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Articles

CURRENT TRENDS IN CORPORATE GOVERNANCE: GOING FROM LONDON TO MILAN VIA TORONTO

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I. INTRODUCTION

Corporate governance concerns the systems by which companies are directed and controlled.[1] The topic should not be studied in isolation within any one country. Instead, corporate governance is becoming an important issue in all industrial economies, and students of the topic need to be aware of what is occurring outside their respective countries.[2] As trade barriers fall, markets expand, information flows improve, and restrictions on investment disappear, it will become progressively easier for investors of one country to invest in corporations in another. Movement towards a worldwide capital market could in turn have a substantial impact on corporate governance in individual countries. In a world with intense

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1. *See* COMMITTEE ON THE FINANCIAL ASPECTS OF CORPORATE GOVERNANCE, REPORT OF THE COMMITTEE ON THE FINANCIAL ASPECTS OF CORPORATE GOVERNANCE ¶ 2.5 (1992) [hereinafter CADBURY REPORT]; THE COMMITTEE ON CORPORATE GOVERNANCE, REPORT OF THE COMMITTEE ON CORPORATE GOVERNANCE ¶ 1.15 (1998) [hereinafter HAMPEL REPORT]; DEPARTMENT OF TRADE AND INDUSTRY, MODERN COMPANY LAW FOR A COMPETITIVE ECONOMY 9 (1998). For further background on the definition of corporate governance, see Kevin Keasey et al., *Introduction: The Corporate Governance Problem—Competing Diagnoses and Solutions*, *in* CORPORATE GOVERNANCE: ECONOMIC, MANAGEMENT AND FINANCIAL ISSUES 1, 2 (Kevin Keasey et al. eds., 1997) (stressing that the term "corporate governance" is often used inconsistently).

2. *See* Klaus J. Hopt & Eddy Wymeersch, *Preface* to COMPARATIVE CORPORATE GOVERNANCE: ESSAYS AND MATERIALS, at v (Klaus J. Hopt & Eddy Wymeersch eds., 1997); Brian R. Cheffins, *Corporate Governance in the United Kingdom: Lessons for Canada*, 28 CANADIAN BUS. L.J. 69, 69 (1997).

competition for global savings, sophisticated investors will be attracted to jurisdictions in which investment structures serve shareholders' interests.[3] Since the attractiveness of a particular locality will depend on its system of corporate governance,[4] local norms may be adjusted to make domestic markets more accommodating to global trends.[5]

Events taking place in Britain merit the attention of those who wish to learn more about how companies should be directed and controlled. An American academic observed in an article published in 1998 that "the process by which British businesses have addressed the problems of governance have a singularly appealing character."[6] Studies carried out by investment advisers indicate that the corporate governance framework adopted in the United Kingdom is more stringent and highly developed than those in other European markets and elsewhere around the world.[7] Moreover, the topic of corporate governance has preoccupied much debate in Britain over the past few years.[8] There has been a great amount of commentary in the press and a trilogy of committees—Cadbury, Greenbury, and Hampel—have reviewed aspects of the problem.[9] The work which has been done in the United Kingdom has spurred reviews of corporate governance in markets around the world and has provided a yardstick against which investment frameworks in other countries are measured.[10]

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3. *See* ROBERT A.G. MONKS & NELL MINOW, CORPORATE GOVERNANCE 270-71 (1995).

4. *See* Erik Berglöf, *Reforming Corporate Governance: Redirecting the European Agenda*, 24 ECON. POL'Y 93, 93 (1997); *see also* Sir Adrian Cadbury, *Postscript*, *in* CORPORATE GOVERNANCE & CORPORATE CONTROL 391, 393 (Saleem Sheikh & William Rees eds., 1995); Joseph Sargent, *Governance Goes Global*, GLOBAL FIN., Nov. 1997, at 16 ("A superior governance profile increasingly provides the honey that investor bees are seeking.").

5. *See* Mary E. Kissane, *Global Gadflies: Applications and Implementations of U.S.-Style Corporate Governance Abroad*, 17 N.Y.L. SCH. J. INT'L & COMP. L. 621, 672-73 (1997).

6. Jayne W. Barnard, *The Hampel Committee: A Transatlantic Critique*, 19 COMPANY LAW. 110, 111 (1998).

7. *See* Sargent, *supra* note 4; Jean-Nicholas Caprasse & Shervin Setareh, *Dèminor Corporate Governance Survey*, 9 EUR. BUS. L. REV. 126 (1998); *Higher Corporate Governance Standards Can Increase Returns, Study Claims*, 11 INT'L SEC. REG. REP., Feb. 12, 1998, *available in* LEXIS, News Library (discussing a study carried out by a Brussels based consulting group).

8. *See* HAMPEL REPORT, *supra* note 1, ¶ 1.1.

9. *See* Gerard McCormack, *Institutional Shareholders and the Promotion of Good Corporate Governance*, *in* THE REALM OF COMPANY LAW: A COLLECTION OF PAPERS IN HONOUR OF PROFESSOR LEONARD SEALY, S.J. BERWIN PROFESSOR OF CORPORATE LAW AT THE UNIVERSITY OF CAMBRIDGE 131, 131 (Barry Rider ed., 1998).

10. *See* HAMPEL REPORT, *supra* note 1, ¶ 1.5; Kissane, *supra* note 5, at 644; Bob Tricker, *Cadbury Revisited*, 3 CORPORATE GOVERNANCE—AN INTERNATIONAL REVIEW 59, 59-60 (1995).

Since recent developments in the United Kingdom are important from a corporate governance perspective, this Article will analyze them in some detail. As background, the opening section will discuss the legal regime that applies to British companies and will describe the key factors that shape corporate governance in the United Kingdom. Next, this Article will identify problems that affect the management and control of British public companies. This will be followed by a summary of the solutions proposed by the Cadbury, Greenbury, and Hampel panels. There will then be an assessment of the impact of the work of these three committees and a description of corporate governance themes that are likely to attract attention in the near future.

While, from a global perspective, good reasons exist for considering the current debate over corporate governance in the United Kingdom, the presence of differing market conditions must be considered. Companies with shares quoted for trading on London's Stock Exchange generally do not have a dominant shareholder. In contrast, ownership by a dominant shareholder is common in public companies in most other countries, including many with highly developed economies, such as Germany, France, Italy, and Canada.[11] The existence of a concentrated ownership structure has a profound impact on corporate governance. When public companies have controlling shareholders, the position of the minority becomes a primary source of concern, and probably deserves a higher priority than managerial accountability, the issue that has attracted the most attention in the United Kingdom.

The situation in Italy illustrates the foregoing points. The corporate governance debate that has taken place in the United Kingdom should be relevant in an Italian context because the two countries are both member states in the European Union and because they have economies of a similar size.[12] Still, since Italy is a country where concentrated ownership of public companies is prevalent, those who are interested in reforming Italian corporate governance may well learn more by studying how similarly situated countries have dealt with minority shareholder protection. The Canadian experience is particularly instructive because the country's minority shareholders have a wide range of remedies available to them. We will therefore consider whether reforms adopted in Canada might be

11. *See* Rafael La Porta et al., *Corporate Ownership Around the World*, 54 J. FIN. 471, 491-95 (1999).

12. *See* WHITAKER'S ALMANACK 1999, at 771 (131st ed. 1998).

suitable for export. Since we will focus on developments affecting public companies in the United Kingdom, Italy, and Canada, this Article will take us from London to Milan, the home of Italy's stock exchange, via Toronto, the location of Canada's leading stock market.[13]

II. THE LEGAL FRAMEWORK GOVERNING BRITISH COMPANIES: AN OVERVIEW

In Britain, the vast majority of companies are incorporated under the Companies Act 1985.[14] The Act creates a distinction between private companies and public limited companies.[15] Only a tiny fraction of companies incorporated in Britain are registered as public limited companies.[16] Nevertheless, from a corporate governance perspective, they are of primary importance. A private company cannot apply to have its equity traded on a stock exchange, and debates about corporate governance in the United Kingdom have focused almost exclusively on companies that are publicly quoted.[17]

In the United Kingdom, most public companies that have their shares quoted for trading have been admitted to the Official List maintained by the Stock Exchange and are known as "listed" companies.[18] A listed company is obliged to comply with the Listing Rules of London's Stock Exchange (commonly referred to as the "Yellow Book").[19] The Yellow Book regulates the conduct of key transactions and imposes substantial disclosure obligations on listed companies.[20] If a listed company breaches a provision of the Yellow

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13. On Italy's stock market, see R.S. Karmel, *Italian Stock Market Reform*, N.Y. L.J., Aug. 20, 1998, at 3. On Toronto's situation, see *Spotlight on Toronto*, INVESTOR REL., May 1998, at 71.

14. *See* Companies Act 1985, Ch. 6 (Eng.). *See* PAUL L. DAVIES, GOWER'S PRINCIPLES OF MODERN COMPANY LAW 3-7, 44-53 (6th ed., 1997).

15. *See* Companies Act 1985, §§ 1(3), 25, 27(1) (Eng.).

16. *See* DAVIES, *supra* note 14, at 13.

17. *See* Financial Services Act 1986, ch. 60, § 143 (addressing the listing of shares by private companies); *see also* DAVIES, *supra* note 14, at 425-26. On the link between corporate governance reform and listed companies, see CADBURY REPORT, *supra* note 1, ¶ 3.1; THE STUDY GROUP ON DIRECTORS' REMUNERATION, DIRECTORS' REMUNERATION: REPORT OF A STUDY GROUP CHAIRED BY SIR RICHARD GREENBURY ¶ 1.4 (1995) [hereinafter GREENBURY REPORT].

18. *See* JOHN H. FARRAR & BRENDA HANNIGAN, FARRAR'S COMPANY LAW 541-43 (4th ed. 1998). Farrar and Hannigan also describe the Alternative Investment Market, a market for smaller, growing companies launched by the Stock Exchange in 1995. *See id*.

19. *See id.* at 541.

20. *See id.* at 490, 542.

Book, the Stock Exchange is entitled to publicize the infraction and, if necessary, can suspend trading of the company's shares.[21]

The Yellow Book plays a crucial role with respect to corporate governance. In 1998, the Stock Exchange amended its listing rules by appending a document entitled "Principles of Good Governance and Code of Best Practice;" this document, otherwise known as the "Combined Code," embraces work carried out by the Cadbury, Greenbury, and Hampel Committees.[22] The Yellow Book does not oblige listed companies to comply with the principles set out in the Combined Code. Instead, a company is only required to discuss in its annual report to shareholders and its annual accounts the extent to which it has followed the relevant guidelines and to explain any significant failures to comply.[23] The objective of the exercise is to secure sufficient disclosure so that investors and others can assess a listed company's corporate governance practices and respond in an informed manner.[24]

British companies have corporate constitutions composed of two documents: the memorandum of association and articles of association.[25] In the ordinary course, a company's articles of association vests the authority to manage the business in the hands of the board of directors and gives the shareholders the power to choose who sits on the board.[26] Though the directors of a U.K. public company are authorized to run the company, they usually do not carry out day-to-day corporate decision-making activity. Instead, pursuant to a clause in the articles of association, the board delegates its powers to individuals holding executive offices with the company.[27]

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21. *See* Financial Services Act 1986, ch. 60, §§. 145, 153 (Eng.); THE STOCK EXCHANGE, LISTING RULES ¶¶ 1.5, 1.19, 1.22 (1999).

22. *See* The Combined Code, preamble ¶ 1, *in* THE STOCK EXCHANGE, LISTING RULES (1999).

23. *See* THE STOCK EXCHANGE, LISTING RULES ¶ 12.43A(a) (1999); The Combined Code, preamble ¶¶ 4, 5, *in* THE STOCK EXCHANGE, LISTING RULES (1999).

24. *See* HAMPEL REPORT, *supra* note 1, ¶ 1.25.

25. Section 14 of the Companies Act 1985 specifically states that these documents constitute a contract that binds a company and its shareholders. *See* Companies Act 1985 § 14 (Eng.).

26. *See* BRIAN R. CHEFFINS, COMPANY LAW: THEORY, STRUCTURE AND OPERATION 61, 95 (1997); Companies (Tables A to F) Regulations 1985, S.I. 1985, No. 805, tbl. a, arts. 70, 73. Section 303 of the Companies Act 1985 authorizes a company's shareholders to remove a director before his or her term has expired.

27. *See* Companies (Tables A to F) Regulations 1985, S.I. 1985, No. 805, tbl. a, arts. 72, 84. Many companies have a committee of managers which is vested with authority to deal with operational issues. *See* THE CORPORATE GOVERNANCE HANDBOOK ¶ 1.2 (R.A. Derwent ed., 1996).

The full-time executives then make the decisions regarding hiring and firing, assigning work, launching product lines, setting prices, and other important managerial matters.

In a typical U.K. listed company, a number of senior full-time executives sit on the board, joining a group of "outside" or "non-executive" directors who are not involved with the affairs of the company on a day-to-day basis.[28] Outside directors fulfill two key functions.[29] First, they provide full-time executives with support and assistance as they carry out their managerial tasks. For example, they may offer advice on the basis of special expertise or foster links with other organizations. Second, they monitor executive decision-making. This involves reviewing the performance of management to ensure that those in charge are acting in the shareholders' interests and are complying with the legal duties, regulatory requirements, and ethical imperatives associated with the operation of a public company.

Non-executive directors, in their capacity as corporate monitors, are expected to play an important corporate governance role in British publicly quoted companies. Nevertheless, U.K. company law does not recognize non-executives as a separate class of director. Although some allowances may be made for differences in knowledge and experience, all directors owe the same legal duties and are equally responsible for decisions taken by the entire board.[30]

The legal obligations placed on directors arise by virtue of a combination of case law principles and statutory provisions. The United Kingdom uses its case law to define directors' core legal duties and its statutory law to provide a vehicle to further administer those broadly defined obligations. British case law dictates that directors have an obligation to act in their companies' best interests, to avoid conflicts of interest, and to carry out their duties with care, skill, and

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28. *See* CHEFFINS, *supra* note 26, at 96; THE CORPORATE GOVERNANCE HANDBOOK, *supra* note 27, ¶ 2.2; Ken Peasnell et al., *A New Model Board*, ACCOUNTANCY INT'L, July 1998, at 91.

29. *See* HAMPEL REPORT, *supra* note 1, ¶ 3.8; THE CORPORATE GOVERNANCE HANDBOOK, *supra* note 27, ¶¶ 1.11, 2.2; ROBERT I. TRICKER, INTERNATIONAL CORPORATE GOVERNANCE: TEXT, READINGS AND CASES 148-50 (1994).

30. *See* Dorchester Fin. Co., Ltd. v. Stebbing [1989] B.C.L.C. 498 (Ch. 1977); RICHARD SMERDON, A PRACTICAL GUIDE TO CORPORATE GOVERNANCE 37, 52 (1998); Colin Mercer, *Non-Executive Directors: Watchdogs, Oracles or Fall-Guys*, PRACTICAL L. FOR COMPANIES, June 1992, at 15, 16-17. The Hampel Committee recommended that the law should remain the same "in the interests of the unity and cohesion of the board." HAMPEL REPORT, *supra* note 1, ¶ 3.3.

diligence.[31] On the statutory front, the Companies Act 1985 provides for more than 200 punishable offences for directors.[32] Directors can also face sanctions under a wide range of other statutes, including the Insolvency Act 1986 and environmental protection measures.[33]

III. FACTORS THAT SHAPE CORPORATE GOVERNANCE IN THE UNITED KINGDOM

Considering the factors that shape Britain's system of corporate governance helps one to understand the trends which have emerged. This is because corporate governance arrangements in any one country are, to a significant extent, a product of the local economic and social environment.[34] A distinctive feature of the British corporate governance system is that the environment in which its public companies operate strongly resembles that which exists in the United States.

An important similarity is the presence of well-developed equity markets. Almost all of America's largest corporations are quoted on the stock market, as are most major British companies.[35] As of 1996, the United Kingdom had thirty-six listed companies per one million people and the United States had thirty, whereas France had eight, Germany had five, and Italy had four.[36] That same year, the market capitalization of U.S. stock markets (the total market value of all of the shares of all corporations listed for trading) was around 95% of the country's Gross Domestic Product (GDP), and in Britain the

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31. *See, e.g.*, *In re* Smith & Fawcett, Ltd. [1942] Ch. 304 at 306 (C.A. 1942); Aberdeen Rly. Co. v. Blaikie Bros. (1854) 1 Macq. 461 at 471-72 (H.L., 1854); Regal (Hastings) Ltd. v. Gulliver [1942] 1 All ER 378 (H.L., 1942) and City Equitable Fire Insurance Co. [1925] 1 Ch. 407 (Ch.D., 1925).

32. *See* NIGEL G. MAW ET AL., MAW ON CORPORATE GOVERNANCE 19-20 (1994); Companies Act 1985, ch. 6, sched. 24.

33. *See* Insolvency Act 1986, ch. 45, §§ 213-214. On other statutory measures, see discussion by MAW ET AL., *supra* note 32, at 19-20, 99-107; P. SOUSTER, DIRECTORS: YOUR RESPONSIBILITIES AND LIABILITIES 25-26, 30-34 (4th ed. 1998).

34. *See* HAMPEL REPORT, *supra* note 1, ¶ 1.4.

35. *See* Pieter W. Moerland, *Alternative Disciplinary Mechanisms in Different Corporate Systems*, 26 J. ECON. BEHAVIOR & ORG. 17, 19 (1995); Julian Franks & Colin Mayer, *Corporate Ownership and Control in the UK, Germany, and France*, *in* STUDIES IN INTERNATIONAL CORPORATE FINANCE AND GOVERNANCE SYSTEMS: A COMPARISON OF THE US, JAPAN, AND EUROPE 281, 283 (Donald H. Chew ed., 1997) [hereinafter STUDIES IN INTERNATIONAL CORPORATE FINANCE AND GOVERNANCE SYSTEMS].

36. *See* Rafael La Porta et al., *Legal Determinants of External Finance*, 52 J. FIN. 1131, 1137-38 (1997).

proportion was even higher (approximately 135% of GDP). In other major European countries, the equivalent figure was 35% or less.[37]

Another common feature in the United Kingdom and the United States is diffused share ownership. In Britain, very few large companies are controlled by families, and fewer than one-fifth of the country's publicly quoted firms have an owner who controls more than twenty-five percent of the shares.[38] Likewise, in the United States, large shareholdings, and especially majority ownership, are uncommon.[39] An additional similarity between Britain and the United States is that institutional investors, such as pension funds, insurance companies, and mutual funds (known in the United Kingdom as investment or unit trusts), play an important role in the ownership of listed companies. In the United States, institutional investors own approximately fifty percent of the equity market.[40] In the United Kingdom, the figure is between sixty and seventy percent.[41]

The structure of ownership and control in the United Kingdom and the United States has been characterized as an "outsider" or "arm's-length" system.[42] The "outsider" typology is used because share ownership is dispersed among a large number of institutional

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37. *See* Eddy Wymeersch, *A Status Report on Corporate Governance Rules and Practices in Some Continental European States*, *in* COMPARATIVE CORPORATE GOVERNANCE: THE STATE OF THE ART AND EMERGING RESEARCH 1045, 1057, 1061 (Klaus J. Hopt et al. eds., 1998); *see also Le Défi Américain, Again*, ECONOMIST, July 13, 1996, at 21. La Porta offers similar evidence, though the method of calculation is somewhat different. *See* La Porta et al., *supra* note 36, at 1137-38.

38. *See* Berglöf, *supra* note 4, at 101; Wymeersch, *supra* note 37, at 1170-72; Paul L. Davies, *Institutional Investors as Corporate Monitors in the UK*, *in* COMPARATIVE CORPORATE GOVERNANCE: ESSAYS AND MATERIALS, *supra* note 2, at 48; S. Thomsen & T. Pedersen, *Nationality and Ownership Structures: The 100 Largest Companies in Six European Nations*, 36 MGMT. INT'L REV. 149, 150 (1996).

39. *See* La Porta et al., *supra* note 11, at 493, 497; Andrew Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737, 754 (1997); P. Someshwar Rao & Clifton R. Lee-Sing, *Governance Structure, Corporate Decision-Making and Firm Performance in North America*, *in* CORPORATE DECISION-MAKING IN CANADA 43, 47 (Ronald J. Daniels & Randall Morck eds., 1995).

40. *See* Rao & Lee-Sing, *supra* note 39, at 50; Richard Waters, *Large Investors' Power Stalls*, FIN. TIMES, June 12, 1998, at 25.

41. *See* HAMPEL REPORT, *supra* note 1, ¶ 5.1; CHEFFINS, *supra* note 26, at 51; MONKS & MINOW, *supra* note 3, at 303.

42. *See* Erik Berglöf, *A Note on the Typology of Financial Systems*, *in* COMPARATIVE CORPORATE GOVERNANCE, *supra* note 2, at 151, 152, 157-64; Colin Mayer, *The City and Corporate Performance: Condemned or Exonerated?*, 21 CAMBRIDGE J. ECON. 291, 298-99 (1997); MARC GOERGEN, CORPORATE GOVERNANCE AND FINANCIAL PERFORMANCE: A STUDY OF GERMAN AND UK INITIAL PUBLIC OFFERINGS 1-2 (1998).

and individual investors, rather than being concentrated in the hands of a small number of families, banks, or other firms. The term "arm's-length" signifies that investors in the United States and the United Kingdom are rarely poised to intervene or take a hand in running a business. Instead, they tend to maintain their distance and give executives significant managerial discretion.

To understand why shareholders in the United Kingdom and the United States tend to treat their investment in a company in an arm's-length manner, it is helpful to consider the position of a typical institutional investor. Most often, an institution will own equity in a large number of companies and thus will have a highly diversified portfolio of shares. Under such circumstances, participating in the affairs of any one firm is unlikely to be worthwhile; the impact on the overall value of its share portfolio will probably be trivial. Also, the presence of an "exit option" is important. If a company is poorly run, taking advantage of the liquidity the stock market offers by selling the equity could offer a much quicker and less costly solution than trying to turn things around by acting in a "hands-on" manner.[43] As the next part of this article will show, the detached approach that shareholders tend to take has had a pivotal influence on discussions of corporate governance in both the United Kingdom and the United States.

IV. THE SEPARATION OF OWNERSHIP AND CONTROL: THE CORPORATE GOVERNANCE IMPLICATIONS

In *The Modern Corporation and Private Property*, a highly influential book published in the early 1930s, Adolf Berle and Gardiner Means drew attention to the arm's length approach to investment that is a characteristic of British and American equity markets.[44] The authors asserted that while the law treated shareholders as a company's owners, investors in public corporations usually did not act in the manner one would expect of an owner.

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43. For further details on why institutional investors might be reluctant to take on an activist role, see CHEFFINS, *supra* note 26, at 62-64; JONATHAN CHARKHAM, KEEPING GOOD COMPANY: A STUDY OF CORPORATE GOVERNANCE IN FIVE COUNTRIES 206-8, 280-91 (1994); Helen Short & Kevin Keasey, *Institutional Shareholders and Corporate Governance*, *in* CORPORATE GOVERNANCE: RESPONSIBILITIES, RISKS AND REMUNERATION 23, 25-27 (Kevin Keasey & Mike Wright eds., 1997); *see also* HAMPEL REPORT, *supra* note 1, ¶ 5.2.

44. ADOLF BERLE & GARDINER MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932). On the book's impact, see Davies, *supra* note 38, at 49; Edward B. Rock, *America's Shifting Fascination with Comparative Corporate Governance*, 74 WASH. U. L.Q. 367, 368-70 (1996).

Instead, shareholders allowed management to deal with matters of importance, resulting in a separation of ownership and control.

In the years after Berle and Means outlined their separation of ownership and control thesis, many commentators bemoaned the passivity of shareholders.[45] Giving executives the freedom to run a widely held public company, however, is in many respects a sensible division of labor. Theoretically, the individuals hired as senior managers should have the training, experience, and abilities necessary to be effective corporate decision-makers. They should also have ample time to become familiar with the operations of the company on behalf of which they act. Moreover, a company's top managerial personnel should constitute a sufficiently small and cohesive group to allow for effective decision-making.[46]

While executives in a widely held public company typically should be well positioned to act in a managerial capacity, shareholders are unlikely to be well suited for a hands-on role. It is not feasible for all who own equity to be consulted on managerial decisions since the delay would be costly, resulting in lost customers and foregone opportunities.[47] Most shareholders in widely held public companies are not experienced business managers and cannot properly substitute for them.[48] Even those investors who can claim managerial expertise are unlikely to be sufficiently acquainted with a company to offer constructive solutions on questions executives have to confront (e.g., resolving how to finance an expansion of the business and determining which plants to build and close).[49]

Though delegating decision-making to an inner circle of company executives offers important advantages, the arrangement is not without its faults. Typically, managers who work for widely held British and U.S. corporations own a small percentage of the equity.[50]

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45. *See generally*, *e.g.*, David C. Bayne, *A Philosophy of Corporate Control*, 112 U. PA. L. REV. 22 (1963); LEWIS D. GILBERT, DIVIDENDS AND DEMOCRACY (1956).

46. *See, e.g.*, MONKS & MINOW, *supra* note 3, at 99-100, 179; R.C. CLARK, CORPORATE LAW 23-24 (1986).

47. *See* MONKS & MINOW, *supra* note 3, at 179.

48. *See* HAMPEL REPORT, *supra* note 1, ¶ 1.19; *see also* Shleifer & Vishny, *supra* note 39, at 741; J.E. PARKINSON, CORPORATE POWER AND RESPONSIBILITY: ISSUES IN THE THEORY OF COMPANY LAW 51 (1993).

49. *See* C. MACKENZIE, THE SHAREHOLDER ACTION HANDBOOK: USING SHARES TO MAKE COMPANIES MORE ACCOUNTABLE 60-61 (1993).

50. *See* Andy D. Cosh & Alan Hughes, *The Changing Anatomy of Corporate Control and the Market for Executives in the United Kingdom*, 24 J.L. & SOC'Y 104, 118 (1997) (noting, however, that the percentage of shares owned by directors in British companies was increasing);

Since corporate executives receive only a tiny fraction of returns derived from the profit-enhancing activities they engage in on behalf of shareholders, they may be tempted to use their control over corporate assets to further their own interests at the expense of those who own equity. To the extent that top managers pursue their own agenda, they impose what economists refer to as "agency costs" on these investors.[51]

The agency cost problem can manifest itself in a variety of ways. Company executives can "shirk" their responsibilities by carrying out more desirable activities (for example, playing golf or setting up business ventures they want to pursue in their personal capacity).[52] Alternatively, they might engage in "looting" or "diversion" of corporate assets by constructing unnecessarily lavish offices, by carrying out exotic "business" travel, by providing high-paying jobs to family members, or by squandering funds on ill-conceived "pet" projects.[53] Moreover, senior executives might use their influence in the boardroom to ensure that the board awards them overly generous salaries and excessive bonuses.[54] In addition, a corporation's managers might use their leverage to entrench themselves and continue in office even if they are no longer competent or qualified to run the business.[55]

While those acting in a managerial capacity in widely held companies will be tempted to act in a self-serving manner, various factors serve to align the interests of executives and shareholders.[56] One is the labor market for executives—to impress potential alternative employers, senior managers want to run companies well. Another factor is the market for a company's products or services—executives will lose their jobs if a decline in market share is sufficiently precipitous to cause the company to fail. The capital market is also significant—companies that want to raise money will

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Michael C. Jensen & Kevin J. Murphy, *CEO Incentives—It's Not How Much You Pay, But How*, HARV. BUS. REV., May-June 1990, at 138, 141, 144.

51. *See* Brian R. Cheffins, Michaud v. National Bank of Canada *and Canadian Corporate Governance: A Victory for Shareholder Rights*?, 30 CANADIAN BUS. L.J. 20, 25-26 (1998) [hereinafter Canadian Corporate Governance].

52. *See* JOHN MCMILLAN, GAMES, STRATEGIES AND MANAGERS 98-99 (1992).

53. *See* J.S. ZIEGEL ET AL., CASES AND MATERIALS ON PARTNERSHIPS AND CANADIAN BUSINESS ORGANIZATIONS 391-92 (3d ed. 1994).

54. *See* Shleifer & Vishny, *supra* note 39, at 745; Chris Riley & Diane Ryland, *Directors' Remuneration: Towards Some Principles of Substantive and Procedural Review*, *in* CORPORATE GOVERNANCE & CORPORATE CONTROL, *supra* note 4, at 181, 182.

55. *See* Shleifer & Vishny, *supra* note 39, at 742-43.

56. *See* CHEFFINS, *supra* note 26, at 117-19.

receive less advantageous terms if there is evidence of mismanagement. Moreover, there is the threat of a hostile takeover bid, which occurs when a bidder makes an offer to the shareholders of a target company to buy their equity with a view to installing new executives. Hostile takeovers are feasible in companies with a widely dispersed ownership structure because bidders can acquire control on the open market rather than by negotiating with a dominant shareholder.[57]

Although various market instruments can serve to deter self-serving managerial conduct in widely held companies, they do not entirely eliminate agency cost problems. Instead, those managing widely held corporations retain some scope to pursue their own agenda at the expense of shareholders.[58] In the United Kingdom, fears that top executives lead a privileged existence and have ample scope to act in a misguided or dishonest manner have helped to bring the topic of corporate governance to prominence in recent years. The process began with a spate of unexpected company failures and financial scandals in the early 1990s, with the most spectacular example involving the collapse of the business empire of controversial press baron Robert Maxwell.[59] Since low standards of managerial accountability were identified as an important cause of these incidents, concern grew about how British companies were being run.

Subsequently, a different complaint was heard, this being that Britain's executives were overpaid. Executive remuneration prompted heated debate in the United Kingdom in the 1990s, as the media characterized the awarding of generous salaries and the operation of lucrative share option schemes as examples of

57. *See* G.P. STAPLEDON, INSTITUTIONAL SHAREHOLDERS AND CORPORATE GOVERNANCE 228 (1996); *cf.* Shleifer & Vishny, *supra* note 39, at 756. On the extent of takeover activity in the United Kingdom, see Wymeersch, *supra* note 37, at 1190-92. Just how effective the threat of a takeover is in disciplining management is controversial. *See, e.g.*, Mayer, *supra* note 42, at 297.

58. *See* Shleifer & Vishny, *supra* note 39, at 746-47; Michael C. Jensen, *The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems*, 48 J. FIN. 831, 850-52 (1993); Jonathan R. Macey, *Institutional Investors and Corporate Monitoring: A Demand-Side Perspective in a Comparative View*, *in* COMPARATIVE CORPORATE GOVERNANCE, *supra* note 37, at 903, 907.

59. Other prominent examples included Polly Peck International plc, a food and consumer electronics group, and Brent Walker plc, a property and leisure group. *See generally* SMERDON, *supra* note 30, at 1; C. Boyd, *Ethics and Corporate Governance: the Issues Raised by the Cadbury Report in the United Kingdom*, 15 J. BUS. ETHICS 167, 168 (1996).

managerial "gluttony."[60] Concerns about low standards of managerial accountability and rising executive pay levels were sufficiently serious to provide the catalyst for the establishment of the trilogy of committees—Cadbury, Greenbury, and Hampel—that reviewed corporate governance in the United Kingdom in the 1990s. We will analyze the work done by these three panels after we have considered in a general way possible solutions to the sort of corporate governance problems likely to arise in widely held public companies.

V. REFORMING CORPORATE GOVERNANCE: AN OVERVIEW

Concerns about low standards of corporate governance have led to much discussion about possible reform. First, many of those who fear that corporate executives are not sufficiently accountable for their conduct have stressed that the board of directors can act as a crucial corrective mechanism. They posit that a company's non-executive directors can reduce agency costs by monitoring the management team in a conscientious and objective manner. Outside directors are the logical candidates to act as managerial "watch-dogs" because their independent status theoretically ensures that they will have the detached perspective required to carry out supervisory tasks effectively.[61]

The restructuring of executive pay schemes has been suggested as a second method available for improving managerial accountability. A popular thesis is that remuneration levels should fluctuate in accordance with shareholder return.[62] The theory is that executives need to be motivated to think like shareholders: if those who run companies face the same risks and opportunities as those who invest, they will have a direct incentive to do what is best for investors.[63] In publicly quoted British companies, fluctuations in executive pay typically exhibit a weak correlation with changes in shareholder return.[64] It therefore follows that changes should be

60. *See, e.g.*, David Cohen, *Executive Gluttony Under Attack*, FIN. TIMES, November 26/27, 1994, at 3; *see also* CHEFFINS, *supra* note 26, at 655-56; THE CORPORATE GOVERNANCE HANDBOOK, *supra* note 27, ¶ 6.1.

61. *See* Canadian Corporate Governance, *supra* note 51, at 29.

62. *See* Andrew R. Brownstein & Morris J. Palmer, *CEO Pay: How Much is Enough?*, HARV. BUS. REV., July-Aug., 1992, at 130, 137 (quoting comments of Nell Minow).

63. *See* MONKS & MINOW, *supra* note 3, at 238; Michael C. Jensen & Kevin J. Murphy, *Performance Pay and Top-Management Incentives*, 98 J. POL. ECON. 225, 225-26, 242-43 (1990).

64. *See* Martin J. Conyon & Paul Gregg, *Pay at the Top: A Study of the Sensitivity of Top Director Remuneration to Company Specific Shocks*, NATIONAL INSTIT. ECON. REV., Aug.

made to ensure that managerial remuneration packages are designed to suit investors better.[65]

Third, many of those concerned about managerial agency costs think that increasing the role of institutional investors as active company owners will enhance accountability.[66] Pension funds, insurance companies, and other institutional investors allegedly do little more than attempt to enhance the value of their share portfolios by buying and selling equity in various companies. It is felt that they should forsake this "hands-off" approach and seek to improve the performance of the companies in which they already own stock. As a key step, these large investors could promote good governance. Doing so could potentially improve their rate of return because companies are likely to be more profitable when those in charge are held properly accountable.[67] From a broader perspective, reuniting ownership with responsibility will help to secure the continued benefits of a healthy capitalist system.[68]

The foregoing proposals can function as complements rather than alternatives. Executive pay is instructive in this regard. Various advocates of corporate governance reform have argued that a remuneration committee composed entirely of outside directors should address executive pay issues.[69] According to this theory, the individuals sitting on the remuneration committee should have sufficient time, resources, and expertise to consider all relevant factors, and their detached perspective should allow them to

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1994, at 83; Paul Gregg et al., *The Disappearing Relationship Between Directors' Pay and Corporate Performance*, 31 BRIT. J. IND. REL. 1, 3 (1993). Typically the pattern has been the same in the United States. For example, see Jensen & Murphy, *supra* note 63. Things, however, appear to be changing. *See* Brian J. Hall & Jeffery B. Liebman, *Are CEOs Really Paid Like Bureaucrats?*, 113 Q.J. ECON. 653 (1998).

65. On possible flaws with this line of reasoning, see CHEFFINS, *supra* note 26, at 685-87.

66. *See, e.g.*, STAPLEDON, *supra* note 57, at 17-18, 207-12, 284-85; J.P. Charkham, *A Larger Role for Institutional Investors*, *in* CAPITAL MARKETS AND CORPORATE GOVERNANCE 99 (Nicholas Dimsdale & Martha Prevezer eds., 1994); Bermard S. Black, *Agents Watching Agents: the Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811 (1992).

67. *See* MARK J. ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE 235-36 (1994); Bernard S. Black, *Institutional Investors and Corporate Governance: The Case for Institutional Voice*, *in* STUDIES IN INTERNATIONAL CORPORATE FINANCE AND GOVERNANCE SYSTEMS, *supra* note 35, 160, 161.

68. *See* ROBERT A. G. MONKS, THE EMPEROR'S NIGHTINGALE: RESTORING THE INTEGRITY OF THE CORPORATION 69, 162-64 (1998); S. WRIGHT, TWO CHEERS FOR THE INSTITUTIONS 20-21, 68-69 (1994).

69. *See* Ian M. Ramsay, *Directors' and Officers' Remuneration: The Role of the Law*, 1993 J. BUS. L. 351, 373; Charles M. Elson, *Executive Overcompensation—A Board-Based Solution*, 34 B.C. L. REV. 937, 939, 942-43 (1993).

approach their task in an unbiased manner. Moreover, institutional investors may well have the leverage required to induce a remuneration committee to carry out its assignment prudently and diligently. In a company where institutions own a majority of the shares, they can potentially use their combined voting power to determine who sits on the board.[70] Directors serving on the remuneration committee of such a company therefore have an incentive to take into account institutional preferences regarding executive pay.[71] Assuming that institutional shareholders will support linking pay with performance, this example illustrates that corporate governance proposals which have been made can operate effectively on an integrated, complementary basis.

VI. IMPLEMENTING CORPORATE GOVERNANCE REFORM IN THE UNITED KINGDOM

Corresponding to the recommendations for reform discussed above, the corporate governance regime in the United Kingdom evolved considerably during the 1990s. The changes were primarily a result of the work done by three committees, each of which is known by the name of its chairman: Cadbury, Greenbury, and Hampel. Sir Adrian Cadbury's Committee on the Financial Aspects of Corporate Governance was established in 1991.[72] The Committee was sponsored by the accounting profession, the London Stock Exchange, and the Financial Reporting Council, which supervises the setting of accounting standards that apply to British companies. The sponsors established the Cadbury Committee because of two concerns—a low level of confidence in the corporate financial reporting regime and fears that auditor shortcomings were undermining the effectiveness of companies' internal control systems.[73]

In 1992, the Cadbury Committee set out its findings and conclusions in a report (the "Cadbury Report") accompanied by a Code of Best Practice.[74] Because auditing was seen as an important topic by the Committee, the Cadbury Report considered how the

70. *See* CHEFFINS, *supra* note 26, at 61, 95 (discussing the authority which shareholders have to select a company's directors under U.K. law); JAMES D. COX, ET AL., CORPORATIONS § 9.12 (1995) (discussing removal of directors by shareholders under U.S. law).

71. *See* CHEFFINS, *supra* note 26, at 695.

72. *See* CADBURY REPORT, *supra* note 1, ¶¶ 2.1, 2.2., app. 1 (containing background material).

73. *See id.*

74. The Cadbury Code of Best Practice is set out in the CADBURY REPORT, *supra* note 1, at 58.

professional objectivity of auditors could be preserved and canvassed potential methods for increasing the effectiveness and value of audits.[75] The bulk of the Cadbury Report (and most of the guidelines in the accompanying Code of Best Practice) focused, however, on the role which the board of directors should play in supervising executive decision making. The Cadbury Committee's stated philosophy was that proper managerial accountability was the key to any system of corporate governance. Its view was that companies that adhered to its Code of Best Practice would experience improvement on this front.[76]

The Cadbury Committee declared that primary responsibility for compliance with its Code of Best Practice lay with companies themselves, via their boards of directors.[77] Correspondingly, the Cadbury Committee favored only one enforcement mechanism of a legal character: a requirement that, as a continuing obligation of listing on London's Stock Exchange, companies publish a statement of compliance with the Code. Following publication of the Cadbury Report, the Stock Exchange imposed such an obligation in its Yellow Book.[78]

The Greenbury Committee, chaired by Sir Richard Greenbury, also examined corporate managerial policy, but with a focus on executive remuneration. The Confederation of British Industry, an organization representing the business community, established the Greenbury Committee in 1995.[79] Later that same year, the committee issued its findings in a report ("the Greenbury Report"), together with an accompanying Code of Best Practice.[80] The Greenbury Report recommended that in a publicly quoted company, a remuneration committee composed of non-executive directors should play a central and constructive role in setting executive pay.[81] The report also emphasized the importance of shareholder participation. The Committee acknowledged that meaningful shareholder involvement could only occur if investors had sufficient information to determine whether a company's approach to remuneration issues

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75. *See id.* ¶¶ 5.1-5.48.

76. *See id.* ¶¶ 1.6-1.11.

77. *See id.* ¶ 3.14.

78. *See* THE STOCK EXCHANGE, LISTING RULES ¶ 12.43(j) (1999) (deleted January 1999).

79. On the history, see Cheffins, *supra* note 2, at 79.

80. *See generally* GREENBURY REPORT, *supra* note 17; *Code of Best Practice*, *in* GREENBURY REPORT, *supra* note 17, at 13.

81. *See* GREENBURY REPORT, *supra* note 17, ¶¶ 1.14, 4.3, 4.8; *Code of Best Practice* ¶ A1, *in* GREENBURY REPORT, *supra* note 17, at 13.

was sound and to decide whether corrective action was required. The Greenbury Report correspondingly urged a "philosophy of full transparency," and made a series of recommendations designed to foster enhanced disclosure.[82]

As with the Cadbury Committee, the Greenbury Committee did not support the use of legislation as a means for implementing its recommendations.[83] Instead, the Greenbury panel advised that companies themselves should take steps to address executive pay issues.[84] The Greenbury Committee did recommend, however, that the Stock Exchange provide backing for various elements of the Committee's Code of Best Practice via the Exchange's listing rules.[85] The Stock Exchange agreed and implemented many of the Greenbury Committee's recommendations in amendments to the Yellow Book.[86]

After the Cadbury and Greenbury Committees issued their reports, the Committee on Corporate Governance was established, with Sir Ronald Hampel as chair (the "Hampel Committee").[87] The Hampel Committee's primary assignment was to review the Cadbury and Greenbury Reports, but it was also urged to consider the entire spectrum of corporate governance.[88] Hence, its task was "to promote high standards of corporate governance in the interests of investor protection and in order to preserve and enhance the standing of companies listed on the Stock Exchange."[89]

When the Hampel Committee issued its final report in 1998, it identified a series of broad principles of good corporate governance and presented a series of more detailed recommendations concerning best practice. The Stock Exchange then implemented many facets of the Hampel Report by appending "the Combined Code" to the Yellow Book. The Combined Code is divided into two parts: the first

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82. *See id.* ¶¶ 5.1-5.33.

83. Nevertheless, some minor legislative changes were made to implement the Committee's recommendations. *See* The Company Accounts (Disclosure of Directors' Emoluments) Regulations 1997, S.I. 1997, No. 570.

84. *See* GREENBURY REPORT, *supra* note 17, ¶¶ 1.13, 1.14.

85. *See id.* ¶¶ 1.19, 3.3.

86. The Stock Exchange did so by adding paragraphs 12.43(w) and 12.43(x), and an appendix entitled Best Practice Provisions: Directors Remuneration to the Yellow Book. These provisions have now been deleted. *See* THE STOCK EXCHANGE, LISTING RULES ¶ 12.43 (1999).

87. This was done pursuant to a suggestion of the Cadbury Committee. *See* CADBURY REPORT, *supra* note 1, ¶ 3.12.

88. *See* V. Younghusband, *Corporate Governance in the United Kingdom*, 9 INT'L CORP. & COM. L. REV. 275, 275 (1998).

89. HAMPEL REPORT, *supra* note 1, at app. B.

sets out general "Principles of Good Governance", the second presents a more detailed Code of Best Practice.[90] The Combined Code embraces not only the recommendations of the Hampel Committee but also those made to the listing rules as a result of work done by the Cadbury and Greenbury Committees. Correspondingly, it is now the definitive guide to corporate governance for companies listed on the Stock Exchange.[91]

In addition to appending the Combined Code to its Yellow Book, the Stock Exchange altered the main text of its listing rules by adding a new provision.[92] The new provision requires a listed company to provide in its annual report and its annual accounts a narrative statement which enables shareholders to evaluate how the Combined Code's Principles of Good Governance have been applied.[93] A company must also state whether it has complied with specified provisions in the Code of Best Practice and explain any non-compliance.[94] In addition, a company's board of directors must provide shareholders with a report discussing the company's policy on executive remuneration and disclosing various specified items, including the details of the elements of each director's pay.[95]

As mentioned above, if executives are not sufficiently accountable for their conduct, a possible solution is to prompt company boards to step forward and do a proper job of supervising and monitoring management.[96] The Cadbury and Hampel Committees both endorsed this thesis in their respective reports and their recommendations on the matter are reflected in the contents of

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90. The "Principles of Good Governance," also called the "Combined Code Principles," are contained in Part 1 of the Combined Code. *See* The Combined Code, Principles of Good Governance, *in* THE STOCK EXCHANGE, LISTING RULES (1999). The "Code of Best Practice," also called the "Combined Code of Best Practice" is contained in Part 2 of the Combined Code. *See* The Combined Code, Code of Best Practice, *in* THE STOCK EXCHANGE, LISTING RULES (1999). *See also* Younghusband, *supra* note 88; Roger Davis, *Cut Out the Boilerplate*, ACCOUNTANCY INT'L, Aug. 1998, at 69.

91. *See* SMERDON, *supra* note 30, at 16, 67; J. Gibbs & D. Tankel, *Rewarding Executives: Disclosure and Approval*, PRACTICAL LAW FOR COMPANIES, Oct. 1998, at 31.

92. *See* THE STOCK EXCHANGE, LISTING RULES ¶ 12.43A (1999); Gibbs & Tankel, *supra* note 91, at 32.

93. Companies are not required to discuss Section 2 of the Principles, which addresses institutional investors. *See* The Combined Code, Principles of Good Governance § 2(E), *in* THE STOCK EXCHANGE, LISTING RULES (1999).

94. Companies are not required to discuss Section 2 of the Code, which addresses institutional investors. *See* The Combined Code, Code of Best Practice § 2(E), *in* THE STOCK EXCHANGE, LISTING RULES (1999).

95. *See* Gibbs & Tankel, *supra* note 91, at 35, 37 (discussing the contents of this report).

96. *See supra* note 61 and accompanying text.

the current Combined Code.[97] For instance, the Principles of Good Governance state that every listed company should be headed by an effective board which will provide leadership and which will safeguard the investment of the shareholders by maintaining a sound system of internal control.[98] Moreover, to ensure that no individual or small group of individuals can dominate decision making, a company's board should be composed of a balance of executive and non-executive directors.[99]

The Code of Best Practice supports the Principles of Good Governance by stating that there should be a strong and independent non-executive element on the board.[100] More precisely, outside directors should comprise not less than one-third of the board and a majority of these non-executives should be "independent", in the sense that they are free from any relationship which could interfere with the exercise of their judgment.[101] Because of their independence, a company's outside directors should perform the pivotal role of sitting on influential board committees. For instance, the Code of Best Practice states that a listed company should have an audit committee composed of non-executive directors who review the work of the company's auditors to ensure that audits are done in an objective and independent manner.[102] Moreover, new directors should be recruited by a nomination committee composed primarily of non-executives to help ensure that the board will be structured to meet desired standards of objectivity.[103]

Linking pay with performance has been suggested as another method for addressing concerns about managerial agency costs.[104]

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97. *See* CADBURY REPORT, *supra* note 1, ¶¶ 4.5, 4.6; HAMPEL REPORT, *supra* note 1, ¶ 3.8. The Hampel Committee did emphasize as well that outside directors make an important contribution to the development of a company's business strategy.

98. *See* The Combined Code, Principles of Good Governance, § 1(A)(1), *in* THE STOCK EXCHANGE, LISTING RULES (1999).

99. *See id*. § 1(A)(3).

100. *See* The Combined Code, Code of Best Practice § 1(A)(3), *in* THE STOCK EXCHANGE, LISTING RULES (1999).

101. *See id*. § 1(A)(3)(1), (A)(3)(2). Empirical evidence suggests that in smaller listed companies, non-executives often do not qualify as being fully independent. *See* SMERDON, *supra* note 30, at 61-62.

102. *See* The Combined Code, Code of Best Practice § 1(D)(3), *in* THE STOCK EXCHANGE, LISTING RULES (1999); SMERDON, *supra* note 30, at 62, 133.

103. *See* The Combined Code, Code of Best Practice § 1(A)(5)(1), *in* THE STOCK EXCHANGE, LISTING RULES (1999); SMERDON, *supra* note 30, at 56-57.

104. On the theory that linking pay with performance will reduce agency costs, see *supra* note 63 and accompanying text.

The Greenbury and Hampel Committees both agreed with this diagnosis. The Greenbury Committee stated that a company's remuneration policy should be structured to ensure that managerial personnel share the interests of shareholders and want to see the business succeed.[105] The Hampel Committee said that a significant part of an executive director's remuneration should be linked to the company's performance.[106] Moreover, the two Committees, in their respective reports, both indicated that it is inappropriate for full-time board executives to participate in decisions about their own remuneration packages, and recommended that a remuneration committee composed of outside directors should be responsible for formulating a company's policy on executive pay.[107]

The Combined Code implements important elements of the findings of the Greenbury and Hampel Committees regarding executive pay. With respect to remuneration committees, one of the Principles of Good Governance is that "no director should be involved in deciding his or her own remuneration."[108] The Code of Best Practice provides more detailed guidance on the same point, instructing a company's board of directors to establish a remuneration committee consisting exclusively of non-executive directors who are independent from management.[109]

Consistent with the thesis that executives should have financial incentives to take shareholders' interests into account, another Principle of Good Governance is that "a proportion of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance."[110] Similarly, the Code of Best Practice provides that managerial remuneration schemes should be designed to align the interests of executives with those of shareholders and to give management incentives to perform at the

105. *See* GREENBURY REPORT, *supra* note 17, ¶ 6.16.

106. *See* HAMPEL REPORT, *supra* note 1, ¶ 4.6.

107. *See* GREENBURY REPORT, *supra* note 17, ¶ 4.8; HAMPEL REPORT, *supra* note 1, ¶ 4.12. The Cadbury Committee expressed similar views. *See* CADBURY REPORT, *supra* note 1, ¶ 4.42.

108. The Combined Code, Principles of Good Governance § 1(B)(2), *in* THE STOCK EXCHANGE, LISTING RULES (1999).

109. *See* The Combined Code, Code of Best Practice § 1(B)(2)(1), (B)(2)(2), *in* THE STOCK EXCHANGE, LISTING RULES (1999). As a practical matter, however, the remuneration committee can expect to receive strong input from the company's CEO. *See* HAMPEL REPORT, *supra* note 1, ¶ 4.11; SMERDON, *supra* note 30, at 63.

110. The Combined Code, Principles of Good Governance § 1(B)(1), *in* THE STOCK EXCHANGE, LISTING RULES (1999).

highest levels.[111] Further guidance on the proper design of performance-related remuneration is provided in a schedule appended to the Combined Code.[112]

Prompting institutional investors to consider seriously their responsibilities as owners of companies may be an additional way to improve managerial accountability.[113] The Cadbury Report strongly endorsed this line of reasoning, saying that shareholders should insist on a high standard of corporate governance.[114] Moreover, the Cadbury Committee urged institutional investors to exchange views regularly with senior executives of companies, to "make positive use of their voting rights" at shareholder meetings, and to "take a positive interest in the composition of boards of directors" by ensuring that non-executives of the necessary caliber, experience, and independence are appointed.[115]

The Hampel Committee acknowledged that after the publication of the Cadbury Report, institutional investors had begun to take a more activist approach to corporate governance.[116] The Committee suggested this was a healthy trend and, like the Cadbury Committee, urged institutional investors to vote at shareholder meetings and strongly supported ongoing dialogue between a company's executives and its institutional shareholders.[117] The contents of the Combined Code reflect, to a certain extent, the views expressed by the Cadbury and Hampel Committees. The Principles of Good Governance state that institutional shareholders "have a responsibility to make considered use of their votes."[118] Moreover, companies and the institutions that own shares in them should be ready, where

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111. *See* The Combined Code, Code of Best Practice § 1(B)(1)(4), *in* THE STOCK EXCHANGE, LISTING RULES (1999).

112. *See* The Combined Code, Schedule A, *in* THE STOCK EXCHANGE, LISTING RULES (1999). The schedule was derived from an appendix added to the Yellow Book in 1996 to implement recommendations made by the Greenbury Committee. The appendix was entitled "Best Practice Provisions: Directors Remuneration, Section B: Remuneration Policy, Service Contracts and Compensation."

113. *See supra* note 66 and accompanying text.

114. *See* CADBURY REPORT, *supra* note 1, ¶ 6.6.

115. *Id.* ¶ 6.11.

116. *See* HAMPEL REPORT, *supra* note 1, ¶¶ 5.3, 5.5.

117. *See id.* ¶¶ 5.7, 5.10. The Hampel Committee indicated, however, that executives and investors should not be required to enter into a dialogue. *See id.* ¶ 5.11.

118. The Combined Code, Principles of Good Governance § 2(E)(1), *in* THE STOCK EXCHANGE, LISTING RULES (1999). Listed companies are not obliged to discuss principle 2(E)(2) when they provide a narrative statement of how they have applied the Combined Code principles. *See* THE STOCK EXCHANGE, LISTING RULES ¶ 12.43A(a) (1999); *supra* note 93 and accompanying text.

practicable, to enter into a dialogue based on the mutual understanding of objectives.[119]

VII. ISSUES ARISING FROM THE WORK DONE BY THE CADBURY, GREENBURY, AND HAMPEL COMMITTEES

While the Combined Code can now be thought of as the definitive guide to corporate governance in the United Kingdom, this does not mean that debate concerning the topic has ended. Instead, the work carried out by the Cadbury, Greenbury, and Hampel Committees has raised various issues that are likely to generate further discussion and analysis. Although it is beyond the scope of this Article to provide a detailed overview of all such matters, it will highlight issues where substantial changes in approach could occur in the foreseeable future.

One topic that has generated considerable debate is enforcement. The Combined Code does not have any direct statutory backing. The only applicable enforcement mechanism of a legal character is a requirement that companies, as a continuing obligation of listing on the Stock Exchange, describe how they have applied the Combined Code's Principles and discuss the extent to which they follow the Code of Best Practice.[120] The objective of this regime is not to compel companies to comply with the Combined Code, but to secure sufficient disclosure so that investors and others can assess a listed company's corporate governance practices and respond in an informed way.[121]

Some critics are skeptical of the enforcement approach that underpins the Combined Code. They question whether the current regime is likely to address problems of corporate governance properly since compliance is not required by law.[122] However, the

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119. *See* The Combined Code, Principles of Good Governance § 1(C)(1), 2(E)(2), *in* THE STOCK EXCHANGE, LISTING RULES (1999). Listed companies are not obliged to discuss Section 2(E)(2) in the narrative statement they prepare on compliance with Combined Code Principles. *See* THE STOCK EXCHANGE, LISTING RULES ¶ 12.43A(a) (1999); *supra* note 93 and accompanying text. This Combined Code Principle was drawn from recommendations put forward by a City/Industry Working Group chaired by Paul Myners (*Developing a Winning Partnership: How Companies and Institutional Investors are Working Together* (1995)). *See* Younghusband, *supra* note 88, at 278.

120. *See supra* notes 24, 93 and 94 and accompanying text; Gibbs & Tankel, *supra* note 91.

121. *See id*.

122. *See* CHARKHAM, *supra* note 43, at 333-35, 341-42 (this author was a member of the Cadbury Committee); Riley & Ryland, *supra* note 54, at 190-91; Jim Kelly et al., *DTI Gives Guarded Welcome Ahead of Review*, FIN. TIMES, Jan. 29, 1998, at 11 (quoting views expressed by the Trades Union Congress).

evidence concerning the Codes of Best Practice introduced by the Cadbury and Greenbury Committees suggests that such fears are misplaced.[123] Admittedly, the guidelines in question did not foster a complete transformation on the corporate governance front. Nevertheless, because listed companies took seriously the recommendations made by the two committees, the guidelines had a noteworthy impact on corporate behavior.[124]

Because listed companies have paid attention to corporate governance guidelines, it seems unlikely that wide-ranging statutory intervention will occur, at least in the near future. The Department of Trade and Industry (DTI), which has primary control over legislative initiatives concerning U.K. companies, announced in 1998 that it was carrying out a fundamental review of the framework of core company law.[125] In a discussion paper published to launch the project, the DTI endorsed the approach to corporate governance adopted by the Cadbury, Greenbury, and Hampel Committees, saying that "the Government does not intend to replace the use of best practice by legal rules."[126]

Although the DTI spoke favorably of the current self-regulatory regime in its 1998 discussion paper, its endorsement was a qualified one. The DTI said that changes would not occur so long as "best practice is seen to be working."[127] Presumably, if evidence emerges which suggests that the current regime is failing to have a sufficient influence on corporate behavior, statutory intervention will be placed back on the agenda.[128] Indeed, the DTI specifically indicated in its

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123. *See* Ben Pettet, *The Stirring of Corporate Social Conscience: From "Cakes and Ale" to Community Programmes*, 50 CURRENT LEGAL PROBS. 279, 303 (1997).

124. *See* HAMPEL REPORT, *supra* note 1, ¶ 1.10; Cheffins, *supra* note 2, at 83-86 (discussing empirical studies). For additional evidence indicating that the work done by the Cadbury and Greenbury has had a significant influence on listed companies, see Peasnell et al., *supra* note 28; Paul Collier, *Audit Committees in Smaller Listed Companies*, *in* CORPORATE GOVERNANCE: RESPONSIBILITIES, RISKS, AND REMUNERATION, *supra* note 43, at 93; Robert Bruce, *UK plc Enjoys the Sweet Success of Cadbury Code*, TIMES, Nov. 12, 1998; Andrew Verity, *Incentive Schemes Getting Tougher*, INDEPENDENT, Mar. 15, 1999, 17. Other studies are more pessimistic. *See* Jason Nissé, *Most Directors Fail to Meet Codes of Best Practice on Pay*, TIMES (London), Jan. 6, 1997, at 44; Jane Martinson, *Half of Top Companies Failing to Comply with Hampel*, FIN. TIMES, Dec. 1, 1998, at 12 (discussing companies which had failed to comply with a Hampel Committee recommendation on disclosure of shareholder voting patterns).

125. *See* DEPARTMENT OF TRADE AND INDUSTRY, *supra* note 1.

126. *Id.* at 9.

127. *See id.*

128. *See* Ben Pettet, *Towards a Competitive Company Law*, 19 COMPANY LAW. 134, 138 (1998). The prospect of legislative intervention has been present since the Cadbury Report was issued. The Cadbury Committee stated explicitly that if companies did not act in accordance

1998 discussion paper that legislative reform concerning corporate governance could be expected to take place "where experience shows that some legal underpinning is needed."[129] For example, the DTI mentioned that shareholders might be compelled by statute to take a more active role at general meetings and might be given increased supervisory jurisdiction over executive pay.[130]

Another issue that can be expected to receive attention in the aftermath of the work done by the Cadbury, Hampel, and Greenbury Committees is the structure of the board of directors. In British companies, the board is a unitary institution and, strictly speaking, all directors bear equal responsibility for direction of the company.[131] This framework poses problems for outside directors if they concern themselves primarily with monitoring and supervising management. Under such circumstances, they will be acting as watchdogs at the same time that their participation in corporate decision-making leads them to identify with management's decisions and view the executive directors as colleagues.[132]

The difficulties non-executives face within a unitary board structure may be solved by the adoption of the two-tier model public companies used in Germany and some other countries.[133] In such firms, the board is divided explicitly into supervisory and management components and there is a clear delineation of the tasks that executive and non-executive directors are expected to perform.[134]

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with its Code, legislation and other external regulation would likely be proposed as a solution to the problems the Committee had sought to address. *See* CADBURY REPORT, *supra* note 1, ¶ 1.10.

129. *See* DEPARTMENT OF TRADE AND INDUSTRY, *supra* note 1, at 10.

130. *See id.* at 11. The Secretary of State for Trade and Industry made suggestions of a similar nature with respect to executive pay in 1999. *See* Stephen Byers, *Principles of Greenbury and Hampel Apply to Pay Issue* (letter to the editor), FIN. TIMES, Feb. 18, 1999, at 14; Jane Martinson, *Minister Warns Over Executive Remuneration*, FIN. TIMES, Mar. 24, 1999, at 11.

131. *See* discussion *supra* note 30 (explaining that all directors have the same duties and responsibilities under English law).

132. *See* CHARKHAM, *supra* note 43, at 272-73; James D. Cox & N. Clausen, *The Monitoring Duties of Directors Under the EC Directives: A View from the United States Experience*, 2 DUKE J. COMP. & INT'L L. 29, 47-48 (1992).

133. Some in the United Kingdom have recommended that such a change be made. *See* THOMAS SHERIDAN & NIGEL KENDALL, CORPORATE GOVERNANCE: AN ACTION PLAN FOR PROFITABILITY AND BUSINESS SUCCESS 107-8, 161-62 (1992); John Parkinson, *Company Law and Stakeholder Governance*, *in* STAKEHOLDER CAPITALISM 142, 152-54 (G. Kelly et al. eds., 1997).

134. *See* Wymeersch, *supra* note 37, at 1134-48 (discussing the two-tier system in Germany and in other countries).

Adoption of such a system in Britain would eliminate ambiguities concerning the status of a company's outside directors because they would be members of the supervisory board and would not interact in any sort of continuous fashion with the company's management team.

The Hampel Committee was aware of the debate concerning the merits of a unitary board structure and therefore took the opportunity to review opinions of its two-tiered counterpart.[135] The Committee found overwhelming support for the unitary board and little enthusiasm for the two-tier framework and, therefore, did not recommend any changes.[136] It is unlikely, however, that this will be the last word on the issue. The European Union currently has a proposed company law directive that, if adopted, will give member states the option to adopt a two-tiered structure.[137] At this point, the proposal is effectively dormant, but if the situation changes, debate about the merits of the two-tier system will arise again.[138]

Similarly, the position that various constituencies have in relation to companies is an issue likely to attract future attention. The classic view under U.K. company law is that a company should be run for the benefit of the owners of the company, namely, the shareholders.[139] A competing view is that other constituencies affected by corporate activity deserve recognition. Employees, suppliers, customers, and even society at large have been identified as interest groups with an important "stake" in companies.[140] However, the Cadbury, Greenbury, and Hampel Committees paid little attention to the "stakeholder" model of the company. Instead, the panels equated a

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135. On the intentions of the Hampel Committee in this regard, see William Lewis, *Guide to the Great "Untouchables*,*"* FIN. TIMES, Mar. 11, 1996, at 12. The Cadbury Committee assumed without reviewing the issue that the board should remain a unitary structure. *See* CADBURY REPORT, *supra* note 1, ¶ 1.8.

136. *See* HAMPEL REPORT, *supra* note 1, ¶ 3.12.

137. *See* DEPARTMENT OF TRADE & INDUSTRY, THE FIFTH COMPANY LAW DIRECTIVE: AMENDED PROPOSAL FOR A FIFTH DIRECTIVE ON THE HARMONISATION OF COMPANY LAW IN THE EUROPEAN COMMUNITY, ¶ 8 (Jan. 1990). There have been various drafts of this measure. The latest, which was circulated by the European Commission in 1988, is appended to this consultative document issued by the Department of Trade & Industry.

138. On the current status of the Fifth Directive, see LAW COMMISSION AND SCOTTISH LAW COMMISSION, COMPANY DIRECTORS: REGULATING CONFLICTS OF INTERESTS AND FORMULATING A STATEMENT OF DUTIES 19 (Law Commission Consultation Paper No. 153; Scottish Law Commission Discussion Paper No. 105, 1998).

139. *See* PARKINSON, *supra* note 48, at 81-88 (also discussing how the "classic" view has been modified by statute and case law in the United Kingdom).

140. *See, e.g*, Parkinson, *supra* note 133, at 148-52; Fiona M. Patfield, *Challenges for Company Law*, *in* PERSPECTIVES ON COMPANY LAW: 1, 10-14 (Fiona M. Patfield ed. 1995).

company's interests with those of its shareholders, and the recommendations they offered were framed accordingly.[141]

The failure of the Cadbury, Greenbury, and Hampel Committees to address stakeholder issues provoked disapproval in some circles. According to the critics, the committees missed an ideal opportunity to evaluate managerial accountability in its proper context and to recommend truly meaningful corporate governance reform.[142] As part of its current review of core company law, however, the Department of Trade and Industry has taken steps that should please those disappointed with the Cadbury, Greenbury, and Hampel Reports. The DTI said when it launched the review in 1998 that it wanted to open for discussion fundamental issues concerning the model of company which society wants to adopt.[143] A steering group responsible for orchestrating the DTI's company law review followed up when it issued a consultation document in 1999.[144] This consultation document assessed whether directors should be encouraged to adopt a "pluralist" approach when running companies, rather than catering solely to shareholders. The steering group also discussed changes that could be made to the law to implement the pluralist model. These included compelling directors to have due regard for social and ethical objectives, altering the composition of company boards to ensure that "stakeholders" have suitable representation and requiring companies to issue a report on relations with employees, suppliers, customers, and the community.[145]

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141. *See* HAMPEL REPORT, *supra* note 1, ¶¶ 1.16-1.18; Barnard, *supra* note 6, at 112; SMERDON, *supra* note 30, at 10-12; George Pitcher, *Like it or Not, Shareholders Will Always Rule the Corporate Roost*, MARKETING WK., Aug. 7, 1997, at 23; Alan Dignam, *A Principled Approach to Self-Regulation? The Report of the Hampel Committee on Corporate Governance*, 19 CO. LAW. 140, 141-42 (1998).

142. *See* Boyd, *supra* note 59, at 177; Dignam, *supra* note 141, at 142, 153; C.A. Riley, *Whither UK Corporate Governance?*, AMICUS CURIAE, Oct. 1997, at 16; Jennie Walsh, *Hampel Blasted for Failing to Tackle Old-Boy Culture*, PEOPLE MGMT., Feb. 5, 1998, at 16.

143. *See* DEPARTMENT OF TRADE AND INDUSTRY, *supra* note 1, at 10. For further discussion of the implications of the points the DTI has raised, see Pettet, *supra* note 128, at 140; Janet Dine, *The Comprehensive Review of Company Law: Consultative Document*, 19 CO. LAW. 82, 83 (1998).

144. *See* COMPANY LAW REVIEW STEERING GROUP, MODERN COMPANY LAW FOR A COMPETITIVE ECONOMY § 5.1 (1999).

145. *See id*. §§ 5.1.30-5.1.33, 5.1.46-5.1.47, 5.1.50.

VIII. THE CORPORATE GOVERNANCE DEBATE IN THE UNITED KINGDOM AND ITS RELEVANCE ELSEWHERE: THE ITALIAN PERSPECTIVE

The Hampel Report acknowledged that while corporate structures and governance arrangements vary widely from country to country, the underlying issues of managerial accountability are the same everywhere.[146] It would seem to follow that the debate over corporate governance that has taken place in the United Kingdom is directly relevant for those in other countries who are interested in managerial accountability and related topics. It is unlikely, however, that this is the correct inference to draw. Since the "arms-length" or "outsider" system of ownership and control that prevails in the United Kingdom is uncommon elsewhere,[147] the corporate governance issues that matter most in other countries tend to be of a different character than in Britain. This point can be illustrated by considering the situation in Italy.[148]

In Britain, large companies are usually publicly quoted, public companies have widely diffused share ownership, equity markets are well developed, and institutional investors participate extensively in these equity markets. By contrast, in Italy, the majority of large business enterprises are not quoted on the Milan stock exchange.[149] Instead, most Italian companies have shied away from carrying out public offerings and are privately held.[150] Moreover, Italy's equity market is underdeveloped relative to the state of the economy,[151] and

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146. *See* HAMPEL REPORT, *supra* note 1, ¶ 1.4.

147. *See* discussion *supra* notes 11 and 37 and accompanying text; *see also* discussion *infra* note 158.

148. *See* Lorenzo Stanghellini, *Corporate Governance in Italy: Strong Owners, Faithful Managers: An Assessment and a Proposal for Reform*, 6 IND. INT'L & COMP. L. REV. 91, 99, 155-65, 183-85 (1995); Jonathan R. Macey, *Italian Corporate Governance: An American Perspective*, 1998 COLUM. BUS. L. REV. 121, 141-44. Others who have considered corporate governance issues from a comparative perspective have made the same point on a more general level. *See, e.g.*, Shleifer & Vishny, *supra* note 39, at 739, 769-71; La Porta et al., *supra* note 11, at 27-31; Rafael La Porta et al., *Law and Finance*, 106 J. POL. ECON. 502-5, 511-12 (1998); Marco Becht, *Strong Blockholders, Weak Owners and the Need for European Mandatory Disclosure*, *in* THE SEPARATION OF OWNERSHIP AND CONTROL: A SURVEY OF 7 EUROPEAN COUNTRIES (PRELIMINARY REPORT TO THE EUROPEAN COMMISSION) 1, 10-14, 21-25 (1997).

149. *See* Moerland, *supra* note 35, at 21.

150. *See* La Porta et al., *supra* note 36, at 1131.

151. *See id.*; Eugenio Ruggiero, *Italy*, *in* THE LEGAL BASIS OF CORPORATE GOVERNANCE IN PUBLICLY HELD CORPORATIONS 79, 81-82 (Arthur R. Pinto & Gustavo Visentini eds., 1998); Marco Pagano et al., *Why Do Companies Go Public? An Empirical Analysis*, 53 J. FIN. 27, 28 (1998).

institutional investors "have so far been the great absentee in the Italian stock market."[152]

Those Italian companies that are quoted on the stock market generally have highly consolidated control structures.[153] Frequently, such enterprises are majority owned by a single shareholder.[154] Many other quoted firms form part of a multi-company group established by way of an elaborate cross-shareholding scheme.[155] This ownership structure ensures that control ultimately rests in the hands of one party or a closely allied set of investors, such as a family.[156] Ultimately, powerful families, together with the Italian state, dominate the country's public companies.[157] This pattern means that Italy shares an "insider" or "control-oriented" system of ownership and control with most of its neighbors in continental Europe.[158]

Since there is a highly concentrated distribution of equity in Italian business, the corporate governance issues that are of primary importance in the "outsider/arms-length" system in the United Kingdom are of limited relevance in Italy. As we have seen, in a publicly quoted company without a controlling shareholder, those owning equity should be fearful of "agency costs" arising from self-serving managerial conduct.[159] Investors in this type of company should therefore be supportive of initiatives designed to induce

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152. Stanghellini, *supra* note 148, at 145; *see also* Berglöf, *supra* note 4, at 102; Luca Enriques, *The Law on Corporate Directors' Self-Dealing: A Comparative Analysis*, SOC. SCI. RES. NETWORK J. 1, 10 (Oct. 1998) <http://papers.ssrn.com/paper.taf?ABSTRACT_ID=1356 74>.

153. *See* Wymeersch, *supra* note 37, at 1164-66; Stanghellini, *supra* note 148, at 136; Marcello Bianchi et al., *Ownership, Pyramidal Groups and the Separation Between Ownership and Control*, *in* 3 THE SEPARATION OF OWNERSHIP AND CONTROL: A SURVEY OF 7 EUROPEAN COUNTRIES (PRELIMINARY REPORT TO THE EUROPEAN COMMISSION) 1, 18 (1997) <http://www.ecgn.ulb.ac.be/ecgn/euprelimreport.htm#Report>.

154. *See* Wymeersch, *supra* note 37, at 1164-66; Ruggerio, *supra* note 151, at 84-86; Bianchi et al., *supra* note 153, at 18-19; Gian B. Bruni, *The New Consolidated Act on Companies Listed on the Italian Stock Exchange*, 13 BUTTERWORTHS J. INT. BANKING & FIN. L. 416, 417 (1998).

155. *See* Berglöf, *supra* note 4, at 102; Macey, *supra* note 148, at 134-35; Bianchi et al., *supra* note 153, at 24-27.

156. *See* Macey, *supra* note 148, at 135; Stanghellini, *supra* note 148, at 138-40; Ruggerio, *supra* note 151, at 82, 100.

157. *See* La Porta et al., *supra* note 11, at 492-93 tbl.2-3; Bianchi et al., *supra* note 153, at 2; Alessandro Zattoni, *The Structure of Corporate Groups: The Italian Case*, 7 CORP. GOVERNANCE—AN INT'L REV. 38, 39-45 (1999); John Glover, *The End of "Spaghetti" Governance*, INSTITUTIONAL INV., July 1996, at 30.

158. *See* Berglöf, *supra* note 42, at 155-63. While there are similarities between Italy and other Continental European countries, there are also important differences. *See, e.g.*, JOHN SCOTT, CORPORATE BUSINESS AND CAPITALIST CLASSES, ch. 6, 142-203 (3d ed. 1997).

159. *See supra* notes 51-55 and accompanying text.

executives to act in shareholders' interests, such as aligning executive pay with performance and ensuring that the board of directors supervises management properly.[160]

Companies with a dominant shareholder are different. Managerial fidelity seems unlikely to pose a serious problem. Controlling shareholders are likely to have a financial stake large enough to motivate them to keep a careful watch on corporate management.[161] They should additionally have sufficient influence to orchestrate the removal of disloyal or ineffective managers.[162] Again, enhancing managerial accountability was a primary goal of the Cadbury, Greenbury, and Hampel Committees. Given the highly consolidated control of Italy's public companies, this should not be a matter of great urgency in an Italian context.

While self-serving managerial conduct is unlikely to be a serious concern when a company has a dominant shareholder, difficulties of a different character may arise.[163] There is a real danger that controlling shareholders will collude with management to cheat other equity owners.[164] This might be done in several ways.[165] For instance, a controlling shareholder might arrange to purchase additional shares on favorable terms not otherwise made available.[166] Alternately, the controller could engineer "sweetheart" deals with related corporations in order to siphon off a disproportionate share of the

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160. *See supra* notes 61-65 and accompanying text.

161. *See* Shleifer & Vishny, *supra* note 39, at 739, 754; Macey, *supra* note 148, at 142; Ronald J. Daniels & Jeffrey G. MacIntosh, *Toward a Distinctive Corporate Law Regime*, 29 OSGOODE HALL L.J. 863, 884-85 (1991).

162. *See* Becht, *supra* note 148, at 23; Daniels & MacIntosh, *supra* note 161, at 885; Ronald J. Daniels & Randall Morck, *Canadian Corporate Governance: The Challenge*, *in* CORPORATE DECISION-MAKING IN CANADA, *supra* note 39, at 12. For empirical evidence from Germany which demonstrates the point, see GOERGEN, *supra* note 42, at 57-64, 68-69.

163. *See* Berglöf, *supra* note 4, at 97; Shleifer & Vishny, *supra* note 39, at 758-60; Becht, *supra* note 148, at 23-24. The point has also been raised in the Italian context. *See* Ruggerio, *supra* note 151, at 88; Bruni, *supra* note 154, at 417. Similar views are expressed in a 1999 report issued by the Borsa Italiana S.p.A's Committee for the Corporate Governance of Listed Companies. *See* Borsa Italiana S.p.A's Committee for the Corporate Governance of Listed Companies, *Code of Conduct* 21 (Oct. 1999) <http://www.borsaitalia.it/ing/news/CodeofConduct .pdf> (Italian version available at < http://www.borsaitalia.it/ita/news/CodicediAutodisciplina. pdf.>.

164. *See* Berglöf, *supra* note 4, at 120 (response and commentary by Alisa A. Röell).

165. *See* Jeffrey G. MacIntosh & Lawrence P. Schwartz, *Do Institutional and Controlling Shareholders Increase Corporate Value?*, *in* CORPORATE DECISION-MAKING IN CANADA, *supra* note 39, at 303, 308-09.

166. *See* Deborah A. DeMott, *Agency Principles and Large Block Shareholders*, 19 CARDOZO L. REV. 321, 333-34 (1997).

public company's earnings.[167] Minority shareholders can also be prejudiced if companies are dominated by entrepreneurs who, motivated by vanity, sentiment, or loyalty, continue to run the business when no longer suited to do so or transfer control to family members ill-prepared for the job.[168]

Since Italy's "insider" or "control-oriented" system of ownership and control poses serious risks for minority shareholders, providing suitable protection for such investors should, at least for the time being, be a higher priority than fostering managerial accountability. Consistent with this line of thinking, minority shareholder protection has recently been the subject of attention in Italy. Many hold the view that Italian corporate law leaves those who control a company pretty much free to act as they wish and does little to protect the minority from opportunistic and self-serving conduct.[169] In 1998, the Italian Government responded to such concerns by making a number of changes to the legal regime governing companies.[170] For example, an Italian public company (*Societa per Azioni*) is required to have a supervisory board of internal auditors (*collegio sindacle*), and minority shareholders now have the right to representation in this body. Furthermore, minority shareholders now have the right to force management to hold a shareholder meeting and to use allegations of serious irregularities to obtain a court order for the inspection of a company's affairs.[171] While individual shareholders in Italian companies traditionally have not been able to bring a derivative suit against directors, now a minority representing at least five percent of the issued capital of a listed company may do so.[172]

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167. *See* Daniels & MacIntosh, *supra* note 161, at 885.

168. *See* Daniels & Morck, *supra* note 162, at 13; Ronald J. Daniels & Paul Halpern, *Too Close for Comfort: The Role of the Closely Held Public Corporation in the Canadian Economy and the Implications for Public Policy*, 26 CANADIAN BUS. L.J. 11, 17, 20-21 (1996).

169. *See* Macey, *supra* note 148, at 129-34, 140.

170. *See* Law n. 58 of Feb. 24, 1998 (Gazz. Uff. n. 71, Mar. 26, 1998, Supp. Ord. n. 52) (It.). For an English-language overview of the changes made, see generally Marcello Bianchi et al., *Pyramidal Groups and the Separation Between Ownership and Control in Italy*, 1, 8-9 (Oct. 1998) <http://www.ecgn.ulb.ac.be/newpapers>; Bruni, *supra* note 154, at 417; Ruggerio, *supra* note 151, at 108-10; Centre for Law and Business, University of Manchester, *Company Law in Europe: Recent Developments*, 1, 41-42 (last modified Feb. 1999) <www.dti.gov.uk/cld/milman.pdf>; Giuseppe Scassellati-Sforzolini & Pietro Fioruzzi, *Italy*, INT'L FIN. L. REV. 35, 35 (Supp. Apr. 1998).

171. *See* Bianchi et al., *supra* note 170, at 8-9. On the law prior to the 1998 reforms, see Massimo Audisio, *Italy*, *in* PROTECTION OF MINORITY SHAREHOLDERS 125, 128-30 (Matthais W. Stecher ed., 1997).

172. *See* Bianchi et al., *supra* note 170. On the pre-1998 position, see Stanghellini, *supra* note 148, at 123, 169-71; Audisio, *supra* note 171, at 132-33.

It is unlikely that the changes made by the Italian government in 1998 will end debate concerning protection of minority shareholders. One reason is that the reform carried out could have been more ambitious in nature. For instance, while allowing minority shareholders to pursue derivative litigation was one of the more important innovations of 1998, the five percent limitation may be too high to allow this procedure to be an effective tool for minority shareholders in publicly quoted companies. This is because most investors in such firms will not own enough shares to meet the relevant threshold.[173]

Another reason that protection of minority shareholders will remain on the agenda is that Italian companies, like their counterparts throughout continental Europe, are becoming increasingly eager to obtain financing through equity markets.[174] Since a company that is attractive to investors will be well positioned to make a successful entry to the stock market and to carry out subsequent public offerings of shares, firms making a move towards public ownership face pressure to respond to the concerns of the financial markets.[175] If a company planning to offer shares to the public is going to have a controlling shareholder, potential investors will likely fear that they will be victims of schemes designed to cheat the minority. Because such concerns will exist, if Italian companies are going to rely more heavily on the stock market as a source of financing, they will need to give careful thought to the protection of minority shareholders.[176]

If the trend toward public ownership becomes sufficiently strong in Italy, controlling shareholders could fade away as part of a shift toward the "outsider/arm's-length" system of ownership and control that exists in the United Kingdom and the United States.[177] Such changes, however, seem unlikely to occur in Italy, at least in the short

173. *See* Bianchi et al., *supra* note 170, at 9; Ruggerio, *supra* note 151, at 109. On the case for reform generally, see Stanghellini, *supra* note 148, at 181.

174. On Europe, see Stefan Wagstyl, *Crumbs from the Table*, FIN. TIMES, Sept. 25, 1996, at 27; *Going for the Golden Egg*, ECONOMIST, Sept. 28, 1996, at 89; John C. Coffee, *The Future as History: Prospects for Global Convergence in Corporate Governance and its Implications*, 93 NW. U. L. REV. 641, 664-67 (1999). On Italy, see John C. Coffee, *supra*; Glover, *supra* note 157; Stanghellini, *supra* note 148, at 164-65.

175. *See* Brian R. Cheffins, *UK Football Clubs and the Stock Market: Past Developments and Future Prospects: Part 1*, 18 CO. LAW. 66, 74 (1997). For anecdotal evidence illustrating the point in an Italian context, see Glover, *supra* note 157.

176. *See* Stanghellini, *supra* note 148, at 165. *See generally* Glover, *supra* note 157; Leslie Kramer, *Too Little, Too Late?*, INSTITUTIONAL INV., Apr. 1998, at 137.

177. *See* Kissane, *supra* note 5, at 625, 672-73.

term.[178] A more plausible scenario is that public ownership will become increasingly prevalent but that controlling shareholders will continue to play a dominant role.[179] If this is correct, minority shareholder protection is a topic that is likely to receive attention for some time to come.[180]

IX. THE TREATMENT OF MINORITY SHAREHOLDERS IN CANADA

The Canadian situation can give a sense of the possible direction for debate concerning the protection of minority shareholders in public companies. As in the United Kingdom and the United States, Canadian businesses are commonly publicly quoted. Also, the country has a number of well-established stock exchanges, the largest and best known being in Toronto.[181] At the same time, however, an important feature distinguishes the Canadian equity market from its counterparts in Britain and the United States. In the United Kingdom and the United States, ownership in publicly quoted companies is widely dispersed because large shareholdings, especially majority ownership, are uncommon.[182] By contrast, in Canada, more than seven out of ten public corporations are either under legal control (one shareholder or a small affiliated group owns more than 50% of the voting shares) or effective control (one shareholder or a small affiliated group owns between 20 and 50% of the equity).[183]

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178. *See* Wagstyl, *supra* note 174; Zattoni, *supra* note 157, at 46-47; Paul Betts, *Italy's Grand Old Men Seek Professional Help*, FIN. POST (Canada), Jan. 27, 1998, at 17.

179. The experience with initial public offerings involving German companies is potentially instructive; on this, see GOERGEN, *supra* note 42, at 46-50, 69, 80-83, 103-05.

180. *See* Stanghellini, *supra* note 148, at 181. *See also* Coffee, *supra* note 174, at 658-59, 673-76 (arguing that minority protection will arise in European companies because these companies will opt to issue shares in the United States and thereby become subject to "minority friendly" United States securities laws). *See generally* Erik Berglöf, *Company Reforms Must Shed More Light*, INDEP. (London), Aug. 10, 1997, at B5; *Comic Opera*, ECONOMIST, Aug. 30, 1997, at 54, 55.

181. On Toronto's situation, see *Spotlight on Toronto*, *supra* note 13. As a result of a reorganization carried out in 1999, the Toronto Stock Exchange operates as the sole seior equities market for Canada. The Canadian Venture Exchange offers trading for small-capitalization companies and the Montreal Exchange offers trading in small capitalization Quebec-based companies and is Canada's market for derivative products. For further details, see *TSE Welcomes Companies from the Montreal Exchange*, TSE NEWS RELEASE (Toronto Stock Exchange), Dec. 6, 1999, <http://www.tse.com/cgi-bin/uni_framset.cgi?content%3Dnews/press.html>.

182. *See supra* notes 38 and 39 and accompanying text.

183. *See* Daniels & MacIntosh, *supra* note 161, at 884 (setting out definitions of "legal control" and "effective control"); Randall K. Morck, *On the Economics of Concentrated Ownership*, 26 CANADIAN BUS. L.J. 63, 69 (1996); Kathryn E. Montgomery, *Market Shift—The*

Canada is therefore in the position Italy could soon occupy: public ownership of companies is prevalent but controlling shareholders remain an important presence.[184]

As mentioned, in companies with a concentrated ownership structure, there is a real danger that the dominant shareholder will collude with management to cheat others who own equity in the company.[185] In Canada, however, "the position of minority shareholders has received sympathetic attention from legislators, regulators[,] . . . and courts," and disgruntled investors have a wide range of remedies potentially available to them.[186] For example, securities regulation offers one source of protection.[187] Because Ontario is the country's largest province, most Canadian public corporations distribute shares to Ontario citizens and thus fall under the jurisdiction of the Ontario Securities Commission (OSC). The OSC regulates various transactions made by public companies in which the majority may benefit at the expense of the minority. For instance, the OSC seeks to ensure that bids to acquire control of a corporation are structured in a manner that is "fair and which is perceived to be fair."[188] Also, OSC rules stipulate that when there is a major transaction between a corporation and a related party (such as a controlling shareholder), the relevant details of the transaction must be disclosed to all investors, the transaction should be scrutinized by a committee of non-executive directors, and the transaction must be approved by a majority of disinterested shareholders.[189]

Role of Institutional Investors in Corporate Governance, 26 CANADIAN BUS. L.J. 189, 194 (1996).

184. There are other countries which fall into this pattern. *See, e.g.*, STAPLEDON, *supra* note 57, at 4-5; Ian M. Ramsay & Mark Blair, *Ownership Concentration, Institutional Investment and Corporate Governance: An Empirical Investigation of 100 Australian Companies*, 19 MELBOURNE U. L. REV. 153, 165-71 (1993) (discussing Australia); John C. Coffee, *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277, 1306-8 (1991) (discussing Sweden).

185. *See supra* notes 163-64 and accompanying text.

186. Philip Anisman, *The Commission as Protector of Minority Shareholders*, *in* LSUC SPECIAL LECTURES 451, 451 (1989) [hereinafter *The Commission*]. The range of legal remedies available to minority shareholders was expanded substantially in the 1970s and 1980s. On the history of this expansion, see Philip Anisman, *Majority-Minority Relations in Canadian Corporate Law: An Overview*, 12 CANADIAN BUS. L.J. 473 (1987).

187. *See generally The Commission*, *supra* note 186.

188. *Ontario Securities Commission Policy No. 9.1*, Can. Sec. L. Rep. (CCH) ¶¶ 471-901, at § 1.1 (June 26, 1992). *See also Ontario Securities Commission Policy No. 9.1*, Can. Sec. L. Rep. (CCH) ¶¶ 471-901, at §§ 4-11 (June 26, 1992); *The Commission*, *supra* note 186, at 464-73.

189. *See* Ontario Securities Commission Policy No. 9.1, Part V, 1994 Can. Sec. L. Rep. (CCH) ¶¶ 471-901.

Minority shareholders in Canadian public companies are also entitled to rely on a variety of remedies set out in corporations law. Most businesses in the country are incorporated under a federal statute known as the Canadian Business Corporations Act (CBCA) or provincial laws modeled after the CBCA.[190] Under the CBCA, regardless of the percentage of shares a shareholder owns, if prescribed criteria are met, he or she can obtain leave from a court to pursue a derivative action.[191] Shareholders also have "appraisal" rights that allow them to vote on specified fundamental changes that management might propose. In the event that such changes are implemented against their wishes, individual shareholders can demand the corporation to buy out their stock at fair value.[192] Moreover, a shareholder can apply for relief on the grounds that the affairs of the corporation are being conducted in a manner that is oppressive or unfairly prejudicial to him or her.[193] Finally, all shares of a class are entitled to vote separately as a class on changes that will affect the class differently from the ways that shares of other classes will be affected.[194]

Though the concentrated nature of share ownership in Canadian public companies means that protection of minority shareholders is a legitimate concern, it is uncertain whether the current legal regime operates in an ideal manner. For example, some fear that there is a counterproductive bias in favor of those owning a minority stake. A possible danger is that minority shareholders will use their leverage to hold out for a disproportionate share of the spoils, thereby deterring corporations from carrying out desirable fundamental changes.[195] A

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190. *See generally* Canadian Business Corporations Act, R.S.C., ch. C-44 (1985) (Can.). Six of Canada's ten provinces—Alberta, Saskatchewan, Manitoba, Ontario, New Brunswick and Newfoundland—have legislation based on the CBCA. On incorporation percentages and differences between the various statutes, see Ronald J. Daniels, *Should Provinces Compete? The Case for a Competitive Corporate Law Market*, 36 MCGILL L.J. 130, 152-54, 157-58 (1991).

191. *See* R.S.C., ch. C-44, § 239 (1985) (Can.). Before granting leave under this measure, a judge must be satisfied that the shareholder has given reasonable notice of his or her intentions to the corporation's directors, that the shareholder who is applying is acting in good faith and that it appears to be in the interests of the corporation that the action be brought. *See id*. § 239(2).

192. *See id*. § 190.

193. *See id*. § 241. For examples of cases where this remedy has been used by minority shareholders in public companies, see Palmer v. Carling O'Keefe Breweries of Canada Ltd. [1989] 67 O.R.2d 161 and Westfair Foods v. Watt [1991] 79 D.L.R. 48.

194. *See* R.S.C., ch. C-44 § 176 (1985) (Can.).

195. *See* Jeffrey G. MacIntosh, *Minority Shareholder Rights in Canada and England: 1860-1987*, 27 OSGOODE HALL L.J. 561, 564-65, 644-45 (1989).

similar concern is that there are too many instruments in the minority shareholders' arsenal, allegedly engendering overlap and confusion.[196]

While it is not clear whether Canadians have struck the correct balance with respect to protection of minority shareholders, Italian lawmakers and securities regulators may well benefit from examining the Canadian system of corporate governance. Canada is a country where equity markets are well developed, but many quoted companies are controlled by one shareholder or an affiliated group of investors. Since Italy may soon end up in the same situation, the Canadian response to the problem of abuse by dominant shareholders may prove instructive to Italian policymakers as they evaluate their country's system of corporate governance.

X. CONCLUSION

When a country such as Italy has an "insider" or "control-oriented" system of ownership and control, providing suitable protection for minority shareholders should be a higher priority than fostering managerial accountability. This does not mean, however, that the debate over corporate governance that has taken place in the United Kingdom is irrelevant. If there is a strong move towards the stock market in a jurisdiction where control of companies has traditionally been highly consolidated, there ultimately could be a shift toward the "outsider/arm's-length" system of ownership and control that exists in the United Kingdom and the United States. Under such circumstances, executives would have greater scope to impose agency costs on shareholders than was formerly the case. Adoption of proposals endorsed by the Cadbury, Greenbury, and Hampel Committees, such as providing outside directors with a prominent role, using executive service contracts to link pay with performance, and fostering institutional investor activism, stand out as potentially attractive solutions to the "agency cost" problem.

Even if a move toward the stock market does not cause a country's "insider" or "control-oriented" system of ownership and control to fade away, reforms being discussed and implemented in Britain are still potentially relevant. In the United Kingdom, an important corporate governance theme has been that non-executive directors and institutional shareholders should play a constructive role by monitoring executive performance. It is possible that they can

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196. *See* Ronald J. Daniels & Randall Morck, *Canadian Corporate Governance: Policy Options*, *in* CORPORATE DECISION-MAKING IN CANADA, *supra* note 39, at 661, 675-76.

also offer protection to minority shareholders by acting in a supervisory capacity.

Consider first outside directors. Through active vigilance, they might be able to deter a dominant shareholder from carrying out unfair self-dealing transactions or from implementing ill-conceived executive succession strategies.[197] Italian lawmakers have been thinking along such lines, since in 1998 the country's corporate law was amended to ensure that outside shareholders have representation on the supervisory board of internal auditors.[198]

Institutional shareholders may also be able to play a useful disciplinary role in a company that has a controlling shareholder.[199] Since the financial institutions will only own a minority of the shares, they will not be able to exercise influence by passing resolutions at shareholder meetings. Still, they should have potentially significant leverage. This is because they will be important prospective buyers of shares in future public offerings and because they are likely to have sufficient access to the media to ensure that their misgivings are reported widely in the business press.

The Canadian experience illustrates that the analysis of non-executive directors and institutional shareholders carried out in Britain is relevant in a country where public companies are typically controlled by one shareholder or an affiliated group of investors. In a 1994 report, the Toronto Stock Exchange Committee on Corporate Governance dealt with several themes that have been important in the United Kingdom (such as non-executive directors and internal financial controls) and acknowledged the value of the Cadbury Committee's findings.[200] The following year, in order to implement the report's recommendations, the Toronto Stock Exchange amended

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197. *See* Daniels & Halpern, *supra* note 168, at 59; *see also* HAMPEL REPORT, *supra* note 1, ¶ 3.10.

198. *See supra* note 170 and related discussion; *cf.* Borsa Italiana, *supra* note 163, at 18-19, 21 (discussing the role outside directors can play when conflicts of interest exist between the interests of the company and the controlling shareholders).

199. *See* MacIntosh & Schwartz, *supra* note 165, at 313, 330; Jeffrey G. MacIntosh, *Institutional Shareholders and Corporate Governance in Canada*, 26 CANADIAN BUS. L.J. 145, 174 (1996); *e.g.*, *Telecom Italia Scuttles its Split-Off of Wireless Unit, Bowing to Pressure*, WALL ST. J., Nov. 22, 1999, at A18 (describing the role institutional investors played in halting a transaction proposed by the majority shareholder of Telecom Italia that was highly unpopular with the company's minority shareholders).

200. Toronto Stock Exchange Committee on Corporate Governance in Canada, "Where Were the Directors?" Guidelines For Improved Corporate Governance in Canada, ¶ 3.18-3.20 (Dec. 1994).

its requirements for maintaining a listing.[201] The resulting scheme resembled the system in the United Kingdom that had emerged as a result of amendments made to the London Stock Exchange's Yellow Book to implement changes suggested by the Cadbury Report.[202]

While the Canadian experience indicates that the analysis of corporate governance issues carried out in the United Kingdom is potentially relevant in a country where controlling shareholders play a prominent role, emulation of British reforms must be carried out cautiously in countries with a different system of ownership and control. The changes introduced as a result of the work of the Cadbury, Greenbury, and Hampel Committees were designed in large measure to enhance managerial accountability. In a country like Italy, protection of minority shareholders is likely a more pressing concern.

If policymakers in Italy and other countries with an "insider/control-oriented" system of corporate governance seek guidance concerning minority shareholder protection, the experience in Canada deserves examination. One reason is that minority shareholders in Canada have a wide range of legal protections available to them. Also, countries with "insider/control-oriented" systems of ownership and control may well be moving towards the position which Canada currently occupies, this being one where publicly traded companies are well-established but controlling shareholders remain an important factor. Since the Canadian experience is potentially relevant for countries such as Italy, this Article has drawn attention to circumstances existing in Toronto as well as in London.

One can only speculate at this juncture whether specific shareholder protection mechanisms operating in Canada will in fact be suitable for companies listed on a stock market such as the one based in Milan. Still, it should be evident from what has been said that the issue of minority shareholder protection will need to be high on the agenda in a country like Italy. This, in turn, serves to put in perspective what countries can learn from the UK experience with corporate governance. Corporate governance should not be studied in the isolation of a single country and the process by which Britain has addressed managerial accountability issues may well "have a

201. *See Toronto Stock Exchange Company Manual*, 1 Can. Stock Ex. Man. (CCH) §§ 472-75 (Feb. 1998); *Toronto Stock Exchange General By-Law*, 1 Can. Stock Ex. Man. (CCH) § 19.17 (Aug. 1997).

202. *See* Cheffins, *supra* note 2, at 97.

singularly appealing character."[203] Nevertheless, for countries that have a different system of ownership and control than Britain's, the experience of jurisdictions other than the United Kingdom should be used to discover the norms that need adjustment in an increasingly global market.

203. Barnard, *supra* note 6.