

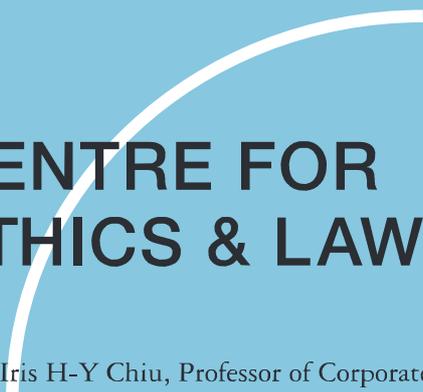
**CENTRE FOR  
ETHICS & LAW**

**Submission to the Business Skills and Innovation**

**Commons Select Committee**

*Corporate Governance Enquiry*





# CENTRE FOR ETHICS & LAW

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# BIOGRAPHIES

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Dr Chiu has published extensively on directors' duties, shareholder stewardship and corporate governance, as well as regulatory theories and governance in the financial sector, in over 40 peer-reviewed journals in the UK and US. She has published a number of books including *Regulatory Convergence in EU Securities Regulation* (Wolters Kluwer 2008) which deals with EU securities regulation and a systemic analysis of harmonisation in the law in books as well as the law in action; *The Foundations and Anatomy of Shareholder Activism* (Hart Publishing 2010) which deals with the legitimacy issues surrounding various forms of shareholder activism in the UK and EU; and *The Foundations and Future of Financial Regulation* (Routledge, 2014, co-authored with Mads Andenas) and *The Legal Framework for Internal Control in Banks and Financial Institutions* (Hart Publishing 2015). She is editor of *The Law of Corporate Governance in Banks and Financial Institutions*, one of the Elgar Law and Finance Series and the *Research Handbook on Shadow Banking*. She is Executive editor of the *European Business Law Review* and co-series editor of the *Palgrave Macmillan Corporate and Financial Law Series*.

Dr Chiu is co-Director of the UCL Centre for Ethics and Law, a research centre focused on thinking and development in topical issues of business and society, law, regulation and ethics, the professions and ethics, and ethical dimensions in medicine and technology. The Centre of Ethics and Law may be found at the website: <http://www.ucl.ac.uk/laws/law-ethics>.

## Roger M Barker

Dr. Roger Barker is an internationally-active expert in corporate governance and board effectiveness. Prior to launching Barker & Associates Corporate Governance Consulting, Dr. Barker served as the Director of Corporate Governance and Professional Standards at the Institute of Directors for 8 years. He remains a Senior Consultant at the IoD, and also sits on the board of European Women on Boards ASBL. Dr. Barker is a UK Member of the European Economic and Social Committee (the EU advisory body), Senior Advisor to the Board of the European Confederation of Directors Associations (ecoDa) and Chairman of the ecoDa Education Programme for European Directors. In recent years, Dr Barker has acted as an external governance consultant to the International Finance Corporation, the OECD, GUBERNA, VisionFund International, The European Bank for Reconstruction and Development, Securities Investors Association Singapore and the Asian Development Bank. A former investment banker, he spent 13 years in a variety of research and management roles in the Equities businesses of UBS and Bank Vontobel, both in the UK and Switzerland. Dr. Barker is the holder of a doctorate from Oxford University and the author of several books on corporate governance and board effectiveness, including 'The Effective Board: Building Individual and Board Success' (Kogan Page, 2010) and 'Corporate Governance, Competition, and Political Parties: Explaining Corporate Governance Change in Europe' (Oxford University Press, 2010).

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# EXECUTIVE SUMMARY

1. Corporate ethics can be improved through corporate governance reforms that address the balance of power in a corporation and move away from shareholder primacy.
2. There should be a fundamental willingness to recognise the valuable and plural inputs of different categories of 'capital' for a corporation's wealth creation beyond that of managerial talent and shareholders' investment.
3. Corporate governance reforms should orient towards greater stakeholder engagement and protection, and these can be operationalised in corporate law reform.
4. Directors should have a duty to map and engage the key stakeholders of a company relevant to its long-term success as a whole.
5. Key stakeholders of a company should be protected by a constitutional document/s with the company setting out engagement frameworks and each other's responsibilities and obligations.
6. Directors should owe their duties to promote the long-term success of the company as a whole and not just to members (i.e. shareholders) as a whole.
7. Directors should have a duty to ensure prevention of asset stripping or excessive corporate wealth transfers.
8. Controlling shareholders should owe fiduciary duties to the company, whether in a public or private company.
9. Enforcement of directors' and controlling shareholders' duties should be widened to enhance stakeholder accountability and to address current weaknesses in enforcement.
10. Best practices in corporate governance should extend to issues of firm-wide corporate culture, internal control, middle to lower levels of governance, firm-wide communications and scrutiny, and whistleblowing institutions.
11. Board composition should be reformed to include some measure of stakeholder and independent representation, subject to minimum criteria of directorial competence.
12. Board diversity should be encouraged in light of the composition reform proposed immediately above, but should still be determined by an independent nomination committee of the Board.
13. Executive pay should reflect a fair balance of power and wealth distribution in the company. It should encourage long-term business success and be seen as legitimate by wider society.
14. There is scope to consider if malus and clawback rights over a defined period of time against executive pay should be legislated in favour of companies.
15. There is a case for an independent Board committee for ethics and good culture in every publicly traded and significant private company.

# MODERN CORPORATIONS AS THE FACE OF A FLAWED CAPITALISM

The context for this Parliament Inquiry into corporate governance in the UK largely revolves around public distaste for the 'unacceptable face of capitalism' (eg see 'Philip Green is not the only unacceptable face of capitalism', Financial Times (28 July 2016)) which has manifested itself in several recent corporate scandals, such as those at BHS and SportsDirect. We believe that the capitalist model is still a sound basis for economic order as it can be supportive of individual development and freedom, economic growth, and aligned with our democratic values. Adam Smith's and David Ricardo's writings reflected an optimistic vision of capitalist order where productivity is fairly rewarded in a free market. However, modern capitalism is interposed by the corporation (eg Galbraith, 1976), now the predominant way of organising business and enterprise. For various reasons, the modern corporation can fall short as an effective vehicle through which to realise the optimistic capitalist vision.

The modern corporation is both a legal form and an ideological construct. Furthermore, it is both an economic organisation that manages resources, channels productivity and creates wealth as well as a societal institution for human development, innovation, employment and social citizenship (see Bratton et al, 2010).

In the UK, the legal construct of the modern corporation is a 'separate legal person' subject to internal control by the 'Board of Directors' and, to a greater latitude than in many jurisdictions, by shareholders. The dominant 'contractarian' ideology of the corporation (from Coase, 1937) which underlies shareholder primacy (notably, Easterbrook & Fischel, 1984) unabashedly supports the purpose of the modern corporation as maximising shareholder wealth. Neither the legal nor prevailing ideological construct of the modern corporation reflects the reality that (a) the economic organisation is made up of many more parts than its 'Board' or shareholders, and (b) the societal institution that is the corporation serves multifaceted purposes and carries out activities not narrowly confined to shareholder wealth maximisation. Although there are many opposing views that moderate the 'shareholder primacy' view of the modern corporation,

corporate law in the UK still largely reflects shareholder primacy (Keay, 2009, 2012; on the US see Strine, 2012). Where recent corporate practices now reflect the 'unacceptable face of capitalism', we argue that this is because such practices are based on exploiting the limits in existing corporate law and ideology, i.e. pursuing a narrow-minded view of 'shareholder primacy' which ultimately subverts the more positive elements that could characterise a capitalist economic system.

How can the modern corporation be reformulated in order to foster both ethical business behaviour and efficient/competitive economic organisation? We argue that there is a need to recognise the crucial importance of different types of 'capital' that the corporation mediates for wealth creation. The shareholder primacy mantra in corporate law and ideology places undue emphasis on the importance of managerial talent and shareholders' investment. We need to move away from these narrow frames and extend recognition to the importance of the intellectual and human capital of employees, reputational capital conferred by the corporation's community, financial markets, media etc, loyalty capital committed by customers, users etc, firm-specific capital such as committed by dedicated suppliers and other forms of capital which could be tangible or intangible resources that the corporation draws upon for its business success. The legal and ideological construct of the modern corporation has distorted the playing field for various types of 'capital', resulting in the relative value of managerial talent and shareholders' investment being treated as far superior to the value of other types of capital mentioned above, with negative impact on both business ethics and long-term corporate performance.

## Importance of Corporate Governance

The economy-wide framework of corporate governance (as embodied in both legislation/regulations imposed by the state and company-level business practices and attitudes) could play a significant role in driving recognition and fair valuation of plural and diverse sources of 'capital' mediated by the modern corporation. The corporate governance system distributes decision-making, participation and governance rights over the creation and distribution of wealth by the corporation. Hence, we should not accept that corporate governance should only be about the Board's accountability to shareholders. The argument for accepting such a model, which has been in the past justified by arguments concerning corporate efficiency, is increasingly weak, as the US and UK corporate sectors, representative of this approach, have produced many instances of corporate scandals and malpractices, and have contributed greatly to social inequality (eg Ireland, 2009).

It is also increasingly clear that a corporate objectives driven by considerations of short-term shareholder value maximisation are associated with various undesirable features of the UK economy, such as internationally weak levels of research and development expenditure (less than half that of China as a percentage of GDP), an unhelpful tendency amongst listed companies to distribute cash flow to shareholders (through share buy-backs and dividends) rather than re-invest in innovation, training and long-term success, and low levels of labour productivity relative to other advanced economies. Rising levels of income inequality and low levels of public trust in business are also deleterious side effects of the UK model of corporate and economic governance.

The OECD's definition of corporate governance is more balanced in its recognition of the role of different stakeholders, viz 'involving a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined' (OECD, 2015).

This does not mean that we argue for corporate law to intervene into the distributive outcomes in a corporation directly, as we view this approach to be too intrusive. We argue that there is a need for more emphasis on 'procedural justice', i.e. in the adoption by companies of a framework for corporate governance where the voice of different 'capital' suppliers to the corporation can be heard in such a way that the interests of any one powerful group may be effectively balanced and complemented

The Board of Directors is typically seen as lying at the centre of managing diverse 'capital' inputs into the corporation (Blair and Stout, 1984) As 'team manager' and centralised decision-maker of the company, the Board is at once supreme in exercising the company's powers but also a steward of the corporation's resources. We agree that the Board and executive functions in a corporation are essential for the purposes of efficient and effective organisation (Williamson 1980). Hence it is also right that their discretionary responsibilities and accountability remain at a level exceeding other 'capital' providers to the corporation. However, we believe that it is welfare-enhancing, ethically just and also efficient to distribute some aspects of power in the corporation more widely subject to adequate responsibility and accountability standards (Freeman 2001, Philips 2003). Stakeholder involvement in corporate governance has been criticised in some quarters as being impractical or counter-productive (Hendry, 2001, Kaler 2009, Keay 2010). However, critics have not engaged sufficiently with options in procedural design to justify such dismissive conclusions (Greenfield, 2005).

We also suggest that focusing on 'the corporate governance of the Board and Shareholders', although relevant to corporate problems that are attributable to high level issues of distribution of power and decision-making, is less relevant to corporate malpractices at lower levels in the corporation (Free et al, 2006). The SportsDirect scandal for example highlights a pervasive adverse corporate culture at all levels.

Although 'tone at the top' is extremely important for corporate culture (de Vries et al, 2009), and we offer a proposal as to how corporate governance can provide leadership to change corporate culture in the Section relating to 'Board Composition', we are also of the view that corporate culture can be improved by the enhancement of control, reporting, training and whistleblowing systems at all levels of the Firm. Hence, corporate governance reform should be supported by other systems that shape corporate culture at the top, middle and bottom of the organisation (Regan, 2008).

These key points are addressed in the Sections that follow, which respond to the questions posed in the Terms of Reference.

We submit that:

- (a) Directors' duties framed towards the long-term success of the company is the correct position but the current s172 should be redrafted and linked by new duties proposed in this submission;
- (b) The corporate governance of a corporation must incorporate 'key stakeholder' representation in salient decisions;
- (c) There should be a case for considering duties for controlling shareholders whether in private or public companies in order to be consistent with the long-term success of the company as a whole;
- (d) There is scope for more governance over executive pay other than relying on shareholders' vote. Executive pay levels at larger companies often represent the unbalanced and distorted face of capitalism that society is increasingly finding unacceptable and symptomatic of weak underlying governance;
- (e) Reform in Board composition that reflects a balanced corporate governance framework is desirable.

# DIRECTORS' (AND SHAREHOLDERS') DUTIES

Is company law sufficiently clear on the roles of directors and non-executive directors, and are those duties the right ones? If not, how should it be amended?

The duties in company law are to the company as a whole (s170 and case law antecedent to the Companies Act 2006). However, this is confused by the drafting in s172 that requires directors to promote the long-term success of the company for the members as a whole. It is *Awed* (argued above) to prioritise equity investors' interests above others, and certainly not warranted under the historical duty towards the company as a whole. There is a need to clarify that directors' duties are unambiguously towards the company as a whole (see also Keay, 2012).

Directors' duty for Mapping Stakeholders and A Proposal for Making Stakeholders Count in the Concept of the Corporate Constitution

We support 'the company as a whole' to be understood as all the productive 'capital' providers that create the company's wealth, whom we argue should be regarded as a company's 'key stakeholders'. Directors should be mandated with a duty to maintain a map of such 'key stakeholders' and to ensure that key stakeholders are given participation processes in decisions that affect them. This does not necessarily mean Board representation in all cases, but we consider that stakeholder nominated Board representation can often be useful, subject to the considerations we propose in relation to Board Composition we discuss shortly.

One should consider if key stakeholder relations should be embodied in a form of a stakeholder constitutional agreement that can be enforced in a similar manner under s33 of the Companies Act 2006. Such documents should not merely be contractual, as contracts are based on commercial interests and can be heavily one-sided due to inequality of bargaining power. Company law should provide a platform for stakeholder constitutions to be forged on the basis of interests that are relational but non-commercial in nature. Such a provision in company law is necessary as the market alone will not develop

these mechanisms for stakeholder justice.. The requirement to institute relational agreements in companies is not a new legal approach - the FCA has introduced this for controlling shareholders and their listed companies in the Listing Rules in 2015 (see Barker and Chiu, 2015). Further, such stakeholder-company 'covenants' are being discussed in the Netherlands as a way to enforce corporations' obligations in business and human rights.<sup>1</sup>

We believe that such arrangements could be relevant for all companies, public and private, although the size and scale of small private companies would moderate these arrangements proportionately. In publicly traded companies, we think it is useful for the securities regulator to have some oversight of the Board's map of key stakeholders and the constitutional arrangements and engagement mechanisms made with each group, similar to what the FCA has in place for controlling shareholders of listed companies at the moment. We also think it would be ideal for some scrutiny to be had over large private companies in terms of their stakeholder mapping and constitutional arrangements, but it may be difficult to make an ex ante case for such scrutiny. In this case, stakeholder failures in such companies may have to be addressed ex post through liquidators' actions on behalf of insolvent companies, a point we will return to under 'Enforcement' below.

In our view, it is in the interests of the continuing symbiotic relationship between business and society that the law should ensure that the dominant business form, the company, should introduce greater stakeholder inclusion in some form. Our proposals above can be further fleshed out in legal and institutional design.. We do not advocate a non-discriminating enrolment of stakeholders; neither are we introducing open-ended and uncertain responsibilities for directors. Further, to those who argue that stakeholder engagement in corporate governance creates only conflicts of objectives for directors, this argument is based on a misapprehension. This is because directors' duties are to

<sup>1</sup> <http://www.shiftproject.org/resources/collaborations/sector-wide-risks-negotiated-covenants-netherlands/>.

promote the long term success of the company as a whole, and their use of discretion necessarily already involves mediating a variety of objectives.<sup>1</sup> The current imbalance in company law towards sidelining of stakeholder interests tends to only obscure underlying problems and discontent in a corporation, which may eventually explode into a scandal like BHS. The BHS scandal may have been averted if there were a mechanism for enrolling pension trustees and employee representatives in monitoring, checking and providing input to the Board's decision in relation to the distribution of corporate wealth.

It may be argued that there is no one to check that the 'map of key stakeholders' is not merely cosmetic and minimal, and that stakeholders are meaningfully engaged. Shareholders are unlikely to take derivative claims in respect of this issue. In this respect we agree that increased stakeholder engagement in a company cannot be based on today's shareholder primacy model in UK corporate law. Certain shareholder primacy norms should give way towards a more balanced corporate governance approach. There are two key aspects that will be further developed below. One is that certain exclusive shareholder rights should be widened in favour of stakeholders, such as enforcement against directors and the company. The other is that certain exclusive shareholder powers should be moderated, such as in capital-related decisions, and the power to dismiss directors, so as not to undermine the proposed efforts to improve stakeholders' positions in corporate governance.

Next, we also suggest that specific duties could be drafted to prevent directors from undermining the spirit of the framework for distribution of power proposed above. We also extend this concern to controlling shareholders, who, especially in private companies, have a wide berth of power to extract private benefits for themselves (Gilson, 2006).

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<sup>1</sup> These duties of loyalty, good faith, due care and diligence, set out in s173-177 are rather 'universal' in nature across many jurisdictions and not controversial (Gerner-Buerle and Schuster, 2014).

## Duty Against Asset Stripping

Directors should be imposed with a duty to ensure that there is no asset stripping and excessive transfers of wealth, in the interests of the long-term success of the company as a whole. Many legitimate opportunities exist for asset stripping or excessive transfers of wealth in company law that may favour shareholders at the expense of other stakeholders (Campos et al 2006, White et al, 1992), as shareholders hold the main say in most capital decisions, and dividends can be distributed as long as there are 'profits' without further controls on the proportionality of distribution vis a vis the level of profits. There is no provision in company law regarding impact on stakeholders in a legal distribution or transfer of wealth effected by the company. Substantial and related transactions may be carried out if there is agreement or ratification between shareholders and the Board. The depletion of BHS' pension pot in favour of massive dividends out of thin profitability is an instance of legal but excessive transfers of wealth that adversely affected a wide range of stakeholders. Such could only be possible as the decision-makers for wealth allocation exclude the key stakeholders in this issue - the employees, pensioners and the Pensions Regulator. In Debenhams, another example of a company taken private by private equity funds, massive dividends were made possible for the benefit of the investors by saddling the company with excessively high levels of leverage. This required cost-cutting and reduction in wealth distribution to employees and key suppliers. Such imbalances are not only patently unjust but are also deleterious to a company's long-term success.

The prevailing insular forms of corporate governance are inadequate to ensure that the company's wealth is protected for long-term

investment and appropriate distribution (Blair 2014).<sup>1</sup> Besides the director's duty proposed above, we also urge that exclusive powers currently given to shareholders in relation to potential transfers of wealth to directors (such as in loans to directors, guarantees, related party transactions etc) should be revisited to ensure that the balance of power does not undermine stakeholder engagement and empowerment suggested above. See 'Board Composition' below for more elaboration.

#### Duty for Controlling Shareholders

Finally, there is a need to consider if controlling shareholders of private companies in particular, should be subject to a fiduciary duty to the company as a whole, or at least a proscriptive duty against asset stripping and excessive transfers of wealth. A limited conception of the controlling shareholders' fiduciary duty exists in the US, and is increasingly a question for scrutiny due to the rise of publicly traded companies that issue dual-class shares.<sup>2</sup>

Is the duty to promote the long-term success of the company clear and enforceable?

As mentioned above, this duty as currently drafted in section 172 ought to be amended to be owed to the company as a whole and not to members (i.e. shareholders) as a whole. The proviso to consider stakeholders' interests should be amended to strengthen stakeholder engagement and power as suggested in the response above. The current provision in section 172 has been conservatively applied in court (eg Hedgerv Adams, 2015) as requiring the subjective demonstration of good faith and reasonable belief (Davies, 2007, Keay, 2007; Keay et al, 2008, Lynch, 2012) and has not had significant practical impact on directors' practices.

<sup>1</sup> Indeed we point out that one of the provisions in the Alternative Investment Fund Managers Directive states clearly that companies bought out by private equity funds must be protected from asset stripping in the 2 years following private equity investment.

<sup>2</sup> Pros and cons of such corporate structures are discussed in Moore and Walker-Arnott, 2015, Barker and Chiu, 2015.

#### Reforms in Enforcement of Duties

In light of our proposals to expand and enhance directors' duties and controlling shareholders' duties above, we propose that current enforcement mechanisms must be changed. We rely on shareholders to take derivative actions against errant directors, or liquidators in insolvent companies. There is scope for disqualification actions against directors too, but such remedies have been inconsistently used (see Lowry et al, 2014). In addition to the current derivative action for minority shareholders, we consider that there is scope for a form of public interest litigation for affected key stakeholders of private companies. The scope of such rights can be derived from the constitutional footing we propose above, and frivolous litigation can be prevented by requiring that key stakeholders who wish to sue must pass a preliminary stage adapted from the statutory derivative action (s260-263, Companies Act 2006). Further, there is scope for developing public interest-based enforcement against directors for breaches of their duties. One way is to allow the securities regulator to take enforcement action against publicly traded companies, such as carried out by the Australian Securities and Investments Commission (see Keay and Welsh 2015, Harris et al, 2009).<sup>3</sup> This is especially pertinent to issues of excluded stakeholders who may not have a basis to sue above. Where large private companies are concerned, exclusion or failures towards stakeholders should be enforced by the liquidator in respect of failures of directors' duties, and there should be scope in extending the Secretary of State's disqualification action in a similar way.

The marginalisation of 'public interest' from corporate law is largely a manifestation of the insular contractarian and shareholder primacy ideologies of corporate law and theory, which seem less and less justified where corporations

<sup>3</sup> The basis for such actions should however be clear so that confusion does not arise between the jurisprudence relating to regulatory enforcement and share/stakeholder enforcement in private litigation, see Langford, 2015 and Chiu, 2016.

have large social footprints and do affect public interest (for example Pirson, 2014; Hockett and Omarova, 2016; McIntosh 2010).

How are the interests of shareholders, current and former employees best balanced?

See response to the first question in this Section on the general balance required between shareholders and other stakeholders.

How best should the decisions of Boards be scrutinised and open to challenge?

We suggest that our stakeholder engagement and empowerment framework proposed above is able to provide new opportunities in critical scrutiny and challenge for the Board. Such external channels of challenge are important as internal challenge coming from within the Board, even if independent directors are properly trained and have a critical disposition, can be subject to dynamics of persuasive consensus and group-think. Further, independent directors are likely to scrutinise and challenge in the abstract, as they often do not have real stakes in particular decisions like relevant stakeholders do. We support a degree of stakeholder representation on Boards in our response to Board Composition below, and we believe that such representation can bring about challenge from diverse and competent points of view without being partisan. We are also of the view that independent directors have been poorly resourced thus far for the purposes of their roles, and a dedicated unit in each publicly listed company could be set up to assist independent directors with information and analysis, with input from key departments in the company such as Legal, Compliance and Internal Audit.

Should there be greater alignment between the rules governing public and private companies? What would be the consequences of this?

There are already many common corporate law rules for public and private companies, and perhaps the question is whether the special regimes for public companies such as the

Corporate Governance and Stewardship Codes would improve private company governance too. We think it is good practice for larger private companies to also adopt Board composition which reflects independent elements as under the Corporate Governance Code, and minority shareholders should play a part in monitoring and engaging with their investee companies (as under the Stewardship Code). But the problems with private companies are unlikely to be addressed significantly by adopting these regimes alone.

Private companies are not as transparent as publicly traded companies, and information about malpractices can take a long time to be revealed. There is a case to consider if private companies above certain turnover and employment levels should report narrative and stakeholder-related information, or produce integrated reports, like the requirements imposed on private equity buy-outs of public companies under the Alternative Investment Fund Managers Directive 2011.

Further, the greatest potential for abuse of power in private companies comes from controlling shareholders, as we have seen how the unbridled transfer of wealth in BHS led ultimately to the depletion of the pension pot. Hence, there is a need to consider imposing fiduciary duties on controlling shareholders, see response to question 1 above.

Should additional duties be placed on companies to promote greater transparency, e.g. around the roles of advisors. If so, what should be published and why? What would the impact of this be on business behaviour and costs to business?

Advisors engaged by a company serve the management's purposes, and it would be rather naïve to see them acting as watchdogs or gatekeepers. Perverse practices could indeed involve advisers' exploitation of company law loopholes in order to help companies minimise their obligations. Hence, the priority should be to ensure that company law is *fit for purpose* so that the scope for advisers' perverse practices can be circumscribed. We do not see the governance of advisers' conduct as a matter for corporate law. In this area we rely on professional standard or regulatory bodies to punish poor professional practice, such as in legal and auditing practice. The same principle should apply to other professional advisers such as corporate finance advisers. In the absence of a credible industry watchdog, one should consider extending the Financial Reporting Council's scope, or rethinking its role as a professional disciplinary body for those that provide external advisory, consultant or gatekeeper type services to corporations.

How effectively have the provisions of the 1992 Cadbury report been embedded? How best can shareholders have confidence that Executives are subject to independent challenge?

The Corporate Governance Code of the UK is largely based on shareholder primacy and applies purely to premium listed companies. Although it has introduced independent elements in Board composition as good practice, adherence to the Code is not sufficient to ensure that UK corporations, are governed as efficient economic organisations and legitimate societal institutions. The answer to transforming corporate law in the UK cannot excessively rely on extending the Code to private companies. See response to question 1 for reform proposals.

Should Government regulate or rely on guidance and professional bodies to ensure that Directors fulfil their duties effectively?

As stated in our response to question 1, directors' duties need to be reformed, and the courts continue to have a meaningful role to play in articulating what the duties mean. It will be especially meaningful if stakeholders can also litigate under constitutional rights proposed in our response above. Access to justice is another matter that perhaps need reforming, but is beyond the scope of this inquiry.

Professional bodies have a part to play in introducing training and qualifications, and promoting certain best practices. As discussed in Board Composition below, professional bodies' qualifications and certifications (e.g. those of the Institute of Directors) may go some way towards helping nomination committees of the Board assure themselves of a director's competence. However, relying on them to change corporate practices without changing the law would be ineffective.

# EXECUTIVE PAY

What factors have influenced the steep rise in executive pay over the past 30 years relative to salaries of more junior employees?

The rise in executive pay has coincided with calls to link pay and performance and to make awards in share-based instruments, aligning executives' interests with shareholders. The shareholder primacy ideology underlies this practice. Paradoxically, the reforms to executive pay along these lines have more firmly entrenched executives' share of corporate wealth, allowing pay to rise to phenomenal levels. There is little evidence that 'say on pay' votes undertaken by shareholders are exerting any material restraint on this phenomenon. Lower level employees do not usually have the power to bargain for a share in corporate wealth like senior executives do. This is not surprising as corporate law privileges only the Board and shareholders who have decision-making rights to distribute corporate wealth, and have inevitably benefited themselves the most in the exercise of such power. This is the case with most industries (with the possible exception of banking and finance where employees such as analysts and traders and deal-makers are promised performance-based remuneration and have earned eye-watering amounts in remuneration). Although the latter practice has become excessive and a byword for the 'unacceptable face of capitalism', there is a case for saying that neither extreme is desirable.

We consider the issue of executive pay to be related to underlying weakness in the corporate governance frameworks of listed companies. Neither current boards nor their institutional shareholders are in a position to exert meaningful control over executive pay despite the good intentions that are frequently expressed on all sides. Consequently, governance over executive pay should no longer be based on shareholder votes alone. It must be based on a stronger remuneration committee that has stakeholder representation (in the manner specified in Board Composition, below), public disclosure of the pattern of corporate wealth distribution and the directors' duty to prevent asset stripping/excessive transfers of wealth (proposed above). This three-pronged approach subjects executive pay

and pay policies in the corporation to more holistic considerations, scrutiny and accountability.

How should executive pay take account of companies' long-term performance?

The new incentives that have been introduced in bankers' pay to compel them to take account of long-term performance are based on malus and claw-back. Malus allows deferred remuneration to be adjusted for poor subsequent performance, and claw-back allows banks to recover vested or paid compensation up to a certain period such as 7- 10 years after vesting. These structures are useful for consideration in pay design for highly paid executives, although corporations may be reluctant to use them in a competitive executive labour market. However, the effectiveness of such devices may be questioned if corporations are not prepared to enforce them.

Should executive pay reflect the value added by executives to companies relative to more junior employees? If so, how?

Please see response to question 1 in this Section.

What evidence is there that executive pay is too high? How, if at all, should Government seek to influence or control executive pay?

It is undoubtedly difficult to state in a scientific or objective manner that executive pay is 'too high'. High relative to what? Attitudes towards the quantum of remuneration are obviously dependent on political and ethical considerations which are subjective in nature. We should state that our own perspective is not unsympathetic to a significant degree of income inequality within an organisation depending on an individual's abilities and job responsibilities.

But equally it is not sufficient to accept existing executive pay levels on the basis that they arise from an efficient market process – there is significant evidence that the market for executive pay is distorted and imperfect.

In assessing current levels of executive pay

across the economy as a whole, we ask a number of questions:

- 1) Have the increases in executive pay over the last 1-2 decades been closely aligned to the operational performance of underlying companies?
- 2) Is there a growing sentiment in mainstream society that executive rewards are excessive, and give rise to deeply negative attitudes towards business and the viability of capitalism?
- 3) Is there evidence that executive pay structures create perverse incentives which foster short-termism and sub-optimal business decision-making?

Our analysis in relation to each of these three questions leads us to the conclusion that executive pay at large UK-listed companies can be considered as being 'too high' and unsupported by the economic performance or social legitimacy of UK Plc.

How can executive pay be brought back to more sustainable and acceptable levels? There are many policy papers from the UK and EU, such as the Greenbury Report 1995, the policy papers predating the Directors' Remuneration Report Regulations 2002, and those preceding the shareholders' binding vote on pay in s439A Companies Act 2006 and in the proposed EU Shareholders' Rights Directive 2014 that discuss uncontrolled levels of executive pay and how to address it. In the US, the SEC has also made rules to bring into force the binding shareholder vote on pay. Academic commentary on excessive levels of pay on both sides of the Atlantic is prolific (Bebchuk & Fried, 2004; writings by Bebchuk, 2003, 2009, Gordon, 2009).

Shareholder say on pay does not seem to be an effective moderating influence, as shareholders do not seem to scrutinise large wealth transfers to executives as long as share prices are high and their wealth is therefore protected (Gerner-Buerle and Kirschmaier, 2016). For both non-executive directors and institutional investors, it is simply easier to acquiesce in large pay awards to executives as it is not their personal wealth at stake and, in most circumstances, it is

more important to sustain positive relationships with executives rather than potentially alienate them by being 'tough on pay'.

We suggest that a fundamental issue regarding executive pay has to do with the imbalance in corporate wealth distribution favouring executives and shareholders while marginalising other stakeholders, notably employees. Hence a more thorough way of addressing this is to reform stakeholder involvement in the manner proposed in our above response, subject to the directors' overall duty to prevent asset stripping and excessive transfers of wealth in order to preserve inter-generational equity in long-term corporate wealth.

Do recent high-profile shareholder actions demonstrate that the current framework for controlling executive pay is bedding in effectively? Should shareholders have a greater role?

Recent shareholder action in voting down executive pay packages can be effective in signalling discontent with corporate wealth distribution, as well as other discontent with governance and performance. To an extent this acts as a form of market discipline, although recent empirical research from the LSE (Gerner-Buerle and Kirschmaier, 2016) show that shareholder scrutiny is largely superficial and inconsistent.

At a broader level, this question deals with the potential of shareholders as an all-round corporate watchdog, fulfilling scrutiny functions that effectively challenge the Board. On this we have doubts as to the consistent effectiveness of such challenge, and the motivations on the part of shareholders. Many shareholders are institutions, whether domestic or foreign, subject to contractual, regulatory and commercial interests in relation to their responsibility for investing beneficiaries' money. We have examined a range of key investment institutions that own equity and critically appraise their corporate governance roles in a forthcoming book (Barker and Chiu, 2017). We are sceptical that institutions' interest in their shareholder roles is always aligned with the public interest underlying those roles (also Davies 2015, Chiu 2013). Institutions'

multiple obligations affect their investment management behaviour in such a way that do not consistently reinforce a socially optimal model of shareholder engagement.

# BOARD COMPOSITION

In line with our call towards greater stakeholder recognition, engagement and distributive considerations, Board composition is an area that should be reformed.

Best practice in UK corporate governance now requires a substantial proportion of independent Board members on UK listed companies. However well-intentioned, competent and critical independent directors may be, they are not in a position to give voice to stakeholder concerns. Ultimately, any director – whether ‘independent’ or not – can be voted off the board by a simple majority of current shareholders. This basic feature of the corporate power structure underpins the attitudes and legitimacy of much existing corporate behaviour. We believe that there is a case to reform Board composition to allow for key stakeholder representation as part of the ‘independents’ cohort. In other words, there should be directors on boards who are not dependent on shareholders for their continued appointment, and who are therefore either truly independent in terms of their ability to consider the interests of the company as a whole or have been appointed to represent stakeholder interests.

However, stakeholder representation should not be seen as an opportunity to bring in partisan interests without any business training and skills. The Co-operative Bank Board before its capital shortfall episode in 2014 has often been highlighted as a bad example of stakeholder representation. Further, worker representation has been criticised as ineffectual and partisan in Germany (Hopt, 1994). Hence, directors that are elected to represent stakeholder interests should still be professional directors with all the requisite skills and experience.

We are of the view that stakeholder representation should be made through nominating suitable candidates for the nomination committee’s consideration. The rights to nomination may be part of the constitutional document defining stakeholder relations we suggest above. Stakeholder-nominated candidates should have business skills such as in financial literacy as case law has espoused (Re Brian D Pierson for example). We recommend that directors of publicly traded and large private companies should

be adequately trained,<sup>1</sup> for the specific needs of the business. The nomination committee should play a stronger and more accountable role in recruitment and periodic evaluation of directors, and ensure that their tenure is appropriately designed.

Further we believe that this proposal goes some way towards addressing Board diversity, as competent stakeholder representation introduces diversity in voice and perspectives, and is not only based on inherent characteristics such as gender or ethnicity as proxy indicators for diversity.

What evidence is there that more diverse company boards perform better?

How should greater diversity of board membership be achieved? What should diversity include, e.g. gender, ethnicity, age, sexuality, disability, experience, socio-economic background?

What more should be done to increase the number of women in Executive positions on boards?

Empirical research on diversity and corporate performance (short-medium term) is mixed (there is a lot of literature on this, for example, see Rhode et al 2010 as contrary to Adams et al 2008). However, diversity on boards seems consistent with the ethos of recognising and valuing plural and diverse ‘capital’ providers of wealth creation. A diversity ethos could be the first step towards an inner cultural change in the corporate sector away from the insularities of shareholder primacy and managerial supremacy. We believe that diversity on Boards should tie in with the diversity in stakeholder voice proposed above, and be subject to criteria for recruitment based on competence as discussed above.

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<sup>1</sup> Courses of general training are the Director Competence Framework introduced by the UK Institute of Directors. Educational qualifications in business such as the MBA and other specialist qualifications such as a charter in relevant professional qualifications appropriate for the business could also be useful.

Should there be worker representation on boards and/or remuneration committees? If so, what form should this take?

In relation specifically to workers, we believe that employees are key stakeholders whose representation on Boards, in the manner discussed above, would be valuable. In particular, such stakeholder representation in key committees such as nomination, remuneration, and the ethics and culture committee we propose below, could help catalyse some of the key changes that we are seeking in business behaviour.

In relation to the remuneration committee in particular, we think the remit of the remuneration committee should not be confined to executive pay, but should expand towards holistically looking at pay policy across the corporation. In this way, pay policies can be developed across the corporation instead of in a fragmented manner, taking into account an overall responsible and sustainable ethos in corporate wealth distribution.

#### Ethics and Culture Committee

We believe that it will be useful for Boards to institute a committee of independent and stakeholder representation directors to monitor issues of corporate ethics and culture. This should at least apply to publicly traded companies and private companies of a significant turnover and employment level. This is important as at the highest level, Boards may be unaware of adverse practices in clusters and sub-groups in the corporation. The committee should have regular access to information reporting from the internal control departments of the corporation and departments that may provide information on corporate practices, ethics and culture, such as Compliance, Legal, Risk Management at various levels, Internal Audit, Human Resources, Operational Risks, Communications etc. It has been highlighted in practice that Boards, non-executive directors in particular, do not access services provided by important information and control departments such as Legal and Compliance (Moorhead et al, 2016). The insularity of Boards must change and corporate governance should encompass more firm-wide information and control mechanisms. In particu-

lar, high-risk industries such as energy, extractive, and pharmaceuticals should adopt the best practice of instituting Chief Risk Officers who should be directly accountable to the proposed Ethics and Culture Committee.

Further, the proposed Ethics and Culture committee should support whistle-blowing frameworks in corporations to ensure that they are independent and robust. We believe that such a reform would go a long way towards enhancing Board responsibility in shaping corporate culture and in bringing about holistic and enterprise-wide impact.

## Implications for Shareholder Power

As our proposal supports reforms in company law to support greater stakeholder engagement and representation in corporate governance, the existing balance of legal power in favour exclusively of shareholders must be reformed.

At the moment shareholders enjoy exclusive decision-making powers under the Companies Act 2006 in removal of directors, capital structure decisions such as reduction of capital or buy-backs, ratification decisions involving directors' conflicts of interest such as loans or substantial transactions with directors.

We do not think that shareholders' exclusive decision-making power in removing directors should remain if the Board consists of directors elected for stakeholder representation purposes. However, we are also mindful that introducing new mechanisms for removal should not become so cumbersome that directors become entrenched. There are various options in designing an efficient discipline process for directors through removal that do not risk stakeholder representation from being undermined by existing shareholder power. For example, directors for stakeholder representation may have fixed and limited tenure even if they cannot be removed by shareholders. Or we could require that proposals for removal must be approved by both the nomination committee and the majority of shareholders. Options can be further studied, but the principle of exclusive shareholder power in this area should be changed.

Further, reforms to exclusive shareholder power in capital and ratification decisions should also take place. For example, capital decisions may only be put forward if directors are of the view that no implications for asset stripping/excessive transfers of wealth are involved. We may also consider requiring both shareholder approval and the approval of the ethics and culture committee for ratification decisions. As above, design options in recalibrating the balance of power should be explored in order to achieve an efficient and accountable framework in corporate governance.

# CONCLUSION

It is time to reform company law to support a corporate governance framework of stakeholder inclusiveness for a new business ethos. The importance of 'environmental, social and governance' factors to a business's long-term success cannot be under-estimated, and existing company law is too insular to accommodate these concerns adequately. In the broader context, a more balanced distribution of corporate power and wealth is important in order to address the looming problem of increasing social inequality and discontent. We also believe that it is in the interests of the UK to maintain its reputation as a place for business to be conducted in a responsible and long-termist manner, which in due course will become much more attractive for national and global corporations.

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