CORPORATE GOVERNANCE: CHANGE, CONSISTENCY AND EVOLUTION - PART 1

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INTRODUCTION

Public attention has again been focused on corporate governance by a combination of major corporate scandals such as Enron and Worldcom[1]. The impact of Enron has been particularly significant[2]. Its shareholders saw the value of the company's shares go from moving towards $100 by December 2000 to junk bond status. Its directors, including UK non-executive director Lord Wakeham, faced substantial litigation estimated to exceed insurance cover to protect them. President and Chief Operating Officer, Jeffrey McMahon, resigned effective 1st June 2002 whilst former vice-chairman, Clifford Baxter, was found to have committed suicide in January 2002. Andrew Fastow was subsequently charged with multiple counts of fraud, money laundering and conspiracy for his alleged role. Enron employed 21,000 staff in more than 40 countries, who invested on average 60% of their retirement plans in Enron. Creditors faced substantial losses with more than 1,000 companies having lost out on deals worth billions of pounds. Enron's four companies in Europe transpired to owe each other more than £2.2 billion through a series of tangled inter-company debts. The reputation of auditors, Andersens, was left in shreds. Even the political establishment was touched by Enron: it seems that roughly 75% of all US senators and congressmen accepted campaign contributions from Enron and that it was the 12th largest donor to George Bush's campaign. Controversy further erupted in the UK with allegations of Enron donations to the Labour Party. Yet economically the long-term impact of Enron may well be marginal and indeed even lead to the strengthening of the US economy. These scandals have emerged, however, during a period when there has been much activity in relation to UK corporate governance, especially, but not exclusively, with the completion of the Modern Company Law

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[1] This section is based on Copp, S.F. "The Enron Scandal" (2002) 6(1) F.I.B.Q. 8.

[2] See, in particular: Broughton, P.D., "Political Fears Grow Over Links To The White House" (news.telegraph.co.uk, filed 26th January, 2002); Wastell, D., Delves-Broughton, P. and Craig, O., "The man who knew too much" (news.telegraph.co.uk, filed 27th January 2002); Jones, G., "Enron 'cash for access" hits Labour" (news.telegraph.co.uk, filed 29th January 2002); Wastell, D. and Ringshaw, G., "Wakeham faces ruin over Enron" (news.telegraph.co.uk, filed 3rd February 2002); BBC News "Timeline: Enron's rise and fall", 4th February 2002, pp. 1 and 4; Doran, J., "Creditors to get tiny fraction of Enron debts" The Times 7th February 2002; BBC News "Enron scandal at a glance" 25th February 2002; Burnett, V., "Enron president Jeffrey McMahon stands down" (FT.com – Special Reports/ Enron, 20th April 2002); Doran, J., "Fastow charged with fraud at Enron" The Times, 3rd October 2002; Naim, M., "The Creative Destruction of Enron" (FT.com – Special Reports/ Enron).

Review[3] and the publication of the *Modernising Company Law White Paper*[4]. Corporate governance has tended to become a portmanteau term for a wide range of concerns encompassing not only law but a growing range of related disciplines. With so much activity, it would be impracticable to summarise all recent developments in corporate governance. This two-part article will, therefore, examine the following principal themes that emerge:

- The proliferation of reform agendas;
- Continued debate over the purpose of the company;
- Increased choice between – but some tinkering with - corporate vehicles and structures;
- Deregulation and modernisation of corporate decision-making;
- More accountability expected of directors.

The law is stated as at 16th October 2002. Regrettably, it was not therefore possible to cover the "Winter Report" of the EU High Level Group of Company Law Experts published 4th November 2002. It is hoped to cover this important report in a later article.

THE PROLIFERATION OF REFORM AGENDAS

Concerns over corporate governance and the breadth of the scope of the term make it inevitable that there will be many bodies who have a direct or indirect interest in its reform. These include international organisations, regional trading blocs, national governments with their various departments and regulatory organisations, professional associations across a range of disciplines, as well as market participants and representative bodies. The resultant cacophony presents a real risk that consultation processes become unduly strained under the burden of the various White Papers, Green Papers, Consultative Documents and Discussion Papers being produced and accordingly that inadequately thought through proposals or conflicting proposals could be adopted. For practical reasons, this article is limited to consideration of EU and UK issues[5].

Growth in EU interest

[3] URN 01/942 (DTI, 2001).

[4] Cm 5553-I and II (TSO, 2002).

[5] As a consequence it has been necessary to exclude developments which are likely to have a significant impact on UK companies with say a joint listing on the NYSE or NASDAQ, such as the report of the NYSE Corporate Accountability and Listing Standards Committee of 6th June 2002 or the submission by NASDAQ of its first round of corporate governance rule changes to the SEC on 5th June 2002. It was also felet necessary to generally exclude accounting and auditing issues, although the establishment of a Co-ordinating Group on Audit and Accounting was covered because of its function in following up on the Enron scandal; however, other developments, such as the EC Commission recommendation on the independence of statutory auditors (16th May 2002) and the EC Regulation on the Application of International Accounting Standards (7th June 2002) have been omitted.

At an international level, the OECD has gained a significant role with its publication of *Principles of Corporate Governance* in 1999[6]. This has been followed up with its establishment of a Corporate Affairs Division created in 2000 within the OECD Directorate of Financial, Fiscal and Enterprise Affairs[7]. The reason for this is to serve an increasing amount of policy work in areas including corporate governance[8]. The EU has been responsible for a number of initiatives. After a long gestation, the legislation for a Societas Europaea has been concluded. The EC Directorate for Employment and Social Affairs has issued a Green Paper *Promoting a European Framework for Corporate Social Responsibility* in July 2001[9]. The aim of the Green Paper was to launch a wide debate on how the EU could promote corporate social responsibility at both the European and international level[10] and is considered further below, together with the response of the UK Government. The EC Commission has also issued a Green Paper on alternative dispute resolution in civil and commercial law[11]. At an institutional level there has been the creation of the Committee of Wise Men on the Regulation of the European Securities Markets[12], and the establishment of a European Securities Committee and a Committee of European Securities Regulators. Perhaps of more direct significance to corporate governance, in September 2001, the European Commission set up a Group of High Level Company Law Experts to initiate a discussion on the need to modernise company law in Europe. It was given a dual mandate: to address concerns expressed in 2000 by the European Parliament during the negotiation of the proposed 13th Company Law Directive on Take-over Bids; and to provide the Commission with recommendations for a modern regulatory European company law framework. The mandate for the second part included corporate governance in its own right and related issues, such as shareholders' rights, which bear on corporate governance. The four main corporate governance issues identified for consultation involve the need for: (1) better information for shareholders and creditors, in particular better disclosure of corporate governance structures and practices, including remuneration; (2) strengthening shareholders' rights and minority protection, in particular, supplementing the right to vote by special investigation procedures; (3) strengthening the duties of the board, in particular, where the company becomes insolvent; (4) a European corporate governance code or co-ordination of national codes to stimulate the development of best practice or convergence. It is encouraging to see the influence of economic analysis in an area which might instead have been characterised by political ideology. For example, the Group states its belief that the primary focus of the EU should be to " … develop and implement company law mechanisms that enhance the efficiency and competitiveness of business across Europe"; there are further references to economic concepts such as "efficiency", "efficient regulatory tool", "light regulatory regimes where possible", "efficient company law

[6] See http://www.oecd.org/daf/governance/principles.htm. A further amplification of these principles, the "Statement on the OECD Principles", was adopted by the International Corporate Governance Network at its annual conference in Frankfurt on 9th July 1999.

[7] Corporate Affairs Newsletter (OECD, 2002).

[8] Ibid., p. 1 which incorporates a detailed statement of the mission of the new division.

[9] See http://www.europa.eu; see further Council Resolution 2002/C86/03 on the follow-up to the Green Paper.

[10] Op. cit., p. 4.

[11] COM (2002) 196 final.

[12] Final Report, 15 February, 2001.

structures" and "rational apathy"[13]. In addition, there has been activity at a European level from non-governmental groups, such as Euroshareholders, the European Shareholders Group, which has issued its own Corporate Governance Guidelines in 2000[14] and the Corporate Governance Committee of the European Association of Securities Dealers, which also issued its Corporate Governance Principles and Recommendations in 2000[15].

The continuing "juridification" of UK corporate governance

The general trend in the UK is, to borrow Riley's terminology[16], the continuing juridification of UK corporate governance with much – but far from all - of the debate being focused through the continuing *Modern Company Law Review*. In June 2001 the Company Law Review Steering Group completed its "Final Report"[17] and the White Paper "Modernising Company Law" was presented to Parliament in July 2002[18]. Despite the high aspirations of the Review it appears likely – so far as can be gathered from the patchy Companies Bill published to date – that this will be a disappointing compromise satisfying neither the advocates of a radical "stakeholder" orientated company law nor the advocates of a "free market" deregulation of company law. Proof of the pudding is the presentation of the (albeit now lapsed) *Corporate Responsibility Bill* – a private members' bill being a rare event in company law. As the White Paper itself points out:

> "Preparing a new draft *Companies Bill* is a huge undertaking. The current legislation is set out in a number of different Acts, which run to over 700 pages … The new Bill may approach that length. Rather than await completion of the entire draft Bill we have opted to publish over 200 draft clauses now. We expect to publish further draft clauses for consultation, and key draft statutory instruments, over the coming months. These will cover … new areas, such as company investigations and company management … we recognise that some would prefer to comment on the draft Bill as a whole"[19].

Given that one of the principal complaints prior to the Review was the length and complexity of companies' legislation, the Review must *prima facie* be considered a failure if it has done little to curb its growth. More worrying is the difficulty in consultees being expected to provide meaningful comment on an incomplete *Companies Bill* when so many company law concepts inter-link. This is particularly disturbing when it is considered how many seemingly significant proposals which have formed part of the Review process have had to be dropped at different stages of the Review, for example, on

[13] See the Consultative Document "A Modern Regulatory Framework for Company Law in Europe" (25th April 2002), pp. 4, 7, 8, 14.

[14] See http://www.dcgn.dk/.

[15] See http://easd.com.

[16] Riley, C., "The Juridification of Corporate Governance" in "The Reform of UK Company Law", ed. De Lacy, J. (London: Cavendish, 2002), p. 179.

[17] Op. cit. See further Sheikh, S., "Company Law for the 21st Century, Parts 1 and 2" [2001] and [2002] I.C.C.L.R. 311 and 88 respectively.

[18] Op. cit.

[19] Op. cit., p. 12.

the basis that there were technical flaws which prevented implementation[20]. Nonetheless, as indicated, further reviews are forthcoming and subject to consultation, before the final *Companies Bill*, anticipated in 2004.

The DTI in the UK has continued with some highly significant reforms to company law notwithstanding the progress of the Modern Company Law Review. Those bearing on corporate governance include the enactment of the *Limited Liability Partnerships Act 2000*, the *Political Parties, Elections and Referendums Act 2000*, *The Companies Act 1985 (Electronic Communications) Order 2000*, *The Directors' Remuneration Report Regulations 2002* and *The Companies (Summary Financial Statement) Amendment Regulations 2002*. The DTI has also conducted a substantial review of its own powers of inspection and investigation which has made far-reaching and potentially radical proposals, which may well have a major impact on the nature of the proposed *Companies Bill*. In May 2000, the London Stock Exchange's function as "competent authority" for listing and its responsibility for the Listing Rules were transferred to the Financial Services Authority, under the auspices of the UK Listing Authority. This led to a number of changes, including the transformation of the well-known "Yellow Book" into the infamous "Purple Book". In July 2002, the FSA issued a Discussion Paper "Examination Review". The review of the listing regime is wide-ranging and covers issues such as: the value of the existing regime; ensuring the overall regulatory framework for the London market will remain attractive for capital-raising and investors; setting the boundaries of the listing regime; the impact of EC legislation and consultation process. Five specific aspects of the present regime are highlighted for further policy development, including corporate governance (at the top of the list) as well as related areas such as corporate communication and shareholders' rights. The White Paper confirms the Government's intention that the Combined Code should remain non-statutory but also states the Government's support for transferring responsibility for reviewing the Combined Code from the FRC to the Standards Board and that the Standards Board should take over from the UKLA rule-making responsibility for disclosure of compliance with the Combined Code[21]. As Riley argues, this would represent a consolidation of public control over the Combined Code[22].

Over-reaction might have been expected in response to the Enron scandal. Perhaps surprisingly, it was felt that the UK was less exposed to some of the problems exposed than the US and the response has been commendably cautious. Nonetheless, there were concerns as to the role of non-executive directors and on 15th April 2002 Gordon Brown, Chancellor of the Exchequer, and Patricia Hewitt, Secretary of State for Trade and Industry, announced the *Independent Review of Non-Executive Directors* by Derek Higgs. On 7th June 2002 a Consultation Document was issued[23], with a report being due by around Autumn 2002. In addition, a "Co-ordinating Group on Audit and Accounting Issues" was established. Its remit was to: ensure a co-ordinated and comprehensive work programme by individual regulators to review the UK's current regulatory arrangements

[20] See, for example, the proposed reform of the unanimous consent rule, below.
[21] Paras 5.11 and 5.12.
[22] Riley, C., op. cit., p. 201.
[23] The response date expired on 6th September 2002.

for statutory audit and financial reporting; to commission additional work/ reviews as appropriate; and to reach a view on the adequacy of the proposals and make recommendations, as appropriate[24]. An Interim Report was published in July 2002, which made important references to accountability and governance[25].

In conclusion, it can be seen that there has been some proliferation in the number of bodies concerned with reforming aspects of corporate governance law and regulation. However, this has been mainly at the international level; indeed, the UK has resisted the encroachment of the EU into matters of corporate responsibility and appears to be playing an influential role in the High Level Experts Group.

CONTINUED DEBATE OVER THE PURPOSE OF THE COMPANY

The purpose of the company and, therefore, of company law, whilst a major component of the corporate governance debate is dealt with implicitly, rather than explicitly, in company law. It has to be discerned from a number of disparate doctrines, including the (almost defunct) "*ultra vires*" rule, the duties of directors, shareholder remedies and the rules on disclosure. This is in some ways unfortunate because it tends to obscure the consequences of proposed and actual changes to the law.

From an academic perspective the parameters of the debate are by now highly familiar: the extent to which companies should pursue shareholder value or a wider range of stakeholder interests (including social responsibility). At EU level the issue has been highlighted by the EC Directorate-General for Employment and Social Affairs Green Paper *Promoting a European Framework for Corporate Social Responsibility*[26] in July 2001. It is anticipated that the main contribution of a European approach would be to complement and add value to existing activities by providing an overall European framework and supporting best practice. Corporate social responsibility is defined in the Green Paper as " … a concept whereby companies integrate social and environmental concerns in their business operations and in their interaction with their stakeholders on a voluntary basis …". The emphasis can be seen, therefore, to be voluntary. The Green Paper distinguishes between the internal dimension of corporate social responsibility, identifying matters such as investment in human capital, health and safety, managing change and environmentally responsible practices, and the external dimension, extending to the local community and a wide range of stakeholders, including business partners and suppliers, customers, public authorities and NGO's representing local communities as well as the environment, extending beyond Europe. The Green Paper identifies a "holistic" approach towards corporate social responsibility. Specific courses of action identified include: the need to integrate corporate social responsibility into the training of managers and employees; the need to provide guidance and tools to companies and SME's to enable them to report on relevant policies, processes and performance effectively, together with independent verification, perhaps involving stakeholders, such

[24] See Interim Report (URN02/1092, July 2002), para 1.1.

[25] Ibid.

[26] Com. (2001) 366 final, in particular, pp. 7, 8,12, 17, 19 – 24; see further Sheikh, S. "Promoting Corporate Social Responsibility Within the EU" [2002] I.C.C.L.R. 143.

as trade-unions; a European award for progressive companies; improving the effectiveness of social and eco-labels; improving the quality and objectivity of social and environmental market performance indicators. The consultation closed on 31st December 2001 and there was a wide range of responses, including a cautious response from the UK Government[27]. It is interesting to compare this with the general themes identified by the EC Commission High Level Group of Experts, which bear more than a passing resemblance to those emerging from the Modern Company Law Review, namely "facilitating efficient and competitive business in Europe", "modern company law making", "disclosure of information as a regulatory tool", "distinguishing different types of companies", "increased flexibility vs. tightening of rules" and "modern technology"[28].

The issue of corporate social responsibility has continued to be the subject of debate in the UK with quite significant changes being initiated both within and without the general framework for company law reform[29]. Given the high proportion of listed company shares held by institutions generally, and pension funds in particular[30], legislation which bears upon how they exercise their governance role is potentially far reaching in its effect. Delegated legislation introduced under *s. 7 Superannuation Act 1972* and *s. 35 Pensions Act 1995* amending the *Local Government Pension Scheme (Management and Investment of Funds) Regulations 1998*[31] and the *Occupational Pension Schemes (Investment) Regulations 1996*[32] may well achieve a significant effect. Reg. 9A of the former of these requires local government pension schemes to publish a written statement of the principles governing their investment decisions, including materially " … the extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments, and … the exercise of the rights (including voting rights) attached to investments … if they have any such policy"[33]. Reg. 11A of the latter of these requires occupational pension scheme trustees to include in their statement of investment-principles policy an identical policy statement[34]. In similar vein it is interesting to observe the revisions made in Hermes' *Statement on Corporate Governance and Voting Policy* 2001 edition, which now sets out detailed guidelines for reporting on social, environmental and ethical matters[35]. Changes include a recommendation that companies should disclose in the annual report matters such as whether the formal schedule of matters reserved to the board takes account of "SEE

[27] The UK Government's response of 20th December 2001 argued that a European approach should not seek to establish a separate European framework (p.1). Generally, the response was favourably disposed to approaches of a non-interventionist nature, such as examining the opportunities to promote corporate social responsibility (p. 8). However, the response was against more interventionist measures, specifically rejecting the need for a separate European code of practice and generic European standardisation of social labelling (pp. 9 and 10).

[28] See http://www.europa.eu.

[29] See further Copp, S.F., "Corporate Governance: Change, Consistency and Evolution, Part 2" (International Company and Commercial Law Review, forthcoming).

[30] See *The Strategic Framework* (URN 99/654)(DTI, 1999), para. 2.15.

[31] SI 1998/ No. 1831, as amended by SI 1999/ No. 3259, regs 2 and 5.

[32] SI 1996/ No. 3127, as amended by SI 1999/ No. 1849, regs 2(1) and 4(b).

[33] Regs 9A(2)(f) and (g).

[34] Regs 11A (a) and (b).

[35] See App. 4.

matters" and whether account is taken of such matters in the training of directors[36]. If disclosure is regarded as an effective regulatory tool then it is possible that these changes promise a significant refocusing of corporate governance; however, there may be reason to doubt this given its lack of effectiveness in other contexts.

A more focused approach to corporate social responsibility lies with targeting the permissible activities of the company. Whilst the proposed *Companies Bill* commendably proposes that a company formed under the Act should have unlimited capacity, removing the requirement that a company should have an objects clause specifying its permissible activities, a more targeted approach to setting the acceptable boundaries of corporate activity is provided by the *Political Parties, Elections and Referendums Act 2000*[37]. The Act has inserted[38] a new Part XA "Control of Political Donations" into the *Companies Act 1985*[39], and a new paragraph 3 in *Schedule 7 Companies Act 1985* which specifies the matters to be dealt with in the directors' report[40]. Central to the changes is that companies are now prohibited[41] from making any "donation"[42] to a "registered party"[43] or to any other "EU political organisation"[44] or to incur any "EU political expenditure"[45] unless the donation or expenditure is authorised by the company in general meeting before "the relevant time"[46] by "an approval resolution"[47]. An "approval resolution" must authorise the company to make donations to EU political organisations and/ or to incur EU political expenditure, in each case up to a specified sum, for a period of 4 years unless the directors determine or the articles require that the period should be shorter. The resolution has to be in general terms and may not purport to authorise particular donations or expenditure. Where a company makes a donation or incurs expenditure without complying with the rules, the main remedy is that every director[48] who held office at the time is jointly and severally liable to pay the company the relevant amount of money

[36] Paras 1.1 and 1.3.

[37] For the background to the Act, see the Report of the Committee on Standards in Public Life (Cmnd 4057-1) ("the Neill Report"); the DTI Consultative Paper (URN 99/ 757) and the White Paper (Cmnd 4413). For a detailed discussion of the Act, see Perkin, C., "Political Funding by Companies: The New Regime" Business Law Review, April 2001, p. 87.

[38] By s. 139(1) and Sch. 19. The changes were effective broadly from 16th February 2001.

[39] Comprising new ss. 347A to 347K.

[40] However, they do not authorise a company to do anything that would otherwise be unlawful: s. 347C(6) and therefore it would seem that the effect of any existing constitutional restrictions and the *ultra vires* rule would continue to apply. The period of 4 years was chosen, as it was the life of the average Parliament: see Perkin, C., op. cit., p. 87.

[41] s. 347C(1). There are a number of exemptions from this general prohibition. For example, subscriptions paid to an EU trade association are usually not regarded as donations: s. 347B. There are also special rules to prevent evasion by subsidiaries and non-GB subsidiary undertakings (ss. 347D and E).

[42] Defined in s. 347A(4).

[43] Defined in s. 347A(9) as parties registered under Part II of the *Political Parties, Elections and Referendums Act 2000.*

[44] Defined in s. 347A(6) – (8) to include both registered parties and EU political organisations, which is in turn defined to cover non-UK EU political parties, organisations which are intended to affect public support for both such types of parties or independent candidates, or to influence voters in referenda.

[45] Defined in s. 347A(5).

[46] Defined in s. 347A(10).

[47] Defined in s. 347C(2) – (4).

[48] Including any shadow director: see s. 347A(3).

together with damages for any loss or damage incurred as a result as well as interest[49]. However, a director may have a defence where it can be shown that the unauthorised amount has been repaid (presumably by the recipient) and that following a notice of the relevant resolution making full disclosure of the circumstances of the breach and repayment, the repayment has been approved by the company in general meeting[50]. A mechanism has been included to facilitate an "authorised group of shareholders", in enforcing directors' liabilities for breach, to ensure that information is provided by the company for such action, and to enable the court to order that the company indemnify the costs of shareholder action[51]. The disclosure provisions in the Directors' Report have now been considerably widened, not least to cover donations to any EU political organisation, any EU political expenditure as well as any non-EU political party[52].

A potentially far more sweeping approach to reform was suggested by the presentation to Parliament of the *Corporate Responsibility Bill*[53] by a variety of backbenchers, including notable figures such as Frank Field and Glenda Jackson. Like all Private Members' Bills it was unlikely to succeed unless adopted by the Government and this was highly questionable since it conflicted with the Government's own policy set out in the *Modernising Company Law White Paper*[54]. Nonetheless, it is interesting to study its main concepts[55]. The Bill would have applied to UK registered companies in respect of their world-wide activities and to companies operating in the UK in respect of their UK operations, in either case with an annual turnover of £5 million or more. Parent companies would have been obliged to ensure that their subsidiaries complied and the Secretary of State would have been given one year to report to Parliament to change the law to impose parent company liability for subsidiary companies and to ensure that liabilities could be met following any merger/ restructuring. Under the Bill, these companies would have been required to publish an annual report dealing with any significant environmental, social, economic and financial impacts of their operations; employment policies and practices; certain financial dealings with governments, government agencies and political parties; as well as the way in which the company's directors had discharged their environmental and social duties under the Bill. The company would have been required to take reasonable steps to make the report available to "its stakeholders", relevant regulators and "any other person with an interest in the report". The term "stakeholder" was to be defined as "any person who may be affected by any operations to which a report applies and includes but is not limited to- (a) shareholders and investors; (b) employees; (c) communities; (d) individuals". Companies would also have been required to take reasonable steps to consult with and to respond to stakeholders affected by any major proposed project of the company and as part of the consultation process produce an environmental, social, economic and financial impact assessment. Background papers used to prepare the annual report and environmental, social, economic and financial impact statement and as to how directors had discharged

[49] S. 347F(2) – (4).
[50] S. 347H(1).
[51] Ss. 347(I) – (K).
[52] See generally Sch. 7, paras 3 – 4.
[53] Bill 145, printed 12th June 2002.
[54] The Bill lapsed because of the prorogation of Parliament.
[55] See especially Cls 1, 3 – 11.

their environmental and social duties under the Bill would generally have been subject to public inspection with the Financial Services Authority and, where appropriate, the London Stock Exchange. Directors would have been required to disclose in an annual report any relevant training, qualifications or experience on environmental or social matters and on the disclosure of economic and financial information by companies. Directors would have been required to consider not only the environmental, social and economic impact of operations and proposed operations but the interests of all their stakeholders; to take all reasonable steps to minimise any negative environmental, social and economic impacts; to identify any such risks to the company and how they were to be managed. Directors would have been made personally liable for any significant adverse environmental or social impacts of operations arising from their negligence, wilful misconduct in relation to their duties or the disclosure of information. A Corporate Responsibility Board was to be established within a year with various far-reaching powers. "Stakeholders" would have been given powerful remedies, including "a right of action against a company … and any directors thereof for any breach of duty owed towards him as a result of this Act …". The Bill would generally have been supported by criminal penalties. To a large extent the proposal for a *Corporate Responsibility Bill* must be seen as a reaction to the compromise approach adopted by the UK Government in the *Modern Company Law Review* and which is reflected in the *Modernising Company Law White Paper*. The key proposals emerging from these to address corporate social responsibility - the codification of a more inclusive statement of directors' duties and the requirement for a mandatory Operating and Financial Review, considered later in this article – have clearly not been adequate to quieten down the debate.

INCREASED CHOICE BETWEEN –BUT SOME TINKERING WITH - CORPORATE VEHICLES AND STRUCTURES

The basic framework for corporate governance in the UK has remained remarkably similar since the inception of the company in the mid-19th Century. Globalisation has presented a new challenge to this by potentially opening the door to the creation of an international market in corporation privileges. The *Modern Company Law Review* had proposed to make it easier for companies to move from one company law jurisdiction to another. However, in the *Modernising Company Law White Paper*, the Government has rejected this, noting that it might have led to a significant loss of tax revenues[56]. Nevertheless, there has been a move to increase the supply of alternative corporate structures, albeit with little evidence of any real demand for what is to be supplied, as well as some minor tinkering with existing structures.

Societas Europaea eventually adopted

After many years of wrangling, on 8th October 2001 a Council Regulation[57] was adopted on the European Company Statute together with a supplementary Council Directive[58] on

[56] Op. cit., paras 6.21 – 6.22.
[57] 2157/2001.
[58] 2001/86.

employee involvement[59]. The Council Regulation does not come into force until 8th October 2004[60]. The broad intention of the European Company Statute is to enable an SE to be registered in one member state but to be able to operate throughout the EU on the basis of a single set of rules. An SE may be formed by a merger, as a holding SE or by conversion of an existing plc into an SE[61]. The governance structure of an SE essentially comprises a general meeting and either a one-tier system comprising an "administrative organ" (referred to as the "board" below for convenience) or a two-tier system comprising a "supervisory organ" and a "management organ", depending on its "statutes" or constitution[62]. Generally, the rules governing general meetings in the member state where an SE is registered will apply, with limited exceptions where the Council Regulation establishes some minimum standards, such as the need to hold/ convene general meetings, place requisitioned items on the agenda, majority voting and amendment of the SE's statutes. The few truly mandatory provisions relate to the counting of votes cast and class rights. There are a number of rules applicable to both one-tier and two-tier board structures. In terms of eligibility to sit on a company organ, members cannot be appointed for more than 6 years but may be reappointed[63]; a company or other legal entity may be a member of a company organ but must designate a natural person to exercise its functions[64]; a person disqualified from being director of an equivalent plc organ may not be a member of such an SE organ[65]; and special conditions may be imposed on shareholder representatives[66]. In terms of decision-making an SE's statutes must list the categories of decision-making requiring an express decision from the administrative organ in a one-tier SE or by the supervisory organ in a two-tier SE[67]; further, rules for quorums, majority voting and casting votes are specified[68]. Members of SE organs are subjected to a duty of confidentiality, except where disclosure is required/ permitted under national law or "is in the public interest"; generally their liabilities are to be determined by the rules applicable to plc's under the relevant national law[69]. There are further rules applicable to one-tier and two-tier boards respectively[70]. The role of the board is specified as being to "manage" the SE although member states may permit an MD(s) to be responsible for day-to-day management as for plc's registered in the same member state. A SE must provide for the number of members of its board in its statutes, and member states may set a minimum and/ or maximum number, but where employee

[59] See further Chuah, J., "Council Regulation on the Statute for a European Company (SE)" [2002] I.C.C.L.R. 317.

[60] Art. 70.

[61] Arts 17, 35 to 37.

[62] Arts 38, 52 to 60.

[63] Art. 46. These are subject to the company's statutes.

[64] Art. 47(1). This is subject to the law of the member state in which the SE is registered.

[65] Art. 47(2). The disqualification must be under the law of the member state in which the SE is registered.

[66] Art. 47(3). These must be in the SE's statutes and are subject to the law of the member state in which the SE is registered. National laws permitting minority shareholder representation to a company organ are expressly unaffected: Art. 47(4).

[67] Art. 48(1). Member states may determine a minimum list of transactions which must be indicated in SE statutes and, where there is a two-tier system, may permit the supervisory organ itself to make certain categories of transactions subject to authorisation.

[68] Art. 50. The rules are subject to the Regulation, and a SE's statutes.

[69] Arts 49 and 51.

[70] Arts 43 to 45.

participation rules apply there must be a minimum of 3. Initial appointment to the board of a SE may be made by the SE's statutes but thereafter must be by the general meeting and subject to any employee participation arrangements. A chairman must be elected to the board but where half the members are appointed by employees he must be appointed by shareholders. The board is required to meet at least once every three months to discuss the progress and foreseeable development of the SE's business and each board member is entitled to examine all information submitted to it. Employee participation is dealt with by a separate Council Directive[71]. It broadly recognises that it would be inadvisable to set up a single European model of employee involvement because of the diversity of existing law and practice whilst insisting that information and consultation procedures should nevertheless be ensured on the creation of a SE[72]. Accordingly, Member States should have the option of not applying employee participation where a SE was created by merger[73]. Otherwise, a standard negotiating body must be set up to negotiate an agreement on employee participation, failing which a system of standard rules would apply[74]. In each case detailed rules are established by the Directive.

Limited liability partnerships: little impact

The *Limited Liability Partnerships Act 2000* came into force in April 2001[75] together with the *Limited Liability Partnerships Regulations 2001*[76]. The purpose of the legislation was initially to enable the incorporation of large professional partnerships but at a later stage was opened up to be a vehicle for small businesses generally. The legal entity created is a hybrid, generally owing more to company law than partnership law principles[77]. The governance of an LLP essentially encompasses its members; as Finch and Freedman put it " … It is central to the LLP that, whilst external relations provide a similar level of safeguards to that provided by company law, internal organisation is modelled on partnership law …"[78] It has attracted serious criticism and it appears that take-up has been very limited[79] and therefore it will not be considered further here. The Law Commissions have also published a Consultation Paper on the "Limited Partnerships Act 1907"[80] arguing that there is a strong case for updating the legislation to enable the UK to continue to maintain its competitive position in the venture capital market.

General tinkering with UK company law

[71] Op. cit.

[72] Preamble, paras (5) and (6).

[73] Preamble, para. (9).

[74] Preamble, para. (8). The standard rules are set out in an Annex to the Directive and cover such issues as the composition of the employee representative body, information and consultation, and participation.

[75] See the *Limited Liability Partnerships Act 2000 (Commencement) Order 2000*, SI 2000/ No. 3316.

[76] Reg. 1.

[77] S. 1(5) provides that " … except as far as otherwise provided by this Act or any other enactment, the law relating to partnerships does not apply …" to an LLP.

[78] See Finch, V. and Freedman, J., "The Limited Liability Partnership: Pick and Mix or Mix-Up?" [2002] J.B.L. 475 at 488.

[79] Ibid., esp. p. 478.

[80] LCCP 161/ SLCDP118 (TSO, 2001).

Generally, the Modern Company Law Review has not favoured any radical change to the structures for corporate governance applicable to companies generally. Early on in *Developing the Framework* it was stated[81] that: "we agree with the great majority of respondents that mandatory change (such as mandatory two-tier boards) to reflect wider stakeholder concerns would not be justified". It further expressed the view that without strong support non-mandatory provision would not be justified because of the legal complexity.

The White Paper maintains the definition of "director" on the same lines as at present[82]. The Final Report proposed to keep the present definition of a shadow director and by implication that of a *de facto* director[83]. The issue does not arise again in the White Paper. However, one major surprise is that the White Paper has raised for the first time a proposal to: (1) prohibit corporate directors for companies formed under the *Companies Bill*; (2) prohibit the appointment of corporate directors to existing companies; and (3) after a transitional period of say 3 years prohibit all corporate directors[84]. However, this seems an exceptionally strong regulatory approach in the absence of strong evidence of some identifiable mischief and it would be hoped that in the absence of more evidence that it will be abandoned. Other related issues which had been debated in the Final Report, such as directors' training and qualifications are likely to be dealt with through new disclosure requirements[85].

The White Paper states that the Government agrees with the Modern Company Law Review's conclusion that the requirement for private companies to appoint a company secretary[86] should be removed although it should remain open to private companies to appoint a company secretary if they choose[87]. The rationale for this is that the role is not essential to good corporate governance and represents a regulatory burden on small private companies. One minor change applicable to public companies is a proposal in the Final Report that the age requirement for directors of public companies[88] should be removed[89]. Potentially more far-reaching is the work commenced by the Higgs Committee. Its purpose was to assess: the population of non-executive directors in the UK – who they are, how they are appointed and how they can be drawn from a wider pool of talent; the independence and effectiveness of non-executives; the actual and potential relationship between non-executives and institutional investors; and what could be done to strengthen the quality, independence and effectiveness of UK non-executive directors. The Consultation Document itself was fairly minimal in terms of commentary, mainly consisting of 34 questions under the following headings: A. What role should non-executive directors perform, and how does this compare to the present position; B.

[81] Op. cit., para. 2.24.
[82] Cl. 225 *Companies Bill.*
[83] Op. cit., para. 6.7.
[84] Op. cit., para. 3.32. This proposal is justified by reference to other jurisdictions, the need to be able to identify those who actually control a company and apply directors' duties to them.
[85] Final Report, para. 6.18.
[86] S. 283(1) *Companies Act 1985.*
[87] Op. cit., para. 6.6.
[88] S. 293 *Companies Act 1985.*
[89] Op. cit., para. 6.18.

What knowledge, skills and attributes are needed, and what can be done to attract, recruit and appoint the best people to non-executive roles; C. Do existing structures and procedures facilitate effective performance by non-executive directors; D. Do existing relationships with shareholders or others need to be strengthened; E. How can non-executive directors best be supported to perform their role; F. In what ways is the position different for small listed companies; G. What can we learn from international experience? There is considerable evidence that the market in non-executive directors is unduly restricted[90] and therefore this consultation is broadly to be welcomed, provided that it is used to enhance the operation of the market.

It is proposed to expand the definition of a member so that in the case of a founder member a person becomes a member on the issue of the incorporation certificate[91]. More significantly, a major concern of the *Modern Company Law Review* was to redress issues of corporate governance accountability arising from the separation of legal and beneficial ownership of shares[92]. Problems of extending rights in this situation derive from a number of statutory provisions[93]. The White Paper sets out the Government's support for amending *s. 360 Companies Act 1985* to clarify that companies are able, if they wish, to recognise the rights of the holders of beneficial interests in shares at the request of the registered member[94]. However, it also states that the Government is now only considering the practicality of the proposal to include a reserve power to compel companies to recognise the rights of others where requested to do so by the registered member. The Government's stated objectives in relation to institutional investors are to ensure the effectiveness and integrity of the governance regime for quoted companies. The White Paper noted the Review's belief that its proposals were fundamentally dependent on the responsible, diligent and active exercise of these powers by these investors and their agents and summed up two main areas considered in relation to institutional investors. These were the effectiveness of the machinery to enable shareholders to exercise effective and responsible control of quoted companies, such as lack of transparency in the voting system and also possible conflicts of interest which might inhibit institutional investors in the performance of their governance role. The White Paper however, recognises that dealing with conflicts of interest is difficult and controversial and that company law might not be the appropriate vehicle. Accordingly, the Government has rejected the Review's proposal that companies should disclose their suppliers of financial services. However, the Government is continuing to consider issues such as disclosure of how institutions vote their shareholdings in quoted companies. In addition, the DTI and HM Treasury have jointly issued a consultation document seeking views on a Regulatory

[90] See, e.g. Nelson, F. "Clique of 30 runs old-boy network on pay", The Times, 1st July 1999.

[91] Cl. 215 *Companies Bill.*

[92] Examples of this were cited in *Developing the Framework* (para. 4.7), including some major UK companies with a high proportion of their shares owned overseas where overseas shareholders may prefer not to hold shares directly but in the form of depository receipts instead.

[93] Those on which the Review concentrated were: s. 360 *Companies Act 1985*, which provides that no notice of any trust, express, implied or constructive, shall be entered on the Register of Members; s. 372(1) *Companies Act 1985*, which confers a right to appoint a proxy on the legal holder; and s. 372(3*) Companies Act 1985*, which requires notice of a general meeting to inform the recipient of their right to appoint a proxy.

[94] Op. cit., paras 2.40 to 2.47.

Impact Assessment on the disclosure of beneficial ownership of the shares of unlisted companies, assessing a number of options for improving disclosure in order to assist law enforcement agencies to track down criminal and terrorist forces[95].

Amongst the various responses to the Enron scandal has been the establishment of a "Co-ordinating Group on Audit and Accounting Issues". Key recommendations made in its *Interim Report* include that[96]: the role and membership of audit committees need to be strengthened; tougher mechanisms are needed to strengthen auditor independence; there should be an early review of the regulatory arrangements for the accountancy and audit professions; major accountancy firms should be more open and transparent and competition implications considered further; the adequacy of the current arrangements for accounting standards should be considered by the Government with a view to more pro-active and wide-ranging enforcement; and the impact on unlisted and smaller companies should be considered. Subsequently, the terms of reference for a review of the regulation of the audit and accounting professions in the UK has been published as well as a consultation document setting out the issues which the review will examine[97].

CONCLUSION TO PART 1

In this part of the article, three themes have emerged in terms of recent developments in corporate governance: the proliferation of reform agendas, continued debate over the purpose of the company and increased choice between – but some tinkering with - corporate vehicles and structures. The important themes of deregulation and modernisation of corporate decision-making and more accountability expected of directors remain to be considered in the second part. If the themes which have been considered so far are examined in terms of their consistency with economic efficiency the picture is not promising. The proliferation of reform agendas is regrettable. From the perspective of individual companies there are rising costs to be incurred in terms of consultation and compliance. This is particularly so where such agendas include the promulgation of overlapping codes of practice. Whilst there must be a degree of sympathy for market-based initiatives which may well be desirable attempts to resolve collective action problems, for example, on the part of shareholders, without recourse to the state, the contribution of other initiatives to efficiency may well be suspect. The continued debate over the purpose of the company is somewhat surprising, indeed a reasonable person might have thought the arguments between stakeholding, shareholding and related issues had been done to death five times over by now. Similarly, in terms of increasing choice between corporate vehicles, the eventual emergence of the Societas Europaea is perhaps equally surprising and reflects the dominance of supply-side concerns – it being somewhat of a ghost from the past in competitive global markets. Tinkering with corporate structure may well result in desirable evolutionary effects by increasing the number of trials undertaken; however, such tinkering should be methodologically sound – apart from its consultative status the late proposal to abolish

[95] See http://www.dti.gov/cld/current.htm.

[96] Interim Report, paras 1.6 – 1.10 and 1.12 (a) and (b).

[97] DTI Press Release 9th September 2002 and Consultation Document 8th October 2002: see http://www.dti.gov.uk/cld/post-enron.htm.

corporate directors appears to be a good example of how not to proceed. In terms of an efficiency perspective on these themes, perhaps the best conclusion to Part 1 of this article is MacNeil's warning that[98]:

> "... the pursuit of objectives other than efficiency will narrow the extent to which company law will be efficient. This is a question of prioritisation of values – it is not possible to have the penny and the bun at the same time."

[98] MacNeil, I. "Company Law Rules: An Assessment From the Perspective of Incomplete Contract Theory" (2001) Journal of Corporate Law Studies 107 at 125.