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What Directors Do (and Fail to Do): Some Comparative Notes on Board Structure and Corporate Governance

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WHAT DIRECTORS DO (AND FAIL TO DO)

I. INTRODUCTION

The question of what directors do has long preoccupied corporate governance scholars, without any clear answer becoming available. We have a fairly clear idea of what they *should* be doing based on the content of the common law on directors' duties and from the standards set out in corporate governance codes, listing rules, and, increasingly, in legislation. Even here, there is room for uncertainty, in part because the legal model of the board, which has evolved over many decades and has roots in primordial common law concepts of property and trusteeship, does not entirely map on to the idea of directors as the agents of shareholders, which has informed corporate governance standards since the 1980s.¹ But even assuming that we can identify a clear set of normative guidelines for director behavior, how boards perform in practice is another matter, and one on which empirical social science offers only limited guidance. It is difficult, because of confidentiality considerations, to observe boards directly, although a few researchers have succeeded in overcoming the constraints, with interesting results.²

Quantitative approaches try to determine if there are correlations between measurable variables, such as board independence or separation of the positions of CEO and board chairperson, on the one hand, and financial performance of the corporation, on the other. These studies, by their nature, look at quantifiable outcomes rather than internal board dynamics, and so can provide us with a partial picture, at best, of how boards work.³ That they frequently fail to find a statistically significant link between board independence and corporate performance, of the kind which theory predicts and on which policy is predicated,⁴ suggests that there is a mismatch between normative models and the reality of board behavior. The extraordinary and (in the post-1945 period) unprecedented corporate failures that attended the financial crisis of 2008–2009 make it essential to understand these issues better.

To that end, this article will firstly consider the extent to which the legal models of directors' duties under U.K. company law depart from the idea of directors as

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1. See Simon Deakin, *The Coming Transformation of Shareholder Value*, 13 *CORP. GOVERNANCE: AN INT'L REV.* 11, 12–15 (Jan. 2005) (discussing the rise of the shareholder value norm in corporate law, and the related idea that directors should act as the agents of shareholders).
 2. See JAY W. LORSCH & ELIZABETH MACIVER, *PAWNS OR POTENTATES? THE REALITY OF AMERICA'S CORPORATE BOARDS* 4 (1989), available at <http://hbr.org/products/216X/216Xp4.pdf>; see also John Roberts, Terry McNulty & Philip Stiles, *Beyond Agency Conceptions of the Work of the Non-Executive Director: Creating Accountability in the Boardroom*, 16 *BRIT. J. OF MGMT.* S5 (2005), available at <http://onlinelibrary.wiley.com/doi/10.1111/j.1467-8551.2005.00444.x/pdf>; John Roberts, Terry McNulty & Philip Stiles, *Undertaking Governance Reform and Research: Further Reflections on the Higgs Review*, 16 *BRIT. J. OF MGMT.* S99 (2005).
 3. Paul A. Gompers et al., *Corporate Governance and Equity Prices*, 118 *Q.J. ECON.* 107 (2003); see also Lucian Bebchuck et al., *What Matters in Corporate Governance?*, 22 *REV. FIN. STUD.* 783 (2009).
 4. See Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long-Term Economic Performance*, 27 *J. CORP. L.* 231 (2001); Victor Dulewicz & Peter Herbert, *Does the Composition and Practice of Boards of Directors Bear Any Relationship to the Performance of Their Companies?*, 12 *CORP. GOVERNANCE: AN INT'L REV.* 263 (2004).

monitors, an idea that has informed corporate governance codes and related standards, particularly in the United States and the United Kingdom, but increasingly at a global level, in recent years. In Part II, the focus will be on the formulation of the director's duty of care, looking mainly at U.K. company law. Then, in Part III, empirical evidence relating to litigation against directors and director disqualification will be reviewed. This is followed, in Part IV, with an assessment of the role of the boards in the large-scale corporate failures of the recent financial crisis, an examination which, to some extent, must be preliminary as evidence is still emerging. Part V offers, by way of comparison, reflections on the very different approach taken to these issues in Japanese corporate governance. The approach in Japan is instructive because of the limited impact made in that system by the idea that boards should act as the agents of shareholders.⁵ Part VI concludes by arguing that the recent financial crisis raises serious questions about the future of the monitoring model.

II. U.K. COMPANY LAW AND CORPORATE GOVERNANCE: COMPETING MODELS OF THE BOARD?

The legal model of directors' duties which has informed the development of company law in Britain and corporate law in the United States is essentially facilitative, rather than prescriptive.⁶ The concept of fiduciary duty originates in the legal institution of the trust, which has been adapted over time to the particular features of the company limited by share capital. The kernel of agency theory is observable here: the corporate form is a structure based on the delegation of use or control rights over property by the shareholders to the board, with accountability running back in the other direction. Beyond this basic idea, however, the law does not clearly define the role or function of company directors, and it is more agnostic on this point than agency theory is, with its emphasis on non-executive directors as monitors of management.

In the legal model, directors must, in a manner analogous to trustees, avoid (or at least disclose) conflicts of interest, and exercise care in the way they handle the company's property.⁷ They may be, but need not be, involved in the management of the enterprise. If they are not so involved, their responsibilities are surprisingly hard to pin down. For most of the history of Anglo-American company law, there was no legal principle requiring directors, whether executive or non-executive, to act as

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5. *See generally* CORPORATE GOVERNANCE AND MANAGERIAL REFORM IN JAPAN (D. Hugh Whittaker & Simon Deakin eds., 2009).
 6. Not all scholars would go so far as to say that the model of the corporation as a set of contractual default terms explains *all* features of the American and British systems. However, the idea that the role of company law in these systems is to facilitate the formation of business associations, with limited external regulation of the choices made by corporate actors, enjoys broad support. *See* FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (1990) (developing this idea in the context of U.S. corporate law); BRIAN R. CHEFFINS, *COMPANY LAW: THEORY, STRUCTURE, AND OPERATION* (1997) (discussing the application of the idea to U.K. company law).
 7. *See* PAUL L. DAVIES, *GOWER AND DAVIES' PRINCIPLES OF MODERN COMPANY LAW* 475–574 (8th ed. 2009).

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“monitors” of management, or specifying an objective standard to which they had to adhere when doing so.⁸ In so far as there is now such a duty to monitor in U.K. company law, it is largely the consequence of recent changes to case law and legislation, which have been influenced by the adoption of corporate governance codes, by stock exchange and listing authorities, and by changes in practice affecting listed companies.⁹ The underlying legal model did not dictate this outcome, but nor did it prevent it. Just as the legal model operated in a certain degree of tension with the “managerialist” or insider-dominated board of the 1960s, without necessarily being incompatible with it, so it has a similar relationship today with the widely practiced model of the “monitoring” or independent board.¹⁰

Those tensions are visible in the evolution of the law relating to the director’s duty of care. In English law, this duty was originally expressed in entirely subjective terms. In other words, a director could only be held liable for breach of the duty of care by reference to his or her failure to satisfy a subjective standard based on their individual capabilities. The law also reflected the different functions, executive and non-executive, which directors could, in principle, be expected to perform. The effect was to make it very difficult for a non-executive director to be held liable for ineffective oversight of the company’s management.¹¹ Indeed, the less such directors professed to do, the less likely it was that they could be held personally liable for the consequences of the company’s failure or other losses stemming from mismanagement. Periodic financial crises led to attempts to move the law forward through litigation. But the answer was the same in the 1930s, in *Re City Equitable Fire Insurance Co.*,¹² as it had been in the Marquis of Bute’s case in the 1890s.¹³ As Professor Paul Davies more recently put it, the law at this time was decided “with non-executive rather than executive directors in mind and, moreover, on the basis of a view that the non-executive director had no serious role to play within the company but was simply a piece of window-dressing.”¹⁴

The immediate aim and effect of the subjective approach was to protect non-executives from what were seen as excessive risks of personal liability.¹⁵ However, the

8. *See id.*

9. *See* Deakin, *supra* note 1.

10. CO. LAW REVIEW STEERING GRP., MODERN COMPANY LAW FOR A COMPETITIVE ECONOMY: DEVELOPING THE FRAMEWORK, 17–81 (2000) (discussing the tension between the underlying legal model and the “monitoring” or independent board), available at <http://webarchive.nationalarchives.gov.uk/+http://www.berr.gov.uk/files/file23245.pdf>.

11. *Re Cardiff Sav. Bank*, [1892] 2 Ch. 100, 107–10; *Re City Equitable Fire Ins. Co.*, [1925] Ch. 407 (A.C.) 527–32 (discussed *infra* note 13).

12. [1925] Ch. 407 (A.C.).

13. *Re Cardiff Sav. Bank*, [1892] 2 Ch. 100. This case and *Re City Equitable Fire Insurance*, [1925] Ch. 407, were both cases arising out of the failure of large financial institutions (a bank and insurance company respectively).

14. DAVIES, *supra* note 7, at 489.

15. *See id.*

idea that the non-executive director had no real part to play in internal corporate affairs was undoubtedly consistent with the managerialist ethos of the mid-twentieth century. It was managerialism, too, which provided the context for the next stage in the development of the law. This next stage involved raising the standard for the duty of care, which was principally designed to ensure that executive directors possessed an objective level of managerial competence and were held to a higher, subjective standard in areas where they held themselves out as having a particular type of expertise. Although in principle applicable to non-executives too, this test first emerged in the late 1980s and early 1990s in the context of litigation involving executive directors who had been involved in the day-to-day management of insolvent firms.¹⁶ Under these objective standards, there was now a greater likelihood that they could be held personally liable under the breach of the duty of care. Around the same time, legislation was passed in the United Kingdom to introduce a procedure for the disqualification of directors who are found to be “unfit” to manage the affairs of a company following insolvency.¹⁷

The government-sponsored review of U.K. company law, which was initiated in the late 1990s¹⁸ and resulted in the passage of the Companies Act 2006, looked in detail at the issue of director’s duties and liabilities. Section 174 of the 2006 Act has restated the common law test of the duty of care.¹⁹ The standard requires a company director to exercise

the care, skill and diligence that would be exercised by a reasonably diligent person with (a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company, and (b) the general knowledge, skill and experience that the director has.²⁰

This formally extends the mixed objective/subjective test, originated in insolvency law, to cases concerning breach of the duty of care in general.²¹

In principle, it applies to executive and non-executive directors alike. In practice, the content of the duty will differ from one case to another.²² The objective test, set

16. *See, e.g.*, *Dorchester Finance Co. v. Stebbing*, [1989] B.C.L.C. 498 (decided in 1977); *Norman v. Theodore Goddard* [1991] B.C.L.C. 1028 (Eng. Ch. Div.); *Re D’Jan of London Ltd.* [1994] 1 B.C.L.C. 561 (Eng. Ch. Div.) (applying section 214(4) of the Insolvency Act of 1986).

17. *Company Directors Disqualification Act*, 1986, c. 46 § 12B.

18. *See* CO. LAW REVIEW STEERING GRP., *MODERN COMPANY LAW FOR A COMPETITIVE ECONOMY: THE STRATEGIC FRAMEWORK* (1999), *available at* <http://www.bis.gov.uk/files/file23279.pdf>; CO. LAW REVIEW STEERING GRP., *MODERN COMPANY LAW FOR A COMPETITIVE ECONOMY: DEVELOPING THE FRAMEWORK* (2000), *available at* <http://webarchive.nationalarchives.gov.uk/http://www.berr.gov.uk/files/file23245.pdf>; CO. LAW REVIEW STEERING GRP., *MODERN COMPANY LAW FOR A COMPETITIVE ECONOMY: FINAL REPORT* (2001).

19. *Companies Act*, 2006, c. 46 § 174(2).

20. *Id.*

21. *See* DAVIES, *supra* note 7, at 490–95.

22. *Id.* at 491.

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out in (a) above, implies a higher standard of care in the case of executive directors, who are directly involved in running the business, than in that of non-executive directors. However, this line of reasoning by no means absolves non-executive directors from responsibility. If their task is seen as monitoring, as distinct from managing, they will now be held liable through a general standard of care based on the type of oversight they are capable of exercising. This standard is likely to be higher in the case of publicly listed companies, in part because of corporate governance standards and listing rules specific to companies of this type.²³

More generally, there is now a clear expectation that one of the main functions of non-executive directors, in the context of listed companies, is to ensure managerial accountability. The subjective test, embodied in (b) above, means that non-executives with particular knowledge and expertise will, as before, be held to the higher standards that their individual position entails. Non-executive directors of listed companies normally receive extensive training as part of induction courses provided by their companies. In these circumstances, a defense of lack of knowledge of the way the company generally operates will rarely be available, although this is not the same as requiring a non-executive director to have the same degree of knowledge as an executive director. A clear statement of the duties of non-executive directors is set forth in the New South Wales Court of Appeal's case of *Daniels v. Anderson*.²⁴ The standard to which non-executive directors will be held in any given case is unlikely to be the same as that for executives. The objective test nevertheless requires non-executive directors to "take reasonable steps to place themselves in a position to guide and monitor the management of the company."²⁵ It seems likely that this test represents U.K. law.²⁶

The most difficult issue in ascertaining the limits of directors' liability for breach of duty of care concerns the question of delegation. Delegation from the board to management is inevitable, and the courts recognize this reality. The duty of the board is not to be informed on every single aspect of the company's operations, but rather is to put in place an effective system of internal control and audit. In the United Kingdom, the Turnbull report of 1999,²⁷ which came out of the standard-setting process that began with the Cadbury Code,²⁸ clarified this obligation. The

23. *See id.* at 490–95.

24. [1995] 118 FLR 248 (NSW).

25. *Id.* at 306.

26. *See* DAVIES, *supra* note 7, at 491.

27. FIN. REPORTING COUNCIL, INTERNAL CONTROL: REVISED GUIDANCE FOR DIRECTIONS ON THE COMBINED CODE (2005), available at <http://www.frc.org.uk/documents/pagemanager/frc/Revised%20Turnbull%20Guidance%20October%202005.pdf>.

28. The Cadbury Code set out guidelines for listed companies to follow in relation to good corporate governance practice. *See* DAVIES, *supra* note 7, at 402–05; *see also* THE COMM. ON THE FINANCIAL ASPECTS OF CORP. GOVERNANCE, REPORT OF THE COMMITTEE ON THE FINANCIAL ASPECTS OF CORPORATE GOVERNANCE § 1.3 (1992).

Turnbull recommendations (amplifying the U.K. Corporate Governance Code)²⁹ set out guidance for listed companies rather than a strictly binding legal provision in the manner of its nearest U.S. equivalent, section 404 of the Sarbanes-Oxley Act of 2002 (SOX). In common with other recommendations of the U.K. Corporate Governance Code, listed companies subject to the principles initially set out by Turnbull have a choice of complying with its recommendations or explaining why they do not comply. In practice, most U.K.-listed companies are compliant with the internal audit recommendations of the U.K. Corporate Governance Code.³⁰ Turnbull reinforced a move to a more systematic internal audit and reporting system that had begun earlier in the 1990s.

Turnbull maintained that “a company’s system of internal control has a key role in the management of risks that are significant to the fulfilment of its business objectives.”³¹ Turnbull required boards to issue regular reports on the effectiveness of their system of internal control in managing key risks, and to undertake an annual assessment of those controls for the purpose of disclosure in their annual report to shareholders. It also recommended that internal controls “should be embedded in the operations of the company and form part of its culture,”³² should “be capable of responding quickly to evolving risks to the business,”³³ and should be capable of being applied in a manner which was appropriate to “the nature of the significant risks that the company faces.”³⁴ Thus, the emphasis was on internal control systems that were flexibly designed and sensitive to the particular cultures of different companies.

The passage of SOX has created practical difficulties for U.K. companies with dual U.K.-U.S. listings. Section 404 of SOX and its associated regime of audit controls is much more detailed and prescriptive than Turnbull. Some U.K. companies with a long track record of good practice in the corporate governance field had to alter their approach with the advent of SOX. For example, companies such as Cadbury (a major U.K.-based food manufacturer until its takeover by Kraft in 2010) had pioneered internal audit procedures several decades previously.³⁵ Cadbury Schweppes (as it was called in the mid-2000s) was subject to SOX because its shares

29. The U.K. Corporate Governance Code § C.2 (2010), *available at* http://www.frc.org.uk/documents/pagemanager/Corporate_Governance/UK%20Corp%20Gov%20Code%20June%202010.pdf; *see* DAVIES, *supra* note 7, at 402–10 (explaining the evolution of the U.K. Corporate Governance Code, which became the new name of the code after amendments to the Combined Code on Corporate Governance in 2009 and 2010).

30. *See* MICHAEL PAGE & LAURA F. SPIRA, *THE TURNBULL REPORT, INTERNAL CONTROL AND RISK MANAGEMENT*, at vii (2004).

31. THE INST. OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES, *INTERNAL CONTROL GUIDANCE FOR DIRECTORS ON THE COMBINED CODE 4* (1999).

32. *Id.* at 7.

33. *Id.*

34. *Id.* at 8.

35. Simon Deakin & Chris Orchard, *Sarbanes-Oxley: How is it Impacting Corporate Practice?*, CRITICALEYE (June 2005) (on file with author).

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were listed on the New York Stock Exchange.³⁶ The company saw Turnbull as an expression and codification of good practice in the management of risk; compliance with section 404 of SOX, by comparison, was itself a risk that had to be controlled and managed. Section 404 was viewed as a risk because of the volume of documentary evidence that had to be produced in order to demonstrate compliance. This documentation was necessary to prove to the company's external auditors that internal processes had been carried out correctly. When it came to implementing SOX, the approach taken by Cadbury was one of "achieving compliance while minimising the impact on the business."³⁷ To minimize the cost of compliance, the company took the approach of concentrating only on significant financial reporting risks. As a result, fewer than 2000 controls across the whole company were put in place, compared to over 20,000 in some comparable organizations.³⁸ Nevertheless, it was estimated that in 2004 alone, eight to nine years of person effort from the internal audit team was needed to ensure compliance with SOX.³⁹

A senior risk manager of Cadbury Schweppes at this time explained its approach in the following terms: "If someone in the company says they have done something, we tend to believe them—we do not say, prove it to me!"⁴⁰ This approach, which many British companies probably shared until recently, saw the development of a high-trust organizational ethos as the best protection against corporate mismanagement or default. The introduction of detailed internal audit procedures, based on formal compliance, was seen as having the potential to undermine trust-based relationships built up over decades. At the same time, there was an understanding that little could be done to reverse the trend.

The shift to formalized internal audit systems places a considerable burden on boards and, in particular, on non-executive directors to ensure that they are in a position to make an informed assessment of the risks facing the company. Non-executive directors, because of their separation from the day-to-day management of the business, are dependent on management for the flow of information needed to perform their monitoring role. Under these circumstances, it is far from straightforward for non-executives to ensure that they have been adequately informed, and very hard to know at what point a lack of oversight, or a misjudgment, amounts to a breach of the duty of care.

The leading authority on the disqualification of U.K. directors of listed companies for a failure of oversight is *Re Barings plc (No. 5)*.⁴¹ In this case, executive directors of the parent bank were disqualified following the insolvency of its Singapore subsidiary in the aftermath of frauds perpetrated by one of the subsidiary's traders. *Barings*

36. *Id.*

37. *Id.*

38. *Id.*

39. *Id.*

40. *Id.*

41. [1999] 1 B.C.L.C. 262 (U.K.)

indicates the potential reach of the disqualification law under which directors may be deemed unfit to manage the affairs of a company following its insolvency. Because disqualification involves the exercise of administrative authority by a government agency, it is in practice a more potent sanction than litigation based on the breach of the duty of care. However, *Barings* was a case involving executive directors. There has been no decision involving the disqualification of non-executive directors. Also, directors' duties are very rarely directly enforced in the context of U.K.-listed companies, for reasons explored in the next section.

III. LITIGATION AGAINST DIRECTORS

Litigation against company directors in the United Kingdom is a rare event. A recent empirical study by John Armour, Bernard Black, Brian Cheffins, and Richard Nolan⁴² found that there were only twenty-four legal claims in total against directors of public limited companies for breach of their duties in the period 2004–2006.⁴³ Of these, only six involved listed companies, three of which were disqualification actions. Of the remaining three, only one involved a claim for damages, and it was struck out by the court. At the time of this study, there were approximately 2000 companies listed on U.K. stock exchanges.

In the United States, by contrast, Armour and his coauthors found approximately fifty reported cases per year, in the same time period, involving litigation against directors of publicly listed companies for breach of their fiduciary duties as directors. Thus, while “we cannot say with confidence that directors of publicly traded U.K. companies face *no* risk of being named as a defendant in a claim in English courts under U.K. company law, . . . [we] can say . . . that the risk is very low.”⁴⁴ There seems to be a greater chance of directors of cross-listed companies being sued in the United States, as some recent litigation in the New York courts indicates.⁴⁵

The disqualification procedure, introduced into U.K. law by the Company Directors Disqualification Act 1986, applies where a person is found by a court to be “unfit” to manage the affairs of a company following its insolvency. They may then be disqualified from acting as a company director for a fixed period of time, normally several years. Enforcement is the responsibility of a government department (currently the Department for Business, Innovation and Skills) and can involve a court hearing if the disqualification is contested. Specific grounds for disqualification under the Act include: commission of a serious criminal offence involving dishonesty, in connection with the management of the company; being found civilly liable for fraudulent or wrongful trading, and therefore required to contribute to the assets of

42. John Armour et al., *Private Enforcement of Corporate Law: An Empirical Comparison of the United Kingdom and the United States*, 6 J. EMPIRICAL LEGAL STUD. 687 (2009).

43. *Id.* at 698.

44. *Id.* at 700.

45. *See, e.g.*, RSL Commc'ns PLC v. Bildirici, No. 04-CV-5217 (KMK), 2006 U.S. Dist. LEXIS 67548, at *2 (S.D.N.Y. Sept. 15, 2006).

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the company upon its insolvency; and failing to comply with certain rules on the filing of accounts.⁴⁶

There are currently around 1500 disqualifications per year in the United Kingdom,⁴⁷ but hardly any of these affect listed companies, for the simple reason that listed companies are virtually never forced into insolvency. A takeover or merger is a more likely outcome of corporate mismanagement or, failing that, a bank-led rescue. The three cases of disqualification claims involving listed companies identified by Armour and his co-authors between 2004 and 2006 involved a total of six directors. Only one of the cases resulted in a disqualification; an executive director was disqualified for a period of ten years.⁴⁸

In contrast, the United States has a much more interventionist disqualification regime for directors of listed companies. The Securities and Exchange Commission's (SEC) enforcement actions against directors of publicly traded companies committing financial misrepresentations result in around twenty-five dismissals per year.⁴⁹ Why is there apparently so little enforcement of the duty of care in the United Kingdom? The reasons are partly historical. In framing the traditional, subjective duty of care, the English courts were "influenced by a model of corporate decision-making which gave the shareholders effective control over the choice of directors."⁵⁰ Shareholders can replace directors by a simple majority vote at the Annual General Meeting or an extraordinary meeting. They also have long had the right to intervene to vet transactions, such as asset sales having a significant impact on the company's business or holdings.⁵¹ These rights give U.K.-based shareholders legal powers of control, which their U.S. equivalents often lack. Thus litigation was, according to one view, unnecessary.⁵² However, the historical justification for limiting litigation may no longer hold. In the case of listed companies with dispersed ownership, shareholders cannot exercise direct control over the management of the business to the extent that they can in other cases. It is also very rare to see a director of a listed company removed by a shareholder vote.

Attitudes towards litigation in the United Kingdom are also changing to an extent not reflected in the data reported by Armour and his co authors.⁵³ A watershed in this area was the claim brought by the life assurance company Equitable Life against former directors of the company, both executive and non-executive, in the

46. See DAVIES, *supra* note 7, at 238; see also Richard Williams, *Disqualifying Directors: A Remedy Worse Than the Disease?*, 7 J. CORP. L. STUD. 213 (2007) (offering an informative critique of this legislation).

47. Armour et al., *supra* note 42, at 716.

48. *Id.*

49. See Jonathan M. Karpoff et al., *The Consequences to Managers for Financial Misrepresentation*, 88 J. FIN. ECON. 193 (2008).

50. DAVIES, *supra* note 7, at 489.

51. See *id.* at 411–75.

52. See *id.* at 489.

53. Armour et al., *supra* note 42.

early 2000s. The litigation arose out of alleged mismanagement of the claims of different groups of policyholders, which left the company facing insolvency. The board, acting on legal advice, had taken steps to resolve the conflicting claims. The advice it received turned out to be incorrect. But this was evident only when litigation over policyholders' rights was ultimately resolved by the House of Lords, which had a different interpretation of the relevant contracts than the lower courts. The company was kept afloat by a merger and the board resigned. The new board then authorized, in the company's name, a claim against the former directors for breach of the duty of care. It seems highly likely that the claim, or at least the claim affecting non-executive directors, would have failed given the reliance placed by the board, in good faith, on external legal advice. In the event, the claim against the directors was settled eight months into the trial.⁵⁴ The amounts being sought by the company greatly exceeded the directors' and officers' liability insurance held by the former board members and would, if successfully pursued, have resulted in their personal bankruptcy. The settlement of the claim avoided this outcome.

Equitable Life was not a listed company, and the claim it brought was settled; but it seems to have changed attitudes among non-executive directors of listed companies. These directors are now much more sensitive to the possibility of litigation. The perception that their financial well-being may be at stake, and not just, as before, their personal reputation, in the event of a major corporate failure, marks a significant shift. Litigation remains a very rare event and there is seemingly no record of the disqualification of a non-executive director of a listed company. Despite the raw figures on the number of directors sued, there is a growing perception of an increased litigation risk in the U.K. context.

IV. THE IMMEDIATE REACTION TO THE FINANCIAL CRISIS IN THE U.K.

The U.K.'s experience of the financial crisis began with the near-failure of Northern Rock in the early phase of the credit crunch of 2007, followed by the near-insolvency of one of the major high street clearing banks, Royal Bank of Scotland (RBS), in 2008. Taxpayer support was also provided to Lloyd's Bank, which acquired HBOS, a banking and insurance company, with government support in the autumn of 2008, thereby averting the insolvency of that company.⁵⁵ In the cases of Northern Rock and HBOS, the difficulties the banks found themselves in were linked to their exposure to volatile conditions in credit and equity markets, and to high-risk lending in the residential and corporate property sectors.⁵⁶ RBS's vulnerability was linked to

54. See *Litigation Against Former Directors and Ernst & Young*, EQUITABLE LIFE, http://www.equitable.co.uk/content/content_11.htm (last visited Nov. 11, 2010).

55. See TREASURY COMMITTEE, BANKING CRISIS: DEALING WITH THE FAILURE OF THE UK BANKS, 2008–09, H.C. 416, at 22–27, 58 (U.K.).

56. See TREASURY COMMITTEE, THE RUN ON THE ROCK, 2007–08, H.C. 56–1 (U.K.); see also TREASURY COMM., *supra* note 55, at 22–26.

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its strategy of corporate expansion, which had culminated in the hostile takeover of the Dutch bank ABN Amro earlier in 2008, and its resulting debt burden.⁵⁷

Because none of these banks was insolvent, the director disqualification regime under the Company Directors Disqualification Act of 1986 did not apply. Directors of the companies concerned have given evidence to parliamentary select committees conducting inquiries into the causes of the crisis, but no court has yet had the opportunity to rule on potential claims arising out of the events leading up to the crisis. It remains to be seen whether convincing claims can be made for a breach of the duty of care or related legal obligations of the directors concerned.

There is no evidence linking non-compliance with corporate governance standards to these failures. Brian Cheffins's empirical study suggests that companies that failed within the United States in the period of the financial crisis had not, by and large, failed to comply with corporate governance norms on matters such as independent directors and chair-CEO separation.⁵⁸ This also seems to have been true for the United Kingdom: Northern Rock, HBOS, and RBS all had exemplary corporate governance arrangements, at least on the surface.

This poses the question of what, if anything, the independent directors of these companies could have done to avert their near collapses. The answer, most likely, is nothing. Evidence has yet to emerge of a serious failure of internal monitoring, of the kind that would give rise to a breach of the standard set by the common law duty of care, in the case of these directors. The events of the late summer of 2007 (in the case of Northern Rock) and of the autumn of 2008 (in the cases of HBOS and RBS) seem to have come as a complete surprise to the executive managers of these companies. Their non-executive directors would seem to have been just as surprised. But as the non-executive directors also had less direct knowledge of the businesses concerned, it cannot be assumed that their failure amounts to a breach of their legal duties. Nor is it clear that the general knowledge of sectoral conditions, which they could have been expected to have, would have left them in a significantly better position to judge the risks facing their respective companies than the executives who were directly responsible for formulating corporate strategy. In due course, it is possible that more may be revealed, through litigation, of what went on in boardroom discussions at this time. But, if previous corporate crises are a good guide, we may never find out exactly what happened. There are no British precedents for ex-post disclosure of board-level deliberations of the kind that occurred in the United States in the Enron and Lehman Brothers cases.

Of more immediate interest is the diagnosis of the role of corporate governance in triggering the crisis that has taken place since the autumn of 2008. A case can be made that risk-taking was encouraged by the shareholder-value orientation of the U.K. corporate sector in general and by the large banks in particular. This assessment, made by Vice Chancellor Strine in the U.S. context, is also relevant to the British case:

57. See TREASURY COMMITTEE, *supra* note 55, at 18–22.

58. Brian R. Cheffins, *Did Corporate Governance 'Fail' During the 2008 Stock Market Meltdown? The Case of the S&P 500* 40 (Univ. of Cambridge and ECGI, Law Working Paper No. 124, 2009), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1396126.

Because of tighter independence rules, most of the directors [of U.S. listed companies] are completely independent of the corporation. As a result, many of the directors lack industry-specific experience or knowledge. Long gone are the days when a corporation's lender or key supplier might be on a board. These directors might have had some conflicting interests, but they also brought a concern for the long-term solvency of the corporation that was real and a knowledge of the corporation that is difficult for independent directors to match. In that regard it is also clear that American corporate directors—in contrast to their predecessors of decades past—now have a clear focus on one constituency, the equity holders, and that is the constituency most interested in aggressive risk taking.⁵⁹

Northern Rock and HBOS had been building societies⁶⁰ up to the 1990s. Legislation passed in 1986 that made it possible for building societies to be demutualized and listed on the stock exchange.⁶¹ This option gave existing deposit holders a windfall, so it was widely adopted. Legislation had previously placed building societies in a legal “straitjacket”: they could only approve loans for the specific purpose of supporting the purchase of residential properties, and the extent of their lending was confined, in practice, by the size of their deposit base. Demutualization left them free to compete with the major retail banks in the domestic mortgage market.⁶² Northern Rock and HBOS were among the newly converted banks which pursued the most aggressive lending strategies, offering mortgages of up to 125% of the value of the properties against which they were secured, and making use of special purpose vehicles and structured finance to gain access to the wholesale credit markets. They were also strong enthusiasts for shareholder value-orientated corporate governance.⁶³

In the aftermath of the crisis, the Walker Review⁶⁴ recommended additional powers for non-executive directors and strengthened internal controls for banks as means of avoiding a repetition of the events of 2007 and 2008. This approach arguably does nothing to address the problem of risk-taking, which is encouraged by

59. Vice Chancellor Leo E. Strine, Jr., *The Role of Delaware in the American Corporate Governance System, and Some Preliminary Musings on the Meltdown's Implications for Corporate Law at Utrecht Univ. Molengraaff Inst. for Private Law Conference on Governance of the Modern Firm 2008*, at 26 (Dec. 13, 2008).

60. Building societies are the British equivalent of savings and loans institutions.

61. Building Societies Act 1986, c. 53 (U.K.), <http://www.statutelaw.gov.uk/legResults.aspxLegType=All+Primary&PageNumber=35&NavFrom=2&activeTextDocId=2504059>.

62. See Jacqueline Cook et al., *Mutuality and Corporate Governance: The Evolution of UK Building Societies Following Deregulation*, 2 J. CORP. L. STUD. 110 (2002).

63. On the trajectory of Northern Rock and another of the demutualized building societies, Bradford & Bingley, which also collapsed in the course of the recent financial crisis, see Robin Klimecki & Hugh Willmott, *From Demutualization to Meltdown: A Tale of Two Wannabe Banks* (2008), available at <http://ssrn.com/abstract=1296482>.

64. HM TREASURY, *Walker Review of Corporate Governance of UK Banking Industry*, http://www.hm-treasury.gov.uk/walker_review_information.htm (last visited Nov. 11, 2010). The Walker Review was set up by the government to consider the case for corporate governance and regulatory reforms in the wake of the financial crisis and the failure of several UK banks.

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the focus of boards on shareholder value as the lodestar of corporate success. By further highlighting the role of non-executive directors, it could even exacerbate the problem. An alternative solution, the remutualization of parts of the banking sector, has been proposed in the case of Northern Rock, but has yet to materialize.⁶⁵

V. A CONTRASTING CASE: CORPORATE GOVERNANCE AND BOARD STRUCTURE IN LISTED JAPANESE COMPANIES

The Japanese case is of interest for illustrating the very different incentives and dynamics which operate in largely insider-dominated boards. Japanese corporate law, which has been heavily influenced by models drawn from U.S. legislation throughout the post-1945 period, is on its face very pro-shareholder. Shareholders can replace the directors with a majority vote and can initiate litigation against directors. In practice, however, Japanese shareholders rarely exercise these rights, and most large Japanese firms are run on a variant of the “community firm” model in which the influence of external investors is minimized. Most Japanese executives continue to see themselves as having a commitment to maintain the company as an entity in its own right, and view their obligations to customers and employees as taking priority over those owed to shareholders.⁶⁶

Under the influence of growing overseas ownership and trading of shares, Japanese corporate law has adjusted to reflect shareholder concerns. In 2002, a law came into effect that allowed companies to adopt a U.S.-style board structure, with the traditional committee of auditors (or supervisors) being replaced by a unitary board with significant independent membership. Under the so-called “company with committees” model, there must be a majority of independent directors on board subcommittees for audit, remuneration, and nomination. The law does not mandate that there be a majority of independent directors on the main board, and it allows directors from parent or subsidiary companies to be classified as independent. The “company with committees” model is only optional, and at the end of 2008 only just over 110 companies, out of a total listed company sector of over 7000, had adopted it. But these 110 companies included some of the most significant industrial and financial companies in Japan. The practice of electing non-executive directors has also become widespread among companies retaining the traditional legal structure, although they generally do not form a majority on the board.⁶⁷

These changes, significant as they are, have not led to a fundamental reappraisal of the role of non-executive or, as they are commonly known, “outside,” directors in large

65. Jill Treanor, *Government Considers Remutualising Northern Rock*, GUARDIAN, Oct. 4, 2009, <http://www.guardian.co.uk/business/2009/oct/04/government-considers-remutualising-northern-rock>.

66. See generally CORPORATE GOVERNANCE AND MANAGERIAL REFORM IN JAPAN, *supra* note 5.

67. For a discussion on the background to the recent legal reforms to board structure in Japan and their implementation, see JOHN BUCHANAN & SIMON DEAKIN, *In the Shadow of Corporate Governance Reform: Change and Continuity in Managerial Practice at Listed Companies in Japan*, in CORPORATE GOVERNANCE AND MANAGERIAL REFORM IN JAPAN, *supra* note 5, at 28–69.

Japanese companies.⁶⁸ Outside directors are seen as advisers and not as monitors. There is a frank recognition that their lack of a deep knowledge of the company's business makes it inappropriate for them to make decisions concerning corporate strategy, and that this in turn limits their monitoring role.⁶⁹ The point was made by a director of a listed company that had moved over to the "company with committees" model:

[O]ur current structure differs from the American style, where the CEO has become virtually the only one there with executive powers . . . we are discussing matters by involving people who have a better familiarity with how the company operates . . . it is not possible to reach decisions on things like the company's culture and matters of [similar] importance through discussions with external directors.⁷⁰

Another director expressed it in these terms:

The externals are not determining the companies' strategy. . . . They can't do that. You see, people who have been in the company for a long time, who bear executive responsibility, put together the strategy, then they obtain the approval of the external people on the board of directors, the matter is decided and then they implement it.⁷¹

This process is not without its critics, who see the absence of formal mechanisms of accountability as a major impediment to the modernization of Japanese corporate practice:

In Japan in a strict sense there is no management, there are just people in companies who are just cooperating—there is no real tough management and there is no leadership—just cooperation. So there is no real management as a modern management system—in the modern meaning of "management." So people don't think we need corporate governance. If there is no management, then no governance. It's very typical—very symbolic.⁷²

The tension between simple "cooperation" and "management" in the sense of "leadership" and the necessity of governance reforms for implementing the shift to "modern" forms of management, is telling.

Notwithstanding the reforms of the past decade, Japanese boards remain dominated by corporate insiders.⁷³ This does not mean, however, that monitoring is non-existent. There is strong peer-based monitoring, with senior executives in effect monitoring each other throughout their careers. Retired executives also play a

68. *Id.* at 38–44.

69. *Id.* at 40.

70. John Buchanan & Simon Deakin, *Japan's Paradoxical Response to the New 'Global Standard' in Corporate Governance*, 13 ZEITSCHRIFT FÜR JAPANISCHES RECHT [JOURNAL OF JAPANESE LAW] 59, 66 (Autumn 2008) (quoting a Japanese company director interviewed by John Buchanan & Simon Deakin).

71. *Id.* at 69.

72. *Id.* at 72 (quoting a former Japanese external auditor and external director of several different companies, interviewed by John Buchanan and Simon Deakin).

73. See BUCHANAN & DEAKIN, *supra* note 67, at 39–41.

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significant role in monitoring, often through informal channels.⁷⁴ Although bank-based monitoring⁷⁵ is now largely a thing of the past, shareholders often have relational ties with the firm, as suppliers or customers, and take large equity holdings in the company not as portfolio investors but in order to preserve these business relationships. Informal mechanisms of accountability play a role here too.⁷⁶ It is unlikely that Japanese companies will altogether escape the pressure to move to systems of internal audit. As they do so, there is a risk that they will lose the benefits of more traditional, informal mechanisms of accountability, while replacing them with less than fully effective formal systems. As a senior manager in a large Japanese company put it when interviewed in the mid-2000s:

The one thing that I am personally worried about, that I feel needs to be done, is strengthening of our internal control system At our current level of audit competence, I have the feeling that the arrangements we have put in place for auditing perhaps lack the ability to move in on the real heart of problems, that our audits are maybe a bit superficial. It may be that I am seeing problems where none exist but I feel that we need to improve our audit competence a little bit more and that we need to give it more ability to seek out things such as dealing with intrinsic dangers in the organization before they become problematical and looking at the business with regard to illegalities. So that's why I think that we should continue with our board governance arrangements just as they are for a while but I would like to look a little more closely at matters surrounding internal controls.⁷⁷

It remains to be seen how these pressures will be handled in the future. The Japanese model is not necessarily a better one than that of the U.S. or U.K. models. But in its emphasis on a range of internal and external modes of monitoring, with varying degrees of formality, it contrasts strongly with the exclusive focus on formal, external monitoring that has come to characterize Anglo-American corporate governance practice.

VI. CONCLUSION

An event of the scale and complexity of the financial crisis of 2007–2009 cannot be straightforwardly grasped. As full accounts of some of the corporate failures are only now emerging, it will be some time before we have a clear picture of the causes

74. See GEORGE OLCOTT, *Whose Company Is It? Changing CEO Ideology in Japan*, in *CORPORATE GOVERNANCE AND MANAGERIAL REFORM IN JAPAN*, *supra* note 5, at 199–200 (discussing the role of informal networking within the “web” of former senior executives as a constraint on CEO autonomy).

75. See MASAHIKO AOKI, *Monitoring Characteristics of the Main Bank System: An Analytical and Developmental View*, in *THE JAPANESE MAIN BANK SYSTEM: ITS RELEVANCE FOR DEVELOPING AND TRANSFORMING ECONOMIES* 109–40 (Masahiko Aoki & Hugh T. Patrick eds., 1995) (discussing on the monitoring of corporate performance by banks, a feature of the Japanese model in the middle decades of the twentieth century which has been in decline since the bursting of the real estate “bubble” in Japan in the early 1990s).

76. For a discussion on informal monitoring by shareholders, see OLCOTT, *supra* note 74, at 202–04.

77. See Buchanan & Deakin, *supra* note 70, at 73.

of the crisis. Corporate governance is only one piece, and perhaps not the most important element, of the regulatory framework that has been called into question. However, a working hypothesis on the role of corporate governance in contributing to the crisis is becoming clear. This hypothesis would focus on the transformation in the structure and function of corporate boards that took place in the United States and Britain in the period of deregulation and financialization of the economy,⁷⁸ which began in the 1980s. At the start of this period, corporate boards consisted largely of insiders with a deep knowledge of companies for which, in many cases, they had worked continuously throughout their careers. The task of the board was principally managerial, that is, to set and implement corporate strategy. At the end of this period, boards consisted mostly of outsiders who viewed their role as representatives of the shareholder interest and whose task was understood to be the monitoring of managers. Independence had replaced working knowledge of the company as the principal criterion for appointment to the board.

The events surrounding the financial crisis suggest that there are limits to the effectiveness of independent directors as monitors that derive from the complexity of modern business organizations and the volatility of the markets in which they operate. Independent directors appear, on the other hand, to have been highly effective in articulating shareholder concerns and in ensuring that executives orientated their own conduct to maximizing shareholder wealth. In performing this part of their role with such effectiveness, boards may have exacerbated the pressures which led to the critical corporate failures of 2008.

78. For a discussion on the concept of “financialization,” see JULIE FROUD ET AL., *FINANCIALIZATION AND STRATEGY: NARRATIVE AND NUMBERS* (2006).