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Non-executive directors and corporate governance

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The focus of this contribution is on corporate governance and corporate boards in the public, for profit, sector, in particular the role of non-executive or outsider directors, and the ideas of accountability under which it is presumed they operate. However, the message of the paper is wider than this. Given the nature of corporate power in the global context, ensuring accurate and trustworthy corporate governance is a broader issue than simply one that concerns individual shareholders or nation-state-level economic policy.[1] The world's largest corporations have turnovers in excess of the GDP of many individual states and have a transworld presence in the sense that their market listing is not confined to one nationally based exchange. At the domestic level, there is an argument to be made that corporations are not any longer private actors. They are public actors in terms of power and influence in areas such as environmental impact, location and relocation decisions, and corporate social responsibility.

The most popular and pervasive model of corporate regulation sees the shareholders of the corporation as those most in need of the protection of good governance. This model naturally emphasises the private nature of the corporation and its governance structure. Its dominance means that it makes sense to accept this model for the purposes of this paper, although it is possible to find vigorous condemnation of it among UK and US commentators[2] for its concentration on financial performance, short-term profits and its neglect of wider interests. Taking just two points of qualification should make it clear that governance failure has consequences wider than the official model would lead us to believe. The first is that the rise of defined contribution pension plans in the UK and the US makes many employees interested parties in corporate governance through the medium of institutional investment. They are literally arms-length investors, for their financial wellbeing post-retirement depends on favourable market returns on their personal retirement investment plan. The second is that a key function of boards of directors is the monitoring of the strategic direction of the corporation's business model and its risk management contingency. Should these functions and the monitoring of them not be exercised properly, it is likely that the pool of those looking for accountability will be wider than simply shareholders. Fannie Mae and Freddie Mac in a US context and Northern Rock in a UK

1 M Huse "Renewing management and governance: new paradigms of governance?" (2003) 7 *J of Man and Gov* 211–21.

2 L Mitchell, *Progressive Corporate Law* (Boulder, Colorado: Westview Press 1995).

context demonstrate this nicely. The idea that governance failure in a corporate sense is not always driven by fraud is a point to which I return later in this contribution. All of these issues make the executive management of the corporation an issue wider than simply the mechanics of private governance.

Boards of directors are "the apex of the internal control system"[3] of the corporation. The official narrative in Anglo-American corporate law is that directors are appointed by shareholders and are the representatives of shareholders, or owners. Corporate boards are responsible for devising and/or revising corporate strategy, ensuring that management operates effectively in the interests of shareholders, setting performance incentives for managers, appointing, monitoring and if necessary removing the chief executive officer (CEO). Outside or non-executive directors form a second layer, if you like, within the board itself to watch over executive directors who are doing these things. The reality is that the appointment of directors, both executive and non-executive, is approved by the shareholders without, in the overwhelming majority of cases, any discussion. The board in many ways is a self-perpetuating oligarchy. Its existing members put up new members for election and re-election. Shareholders do not interview directors and rarely even look at their curricula vitae to determine their suitability. These things are done by existing board members who "market" the suitability of new appointees to the shareholders.[4] Directorships are rarely contested. While the recent example of Yahoo! and Microsoft provides a different story to this, its news value lies in its novelty and hence helps to distinguish between official and realist narratives.

The strategic and managing function of directors sits alongside the structural requirements of the regulatory framework in which the corporation operates, although both the US and UK are characterised in the main not by specific regulatory demands but by broad regulatory directives which the corporation, through its directors and managers, absorbs and interprets into internal structures.[5] That said, however, the UK exhibits this approach on a larger scale than the US. The UK experienced huge corporate collapses that were thought to be due to poor governance rather than market conditions in the last fifteen years of the last century; the examples of BCCI, Polly Peck and the Maxwell empire spring to mind. There was also an outbreak of executive salary increases which were thought to be "excessive", particularly as they often seemed to concern the executive leadership of recently privatised formerly publicly owned utilities. The UK, rooted in a principles rather than rules culture,[6] established a tradition of dealing with pressures on the corporate system by holding a private inquiry, led by a "City" figure,[7] leading to the publication of a voluntary regulatory code supported by the listing authority. This means that corporations that do not either follow the voluntary code or explain why they are not following it will be denied a listing on the London Stock Exchange. The City figure for the first such inquiry was Sir Adrian Cadbury, the recently retired chair of the then FTSE 100 company Cadbury Schweppes plc, a director of the Bank of England and of IBM. Subsequent inquiry chairs

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3 M Jensen and W Meckling "Theory of the firm: managerial behaviour, agency costs, and ownership structure" 3 *J Fin Econ* (1976) 305–60.

4 G F Davis and G E Robbins, "Nothing but net? Networks and status in corporate governance" in K Knorr-Cetina and A Preda (eds), *The Sociology of Financial Markets* (Oxford: OUP 2004), pp. 290–311, at p. 292.

5 L Edelman, "Legal environments and organizational governance: the expansion of due process in the American workplace" (1990) 95 *Am J Soc* 1401–40.

6 D Kershaw, "Evading Enron: taking principles too seriously in accounting regulation" (2005) 68 *Modern Law Review* 594–625.

7 I Jones and M Pollitt, "Who influences debates in business ethics? An investigation into the development of corporate governance in the UK since 1990" in I Jones and M Pollitt (eds), *Understanding How Issues in Business Ethics Develop* (Basingstoke: Palgrave Macmillan 2002), pp. 14–66.

have been equally illustrious figures within the City of London, as my comments about Derek Higgs below demonstrate. The importance of elites and the social capital they generate is something that I return to later in this contribution.

The Code appears as a series of "Main Principles" with "Supporting Principles". The philosophy of the Code is that corporations should "comply or explain", that is, either comply with the code or offer reasons for non-compliance, made public through the channels of corporate reporting, leaving the market to decide on the appropriateness of any non-compliance. This philosophy has developed since 1992 into one where the nature of compliance with Main Principles has to be explained while an indication of whether there is compliance or explained non-compliance with Supporting Principles has to be given. What this means in effect is that shareholders, through the disclosure mechanism, can decide if the measures set out as constituting compliance with Main Principles meet with their approval. Likewise if non-compliance with Supporting Principles is announced, the shareholders will decide on whether they approve of the corporation's decision not to comply for the reasons it gives, by either selling their shares – resulting in a share-price drop – or keeping their shares – resulting in price stability.[8] A recent example is provided by the governance changes at Marks & Spencer plc. A key component of the Cadbury Report, or Cadbury Code as it became, was the separation of the function of chair and chief executive.[9] These positions, it recommended, should be held by different members of the board of directors. The Higgs Report of 2003[10] expressed this view with considerably more vigour and the Combined Codes[11] of 2003, 2006 and 2008 enshrined this in Principle A.2.1.

In March 2008, Marks & Spencer plc, a long-established FTSE 100 company, announced that upon the retirement of its current chair later that year the position would be filled by its current chief executive who would then hold both jobs until his scheduled retirement in 2011. Shareholders were issued with individual letters explaining the background to and the reasons for the decision, which amounted to an admission that the corporation had been guilty of succession planning failure and that no insider was ready to take on the job and bringing in an outsider was thought to be too disruptive. The immediate reaction of the market, assessed by share-price change, was indifference; the share price dropped 3 pence in that day's trading. At the actual shareholders' meeting some months later in July 2008, holders of 22 per cent of the company's equity voted against or abstained from the resolution to appoint the chief executive as chair. This was accompanied by a share-price drop of 25 per cent, but also, at the same time, an unexpected profits warning. In August 2008, the share price had recovered some of this loss and was on a roughly upward trajectory, despite holding its listing in a steadily dropping exchange during this time. So, we can deduce from this that either the market is not as responsive to governance issues as those who drafted these *ex ante* principles thought that it would be or that the market generally did not disapprove of the governance change so much as to use the exit option of share sale, despite exercise of the voice option in relation to the shareholders' meeting.[12] Despite the importance attached to the separation of these roles within the Cadbury Report

8 I MacNeil and X Li, "'Comply or explain': market discipline and non-compliance with the Combined Code" (2006)14 *Corporate Governance* 486–96.

9 *Report of the Committee on the Financial Aspects of Corporate Governance* (Cadbury Report) (London: Gee & Co. December 1992), para. 4.9.

10 *Review of the Role and Effectiveness of Non-executive Directors* (Higgs Report) (London: DTI January 2003).

11 Combined Code, www.frc.org.uk/corporate/combinedcode.cfm.

12 A Shabbir and C Padgett, "The UK Code of Corporate Governance: link between compliance and firm performance" (2008), www.som.cranfield.ac.uk/som/research/researchpapers.asp.

and from practitioner comments,[13] there is no empirical evidence to the effect that this sort of structural independence produces results in terms of improved financial performance,[14] although it does seem to be the case that the overwhelming majority of listed companies complied with the Code on this point soon after its inception.[15]

The net result of these inquiries has been an enhanced role for independent (or, as they are termed in the UK, non-executive directors), greater accounting disclosure and instructions to the corporate sector to improve its communications with its larger institutional shareholders. This model of governance, with professional board members directing and producing strategy but held in check by the addition of lay members, has, in the context of the UK, become a very popular method of governance. It is the preferred method of governance for organisations as diverse as hospital trusts, judicial appointments and school governing boards. It is seen as the mechanism for ensuring compliance and probity for a distant public. In the context of the corporation, this form of governance can be seen as embodying the classic law and economics approach to corporate regulation.[16] Regulation is enabling, rather than mandatory, and ultimate judgment on the structures adopted is exercised by the financial market. Shareholder value is maximised through the adoption of efficient structures that both police the behaviour of potentially errant managers – errant in the sense that they might indulge in "shirking" or other "opportunistic behaviour" at the expense of shareholders[17] – and ensure that accurate and sufficient information is relayed to shareholders – otherwise described as the principal and agent approach.[18] The only suggestion that the contractarian approach is not on its own able to tell the story of corporate governance is the recourse to a City figure to produce the voluntary code. In essence, a system of accountability based around an impersonal financial market could not be imposed without acknowledging that the corporate sector is embedded in social relationships and social networks, in fact no system could be imposed without acknowledging this. This system of governance had to be created and endorsed as appropriate by an insider if it was to gain traction. Participants in governance are discriminating about whom they acknowledge as a relevant and meaningful insider in any particular context.[19] The Higgs Report, the final report in this list, to which I turn next, is an exemplar of this need to acknowledge the power of social and political context. Higgs was an executive director of an FT 100-listed corporation, a non-executive director of a large plc and an institutional director.[20]

A succession of reports, recommendations and statements of best practice have followed the initial report, compiled under the auspices of self-regulation, each seeking to improve the standards of corporate governance generally and mechanisms for setting

13 J Keenan, "Corporate governance in UK/USA boardrooms" (2004) 12 *Corporate Governance* 172.

14 C Dalton and D Dalton, "Boards of directors: utilizing empirical evidence in developing practical prescriptions" (2005) 16 *British Journal of Management* S91–7.

15 MacNeil and Li, "Comply or explain", n. 8 above.

16 A Shleifer and R Vishny, "A survey of corporate governance" (1997) 52 *J of Finance* 737–80.

17 O Williamson, *The Economic Institutions of Capitalism* (New York: Free Press 1985).

18 E Fama, "Agency problems and the theory of the firm" (1980) 88 *J Pol Econ* 288–307; E Fama and M Jensen, "Separation of ownership and control" (1983) 26 *J L and Econ* 301–25.

19 G F Davis and H R Greve, "Corporate elite networks and governance changes in the 1980s" (1997) 103 *Am J Soc* 1–37.

20 Higgs Report, n. 10 above; I Jones and M Pollitt, "Understanding how issues in corporate governance develop: Cadbury Report to Higgs Review" (2004) 12 *Corporate Governance* 162–71, at p. 164.

directors' remuneration, specifically, for the benefit of shareholders.[21] Taken together these codes are now known as the Combined Code the latest iteration of which was in June 2008.[22] When a corporation releases its statement of compliance or explained non-compliance, it is doing so against the principles and supporting principles of the 2008 Combined Code. The Higgs Report[23] was the last in the series of reports that make up the Combined Code and is the main focus of attention in this contribution. It was commissioned by the UK Government specifically to look at how corporate governance in the UK could be strengthened in the wake of the Enron, WorldCom and Tyco failures and scandals in the US. The Higgs Report, then, was proactive in a UK context but also reactive in the sense that it was a direct response to the Sarbanes-Oxley legislation in the US. The brief of the Higgs Report was to look at outsider directors; their identity, their independence, their effectiveness. The first iteration of the voluntary code on corporate governance, the Cadbury Report, had handed a key monitoring role in corporate governance to outsider directors. The Higgs Report was the first time in over ten years that the role of this group had been subjected to serious examination. The decision to look at outsider/non-executive directors was no doubt inspired by the view that they and their independence were thought to be significant in the failure of Enron. Enron looked to have a largely independent board with only two of its directors occupying executive positions within the corporation. However, when industry ties and other factors such as charitable donations were factored in, the board had 43 per cent independent directors as opposed to 72 per cent in its peer corporations and 63 per cent for investment banks.[24] The results of the Higgs Report, after much debate, were amendments to the voluntary code that included: a requirement that outsider directors make up a significant part of the board – the actual phraseology is that there should be a "balance of executive and non-executive directors . . . such that no individual or small group of individuals can dominate the board's decision taking";[25] that letters of appointment of non-executive directors were made available through corporate reporting mechanisms (so that shareholders would be able to see the terms on which they had been appointed to the board and for how long); a definition of independence from the board for outsider directors, and a requirement that outsider directors be declared to be independent or not and, if so, on what grounds their independence was asserted; a designation of one of the outsider directors as the senior director; and an identification of one of the outsider directors as being the communication conduit between investors and the board.

Given that each review of corporate governance has been in the shadow of an actual or feared failure of governance, it is hardly surprising that the thrust of these recommendations should be towards monitoring and control of executive directors by non-executive directors through structural reforms for the benefit of distant shareholders. The test for code amendments is colloquially known as the "Maxwell test" – will this stop another Maxwell? By way of explanation for the uninitiated, the now-deceased Robert Maxwell provides the complete antithesis of the City figures used to suggest and endorse corporate governance codes and amendments to them. He did not come from an established family business background, as part of the East-European Jewish diaspora, he

21 Cadbury Report, n. 9 above; *Directors' Remuneration* (Greenbury Report) (London: Gee & Co. July 1995); *Committee on Corporate Governance* (Hampel Report) (London: Gee & Co. April 1998); *Internal Control: Guidance for directors on the Combined Code* (Turnbull Report) (London: ICAEW 1999).

22 See Combined Code, n. 11 above.

23 See Higgs Report, n. 10 above.

24 S Gillan and J Martin, "Corporate governance post-Enron: effective reforms or closing the stable door" (2007) 13 *Journal of Corporate Finance* 929–58.

25 Main Principle A.3, see Combined Code, n. 11 above.

was not British by birth and compounded these disadvantages by both serving as a Labour Member of Parliament and remaining a Labour Party activist. He was an outsider in every sense of the word. He had been the subject of a Department of Trade and Industry investigation in the early 1970s which had resulted in the department declaring that he was an unsuitable person to be involved in the running of a public company. Later in his business career he was found to have used the pension funds of several of his companies to purchase shares in one of his own corporations to prop up its share price. The result was a huge corporate collapse and the personal bankruptcy of several family members.

The volatile nature of markets and the boom and bust cycles which it seems are endemic to capitalism means that each new set of *ex ante* rules is set up with the last high-profile business failure or scandal in mind. Failure is not always the result of dishonesty, and perhaps this is the problem with the Maxwell test. Northern Rock is a good example of the environment external to the business itself changing and so putting pressure on what had been seen as a successful and innovative business model previously. While there was no suggestion of dishonesty or sharp practice in Northern Rock, the Treasury Select Committee found that:

> The non-executive members of the board, and in particular the chairman of the board, the chairman of the risk committee and the senior non-executive director, failed in the case of Northern Rock to ensure that it remained liquid as well as solvent, to provide against the risks that it was taking and to act as an effective restraining force on the strategy of the executive members.[26]

While this was a failure of the non-executive, the failure to ensure that the UK's biggest mortgage lender had a chief executive with a banking qualification was the failure of the Financial Services Authority, the relevant financial regulator. So, in some senses the watchers watching the watchers have failed their first real test post-Higgs. What is lauded in boom times as creative accounting and innovation becomes in recession the latest loophole to be closed.[27] Corporate success is often founded on the use of practices which take compliance with governance regimes to their limit and governance changes merely result in new devices being created.[28] Corporate governance regimes, then, are linked less to performance measurement and more to the policing of periodic market crises. The terms of each intervention in corporate governance are not strictly *ex ante* as they are dealing with *ex post* events. Despite the UK approach of general principles and flexibility as to how the principles are adopted or even if they are to be adopted, the emphasis is still on structural change as a way of creating better governance. The most important tasks that non-executive directors are charged with are overseeing the setting of incentives for managers (executive pay in other words), appointing and if necessary removing the chief executive or other non-performing executives, and assessing strategy and performance of the corporation. This last task is of course also the task of executive directors so ostensibly this creates a double layer of protection for shareholders.

The seriousness with which these Code reforms are made should not be underestimated. The UK financial sector needed to be able to convince the US Securities and Exchange Commission in particular, that the requirements of its corporate governance code were as strict as those imposed on US listed corporations courtesy of the Sarbanes-Oxley legislation, in order to soften the legislative impact on those UK-based firms that had a cross-listing in the US. Higgs himself said in an interview with the *Daily Telegraph* in

26 Treasury Select Committee session 2007–2008, *5th Report: The Run on the Rock*, 24 January 2008.

27 T Clarke, "Cycles of crisis and regulation: the enduring agency and stewardship problems of corporate governance" (2004) 12 *Corporate Governance* 153–61.

28 D McBarnet and C Whelan, *Creative Accounting and the Cross-Eyed Javelin* (New York: Wiley 1999).

January 2003: "We want to raise the bar for performance from corporate boardrooms and blow away the last vestiges of perhaps how things were a few decades ago when it was all a bit cosy, a bit familiar, a bit Christmas-ornamenty." So, legitimate questions to ask are: how likely is this sort of double-layered accountability to "raise the bar for performance"; and what is meant by "performance"? Perhaps unsurprisingly, given the nature of the pervasive corporate governance model, this second question can be answered rather more easily than the first – performance is financial performance measured in terms of profit levels and dividend declarations for shareholders.[29] Agency theorists are unable to agree on whether the presence of outside directors does or does not improve a corporation's financial performance. There are a number of studies which provide conflicting conclusions. For example, Baysinger and Butler[30] find that it might have a "mild effect", Kesner[31] asserts that it has no effect (although Kesner's primary agenda was to look at questions of gender and board diversity within board committees rather than specifically examining financial performance) and Dalton et al.[32] use meta-analysis of fifty-four studies of board composition and thirty-one studies of board leadership structure to conclude that there is little evidence of a link between a corporation's governance structure and its financial performance. Conflicting empirically based accounts about the effect of the presence of non-executive or outside directors occur throughout the literature on takeover defences, the composition of board committees, executive composition and removal of the chief executive.[33] The equivocal findings in these areas tell us something about using agency theory to explain board behaviour. Agency theory can only look at the structural components of board composition and then only judge them against its assumptions about what motivates opportunistic behaviour[34] and its rather one dimensional picture of human nature.[35] This could then take us into the literature on the failings of agency theory. However, there are plenty of reviews of this elsewhere.[36] It is also the case, however, that once we move away from the formulistic approach to board behaviour and firm performance offered by agency theory then the "outsider director as the ultimate watcher" model starts to come under considerable pressure. If we are only testing the presence of outside directors against fixed variables, such as the presence or absence of shareholder litigation,[37] for example, then more nuanced questions about role, behaviour and perceptions of status are not on the agenda.

29 S Bhagat and B Bolton, "Corporate governance and firm performance" (2008) 14 *Journal of Corporate Finance* 257–73.

30 B Baysinger and H Butler, "Corporate governance and the board of directors: performance effects of changes in board composition" (1985) 1 *Journal of Law, Economics and Organization* 101–34.

31 I Kesner, "Directors' characteristics and committee membership: an investigation of type, occupation, tenure and gender" (1987) 31 *Acad of Management Journal* 66–84.

32 C Dalton, C M Daily, A E Ellstrand and J L Johnson, "Meta-analytic review of board composition, leadership structure and financial performance" (1998) 19 *Strategic Management Journal* 269–90.

33 See, generally, I Filatotchev, G Jackson, H Gospel and D Allcock, *Key Drivers of "Good" Corporate Governance and the Appropriateness of UK Policy Responses* (London: Department of Trade and Industry 2007).

34 J Davis, F D Schoorman and L Donaldson, "Towards a stewardship theory of management" (1997) 22 *Academy of Management Review* 20–47.

35 C Daily, D R Dalton and A A Cannella, "Corporate governance: decades of dialogue and data" (2003) 28 *Academy of Management Review* 371–82.

36 D Anderson, S J Melanson and J Maly, "The evolution of corporate governance: power redistribution brings boards to life" (2007) 15 *Corporate Governance* 780–97; G F Davis, "New directions in corporate governance" (2005) 31 *Annual Rev of Soc* 143–62.

37 I Kesner and R Johnson, "An investigation of the relationship between board composition and stockholder suits" (1990) 29 *Strategic Management J* 327–36.

To make any judgment about the strategy and performance assessment role of outsider directors we need to look at a wider picture.[38] This takes us into the realm of stewardship theory and resource dependency theory and to the last (but I think the most significant) part of this paper, the potential effect of the presence of elites and networks. We need to open the black box of the board room[39] and think about the sort of issues that arise when the shareholders' original watchers – executive directors – are themselves being watched by outsider directors. The key questions would appear to circle around power, influence, independence and trust. These issues have to be negotiated within the boardroom itself if the individuals there are to be able to function as a unit. If this is achieved, then the next question has to be: what effect does this successful negotiation have on the accountability function of non-executive directors? Or, in other words, can distant accountability be maintained in the presence of a locally negotiated functionality?

The extract from the first Principle of the Code below makes it clear that outside directors are required to engage with and endorse corporate strategy in addition to their monitoring of performance and remuneration. This makes sense in its operational context as it is hard to see how any meaningful monitoring of performance etc. could take place without a reasonably detailed understanding of the corporation's market position, product placement and expansion strategies. However, the explicit rendition of performance review and endorsement of strategy makes it clear that there has been a considerable expansion of what can be termed internal service tasks.[40]

> **A.1 The Board**
>
> **Main Principle**
>
> Every company should be headed by an effective board, which is collectively responsible for the success of the company.
>
> **Supporting Principles**
>
> The board's role is to provide entrepreneurial leadership of the company within a framework of prudent and effective controls which enables risk to be assessed and managed. The board should set the company's strategic aims, ensure that the necessary financial and human resources are in place for the company to meet its objectives and review management performance. The board should set the company's values and standards and ensure that its obligations to its shareholders and others are understood and met . . .
>
> As part of their role . . . non-executive directors should constructively challenge and help develop proposals on strategy. Non-executive directors should scrutinise the performance of management in meeting agreed goals and objectives and monitor the reporting of performance. They should satisfy themselves on the integrity of financial information and that financial controls and systems of risk management are robust and defensible. They are responsible for determining appropriate levels of remuneration of executive directors and have a prime role in appointing, and where necessary removing, executive directors, and in succession planning.

38 K Eisenhardt, "Agency theory: a review and assessment" (1989)14 *Academy of Management Review* 57–74.

39 R Leblanc and M Schwartz, "The black box of board process: gaining access to a difficult subject" (2007) 15 *Corporate Governance* 843–51; A Pettigrew, "On studying managerial elites" (1992) 13 *Strategic Management Journal* 163–82.

40 P Bezemer, G F Maassen, F A J Van den Bosch and H W Volberda, "Investigating the development of internal and external service tasks of non-executive directors: the case of the Netherlands (1997–2005)" (2007) 15 *Corporate Governance* 1119–29.

In order to be able to provide the sort of input that the Code requires, outside directors must be able to display an awareness of how business works and be able to assimilate quickly information about how the particular business works. They need to be able to understand the dynamics between executive directors. They need to understand how individual strategic decisions will impact on share price and how strategy is formulated within the organisation and then packaged to those outside the organisation.[41] They need to be able to display sufficient knowledge in these areas to garner the trust of executive directors, thus enabling their comments and views to have an effect, and yet they need to maintain a sufficient distance such as to avoid capture by executive directors and remain independent. Obviously, they will be influenced by executive voices around them but not dwarfed by that influence. Trust is a two-way process, as outside directors have to feel able to rely on the extent and quality of information they are given by executive directors in order to perform their monitoring function.[42] Distrust between the two groups splits the board and results in a "circle of control and counter control".[43] Outside directors are nominated by the board for a five-year term initially and, if they wish to be reappointed, then they need to be considered effective and not divisive or undermining of their executive counterparts. Shareholders need to feel that the outside directors have sufficient influence within the board dynamic such that they can get their voice heard. The black box of management process is gradually being opened by empirical work looking at the dynamics of board relationships.[44]

The Higgs Report itself commissioned a piece of research from academics steeped in management process research.[45] Their task was to interview corporate chairs and non-executive directors to ascertain how they conducted the tasks listed above. The results of this research make fascinating reading. It tells the story of combining control and collaboration in a dialogue that the authors see as creating accountability, setting up intelligent accountability in place of distant accountability. Roberts (one of the authors of the Higgs research) describes in a different context what takes place as the "socializing forms of accountability".[46] This form of accountability occurs when two conditions are met: where there is frequent face-to-face contact between people and where there is no (or relatively no) power differential between the participants. It seems that what actually occurs in board processes is a non-defensive form of local accountability – so what non-executive director activities are doing is ensuring that board processes give rise to reciprocal understanding and dialogue rather than box-checking.

Intelligent accountability, or socialising forms of accountability, may well describe the changes in governance practice that are taking place in the post-Higgs era of boardroom discussions, but what they seem not to acknowledge is that this form of adaption is unlikely to take place without being enmeshed in an elite network that in social capital terms and

41 P Stiles, "The impact of boards on strategy: an empirical examination" (2001) 38 *J of Man Studies* 627–50.

42 R Hooghiemstra and J van Manen, "The independence paradox: (im)possibilities facing non-executive directors in the Netherlands" (2004) 12 *Corporate Governance* 314–24.

43 P Daudi, *Power in the Organisation* (Oxford: Blackwell 1986).

44 A Pettigrew and T McNulty, "Power and influence in and around the boardroom" (1995) 48 *Human Relations* 845–73; D Forbes and F Milliken, "Cognition and corporate governance: understanding boards of directors as strategic decision-making groups" (1999) 24 *Academy of Management Review* 489–505; T McNulty and A Pettigrew, "Strategists on the board" (1999) 20 *Organization Studies* 47–74.

45 T McNulty, J Roberts and P Stiles, *Creating Accountability within the Board: The work of the effective non-executive* (London: DTI 2003); J Roberts, T McNulty and P Stiles, "Beyond agency conceptions of the work of the non-executive director: creating accountability in the boardroom" (2005) 16 *Brit J of Management* S5–S26.

46 J Roberts, "Trust and control in Anglo-American systems of corporate governance: the individualising and socializing effects of processes of accountability" (2001) *Human Relations* 1547–72, at 1554–5, 1567.

network terms encompasses both executive and non-executive directors. The test of independence within the Code (A.3.1) is a test of independence in relation to each particular corporation where office is held. It is not a test of network independence or ties outside that particular boardroom. What occurs is much more accurately described as a negotiation of independence that all parties can live with at this board and every other board, rather than a creation of accountability. Dialogues around control and collaboration are, in fact, an informal sharing of information that may or may not have an effect on delivering distant accountability.

In the US this translates into research on interlocks where discussions about the presence of and effects of what are termed interlocked boards is well-worn ground. The primary concern in the US seems to be the effect of interlocks on firm behaviour rather than on the behaviour of those individuals whose appointments form the basis of the interlock. Following Granovetter,[47] the question for those researching interlocks was whether the embedded nature of economic relations resulted in interlocks powering control or communication.[48] If control over other corporations was the answer in the 1970s, by the 1980s communication through learning from other corporations was the answer presented not least by Useem's[49] influential study of British and American directors. Interlocks helped in the spread of innovation and contemporary business practices. It is unlikely that what was spread was best governance practice – it was far more likely to be conducive to the spread of McBarnet and Whelan's[50] creative compliance to boost short-term profitability. More recent studies in the US have been concerned with corporate donations to political action committees and the role of interlocks. The same questions are asked of interlocks as are asked of the presence of outside directors – what are the effects on takeover defences and compensation payments etc? – thus reflecting two things: the first was referred to above – that structural not behavioural determinants are what matters for agency theory; and the second, that interlocks are caused more often by non-executive or outsider director interchange rather than by executive director exchange.

In the UK, the concept of the interlocks is something mentioned only by sociologists, such as John Scott or Richard Whitley, whose interests are primarily in social network analysis and social stratification[51] and not in governance and accountability. We could speculate on why this is. It is no more difficult to map boardroom elites in the UK than it is in the US – all the information needed is publicly available – it may say something more about perceived hierarchies and stability within British society,[52] but it also might be the influence of the "so what" school – what does the presence of interlocks actually tell us?[53] The answer to that question depends on which story is being told – the story about firm performance (to which Pettigrew's comments are directed) or the story about the prospects for effective boardroom monitoring?

47 M Granovetter, "Economic action and social structure: the problem of embeddedness" (1985) 91 *American Journal of Sociology* 481–510.

48 M Mizruchi, "What do interlocks do? An analysis, critique and assessment of research on interlocking directorates" (1996) 22 *Annual Review of Sociology* 271–98.

49 M Useem, *The Inner Circle* (New York: OUP 1984).

50 McBarnet and Whelan, *Creative Accounting*, n. 28 above.

51 J Scott, *Who Rules Britain?* (Oxford: Polity 1991); J Scott, "Networks of corporate power: a comparative assessment" (1991) 17 *Annual Rev Soc* 181–203; J Scott, *Corporate Business and Capitalist Classes* (Oxford: OUP 1997).

52 M Bond, "Elite social relations and corporate political donations in Britain" (2007) 55 *Political Studies* 59–85, at 61; D Harris and C Helfat, "The board of directors as social network: a new perspective" (2007) 16 *J of Management Inquiry* 227–38.

53 Pettigrew, "On studying managerial elites", n. 39 above.

Recent research by Froud et al.[54] demonstrates that there is an exchange of executive director personnel into non-executive director personnel on retirement, particularly within the FTSE 250. Their key findings were that 60 per cent of FTSE 100 companies had a non-executive director who was an executive director at another FTSE 100 company, possibly suggesting the beginnings of a post-retirement career, but, perhaps more importantly, that in excess of 40 FTSE 100 companies shared a non-executive director with another listed company. More or less the same pattern of appointments emerged from empirical work commissioned by the Higgs Review;[55] sixteen non-executive directors drawn from the FTSE 350 held fifty-four non-executive directorships between them. The same duplication of non-executive appointments was also found by Bond.[56] According to the more recent *Guardian*/Reward Technology Forum report, eight non-executive directors sit on more than three FTSE 100 boards. One might have thought that increased burdens of monitoring on non-executive directors and recent media messages about potential legal liability (rather than actual liability)[57] would have severely reduced the number of people prepared to undertake this role. Instead, what can be observed is that boardroom members, whether they are executives or non-executives, "seem to know one another, seem quite naturally to work together, and share many organizations in common".[58] The incentive for individual directors to hold non-executive and executive appointments at the same time and for non-executive directors to hold more than one appointment at the same time is partly salary uplift but also the opportunity to observe how others deal with the demands of monitoring, to capture innovation from a range of sources and to gain general network endorsement.[59] The incentive for boards to recruit as non-executive directors existing executive directors or outside directors already serving elsewhere is based upon prior experience – their recruits will know what to expect – skills in the area of shareholder relations, takeover defence strategies, and network endorsement, even if these recruits do not have the skills that some institutional investors think they should have. Knight Vinke has, following its much publicised dispute with HSBC over the suitability of Stephen Green as CEO, recently made public its view that non-executives in the banking sector in particular should have a fund assigned to them on which they can draw to obtain their own advice. This concern with the financial management skills of non-executive directors can be linked to the findings of Froud et al.[60] that the percentage of non-executive directors from the financial sector has declined over the last thirty years, unlike in the US landscape where the trend is reversed.[61]

What we do not know is what the consequences of network membership and reputation have for accountability concerns. The post-Higgs Review desire for more non-executive directors is likely to result in a thickening of network ties – there is a finite pool of recruits with these skills available. The corporate governance system itself drafts for interlocks. One

54 J Froud, A Leaver, G Tampubolon and K Williams, "Everything for sale: how non-executive directors make a difference" in M Savage and K Williams (eds), *Remembering Elites* (Oxford: Blackwell 2008).

55 Roberts et al., "Beyond agency", n. 45 above.

56 M Bond, *The Effects of Inter-corporate Networks on Corporate Social and Political Behaviour* (London: ESRC End of Award Report 2006), www.esrc.ac.uk, award ref 000-22-0872.

57 B Black, B R Cheffins and M Klausner, "Liability risk for outside directors: a cross-border analysis" (2005) 11 *European Financial Management* 153–71.

58 C Mills, *The Power Elite* (New York: OUP 1956), at p. 294.

59 S Westphal and I Stern, "Flattery will get you everywhere (especially if you are a male Caucasian): how integration, board room behaviour and demographic minority status affect additional board appointments at US companies" (2007) 50 *Academy of Management Journal* 267–88.

60 Froud et al., "Everything for sale", n, 54 above.

61 N Fligstein and K Dauber, "Intraorganizational power struggle: the rise of finance presidents" (1987) 52 *American Sociological Review* 44.

of the more interesting features of UK company law, with its mix of common law and statute, was that although common law hinted that interlocks might not be permitted (as in difficult to accomplish without a breach of fiduciary duty), successive Companies Acts ignored the issue and remained silent. The Companies Act 2006, which came into force in October 2008, appears to suggest that directorial conflicts of interest must be declared and can then be ratified by non-conflicted directors. However, at the drafting stage assurances were given that nothing in this new clause (s. 175) was new law; it was merely confirming what the case law had been since 1845 and would not make multiple directorships more difficult. Code drafters and amenders are well aware that there is a limited pool of talent on which to draw within corporate boards and that little attempt is made to find talent in any other pool. Code drafters and amenders are themselves part of the circularity of boardroom appointments. Reputation within the network is maintained not by being an effective monitor but by negotiating sufficient independence to be associated with success and untainted by failure. Higgs was invited to put a limit on the number of boardrooms in which any one individual could sit in any capacity and declined to do so. When questioned by a journalist about his own portfolio of corporate activity (four non-executive directorships and two executive directorships), he answered that "if any of the companies feel that I am not giving the job enough attention they will say so". That comment is an agency theorist's worst nightmare – the group supposed to comment on lack of attention and any consequent monitoring failure is the shareholders. There is a certain circularity to accountability in the boardroom – the watchers (executive directors) are watched by other watchers (non-executive directors) who themselves are watched by shareholders through disclosure to the market. It has the look of a rather unedifying dance.