only be terminated by shareholders' approval or consultation with major investors in advance, and a statement is required to explain the reasons of termination. This is designed to prevent the directors from "revenge" when the consultant gives a poor "mark" to the board.

2.5.4 Full-time Independent Directors

If part-time directors are unable to meet increasing demands of responsibilities of independent directors, a straightforward proposal is then to transform the post into a full-time basis. A conventional wisdom is that independent directors must be non-executive or outside directors who do not devote full time to the company, and in practice, this seems to be a default rule complied by everyone. However, neither

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[88] Geoffrey C. Kiel & Gavin J. Nicholson, "Evaluating Boards and Directors", in *Corporate Governance*, Vol. 13, No.5, Sep. 2005, 613-631.
[89] The Corporate Governance Code, B.6.

the Higgs Review nor the Code expressly prohibits companies from appointing a full-time independent director. Such a full-time independent director would also fit with the Code provision of "senior independent director", who is suggested to serve as a channel between major shareholders and the board and lead meetings between non-executive directors without the chairman and executives present.[90] Since a senior independent director is required to shoulder more duties than a normal non-executive director, it is reasonable to suggest that this director must contribute more energy to his or her work and digest more information so as to fulfil the functions. Thus there is an inherent inclination to demand for a full-time position. Certainly, it is understandable that some arguments might be raised to challenge this proposal: firstly, it may be opposed because of a fear that a full-time position could cause damage to the independence of directors. However, the author does not think this is convincing. There is no fact to imply that independence can only be retained by a part-time member or monitoring cannot be done by a full-time player (otherwise it is impossible to explain the chain of command where senior managers monitor junior managers and junior managers monitor office staffs). As long as other factors are satisfied (e.g. transparency of nomination and reasonable working model), whether working on a full-time post is not a very relevant matter to independence. Secondly, given the gap between the supply and demand of independent directors, failing to find a proper candidate may become a realistic problem. The author agrees with this worry. So it is suggested here that a proposal of full-time independent directors should only be treated as a recommendation of "best practice", which is adopted only when the company finds it beneficial to introduce such a post and a proper candidate can be recruited. In order to prevent incurring an implicit pressure on companies and forcing them to rush to the idea, this proposal should not be included in the Code and placed under the regime of "comply or explain" (or "comply or vote" as the author proposed in Chapter 4).

[90] A.4.1 and A.4.2.

2.5.5 Remuneration of independent directors

Certainly, it is naïve to suggest that only "good personality" is sufficient to tie independent directors to efficient performance. It is rational to use some monetary schemes to stimulate the incentive of independent directors. A well-structured remuneration can certainly achieve this purpose. However, unlike executives whose income is usually bound to performance-related or equity-based compensation, independent directors are traditionally only entitled to a fixed service fee.[91] A significant reason of this diffidence might be that independent directors are required of a different perspective of considering the business of the company. Although stock option or a performance-related pay scheme may align directors' self-interest with the benefit of shareholders, it could also create a side effect of narrowly focusing on short-term financial performance and fluctuation of share price. It can also result in a risk of turning independent directors to like-minded men as management so as to destroy "different thinking" and objectiveness. However, it is questionable whether or to what extent a pay scheme of fix fee can promote the incentive of independent directors. It may be the right time for us to adopt a cautious approach to adjust remuneration structure for independent directors. It is suggested here that a "deferment" scheme should be introduced under which a part of independent director's fee (ratio decided by the remuneration committee) would be paid after a specific period. On the date of awarding "deferment" payment, it should be reviewed by the remuneration committee of the time, according to performance conditions[92] set during appointment, to decide whether or not the director is entitled to the fee.

[91] This is partly because, according to B.1.1 of the Code, it triggers more consideration and explanation about "independence" if the director "has received or receives additional remuneration from the company apart from a director's fee, participates in the company's share option or a performance-related pay scheme, or is a member of the company's pension scheme." In order to prevent a potential suspicion of "independence", companies may be more willing to pay their independent directors by a scheme of fix fee.

[92] The "performance" mentioned here should refer to performance of the director concerned during serving the board, rather than the company's performance in financial term. To assess the director's performance, the annual evaluation of board, as provided in B.6 of the Code, could be used as a relevant parameter.

This remuneration can to a certain extent encourage sufficient focus of independent directors on a consistent diligent performance over the long term.

3. Conclusion

While in an age in which independent directors have been seen as an increasingly important component of corporate governance reform, the central matter of the debate should be focused on how to promote the performance of independent directors to a more effective level. Indeed, there is no doubt that modern corporate governance reform has offered a number of solutions which attempt to tackle obstacles to the active performance of independent directors. However, there are still some things which could be done to further improve the system. In this chapter, several strategies, especially promoting the transparency of nomination and encouraging activity of directors, have been proposed by the author with an intention to guarantee more promising performance of independent directors in the future. It is believed that if the board does incline to play a more active role, it would find it helpful when proper proposals have been applied to corporate governance practice.

CHAPTER SIX

INDEPENDENT DIRECTORS' EXPOSURE TO LEGAL LIABILITY

Any regulatory system would be very vulnerable when non-compliance may only lead to adverse reputational consequences, but without exposure to formal liabilities. In the system of corporate governance, the courts are usually the final defender against unacceptable behaviour at board level, because in normal cases, the average way to deal with the dissatisfaction and anger of shareholders is through personnel changes in the boardroom (either by dismissing the CEO and Chairman from their posts or forcing them to resign under the pressure),[1] or simply selling their shares. It is not often that disputes between shareholders and the board in a publicly traded company would be settled by legal proceedings, but taking the directors to courts for justice may still be seen as a last resort. A common instance here is the case in which directors have failed in their legal duties. If a breach of legal duties is found by the court, the directors would certainly bear liabilities, and as such serious financial damages or other penalties may be imposed upon them. In one sense, the threat of exposure to liability acts as the "stick" to push directors into diligent performance, while considerable remuneration and great power may work as a "carrot" of stimulus. Thus a certain level of deterrence through the possibility of legal sanctions would be necessary to ensure the effectiveness of directors.[2]

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[1] For a recent example, the former boss of RBS, together with seven non-executive directors, was asked to leave the job (although he was not fired as such but rather chose to resign), when his bank had to be bailed out by the government. See BBC, Bank chiefs quit after rescue bid available at: http://news.bbc.co.uk/1/hi/scotland/7666647.stm; RBS announces boardroom clear-out, available at: http://news.bbc.co.uk/1/hi/business/7874174.stm. Similar membership changes at board level have occurred in some large American companies as a condition of receiving government's rescue money.

[2] Bernard Black, Brian Cheffins & Michael Klausner, *The Liability Risk for Outside Directors: A Cross-Border Analysis*, in John Armour & Joseph A. McCahey, *After Enron: Improving Corporate Law and Modernising Securities Regulation in Europe and the US* (Oxford: Hart Publishing, 2006), at p.344 ("legal liability is an important factor in leading outside directors to do a good job".)

1. Independent Directors and Legal Risk

1.1 The Traditional Generosity of the Law

Non-executive or outside directors have long been exposed to such a risk, and sometimes judgements on them have been seen as landmarks in legal development for determining the directors' duties. As long as the management illegally exploited the shareholders' interest or the corporate benefit was damaged by improper business decisions, members of company may naturally ask a number of questions, including: Why did the board or other directors not succeed in preventing the difficulties before they occurred? Was there a failure of duties in negligence so that the directors missed the opportunity to detect the issue? If shareholders cannot convince themselves that the board of directors has diligently fulfilled its responsibilities, it is then possible that a legal action would be launched against directors concerned.

However, traditionally, the courts did not take a tough attitude towards non-executive or outside directors who discharged no managerial role and were inactive in business running.[3] In an age when historically non-executive or outside directors were usually amateurs with little professional skills, the duties imposed on them were often minimal. The courts usually saw it unreasonable to raise the bar too high. The defendant directors may be forgiven and escape liability even if they were in

[3] The duties of non-executive or outside directors referred to here are mainly those other than fiduciary duties. It is clear that, generally under section 175 and 177, all directors should never exploit or misuse the assets or corporate opportunities of their company, and they should avoid being involved in a position of conflict of interest. This duty of loyalty is strict, and there is no way to escape liability except getting certain approval by the general meeting or the board. Moreover, because the policy of D&O Insurance (Director and Officer Insurance) rejects any coverage for damages due to "deliberate fraud" and "gross negligence", directors who betrayed their duty of loyalty would not be able to receive indemnity from their insurer, which means both non-executive and executive directors would have to pay a high price out of their own pocket for breaching fiduciary duties. In this sense, the breach of fiduciary duty is the most intolerable behaviour in relation to directors' duties, and non-executive directors cannot get any favor by the courts in this area just for the reason that they are not deeply involved in the management of the company. However, independent directors are not worried about liability for self-dealing, insider trading, or other dishonest behavior, because a director can easily avoid that risk by refraining from engaging in suspect actions. They are more concerned instead that they will be sued for oversight failures when, unknown to them, management has behaved badly.

complete ignorance of any affair connected with the business of the company.[4] Some previous judgements in this sense would seem shocking if they were made in the current environment of corporate governance. A typical example can be found in what Romer J. said in *Re City Equitable Fire Insurance Co.*: "A director is not bound to give continuous attention to the affairs of his company. His duties are of an intermittent nature to be performed at periodical board meetings, and at meetings of any committee of the board upon which he happened to be placed. He is not, however, bound to attend all such meetings, though he ought to attend whenever, in the circumstances, he is reasonably able to do so".[5]

The reason why the courts were traditionally sympathetic to non-executive or outside directors is quite interesting. This might be partly because of a general understanding of the board's role in the past. The board of directors, as the head organisation within the company, had long been regarded as the "brain" in charge of corporate operations. A common view, which historically prevailed amongst the academy and judiciary, was that the central function of a board is to manage the business of the company.[6] In this sense, the burden had been heavily imposed on executive directors, who acted as managers. On the other hand, non-executive or outside directors were easily underestimated by the courts, because these board members contributed little to the management and business operation. Based on this view, it is not hard to understand why the law has applied a low subjective standard applicable to the duties of non-executive or outside directors.

Nevertheless, such generosity may lead to the notion that non-executive or outside directors could easily escape negligence-based allegations. Inactive directors could

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[4] *Re Cardiff Savings Bank* [1892] 2 Ch 100, *Re Brazilian Rubber Plantations & Estates Ltd.* [1911] 1 Ch 425, *Re City Equitable Fire Insurance Co.*[1925] Ch 407.

[5] [1925] Ch 407, at 427.

[6] *E.g.* P. L. Davies, *Gower and Davies' Principles of Modern Company Law* 8th e.d.n. (London: Sweet & Maxwell, 2008), at p.365: "The board of directors is the most important decision-making body within the company."

luckily be saved by virtue that they are seem as "dummies" or "rubber stamps", stemming ironically from the fact that they contributed little to the company they served. This could of course send the wrong message to those directors that, they could receive substantial board service fees but without any attendant risk of legal liability, as long as they stood behind the executive directors and claimed that they knew nothing about the wrongdoings occurring in the company. The stimulus effect of the law through the possibility of legal sanctions will fail if it cannot constitute a material threat to directors who care little about their company and turn a blind eye to everything.

Similar phenomenon also happened in the US. Professor Brudney has suggested that many directors might not be necessarily uneasy about the risk of being challenged before the court. It was found that "neither legal doctrine nor judicial attitude is particularly hospitable to charges of such inadequacy (of policing management's self-dealing)", and the law imposes "miniscule likelihood of liability" on those inactive independent directors.[7] The legal rule is premised mostly on the basis of the subjective good faith of the directors. If the condition of good faith is satisfied, the court would not go further to the examination of the substance of corporate affairs and it should respect the decision of the board of directors.[8] In general, the test of good faith is restricted in a limited sphere evidenced by noninterest in the transaction or in the interested persons.[9] When objective factors have been met, there is little room for the court to question the good faith of directors unless strong evidence exists to the contrary. In sum, traditionally, the prospect of legal liability could hardly be seen as compelling force to ensure that independent directors diligently played their roles in corporate governance.

[7] Victor Brudney, *The Independent Director – Heavenly City or Potemkin Village*, 95 Harv. L. Rev. 597 (1981-1982), at 610 and footnote 50.
[8] However, it is necessary to emphasize here that during the process of Company Law Reform, the counseling committee had explicitly rejected such a "business judgement rule" to be applied in UK.
[9] See *re Caremark Int'l Inc. Derivative Litg.*, 698 A.2d 959 (Del. Ch. 1996).

1.2 More Stringent Standards in Modern Law Development

The judicial climate gradually changed in the late second half of 20th century. The courts started to re-consider their historical policy of setting the low standards that rendered non-executive or outside directors more or less immune from legal suits on the basis of non-participation.[10] The origins of reform can be found in *Dorchester Finance Co. v. Stebbing*,[11] in which a line was drawn between a subjective standard of duty of skill and an objective test for duty of care. Foster J. held that, "[a] director is required to take in the performance of his duties such care as an ordinary man might be expected to take on his own behalf", but on the other hand, "[a] director is required to exhibit in the performance of his duties such degree of skill as may reasonably be required from a person with his knowledge and experience".[12] This combined standard was subsequently replaced by the view that both elements of the duties of skill and care should be consolidated and assessed on an objective basis.

In two more recent cases *Norman v. Theodore Goddard*[13] and *Re D'Jan of London Ltd.*[14], Hoffman J. took inspiration from s.214(4) of the Insolvency Act 1986 in relation to wrongful trading, and expressed that the duties of skill and care should be determined with reference to that standard, which is basically objective but combined with the tough aspects of a subjective duty.[15] This shift of standard to a combined formulation became crucial in setting the bar for directors' behaviour. In the judgement of Romer J. in *Re City Equitable Fire Insurance*, the level of directors'

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[10] For many years, it has been argued by many commentators that the traditional standard of the duty of care and skill at common law is too lax, overly deferential and lacking in rigour. See *e.g.* A. Mackenzie, *A Company Director's Obligations of Care and Skill*, [1982] J.B.L. 460; Tim Pryce-Brown, *Directors - Duty of Skill and Care: A Response*, Bus. L.R. 2004, 25(12), 306-307.
[11] [1989] B.C.L.C. 498.
[12] *Ibid.* at 501-502.
[13] [1992] B.C.L.C. 1027.
[14] [1993] B.C.L.C. 561.
[15] See also *Re Westlowe Storage & Distribution Ltd. (In Liquidition)* [2000] 2 B.C.L.C. 590; *Cohen v. Selby* [2001] 1 B.C.L.C. 176.

duty of skill could vary case by case, because the standard was marked by the actual knowledge of the individual director. If the director was ignorant of everything, the law would not require any higher performance from him. However, under the standard introduced from the statutory formulation of s.214(4), the directors are first subject to an objective test to assess their duty of skill. All directors must satisfy the minimal level of skill found in “a reasonably diligent person” carrying out the same job. A director cannot claim to be lacking in necessary knowledge and experience, because nowadays directorships should never be awarded to a pure “amateur”. The test goes further to add a subjective standard. It is suggested that, if the director did have a professional skill, he should then be expected to draw upon such talents to serve the company. Thus it is concluded that the subjective standard only increases the level of duty required of a director, rather being used to lower the objective assessment.

Based on this legal development, the new Companies Act 2006 mostly inherits the judgements of Hoffman J. and endorses the combined standard, by providing that: A director of a company must exercise reasonable care, skill and diligence, which means the care, skill and diligence that would be exercised by a reasonably diligent person with – (a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company, and (b) the general knowledge, skill and experience that the director has.[16]

To comprehend the implication of this trend of raising standards to independent directors, once again it is necessary to take account of the modern functions of the corporate board and independent directors. As discussed in Chapter 3 there is an increasing demand for more monitoring within the company to restrict the

[16] Companies Act 2006, s. 174(2).

over-expansion of management power. The board has been regarded as the first place to achieve this purpose. In order to realize the role of monitoring, directors who are independent of management, would inevitably be seen as proper candidates to take charge of internal control. In *Re Baring Plc (No.5)*,[17] while dealing with a case in relation to disqualification of directors, the Court of Appeal held that, although it was common in large companies to delegate certain functions to management or other lower level personnel, running the company with no system for supervising the discharge of delegated functions or the inability of directors to understand information produced by the internal control system might still render the directors as incompetence in the eyes of the court. The "duty to supervise the discharge of the delegated functions" should always be imposed on independent directors, even if they may take no active position in managing the company.[18] Referring to the objective standard in s.174(2) of "the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company", an independent director must have a sufficient level of competence and take necessary participation in monitoring so as to ensuring his fulfilling of responsibilities. Ignorant or passivity, like what occurred in *Re City Equitable Fire Insurance*, can no longer be an excuse. Consequently, the law has become more inclined to set out a basic standard which is intended to discourage independent directors from being inactive and ignorant, and at the same time, persuade those directors to contribute all of their abilities to serve the board.

1.3 From Shareholder Litigation to Disqualification Charge

It is obvious that the irresponsible performance of directors is not only harmful to the interests of shareholders, but also raises a serious public interest concern. There is no

[17] [2001] 1 B.C.L.C 433.
[18] *Ibid.* at 489. See also the Australian case, *Daniel v Anderson* (1995) 16 ACSR 607, at 664, in which the Court of Appeal of New South Wales held a similar view that even non-executive directors are required to "take responsible steps to place themselves in a position to guide and monitor the management of the company".

doubt that the corporate sector is the cornerstone of our society and the fate of the economy is to a great extent placed in the hands of those who occupy boardroom seats. Directors who are remiss in their endeavours can be seen as a bane to the healthy development of corporate governance and the stability of the market. In this sense, banishing indolent directors and encouraging others to be diligent may have the practical effect of promoting the welfare of the public. Therefore, for the purpose of protecting the public from sloppy directors, there is a strong argument that public authorities should take up the battle against those on company boards who are ineffective, dishonest or needlessly allow businesses to slide into the financial abyss.

In response to the suggestions discussed above, in recent years, especially in the UK, modern company law has been gradually reformed to emphasize the role of the public authority in shaping the regime of directors' duties. To be sure, shareholder litigation is not the exclusive way to bring directors, who have failed in their duties, to justice. Governmental bodies, representing the public interest, have stepped onto the battle field. One of the most significant examples of such a move is the Company Directors Disqualification Act 1986 (CDDA), by which lawmakers explicitly announced a desire to eliminate those "rogue directors" and purge the industry.[19] It is provided that qualified applicants [20] may make an application for a "disqualification order"[21] to a court against a person on a series of grounds.[22] This order has the effect that such a person shall not, without leave of the court,[23] be a director of a company or take part in the management of a company, in any way,

[19] *Re Blackspur Group Plc* [1998] 1 B.C.L.C. 676, at 680: "The purpose of the 1986 Act is the protection of the public, by means of prohibitory remedial action, by anticipated deterrent effect on further misconduct and by encouragement of higher standards of honesty and diligence in corporate management … "

[20] An application may be made by the Secretary of State, the Official Receiver, or the liquidator or any past or present member or creditor of any company in relation to which the person in question has committed or is alleged to have committed an offence or default. But it is necessary to emphasize that, under s.6 of disqualification on the ground of unfitness, only the Secretary of State, or the Official Receive acting under the direction of the Sectary, can apply for a disqualification order.

[21] In2001-2002, an alternative regime, i.e. "disqualification undertaking", was introduced by the Insolvency Act 2000, inserting a new s.1A into the CDDA. It is provided that the Sectary of State and the director can reach an agreement out-of-court on a disqualification undertaking, which will restrict the director's future activities in the same way as a disqualification order but without the need for a court hearing.

[22] Section 1, 6 and 9A.

[23] Applications for leave are governed by Section 17.

either directly or indirectly, for a specified period beginning with the date of the order. Breaching such a disqualification order would be deemed a criminal offence.[24]

Within all valid grounds for disqualification,[25] undeniably, s.6 of the CDDA, i.e. "disqualification for unfitness", is the most important category, which has attracted most attention of the academy.[26] The Secretary of State (or the Official Receiver in the case of a company being wound up by the court in England and Wales) may apply to the court to have a director (including *de facto* director or shadow director[27]) of an insolvent company[28] disqualified where the Secretary thinks "it is expedient in the public interest".[29] The court shall make a disqualification order when it is satisfied that the given director's conduct "makes him unfit to be concerned in the management of a company".[30] In practice, disqualification on the ground of "unfitness" has been widely adopted by the authorities and courts as a weapon to punish directors who have failed in their activities and safeguard the public interest.[31]

It is interesting to see how this provision of "disqualification for unfitness" relates to the traditional rules of directors' duties of skill and care. The first item of Sch.1 explicitly suggests that "any misfeasance or breach of any fiduciary or other duty by the director in relation to the company" can trigger the court to draw a finding of unfitness. On account of this fact, it is unsurprising that the requirement of "fitness of conduct" set in s.6 of CDDA, as the author terms here, has a somewhat close link

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[24] s.13.
[25] The grounds for disqualification include: (1) s.2: conviction of an offence; (2) s.3: persistent default in relation to provisions of the companies legislation requiring any return, account or other documents to be filed delivered or sent, or notice of any matter to be given, to the registrar; (3) s.4: fraud; (4) s.6: unfitness; (5) s.10: wrongful and fraud trading; (6) s.9A: competition infringements. For a brief description, see John Birds & A.J. Boyle, *Boyle & Birds' Company Law* 7th e.d.n. (Jordans, 2009), at 569-574.
[26] *Ibid.*, at 570.
[27] s.22 (4) and (5).
[28] s.6(2).
[29] s.7(1).
[30] In determining the concept of "unfitness", the court is directed to refer to the matters listed in Schedule 1. See s.7(1). However, Sch.1 only serves as a helpful guideline but is not exhaustive. The court is given great discretion in deciding the issue.
[31] It was revealed by government data that more than half of directors disqualified by court order were on the ground of unfitness. See DTI, Companies in 2005-2006 (2006), Table D1.

with the duties of skill and care owed by a director under s 174 of the Companies Act. As one commentator has noted, the CDDA has been viewed as a matter of doctrine used to "refashion" the traditional duties of skill and care, by developing jurisprudence of this "standard" through disqualification cases.[32] Directors are bound to retain a reasonable performance rendering them fit to run the business. Otherwise they may face a penalty of disqualification, in addition to any litigation brought by the companies they have served. Compared with a derivative action initiated by shareholders in enforcing the duties of skill and care, a case of application of disqualification order is quite different, since the process is pursued by the public authority, which suffers less from the encumbrance of the "gain and cost" problem that individual shareholders might be subject to. In this sense, it is evident that directors are now exposed to a new risk of legal liability that their ancestor never faced decades ago. After some significant cases were brought to the courts against a few non-executive directors,[33] the disqualification order may be seen as a more threatening phenomenon, than shareholder litigation.

2. Is The Legal Risk So Threatening?

2.1 The Fears of Independent Directors

As stated above, the law began its role to promote the effective performance of independent directors through increasing the possibility of exposure to legal liability. More detailed and clarified duties are required of independent directors. However, it could also lead to an unexpected side effect that might counteract its primary purpose.

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[32] See Adrian Walters, *Directors' Duties: The Impact of the Company Directors Disqualification Act 1986*, Com. Law, 2000, 21(4), 110-119.

However, we must be cautious that, in disqualification proceedings, a finding of breach of duty will not automatically result in a finding of unfitness. The court must look at each element of the alleged misconduct and decide whether on its own, or taken cumulatively with other elements, it is sufficient to make the defendant unfit. It follows that a finding of "breach of duty" in disqualification is not necessarily a sure guide as to whether similar conduct would amount to a breach of duty under s.174. The correlation between the duty as espoused in the disqualification cases and the general duty is therefore imprecise.

[33] Most famous case is certainly *Re Blackspur Group Plc* [1999] 1 B.C.L.C. 226.

An overly burdensome obligation would usually discourage people from taking up such posts, rather than encourage them to accept responsibilities. A candidate can certainly refuse invitation from the board, if he regards that the potential threat of exposure to legal liability is too high to justify the fee received from the company. There are three realistic risks that independent directors might be concerned about when it was determined by the courts that they might have to bear liability:

First, directors would worry about a possible monetary loss when they were ordered to pay substantive damages and legal expenses. For example, in the high profile Enron and WorldCom cases, the plaintiff shareholders and defendant outside directors finally reached a settlement based on the condition that the directors were required to pay compensation totalling 38 million dollars by themselves.[34] The second fear of independent directors may be that they could suffer reputational harm from losing in court. Even if at the end of the day independent directors get a favourable judgement at trial or pay no damages, it is still an extreme nuisance to be sued and subject to negative reporting in the media. In the case of Equitable Life Assurance Society, although in 2005 the plaintiff dropped its claim and agreed to pay the litigation expenses of the defendant non-executive directors, this long-drawn suit was still an undesirable experience for those directors given the fact that they were continuously regarded as the same type of negligent directors as those in Enron and WorldCom. Some commentators have not hesitated to place the name of Equitable life in the same category as those extremely unfavourable companies.[35] Third, the disqualification regime might also cause an additional inconvenience in the career of independent directors. In a possible care of breach of duties of skill and care, even if

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[34] Brian R. Cheffins & Bernard S. Black, *Outside Director Liability Across Countries*, 84 Tex. L. Rev. 1385 (2005-2006). In announcing the WorldCom settlement, Alan Hevesi, the Comptroller of the State of New York and Trustee of the New York State Common Retirement Fund (NYSCRF), stated that the payments were intended to send “a strong message to the directors of every publicly traded company that they must be vigilant guardians for the shareholders they represent. ...We will hold them personally liable if they allow management of the companies on whose boards they sit to commit fraud.” Press Release, Office of the New York State Comptroller, Hevesi Announces Historic Settlement, Former WorldCom Directors To Pay from Own Pockets (Jan. 7, 2005).

[35] R. Baldwin, *The New Punitive Regulation*, 67 Mod. L. Rev. 351 (2004), at p.353 (“Names such as Maxwell, Polly Peck, BCCI, Marconi, Equitable Life, Enron and WorldCom are now familiar...”).

shareholders determine not to pursue directors, the authorities might decide to apply for disqualification orders on account of the necessity of protecting public interest. Provided the person who is disqualified due to his conduct as a non-executive director in one company, is also an executive officer of another company, the court order would generally have the effect that he has to stand down from his management position.[36] In other words, his main career would be ruined, simply because of some error resulting from his part-time directorship. Thus, all these factors may influence the decision of candidates about whether or not to accept the post of independent director.

Certainly, significant media coverage of some high-profile lawsuits against independent directors could solidify a general feeling that being an independent director is becoming too risky.[37] Indeed empirical surveys have in some ways suggested that the fear of litigation and legal liability can cause trouble in the recruitment of qualified independent directors, and also indirectly force incumbent directors to quit the job.[38] The difficulty in recruiting enough candidates may be anathema to the role of independent directors in corporate governance.

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[36] However, under s.17 of CDDA, leave may be applied by the director for acting in limited capacities, e.g. continuing managing another company. See *Re Majestic Studios* [1998] B.C.L.C. 1

[37] See, e.g., Anne Fisher, *Board Seats Are Going Begging*, FORTUNE, May 16, 2005, at 204; Suzanne McGee, *The Great American Corporate Director Hunt*, INSTITUTIONAL INVESTOR, Apr.1, 2005, at 32; Joann Lublin, Theo Francis & Jonathan Weil, *Directors Are Getting the Jitters; Recent Settlements Tapping Executives' Personal Assets Put Boardrooms on Edge*, WALL ST. J., Jan. 13, 2005, at B 1.

Most US outside directors believe that the enactment of Sarbanes-Oxley Act and related corporate governance reforms have significantly increase the legal risk they face. See Corporate Board Member, What Director Think: Research Study 2003, available at: http://www.boardmember.com/network/WhatDirsThink2003.pdf

The Equitable Life litigation implied that non-executive directors are becoming increasingly subject to negligence claims for inadequate performance of their role. There can be little doubt that there is a general feeling that directors are being increasingly exposed to negligence claims following corporate failures. The Equitable Life litigation arguably has the potential to impose more liability on non-executive directors than all the previous cases put together. See Lee Roach, *Equitable Life and Non-Executive Directors: Clarification from the High Court?*, Comp. Law. 2005, 26(8), 253-254; Bob Sherwood, *Non-Executives Worry Over Legal Liabilities*, FIN TIMES, June 30, 2003, at 4.

[38] Korn/Ferry Internatinal, Annual Board of Directors Study (2003), at 24. A survey by Legal Director found that 43 percent of non-executive directors had, to varying degrees, considered standing down post-Enron. Ernst & Young's own Third Corporate Governance Survey in 2004 and 2005 found that a significant part of respondents would be less likely to accept a non-executive directorship than before, possibly because of the worry about an increased risk of negligence liability.

2.2 The Lesson Learned From Empirical Studies

The concentrated media coverage following high-profile market scandals, the continuous criticism and the shocking scale of the settlements reached in many of the law suits may all make most independent directors nervous that they cannot afford the burden imposed upon their roles. We must ask, however, whether the law is in fact so threatening. Through the reviews of recent empirical studies, we may have a chance of getting a clear picture of this issue.

First of all, it is important to see whether independent directors are exposed to a higher risk than their ancestors while faced with a trend of raising the bar of directors' duties. Some studies have suggested that an understanding of "independent directors are exposed to a higher risk" is not in accordance with reality. It has been traditionally thought that "the search for cases in which directors of industrial corporations have been held liable in derivative suits for negligence uncomplicated by self-dealing is a search for a very small number of needles in a very large haystack".[39] Modern evidence nowadays has still shown that, based on research across different countries, the risk of legal liability is relatively rare, and it is uncommon that non-executive or outside directors would be the subject of litigation which results in compensation payments being made from their own pockets.[40] It is fair to say that, at least, being an independent director does not necessarily bring with it potential personal liability.

Furthermore, paying personal compensation does not necessarily follow liability. In

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[39] J. W. Bishop, Jr., *Sitting Ducks and Decoy Ducks: New Trends in Indemnification of Corporate Directors and Officers*, 77 Yale L. J. 1078 (1968), at 1099-1101.

[40] Bernard Black, Brian Cheffins & Michael Klausner, *Outside Director Liability*, 58 Stan. L. Rev. 1055 (2005-2006) (finding that the out-of-pocket liability risk (i.e. the risk of paying legal expenses or damages pursuant to a judgement or settlement agreement that are not fully paid by the company or another source, or covered by directors' and officers' (D&O) liability insurance) facing outside directors is very low (only thirteen cases in the last twenty-five years), far lower than many commentators and board members believe, notwithstanding the WorldCom and Enron settlements). See also Brian R. Cheffins & Bernard S. Black, *supra.* note 34.

order to understand this rarity, there are several possible explanations. The combination of exculpation provisions, indemnification provisions and insurance has been called the three-legged stool of director protection.[41] In the US, it is not unusual that corporate codes might contain provisions which allow companies to eliminate some portions of director liability.[42] As long as the directors carried out their responsibilities in good faith, companies may have the option to indemnify directors who are in breach of their duties. British company law takes a stricter position in this area. It has long been prohibited by the law that the provisions in the Articles of Association or any other contract are drafted to exempt the directors from liability in relation to breach of duties.[43] The Companies Act 2006 makes it clear that, except in certain circumstances, "any provision that purports to exempt a director of a company (to any extent) from any liability that would otherwise attach to him in connection with any negligence, default, breach of duty or breach of trust in relation to the company is void".[44] However, the prohibition against the exemption provision does not wholly ban any protection available to directors. As one of the exceptions, companies are lawfully permitted to arrange insurance for their directors to cover their potential legal expenses in exposure to litigation and liability. Voiding indemnity for directors does not "prevent a company from purchasing and maintaining for a director of the company, or of an associated company, insurance against any such liability as is mentioned in that subsection".[45]

The practice of holding insurance protecting directors from liability has also been confirmed by the Code, in which it is provided that "the company should arrange appropriate insurance cover in respect of legal action against its directors".[46] D&O (Directors & Officers) Insurance is a relatively new business, in response to the

[41] See Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. Pa. L. Rev. 1735 (2001), at 1790-1791
[42] *E.g.* Model Business Corporations Act (2005), §2.02(b)(4).
[43] Companies Act 1948. s.205; Companies Act 1985, s.310.
[44] Companies Act 2006, s.232(1).
[45] S.232(2) and 233.
[46] The UK Corporate Governance Code (June 2010), A.1.3.

increasing demand for safely covering the possible risk of exposure to legal liability. It first occurred and prevailed in the US, where directors were traditionally more likely to be involved in legal suits. Gradually, however, such insurance policies gained popularity in other countries, even if the threat of legal sanctions remained relatively low.[47] The expense of legal proceedings would be covered by the insurance if the defendant directors were not found to be in "bad faith" or involve "gross negligence". Thus both above measures constitute a shield to render directors immune, in some circumstances at least, from the threat of exposure to legal liability. It is understandable that industry might reasonably use these practices as a convenient way to recruit qualified independent directors, through convincing them in practice their job entails little risk in a legal sense. Although it was true that independent directors may face huge costs when a "perfect storm",[48] such as Enron and Equitable Life, hits the industry, such events may represent the exception rather than the norm. In practice, there is in fact a decreasing likelihood that directors will face financial losses as a result of the transactional or substantive costs created by their breach of duty.[49]

2.3 Reconsidering the Legal Risks

As analyzed above, there is an exaggeration of the risk. It is wrong to suggest that in practice independent directors are now significantly affected by a rising standard of duties. It is interesting to ask why the legal risks of independent directors still remain almost invariable in an atmosphere of enhanced duties. In the following parts, the

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[47] Bernard Black, Brian Cheffins & Michael Klausner, *supra.* note 34.

[48] "Perfect storm" refers to the situation where: the company is insolvent, there is significant evidence of outside director culpability, D&O insurance is inadequate, and one or preferable several outside directors have serious personal wealth. Or in Enron and WorldCom cases, there is an alternative model of "perfect storm", where involves all of elements except a less than customary level of D&O cover, but adds a factor that the lead plaintiff in a securities suit to insist on out-of-pocket payments by the outside directors as a condition of settlement, in order to send a warning to directors of other companies. See Bernard Black, Brian Cheffins & Michael Klausner, *supra.* note 34, at p.352.

[49] See Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. Rev. 1009 (1997), at 1012.

author will examine three potential reasons to this phenomenon.

3. Why are the Problems (and What Can be Done)?

3.1 The Weak Incentive of Shareholders to Bring Directors to Justice

Certainly shareholders are important players in holding directors liable through the approach of "derivative claim".[50] In respect of the negligence of directors in directing the affairs of the company, a member of a company can seek relief on behalf of the company by calling the directors concerned to compensate the loss of the company due to their behaviours.[51] "Derivative claim" is an extremely useful weapon in the hands of shareholders, especially when the company, to whom the directors owe their duties, is reluctant to bring an action[52] and an alternative remedy of s.994 "protection against unfair prejudice" is restrictively available to members of publicly traded companies.[53]

However, in reality, litigation is rarely a preference for shareholders. They are not strongly interested in bringing directors, particularly, independent directors, to court, just on the basis of business failure. Errors and misguided decisions are commonly placed. Shareholders invest their money into the business with an understanding of a normal scale of risk-bearing. Moreover, in a highly developed stock market, investors, especially institutional investors, can to a great extent minimize their risk by diversifying their contributions and creating a "portfolio investment package". In such a way, failure of a single business is not so important. Therefore, it is questionable whether investors would have sufficient incentive to pursue a

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[50] Companies Act 2006, Part 11.
[51] S.260(1) and (3).
[52] However, it is necessary to note that, under s.263(3), in considering whether to give permission to continue derivative claim, the court must take into account, in particular, "whether the company has decided not to pursue the claim". It seems clear that, only when the company's decision is tainted by bad faith (undue influence from the directors who are accused of negligence), the court would then possibly give the permission.
[53] *Re Blue Arrow plc* [1987] B.C.L.C. 585.

complicated lawsuit, rather than look for a new target of investment.[54]

Even in more obvious cases of board malpractice, shareholders may remain reluctant to instigate litigation. First, legal procedures are often time-consuming and expensive.[55] The claimant or pursuer has to foresee and assess both the potential cost and gains, and ask himself whether it is worthwhile bringing the action forward. In average cases, even if shareholders in a derivative claim succeed in their claim, the actual benefits would merely go to the company, rather than directly to shareholders. Provided that directors have breached their duties and they are finally ruled accountable for their actions, the remedy would generally be passed to cover the loss of the company, who is in law the primary victim of the irresponsible behaviour of directors. The only benefit of litigation, which could possibly be treated as an incentive of shareholders, is that the money recovered from liable directors may flow into the pool of the company's fund, and at the end, promote the value of shareholders' investment as the compensation is regarded as income of the company.[56] For investors who hold an insignificant block of stocks within a large listed company, it is hard to see how litigation could be described as a great attraction which can persuade shareholders to put their energy and money into the venture. By contrast, either following "the Wall Street rule" by selling their stocks or accepting the loss as bad luck tends to be the more usual courses of action.

On the other hand, in order to bring forward a legal action, the costs problem seems to be inevitable, especially if shareholders lose their claim. Unlike directors, who can hide behind the shield of exemption clauses and D&O insurance, shareholders may

[54] The passivity of institutional investors has been discussed in Chapter 4.

[55] For example, in the famous case of Equitable Life, the fight went on for several years before reaching a settlement when both parties had spent millions of pounds on legal costs.

[56] Furthermore, a prospective plaintiff, being aware that the company and other shareholders will "free-ride" on his or her efforts, has a strong incentive to leave it to someone else to sue. If all shareholders share the same view, then no one is likely to step forward even in situations where litigation would increase total share value. See B.R. Cheffins, *Reforming the Derivative Action: The Canadian Experience and British Prospects*, C.F.I.L.R. 1997, 1(2), 227-260, at 257-258; Quigxiu Bu, *The Indemnity Order in a Derivative Action*, Comp. Law. 2006, 27(1), 2-13.

have to pay the expenses of litigation and if they lose, also the legal expenses of the defendant by their own money. There is no doubt that this treatment of fees could have a direct impact on the frequency of suit, as "the more advantageous the fee rule is to the prospective plaintiff, the greater the employment of litigation".[57] In order to reduce this problem, the court did try to introduce an interesting procedure, by allowing the shareholder, who is bring the action, an indemnity for costs he may become liable for. This was first recognised in *Wallersteiner v Moir (No.2)*,[58] a derivative action where a minority shareholder brought litigation against one of the directors. With the sympathy toward the perseverance of Mr. Moir,[59] permission was given by the Court of Appeal that the company should be liable for the costs of the claim, even, in fact, where the litigation was ultimately unsuccessful.[60]

Now an application for indemnity order has been formalized by the Civil Procedure Rule as part of the application for permission to continue the derivative claim.[61] It is necessary to bear in mind, however, that the authorization of indemnity is at the discretion of the courts.[62] Furthermore, recently, indemnity orders have not been much welcomed by the judiciary, as they have often been regarded as potentially oppressive. In the later case of *Smith v. Croft*,[63] Walton J. attempted to redirect the judicial approach, through tightening the standard of availability of indemnity. It was indicated that, in applying for a "Wallerstein order", the claimant must show that it is genuinely needed. Even when an order is granted, some proportion of the costs

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[57] S. Shavell, *Foundations of Economic Analysis of Law* (Harvard University Press, 2003), Ch.18.
[58] [1975] Q.B. 373.
[59] "The only way he has been able to have his complaint investigated is by action in these courts. And here he has come to the end of his tether. He has fought this case for over 10 years on his own…has expended all his financial resources on it and all his time and labour…In this situation he appeals to this court for help in respect of the future costs of this litigation. If no help is forthcoming…Mr Moir will have to give up the struggle exhausted in mind, body and estate." *Ibid.* per Lord Denning, at 380.
[60] However, the court, by a majority against the view of Lord Denning, rejected the idea that legal aid should be available to a shareholder bringing a derivative action. *Ibid.*, at 400-401.
[61] See the Civil Procedure (Amendment) Rules 2007, SI 2007/224 (L26), Sch. 1, r 19.9A.
[62] According to the Civil Procedure Rules 19.9A: "the court may order the company…to indemnify the claimant against any liability for costs incurred in the permission application or in the derivative claim or both".
[63] [1986] 1 WLR 580.

should still be appropriately left to be borne by the claimant.[64] Therefore, in some situations, the matter of cost is a major obstacle.

Recommendation:

Lack of incentive has long been a problem in the way of derivative action. Although the Companies Act 2006 succeeded in introducing a statutory regime of "derivative claim" and simplifying the procedures, it does not make a great difference to the incentive of shareholders. An indemnity order may be an encouraging measure to resolve the problem, but it is not widely available. In accordance with the position of Walton J. in *Smith v. Croft*, an indemnity order seems to be an aid only to those most vulnerable shareholders who have absolutely no resource to cope with the money-consuming legal process. This attitude is, however, too restrictive. It is suggested here that the courts should adopt a more open view to this issue. As long as permission is given with a *prima facie* finding of the court that "the member is acting in good faith in seeking to continue the claim", an indemnity order should normally be available as applied by the claimant. Reliance on indemnity for funding should not be considered as a primary factor in deciding whether or not to allow indemnity. In addition, there should also be a mandatory requirement for the company to indemnify the costs of the action (but be open to challenge by the company if the indemnity will damage the interest of the company). Furthermore, it has been suggested that the system of conditional fee agreement could be considered as a supplement.[65] Such an agreement allows a lawyer to offer a "no win, no fee" arrangement, which means that they will receive a success fee if they win the case,

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[64] Moreover, in another case, the court made it clear that it would not give the claimant a blank cheque but to review the issue and pay on a stage-by-stage basis as the litigation proceeds. See *McDonald v. Horn* [1995] 1 All ER 961, at 974-975.

[65] See Birds & Boyle, *Company Law*, *supra.* note 25, at 667. Conditional fee agreements are regulated under s.58 and 58A of the Courts and Legal Services Act 1990, the Condition Fee Agreements Order 2000, SI 2000/823 and the Conditional Fee Agreements Regulations 2000, SI 2000/692.

A more radical proposal was to introduce a US-style contingency fee system, which allows the lawyer to share in the proceeds of a successful action (which belongs to the company). See See, e.g. A. Reisberg, *Funding Derivative Actions: A Re-examination of Costs and Fees as Incentives to Commence Litigation*, J.C.L.S. 2004, 4(2), 345-383; Arad Reisberg, *Derivative Actions and the Funding Problem: The Way Forward*, J.B.L. 2006, Aug, 445-467. However, in *Wallersteiner v Moir* , Scarman and Buckley L.JJ., against the view of Lord Denning, rejected the adoption of this system. [1975] Q.B. 373 at 373 and 406.

but if the case is lost then no fee will be charged.[66] In some ways, this arrangement mitigates the problem of funding derivative claim by partly transferring risk-taking from shareholders to attorneys. The lawyers would have the incentive to assess the merit of case, calculate the chance of success and achieve a favourable outcome for his client to earn the success fee. On the other hand, the potential risk of shareholders is reduced (the worst result of losing the case is liable for the opposite party's costs). However, given the remaining "freezing effect" under the conditional fee agreement (even only a risk of paying for the opposite party's costs may still deter shareholders from litigation) and the willing of lawyers to accept a conditional fee arrangement (e.g. lawyers sometimes pick only the strongest claims which are most likely to succeed), a supplement is still necessary to counteract the deterrent effect. One way is through the legal expenses insurance, for example, an "after the event" policy, which, if the case is lost, pays the other side's costs and the plaintiff's own out-of-pocket expenses.[67] Due to the fact that this insurance may be very expensive and lawyers may not be willing to shoulder this "upfront costs" of insurance premium, it is also suggested here that the bill can be picked up by the company, by absorbing it into the company's D&O insurance. In order to prevent shareholders abuse the system, it should provided that, when shareholders lost the case, the insurer would pay the plaintiff's cost only if the application for permission to continue derivative claim was not dismissed.

3.2 The Limited Feature of Disqualification

As discussed above, although a reform on funding of derivative claim can encourage the incentive of shareholders, the obstacle may only be mitigated rather eliminated. In a liquid stock market, selling the shares is normally better than bring a legal action.

[66] But the use of conditional fee agreement must it detracts from the right of the company to receive all the proceeds of a successful action. See Birds & Boyle, *Company Law*, *supra.* note 25, at 667.

[67] D. Marshall, *Conditional Fee Agreements*, N.L.J. 2001, 151(6970), 156-159. However, it has been found that such insurances have not been popular in the UK and it is unlikely to change significantly. See M. Zander, *The Government's Plans on Legal Aid and Conditional Fees*, M.L.R. 1998, 61(4), 538-550, at 549.

When shareholder litigation seems an unlikely prospect in practice, other legal sanctions may present a greater threat to directors. Disqualification orders serve as another manner by which to enforce directors' duties. Arguably, however, the threat of disqualification does not impose a significant threat. For some fairly clear reasons, the disqualification regime does not effectively target all directors who are remiss in their duties.

First, under the regime of s.6 "disqualification for unfitness", although insolvency practitioners are obliged to report any suspicious "unfit" conduct of directors, there might still be a confusion "as to precisely when the legal obligation to report a director as unfit arises".[68] Given the fact that the matters set out in Sch.1 of CDDA are abstract and do not represent an exhaustive list, it is certainly hard to offer a consistent answer to insolvency practitioners about exactly what kind of behaviours a court is to view as deserving of disqualification. There is a realistic worry that, though some guidelines have been given,[69] "consistency between practitioners in reporting that a director is or is not unfit is likely to be poor".[70]

Second, even if insolvency practitioners properly report, a question would then be raised about whether the Secretary of State for Business, Innovation and Skills (formerly the Secretary of State for Business, Enterprise and Regulatory Reform and previously Secretary of State for Trade and Industry) and his official receiver, who are entitled to apply for disqualification orders (in practice, the Insolvency Service Executive Agency is delegated the responsibility for exercising the Secretary of State's powers), have enough personnel resource to bring every case before the courts.[71] Owing to such a problem, it has been suggested in the past that probably "up to half of those cases meriting disqualification in the public interest never result

[68] Andrew Hicks, *Director Disqualification: Can It Deliver?*, J.B.L. 2001, Sep, 433-460, at 436.
[69] *E.g.* "Guidance Notes for the Completion of Statutory Reports and Returns" issued by the Insolvency Service in 1993 and 1999, and the Insolvent Companies (Reports on Conduct of Directors) Rules 1996.
[70] Andrew Hicks, *supra.* note 68.
[71] Kingsley T.W. Ong, *Disqualification of Directors: A Faulty Regime?*, Comp. Law. 1998, 19(1), 7-10.

in proceedings".[72] So possibly, only those extremely intolerable cases would be deemed by the authority as worthwhile to pursue. In this sense, the exposure to potential risk of disqualification is still limited.

Third, the most important point is that, when the court disqualifies a director on the ground of "unfitness", it can only make the order against a person if the first condition is satisfied: the company of which the person is a director has become insolvent. Unlike other grounds of disqualification,[73] e.g. for criminal convictions or persistently breaching the provisions of the Companies Act regarding filing and registration, "disqualification for unfitness" is a more restrictive power.[74] For example, in the case of Baring, a collapsed bank partly because of a failure of internal monitoring, the authority carried out high-profile disqualification proceedings against the directors involved; but a decade later, as RBS, a giant bank group, careered dangerously close to the brink, it has become clear that the authorities would not apply to disqualify any RBS director, who might possibly be regarded as "unfit", because, ironically, the bank was saved from financial collapse by a bail-out from government.

Fourth, unlike a successful derivative action which may possibly lead to a great monetary liability against directors, a disqualification order has little direct impact on the offender's wealth, except that independent directors may find themselves precluded after disqualification from holding executive appointments, which may mean financial hardship. Other than the fees and costs from the legal process,

[72] National Audit Office, Insolvency Service Executive Agency, Company Directors Disqualification, 1992/3 House of Commons 907 at 2. See also Public Accounts Committee, Insolvency Service Executive Agency, Company Directors Disqualification, 1993/4 House of Commons 167 at v.

[73] *Supra.* note 25.

[74] Under s.8 of CDDA, the Secretary of State may apply to the court for a disqualification order (or accept a disqualification undertaking) in relation to a director, whether the company is insolvent or not, if it appears to him from investigative material that it is expedient in the public interest to apply. The court may make a disqualification order against a person where, on an application under this section, it is satisfied that his conduct in relation to the company makes him unfit to be concerned in the management of a company. However, it was suggested that an official investigation of the company has rarely been launched unless a strong case for doing so could be made out. See Paul L. Davies, *supra.* note 6, at p.629-630. In 2005-2006, only 26 undertaking were accepted and no order was made under this section. See DTI, *Company in 2005-2006* (2006), Table D1.

directors are not required to pay any money out of their pocket to cover the loss of the business.[75] The only result is that they can no longer be concerned or take part in the promotion, formation or management of a company in a specific period, but without any further penalty. Apart from a likely humiliation and damage to their reputation, the disqualification order can be seen as a somewhat impotent threat. For those independent directors, who may have their primary career as non-business professionals or professionals capable of doing business in a non-company form (e.g. partnership), the negative impact could be further minimized, because they do not rely upon directorial functions to earn a living.

Recommendation:

It is absolutely justified under the CDDA regime that an "unfit" director must be removed out of the business community before making any damage to the public interest in the future. However, as discussed above, the lesson we learned from the impotence of CDDA is that merely *ex post* disqualification is not sufficient. It does not effectively stop rogues or incompetent people from entering into business in the first place. British company law has traditionally been silent about positive qualification of directors' skill, knowledge and experience. Such an allowable attitude is reasonable in a sense of encouraging normal people to start their own business in the form of company. However, for being a director of a large corporation which has a great impact on general economy and society, a low threshold may mean a potential risk of misjudgement and inefficiency. Although it might be true that the board itself has certain incentive to recruit the best man (because working as a team, members normally expect a competent colleague to promote the success, rather than

[75] However, provided that in certain circumstances, the "unfitness" conduct of directors can also be equally viewed as one of "wrongful trading", s.214 of the Insolvency Act, an additional risk of exposure to legal liability may arise in that the director would be accountable for certain of debts of the failed company. S.214 provides that the court, on the application of the liquidator, may declare that a person is to be liable to make such contribution (if any) to the company's asset as the court thinks proper, if: (a) the company has gone into insolvent liquidation; (2) at some time before the commencement of the winding up of the company, that person knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation, and; (c) that person was a director (including a shadow director) of the company at that time.

an inept partner to rock the boat), we cannot be completely sure that all new independent directors certainly have sufficient and specific knowledge relating to the industry of the company, which can help them effectively discharge their responsibilities. The penalty of *ex post* disqualification cannot match the damage caused by poor performance of incompetent independent directors to the public interest. What should be included as a complement is an *ex ante* control of entry.

Such an *ex ante* control is not found in either the Companies Act or the CDDA, but fortunately, it is introduced in a statute applied to a specific area of law, i.e. the Financial Services and Markets Act 2000 (FSMA). Under Part V, a person must be approved by the FSA to perform a controlled function in a FSA-authorised institution, through application to the FSA by the proposing company.[76] Without such an approval, no person should be allowed to carry on regulated activities in the financial industry. Given that the role of directors (certainly including independent directors) is regarded as a controlled function, it means that the FSA has a crucial authority in deciding whether a candidate of independent director is a fit and proper person for this job. Only when the FSA is satisfied of his competence, it would then give the approval. Although traditionally the FSA largely relies on the judgement of the chairman and board of choosing a new member,[77] this does not reject the ultimate control of the FSA on entry of independent directors. The only practical question is how the FSA should reasonably use this power in shaping a better corporate governance system. The Walker Review suggested that the FSA should adopt a more active and demanding attitude in this approval process, taking into account the relevant experience and other qualities of proposed directors and their access to adequate induction and development programmes.[78] By this measure, boards are encouraged to take more seriously that "those they put forward are fit for the role for

[76] Section 59 of the Financial Services and Markets Act 2000.
[77] The Walker Review, para. 3.24.
[78] *Ibid.* See also Recommendation 4.

which they are proposed and that NEDs who obtain authorisation take on their roles with heightened awareness of their responsibilities."[79] While firmly agreeing with the comment of the Review, it is also further proposed here by the author that this approval regime should be extended to all non-executive directors in listed companies. After completing a formal and robust nomination procedure as discussed in Chapter 5, the company should make an application for the authority's approval, along with supplementary information including: whether this putative new board member has been properly interviewed; whether he or she has relevant qualification or experience or other capability for which is appreciated by the company in relation to the proposed status; the time commitment expected by the company and agreed by the candidate; the full availability of induction and training programmes and the consent of the proposed director to spend sufficient time on these programs; and so on. Companies and directors should stick to their promises in the application. The authority may refer to all above information in deciding whether to make a punitive order against an unfit non-executive director (as what will be discussed below).

Other than lack of *ex ante* control of entry, the current disqualification system suffers another pitfall: frustration of failing to bring applications of disqualification within the strict 2-year period.[80] Interestingly, Part V regime of FSMA is not seriously bothered by this time-horizon problem. According to section 56(1) and (2), the FSA may make an order prohibiting an individual from continuously performing as a director, if it appears that this person is not a fit and proper person to perform functions in an authorised institution. Such a prohibition order is very similar to effect of disqualification. But an advantage is clear in the procedure: the authority can directly make the decision of issuing the order by itself, rather than refer it to the

[79] *Ibid.*
[80] Section 7(2) of the CDDA: "Except with the leave of the court, an application for the making under that section of a disqualification order against any person shall not be made after the end of the period of 2 years beginning with the day on which the company of which that person is or has been a director became insolvent." The authority may sometimes find it hard to initiate an application in time, and thus cases collapsed. See *EDC v UK* (1998) BCC 370.

judgment of the court (but under the condition that it must send waning notice and decision notice in clear terms).[81] Dispute about the decision may then be referred to the Tribunal.[82] This arrangement can help the authority take actions in due course in response to any market turbulence. For example, the FSA used this power in April of 2010 against two former Northern Rock directors and imposed restrictions, through prohibition orders, on their future working in the financial industry (also fined them for misbehaviours).[83] This sends a strong signal that the authority is in support of tougher liability regime for directors.[84] Possibly, such a disciplinary instrument and rigorous attitude can be more broadly applied to independent directors so as to stimulate their concern about their duties. It is suggested here that a specific disqualification system, separated from the general CDDA regime, should be installed in relation to all directors of listed companies, which is similar to the model of prohibition order under section 56 of FSMA. An authority (currently the FSA in charge of enforcement of listing rule) should responsible of reviewing the behaviours of independent directors and promptly take actions those who are incapable of performing diligently (through a disqualification order made by the authority subject to challenge before the court). Accordingly, directors may be more aware of the fact that accountability is an integral part of their jobs and poor performance can lead to a realistic legal liability.

3.3 The Mystery of Case Law on Independent Directors

Even in those rare circumstances in which derivative actions are launched or

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[81] Section 57(1)-(4).

[82] Section 57(5).

[83] "FSA fines and bans former Northern Rock deputy chief executive and credit director for misreporting mortgage arrears figures", 13 April 2010, available at:http://www.fsa.gov.uk/pages/Library/Communication/PR/2010/066.shtml

[84] Margaret Cole, director of enforcement and financial crime of the FSA, said: "this is a loud and clear message that we are serious about taking action against senior directors where they step over the line." And Bradford & Bingley, HBOS and Royal Bank of Scotland have all confirmed that they are under investigation by the FSA. See Guardian, "Northern Rock directors fined and barred by FSA", 13 April 2010, available at: http://www.guardian.co.uk/business/2010/apr/13/fsa-fines-northern-rock-executives-mortgage-arrearsanks

disqualification proceedings are instigated against independent directors, courts may not always respond in the way that the protagonists had hoped for. As discussed below, more stringent attitudes of judges make it clear that they do not want the life of independent directors to be too cozy, but certainly, neither are they intended to establish too harsh a rule which would act as a disincentive to taking up such posts. The difficulty of how to retain an acceptable balance between these two factors is really serious, leading the courts to hesitate to draft an "all-for-one" policy and inconsistent decisions in different circumstances. Ironically, this swaying attitude makes the law itself a filter of legal risks for independent directors.

3.3.1 The Difficulty of Retaining Balance and Standard

A balance must be struck between setting high enough standards to encourage good corporate governance practices but at the same time not raising the bar too high which may act as a disincentive for appropriate individuals to take up the independent director role. However, this may be problematic to achieve. On the one hand, it is not realistic for the law to retreat to its tradition of mercy. The trend of rising standards of duties is well-grounded when we put the hope of reform on the introduction of independent directors, who are diligent in using their best skill and care to carry out their functions. In other words, Even if it is almost inevitable that some directors may treat this expectation as an onerous demand akin to sitting on a volcano, the law has to be strong in dealing with the duties of independent directors against the backdrop of continuous reform on corporate governance. On the other hand, the courts are always reluctant to judge the conducts of directors based on the view of hindsight.[85] An increasing frequency of exposure to liability may possibly leave an impression that judges are "second guessing" the behaviours of directors, using their *ex post* view to decide how independent directors should have behaved in

[85] *Lagunas Nitrate Co. v. Lagunas Syndicate*, (1899) 2 Ch. 392; *Foss v. Harbottle*, (1843) 2 Hare 461.

the previous, uncertain circumstances of the market and industry. To a certain extent, mercy is inevitable, when the courts have an inherent aversion to reviewing substance of business decisions.

Moreover, while faced with the difficulty of retaining a sound balance, it is impossible for the law to set out a uniform and invariable standard fit for all situations in relation to the director's duty. How independent directors should fulfil their roles may vary, depending on different factors in each individual case, such as the size and nature of the company, the risk in front of the company, the scale of potential conflicts of interest present, and the information independent directors got or should have sought to obtain. Different circumstances might call for different activities. A potential take-over bid, for example, may ask for a more careful consideration about the whole interest of the company and its shareholders,[86] but reviewing a decision whether or not to open a new factory might merely call the independent directors to provide some supplementary advice on the management proposal. Due to the fact that the standard of discharging duties will not be uniform, it is not reasonable to conclude that the law itself can offer a one-off solution to the balance in fluctuating situations of corporate governance.

3.3.2 The Rationality of Collective Liability

A major problem in describing the extent of liability is whether non-executive directors should be accountable for the mistakes of executives. It is necessary to note that a company is governed by the board, not by individual directors separately. The board should act as a whole, rather than work separately. In this sense, it is a common rule that directors, regardless of their type, should share responsibilities for the control of the company. So, as an example, when executives have failed in their

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[86] Robert A. Ragazzo, *Unifying the Law of Hostile Takeovers: The Impact of QVC and Its Progeny*, 32 Hous. L. Rev. 945 (1995).

duties of skill and care and their misjudgement have been approved in the name of the board, it would turn to be the fault of the board in general. Subsequently, liability may be passed to non-executive directors in the unitary board on the basis that they should be collectively responsible, since they failed to carefully review the performance of the executives and allowed their ill-drafted proposals to stand.

In *Re Westmid Packing Services Ltd, Secretary of State For Trade and Industry v. Griffiths*,[87] it was held by Lord Woolf M.R. that, "[e]ach individual director owes duties to the company to inform himself about its affairs and to join with his co-directors in supervising and controlling them". Although it is a common business practice that the board might delegate some of its managerial functions downward to an inner group or those below them in the management chain, it cannot completely offload its duty to supervise the discharge of delegated functions. It is thus necessary, in modern parlance, to maintain a system of "internal control", as discussed in the above chapters, at the level of the board of directors. As stated in *Secretary of State for Trade and Industry v Baker*,[88] both the board as a whole and each individual director "remain responsible for the delegated function or functions and will retain a residual duty of supervision and control".[89] Thus it is not a solid defence for an independent director to claim that he is innocent because he did not write up the wrong policy. While the board retains a collective duty to supervise delegated functions, each of the individual directors is obliged to participate in discharging this collective duty. Based on such a notion, the legal responsibility of one director is in relation to the acts and failings of his co-directors. Hart J. put it in these words: "a director may still be in breach of duty if he leaves to others matters for which the board as a whole must take responsibility."[90] Thus, the destiny of independent directors seems to be closely tied to that of executive. When executives are in the

[87] [1998] 2 B.C.L.C. 646, at 653.
[88] [1999] 1 B.C.L.C 433.
[89] *Ibid.,* para. B4.
[90] *Secretary of State for Trade and Industry v Ball*, [1999] 1 B.C.L.C. 286, at 346.

breach of duties by failing to devote their best understanding and diligence to promote the success of the company, non-executive directors, or called as "independent directors", may also be regarded as breaking the same rules, since they failed the responsibilities to supervise and detect the error of their colleagues. A strict attitude of collective liability certainly makes the life of independent directors tougher, because it would be hard for them to hide behind the behaviour of executives.

3.3.3 A Deviation from Collective Liability

There are clear drawbacks to collectively liability. Rendering someone liable for the conduct of others is not strongly convincing. Particularly given the disproportion of authority and information access between executives and non-executives, it would seem inequitable to unreservedly place the liabilities of the two groups on the same level. Therefore, not surprisingly, the courts have opened a back door from which non-executives may escape the principle of collective responsibility. This mercy has at least been slightly recognized by UK company law in the *Griffiths* case.[91] It was held in this judgement that, "[t]he collegiate or collective responsibility of the board of directors of a company is of fundamental importance to corporate governance under English company law. That collegiate or collective responsibility must however be based on individual responsibility."[92] In some ways, it was shown that the courts are willing to base the policy on a more individual ground. The sign of a distinction between liabilities for different types of directors was repeated in Hoffmann L.J.'s statement in *Bishopsgate Investment Management Ltd. v. Maxwell*: "the existence of a duty to participate must depend on how the particular company's business is organised and the part which the director could reasonably have been

[91] [1998] 2 B.C.L.C. 646.
[92] *Ibid.* at 653.

expected to play."[93] A similar view was shared by Lindsay J. in *Re Polly Peck International plc (No.2)* that, "[a]n individual director who has not been individually charged by the board with the task of instituting adequate financial controls, might or might not be in breach of a duty to the company to use his best endeavours to procure their institution but not, without more with their absence. Were that not so, a director who has striven manfully to introduce them would be as much in breach as one who has resisted them."[94]

The issue was referred to once again in *Re Barings plc (No.4), Secretary of State for Trade and Industry v Baker (No.4)*[95] which was concerned with an application under s.17 of the CDDA 1986 from a disqualified director (referred to as N) to be given leave to continue to act as a non-executive director of three other companies. In granting leave, the court held that: "[s]ince N's directorships of JBEL and CCC did not involve executive responsibilities there was no possibility that the inadequate discharge of executive responsibilities which justified the disqualification order made against him would recur. N would be given leave to continue to be a director of JBEL and CCC on condition that he remained a non-executive, did not enter into a contract of employment and that his directorship remained unpaid." Here, the court was willing to draw a distinction between executive and non-executive functions. It was suggested that the unfitness of Mr. N to act as an executive did not necessarily render him unfit undertake the role of non-executive director, because the respect functions in each role were different. The implication is that, while Mr. N failed in his duty in day-to-day management and is thus unfit (as an executive), he can still be trusted with non-executive responsibilities (which are focusing on monitoring and advisory functions).

[93] [1993] B.C.C. 120, at 139.
[94] [1994] 1 B.C.L.C. 574, at 594.
[95] [1999] 1 B.C.L.C. 226.

A more recent case is *Re Stephenson Cobbold Ltd (In Liquidation)*.[96] In this case, the Secretary of State sought an order under Section 6 of the CDDA 1986 to disqualify Mr. Henstock, a non-executive director of a company, in which its managing director misused the company's funds in breach of his fiduciary duty. The court dismissed the application by finding that Mr. Henstock was not materially involved in the company's financial affairs due to his non-executive directorship. The judge stated that, "I refer to Mr Henstock's business experience in some detail because it is the Secretary of State's case that that experience demonstrates that Mr Henstock was experienced in the running of the financial side of companies … I do not propose to consider the conduct of which complaint is made in this application on the basis that Henstock was a man experienced in the running of the financial side of companies. I shall deal with this application on the basis that Mr Henstock was a non-executive director of Stephenson Cobbold, and for a period was, as the evidence shows, also a signatory on Stephenson Cobbold's bank account."[97] Although the evidence that Mr. Henstock was an experienced businessman meant he ostensibly met the "subjective" bar of duties of skill and care, as introduced by the *D'Jan* test based on s.214(4) of the Insolvency Act,[98] the judge did not actually measure his liability against this higher standard on the basis of his limited expected participation in the company's operations. It is implied, however, that, if it were the case that Mr. Henstock was an executive within the company, it would be fair to suggest that he might not be so lucky to steer clear of liability.

Consequently, in accordance with the case law, there appears to be a trend that in some circumstances, the principle of collective responsibility could be broken. The courts are viewing the role of non-executive directors as less onerous than that of

[96] Also known as *Secretary of State for Trade and Industry v Stephenson*, [2001] B.C.C. 38; [2000] 2 B.C.L.C. 614.
[97] *Ibid.*, at 620.
[98] See also *Secretary of State for Trade and Industry v Ball*, [1999] 1 B.C.L.C. 286, where it was held that the appropriate test for the necessary conduct of a company director requiring disqualification was that set out in the Insolvency Act 1986 s.214(4) requiring such a person to be unfit to be concerned in the management of a company.

executives and thus the law applicable to the no-executive role is less demanding in its nature. If this is so, it might be argued that the actual bar of the "standard" of directors' duties is relatively lower when it is applied to non-executives, even if the general climate of liability is that stricter rules are demanded.

3.3.4 A Code of Conduct of Independent Directors

It is a dilemma when both doctrines of collective responsibility and legal distinction between different types of directors are present in the company law. The principle of collective responsibility may represent a good corporate governance system, which is compatible with the suggestion that independent directors should primarily responsible for monitoring the performance of the board. However, the judicial recognition of distinction between different directors may acquiescence a compromise. Even if the monitoring failed, independent directors can still shrug their shoulders, by claiming "we cannot do more because we are just non-executive directors". Such a maze of case law may confuse many people, who are not familiar with all above cases as non-legal professionals. Thus a clear summary should be drawn to inform independent directors about their duties:

The enactment of the Companies Act 2006 is definitely a proper movement. By realizing the fact that the current rules were "widely misunderstood, and unclear and imperfect in a number of areas", the Company Law Review recommended that there be a legislative statement of the general duties of directors.[99] This proposal finally made its way into the Companies Act 2006, in which the Chapter 2 of Part 10 specifically provides for the "General Duties of Directors". Obscure legal rules have been transferred into a more clarified provision of "bottom line", under section 174(2)(a), suggesting that all independent directors must exercise the general

[99] Final Report I, Chapter 3, para. 3.5.

knowledge, skill and experience that may reasonably be expected of a reasonably diligent independent director. However, the mystery of law is still not over, since s.174(2)(a) does not tell us any detail of what "a reasonably diligent independent director" should do in carrying out his functions. Although the academy has long been proposing brilliant perspectives on this issue, the statute and regulation have long been silent in providing any detailed guideline. The case law has developed to fill in the gap by at least affirming some academic propositions.[100] However, mere reliance on this development is not realistic, because non-legal professional independent directors are not capable of abstracting detailed guidelines from perplexing judgements. In one sense, a code of conduct is necessary to outline the specific responsibilities of or proper practices for independent directors. It is believed by the author that such a code could be a helpful approach to supplement the popularization and achievement of enhanced duties encouraged by the law.

Fortunately, the Code has already sets out required conduct which are relevant in assessing the performance of an independent director.[101] All non-executive directors (no matter whether he or she is independent or not) should themselves:[102]

- Undertake appropriate induction and regularly update and refresh their skills, knowledge and familiarity with the company (Code principle A.5 and provision A.5.1)
- Seek appropriate clarification or amplification of information and, where necessary, take and follow appropriate professional advice. (Code principle A.5 and provision A.5.2)
- Where they have concerns about the running of the company or a proposed action, ensure that these are addressed by the board and, to the extent that they are not resolved, ensure that they are recorded in the

[100] For example, in *Re Barings plc*, the court confirmed that non-executive directors have a duty of monitoring and ensuring that an internal control system has been properly in place. See [1998] B.C.C. 583, at 586E-F.
[101] The Combined Code (June 2008), Schedule B, para. 1.
[102] *Ibid.* para.2(2).

board minutes (Code provision A.1.4)

- Give a statement to the board if they have such unresolved concerns on resignation (Code provision A.1.4)

However, such a guideline is still not perfect, because: first, it only deals with a general category of non-executive directors, rather than specifically targets independent directors; second, it merely discusses the behaviour of directors on a general basis, not exactly about how an independent director should do in a certain situation (e.g. when sitting in the auditor committee or risk committee). In order to resolve this problem, a more specific code is demanded to assist independent directors. A "Guidelines for Independent Directors" would be a proper format offering such practical advices for those serving as an independent director.[103] Moreover, for the purpose of promising a certain level of authority, this practical guide should be made as a supplement of the Code. As for the content of this guideline, it should gather all relevant rules, which are interspersed among several reports (e.g. Turnbull Guidance relating to internal control, Good Practice Suggestions from the Higgs Report, Guidance on Audit Committees (also known as the Smith Guidance), etc), and fit them together as a comprehensive handbook, which specifically refers to responsibilities and practices of independent directors.

3.3.5 The Emphasis on Proper Procedures

Through genuinely complying with a code of conduct, enhanced duties of directors, which are reflected in modern law development, would no longer be just obscure legal principles on paper, but turn to be legible rules that independent directors can have better understanding about how to implement these duties in practice. Moreover,

[103] A similar idea of code-making can also be found in the regime of prohibition order under Part V of FSMA. It is provided in section 64-70 that the FSA may issue statements of principle and a code of practice with respect to the conduct expected of a person performing a controlled function in relation to the carrying on by an authorised institution of a regulated activity (certainly including directors). In such a statement or code, the FSA must clearly specify the authority's expected standard of conduct, its disciplinary powers against misconducts, the imposition and amount of penalties.

it is suggested by the author that, if the courts have recourse to this code as establishing proper directorial conduct, it can also help the courts shape a more solid attitude in dealing with duties of independent directors (reversely, legal recognition can also assist popularization and compliance of the code of conduct). Given the fact that this "Guidelines for Independent Directors" may only focus on matters of procedures (i.e. how independent directors make decisions, e.g. by assessing major risks facing the company and ensuring that that the board is kept informed, rather than what they decide), the courts should similarly express primary concern with procedural elements (the process of discharging duties), avoiding stepping too deeply into substance of business decisions (the aftermath of discharging duties). It is suggested here that as long as the procedural requirements are followed in good faith, directors can rest in a "safe harbour" without worrying about the threat of exposure to severe liability, even if they have made misjudgements and resolution in company losses.

(1) US-Style Business Judgement Rule

Certainly, such a suggestion has traditionally been appreciated by the American law as "business judgement rule". The US courts have long shared the view that the law is not intended to punish directors simply for the corporate failure,[104] but it is to capture the irresponsible who turned blind eyes to company activities. The core principle of "business judgement rule" is thus that reasonable risk-taking should be encouraged by law.[105] Only when the risk-taking becomes over-ambitious and beyond the line of reasonableness, should the law step in to hold the risk takers responsible. In judging whether or not directors have fulfilled their duties in a particular transaction, it often seems that the "business judgement rule" permits judges to consider only the quality of the board's decision-making procedure. When procedural requirements have been met, the courts will not pass their judgement on

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[104] See William T. Allen et al., *Function over Form: A Reassessment of Standards of Review in Delaware Corporate Law*, 56 Bus. Law. 1287 (2001), at 1296.

[105] Stephen M. Bainbridge, *The Business Judgement Rule as Abstention Doctrine*, 57 Vand. L. Rev. 83 (2004).

the basis of the wisdom of a board's decision, unless a transaction is so disadvantageous to the firm that no reasonable person could deem it fair.[106] This emphasis on proper procedures has been well reflected in several high-profile cases:

In the landmark decision of *Smith v. Van Gorkom*[107], it was required that the "business judgement rule" will only give directors the benefit of protection, if a set of procedural steps have been followed. Accordingly, independent directors should ask management hard questions before they can make any proper decision.[108] The rationale for the requirement that corporate directors must "inform" themselves before they act is that the procedural rule can reduce directors' "costs of confrontation" by allowing them to "sugarcoat" their questions by appealing to the law as the reason for their inquiries, rather than distrust of management.[109] It may thus provide a valuable and practical solution to the problem in situations where courts cannot easily assess the substantive quality of directors' business decisions.

In the more recent *Caremark* case,[110] in which a derivative action against the company's directors, following alleged violations by managers of a federal law proscribing referral payments by health care providers, shareholders argued that the directors had breached their duty of care by inadequately supervising employees' conduct. Although the parties settled the proceedings, Chancellor Allen, in approving the settlement, reviewed the principles of law and indicated that, the duty of oversight may require boards of directors to establish monitoring and reporting

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[106] This rule is set out by American courts as "waste standard". See *Lewis v. Vogelstein*, 699 A.2d 327, 336 (Del. Ch. 1997). See also *Brehm v. Eisner*, 746 A.2d 244,262-64 (Del.2000)(suggesting that business judgement rule requires "process due care"; "Courts do not measure, weigh or quantify directors' judgements. We do not even decide if they are reasonable in this context. Due care in the decisionmaking context is process due care only. . .").

[107] 488 A.2d 858 (Del. 1985) (directors breached due care by approving decision to sell company in a two-hour meeting, held on short notice, relying only on oral report from CEO and failing to ask questions). For a recent symposium on this case see, Symposium, *Van Gorkom and the Corporate Board: Problem, Solution, or Placebo?,* 96 Nw. U. L. Rev. 447 (2002).

[108] See, e.g., Lynne Stout, *In Praise of Procedure: An Economic and Behavioral Defense of Smith v. Van Gorkom and the Business Judgement Rule*, 96 Nw. L. Rev. 675 (2002), at 690.

[109] *Ibid*., at 678.

[110] See *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959 (De1. Ch. 1996).

systems to provide the board with "timely, accurate information sufficient to allow management and the board...to reach informed judgements concerning both the corporation's compliance with law and its business performance."[111]

In sum, what we can learn from the above judgement is quite a simple fact: independent directors must get themselves informed. The courts have paid little attention as to whether or not the board's decision was right or smart, but in cases in which liability has arisen, the rules were expressed very clearly that directors were liable because they had made no efforts to be informed and gave almost automatic approval to certain agreements. This is the procedural requirement set out by the law on directors' duties. In detail, this means that the board must maintain a proper system of internal control in order to ensure that the information required for decision-making can smoothly flow to the table of boardroom, and also that the directors should have free access to necessary resources and assistance in to aid discovery of information.[112] Simultaneously, genuine discussions and debates, rather than blind endorsement, is required in the boardroom. In other words, the application of the business judgement rule depends upon showing that informed directors made a decision through robust procedures.

(2) The UK Perspective

At first sight, a US-style "business judgement rule" has received little popularity across Atlantic. The Law Commissions have been reluctant to follow the American path, partly due to the fear that the requirement of a procedural standard would be overly symbolic and freeze the law and the discretion of courts.[113] Thus it was thought that flexibility should be the key in keeping the law alive to deal with

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[111] *Ibid.*, at 970. See also *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006).

[112] The board's consultation with outside experts before making a decision has been held as a factor in other cases granting the business judgement defense to directors.

[113] Law Commission and Scottish Law Commission, *Company Directors: Regulating Conflicts of Interest and Formulating a Statement of Duties*, Cm. 4436, 1999, Pt. 5. *Cf.* C. A. Riley, *The Company Director's Duty of Care and Skill: the Case for an Onerous but Subjective Standard*, 62 Mod. L. Rev. 697 (1999).

complicated assessments of business judgement.[114]

However, this does not mean that the rules applied in Britain have a fundamental difference with those in America. In *Re Baring Plc (No.5)*,[115] the Court of Appeal held that, although it is common in large companies to delegate certain functions to management or other lower levels, the freedom to delegate "does not absolve a director from the duty to supervise the discharge of the delegated functions".[116] In other words, running the company with no system for supervising the discharge of delegated functions or the inability of directors to understand the information produced by the internal control system might still render directors incompetent in the eyes of the law. The directors involved were thus disqualified not because of Baring's collapse *per se*, but most importantly, because they were running the company without any internal control system in proportion to the size and profile of an institution of this size.

To implement this internal control system, the basic request is that all directors, especially independent members who are expected to play the role of monitoring, must make sure that they have obtained all necessary information required for the reasonable discharge of their responsibilities. In certain circumstances, e.g. where there may be reasonable concern or suspicion about wrongdoings, they should ask for a supply of more specific and precise information pertaining to the matters at hand, even if in average situations, such information is less often accessed by independent directors. In one sense, the requirement of an internal control system is in nature the same as the procedural standard of the business judgement rule. Independent directors must convince themselves that certain procedural checks are in place to supervise the behaviour of the management, and at the same time, they must

[114] P. L. Davies, *supra.* note 6, at p.493-494.
[115] [2001] 1 B.C.L.C 433.
[116] *Ibid.*, at 489

maintain a sufficient understanding of corporate information to enable them properly to discharge their duties as gatekeepers.[117] In sum, the more careful and prudent independent directors are in complying with the procedural requirements of internal control systems, the less likelihood that they would be found in breach of duties and thus be exposed to legal liability.

(3) Summary

As discussed above, the courts, both in the UK and US, have explicitly or implicitly referred to procedural considerations in deciding the liability of directors. But there is a key question here: how can the law articulate the details of this rule? Certainly, the court is not the most qualified body to formulate how a corporate governance system should be and what specific responsibilities an independent director should take. Procedural matters are more properly left to the regime of self-regulation, i.e. as the author suggested, a code of conduct in the form of "Guidelines for Independent Directors". By referring to such a code, it certainly makes the courts' work much easier in assessing whether or not an independent director has genuinely followed proper procedures and thus has appropriately discharged his duties. On the other hand, because such a code has no binding force in law and it can be regularly reviewed and updated, the author believes that such an arrangement can to a great extent retain the flexibility of keeping the law alive and avoid freezing the discretion of courts. Unlike the "business judgement rule" which is worried as overly dogmatic, a code of conduct is merely a reference which the courts may prefer to consult. In certain circumstances, the courts are certainly free to depart from the code when the courts think it is reasonable to do so. In addition, such a code is not only reserved for shareholder litigations before the court, but also fit with the proposal mentioned above in relation to the disqualification regime. It was suggested that an authority (the FSA) should have the disciplinary power of reviewing the performance of

[117] *Ibid.* See also *Re Westmind Packaging Services Ltd.* [1998] 2 B.C.L.C. 646, 653

independent directors and making a punitive order if it appears to the authority that this director is unfit for his or her job. Certainly, for this purpose, a code of conduct could be a very necessary guideline for the authority to determine whether or not a director's conduct is in line with the required standard.

4. Conclusion

Although an obvious trend of modern law development is that legal duties of directors have become more stringent, there is a lack of evidence from empirical studies to suggest that independent directors today are exposing to more legal risks. Three factors have been examined to explain this phenomenon: weak incentive of shareholders to bring a derivative action, structural limits of disqualification regime, and obscure attitude of case law. Not all these obstacles are invincible. At least some deterrents can be mitigated. Through improving availability of indemnity order and funding, it is believed that encumbrance could in some ways be removed in the way of shareholder litigation. Through introducing a similar regime as Part V of FSMA, inefficiency of the current disqualification system can be partly minimized. To clarify the ambiguous attitude of the law, it is suggested that a non-legal approach could be adopted, i.e. through making a code of conduct for independent directors. Such a code is not only beneficial to better inform independent directors about how to discharge their duties, but also helpful to courts in establishing a solid policy in applying enhanced duties to independent directors.

Certainly, even by reliance on the above proposals, there may not be a dramatic changing of jumping increase of litigation. Exposure to legal risks would not be suddenly extended. However, we must be conscious that the major impact of legal risks may be in the threat rather than the execution.[118] A pursuing goal of the law is

[118] D. Gordon Smith, *Corporate Governance and Managerial Incompetence: Lessons from K-mart*, 74 N.C.L.

not only to punish irresponsible directors, but also to encourage most directors to diligently discharge their duties. To achieve this purpose, there is no doubt that clarifying the details of legal rules, especially through a code of conduct, would be extremely useful.

Rev. 1037 (1995-1996), p. 1102.

Conclusion

By reviewing the historical development of the board and independent directors, it was found that, in the early age, there was little notion of a division of works or titles within the boardroom. A close tie between ownership, management and directorships was obvious in that the shareholder-directors were commonly viewed as the same men in charge of both leadership and managerial powers. Such an assumption left no room for the appearance of independent directors in modern notion. However, as the size and complexity of businesses grew, large companies became more likely to have a much diversified shareholding structure. Controlling shareholders demised the "Crown" to professional management. In this era, a separation of directorships was also introduced with some known as "non-executive" or outside directors, and the others, executives, who usually comprised the management team. The "union" of ownership, management and directorships had been dismantled.

This radical change of corporate governance required a necessary counterbalance: a force within the board to offset the over-dominance of executives. This counterweight is required to keep an eye on the management so as to avoid executives from abusing their powers and support them to rationally direct the affairs of the company. The development of modern corporate governance has vested this position in non-executive or outside directors. In order to achieve this purpose of balanced power, it is also required that these directors should cut their ties with the management and retain independence in material terms. Independent directors have thus been a notion formally recognised by corporate governance systems. Although facing doubts due to the historical passivity of non-executive/outside directors and competition from other governance mechanisms (e.g. shareholder activism and market forces), it is still obvious that today board independence has become a prevalent measure in shaping an optimum model of corporate governance (especially

in Anglo-Saxon countries). Corporate governance reformers generally presume that a majority-independent board of directors is the ideal structure. Such a proposition has also been shared by regulators through the Sarbanes–Oxley Act and Code.

However, the prevalence of independent directors is a two-sided story. On the one hand, board independence has been a conventional wisdom that "the more independent a board is, the better". Growing independence has been required by statutes, recommended by self-regulatory rules, and embraced by companies. More independent directors have been invited into the board and become dominant in all significant sub-committees (i.e. audit, remuneration and nomination committees). On the other hand, it is important to bear in mind that board independence is not merely concerned with the structure or composition of the board (e.g. how many independent directors should be introduced, or which ratio is reasonable between insiders and independent directors), but rather determined by the behaviours of independent directors (e.g. whether independent directors are diligent in what they are expected to do, or whether they are efficient in playing their roles). Serving as an independent director of a public company is a privilege with substantial responsibility. Inactive independent directors are only "window-dressing" and have no place in corporate governance reform. The collapse of Enron and WorldCom, and currently, the financial crisis of 2008 remind us that general systems of board independence may be inefficient, or at least, not sufficiently efficient. To presume that mere "independent" status – defined by a lack of ties to the company – makes a director an ideal fit for any board, is naive. Corporate governance reform should focus on how to promote the activity and diligence of independent directors.

For such a purpose, endeavours can be made from both external and internal perspectives. In an external perspective, shareholders, especially institutional investors, should be encouraged to become more involved in building the corporate

governance system. They should be more concerned about whether the company has genuinely complied with the Code to construct its board, rather than indifferently justify non-compliance by acceptable financial performance. They should care whether independent directors have been given a proper platform and environment to contribute their skills and intelligence, and register their reaction if board independence is only used by the company as a formality. Given the weak role of investors in the current "comply or explain" regime, it was suggested in Chapter 4 that the system should move to a more straightforward approach of "comply or vote", in which shareholders could have an opportunity to expressly show their attitude when the non-complier decides to depart from the default structure of genuine board independence. It is believed that this model of "comply or vote" could persuade both the company and investors to more carefully consider the importance of corporate governance. Furthermore, it was also suggested in Chapter 6 that a tougher and swifter liability regime, learned from Part V of the Financial Services and Markets Act 2000, should be introduced, along with a code of conduct specifically applied to independent directors. This could be very helpful to produce and clarify the enhanced duties of independent directors. By promoting legibility and transparency, independent directors could better understand what are required to do in certain circumstances and how they can fulfil these requirements. Through this measure, the aim of enhanced duties may still to a certain extent be achieved by compliance with the code.

In an internal perspective, a number of strategies can be adopted to stimulate efficient performance of independent directors. In Chapter 5, it was examined that disclosure could be a useful weapon to guarantee the true independence of directors. Contrary to the current approach which only requires endorsement from the company, the author suggested that directors themselves should also shoulder the burden of affirming their independence. This could be used as a measure to indirectly dissuade

dubious “independent directors” from taking up such posts. In addition, the disclosure system could move toward to an incident-based model in which the company should disclose more detail about the nomination of any individual independent director. Moreover, in order to offset managerial power over nominations, it was proposed that investors could be invited to nominate their candidates or express their opinions for the nomination committee to consider. In its statement of nomination, the committee should explain whether investor-nominated candidates have been appointed and the reason why specific nominees have or have not been appointed. This enhanced disclosure of nomination would arguably promote transparency and accountability. Furthermore, for the purpose of minimizing the inertia and indifference of independent directors, it is necessary to further improve the working environment of the board. The adoption of a sub-committee model and separation of CEO and chairman have long been recommended by the academe and regulatory rules. The author suggested that more things could be done to provide sufficient stimulus, for example, by appointing full-time independent directors and using a deferred pay scheme. Independent directors may find it easier to enter into an honest discussion and more difficult to be turn a blind eye to the affairs of the company.

In sum, the author firmly holds a faith that the inefficiency of independent directors is not an invariable phenomenon which can never be reversed. Historical experience has told us that circumstances can be improved by consistent reforms. Thus further reform proposals were submitted by the author with an intent to promote efficiency of independent directors in the future. However, the author does not provide all the solutions to the current problems arising in company boards. Independent directors are still relatively new participants in corporate governance, and academic studies remain at an embryonic stage. The effect of board independence needs to be continuously evaluated by the development of the industry, and it is far too early to

draw concrete conclusions. This thesis may be properly viewed then as a pioneer in exploring the essence of board independence, but it represents a starting point rather than the end of the studies. Future studies would be very welcomed in two specific angles: first, because the analysis of board independence should pay more attention to the behaviours of independent directors, empirical studies of behavioural science would be important to review in what situation independent directors can better influence board dynamics. This may help the academe ascertain which reform proposals (including all proposals suggested by the author in this thesis) are effective in serving the purpose of corporate governance. Second, on the assumption that there is now a convergence of corporate governance around the world following the trend of board independence, a further study from an international and comparative perspective would be useful. It is important to review how the reform based on board independence (prevalent in Anglo-Saxon countries and consonant with the unitary board structure) can be compatible with other jurisdictions in which the two-tier board system is the leading model and a concentrated ownership structure (rather than the "separation of ownership and control") is common. Is board independence really relevant in these countries? How can responsibilities be properly allocated between the supervisory board and independent directors? Does the existence of controlling shareholders make any difference to the roles of independent directors? All these issues deserve more systematic studies in the future.

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