

GATEKEEPING THE CEO: THE ROLE OF LAW, SELF-REGULATION AND INTERNAL MECHANISMS

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INTRODUCTION

“. . . in the entrepreneurial organisation, power is usually centralised in the hands of a strong, frequently charismatic CEO. Such individuals usually dislike submitting to authority.”¹

The Chief Executive Officer (CEO) in a company has been identified as the chief co-ordinator, policy maker, and motivator.² Others have described the CEO as representing the “pinnacle of the management structure with personal responsibility for the success of the company’s operations within the strategy determined by the Board”.³ Whatever the description, two things are clear. First, CEOs are often attributed with corporate success and they have a clear influence on the activities of the company and others through what has been described as a “clout” position⁴ – a position that often allows CEOs to manipulate boards of directors in order to pursue their own personal goals. Second, although CEOs exist in practice, there is little legal recognition of the existence and power of a CEO beyond the recognition of CEOs as being part of the Board and thereby being subject to regular directors’ duties. Inherent in those duties is occasional recognition that the power will be reflected in agency or attribution theory activities but with limited specific success in the recognition of the “clout” of the position.⁵

There has been a consistent confirmation in law that the CEO position does not exist independently from the general duties applicable to all directors. As early as 1955, Viscount Kilmuir confirmed that the position of managing director (the CEO) was not an appointment to a specific and recognised office. It was no more than the appointment to the position of a director who was either a director with additional functions attracting additional remuneration, or else a person holding two distinct positions, that of the director and that of a manager. The position of managing director did not

¹ A. Dent and F. Neubauer, *The Corporate Board – Confronting the Paradoxes*, (1992, Oxford University Press), at 74.

² B.R. Cheffins, *Company Law – Theory, Structure and Operation* (1997, Oxford University Press), at 108.

³ *Guidelines for Directors*, (1990, Institute of Directors, London), at para 77.

⁴ Westphal, “Collaboration in the Boardroom: Behavioural and Performance Consequences of CEO/Board social ties” (1999) *Academy of Management Journal*, 42:7-24.

⁵ J. Kirkbride and S. Letza, “The CEO in Law and in Practice – A Study of Categorisation and Control” (2002) 10(4) *Corporate Governance – An International Review*, 136-152.

exist independently from the allocation of specific duties rather than the generic duties of a recognised post.⁶ This position remains today.⁷

The consequence of all this is a danger that the failure to recognise the clout of the CEO, together with the ability of CEO to pursue personal interests, may result in positional conflicts like those identified by Eisenberg.⁸ It is precisely because of those conflicts and because of the power and influence of CEOs that it is important to consider the effectiveness of all systems of control, whether internal to the organisation or externally imposed by law or other regulatory bodies.

The problem is not to be exaggerated, nor underestimated. Positional conflicts recognise the different forms of personal and corporate interests. The “clout” of the position presents an opportunity to emphasise these conflicts. However the main concern of this article remains the difficulty of identifying and controlling poor performing CEOs and their effect on corporate performance generally; not just the rather narrower issue of protecting the company from unscrupulous chief executives.

In essence CEOs are treated like any other director of the company. The regulatory system involves control at one layer through equitable and common law duties, supplemented by statutory duties which have been subjected to review as part of the Modern Company Law review process.⁹ The development of an inclusive statement of directors’ duties is one output of that Review, albeit little has been brought forward in respect of specific developments on the role of the CEO.¹⁰ This layer of control places heavy reliance upon internal enforcement through the willingness of shareholders, acting individually or collectively to monitor and enforce directors’ duties.¹¹ It is clear that the effectiveness of this system of control depends a great deal upon information and willingness to enforce, together with the process of risk shifting through the existence of directors indemnity insurance. These common law and statutory duties may also facilitate enforcement through state bodies such as the Department of Trade and Industry, notably in the

⁶ *Harold Holdsworth & Co (Wakefield) Ltd v Caddies* (1955) 1 All ER 725, at 729.

⁷ See *Halsbury’s Laws of England*, Vol 7(1) for a description of the “accepted” position.

⁸ M.A. Eisenberg, “The Structure of Corporation Law” (1989) 89 *Columbia Law Review* 1461.

⁹ See DTI, *Modern Company Law for a Competitive Economy* (1998); DTI, *Modern Company Law for a Competitive Economy – The Strategic Framework* (1999); DTI, *Modern Company Law for a Competitive Economy – Developing the Framework* (2000); DTI, *Modern Company Law for a Competitive Economy – Final Report* (2001).

¹⁰ Parkinson expresses the view that any explicit duty is unnecessary as it is already implicit in the directors’ common law duties. See, J. Parkinson, “Evolution and Policy: The Non-Executive Director”, in *The Political Economy of the Company* (2000, Hart Publishing, Oxford), at 261.

¹¹ These “duties” are those developed through the common law, such as duties of care and skill, supplemented by statutory duties in areas of self-dealing and disclosure of conflicts. *Foss v Harbottle* (1843) 67 ER 189 and exceptions emphasise the role of collective and individual shareholder action in ensuring “internal” enforcement of these “duties”.

area of director disqualification.¹² This enforcement agency faces the obvious problems of access to information, resource availability, and the strict requirements of the statutory regimes.

The next layer of control involves reliance on codes of best practice.¹³ The governance codes have been private sector initiatives, supported by the government and financial institutions. Their focus has been to rectify governance weaknesses. This is where specific recognition of the role of the CEO has been present. This can be seen in the Cadbury recommendation that the role of the Chairman and the CEO should be split but that where the same individual does hold the two posts there should be a strong complement of outside directors.¹⁴

It is these codes, together with the statutory and common law duties that provide the accepted framework for the control of directors, but with limited specific recognition or control on the CEO. It is the purpose of this paper to examine two aspects of this regulatory system. The first concerns upon the operation of internal controls on CEOs.¹⁵ This provides a measure of the willingness and actions of the internal participants in a company to control CEOs, particularly in the situation of poorly performing companies. This enforcement activity, if it exists, is central to the actual control of CEOs.

The second part of this study focuses upon the code recommendation that CEOs should be subject to the control of a strong complement of outside directors. This will enable us to explore the Codes' response to the positional conflicts identified by Eisenberg¹⁶ and also to explore a model of control that was not part of the recent Modern Company Law Review (hereafter MCLR).¹⁷ This model considers the position of the outside director and the possible development of "gatekeeper" liability.

Through this analysis, the central focus remains the need to develop an efficient regulatory system to control poorly performing CEOs and assist in limiting the potential for positional conflicts. It is the need to control poorly

¹² See Company Directors Disqualification Act 1986.

¹³ In the UK context, the main codes are: Cadbury Committee *Report of the Committee on the Financial Aspects of Corporate Governance* (1992, London, Gee); Greenbury Committee, *Report of the Study Group on Directors' Remuneration* (1995, London, Gee); Hampel Committee, *Committee on Corporate Governance, Final Report* (1998, London, Gee); Turnbull Committee, *Internal Control: Guidance for Directors on the Combined Code* (1999, London, ICAEW); *The Combined Code: Principles of Good Governance and Code of Best Practice* appended to the Listing Rules; see now Financial Services Authority, Listing Rules (London, 2000), r 12.43A.

¹⁴ Cadbury *ibid* at 58.

¹⁵ *Supra* n 9 for a discussion of the internal controls.

¹⁶ *Supra*, n 6.

¹⁷ *Supra*, n 7. *The Final Report of the Modern Company Law Review* acknowledged that it had not considered this aspect, particularly the position of CEO's. The DTI sponsored review of the role of non-executive directors, chaired by Derek Higgs, has recently reported. Its recommendations about CEOs were mainly that the role of CEO and Chairman should be split between two individuals and that a CEO should not become Chairman of the same company on relinquishing the post of CEO.

performing CEOs rather than the narrow concept of protecting the company from unscrupulous chief executives, that remains the central focus of debate.

This is essentially a legal question – a question of designing an appropriate system of legal obligations and liability. Despite the existence of common law and fiduciary duties, there has been a need to supplement these controls on directors through both statutory rules and codes of best practice. The sufficiency of the Codes was questioned in the MCLR – accompanied with the threat of replacing codes with legislation where this might be deemed necessary. No instance of this threat being carried through can be found. It is the failure of this ‘mix’ of legal controls to recognise the clout of the CEO and to develop specific controls on CEOs that has prompted this study. Recent governance failures such as Enron and World Com highlight some of the inadequacies of the common law approaches to controlling boards and unscrupulous CEOs.

In 1998 Farrar¹⁸ concluded that the law had not fully come to terms with the variety of management structures and practices in modern companies. Despite the MCLR, the CEOs clout appears to be able to avoid the modern “mix” of legal controls. This paper proposed a regulatory model to fill the “gap” in the existing legal framework of controls.

Internal Mechanisms For Monitoring And Controlling The CEO

Various internal mechanisms can be employed by companies to monitor and control the CEO. These range from shareholder involvement in the company or market controls through to “hierarchical” controls where non-executive directors are expected to take the role of controller and monitor of the CEO. As Bratton¹⁹ notes, the corporate structure has been identified in two different ways: either a hierarchical governance structure or market contracting. Pound²⁰ divides corporate governance into market-based solutions and political-based solutions, the former of which refers mainly to takeovers or the market for corporate control and the latter simply to a broad “non-market” approach (not merely a governance role).²¹ Current analyses on corporate governance are all based on the theory of the firm and the related transaction cost economics,²² which asserts that economic transactions may be mediated through either market or hierarchical structures.

¹⁸ J.H. Farrar, *Farrar's Company Law* (1998, London, Butterworths), at 304.

¹⁹ W.W. Bratton, “The “nexus of contracts” corporation: a critical appraisal” 74 (1989) *Cornell Law Review* 407.

²⁰ J. Pound, “Proxy contests and the efficiency of shareholder oversight” (1988) 20 *Journal of Financial Economics* 237.

²¹ J.P. Hawley and A.T. Williams, *Corporate governance in the United States: the rise of fiduciary capitalism* (1996) available on-line at: <http://www.lens-inc.com/info/competition.html>.

²² R.H. Coase, “The nature of the firm” (1937) *Economica* 4: 386; O.E. Williamson, *Markets and Hierarchies: Analysis and Antitrust Implications* (1975, New York, Free Press); “On the governance of the modern corporation” (1975) 8 *Hofstra Law Review* 63; *The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting* (1985, New York, The Free Press).

A historical review of Anglo-American corporate governance structures reveals a circular shift from hierarchy to market and from market to hierarchy again. From the seventeenth century, when modern corporations were created, through to the early twentieth century, corporations were governed dominantly by the hierarchical structure of “checks and balances” designed by corporate law. The gradual separation of ownership and control in Anglo-American corporations, recognised in the early twentieth century, has led to a reduction in the effectiveness of shareholders’ monitoring. The finance conception of control, with its associated market governance structure, emerged in the 1960s and was further developed by the takeover movement in the 1980s. However, with the collapse of the market for corporate control at the end of the 1980s, a “non-market” approach advocated by numerous alternative perspectives has risen to shift market governance back to hierarchical governance structure. Ironically, even the advocates of the market governance model began to change their ideas towards “corporate internal control” on account of “inefficient exit” in the 1990s.²³

The problem with the claimed “optimal” governance structures in current corporate governance analysis is that there is no solid empirical evidence available in support of their presupposition. The validity of the competing analyses on corporate governance, as Keasey *et al.*²⁴ remind us, relies ultimately on the supporting empirical evidence. Market governance or hierarchical governance, if claimed to be optimal, must be tested and demonstrated in practices. However, both sides of the corporate governance debate have offered counter-evidence to reject the opposite arguments, and consequently Anglo-American corporate governance practices have experienced both “hierarchical failure” and “market failure”. Whilst the hierarchical governance failure is in relation to reluctant shareholders and malfunctioning boards, the market governance failure is due primarily to unreliable market forces and short-termism. The following examination will show how the available evidence rejects both assumptions of hierarchical and market optimums.

The Case Against Hierarchical Optimum

This section examines the core corporate monitoring mechanisms like the board of directors, shareholders and institutional shareholders. Available evidence indicates the defectiveness of the hierarchical governance structure as it operates through these mechanisms.

Board Failure

Board failure refers to the existence of broken connections between CEO, boards and shareholders, particularly where CEOs have been totally in control of corporations. Self-regulation and internal monitoring mechanisms

²³ M.C. Jensen, “The modern industrial revolution, exit, and the failure of internal control systems” (1993) 48 *Journal of Finance* 831.

²⁴ K. Keasey, S. Thompson and M. Wright, “Introduction: The corporate governance problem – competing diagnoses and solutions”, in K. Keasey, S. Thompson and M. Wright (eds), *Corporate Governance: Economic and Financial Issues* (1997, Oxford, Oxford University Press).

do not work in practice and tend to operate in a contrary manner to the expectation of traditional theories.

In conventional corporate theory, the board of directors plays a key role in the monitoring mechanism of checks and balances within the corporation. Directors, as the trustees of shareholders, nominate and monitor the CEO or managing director on their behalf. However, as Latham²⁵ observes, corporate governance systems in all major countries are fundamentally flawed because the connection between shareholders and the board of directors is broken. Although there have been various different structures of corporate boards, ranging from two-tier supervisory and management boards, for example in Germany for example, to insider-dominated boards in Japan, to mixed boards in the United States,²⁶ the board's passivity and lack of independence are commonly two main signs of failure. According to Bishop,²⁷ in Britain, America and Japan, the functions of boards have been mostly ineffective. In America, corporate boards are in general captured by management.²⁸ This enables CEO's to choose their friends, who will not challenge their power and interests, to sit on the board. In 1991, a study found that over 80% of board candidates were filled by CEO recommendations.²⁹ It has also been observed that in 76% of the largest companies in the USA, the CEO and the chairman of the board is the same person.³⁰ Sometimes we can see that boards dominated by outside directors remove top managers after poor performance. However, this only tends to occur after a major performance disaster.³¹ In Britain, board members, including a non-executive chairman, are often chosen by the CEO. In Japan, boards are usually honorific.³² The evidence on Japan and Germany indicates that boards are quite passive except in extreme circumstances.³³

The proponents of reforming the traditional board assume that outside directors (or non-executive directors) with little or no equity stake in the company could effectively monitor and discipline the CEO to reduce the

²⁵ M. Latham, "The corporate monitoring firm" (1999) *Corporate Governance* 7(1) 12.

²⁶ J. Charkham, *Keeping Good Company: A Study of Corporate Governance in Five Countries* (1994, Oxford, Clarendon).

²⁷ M. Bishop, "Corporate governance" (1994) *The Economist* 29 January.

²⁸ And J. Kay, *Does Privatisation Work? Lessons from the UK* (1988, London, London Business School).

²⁹ M. Mace, *Directors, Myth, and Reality* (1971, Boston, Harvard Business School Press); M.C. Jensen, "The modern industrial revolution, exit, and the failure of internal control systems" (1993) 48 *Journal of Finance*: 831; J. McRitchie, "Ending the Wall Street walk: why corporate governance now?" (1997) on line, available at <http://www.corpgov.net/forums/commentary/ending.html>.

³⁰ R.A.G. Monks and N. Minow, *Power and Accountability* (1991, New York, HarperCollins).

³¹ M. Weisbach, "Outside directors and CEO turnover", (1988) 20 *Journal of Financial Economics* 431; J. Warner, R. Watts and K. Wruck, "Stock prices and top management changes" (1988) 20 *Journal of Financial Economics* 461.

³² M. Bishop, "Corporate governance", *supra* n 27.

³³ S. Kaplan, "Top executives, turnover, and firm performance in Germany" (1994) 10 *Journal of Law, Economics and Organisation* 142; "Top executive rewards and firm performance: a comparison of Japan and the United States" (1994) 102 *Journal of Political Economy* 510.

fundamental conflict of interest between management and shareholders. In America, outside directors have long been a majority on the board of most big firms.³⁴ In Britain, non-executive directors made up about 33% of the main board in 1990 and 45% by 1996.³⁵ However, “the idea of non-executives” role has proven hollow at best.³⁶ Empirical investigations on UK listed companies during the periods 1989-1993 and 1994-1999 suggest that non-executive directors perform very weak monitoring or disciplining functions and have little or no influence on either CEO or board turnover.³⁷ The reason is that first of all, non-executives are not independent of management as mentioned above. The shareholders’ election is typically a rubber-stamp approval of the candidates chosen by the existing board. Secondly, there tends to be an interlocking relationship between directors.³⁸ Non-executives are in an ambiguous position. Legally they have the same duties as executives and all directors are equal in theory. But in practice, non-executives are asked to act both as team mates of the CEO and as his referee.³⁹ Directors are regarded, both by themselves and by those who choose them, as nothing more than senior managers. Thirdly, outside directors often lack both the personal qualities and the practical resources to perform their fiduciary duties. They may have to bear any expenses occurred in investigating company matters.⁴⁰ They are busy people and probably have little time to think about the company’s affairs or to collect information about the company.⁴¹

The broken connection between shareholders and boards could be shown not only on the board side, but also on the shareholders side, because shareholders are reluctant to play a role in monitoring and controlling the CEO.

Reluctant Shareholders

It has been argued that what is wrong with Anglo-American corporate governance is that far too many shareholders do not behave like owners.⁴² In theory, shareholders as principals have a variety of rights (voice, vote, proxy fight, etc.) to monitor both directors (trustees) and managers (agents). In practice, this mechanism is seriously undermined by many factors.

³⁴ M. Bishop, “Corporate governance” *supra* n 27.

³⁵ K.V. Peasnell, P.F. Pope, and S. Young, “A new model board” (1998) *Accountancy* (July) 115.

³⁶ M.C. Jensen, “The eclipse of the public corporation” (1989) *Harvard Business Review* October 61.

³⁷ J. Franks and L. Renneboog, *Who disciplines management in poorly performing companies?* (1999, unpublished DTI report); S. Letza, P. Hardwick, and J. Ashton, “Who disciplines management in poorly performing companies? An updated study” (2000 Company Law Review Report, DTI).

³⁸ M. Bishop, “Corporate Governance” *supra* n 27; O. Hart, “Corporate governance: some theory and implications” (1995) 105 *The Economic Journal* 678.

³⁹ *Ibid.*

⁴⁰ E. Sternberg, *Corporate Governance: Accountability in the Marketplace* (1998, London, The Institute of Economic Affairs).

⁴¹ O. Hart, *supra* n 38.

⁴² “A survey of capitalism – punters or proprietors”, *The Economist* (5 May 1990).

The obvious problem is that shareholders have less incentive to actively monitor management.⁴³ For instance, even if a reply-paid card or form is offered, the return for annual general meeting resolutions and most extraordinary general meeting resolutions is rarely more than 15%. If a form is provided but not reply-paid, the level of response decreases significantly. If no form is provided, few shareholders are willing to appoint a proxy. For most companies the potential votes in favour of resolutions submitted by proxy forms do not exceed 20% of total possible votes. One important reason for the low incentive is a free-rider problem. In theory, a proxy fight is a very powerful tool for shareholders to discipline directors in a company with dispersed shareholders; a dissident shareholder can put up a slate of candidates to stand against management's slate, and try to persuade other shareholders to vote for his/her candidates. However, as Hart⁴⁴ notes, whereas the benefits from improved management accrue to all shareholders, the dissident shareholder bears all the costs, time and effort in fighting against the current board members. Thus, it is quite reasonable for a shareholder to be reluctant to undertake a proxy fight. Another reason for shareholders' low incentive is that they have often found their proposals useless. According to Strickland *et al.*,⁴⁵ from 1986 to 1993 there were 216 proxy proposals submitted in the USA, among which 53 were negotiated (less than 25%) and 163 were submitted to a shareholder vote (more than 75%). Whilst in a negotiated agreement shareholders might more or less affect the corporate governance structure of the company, most proposals did not see such an effect. A study of 866 shareholder-initiated proxy proposals on governance issues at 317 publicly traded companies in the US from March 1986 to October 1990⁴⁶ found little evidence that shareholders' proposals produced a significant change of corporate policy such as CEO turnover. The average wealth gain from shareholder-initiated corporate governance proposals was not significantly different from zero. The study concluded that even the most successful proposals did not significantly change the companies' policies or stock values.

Another problem with shareholders' monitoring is managers' interference and manipulation. First, shareholders lack sufficient and true information about corporate performance. The content and timing of information distributed to shareholders is determined by directors, whereas the flow of information to directors is determined by executives. Thus, the manipulation of information in favour of management is unavoidable.⁴⁷ Moreover, managers often interfere in the voting process in an attempt to jawbone shareholders into supporting them and conceal information from their

⁴³ *Ibid.*

⁴⁴ See n 41 above.

⁴⁵ D. Strickland, K.W. Wiles, and M. Zenner, "A requiem for the USA: is small shareholder monitoring effective?" (1997) 40(2) *Journal of Financial Economics* 319.

⁴⁶ J.M. Karpoff, P.M. Malatesta, and R.A. Walkling, "Corporate governance and shareholder initiatives: empirical evidence" (1995) *mimeo*.

⁴⁷ E. Sternberg, *Corporate Governance: Accountability in the Marketplace* (1998, London Institute of Economic Affairs); J. Kay and A. Silberston, "Corporate governance" (1995) 84 *National Institute Economic Review* 84.

opponents.⁴⁸ The agenda of general meetings is set by the directors, rather than by shareholders, which significantly limits shareholders' powers.⁴⁹ How to count shareholders' votes is another way of manipulation. Management can find out how shareholders vote proxies in advance of the annual general meeting. Un-voted proxies are often counted in favour of management.⁵⁰ In the process of electing directors, there are no genuine alternative candidates and thus CEOs are re-elected with overwhelming majorities. Also management is allowed by company law to use company funds to promote management's slate of directors. This further facilitates management to act against the dissident shareholder.⁵¹ Due to the ability of the CEO to manipulate voting the shareholders' annual meeting is actually a meaningless election,⁵² "an expensive waste of time and money" (DTI, 1996). The worse thing is that CEOs can use their corporate power to impose commercial sanctions against those who vote against them, for example, not awarding pension fund management or insurance or banking business to their opponents.⁵³ Note the manipulation by the CEO of Enron in this regard.

In addition, shareholders' ability of monitoring is restricted by legislation and jurisdiction:-

It is difficult or even impossible for shareholders to bring forward their own resolutions to the annual general meeting agenda.⁵⁴ According to US securities regulations, to require consideration of their resolutions shareholders must own a minimum of 1 per cent of the securities entitled to vote on the proposition, and must have held these shares for at least one year. In the UK, there is no standard procedure for getting a resolution on to an executive general meeting agenda.

The subject matter for shareholders' resolutions is also severely restricted. In the US, the subject matter is exclusive to the conduct of the ordinary business operations of the company or about company elections.

Shareholders are reluctant and find it difficult to communicate with each other because the procedures for conducting corporate voting are restricted by law or other authorities. In the US, communications amongst shareholders are subject to complex regulatory requirements. Expensive and time-consuming pre-clearance from the Securities and Exchange Commission (SEC) has been required for all communications to shareholders. Proxy contests are severely restricted. Although the SEC revised its proxy rules in 1992, serious obstacles to communication remain.

⁴⁸ J. Pound, "Proxy contests and the efficiency of shareholder oversight" (1988) 20 *Journal of Financial Economics* 237; J.A. Grundfest, 'Subordination of American capital' (1990) *Journal of Financial Economist*.

⁴⁹ See n 47 above.

⁵⁰ J. McRitchie, "Ending the Wall Street walk: why corporate governance now?" (1997) available on line available at: <http://www.corpgov.net/forums/commentary/ending>.

⁵¹ O. Hart, *Firms, Contracts and Financial Structure*, (1995, Oxford, Clarendon).

⁵² J. Kay and A. Silberston, "Corporate governance" (1995) 84 *National Institute Economic Review* 84.

⁵³ See n 47 above.

⁵⁴ *Ibid.*

Filing procedure is still required whenever a voting group owning 5% or more in total agree to vote together.⁵⁵ In the UK, although shareholders are not legally barred from communicating with each other, it is still not easy for them to organise co-operative actions.⁵⁶ For example, shareholders lack sufficient money and information to take action against CEOs.⁵⁷

In many countries, shareholders cannot vote by mail and have to show up at the general meeting to vote. This simply encourages nonvoting by small shareholders.⁵⁸

The incentive problem also exists for large shareholders, particularly institutional shareholders.

The Conflicting Role of Institutional Shareholders

Institutional shareholders are mainly financial institutions such as pension funds, mutual funds, and insurance funds which tend to hold relatively large blocks of shares in publicly quoted corporations. Since the middle of the twentieth century there has been an increasing concentration of ownership into the hands of institutional shareholders. In Britain, financial institutions held approximately 62% of ordinary shares in 1993, more than double that of 1963.⁵⁹ In America, institutional ownership of the top 1000 firms was 57% in 1994, up from 46.6% in 1987, while institutional ownership of the second 50 largest firms was 64.3%. The top five institutional holders held fully 10.8% of all shares in the top 25 largest firms, while the top 25 institutional holders held 24.5% of the shares.⁶⁰ Thus, after the collapse of the market for corporate control in the US at the end of the 1980s, the role of institutional shareholders in the corporate monitoring system has been emphasised as an alternative monitoring mechanism. Institutional shareholders, as large shareholders, are expected by the new advocates of hierarchical governance to play a significant role in the monitoring process. In practice, the activism of institutional shareholders has produced some positive effects on the CEO's performance. Nevertheless, the role of institutional shareholders remains problematic because of their conflicting roles both as shareholders and as investors, the compound agency problem existing between beneficiaries and institutions and between institutions and corporate management, the dilemma of collective choice, and the higher agency costs, all of which raise questions about the effective monitoring of the monitors.

⁵⁵ J. McRitchie, "Ending the Wall Street walk: why corporate governance now?" *supra* n 50.

⁵⁶ See n 47 above.

⁵⁷ M.M. Blair, *Ownership and Control: Rethinking Corporate Governance for the Twenty-first Century* (1995, Washington DC, Brookings Institution).

⁵⁸ A. Shleifer and R.W. Vishny, "A survey of corporate governance" (1997) *The Journal of Finance* LII (2) 727.

⁵⁹ Central Statistical Office (UK), *Share Register Survey Report End 1993* (1994, London, HMSO).

⁶⁰ J.P. Hawley, and A.T. Williams, "Corporate governance in the United States: the rise of fiduciary capitalism" (1996) available on-line at: <http://www.lens-inc.com/info/competition.html>.

The conflicting position of institutional shareholders has been clearly observed by Short and Keasey,⁶¹ who indicate that institutional shareholders have two roles: one is the role of large shareholders who are expected to monitor company management on behalf of smaller shareholders, and the other is the role of investors whose duty is to maximise the return for the beneficiaries of the funds. As shareholders, institutions should take a long-term view of their shareholding positions and incur expense in intervening in management underperformance. As investors, institutions need to be free to exit and incur the least expense intervening in management in order to find the best return for their beneficiaries. Both roles cannot be easily reconciled with each other.

One major problem with institutional shareholders is that as agencies to own and invest the funds on behalf of their beneficiaries, they may not be accountable.⁶² Some scholars find that large pension funds lack the expertise and ability to serve as effective monitors.⁶³ There are several reasons for the belief that agency costs will be higher at the institutional investor level than at the corporate management level. First, the free-rider problem is more severe in institutions than in companies. On the one hand, the beneficiaries of a pension fund are dispersed and do not find it possible or are not willing to undertake monitoring of institutions.⁶⁴ On the other hand, there is no generally accepted mechanism for cost sharing among institutions that undertake collective action like intervening in company management, the result of which is that they prefer to simply do nothing with their fiduciary duties⁶⁵ or report lower returns to their beneficiaries if they have to take costly action.⁶⁶ Second, there is an absence of disciplinary mechanisms to monitor the performance of institutional shareholders. Trustees are typically evaluated on procedural criteria rather than on their investment performance. The usual mechanisms of corporate accountability, such as the disciplinary threat of hostile takeovers, proxy fights, and other corporate control transactions, are neither available nor largely compromised at the institutional level.⁶⁷ Thirdly, institutional shareholders have less incentive and motivation for monitoring because they are merely intermediaries, not the ultimate owners of the shares, and get no direct benefits from attempting to improve corporate governance. The incentive systems of executive compensation used in corporations, such as stock options, are less used and

⁶¹ H. Short, and K. Keasey, "Institutional shareholders and corporate governance" in K. Keasey and M. Wright (eds), *Corporate Governance: Responsibilities, Risks and Remuneration* (1997, Chichester, J Wiley & Sons).

⁶² J.C. Coffee, "Liquidity versus control: the institutional investor as corporate monitor" (1991) 91 *Columbia Law Review* 1277; W. Hutton, *The State We're In* (1995, London, Jonathan Cape).

⁶³ D. Cordtz, "Corporate hangman: hanging some CEOs may encourage others, but should pension funds wield the rope?" (1993) 162 *Financial World* 24; C. Wohlstetter, "Pension fund socialism: can bureaucrats run the blue chip?" (1993) *Harvard Business Review* January-February 71.

⁶⁴ J.C. Coffee, "Liquidity versus control: the institutional investor as corporate monitor", *supra* n 62.

⁶⁵ B.S. Black and J.C. Coffee, "Hail Britannia? Institutional investor behaviour under limited regulation" (1994) 92 *Michigan Law Review* 1997.

⁶⁶ W. Hutton, *The State We're In*, *supra* n 62.

⁶⁷ R.A.G. Monks and N. Minow, *Power and Accountability*, *supra* n 30.

more difficult to design for institutional investors.⁶⁸ This motivational issue has been evidenced by a low level of voting by institutional shareholders. In the top 250 UK companies, only 35% of shares have been voted. In 90% of the companies, the voting level is at 52% or less.⁶⁹ Fourthly, a large shareholder may use its power to improve its own position at the expense of other shareholders. There are two major possibilities: one is that a large shareholder might persuade management to divert profit to itself, for example, by selling goods to a company the shareholder owns at a low price or by buying goods from a company the shareholder owns at a high price. Another possibility is that the shareholder may agree to leave management alone in exchange for having its shares repurchased at a premium⁷⁰ (termed 'greenmail' in the US). One lesson from Germany and Japan is that although getting close to managers can enhance contestability by providing a monitor, it also can reduce contestability if the shareholder become too loyal to the CEO.⁷¹ Finally, institutional shareholders have no clear obligations as owners under company law.⁷² Governments' acquiescence on the conflict of interests in performing the institutional fiduciary duties further worsens the agency costs.⁷³

Hawley and Williams⁷⁴ remind us of a compound agency problem existing between the ultimate beneficiaries of institutional funds and the institution, and between the institution and the fund managers responsible for the investment of those funds. The first-layer agency problem is how to monitor the monitors. This problem arises from the inability of beneficiaries to monitor institutional shareholders since the beneficiaries are extremely diverse. Currently there are approximately 100 million beneficiaries in the US.⁷⁵ The beneficiaries, as a very diverse group, may have quite different interests themselves. To determine what is the "best interest" of beneficiaries for which the institutions are charged to act may be a difficult or even impossible question.⁷⁶ Furthermore, the beneficiaries have little power to hold the trustees accountable. They lack almost all information.⁷⁷ Worse still, the beneficiaries cannot sell their stakes in the pension fund if the fund is under-performing, so they bear all the agency costs.⁷⁸ The second-layer agency problem exists between the institution and the fund

⁶⁸ J.C. Coffee, "Liquidity versus control: the institutional investor as corporate monitor", *supra* n 62.

⁶⁹ C.A. Mallin, "Investors' voting rights" in K. Keasey and M. Wright (eds), *Corporate Governance: Responsibilities, Risks and Remuneration*, (1997, Chichester, J. Wiley & Sons).

⁷⁰ O. Hart, "Corporate governance: some theory and implications" (1995) 105 *The Economic Journal* 678.

⁷¹ *Supra* n 32.

⁷² *Supra* n 66.

⁷³ R.A.G. Monks, "The American corporation at the end of the twentieth century" (a speech at Cambridge University in July 1996), available on-line at: <http://www.lens-inc.com/info/cambridge.html>.

⁷⁴ J.P. Hawley, and A.T. Williams, "Corporate governance in the United States: the rise of fiduciary capitalism", *supra* n 60.

⁷⁵ *Supra* n 73.

⁷⁶ *Supra* n 74.

⁷⁷ R.A.G. Monks, and N. Minow, *supra* n. 30.

⁷⁸ *Supra* n 68.

manager. It lacks appropriate mechanisms to monitor fund managers' performance and prevent them from pursuing their own interests at the expense of institutions. Monks and Minnow⁷⁹ observe that fund managers are seldom accountable for the performance of institutional investments. Long-term rolling contracts can make it difficult for an institutional investor to replace a fund manager.

Monks⁸⁰ remarks that when a large and broadly diversified institutional shareholder such as a pension fund or mutual fund, which owns a cross section of the largest and medium-sized publicly traded companies, and hence owns a small proportion of the entire economy, it gives rise to a universal ownership problem. There are two issues here. The first issue is the problem of competition. If an institution owns majority stakes in all of the major companies in a single industry, what responsibility does the institution have to co-ordinate competition? This is at least an anti-trust issue. The second issue is a collective choice problem. What is good for the group as a whole may not be good for the individuals. There is a dilemma with the fiduciaries and beneficiaries of large institutions. For fiduciaries, institutions would like the companies they invest in to maximise profit aggressively. This could lead to externality problems such as environmental pollution. However, for the beneficiaries of those fiduciaries, as a large proportion of population, they may prefer a cleaner environment. The universal owners find it difficult to deal with the dilemma.

The Case Against Market Optimum

Market optimum is an assumption prevalent in economics. In the field of corporate governance, market governance usually refers to various mechanisms such as capital markets, managerial markets, and markets for corporate control. It is arguable that, although those market disciplinary tools might work under certain circumstances, the market optimum assumption is rarely sustainable in practice and market failure is often evident across time and space.

As explained above, the corporate internal monitoring mechanisms, typically the board and shareholders, are dysfunctional in performing their monitoring duties. It seems to be logical that when internal monitoring mechanisms are seriously defective, the external mechanisms are expected to play a significant role in corporate governance.

Control Of The CEO Through Independent Outside Directors – The Creation Of An “External Mechanism”

It is clear that the Cadbury recommendation for the inclusion of a complement of outside directors, particularly where the CEO occupies the role of Chairman as well, was influenced by the need to recognise and control the clout position and to avoid the apparent positional conflicts that might develop. The background to Cadbury, discussed later, included more extreme measures, including legislative proposals.

⁷⁹ *Supra* n 67.

⁸⁰ *Supra* n 73.

Although there has been doubt cast on the effectiveness of the Codes,⁸¹ the basic premise upon which a separation of CEO and Chairman positions and/or the inclusion of a complement of outside directors is an uncontroversial recommendation in respect of the recognition and control of CEOs.

However, there are some concerns as to whether the recommendation goes far enough in achieving the effective independent monitoring and control of the operation and actions of CEOs. The analysis above⁸² suggests that there is some justification for greater monitoring and control of CEOs and it is the purpose of this section to focus on how this might be developed. This includes the need to explore the role of independent directors and the possibility of developing gatekeeper liability.⁸³

The development of gatekeeper liability and CEO monitoring reflects the fact that it is precisely among top corporate decision makers that legal policies function most effectively to deflect personal and legal risks. It also reflects the concern that monitoring and evaluating the performance of top managers is simply too difficult to permit anything like total convergence of interest between managers and shareholders hence the partial failings of the internal monitoring and control expectations of common law duties.⁸⁴ Eisenberg's positional conflicts⁸⁵ may be an inevitable consequence of the difficulties in this area. The function of gatekeeper liability is identified in Kraakman's model of Corporate Liability Strategies.⁸⁶

STRATEGIES OF MANAGERIAL LIABILITY

Type of Enterprise Liability	Asset Insufficiency	Sanction Insufficiency	Enforcement Insufficiency
Type of Managerial Liability	Shiftable Liability	Central Liability	Gatekeeper Liability

⁸¹ See M.A. Ezzamel and R. Watson, "Organisational Form, Ownership, Structure and Corporate Performance : A Contextual Empirical analysis of UK Companies" (1993) 4 *British Journal of Management*.

⁸² *Ibid.*

⁸³ "Gatekeeper Liability" is explored further in the paper, but it represented an attempt to force a portion of the enforcement burden onto firms' participants (in this case the non-executive director) who are not themselves the initiators of corporate or individual wrongs.

⁸⁴ See Jensen & Meckling, "Theory of the Firm : Managerial Behaviour, Agency Costs and Ownership Structure" (1976) 3 *Journal of Financial Economics* 305.

⁸⁵ *Supra* n 6.

⁸⁶ R.H. Kraakman, "Corporate Liability and the Costs of Legal Controls" (1984) 93 *Yale Law Journal* 857, at 868.

Using Kraakman's model enforcement insufficiency exists where the legal system cannot detect or prosecute a significant proportion of offences or wrongdoing. In the context of the control of CEOs that would reflect the failure of the system of internal controls provided through common law, equity and statutory duties to effectively monitor, detect and enforce those duties. One response to this "insufficiency" is to delegate enforcement to private actors (or gatekeepers) supported by a position of absolute liability. This is the preferred system of "gatekeeper liability" advocated by Kraakman. Potential targets of gatekeeper liability include outside directors and lawyers, accountants and underwriters.⁸⁷ The suggestion is that these outsiders can simultaneously serve as internal monitors of CEO behaviour because they possess privileged information about firm operations which is inaccessible to public enforcement officials or other internal players. It is significant that independent outside directors were identified as potential "gatekeepers", although the main focus of Kraakman's work was on the development of absolute liability on lawyers and accountants as "professionals". Enforcement insufficiency occurs when both enterprise and individual penalties fail to elicit sufficient compliance at an acceptable cost. Much of the recent debate over directors duties and enforcement in the Modern Company Law Review raised questions over the cost effectiveness of enforcement and alternatives. Kraakman's focus on enforcement insufficiency was centred on the firm's top participants. The findings in this area inspired Kraakman to conclude⁸⁸ that only one alternative remained, namely the possibility that civil or criminal liability could induce firm participants outside the circle of controlling managers to discover and prevent offences or wrongdoing. The scope of these participants' gatekeeper liability would depend on the reach of their duties to monitor for and respond to corporate wrongdoing. Gatekeeper liability joins the risk of absolute liability with an active duty to monitor for wrongdoing. It imposes liability on an entirely new class of innocent gatekeepers to reduce enforcement costs, the frequency of wrongdoing, or both. True gatekeeper liability is designed to enlist the support of outside participants in a firm when controlling managers (CEOs) commit wrongdoing or grossly underperform.

The first requisite for gatekeeper liability is identification of an outsider who can influence CEOs to forgo wrongdoing or improve performance. Reflecting on developments in the securities industry, Kraakman concluded that it was easy to see why outside directors, accountants, lawyers and underwriters were likely targets for a gatekeeper liability strategy. Each has, or might have, low cost access to information about a firm's wrongdoings and CEO behaviour. Contractually or informally, each already performed a private monitoring service on behalf of the capital market. But, and perhaps more significantly, each was an outsider with an independent career and assets beyond the firm. It is believed that an outsider with both a career and assets beyond the firm will be influenced by the reputational effects of any failure of their monitoring and enforcement activity. They have larger interests to consider, particularly lawyers and accountants who have both individual and firm reputations to protect. It is also suggested that if these gatekeepers can detect wrongdoing it would be extremely difficult to entice

⁸⁷ *Ibid* at 892.

⁸⁸ *Ibid* at 897-898.

them into a conspiracy or to condone that wrongdoing. On that basis many offences will fail either because the outsiders cannot be corrupted or because the price of corruption exceeds its potential benefits. Thus it is perceived that gatekeeper liability will thwart a class of offences and wrongdoing that are unreachable through enterprise level or managerial sanctions. However, the imposition and development of gatekeeper liability is not without its problems. Clearly there is a cost element and if gatekeepers cannot shift their liability risks they will charge higher premiums. (Although one suspects that if the reputational influences are so great, then the operation of indemnity insurance for outside independent directors will enable the risk shifting required without adversely affecting the incentives to enforce and monitor). There is also concern whether the development of gatekeeper liability through independent non-executive directors might result in a more interventionist approach in the operation of board matters and corporate affairs. This might not enhance efficiency. Finally, there exists the possibility that it may be difficult to identify and persuade individuals to operate as non-executive directors. It is clear that the enforcement potential of a system of gatekeeper liability entirely depends upon the wrongdoing and level of culpability that triggers personal liability and on the choice of gatekeepers and the design of their duties. The problem of the market for gatekeeper services depends upon the sensitivity of potential gatekeepers to risk of personal liability, even though that liability can be shifted through indemnity insurance. It is reputation that is more important. A further issue is the extent to which CEOs dominate the selection of the non-executive director and that selection and relationship may result in the outsider being a captive outsider, only too willing to assume personal liability deferred through indemnity insurance for an appropriate price.

It is in the design of the duties of gatekeepers that we find the greatest difficulties. Do we require them simply to monitor and report to the Board on the potential commission of crimes and the failure to comply with statutory requirements. Or should a broad concept of failure to disclose key information affecting the management and performance of the company be preferred. All of these would require access to information and some of these would require strong technical skills possessed only by lawyers and accountants.

We also have to consider the position of the courts in determining the failure of the duties of gatekeepers and the imposition of absolute liability. Will the courts measure that failure against a broad concept of failure to report poor management, or will they require some more defined and generally acceptable measure, such as the failure to report breach of statutory duties or the provision of selective information to the board to assist in its decision making. One suspects that the courts would be reluctant to consider any broad concept of poor management and would be more comfortable with a more defined concept of duty. However, the greatest contribution would be to assist the board in both its decision making and its assessment of the role and the thoughts of the CEO through the provision of information to the board. In other words a model could be developed which would impose gatekeeper liability on a gatekeeper's clearly defined role of monitoring the provision of information from the CEO on the CEO's activities and other agreed financial and market information to assist the board in its decision making. Thus, the focus for enforcement would utilise the non-executives

and their interests in their reputation in order to control the CEO and ensure that information and decisions were provided to the full board for both the effective control of the CEO and the more effective performance of the broader role of the board in its contribution to the development of the company. On that basis we could respond to Kraakman's concerns of enforcement inefficiency while expanding the Cadbury recommendations to produce a more effective duty to perform imposed upon the non-executive outside director.

An initial assumption to be made in this area is that the independent director role includes a monitoring and reporting and then an individual or collective enforcement role. The assumption behind the Code recommendations on the inclusion of independent directors is the assumption of a role of monitoring the activities of the CEO. This follows earlier recommendations from a number of bodies including the British Institute of Management, that non-executives should have a legally defined role supporting complete independence.⁸⁹ Similarly, a private members Bill was introduced in the early 1970s requiring that non executive directors should be compulsorily part of the Board with a duty to report annually to shareholders on their assessment of the quality of the company's management and of the use of its assets.⁹⁰ Similarly, the Watkinson Committee was set up around the same time to look at the problem of how to improve the accountability of management.⁹¹ The 1977 White Paper on the Conduct of Company Directors similarly concluded that non executive directors should provide independent supervision of the company's management and, to enable them to do so, they should have free access to management information. That report concluded that "the time may come when it would be appropriate to legislate in this field."⁹² There then followed a series of reports and surveys which all saw the value of independent monitoring of management performance.⁹³ These were the forerunners to the Cadbury recommendations. They included a set of guidelines which were published by the Association of British Insurers in 1990, including a statement on the best practice of the role and duties of directors.⁹⁴ These guidelines emphasised the importance of non executive directors being independent and recommended that they be "in sufficient number and calibre for their views

⁸⁹ British Institute of Management, "The Board of Directors : A Survey of Its Structure, Composition and Role" *Management Survey Report No.10* (1992, London).

⁹⁰ Introduced by Sir Brandon Rhys Williams, a Conservative Backbencher, Hansard, House of Commons (1971-1972) Vol 834, Col. 1661.

⁹¹ Reported in 1993 as *The CBI, The Responsibilities of the British Public Company*.

⁹² Department of Trade, *The Conduct of Company Directors* (Cmnd 7037, London, 1977) para 21.

⁹³ These included the "Bullock" Report, Department of Trade, *Report of the Committee of Inquiry on Industrial Democracy* (Cmnd 6706, London, 1977); The Institute of Directors, *A Code of Practice for the Non-Executive Director* (London, 1982); and *Composition of Company Boards* [1988] *Bank of England Quarterly Bulletin*, 242.

⁹⁴ ABI, *The Roles and Duties of Directors* (1990). These were re-issued in 1991, *Institutional Shareholder Committees: The Role and Duties of Directors – A Statement of Best Practice* (1991).

to carry sufficient weight on the board.”⁹⁵ The ABI report went further than Cadbury in recommending that non-executives should “acknowledge a particular duty to monitor the performance of the board as a whole.”⁹⁶ It is clear that the Cadbury Code did not extend to the introduction of a duty. Nevertheless we are in a post-Cadbury position and a duty might now be accepted as appropriate. Other commentators accept the monitoring role of independent directors. Cheffins suggests that outside directors fulfil two key functions.⁹⁷ One relates to support and assistance in managerial tasks, the other is monitoring executive decision making. According to Cheffins this will involve reviewing the performance of management to ensure that those in charge are running the company in the shareholders interests and are complying with legal duties, regulatory requirements, and ethical imperatives associated with the operation of a public company.⁹⁸ In situations where corporate performance is markedly substandard there are examples of outside directors orchestrating the removal and replacement of key executives.⁹⁹ Some have suggested that monitoring by non executives involves subjecting senior managers performance to ex post review and if necessary taking steps to remove them.¹⁰⁰ Such monitoring offers a way of overcoming management entrenchment. It may also play a part in controlling improper self dealing and other hygiene issues and in combating the adoption of growth and diversification strategies that benefit managers but which may be sub-optimal from the point of view of shareholders and the economy as a whole. Others accept that monitoring by non-executives is a potentially viable governance control but that the operation of the market has not been sufficient to induce satisfactory monitoring compliance.¹⁰¹

If we accept that the outside independent director performs a monitoring role, and if we accept the enforcement insufficiency that currently exists, then a number of issues remain in the development of gatekeeper liability. Kraakman suggests that the issues fall under two headings, first the market for gatekeeper services and second the scope of gatekeeper duties.¹⁰² To these we may add a third, namely the regulatory structure. We will consider these heads in turn.

The Market for Gatekeepers Services

The market for independent directors per se exists. Pro Ned¹⁰³ were active in developing this and studies by PIRC¹⁰⁴ confirm the extensive use of

⁹⁵ *Ibid* at n 3.

⁹⁶ *Ibid*.

⁹⁷ *Supra* n 2, at 95-108.

⁹⁸ *Ibid* at 96.

⁹⁹ Examples include the resignation of the CEO of British Petroleum Plc in 1992; the resignation of Mr Maurice Saatchi from Saatchi & Saatchi Plc in 1995, and the resignation of Mr Perot from General Motors in 1992. See D. Clutterbuck and P. Waive, *The Independent Board Director: Selecting and Using the Best Non-Executive Directors to Benefit your Business* (1993).

¹⁰⁰ See Parkinson, *supra* n 10, at 235.

¹⁰¹ See J.B. Parkinson, *Corporate Power and Responsibility : Issues in the Theory of Company Law* (1993, Oxford University Press), at 181-188.

¹⁰² *Supra* n 83, at 892-893.

¹⁰³ PRO NED was set up in 1981 with the active support of the Bank of England. One of the functions of PRO NED was to increase the number and quality of non-

independent directors, many of these being lawyers and accountants. Kraakman saw this issue as one of a concern over the sensitivity of potential gatekeepers to risk of personal liability. This influenced the level of incentive to become involved as gatekeepers although one suspects that the sensitivity over personal liability might be overcome through the extension of directors indemnity insurance cover to such outsiders. It has been widely suggested that the main incentive to act effectively in monitoring the CEO and board performance is reputational.¹⁰⁵ Professionals and their firms have much to lose through an association with poorly performing companies (see Enron). Evidence from the United States confirms the adverse effects upon professionals if the market perceives a failure to monitor effectively in situations of poorly performing companies.¹⁰⁶ Kraakman also perceived a problem in terms of reputational implications and suggested that liability could be extended from the individual to the firm.¹⁰⁷ We suggest that liability should remain with the individual, thereby accommodating the wide range of individuals who might undertake non-executive roles and also avoid any issues in respect of conflicts of insurance.

A related issue in the market for gatekeeper services is one of selection. We don't have nomination committees for non-executive directors. Nor, despite the efforts of Pro Ned, do we have a defined class of skilled non-executives. However there is some suggestion that Pro Ned is widely consulted and nominating committees are sometimes used to promote and appoint to the role of non-executive director.¹⁰⁸ A major concern in the absence of any nomination committee or independent selection process is the influence of the CEO in nominating and recommending non-executive directors. The influence of the CEO is one that without doubt exists, not only in selection but also in the removal of non-executive directors.¹⁰⁹

We have noted that non-executive directors in companies that perform poorly will be penalised in the market for their services. It is clear that there is value in appointing non executive directors who have an interest in developing and protecting a reputation as diligent and skilled monitors and there is value more broadly in attempting to create a distinct profession of non executive directors in order to promote these qualities.¹¹⁰ While the theoretical case for independent monitoring appears fairly strong, the

executives and to act as a clearing house, bringing together companies and suitably qualified candidates.

¹⁰⁴ See PIRC, *A Guide to the Guidelines : A Survey of Institutional Shareholder Corporate Governance Policies* (London, 1997).

¹⁰⁵ See S. Kaplan, and D. Reishers, "Outside Directors and Corporate Performance" (1990) 27 *Journal of Financial Economics* 389.

¹⁰⁶ See M.S. Weisbach, "Outside Directors and CEO Turnover" (1988) 20 *Journal of Financial Economics* 631; and S. Kaplan, and D. Reishers, "Outside Directors and Corporate Performance" (1990) 27 *Journal of Financial Economics*.

¹⁰⁷ *Supra* n 21, at 893.

¹⁰⁸ Cheffins, *supra* n 2, at 98.

¹⁰⁹ See D. Clutterbuck, and P. Waine, *The Independent Board Director: Selecting and Using the Best Non-Executive Directors to Benefit Your Business* (London, McGraw Hill), at 191.

¹¹⁰ See R.J. Gibson, and R. Kraakman, "Reinventing the Outside Director : An Agenda for Institutional Investors" (1991) 43 *Stanford Law Review* 863.

empirical evidence, most of it American,¹¹¹ on the positive contribution of outside directors to economic performance is more equivocal. Apart from the vagaries of career development and exposure, one of the most obvious incentives to consider is that of payment and reward. The non-executive director will normally receive a fee for attending meetings and carrying out related duties. Some may also be in receipt of an annual retainer and may through the company agree that they can claim reasonable expenses such as travel and accommodation. In some cases the non-executive director is not the individual in receipt of any fee. The outside director might permanently work for another company or institution and the fees be paid directly to that primary employer as reimbursement for allowing the individual to spend time acting as a non-executive. In all cases it has been suggested that the fee is not particularly large.¹¹² It is reasonable to assume that exposure to gatekeeper liability might have an effect upon fees, although the reputational effects of a failure to monitor poor performance has not had the expected effect upon fee levels in America. There is rarely any direct correlation between corporate performance and the financial return an outside director receives. In fact, calls for the alignment of non executive directors' interests with those of shareholders, remunerating them with share options, has met with disapproval, notably in Cadbury and Hampel with the suggestion that it tends to undermine independence.¹¹³ There also exists a view that tying director remuneration to corporate performance may simply duplicate the incentives which already exist. For example, it has been reported that non executive directors are keen to serve and carry out their duties because board appointments are prestigious, often an intellectual challenge, and can yield potentially viable business connections.¹¹⁴ There is also the motivational effect which replicates the independence concerns of Cadbury and Hampel, namely, if a company's excellent performance results in a non executive being rewarded richly, that non executive may be more reluctant to speak out freely on crucial and controversial issues for fear of jeopardising a lucrative appointment. Remuneration schemes that induce directors to become deeply involved in corporate affairs affect the directors' independence.¹¹⁵ It is expected that the introduction of gatekeeper liability would enhance the standing and reputation of the role as well as increasing the dangers of

¹¹¹ For the UK position see M. Ezzamel and R. Watson, "Organisational Form, Ownership, Structure and Corporate Performance: A Contextual Empirical Analysis of UK companies" (1993) 4 *British Journal of Management* 161; S. Letza, P. Hardwick and J. Ashton, *Who Disciplines Management in Poorly Performing Companies? – An Updated Study* (a study prepared for the Company Law Review Steering Group) at www.dti.gov.uk.

¹¹² Clutterbuck and Waine, *supra* n 48, at 147, report that for a non-executive director who works approximately 15 days per year, the amount he will be paid annually will vary from about £7,000 for smaller limited companies to something over £20,000 for larger business enterprises. It has been suggested that the fees for non-executive directors appear to be increasing, "Non Executive Fees Rise Along with Extra Responsibility" *The Times*, 13 May 1996 (Survey indicating that fees paid by the largest UK companies rose from an average of £29,000 per year in 1995 to £37,000 in 1996).

¹¹³ See Gibson and Kraakman, *supra* n 110.

¹¹⁴ See Cheffins, *supra* n 2, at 101.

¹¹⁵ C. Villers, "Executive Pay: Beyond Control?" (1995) 15 *Journal of Legal Studies* 260.

liability. The enhanced reputation of the role should bring with it other benefits in terms of business connections and intellectual challenge. This might present a sufficient balance in respect of the level of fees currently payable, or the reasonableness of fees to be paid in the future. If the call continues to relate fees to corporate performance, despite the concerns of independents, then one suggests that the agency funded response of Gilson and Kraakman might be one to consider in the future.¹¹⁶

Gatekeepers' Duties

Kraakman¹¹⁷ suggests that the success of gatekeeper liability hinges on the development of legal duties that encourage the detection and interdiction of offences without overburdening the private relationships that serve as a vehicle. This requires a crafting of circumscribed duties to monitor and respond, that above all, do not ask too much from their target. The design and duties must not compromise the non-executive role as adviser, facilitator and monitor. It becomes a complex issue in terms of should the non executive gatekeeper be responsible for the failure to act to prevent mismanagement by CEOs, should their duties extend only to a duty to monitor and report poor performance, or one that clearly relates only to the so called hygiene issues of compliance with statutorily defined duties? If the duties are those of monitoring and reporting as opposed to monitoring and prosecuting or enforcing, then they are likely to be more manageable. It would also lessen concerns over developing sufficient incentives to act. A duty to monitor and report corresponds with the accepted position of independent directors. The position is one that non-executive directors today enjoy unlimited access to company information.¹¹⁸ The development of a duty to monitor and report should codify this practice. Non-executive directors should have a statutory right to certain information at declared points at or before company board meetings and audit reports. They would need the skills to analyse and present the information to the board, with a right to report and question the CEO. The development of what might be regarded as such a low monitoring and reporting requirement is one that can accommodate concerns over incentives and concerns over skills deficiencies. The latter relates to the ability of the gatekeeper to identify and exercise a monitoring function. One would expect a lawyer or accountant to be proficient, but equally skilled would be a wider class of experienced non-executive directors. The duty to monitor and present information is one that is also sufficient in respect of making a contribution to enhancing corporate governance.

The Regulatory Structure

This invites consideration of a number of matters. First, there is Kraakman's insufficiency of enforcement category.¹¹⁹ Insufficiency of enforcement can be

¹¹⁶ Gibson and Kraakman, *supra* n 49, at 884-892, where it is suggested that an agency funded by institutional investors be established to act as a clearing house for professional outside directors and to monitor their performance.

¹¹⁷ *Supra* n 83 at 893.

¹¹⁸ See Parkinson, *supra* n 10, at 241 and also KPMG, *The Role and Responsibilities of Non-Executive Directors : A Survey* (1999).

¹¹⁹ *Supra* n 83 at 888.

measured against the efficiency of regulation presented through the gatekeeper approach. The efficiency can be measured at the level of enhancement of performance that one would assume to flow from using the independent directors as gatekeepers. It is clear that the independent directors are the ones who have information advantages over other possible nominee gatekeepers, such as shareholders. Efficiency is also present in the sense that board monitoring is free from the other problems that are liable to frustrate shareholder interventions, and avoid the very considerable costs associated with takeovers (bid premiums and transaction costs) that significantly blunt their disciplinary effects. Efficiency is also present in that there are some studies that support the proposition that monitoring by independent directors will have a positive effect upon corporate performance and CEO performance.¹²⁰

The second point to note is that the development of a regulatory regime must be a legislative regime rather than one reliant upon codes or the development of controls based upon market practice. This brings forward the Labour Party suggestions¹²¹ that legislation in this area might be required and also supports the ABI proposals¹²² on the development of a statutory duty. The UK approach in this area has so far been one of developing best practice and voluntary codes and the main cause of concern, certainly for Cadbury, has been the difficulty of removing poor quality managers and the effect of this on corporate performance generally,¹²³ and not just the rather narrow issue of seeking to protect a company from unscrupulous Chief Executives. The introduction of the Codes themselves suggest that, over an extensive period, competitive forces in the market alone were failing to bring about the necessary strengthening of internal control. In this aspect of enhancing corporate performance and the effective monitoring of poor performance by CEOs, the Codes do not appear to be sufficient.

We noted earlier that the Cadbury recommendation did not go as far as the ABI best practice code that preceded it. Even in the MCLR it was noted that the government had an intention to replace the Codes where they were not effective.¹²⁴ The MCLR noted that the broad picture of the operation of codes in this area required a fresh look.¹²⁵ We are not alone in thinking that the codes of practice that we have relied upon to stimulate and shape board reform may need to be further refined or even replaced with a more prescriptive approach. The prescriptive approach we recommend should not

¹²⁰ See the studies by IM Millstein and PW MacAvoy, "The Active Board of Directors and Performance of the Large Publicly Traded Corporation" (1998) 98 *Columbia Law Review* 1282, that suggested that outside directors in the United States play an important role in replacing Chief Executives and in improving the performance of the company.

¹²¹ Department of Trade, *The Conduct of Company Directors* (Cmnd 7037, London 1977), para 20: "the time may come when it will be appropriate to legislate in this field."

¹²² See Association of British Insurers, *The Roles and Duties of Directors* (London, 1990).

¹²³ For an account of the UK position, see Letza, Hardwick and Ashton "Who Disciplines Management? An Updated Study" *supra* n 111.

¹²⁴ DTI (1998) *supra* n 7, at para 3.7.

¹²⁵ DTI (1999) *supra* n 7, at s 5.5, "Regulation and Boundaries of the Law."

be viewed as replacing the codes. It is not an all or nothing approach. The monitoring obligations of the gatekeeper should be those prescribed in statute through an explicit statutory duty to that effect, but the details of board composition and other responsibilities around governance such as remuneration and nominations committees and procedures, should still be subject to the flexibilities of codes. No doubt such an approach will result in a fresh look at other aspects of the Codes in the future. Nevertheless the model suggested might enjoy the flexible benefits of codes through the enhanced position of regulatory conversations which would be a reasonably foreseeable consequence of the monitoring relationship between the CEO and the non-executive director.¹²⁶

Finally, a mention must be made of the concerns that have been expressed in respect of the number of independent directors required on a board to ensure effective independent monitoring. Although it is increasingly common in the US for a substantial number of companies to have boards where non-executive directors constitute a majority, it is a rare occurrence in the UK.¹²⁷ None of the codes adopted in the UK impose such a requirement. The development of the proposed model of regulation and gatekeeper liability does not depend upon the board being comprised of a majority of independent directors. The position of multiple independent directors raises issues in terms of joint and several liability although this is where the code recommendation that a lead non-executive director is identified for the purposes of reporting is sufficient guidance.¹²⁸ That aspect of the Code should be one reflected in the prescriptive nature of the proposed gatekeeper liability control.

CONCLUSION

Thus we are faced with responding to the insufficiency of enforcement of the governance of poorly performing CEOs. The development of gatekeeper liability to be imposed upon the lead non executive director is consistent with empirical evidence of non executive influences on CEO and company performance in the US,¹²⁹ and is also consistent with the trends in the UK for developing an independent monitoring role for non-executive directors. It also overcomes the inefficiency of internal mechanisms of control as supported by the studies presented in this paper. The development of such a gatekeeper approach is not without its problems, notably those of incentives and scope of duties, but these problems are not insurmountable. One matter that may need further examination, albeit not an issue that has caused concern in the US, is the position of the inhibitive effect of interference that

¹²⁶ For an account of the contributions of “regulatory conversations” to the system of control, see J. Black, “Talking about Regulation” (1998) *Public Law* 77. The concept appears to be similar to the political scientists category of “negotiated regulation”.

¹²⁷ Although it has been reported that the boards of virtually all listed companies in the United Kingdom now have a significant proportion of non-executive members (PIRC, *Compliance with the Combined Code: A Study Prepared for the Company Law Review* (1999) see www.dti.gov.uk).

¹²⁸ This originated as a recommendation of the Hampel Committee, *supra* n 11, in an attempt to suggest changes to Cadbury in order to strengthen the monitoring role.

¹²⁹ See Millstein and MacAvoy, *supra* n 120.

monitoring might present in board decision making and corporate strategy development. This ought not to be a real concern when the advantages of regulatory conversations, supported by the powers and responsibilities of the gatekeeper approach, would present the benefits of accommodating interference outwith board meetings. On the face of it, this proposal might seem very radical and yet it is a natural evolution of both the codes of practice and the role of the non-executive director. It is also not an unusual situation in that state interference through legislation in respect of board operations and management performance is nothing new – in the post-Enron era it might well be expected.