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NON-EXECUTIVE DIRECTORS,
LEADERS AND MONITORS

Lord Wedderburn of Charlton QC FBA

A submission to the Higgs Review of the "Role and Effectiveness of
Non-Executive Directors" : September 2002

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Christmas Tree Decorations or Custodians? Widening the Gene Pool

Lord Wedderburn of Charlton ¹

(A submission to the Higgs Review of the "Role and Effectiveness of Non-Executive Directors" ('RNED')

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Non-executives are like "Christmas tree decorations.....pretty but useless":
Tiny Rowlands.²

Fund managers and investors should take "an active interest in the appointment and performance of non-executive directors, exhibiting vigilance in determining an appropriate degree of independence and a proper level of engagement": Paul Myners March 2001 ("This view is supported by the NAPF's guidance....": National Assoc. of Pension Funds Pensions Age July 2002).

"Non-executive directors should be abolished....(The idea) that in some manner non-executives can second guess the executives..... (is)the biggest and most dangerous nonsense":

Lord Young of Graffham.³

"Non-executive directors play a key role in British companies ...We need stronger, more independent and more active non-executives drawn from a wider gene pool of talent to play their part in raising productivity":

Patricia Hewitt, Secretary of State.⁴

¹ QC FBA Professor Emeritus of Commercial Law, London School of Economics and Political Science, University of London.

² The Guardian 28.2.2002 "Low Tide at the Board Gene Pool".

³ President, Institute of Directors, Financial Times 25.4.2002; Accountancy Age, 24.4.2002, (described by IoD Director General, G. Cox, as a "maverick" Independent Director).

⁴ The Mansion House, announcing the RNED, 1 February 2002.

1.0 Introduction In face of such diverse views from distinguished figures, there is manifestly a need for the Review (below referred to as "RNED") to examine rigorously the issues set out in the Consultation Paper "Objectives" and "Issues for Consideration", and in particular without the semantic fudges which have so often disfigured the very terms of debate.

In company law and practice language has traditionally been muddied, at first inevitably by the terms carried over from history. The language of the debate coloured the meaning of the director as "agent" and "trustee" - bequeathed by the combined parent régimes of deed of settlement companies and English partnerships, adapted to the advent of limited liability and corporate personality in the 19th century - and now we face parallel problems with the semantics of the debate on "independent" director, or even the "non-executive". This aspect of the inquiry into "corporate governance" is relatively new and the recent explosion of publications has left a morass of intrinsic uncertainty.

1.1 Indeed, as has already been illustrated in the proposals made by the Institute of Directors on reform of the law to introduce a ban on *executives* holding multiple chairmanships,⁵ the very terms of reference must be treated with flexible generosity by the RNED, if it is to fulfil the hopes reposed in it.

Adjacent areas of company law and practice will inevitably call for contextual comment, if only because the difficult task required of the Review calls for contributions that take a view on the overarching philosophy and practicabilities of the subject.

Even more important, the Government's White Paper on Modernising Company Law⁶ has left the field wide open. Since so far it has been unable to formulate policies or draft clauses on all aspects of directors and their powers, the RNED would be irresponsible if it did not give a lead in this central field of corporate governance.

The RNED should be prepared to make recommendations on company law and practice on matters that affect them generally where they are important to the functioning of non-executive directors.

1.2 It is in this area that, in order to assist the debate that will no doubt take place primarily under the Government's ambitions "especially in the business and financial worlds" (Terms of Reference, "Aim of the Review"), contributions from scholarly and similar independent commentators may perhaps be especially useful.

The literature and comparative research.

2.0 The most noted contribution made by recent scholarship, has undoubtedly been in its analysis of company law in the setting of economic perspectives. In this it was inevitable that North American experience should occupy a more prominent profile. In the experience behind this paper, much assistance has been gained by the best of this writing, notably the work of Cheffins⁷ and the recent provocative survey by Davies.⁸ Work of this character is of primary relevance to the Review.

2.1 It is opportune immediately to point out, however, especially to an inquiry of this kind, that such work reveals the dangers as well as the profit derived from such research.

Most important, economists and lawyers frequently use terms in different and mutually incompatible ways. For example, the use of the analysis of "principal and agent" applied to shareholders and directors diverges. For the lawyer the agent has authority to act on the principal's behalf and in his interests; for the economist the relationship arises much more

⁵ The Times 6.9. 2002.

⁶ Cm. 5553, August 2002.

⁷ B.R. Cheffins Company Law (1997 OUP). See too, the interesting if incomplete study by M. Whincop An Economic and Jurisprudential Genealogy of Corporate Law (Ashgate 2001) with information about Australian developments.

⁸ P.L. Davies Introduction to Company Law (OUP Clarendon 2002), especially his interesting Chapter 7.

generally, from the mere fact that the "principal's" interests depend on the actions of the "agent".⁹ What is an agent for the economist, is often not one to the lawyer - and it is in the legal or normative meaning that the rules proposed for company law and practice must be expressed.

2.2 It is in the analysis of the position of directors (and now non-executive directors) and their relationship to the "owner" shareholders that this divergence in semantics has often created confusion which must be avoided by the RNED. Directors began in law by being juridically the "agents" of shareholders. But the economic developments which gave them a new independence from increasingly dispersed shareholders resulted, where they had functions of management under the corporate constitution, in their acquiring in law a distinct status. In England this sprang primarily from judicial developments.¹⁰

The consolidation of directors' independent status as opposed to agency dependency in law has played an important role in increasing the problems of monitoring and transaction costs of monitoring by shareholders in their "trustee" functions.

These are at the root of some of the central problems of non-executives in modern practice, and clear language is therefore of equally central importance.

2.3 The increase in the reference to the discourse of conventional economics has also inevitably swollen the references to American analysis, for example works such as Easterbrook and Fischel.¹¹ Such work stresses the priority of the shareholder interest as part of its individualised notation of classical economic market thinking, an approach and ideology which has now come in a post-Keynsian era to dominate too the British approach to company law reform.

This is very apparent in the recent *Company Law Review Steering Group Reports* ("CLR").¹² "Shareholder value" is dominant in the CLR as the guide to legislation, modified in the formula that it be "exercised in an enlightened way". Commentators have found that "enlightened shareholder value" - as a *legal* test - "seems impossibly ambitious".¹³

It is obvious that the RNED will realistically need to work within that context; but that constraint need not prevent it from recognising realities which on occasion are not pronounced in the work of the CLR. After all, certain aspects of directors' affairs, especially pay, were withdrawn from the CLR remit.

Groups

3.0 Useful though it is to help pry behind the formalism of legal rules, this approach contains difficulties which are very relevant to the RNED. The first derives from an investigation of the board of the company and "corporate governance in UK companies" (RNED "Background" para. 8). Today "the company" of any size is part of a group, and the large company is increasingly part of a transnational or multinational group, or even of what has been called a global "web of enterprises". Moves have even begun to look at international principles in the International Corporate Governance Network.

The confusions created by the law which has difficulty in coming to terms with the corporate group and the successful efforts of entrepreneurs to avoid liabilities by suitable pirouettes around the corporate personality are manifested every year.¹⁴

It may not be associated with one of the hundred multinationals which rank increasingly higher than important States in GDP,¹⁵ but in a world of mobile capital the large or even medium

⁹ Davies, *Introduction op.cit* n.8 117-8.

¹⁰ See *Automatic Self-Cleansing Filter Syndicate v Cuninghame* [1906] 2 Ch 34 CA; *Shaw & Sons (Salford) v Shaw* [1935] 2 KB 113 CA; *Breckland Group Holdings Ltd v London and Suffolk Properties* [1989] BCLC 100, interpreting the powers in the articles (Table A). In the US, see *Manson v Curtis* 223 NY 313 (1918); but the power to manage was under most jurisdictions given to the board by statute.

¹¹ F.H. Easterbrook & D.Fischel *The Economic Structure of Corporate Law* (1991) See also the pervasive, not always illuminating, influence of R. Posner *Economic Analysis of Law* (3rd.ed 1986).

¹² "Modern Company Law for a Competitive Economy", notably *Final Report Vol.1* (2000); *Developing the Framework* (2000); *The Strategic Framework* (1999).

¹³ Sarah Worthington (2001) *Coy. Law.* 258, 313.

¹⁴ See e.g. *Adams v Cape Industries* [1990] Ch. 433 CA; *Re Polly Peck International* [1996] 2 All E R 433; *Kleinwort Benson v Malaysia Mining* [1989] 1 WLR 379.

company's growth is unlikely to be confined to national boundaries. Yet in corporate governance discussions "the transformation that has occurred since the 1980s is not well understood. It is not even acknowledged".¹⁶

The RNED must acknowledge the realities of the new world of company groups and globalisation.

3.1 The small company is no doubt important to the economy, not least for new entrepreneurial initiative, especially if it is correct that technological "innovation" is as important as crude competitive market forces.¹⁷ It is no doubt inevitable that any new Code like the White Paper¹⁸ for company law should start by considering the position of the smaller company which, viewed as an innovative start-up, has for long been encumbered with too many rules appropriate to larger enterprise. But this Review will be judged by its analysis and recommendations for the public and larger "private" companies (on which this paper concentrates) where great power in society resides and where the vexed problem of separation of "ownership" and control has historically arisen. The non-executive director as a phenomenon in its modern form is an offspring of that separation.

3.2 A failure to put proposals on "companies" into the context of the group, and especially the multinational group, can leave them stranded in a theoretical ivory tower. Muchlinski has illustrated this in his incisive recent analysis of the problems left for such corporate groups by the CLR. After the CLR "the governance questions need to be reconsidered. Not least of these is group liability, which perhaps more than most areas of group action will affect the firm's reputational assets".¹⁹ A reconsideration of group governance and liability, not least particularly after the Cape, Thor and RTZ litigation, could "help reduce the risk of negligent corporate behaviour from arising in the first place".²⁰ The world wide asbestos litigation, it is suggested below, has special implications for the RNED.

The proposals of the RNED must take account of the reality of corporate groups, in particular multinational and transnational groups or webs of enterprises.

Comparisons with the United States

4.0 It has long been appreciated that, despite their adherence to a common family of "common law" jurisdictions in a culture of dispersed share(stock)holding, the difference between the particular doctrines of British and US company law are significant.²¹ Partly through the long influence of the SEC at Federal level (and derivatively in State codes) in particular, and the contrasting role of the City establishment and now the FSA, lessons must be drawn with care from US economic-legal doctrine, not least in the light of proxy contests, cumulative voting, the

¹⁵ Latest UNCTAD report on Multinationals, summarised Financial Times 13.8.2002.

¹⁶ George Soros On Globalization (2002) 35.

¹⁷ See W. Baumol The Free-Market Innovation Machine (2002 Princeton).

¹⁸ Modernising Company Law Cm 35553 2002.

¹⁹ P. Muchlinski "Holding Multinationals to Account: Recent Developments in English Litigation and the Company Law Review" (2002) 23 Coy. Law. 168-179, 177, and in J. de Lacy (ed.) The Reform of UK Company Law (Cavendish 2002).

²⁰ Ibid. 175.

²¹ L.C.B. Gower "Some Contrasts between British and American Corporation Law" (1956) 69 Harv. L.R. 1369- 1402.: but "American corporation law is now incomparably richer and more highly developed than its English parent", 1400.

"business judgement rule", staggered board elections,²² or "repurchase tender offers", not to speak of the different style and methods of accountancy principles or the incidence of junk bonds and poison pills. The difference in accountancy methods, with the "true and fair" principle dominating the British picture, is not the end of the matter. There is no arguable proof that "it could not happen here". The Secretary of State has proved the need to re-examine this issue by instituting an immediate review of auditing and accounting.²³

The RNED should work closely with the review of accounting and audits and integrate its proposals with that inquiry's conclusions.

4.1 But it would be absurd to suggest that the recent experience which has given rise to the Sarbanes-Oxley Act and the implementation of the SEC Rules of 27 August 2002, or the New York Stock Exchange Rules of 16 August 2002 have no interest for British corporate governance, and especially law and practice on non-executive directors.

The literature across the North Atlantic is of general interest in its attempt to see how far the "monitoring board" can provide a solution to the new corporate governance problem.²⁴ It will be suggested below that, whatever caveats have to be entered in respect of the US comparison, the New York Rules in particular are of significant relevance to the British debate.

4.2 The risks of the British market experiencing failures of the character and extent of the Enron or WorldCom scandals are uncertain. These issues are controversial and the RNED should not take them as settled. It should not unquestionably accept the complacent view that "there is no chance of a scandal like Enron or Worldcom happening here".²⁵

Who, after all, predicted the Maxwell, Polly Peck, BCCI, Guinness or Marconi and the now largely forgotten Iceland, Lonrho or London and County debacles? The 1980 Companies Act showed how our law responded after the event to "the large number of financial scandals that had recently occurred".²⁶ Both here and in the United States the past is littered with complacent attitudes which must not be repeated.²⁷

4.3 Enron has relevance to, and must be faced by, the Review. As one American scholar puts it:²⁸

"The company was invariably mentioned in "most admired" lists of US companies; its CEO was lionized in Houston and a nicknamed confidant of the President of the United States. Enron's collapse triggered investigations by a "special committee" of the Enron board, the SEC and the Justice Department, nearly a dozen congressional committees, and various shareholder plaintiffs' attorneys. The Enron board's special committee investigation suggested that a substantial fraction of the company's reported profits over a four year period had been the result of accounting manipulations....."

II. Board-Centered Corporate Governance

²² Similar to but materially distinct from British practice: see L. Bebchuk, J. Coates IV, G Subramanian Olin Paper 353, 2002, Harvard .www.law.harvard.edu/programs/olin_centre.

²³ [Financial Times](#) 10. 9.2002; cf. [The Guardian](#) 27.6.2002.

²⁴ See especially, M. Mace [Directors, Myth and Reality](#) (2nd ed 1986); M. Eisenberg [The Structure of the Corporation](#) (1976); and the work of the American Law Institute [Principles of Corporate Government](#) (1994 et seq.).

²⁵ George Cox, Director General Institute of Directors, 19.8.2002, [Accountancy Age](#).
www.accountancyage.com/News

²⁶ Law Commission [Company Directors: Regulating Conflicts and Formulating a Statement of Duties](#) (1998: Paper 153) para. 1.9.

²⁷ A high point was the Report [Corporate Governance](#) by the [Business Round Table](#) of American CEOs, 1997, which was full of such statements as:"... corporations are generally well served by a structure in which the CEO also serves as chairman of the board", 12.

²⁸ Jeffrey N. Gordon [What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections](#), 2002, Columbia Law School The Center for Law and Economic Studies Working Paper No. 203 (italics supplied). Forthcoming, Univ. of Chicago Law Review, Summer 2002.

The efficient market hypothesis has been one of the underpinnings of the argument for shareholder choice in the decision whether to accept a hostile takeover bid at a premium to the market price. (It is by no means a necessary step to that conclusion, however, since the possibility of a gap between prevailing market price and intrinsic value hardly resolves the question of whether management has markedly better information and superior evaluative skills so as to outweigh the agency problems.) Those who argued most strenuously against unfettered shareholder access to hostile bids, for management's right to "just say no," have offered the visible hand of robust corporate governance instead of the market in corporate control as a solution to the agency problems of large public corporations. That is, the appropriate remedy for the problem of the potentially self-interested or incompetent managerial team is said to be the monitoring board. The major features are independent directors, specialized committees (especially an audit committee) consisting exclusively of independent directors to perform crucial monitoring functions, and clear charter of board authority. Some have additionally argued for stock-based compensation for directors, better to align their interests with shareholders.

Enron is an embarrassment for this position. *Its board was a splendid board on paper*, 14 members, only two insiders. Most of the outsiders had relevant business experience, a diverse set including accounting backgrounds, prior senior management and board positions, and senior regulatory posts. Most of the directors owned stock, some in significant amounts, almost all had received stock options or phantom stock as part of the director compensation package. The audit committee had a state-of-the-art charter, attached to the 2001 Proxy Statement for all to admire, which made it the "overseer of the Company's reporting process and internal controls" and gave it "direct access to financial, legal, and other staff and consultants of the Company" and the power to retain other accountants, lawyers, or consultants as it thought advisable. *But if the report of the Enron Special Investigation Committee is accurate, the board was ineffectual in the most fundamental way, the Audit Committee particularly somnolent if not supine. It turns out that the independence of virtually every board member, including audit committee members, was compromised by side payments of one kind or another. Independence was also compromised by the bonds of long service and familiarity.*

Obviously one bad board does not an argument undo, but it does reveal a certain weakness with the board as a governance mechanism. "

The Modern Origins of the Non-Executive

5.0 Non-executive directors are a comparatively modern institution. In the United States, there is no discussion of them in 1946 in Ballantine,²⁹ though by the 1960's "part time and outsider" directors receive attention in the books³⁰ and SEC pressure for outside directors to form audit committees was added to prolonged complaints about bribery and corruption.³¹ "Thirty years ago, many prestigious corporations had few or even no independent directors, and the audit and especially the nominating committee were in their early days. Now the situation has completely turned around."³²

The first sophisticated textbook on company law in Britain made no mention of them in 1957, knew little or nothing of them in 1979, but devotes a section to them (since now "public companies generally have both executive and non-executive directors") in the 1997 edition.³³

Interest in "independent" directors was shown in the literature of the 1970s.³⁴ By the 1980s *Pro Ned* was formed under City tutelage and elementary surveys of "non-executive directors" began.³⁵ By the 1980s "outside directors" are an established part of "corporate governance", as it had come to be called, in North America, and its day had arrived in Britain.

²⁹ The classic post-war textbook: Ballantine on Corporations (1946).

³⁰ Henn Handbook of the Law of Corporations (1961), 338-9, citing a discussion of their merits in Time in 1957.

³¹ On the latter in the 1970s onwards, E. Herman Corporate Control, Corporate Power (1982) 283 ff.

³² M. Eisenberg "Corporate Law, Social Norms and Belief Systems" 99 Columbia L.R. 1253, 1272 (1999).

³³ L.C.B. Gower Principles of Modern Company Law (1956); (4th ed 1979), and (6th. ed. 1997, ed. P.L.Davies)195-7.

³⁴ R. Tricker The Independent Director (1978); compare the absence of discussion on such directors in the useful work by K. Midgley, Companies and their Shareholders - the Uneasy Relationship (1975 ICOSA).

³⁵ *Pro Ned* 1981 had the patronage of the Bank of England and other dominant City institutions to promote non-executives and it issued a "Code" in 1987; see too Corporate Governance (Oxford Corporate

5.1 The institution is part of the structure of the new competitive era, when capital had achieved a new concentration and a new mobility but not escaped from the fear of falling profit, and when society had failed to settle the fundamental difficulties that had sprung from the so-called 'separation of ownership and control'.

The belief of Berle and Means, in part shared by Galbraith, that the new "self-perpetuating controllers", distanced from the owning stockholders, might act on behalf of social aims as "a purely neutral technocracy" in a "position of trusteeship"³⁶ were not realised. (The falling away of the advanced "fiduciary" concepts was in part represented in the rise to dominance of the Delaware courts in the making of corporate case law.)³⁷ Instead, the non-executive or "outside" director emerged into modern prominence, certainly in Britain, when the compensation accruing to the executives came to represent what American commentators have dubbed, in fashionable economic language, increased "rent extraction" rather than "optimal contracting".³⁸

5.2 The disappearance of the concept of the non-executive as a "golf buddy"³⁹ is contemporaneous with the disappearance of the view that all that was required was voluntary intervention by institutional investors.

This debate cannot be discussed in detail here. Suffice it to note that, more active attention by pension funds and other institutional investors may play a role, including a "dialogue" with the board.⁴⁰ But their image as new "democratic" controls by reason of the nature of the beneficiaries, or in America as institutions which ensure that the company "is being run for the benefit of the country's employees",⁴¹ has long been dispelled.

It may not be the "fault" of these institutions that they cannot solve the problem. But investigation of the relation between finance and industry, and the actual role of the institutions, shows that such visionary concepts do not reflect the realities of today's market or provide any real answer to the problems of corporate control.⁴² On the other hand, the place of institutional investors must be prominent in any solution to the proper role of non-executives. Authoritative scholars have considered the passivity of these funds, which is slightly less pronounced here than for their counterparts in the United States,⁴³ and suggested:

"Non-legal considerations, including fear that their activism may benefit their institutional rivals, inhibit their desire to participate in corporate governance".⁴⁴

If so, proposals for some institutional reform to promote new governance structures in which non-executive directors could more adequately play their role, as are made below, could only encourage and expand the extent to which such investors, with all their influence, could play their part in the development of leadership and trusteeship by persons adequately qualified to do so.

Policy Group 1984); and The Economist 30 December 1986 which revealed that in 100 large companies some 70 per cent of the non-executives (half of them over 60) then spent between 6 and 12 days a year at the job. The development was especially of interest to authoritative foreign observers: A. Tunc Le droit anglais des sociétés anonymes (3rd. ed 1987 Dalloz) 170-1. By 1997, they earned "le qualificatif de *guinea pigs*": ibid. (4th ed.) 151.

³⁶ A. Berle and G. Means The Modern Corporation and Private Property (1932, new ed. 1967) 116, 206, ; Herman op.cit., 11; J.K. Galbraith The New Industrial State (1967) Chaps. VII, VIII.

³⁷ W. Bratton "Berle and Means Reconsidered at the Century's End" Geo. W.U. Research Paper 111, now 26 Jo. of Corporate Law, 3 (2001).

³⁸ L. Bebchuk, J. Fried, D. Walker "Managerial Power and Rent Extraction in the Design of Executive Compensation" 69 Univ. of Chicago L.R. 7521-846.

³⁹ See Financial Times 27. 4. 2002.

⁴⁰ Combined Code of Best Practice, para E.2.

⁴¹ P. Drucker The Unseen Revolution (1976) 2-3.

⁴² See for example, R. Mimms Pension funds and British capitalism: The Ownership and Control of Shareholding (1980).

⁴³ An increased activism was apparent as the new millenium opened: M. Eisenberg "Corporate Law, Social Norms and Belief Systems" 99 Columbia L. R. 1253-1292 (1999) .Part V B.

⁴⁴ B. Black and J. Coffee jr. "Hail Britannia? Institutional Control Behavior Under Limited Regulation" 92 Mich. L.R. 1997-2087 (1994)

5.3 Of course, "ornamental" or "figurehead" directors were commonly found in and from the 19th century. The Marquess of Bute had been President of the family bank since he was six months old⁴⁵ and the 1950s saw in The Times the notorious advertisement for a "Titled person to add distinction to the board of a wine company". There is still evidence that British companies seek "a Lord on the board",⁴⁶ (or at any rate a retired political dignitary).

Lord Wakeham's 16 directorships and the range of other noble pluralists have initiated new interest in imposing a general limit on the number of directorships - executive perhaps as well as non-executive - which it is permissible for one person to hold.⁴⁷ As with all pluralists, noble and plebeian, their effectiveness may be questioned. Experience of them suggests that they are not that clever that they can attend to the affairs of so many companies adequately. The RNED agenda immediately includes the question whether some limit on numbers of directorships be imposed, at least upon non-executives.

5.4 It has been a misfortune that the formative period for the modern institution has occurred in the 1980s. Other surveys have noted the clusters of board room members concentrated in independent schools.⁴⁸ Distinguished economists note that: "The City of London was one place where informal cartels and selective class hiring were routine until the 'Big Bang' of the 1980s".⁴⁹

The misfortune is that there has not been time finally to shrug off, if indeed that is intended, the aura candidly described by the CBI chairman who advised in regard to non-executive candidates -

"the very first thing you do is talk to a mutual friend (and ask whether) he is the sort of person you could get on with"⁵⁰

- not the kind of relationship, it has been commented, "in which the non-executive is expected to be over assertive".⁵¹ Golfing or shooting partnership is not a good test of good non-executives. Nor were Ministers right in thinking there can be no limit to the number of board posts held, though whether "government" should impose it by law is for debate:

"I agree the existence of cross-directorships is concerning, particularly to shareholders. However, the issue is whether the Government should move in and try to establish how many directorships an individual should have... I am not aware of any legislation anywhere in the world with that extremely difficult, if not impossible aim."⁵²

Such legislation has indeed been passed in Ireland, though its qualifications make it of limited effect.⁵³ The idea that pluralist directors can do a proper job for each company has been rightly described by John Monks as "pie in the sky", even if one takes into account that experience gained on one board may be of use to another. Those who make the last point often forget that although interlocking directorships even of competing companies are not *per se* unlawful, use of corporate information on another board runs risks in the modern law of fiduciary duties to which current debate does not always advert.⁵⁴

⁴⁵ Marquis of Butes' Case: Re Cardiff Savings Bank [1892] 2 Ch. 100.

⁴⁶ See The Guardian, 28.2.2002; Financial Times, 13.8.2002; Labour Research July 1999. Some peers appear to have forgotten to register their directorships: K. Maguire, The Guardian 3.7.202. See too Financial Times, 13.8.2002.

⁴⁷ Such as Viscount Chandos (17), Lord Stevenson (of "People's Peers" fame, 9) or even Baroness O'Cathain (6, including British Airways). Lord Razzall's many directorships were explained as including many on group subsidiaries, an explanation which may overlook the duties of a director of a subsidiary.

⁴⁸ The Guardian, 11.6.2000

⁴⁹ Meghnad Desai Marx's Revenge: The Resurgence of Capitalism and the Death of Statist Socialism (2002) 203.

⁵⁰ Sir John Harvey Jones, Financial Times, 24.6.1988; cf.

⁵¹ J. E. Parkinson Corporate Power and Responsibility (1993 Clarendon) 193-4.

⁵² Lord Sainsbury of Turville, Parl. Deb. H.L. 12.2.2002, col 1003.

⁵³ Irish Companies (Amendment) Act (No. 2) 1999 s. 45.

⁵⁴ See the careful discussion in Gower's Modern Company Law (6th ed. ed. Davies 1997) 622-3; and see Mayson, French and Ryan Company Law (18th ed. 2002) 537-542, who point out that the director in

The RNED should propose that a limit on the number of directorships permissible for one individual be placed by law or other enforceable means, by a non-governmental independent body to render directors, and especially non-executives, effective in their role.

5.5 The new torrential pressure for non-executives, however, as an institution to bridge the gap between ownership and control, at least reputationally, has grown to such an unmanageable pitch that a flood of literature and institutions now demands the attention of RNED. This inquiry is necessary to examine what the Secretary of State has dubbed the limited "gene pool" available. "Any business with a £1 million turnover really should get a non-exec. director";⁵⁵ yet only some 392 directors, Labour Research and the TUC agree,⁵⁶ make up the remuneration committees of 98 of the largest companies - and many companies do not even have fully independent remuneration committees.⁵⁷

Apart from the well known work of Labour Research,⁵⁸ the RNED will have available to it such recent surveys among others as those by the Independent Director,⁵⁹ Incomes Data Services⁶⁰ the Pensions Investment Research Consultants Ltd. (PIRC)⁶¹ and the work of Monks Partnership.⁶² These research results are in urgent need of assessment, so that policy debates can begin from a consensual base.

5.6 Non-executives are in fact now the flavour of the global month. Even web sites with the equivalent of dating services and chat rooms offer to help in matching non-executives who advertise their vital details with the right companies. "We act as a sort of marriage broker", says one. "There is no right time to become a Non-Executive Director.... You might be in your middle to late thirties... You might be in your sixties and approaching retirement. The only right time is now."⁶³

To stress that the relationship is a serious one, this analogy is often used: "Now becoming a non-executive director is a bit like marriage".⁶⁴ We must return to this relationship in considering the problems said to exist in the legal duties of the non-executive.

Other activities have mushroomed. A sectoral association exists to represent the work of, lobby for and network among non-executives in IT companies and seek fees (it estimated amounts ranging from up to £30,000 in quoted, and to £23,500 in unquoted companies).⁶⁵ The global reach of the debate is underlined by the extraordinary range of current sources - from the

London & Mashonaland Ltd v New Mashonaland Exploration Co [1891] WN 165, was an inactive "Lord on the Board" figurehead.

⁵⁵ John Courtney, Strategy Consulting Ltd: www.strategy.nildram.co.uk/iodarticle (2002).

⁵⁶ See You Scratch My Back, TUC 1998.

⁵⁷ More than half: Financial Times 24. 6.2002, citing the Cooperative Insurance Society Survey of FTSE 100 companies.

⁵⁸ See inter alia January 2002.

⁵⁹ NOP, Ernst and Young and the Institute of Directors, June 2002; and MORI's "captains of industry" survey, February 2002. The Independent Director and the non-executives web site was launched by Ernst and Young and the IoD in 2000.

⁶⁰ December 2001 (by industry).

⁶¹ Especially "Annual Review of Corporate Governance Trends and Structures in the FTSE Index" (2001), and "The Combined Code: Compliance" (among FTSE Index); "Issues and Trends in Corporate Social Reporting" (1999).

⁶² Especially their Non-executive Director Practice and Fees (2001).

⁶³ The Non-Executive Directorship Exchange www.nedexchange.co.uk

⁶⁴ First Person Global 4.4.2002 "Overview: Becoming a Director" _

⁶⁵ Survey by ITNEA (sponsored by Harvey Baird Group) 1999, cited by First Person Global (Harvey Nash Group) 4.4.2002.

Malaysian Manufacturers Selangor Branch to bodies in South Africa⁶⁶ and even advice on relevant board games from Hong Kong!⁶⁷

In order to establish a firm base for future policy discussion, the RNED should draw together the main results of recent research work in Britain and publish an authoritative summary of the range, character, remuneration and functions of modern non-executives in various types of companies.

The Rent Extraction Problem

6.0 A further word on this vital issue is desirable. Confirmation that the new problems, especially of "rent extraction", have triggered a profound eruption of the need to promote the non-executive director as an institution designed to solve the problem lies in the fact that the seminal Cadbury Committee - an initiative of the private sector - in 1992 was, as its title showed, established to consider the financial aspects of corporate governance.

The Chairman came to understand that the main reason for "unexpected" interest in his deliberations was

"the continuing concern about standards of financial reporting and accountability, heightened by BCCI, Maxwell and the controversy over directors' pay, which has kept corporate governance in the public eye."⁶⁸ Greenbury knew it too:

"The purpose of the accompanying Code is to set out best practice in determining and accounting for Directors' remuneration."⁶⁹

Rent extraction in the new era of unbridled "competitiveness" and profit had exposed the unsolved tensions inherent in the divorce of ownership and control, where the power to displace interests of shareholders "present and future" revived the question: *quis custodiet ipsos custodes?*

6.1 A decade later, the evidence overall is even clearer. Executives, especially COEs, in the USA have extracted huge amounts through fees and share options, billions of dollars even from bankrupt companies, in what has been termed an "infection" of the system.⁷⁰ Robert Reich has said: "... they are acting like barons and robbing innocent people".⁷¹ In the United States, it is true, the sums involved have been astronomical. Executives and directors of corporations which went bankrupt since 2001 appeared to have got out with fortunes of \$33 billion dollars.⁷² But in Britain also the picture has become alarming in a society where relative poverty has increased severely. The reports by the TUC⁷³, Labour Research, PIRC Reports⁷⁴ ICGN, IDS and Monks Partnership surveys⁷⁵ have disclosed a shocking state of affairs in Britain too. There has been injected an increasing diversity in the median pay of directors and other employed persons, in which non-executives appear to have played a full part (not least in acquisition of share options), albeit some of them look for greater remuneration alongside their heavily

⁶⁶ Malaysian Manufacturers Federation 261 Report on Non-Executives and Executives in the Klang Valley www.selangor.fmm.org.my; Sunday Times Business Times www.btimes.co.za.

⁶⁷ G. Li & Co Ltd, "Architects of Governance", 2002 - www.216.239.39.100/gliandcompamny.com/EnglishWeb/Companynews/com; the Hong Kong Society of Accountants produced a report on corporate governance in 1996.

⁶⁸ Sir Adrian Cadbury, Preface to Report on Financial Aspects of Corporate Governance, 1992.

⁶⁹ Recommendations, Greenbury Report, on Directors' Remuneration 1995 para. 2.1.

⁷⁰ See International Corporate Government Network News, December 2001,3.

⁷¹ Financial Times 8. 6.2002.

⁷² Financial Times 1.8.2002, 31 July 2002, 16.4.2002.

⁷³ Executive Excess - Time to Act 2002 is the latest of the many other reports cited in it.

⁷⁴, See its latest annual review of Corporate Government Trends, showing a sharp upwards shift in directors' pay in FTSE 100 companies, of between 12 and 20 per cent.

⁷⁵ Including their survey on Non-Executive Directors Fees.

extracting executive colleagues. The process has not stopped during the Review period.⁷⁶ And the argument that international competition demands huge payments to directors has been authoritatively rejected as "Hooley".⁷⁷

6.2 Where shareholding is widely dispersed and institutional investors are not able or willing to act as a control mechanism, the need for an element on the board to act as a "trusteeship" control mechanism is clearer even than it was in 1992. Only the non-executive directors, it is now said, can play this role.

The insensitivities illustrated in the last decade have left a sense of burning injustice among employees and a black hole in the fabric of society sucking in the trust without which social partnership is ineffective. The call for directors to "share the pain" of failures with workpeople has been met with hollow laughter.⁷⁸ Since June 2001, one Archive contains 128 instances of such rent extraction.⁷⁹

The RNED must found its recommendations on a perspective that includes both shareholders, employees and the wider society. It should publish a clear account of the manner in which the separation of ownership and control in the new age of "competitiveness" for mobile capital has increased the income and wealth gap between company directors and other persons.

6.3. The design of remuneration packages has been influenced significantly by executive directors and CEOs, even where independent non-executives dominate remuneration committees. The leading surveys suggest that the number of such committee which observe the principle of non-executive control is not as large as companies claim, and the number of non-executives receiving share options themselves, especially in smaller companies, has risen.⁸⁰

The history of the Marconi scandal prompts similar inquiry. Lord Simpson's gains secured before the "wreckage" left by the mishandling of the company by him and Sir Roger Hurn required a rescue by creditor banks leaving shareholders with 0.5 per cent of the equity in the successor corporation,⁸¹ and employees grieving over loss of jobs in which they and their unions were relatively unprotected by British law,⁸² is a picture that manifestly speak to the need for more stringent "failure clauses" which remove the contractual right to golden rewards where directors have presided over a disaster of a Marconi dimension.⁸³ Ingenuity in drafting comparative performance clauses has already been shown in share option and other LTIPs.⁸⁴ But rigorous clauses should now be required by law as compulsory terms of directors' contracts.

The Marconi case illustrates how the waves of the rent-extraction issue spread out to involve all the stakeholders in the company, especially shareholders, employees and creditors. The Combined Code requires that all incentive schemes must be "subject to challenging performance

⁷⁶ See the £1.1 million extracted by the CEO of Royal and Sun Alliance after being ousted, Financial Times 13.9.2002: "he will leave the leave the company with more than £1.1 million while shareholders have lost nearly £10 billion during his tenure", Patience Wheatcroft, The Times 13.9.2002. On the United States, A.Hill "Rich bosses feel the squeeze" Financial Times 14. 9.2002.

⁷⁷ Mr A.R. Goobey, formerly of Hermes, chair of the ICGN committee on corporate governance, Financial Times 24. 6. 2002.

⁷⁸ By P.Hewitt, Secretary of State, at the TUC, 10.9.2001.

⁷⁹ The Guardian Archive, to 7 September 2002: www.guardian.co.uk/executivepay/archive.html

⁸⁰ Independent Director Survey 2002.

⁸¹ Financial Times 16, 27, 29. 8. 2002. On Lord Simpson's other directorships, see e.g. The Guardian 28. 1.2002.

⁸² In France, the employer would have been under a duty to institute a "social plan" to save jobs: Code du Travail Art. L. 321-4-1, in default of which the dismissals could be a nullity. For the weakness of protections on the transfers of enterprises by English tests of "constructive dismissal", see Rossiter v Pendragon plc. [2002] ICR 1063 CA.

⁸³ The Institute of Directors had not apparently heard of "failure clauses" until recently (Ruth Lea, BBC discussion Radio 4, 2.1.2001).

⁸⁴ P.L. Davies Introduction to Company Law op. cit. 208.

criteria reflecting the company's objectives".⁸⁵ This has not always been the practice as regular extraction of huge sums and options has accompanied corporate failure.

The terms of appointment of non-executive (and executive) directors in all companies should contain compulsory terms implied in the contract removing the right to payments, share options and other benefits on retirement or removal where the company has not met reasonable performance levels.

Main Issues: Functions and Independence

7.0 Major problems for the Review therefore revolve around the practical functions which can be ascribed to the non-executive and to the meaning and extent of their "independence". This is always said to be their main quality. Yet it is wrapped in confusion and mystery.

7.1. First, it is worth noting that one definition of a "non-executive" rests upon his (or - though less often - her) having no "contract" with the company.

The RNED will clearly need to use a working definition. But the "no contract" element is not, it is suggested, useful as a definition since it rests on the layman's assumption that someone who does not have a formal instrument or document cannot have a "contract". The non-executive director will usually have made an agreement which gives rise to some legal obligation. He will agree, perhaps by exchange of letters, certain features of the appointment with the company, through the board or the CEO, probably about attendance, or general features of the work and certainly about fees for it.

That is enough for a contractual relationship to arise and for an agreement in which statutory implied terms can operate, protecting shareholders and the public rather in the manner of the Consumer Protection Act. The RNED should propose a procedure for inserting suitable statutory clauses.

To define a non-executive by way of absence of a "contract" is to invite endless legal difficulties and defeat the object of the exercise. This of course is a separate point from the legal rule that anyone who intervenes sufficiently in the board to give "instructions or directions" may risk the status of "shadow director" whose contracts must be open to inspection,⁸⁶ or the legal rules about "interested" directors.⁸⁷

The non-executive" can be defined only by reference to not having "executive" functions on the board rather than through legal concepts of "contract". Statutory implied terms should be introduced whereby on failure of a company to come up to professionally described performance levels, the right to options and other benefits for directors would fall away.

7.2 As for the essential functions, an apparent and insufficiently investigated consensus contains important uncertainties and muddles, mainly concerned with the balance of "leadership" and "trusteeship" roles.

Trustees are risk averse. Business leaders must assess and take risks, albeit in a more scientific and transparent manner after the guidance of the Turnbull Report.⁸⁸ Both are needed on the board.

Both qualities, control and leadership functions, are part of those ascribed to the non-executives. They are expected to exercise specific functions on the audit, remuneration and appointment committees. But

"*All* directors should bring an independent judgment to bear on issues of strategy, performance, resources, including key appointments, and standards of conduct."⁸⁹

(The Combined Code adds that a board should be made up of executives and non-executives (not less than a third, and of suitable calibre).

⁸⁵ Combined Code Code of Best Practice Schedule A, para. 4.

⁸⁶ Companies act 1985, s.318, 741.

⁸⁷ See Gower's Modern Company Law, (6th ed.) cit. 610-641; Davies Introduction op.cit. 206.

⁸⁸ Internal Control: Guidance for Directors on the Combined Code, Institute of Chartered Accountants 1999.

⁸⁹ Combined Code, para. A.1.5, emphasis supplied.

Legally this general notion of independence comprises the principle - which nominee directors should particularly note - that directors must not "fetter their discretion" or obey orders from outside when they consider the "best interests of the company" (i.e. those of the shareholders on a long term view).⁹⁰

All that, of course, is encompassed in the role of directors generally. But there are clear indications that whereas all directors must show "independence" in that sense, only some non-executive directors are seen as "independent" by the Codes in the sense relevant to the RNED. Without a resolution of this semantic obscurity, the exercise is pointless.

7.3 The Combined Code requires that a "majority of non-executive directors should be independent of management" (para A.3.2, this is referred to below as "**basic independence**"). But it offers no definition of this quality. How far should this basic independence exclude golfing-buddy links with the CEO or chairmen (even if he is a non-executive), or common links on another board with other directors of the company (executive or other), or any other nexus with management whereby pressure or strong influence can be brought to bear on the non-executive? The Code adds that also ("and") they should be, secondly, "free from any business or other relationship which could materially interfere with the exercise of their independent judgment."

This freedom from other relationships we may call "**secondary independence**". A majority of the nomination committee (in listed companies) should be non-executives (who may or may not be "independent"); but on remuneration committees the sole members should be "executive directors who are independent of management and free from any interests" within the secondary test (Combined Code, paras. A. 5. 1, B.2.2).

All members of the audit committee should be non-executives, but only a majority need be "independent". Both aspects of independence will be vital for a non-executive who, in face of an overbearing CEO, may have to act as a "whistle blower".

The Hampel Report mistook secondary independence as a definition of basic independence (para 3.9) which it plainly is not.⁹¹ That error led it to go out of its way to insist that non-independent non-executives could also make a "useful contribution" to the board.

Cadbury said all non-executives should have basic "independence of judgement" (para 4.12) and that (only) the

"majority of non-executives on a board should be independent of the company" in regard to their business "or other" relationships. (para. 4.12).

The City Reports all agree that it is for the board to identify independent directors. It may be questioned whether this is sufficient to protect shareholders and the public interest.

The best that can be said about this picture is that it is a mess. If we are told that only 65 per cent of companies fulfilled the requirement that a majority of non-executives are independent,⁹² what precisely are the qualities that are being discussed?

There is an urgent need to clarify, what is meant by "independence" in its various contexts and whether or not all or only some non-executive directors need to be "independent" and in what sense. When do all or some non-executives on specific committees need to be "independent", in what sense and why?

7.4 In reality, too, businessmen do not confine themselves to the two basic categories of control ("trusteeship") and leadership ("strategy"). For example, there is often reference to the real work that can be done by a non-executive in "drumming up business" for the company among contacts. This qualification of being well-connected is a part of leadership that is not always in the observer's mind.⁹³

The need for business knowledge and experience is not the same as being on the network of good chaps.

The RNED must decide whether or not all NEDs should be "independent" and if so, what that basic quality means. It must also decide how secondary independence in terms of

⁹⁰ See the delicate discussion in Davies Introduction, op.cit. 168-170.

⁹¹ In a rare lapse, Davies Introduction, op.cit. 202, makes the same mistake.

⁹² PIRC survey, Financial Times 17.12.2001.

⁹³ "Mentoring the non-Executive Way" Institute of Directors, The Director quoted Strategy Consulting Ltd : www.strategy.nildram.co.uk/iodarticle.html

business and outside interests should be judged and propose a strict prohibition on these wherever necessary for the effectiveness of non-executive directors, especially on committees of the board. The definitions should be rigorous.

7.5 But the literature has long included profound critiques of the very concept of "independence" of outside directors.

Brudney's classic analysis doubted the extent of real independence in many American "outside" directors who came to make up the majority of most large American company's boards.⁹⁴ More recent accounts have tried to sweep aside the confusion attendant on muddled concepts of "independence", but have not found easy any fit with market analysis. As Langevoort says:

"The trend towards independence... has encountered an empirical sticking point. If independent boards are so self-evidently desirable, then we should see a fairly clear statistical correlation between measures of board independence and corporate profitability or stock performance. But a growing body of economics research has been unable to find any such connection."⁹⁵

Although his solutions have a primarily American relevance, he strikes a trans-Atlantic chord when he observes:

" Researchers concede that measurement problems plague empirical work in this area.

Independence is a highly subjective concept that connotes a willingness to bring a high degree of rigor and skeptical (sic) objectivity to the evaluation of corporate management and its plans and proposals. However these studies have to use rough proxies for independence: the simple absence of a job with the company, a close family connection or (perhaps) some regular stream of income from the company apart from directors' fees and dividends are all that it takes to qualify. Under these restrictive definitions, many directors who lack any real desire to take their monitoring role seriously - who are on the board for status-seeking, sociability or the perquisites that come from board membership - fall into the "independent" category, thereby muddying the water."⁹⁶

His own subjective definition is merely : "one who takes the monitoring task for the benefit of the shareholders and/or other constituencies seriously....That inevitably means that many formally independent directors will not be serious monitors at all, but simply status-seekers or friends of the CEO."

7.6 The RNED must make its own judgement on these subjective judgements. It cannot escape them. In doing so, it will inevitably be led to make judgements on other questions. One of these is the number of non-executive posts on various companies which it is reasonable for one person to hold and in what capacities where any elements of competition impinge, or where company groups are involved. Of course, this question is inherently linked to the wider issue of how many board seats it is reasonable for one person to hold in an executive capacity, and any judgement on the former must be linked to views on the latter, which should not be masked.

The RNED must express a view on the number of seats on a board which one person may reasonably hold, taking account of the character of the different companies involved.

7.7. Perhaps more directly useful, and quite well known in England, is the earlier American study by Gilson and Kraakman.⁹⁷ It depends less upon subjective definition than reference to the judgements of dominant, if dispersed shareholders and an attempt to reintegrate the institution of some shareholder control.

Their central proposals would harness shareholders (especially in our context especially institutional shareholders) and the independent non-executive directors. The latter should be exclusively non-executive in their capacities (restricted to about six companies), and constitute the great majority of boards. They foresaw that the institutions might form a "clearing house" (acting as a nominating agency) which would certify and nominate qualified non-executive

⁹⁴ V. Brudney "The Independent Director - Heavenly City or Potemkin Village" 95 Harv. L.R. 597-616 (1982). See too J Parkinson *Corporate Power and Responsibility* (1993) Ch. 6.

⁹⁵ "The Human Nature of Corporate Boards: Law, Norms and Unintended Consequences of Independence and Accountability" 89 Geo. L.J. 797-822, 799. Bhagat and Black had even suggested that "firms with supermajority independent boards perform *worse* than other firms": 54 Bus. Law. 921, 921-2 (1999). If this is a general phenomenon, the recommendation must be to exclude or reduce them !

⁹⁶ Citing Brudney's "classic lament", above n.94.

⁹⁷ "Reinventing the Outside Director: an Agenda for Institutional Investors" 43 Stanford Law Rev. 863-893 (1991).

directors on which the shareholders (especially the institutional shareholders) would vote. Although this idea would be objectionable to adherents of pure "market" theory⁹⁸(which results in a lack of independence and little monitoring control) it provides an answer to the problem "who will monitor the monitors" .

Institutional investors might be expected to take sufficient interest to refuse to re-elect non-executives who had proved manifestly inefficient. There would be a clear incentive for the non-executives to remain on the books of the "clearing house", which would be a requirement of their qualification. It is true that there would be a vital need for the qualification tests to see that the persons concerned had adequate business and technical skills and not become a "rubber stamp" for the CEO.⁹⁹ There is some merit in the judgement that "a truly independent board would not tolerate a suboptimal performance by management resulting in a share discount large enough to elicit a takeover".¹⁰⁰

7.8 In respect of these ideas , the new New York Stock Exchange rules, adopted in the wake of Enron and the Sarbanes-Oxley Act, are of interest.¹⁰¹ Under the new Rule 303A, listed companies must have a majority of independent directors. New tightening of the definition of "independent" director includes requirements that the board must affirmatively confirm that he has no "material" relationship with the company; that he has not been an employee of the company , or affiliated with an auditor or been part of interlocking directorates where an executive served on the compensation committee of another company, within the last five years. Directors with family members in any such category are also barred for five years. Non-management directors must meet regularly and appoint a lead independent director. The nominating, "compensation" and "corporate governance" committees must be composed wholly of independent directors. As a member of an "audit" committee a director must not receive fees other than directors' fees from the company; and that committee must have exclusive power over the appointment, firing and approval of links with the auditors. Various other functions of a similar kind are specified on auditing and "risk management", and a code of business ethics and conduct must be produced by the company. The NYSE is also to develop a Directors Institute.

7.9 These are, it is submitted, the broad lines along which the RNED should approach the problem of "independence". We may take for granted that the RNED will propose that all large company boards should include a large number, even a majority, of non-executives with appropriate qualities. The problem is, how to find them.

The RNED should propose that an institution be established, in general terms parallel to the Standards Board for accounting proposed in the White Paper¹⁰². It might be called the "Corporate Governance Standards Board" (CGSB). Among its functions would be seeking and keeping a list of persons who qualify under tests of independence and experience and relevant knowledge in respect of stakeholders' interests, both generally, and where requested in respect of particular companies or groups. It should have the function of establishing training schemes and raising public awareness of the functions of non-executives.

It could propose non-executive candidates for boards on whose election the shareholders would decide. Its annual reports would become the national assessment of gradual progress towards finding an answer in Britain to the problems of separation of ownership and control.

A Modern Institutional Answer.

⁹⁸ See for example F. Easterbrook and D. Fischel "Corporate Control Transactions" 91 Yale L.Jo. 698 (1982).

⁹⁹ See Brudney op. cit. above n. 94, 623-5.

¹⁰⁰ J.C. Coffee "Regulating the market for Corporate Control" 84 Columbia L.Rev. 1445,1203 (1984).

¹⁰¹ NYSE Rules, changes proposed 1 August 2002; adopted by SEC, 16 August 2002.

¹⁰² (Cm5553, 2002) paras. 5.7 -5.16.

8.0 It is crucial that any such CGSB should not be subject to government political control or the client of party or establishment "cronies". Its membership must come primarily from the range of stakeholder interests involved - including City institutions, institutional investors, banks, accountancy and management interests, employee organisations generally and trade unions representing workers and management, CBI, scholars with experience in the field, environmental interests, bodies concerned with equal opportunities and the like. Only such a development will increase the "gene pool" of non-executives.

Indeed, younger trainees may with the assistance of universities, trade unions and business schools, could provide stem cells to play new, flexible roles in a system in which social partnership will be critical. It is much more questionable whether bodies resistant to the whole approach, including it seems the Institute of Directors or British Chambers of Commerce, should be invited to participate as members rather than put their views in the conventional way. It is no good pretending that the issue of non-executive directors involves no "ideological" - as opposed to political - issues. That kind of fudge is an excuse for serious thinking on the subject.

8.1. Less obvious is whether the body and its functions and basic rules should be established by any form of regulation. One thing that is clear is that "purely voluntary" action has failed to meet the new problems described above. Nor does it seem logical to apply "comply or explain" techniques of the Combined Code only to listed companies as at present¹⁰³ and even less sensible to apply them to UK-incorporated companies.

As the City has noted with attention, Sarbanes-Oxley will apply to many foreign companies operating in the United States; there is no reason in a globalised world to discriminate in respect of origin of incorporation. It may be that the new régime should apply compulsorily, primarily to quoted companies, and that "comply or explain" techniques should be used in the first instance to bring up the rear of other large companies. New Regulations now require the directors, on pain of criminal sanctions, to produce a remuneration report (with extensive disclosure), and have it voted on by an "advisory" resolution by the shareholders. It is noteworthy that they apply to all quoted companies - and that includes quotation in Britain, the EEA States and the New York or Nasdaq exchanges.¹⁰⁴

Although City practitioners have with conventional alacrity judged the Regulations "onerous" with "some nasty surprises" - and said the "shareholder approval requirement will be unwelcome to many companies"¹⁰⁵ - it is difficult to see how they could be effective except as mandatory legal requirements covering that sort of range of companies. So too, in the requirements for non-executives - though the extent to which American quotation qualifies might need adjustment.

8.2 It is really not easy to understand why such a modest degree of regulation would be unwelcome on this matter affecting the public interest.

The "independence" of a trade union is defined in legislation; the Certification Officer's certificate is conclusive on the matter (subject to appeal) and lack of the quality has important disadvantages.¹⁰⁶ It is right that in the interests of patients and public that it is a criminal offence to practise as an "osteopath" without meeting the requirements for registration on the register, set by the wide range of persons on the Osteopathic Council.¹⁰⁷ The refusal of business practitioners to bow to the need for some similar regulation to protect the health of companies, investors and the public gives people at large the impression of arrogance and special pleading.

8.3 It has been suggested that the benefits of regulation have been superior in the context of the legal culture found in Anglo-American market systems than in the "cosy club" capitalism of civil law countries on the Continent. This effect of legal culture - plus it may be of particular forms of

¹⁰³ Listing Rules R.12.43A.

¹⁰⁴ Directors' Remuneration Report Regulations 2002, SI 1986, reg. 10.(11).

¹⁰⁵ Freshfields Bruckhaus Deringer The Directors Remuneration Report Regulations 2002, July 2002.

¹⁰⁶ Trade Union and Labour Relations (Consolidation) Act 1992, ss. 5 - 8.

¹⁰⁷ Osteopaths Act 1993, s. 32.

capital concentration - has been marked before.¹⁰⁸ But this analysis is also somewhat puzzling when it is also found that the former are "trumped" by the Scandinavian civil law systems.¹⁰⁹ The effect of social and "soft" norms is important. Of course the RNEC has to work within such social norms that exist in Britain now. But it may be suggested to it that in so far as such norms and law can have an effect on the outcome of protection, the support that could be given by a new set of basic regulations in this area could do good and assist in a more responsible approach generally in companies towards protection. By no means all managers and CEOs are lacking in a conscience that pays attention to the wider society, and a lead by those they respect would be of great psychological help.

8.4 If adequate corporate governance requires a majority of independent non-executives on company boards, it is difficult to see any reason why that basic requirement should not be enshrined in legislation or other regulative provision. The precedent of unqualified medical practitioners being prevented by law from causing harm to the public or non-independent trade unions being legally restricted in their ability to cause damage to workers and industrial relations, is a proper analogy. Such laws are invariably administered by specialist officers or bodies incorporating experience in the field involved. So here.

The White Paper of 2002 explains that the Combined Code was not put into legislation because of the need for "flexibility", the severe "definitional" problems in the field, and the fact that "shareholder control was a more appropriate mechanism".¹¹⁰ In the light of the above discussion, it is suggested that none of these rather fluffy reasons is now valid to sustain rejection of all regulation to introduce compulsory observance of the basic rules of a new system to make non-executive directors effective as part of the answer to the problems of division of control and ownership. Nor can the fact that the Code has "broad business and City support", be sufficient reason for sustaining its "voluntary-comply-or-explain" status when it has, despite strenuous effort, failed to prevent the crisis of rent extraction from erupting into an urgent need to institutionalise and strengthen the non-executive director.

8.5 The fact is that an anti-regulation culture based on hostility to binding rules that cramp profits, has come to permeate companies both in Britain and in other parts of the world, against which non-executives would do well to lean.

Every day brings illustrations - from the Japanese meat packing company which - with many other companies - mislabelled meat in the mad cow disease crisis to retain local government subsidies, to mobile phone companies in Britain whose fines increased five times for a series of offences - with many other companies - for text message "spams" and continued exploitative invitations to teenagers in "text flirt" invitations.¹¹¹ The protection of children against harmful corporate practices is, it will be suggested below, one matter that should be on the agenda of the CGSB. Proposals for regulation cannot simply be swept aside as imposition of "red tape" by those responsible for the ills.

The CGSB should be set up by statute or, preferably, by Royal Charter, which is not under political control. It should include representatives from a wide range of interests and with functions ranging from registration of qualified non-executives to training and development.

¹⁰⁸ R. La Porta, F.Lopez-de-Silanes, A Schleifer "Corporate Ownership Round the World" 54 Jo. Fin. 471.

¹⁰⁹ See the fascinating review by J.C. Coffee Jr. "Do Norms Matter? : A Cross-Country Examination of Private Benefits of Control", Columbia Law School, Center for Law and Economic Studies, Paper 183, January 2000: "Norms may matter most when law is weakest. When formal law does not adequately protect shareholders, the strength of social norms becomes more important, because they could provide a functional substitute for law. Conversely, when legal rights and remedies adequately protect investors, there is less need for corporations to signal their intentions to observe standards that are already legally mandated or to develop creative means by which to bond those promises through self-help corporate governance measures. This may explain why corporate governance measures have seldom been found to affect the corporation's stock price in the U.S., but apparently do have such an impact in Russia." Also see Eisenberg, above, n. 43.

¹¹⁰ Modernising Company Law cit. para. 3.28., and see 3.30.

¹¹¹ Financial Times 28.8.2002, 30. 8.2002. Similar examples can be found quite regularly.

Basic definitions and principles should be established by regulations, and apply to all quoted companies in respect of basic principles, expecting other large companies to "comply or explain".

The broad principles meeting the need to enshrine a suitable place for non-executives on boards should be established on a legislative base.

The Board as a Cohesive Unity : The Whingeing Defence and Duties.

9.0 There has grown up a school of thought among opponents of action on corporate governance and non-executive directors a defence in the nature of a whinge about onerous or expanding duties which could ruin them and threats of which would prevent recruitment.

Usually these voices appear to be noticeably ill informed about the true state of the law. And the much-quoted fact that Equitable Life has commenced legal unfinished proceedings against directors some of whom are non-executives hardly justifies the misguided assessment of legal risk which is often advanced. Nor does it buttress the argument for lowering duties of directors. The pressure appears to point in the direction of reducing the duty of non-executive directors to something like the "business judgment" adopted by many United States jurisdictions, a step which would require them merely to go through a mantra of necessary procedures and which would be disastrous for their monitoring functions.

Now it is sometimes argued that non-executive directors are being subjected to "growing duties"; that lack of insurance cover or indemnity under statute threatens them; and that there are "growing legal risks".¹¹² All of this is based on misunderstanding - indeed, the Companies Act 1989 even clarified the right of a company to insure a director against breach of duty or negligence.¹¹³

9.1 First, there is no strong case for dividing the legal duties of the board of directors in order to reduce the duties of the non-executives. It is not merely that it would be impossible to create a workable category of special non-executives, given all the problems of definition, to which some lower duty would apply. (It is unhappily a common response from the modern corporation and its controllers in the face of scandalous damage to others, that their duties and liability for such misdeeds should be reduced !)¹¹⁴

More important, the great merit of the unitary board system is that it must operate as a cohesive and teamwork body, with all directors sharing the same categories of legal duty, from the duty to act on the "best interests" of the company, within the constitution, with due care and in accordance with the fiduciary duties the law has adapted from the original "trusteeship" status and its statutory clarifications. The rules banning indemnity arrangements or the ban on loans and control of conflict of interest and filching of corporate opportunities must remain common to all directors. Division of the directors into separate categories of duty would, from a very practical point of view, crack the board apart.

The duties of directors on the unitary board of directors should fundamentally remain common.

9.2 Duties of Directors. Care, however, must be taken in application of this fundamental concept. The non-executive is not subject to unreasonable legal standards of duty. As a member of the board, he is, and should remain, subject to the standard duties of a director. But it has been inadequately understood that the vexed issue of directors' duties of "skill, care and diligence" do allow for flexibility. It is often said that whereas the law imposes an objective duty on accountants or doctors to measure up to the standard of care of the "reasonable accountant or doctor", and the ordinary person to meet the level of the "man on the Clapham omnibus", no such rule applies to the director. There is no reasonable director in the Clapham taxi cab. This is only partly true. First, it has been pointed out above that the existence of a contract between company and director (including the non-executive) can on traditional principle make a

¹¹² H. Stevenson, Financial Times, 4.9.2002.

¹¹³ Now Companies Act 1985, as amended s.310 (3).

¹¹⁴ As with reaction to the "time bomb" of asbestos dangers in which thousands of workers have died and suffered injury: Financial Times 9. 9.2002. The alternative plea is to blame the lawyers for their part in enforcing standards.

difference so as to import an objective, implied standard of reasonableness appropriate to the tasks undertaken by him. This is elementary law. The necessary adjustments in the standard of diligence and care required of a non-executive can be satisfied on an individual level by careful attunement of the contractual position. This, as well as a general movement with the times, would allow few non-executives to ignore the affairs of the company in the manner of the Marquis of Bute,¹¹⁵ even though any director may always of course delegate in a proper manner.

9.3 Secondly, while it is true that every director is judged by a subjective standard of skill and care of what "may reasonably be expected from a person of *his* knowledge and experience" (not that of the director in the Clapham taxi cab),¹¹⁶ the standard of care applied has always then been "measured by the care an ordinary man might be expected to take in the same circumstances".¹¹⁷ There was always an objective floor to the subjective test. The Law Commission rightly concluded that this objective/subjective standard "represents the law and would be followed by the higher courts".¹¹⁸

9.4 It is not the case that the judges have overtaken this common law position by reason of the standards inherent in the Company Directors Disqualification Act of 1986 ss. 6 & 8 (to judge whether a person is "unfit" to be a director) and s. 214 Insolvency Act 1986, where a more objective standard of care and diligence appears to be required - though in the latter it is restricted to the knowledge and experience reasonably expected of a person carrying on the same *functions* as those undertaken by that director.

Under these tests, the non-executive is now required under the Disqualification Act to keep himself informed of the company's affairs sufficiently to check within his functions whether all is in order.¹¹⁹ Even so, however, a director (aged 19 and staying abroad) who played no part in management was exculpated from misfeasance where his executive co-director (his father) to whom he had left the conduct of affairs was guilty of recklessness in losing uninsured property.¹²⁰ The statement proposed for Directors Duties in the Government's draft Bill is parallel to the common law tests.¹²¹ It does not appear that the CLR necessarily intended to propose change in this position.¹²²

The board must remain a cohesive unitary board on which all directors start from the same legal duties.

Their contracts must be considered in judging the standard of care required of them and this provides flexibility in the standard sought for non-executives; but the legal duty of care has not been raised in the courts and does not represent a new threat to the non-executive director.

One tier/two tier Boards.

10.0. It has been suggested that to introduce a majority of non-executive directors on to the unitary board with strong functions of monitoring is to begin a move in the direction of the "two tier" board. It is suggested that this analysis is incorrect and unhelpful.

¹¹⁵ Above n. 45 ; also the "country gentleman" in Re Denham (1883) 25 Ch D. 752.

¹¹⁶ Romer J. Re City Equitable Fire Insurance Co Ltd [1925] Ch 407, 428 (emphasis supplied) ,

¹¹⁷ Neville J. Re Brazilian Rubber Plantations & Estates Ltd. [1911] 1 Ch 425,437; see too Lord Hoffmann (1997) 18 Coy. Law. 194.

¹¹⁸ Company Directors: Regulating Conflicts of Interest and Formulating a Statement of Duties (Paper 153, 1998) para 13.19, see too paras. 5.15-20.

¹¹⁹ Re Westmid Packing Services Ltd. [1998] 2 All, E.R.124 CA.

¹²⁰ Re Simmon Box (Diamonds) Ltd, Cohen v Selby [2000] 1 BLC 176 CA. Cf. Sec. of State for Trade v Creegan unreported 27. 11. 2001 CA.

¹²¹ White Paper cit. Vol II Draft Clauses Schedule 2, para. 4 , duty to display (a) "knowledge, skill and experience which would reasonably be expected of a director *in his position*; and (b) any additional knowledge, skill and experience which he has" (italics supplied).

¹²² Final Report (2001) 346, 353. Apparently *contra* Davies Introduction cit. 156, though he seems to rely on the position de lege ferenda in the common law.

Two tier boards are found in Germany, Austria and the Netherlands. The more complex monitoring options of Danish company law have been called a "one and a half tier" system. (All these arrangements are of course the basis there of employee representation on a supervisory Board or Council.) The Supervisory Board is a separate institution, and in Germany the membership of it and the Management Board do not overlap. The invention of the two tier German system in 1860 for commercial reasons, occurred in a context quite different from the present debate; and the conversion of it in post-war times was part of co-determination that owed as much to the system of works councils. Commentary has long questioned, in any case, the effectiveness of real participation for worker directors through the mechanism of the modern German Supervisory Board.¹²³

Other Continental company laws provide mechanisms going some way towards a monitoring structure with one tier boards. Both French and Italian law limitations are placed on the pursuit of "shareholder value" by concepts of *"intérêt social"* and *interesse sociale*, just as in Germany an overarching concept of *Unternehmensinteresse* is found.¹²⁴ The supervisory board of auditors (*collegio sindacale*) is in Italy an organ of the company.¹²⁵ In France two-tier boards are optional but not common; the position of *Président* and *directeur général* (CEO) have been traditionally statutorily linked together in the same person; but after the two *Viénot* Reports in 1995 and 1999, change has begun; more independent directors have been favoured with monitoring functions. In the one tier board in Sweden, we find a small representation of employee directors with informational and monitoring functions, elected through trade union works council machinery.¹²⁶

The complex picture of European company boards shows that various systems accommodate the monitoring function of independent and stakeholder (especially employee) directors in a variety of ways, including one-tier unitary boards.

10.1 In the British system, because of the high "contractual" element in the system, almost any arrangement is possible, from informal "management boards" created for executives to sit separately to nuclear boards in which exceptionally the CEO is, against the advice of the Combined Code, the same person even now as the chairman. One advantage found in the unitary board where it has adequate and effective independent non-executives includes the inside position of the monitors for the purpose of finding out facts and their right to information.¹²⁷

There is no need for or advantage in a debate on a new system of formal two-tier boards. Nor is a two tier structure needed for non-executives to be effective. The cohesive unitary board remains the best pattern for British company law.

Stakeholders : Creditors: Employees

11.0 The RNED must not fail to investigate other fudges which often accompany the semantics of the debate. For example, the notion is understandably advanced that non-executives should be of suitable "calibre" and from "varying backgrounds, qualifications and experience", with some form of "training or external training".¹²⁸ But what does this mean?

The more the legal confines of directors' duties are traced along the borders exclusively of "shareholders' interests and value" (long and short term; even on an "enlightened" view) - as we note below in respect of the new Statement of Duties - the more the question arises how far, and in what way the non-executives can make a contribution in ensuring that interests of other stakeholders, not included in the legal prescriptions, are not forgotten.

¹²³ See P.L. Davies "Employee Participation on Company Boards and Participation in Corporate Planning" (1975) 38 MLR 254-273.

¹²⁴ See e. g. G. Teubner "Company Interest: The Public Interest of the Enterprise", R. Rogowski and T. Wilthagen (eds) *Reflexive Labour Law* (1994).

¹²⁵ Civil Code art. 2397. See generally Wedderburn "*Companies and Employees*" Chap. 2, *Labour Law and Freedom* (1995) 90-95; R. Drury and P. Xuereb *European Company Laws: A Comparative Approach* (1991) 31-38, 145-191.

¹²⁶ A. Viktorin *Employee Participation on Company Boards: The Swedish Experience* (Stockholm, OECD, 2000).

¹²⁷ CLR *Developing the Framework* (2000) para. 3.152; *Financial Times* 10.10.2000.

¹²⁸ Cadbury Report, para. 4.19.

11.1. Creditors and Employees There are two groups which stand out in this context. Both the creditors (especially secured or other long-term creditors) and the employees of the company, have in reality an internal rather than an external relationship with it, unlike suppliers or customers of goods or services. They are not casual or other suppliers of goods or services from outside.¹²⁹ There is still a distinction between the employee and other "subordinated" worker and the independent contractor. Even when outsourcing has reached a peak or gearing is low, loan capital and labour (by hand or brain) are still at the core of the activities of the business company.

11.2 Creditors The law has come to recognise the special place of such creditors. For example, the very construction of the "floating charge" created by the genius of equity lawyers spoke to the creditors' inherent importance. Under the Insolvency Act 1986, directors are placed under a duty of care to creditors when insolvency strikes. (The CLR wished to make that explicit in the Statement of Directors Duties draft Bill Schedule 2) and to advance and strengthen that duty; but the White Paper trembled at such a prospect, thinking it "unhelpful" to "conflate" company and insolvency law and - with more justification - felt the advancement of the duty might run counter to the "rescue culture".¹³⁰

But the law recognises that in, or possibly even before, insolvency, duties are owed to the creditors,¹³¹ and the judges have been as quick as the legislator to recognise the reality of that situation.¹³²

11.3 Employees. The position of the employees in company law, is quite different. Even American scholarship has recognised that employees

"may have made a much greater investment in the enterprise by their years of service, may have much less ability to withdraw, and may have a much greater stake in the future of the enterprise than many of the stockholders".¹³³

In Britain, received conventional wisdom believes in "partnership" between the company and its workers. Indeed, in 1980 the Companies Act did introduce (in what became s.309 of the 1985 Act) an obligation on directors to consider the *interests* of the company's employees "as well as" the interests of its shareholders.¹³⁴

That duty suffered numerous defects. Its meaning was uncertain; other sections of company law suggested that the shareholders' interests were still dominant (e.g. s. 719 Companies act 1985); and there was no effective way for employees to enforce this apparent duty in the light of the Rule in Foss v Harbottle.¹³⁵ Whatever its effect, that provision did recognise the *interests* of employees in company law, but it will, on the recommendation of the CLR, be abolished in the forthcoming Companies Bill.

In its place the statement of directors' duties will introduce, as a rider to the duty to

"act in the way he decides, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole"

the duty to take account of "material factors", so far as a person of care and skill would consider them relevant, including -

- the company's needs to foster its business relationships, including those with its employees and suppliers and the customers for its products or services; (and)

¹²⁹ It is true of course that in some large and multinational enterprises an integrated market is sometimes found on an "internal" basis with suppliers; but existing arrangements on competition are intended to deal with any abuse in that respect.

¹³⁰ Modernising Company Law, cit. paras 3.8 - 3.14.

¹³¹ Official Receiver v Stern (No 2) [2000] BCLC 119 CA.

¹³² West Mercia Safetywear Ltd v Dodds [1988] BCLC 250; see the authorities cited by Mayson, French and Ryan, op.cit., 504-505.

¹³³ Clyde Summers "Codetermination in the United States" 4 Jo. Comp. Corp. Law and Sec. Reg. (1982) 155,170; of course, since the Berle-Doddexchanges of 1932 on corporate governance, American law has known little of the European dimension to "industrial democracy" or debate on German codetermination.

¹³⁴ On what follows, see Wedderburn "Employees, Partnership and Company Law" (2002) I. L.J. 99-111, where the curious history of the provision is set out. Cf. C. Villiers "Section 309 of the Companies act 1985" in H. Collins, P. Davies, R. Rideout Legal Regulation of the Employment Relation (2000) 593-601.

¹³⁵ See further Wedderburn op.cit. 105-108.

- its need to have regard to the impact of its operations on the communities affected and on the environment¹³⁶

11.4 This development replaces the legal concept that the *interests* of employees need to be considered with the different notion that there is a duty to consider the *relationship* between company and employees, just like the relationship with other suppliers. The suppliers of labour are equated in law to suppliers of other commodities. That, of course, runs counter to the basic principle of ILO Conventions that "labour is not a commodity". But it is just that treatment of labour as a commodity that underlies the tensions running counter to so much modern wisdom in industrial relations and the new approach in company law. The exclusion of employees' *interests* from legal consideration, although not shared in practice by all businessmen with experience of the Continental approach,¹³⁷ runs counter to the guidance that what is needed above all is an injection of mutual "trust" in the corporate enterprise at a time when staff - especially highly qualified staff - have become relatively unshackled by the market.¹³⁸ The unemployed would be even less encouraged by the new approach, unless they receive special attention by virtue of the company's social responsibilities, mentioned below. Anger over reduced pension prospects, on which insensitivity in some boardrooms has been noticeable, is not confined to workers in Britain who are now even prepared to initiate strikes over the issue. Even the "business unionists" of the United States have begun to see pensions as a primary issue.¹³⁹ The Government has confirmed that the same approach is dominant in current policies in the Enterprise Bill which puts "competitiveness" in place as the sole test to govern mergers whatever the employment consequences.¹⁴⁰ Under this approach, in general terms the interests of employees, like consumers, are to be safeguarded only by legislation which treats them as external to institutions of the enterprise, as in redundancy, discrimination or even safety at work.

11.5 With the removal of a legal provision compelling boards to have in mind the *interests* as such of employees - which may well be impracticable in present circumstances given Government policies - so that they are left as a secondary adjunct subordinate to the advancement of shareholders interests and "success of the company", it is difficult to contend that their interests should not be of particular interest to non-executive directors. This is not to argue for a "pluralist" approach to legal duties, which the CLR understandably rejected. It is to say that all the arguments promoting the "partnership" approach to industrial relations lend credence to giving employees interests, which are not like creditors' interests specially protected by law, an express place in the recommendations of the RNED. In the real world, company law and practice do not live frozen in a world free from the living problems of the company's employees.

11.6 In practice, what does this mean? If it is to mean anything, there are some obvious specific points of contact with the argument so far.

¹³⁶ Draft Companies Bill, White Paper Vol. II, General Principles by which Directors are Bound, Schedule 2, para. 2, Notes (1)(2).

¹³⁷ See for example, Lord Alexander of Weedon: "...as a Director of Total, or Total Elf as it is now becoming ... I am much more impressed by the concept of worker participation than are others who practise the rubric of Anglo-Saxon capitalism under the simple words "shareholder value". I think there is much in what Lionel Jospin just said recently along the lines: we want a market economy but not a market hegemony. And somewhere I think we have to make certain that in our great corporations we do balance the interests of those who may exist", Lord Alexander of Weedon, Conclusions Company Law as a tool for companies in the Europe of the 21st Century (Exeter, Centre de Recherche sur le Droit des Affaires Conference, 6.12.1999).

¹³⁸ P. Adler "Market, Hierarchy and Trust" Organisation Science, Mar. - April, 2001; R. Rajan & I. Zingales "The Management of the New Enterprise", X. Vives (ed) Corporate Governance (2001 CUP).

¹³⁹ Financial Times 8.6.2002: ranking above "greedy CEO" as an issue.

¹⁴⁰ Lord Sainsbury of Turville "However, we need to say that the OFT will, of course, assess all mergers against the tests set out in the legislation. This is primarily about whether the merger may be expected to result in a substantial lessening of competition. The views of employee representatives will be helpful where they relate to the specific criteria set out in the legislation. However, specific employment issues will not factor in the OFT's decision in whether to refer the merger." Parl Deb. H.L. 18 Jul 2002 : Col. 1460-1.

- The CGSB must have among its members persons experienced in the problems of industrial relations, employment issues and trade unions. The qualifications for non-executive directors should include such issues, and persons promoted as candidates for such posts must include those with a capacity to understand and represent team work and the interests of employees.
- Persons promoted as candidates for nomination to boards, should include expressly such persons as members of nomination and remuneration committees. Without membership of such committees the presence of such non-executives could easily be marginalised and half the point of the exercise lost.
- The CGSB should arrange training and programmes for non-executives, including meetings with representatives of employees of companies.

11.7 Indeed, it must be for serious consideration that representatives of the workforce in a company or corporate group should be included within the members of nomination and remuneration committees. Such a move would be a more flexible and less cumbersome way of promoting the European Union Directive on Information and Consultation which is to come fully into force within the next decade.

This is particularly the case if the Government is serious in its aim to relate the widening of the "gene pool" of independent directors to productivity. It might be better if the CGSB proposed such persons to the company's shareholders than if they were directly elected to the board, a method which might muddy the new mechanisms that will be necessary under the Information and Consultation Directive.

But there can be no doubt that representation of this kind will be necessary if the Directive is ultimately to be implemented in a meaningful way, to make sense of consultation on rent extraction by CEOs and executives. A mere audit of the company's "people policies" would be inadequate.¹⁴¹ an obligation to "comply or explain" might be sufficient if companies were prepared to co-operate in the venture.

This proposal is emphatically not an attempt to create what was once jokingly called a "Trojan Bullock". No doubt those who were always opposed to the formal recognition of employee interests, including many who have figured in rent extraction of the last decade, will join in such debating points. But if the RNED is serious, it cannot escape the fact that were no recommendations to be made concerning specific functions of non-executive directors in regard to employees' interests, the Report will be understandably regarded by workers and their organisations in the light of recent events in the corporate world as a whitewash painted over the cracks in the structure. That would be a mistake and a pity.

The RNED should recommend that the CGSB must include members with special experience and expertise in employment relations and on employees' interests. Employees' interests, unlike those of creditors, will under the next Companies Act no longer have a specific status in the law defining directors' duties. Their place as stakeholders in the enterprise must be specifically represented in the new arrangements for non-executives. The CGSB should ensure that representatives of employees become members of nomination and remuneration committees. This could be one of the most encouraging and courageous initiatives to come out of the RNED.

Corporate Social Obligations.

12.0 Among the matters which the new General Principles of Directors' Duties require directors to consider is :

the impact of [the company's] operations on the communities affected and on the environment ..¹⁴²

The RNED would run counter to the long debate on "corporate social responsibility" if it ignored the environmental and other issues under this heading. Detailed treatment of the issue would not be appropriate here.¹⁴³ But the decision by the British Association of Insurers for adherence to "tough new guidelines" of corporate social responsibility indicates that this is not merely an issue

¹⁴¹ As proposed by J. Charkham Financial Times 21.1.2002.

¹⁴² Modernising Company Law Vol. II - Draft clauses, Schedule 2 para. 2, Notes (2)(b).

¹⁴³ For a review see Wedderburn "The Social Responsibility of Companies" (1985) 15 Melbourne Univ L. Rev. 4.

of importance to "green" enthusiasts.¹⁴⁴ European Union support for such programmes is long-standing.¹⁴⁵

Organisations such as Business in the Community and Greenpeace whose work in the area is renowned¹⁴⁶ should be represented on the CGSB to ensure compliance by company boards, especially companies where the need is strong, as with oil companies, to boost their existing efforts and where more advanced executives begin to show an albeit somewhat defensive interest.¹⁴⁷ Even Starbucks and Macdonalds appoint officers with such functions.¹⁴⁸ The British Government has (in rather more vague terms) given its backing.¹⁴⁹ Yet companies that affirm their strong support of such responsibility sometimes cause disquiet in other ways; Serco is a case in point.¹⁵⁰

12.1 One particular aspect of international business which has caused concern is that of corruption, bribery and "facilitation payments". The Government is concerned to reduce these practices, including their links with terrorism¹⁵¹; but it is perhaps (given the range of standard practices found in parts of the world) more important for business organisations to move against such cultures.

The CBI has suggested that new laws against such bribery and inducements in business may, if it attaches to all small payments, put "British multinationals" at a disadvantage.¹⁵²

More important is the institution within the boardroom of a culture of hostility to payments of this character and a willingness to act abroad, as the DTI has put it, "as they would at home". This would require special attention from the CGSB.

Environmental and other issues of social responsibility require that the CGSB includes members with special interest in that field, and that company boards are encouraged to elect non-executives with experience and knowledge in the field relevant to the company's operations. It should make an input into prevention of corruption in business world-wide.

Discrimination.

13. Three aspects of discrimination deserve special attention. The case for special attention is obvious and may be stated briefly.

(a) Gender If there is one fact that emerges clearly from the various surveys on non-executive directors (indeed, of directors overall) it is the gender gap. There is only a small number of women on company boards compared with the number in senior executive posts in the public sector. This phenomenon indicates that bodies such as the Equal Opportunities Commission and other organisations especially concerned with discrimination, should have a direct input to the work of the CGSB.

(b) Ethnicity The great majority of directors are not only male; they are white. This is understandable given the history of business development, but it is not a state of affairs which will be tolerated for ever. In order to "expand the gene pool" in a manner which serves society's

¹⁴⁴ Financial Times 24.10.2001; cf. D.Varney Financial Times a 15. 1. 2002.

¹⁴⁵ See for example the Commission's "Promoting a European Framework for Corporate Social Responsibility" 18.7.2001, which includes safety at work and "social planning" for other employee interests, within the subject.

¹⁴⁶ See too the critical Report "UK Democracy plc" by Friends of the Earth, December 2001,

¹⁴⁷ See the lecture by Sir John Browne, Group Chief Executive, BP, "Governance and Responsibility - the Relationship between Companies and NGOs" Judge Institute of Management Studies Cambridge, 29.3.2001.

¹⁴⁸ Starbucks Deputy President for Corporate Responsibility resigned in 2002 for personal reasons: in 2002: Seattle Post-Intelligencer 11. 9. 2002.

¹⁴⁹ Developing Corporate Social Responsibility in the UK (2002 DTI).

¹⁵⁰ Financial Times 6. 9. 2002: concern over accounting records.

¹⁵¹ See P. Alldridge, "The Law Relating to Free Lunches" (2002) 23 Coy. Law, 264-273, and sources cited, criticising the recent approach of legislation: "the cases of corruption that prevent the proper functioning of a legitimate market can best be regarded as frauds on those specific markets...".

¹⁵² Financial Times 29. 1. 2002.

needs, the CGSB will need input from bodies concerned with ethnic minorities in business in Britain. The alleged "closed shop" surrounding boardrooms is illustrated in its most significant manner in these issues of gender and ethnic disadvantage. The development of predominantly "Asian" boards in ghetto groups of companies is no answer.

(c) Children. This is a constituency with different needs. The work of the ILO and other international agencies ¹⁵³ has shown that some organisations and networks use child labour in ways that are astonishing in the modern world. The reports of "slave ships" full of children sent to work are only the extreme tip of this iceberg of exploitation.¹⁵⁴

It is not suggested that British companies have a particularly bad record in this matter, only that this is an issue on which special care is required. Child labour is not wholly absent from Europe, but its worst excesses have appeared in India, South Africa, Kenya, Latin America, and many parts of Asia. British companies have close links with organisations in these countries, and there is a need to ensure that boards are cognisant of the risks they run in supporting trade based on exploitative child labour practices, and the need for social and "labelling" schemes to alleviate the lot of millions of child labourers.

The RNED is urged to pay special attention to the place of the CGSB and companies in respect of discrimination, especially issues of gender and ethnic origins in so far as they demand the attention of non-executive directors. It should also ensure that company boards pay adequate attention to the scandals of child labour.

Conclusion

14. The crisis of company law in the context of concentrated and mobile capital and of the absence of satisfactory solutions to the separation of ownership and control, in the light of modern boardroom practices, makes the inquiry into non-executive directors one of the most important social exercises of modern times. It is submitted that provisions of the kind outlined above are a moderate programme for reform, and that a less rigorous analysis will not suffice.

¹⁵³ See especially ILO Convention No. 182; and see the immense amount of factual information now available through the ILO special website Child Labour and from the Programme for the Elimination of Child Labour, 2002, with its new "strategic" approach.

¹⁵⁴ Financial Times 16.4.2001