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Corporate Governance:
The Combined Code 1998
as a Standard for Directors' Duties

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**Corporate Governance:
The Combined Code 1998 as a Standard
for Directors' Duties**

Von

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A. Introduction

The 1990s seemed in “danger of becoming the decade of corporate governance”.¹ Although corporate governance in the sense of the checks and balances by which directors are accountable to shareholders for the way they manage their company was nothing new, the subject had hardly attracted much debate in the United Kingdom. Regulators were largely content to rely on the provisions of the Companies Act to regulate the statutory duties of directors, supplemented by case law to deal with directors’ duties and shareholders’ remedies.²

However, in the 1990s, after a series of corporate scandals, the debate on corporate governance has come to prominence as a specific issue resulting from the work of three Committees: *Cadbury*, *Greenbury* and *Hampel*.³ The work of these Committees led to the issuing of the *Combined Code 1998*⁴ by the *London Stock Exchange (LSE)* on 25 June 1998. Its appearance marked the end of an era of extraordinary creativity in corporate governance⁵ but the development of the discussion on corporate governance has developed even further afterwards. In the U.K. this led to three major developments in relation to the *Combined Code 1998*: first the Company Law Review reviewing the “core of company law”⁶, which was initiated by the *Department of Trade and Industry (DTI)* and which was led by the *Company Law Steering Group*⁷ since 1998, second the *Turnbull Report* in 1999, dealing with Principle D.2 of the *Combined Code 1998*⁸, and third the *Higgs Report* in 2003⁹, dealing with non-executive directors, their role and effectiveness. The *Higgs Report* made a number of significant recommendations to change the *Combined Code 1998*. The *Financial Reporting Council (FRC)* – responsible for overseeing the *Combined Code 1998* – took most of the recommendations from the *Higgs Report* and issued in July 2003 a new version of the *Combined Code*.¹⁰ The *Combined Code 2003* applies for reporting years beginning on or after November 2003.¹¹

On a global level, the OECD issued their “*Principles of Corporate Governance*” in 1999.¹² On a European level, a High Level Group of Company Law Experts had been

¹ Riley, Co Law 19 (1998), 179.

² Sheik, ICCLR 10 (1998), 267.

³ Youngusband, ICCLR 10 (1998), 275.

⁴ *Committee on Corporate Governance*, Combined Code, (Hereafter: *Combined Code 1998*).

⁵ Pettet, JIBL 12 (1998), 394.

⁶ DTI, Modern Company Law – For a Competitive Economy, Introduction.

⁷ Hereafter: *Steering Group*.

⁸ ICAEW, Internal Control, (Hereafter: *Turnbull Report*).

⁹ DTI, Review of the role and effectiveness of non-executive directors, (Hereafter: *Higgs Report*).

¹⁰ The *Combined Code 2003* is available at: <www.ecgi.org/codes/country_pages/codes_uk.htm> (visited on 6 February 2004), (Hereafter: *Combined Code 2003*). Originally, this essay was written in May 2003. Due to the changes through the issuing of the *Combined Code 2003*, additional sections will be included into the essay to take short reference to the development and changes made. It has to be emphasised that the *Combined Code 2003* will not be covered in total.

¹¹ *Combined Code 2003*, Preamble 3.

¹² Download: <www.oecd.org> (visited on 6 February 2004).

set up by the European Commission, and they issued their report, “A Modern Regulatory Framework for Company Law in Europe”¹³, in November 2002.

The aim of this essay is to analyse the *Combined Code 1998* in the light of the question whether it is suitable to set a standard for a modern corporate governance system. This analysis will be restricted to the issue of “directors’ duties” as stated in Section 1.A. of the *Combined Code 1998*. Part B will show the background leading to the development of the *Combined Code 1998*. Part C will explain the position of the *Combined Code 1998* within the existing legal framework of directors’ duties, will discuss the technique of self-regulation and give data of the actual compliance. In Part D the “Principles of Good Governance” and the “Code of Best Practice of the Combined Code” will be introduced, criticised and discussed. This discussion will also include suggested changes to the *Combined Code 1998* made by the *Higgs Report*. Part E will show the development within the area of corporate governance in relation to the *Combined Code 1998* after 1998. In Part F a conclusion will be given on the question if the *Combined Code 1998* is suitable to set a standard for a modern corporate governance system.

B. The Background Leading to the Combined Code 1998

I. Cadbury and Greenbury

In 1991, after harsh economic climate had exposed existing methods of financial reporting to unusual close scrutiny in the 1980s/early 1990s, the *Cadbury Committee* was set up by the *FRC*, the *LSE*, and various members of the accounting profession. It was chaired by *Sir Adrian Cadbury*, chairman of Imperial Chemical Industry (ICI). The *Cadbury Committee* grew out of the continuing concern about standards of financial reporting and accountability heightened by high profile crises such as the collapse of the Bank of Credit and Commerce International¹⁴, Polly Peck¹⁵, and the Maxwell Group^{16 17}.

The stated objective was “(...) to help to raise the standard of corporate governance and the level of confidence in financial reporting and auditing (...).”¹⁸ This resulted in the *Cadbury Report*, which was issued in 1992, and which reviewed the structure and responsibilities of boards of directors, the role of auditors and the rights and responsibilities of shareholders. The recommendations in relation to directors were summarised in a “Code of Best Practice”.¹⁹ This Code required all listed companies to

¹³ Download: <http://europa.eu.int/comm/internal_market/en/company/company/modern/consult/consult_en.doc> (visited on 6 February 2004), (Hereafter: *High Level Report*).

¹⁴ *Financial Times*, 9 November 1991, “Biggest Bank Fraud in History”, 1.

¹⁵ *Financial Times*, 2 October 1990, “Polly Peck Affair”, 27; *Financial Times*, 25 October 1990, “Polly Peck Collapse”, 1 and 24.

¹⁶ *Financial Times*, 6 December 1991, “Collapse of the Maxwell Empire”, 21.

¹⁷ *Proctor/Miles*, Corporate Governance, 13; *Davies*, ZGR 2001, 268 (270).

¹⁸ *Committee on the Financial Aspects of Corporate Governance*, Report of the Committee on the Financial Aspects of Corporate Governance, paras. 2.1 and 2.8, (Hereafter: *Cadbury Report*).

¹⁹ *The Report of the Committee on the Fiscal Aspects of Corporate Governance*, The Code of Best Practice, (Hereafter: *Cadbury Code*).

include a statement in their annual report acknowledging compliance with the Code's terms or justifying instances of non-compliance ("Compliance Statement").²⁰

With their issue of 1 December 1993, the *LSE* added force to the recommendations of the report by amending the Listing Rules so as to require listed companies to make a statement about their level of compliance with the *Cadbury* "Code of Best Practice" under Section 12.43 and to give reasons for non-compliance²¹ – the so-called "comply and explain statement".

In January 1995 the *Greenbury Committee*, chaired by *Sir Richard Greenbury*, chief executive officer of Marks and Spencer, was set up to identify good practice in determining directors' remuneration and prepare a Code of such practice for use of U.K. plcs. The resultant *Greenbury Report*²², issued in July 1995, contained a "Code of best Practice for directors' remuneration." The fundamental principles of this report in relation to directors' remuneration are accountability, transparency and linkage to performance.

Both Committees had been set up as a reaction to the widespread opinion of the weaknesses in corporate governance in the United Kingdom and focused on the most obvious corporate governance problems: financial reporting and boardroom reporting. They did not attempt a reform of corporate governance in its entirety.²³

II. Hampel and the Combined Code 1998

This changed with the set up of the *Hampel Committee* on the initiative of the Chairman of the *FRC* in November 1995, which was chaired by *Sir Ronald Hampel*, chairman of ICI. The *Cadbury* and *Greenbury Reports* had suggested that a new committee should review the extend to which their findings were being implemented. The remit of the *Hampel Committee* was "(...) to review the *Cadbury Code* and its implementation to ensure that its original purpose is being achieved. We are also asked to pursue any relevant matters arising from the *Greenbury Report*. But we have an additional task, to look afresh at the role of directors, shareholders and auditors in corporate governance."²⁴ In contrast to the two former Committees, the *Hampel Committee* was not appointed as a reaction to a particular scandal or public outcry and thus expected to be able to forward a non-defensive, proactive approach to corporate governance.²⁵ Thus the *Hampel Committee* was the first Committee to deal with the whole spectrum of corporate governance.²⁶

The *Hampel Committee* produced a preliminary report in August 1997, a final report in January 1998, and a draft document which was a set of principles and a code which embraced *Cadbury*, *Greenbury* and their own work. This document then was passed on to the *LSE* which published a consultation document setting out the "Draft

²⁰ *Griffin*, Company Law, 243.

²¹ *Belcher*, JBL 1995, 321 (328).

²² *Study Group on Directors' Remuneration*, Directors' Remuneration. (Hereafter: *Greenbury Report*).

²³ *Dignam*, Co Law 19 (1998), 140.

²⁴ *Committee on Corporate Governance*, Final Report, para. 1.6. (Hereafter: *Hampel Report*).

²⁵ *Hampel Report*, para. 1.7.

²⁶ *Dignam*, Co Law 19 (1998), 140 (141).

Combined Code” and the proposed related changes to the Listing Rules in March 1998. Following further consultation, the *LSE* made a number of changes²⁷ to the draft, with the *Hampel Committee’s* agreement. Thus, the “*Combined Code*” was created and published on 25 June 1998.²⁸

The *Combined Code 1998* was then appended (it does not form part of, but has the status of an Appendix) to the *LSE* Listing Rules – which are now the *Financial Service Authority (FSA) Listing Rules*²⁹ – by inserting a new paragraph 12.43A that is effective for annual reports and accounts published by companies in respect of accounting periods ending on or after December 31, 1998.³⁰ Under the heading of “Corporate Governance”, the new paragraph 12.43A required the following items to be included in the annual report and accounts:

- narrative statement of how it has applied the principles set out in Section 1 of the *Combined Code 1998*, providing explanation which enables its shareholders to evaluate how the principles have been applied.
- statement as to whether or not it has complied throughout the accounting period with the Code provisions set out in Section 1 of the *Combined Code 1998*. A company that has not complied (...) or complied with only some (...) must specify the (...) provisions (...) and give reasons for any non-compliance.”

The technique of a “comply and explain statement”, which had been already used by the *Cadbury Committee*, was thus continued.

III. Higgs and the Combined Code 2003

On 21 January 2003 *Derek Higgs* published the report of the “Review of the role and effectiveness of non-executive directors”.³¹ The review was initiated by the Government as an addition to the ongoing Company Law Review.³² *Davies* sees the *Higgs Report* as a powerful example of the globalisation of financial markets: “this must be the first time that the collapse of an American, albeit multinational, company (*Enron*) has triggered an inquiry into the effectiveness of domestic law”.³³

On the same day *Sir Robert Smith*, chairman of an *FRC* appointed group, published his report and proposed guidance on “Audit Committees Combined Code 1998 Guidance”. These recommendations were welcomed by the *Higgs Report*, in-

²⁷ Differences between the *Hampel Report* and the *Combined Code 1998* will be indicated throughout this paper.

²⁸ *Pettet*, JIBL 12 (1998), 394.

²⁹ Under the Official Listing of Securities Regulation 2000 (SI 2000/968), the *FSA* became, with effect of 1 May 2000, the ‘competent authority’ under the Financial Service Act 1986. Now, the *FSA* is acting as UK Listing Authority.

³⁰ *Younghusband*, ICCLR 9 (1998), 275 (276).

³¹ See Fn. 9.

³² *Higgs Report*, Annex K.

³³ *Davies*, Company Law, 324, Fn. 98.

cluded into its proposed new draft of the *Combined Code 2003*³⁴ and now included into the actual *Combined Code 2003*.³⁵

The purpose of the *Higgs Report* was “(...) to let in some daylight on the role of the non-executive directors in the boardroom and to make recommendation to enhance their effectiveness.”³⁶ It regards an effective board as key element to U.K. corporate governance and NEDs as having a crucial part to play within the unitary board.³⁷ It also regards the two roles of NEDs on enhancing the competence and effectiveness of the board as complementary.³⁸ The report states that it does not believe legislation to be the way forward, but rather supports the “comply and explain” approach and sees its review not as a blue-print for “box-ticking” but a counsel of best practice that can be intelligently implemented with discretion.³⁹

The first reactions to the proposed draft *Combined Code 2003* were quite diverse. On the one hand, the government, represented through the DTI, several institutional investors and pension funds (NAPF, Hermes, Association of British Insurers) “warmly welcome the proposals”, “are very pleased” and see a further “evolution” of corporate governance as “positive”. On the other hand, a large number (82 % of FTSE 100 chairman)⁴⁰ of major plcs were not in overall favour of the *Higgs Report*. Especially the recommendation of the *Higgs Report* of having a board with half independent NEDs, the restriction of “independence” to 10 years and the role of the senior independent director gave rise to criticism. At the moment, there is a long list of plcs failing to comply with the *Higgs Report* in terms of having more than one chairmanship, a combination of chairman and CEO and having former CEOs as chairman.⁴¹

Nevertheless, after more than half a year of discussion, the new *Combined Code 2003* has been issued by the *FRC* and took effect for the reporting years beginning on or after 1 November 2003.⁴²

C. Position of the Combined Code 1998 within the framework of law and the question of self-regulation

Within Part 3 of this Essay the position of the directors’ duties deriving from the *Combined Code 1998* are to be put into the existing framework of directors’ duties deriving from the various sources of the English legal system. As a next step, the “technique” of self-regulation will be introduced and evaluated.

³⁴ *Higgs Report*, para. 13.7.

³⁵ *Combined Code 2003*, C.3 Audit Committee and Auditors.

³⁶ *Ibid.*, p. 3.

³⁷ *Ibid.*, paras. 1.1 and 1.4.

³⁸ *Ibid.*, para. 1.12.

³⁹ *Ibid.*, paras. 1.14 and 1.19.

⁴⁰ *Financial Times*, 12 March 2003, “Derek Higgs review”, 4.

⁴¹ *Financial Times*, 21 January 2003, “A threat to unity of the board”, 19; *The Independent*, 13 February 2003, “Liberty chairman hits out at Higgs”; *The Financial Times*, 19 February 2003, “Boardrooms square up to Higgs”, 20; *The Economist*, 15 March 2003, “Hating Higgs”, 79.

⁴² *Financial Times*, 23. Juli 2003, „Higgs’ boardroom reform ideas survive months of wrangling“, p. 3; *Financial Times*, 24. Juli 2003, „Shareholders and business sing same tune over board reforms“, p. 5.

I. Position of the Combined Code 1998 within the framework of law

Directors' duties derive from two main sources in English law, statutory law and case law, and can be broadly categorised into two duties: common law duties of care and skill and fiduciary duties.⁴³ But directors' duties can also derive from other sources such as the article of association of a company or the employment contract of the director.

Looking at the statutory law, there is a large number of statutes – the Institute of Directors counted approximately 750 – directly affecting the daily lives of company directors.⁴⁴ These are mainly embodied in the Companies Act 1985, Companies Act 1989, Insolvency Act 1986, Company Directors Disqualification Act 1986, and the Financial Services and Market Act 2000.

The other main source for directors' duties is the case law. The case law on directors' duties has slowly developed over about 150 years, and often draws from concepts of the even older law of trust. The case law is the result of the courts regarding the directors both a trustee, whose role it is to protect and preserve the assets for the beneficiary, and a dynamic entrepreneur, whose job it is to take risks with the subscribed capital and multiply the shareholders' investments.⁴⁵ Regarding the two main duties of directors – the duties of care and skill and the fiduciary duties – a few number of cases shall be mentioned in brief to explain the main duties derived there from.

Regarding the duty of care and skill, the classic statement setting the standard was given by *Romer J* in *Re City Equitable Fire Insurance Co.*⁴⁶: “A director (a) must act honestly, and (b) must exercise such degree of skill and diligence as would amount to the reasonable care which an ordinary man might be expected to take, in the circumstances, on his own behalf. But, (c) he need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from a person of his knowledge and experience (...); (d) he is not bound to give continuous attention to the affairs of his company (...) and ought to attend (board meetings) when reasonable able to do so; and (e) in respect of all duties which (...) may be left to some other official, he is (...) justified in trusting that official to perform such duties honestly.” The problem with the court's approach towards the standard of the duty of care and skill is obvious though: incompetence is its own defence.⁴⁷

With the introduction of the Insolvency Act 1986 s. 214 (4), a standard of liability was introduced for directors in order to determine liability in cases of a company's insolvency. Section 214 (4) sets this standard at “(...) (a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to the company, and (b) the general knowledge, skill and experience that the director has.” Thus, an element of objectivity had been added to the measurement of a directors' conduct. This new ap-

⁴³ From the large amount of literature on directors' duties see especially: *Bruce*, Rights and Duties of Directors; *Butcher*, Directors' Duties; *Dean*, Public Companies; *Ferran*, Company Law, chapter 5/6; *Pettet*, Company Law, chapter 9; *Walter*, Co Law 21 (2000), 110 et subs.; *Copp*, ICCLR 14 (2003), 115 et subs.

⁴⁴ *Financial Times*, 19 July 1995, “Superbeings in short supply”, 8.

⁴⁵ *Pettet*, Company Law, 173.

⁴⁶ [1925] 1 Ch 407, Ch D and CA.

⁴⁷ *Ferran*, Company Law, 213; *Pettet*, Company Law, 175.

proach has been affirmed by the courts in the case of *Norman v Theodore Goddard*⁴⁸ and *Re D'Jan of London Ltd*⁴⁹ where Hoffmann LJ held that the duty of care and skill owed by a director in common law was accurately stated in s. 214 (4). These two cases and the establishment of the dual “objective-subjective” test was accepted as marking a quantum shift giving courts a scope to distinguish between directors according to their specific position they are having within the company, for example finance director, sales director or non-executive director. Moreover, the new test sets a minimum standard, because under the objective influence “complete incompetence” is no excuse for a director.⁵⁰ At the same time the test is flexible, because what can reasonably be expected from a director can vary.⁵¹

In *Re Barings (No. 5)*⁵² Parker J. established three propositions regarding the principal scope and extend of director’s duties of care and skill, which have their roots in *Re Equitable* but go beyond that scope. The three general propositions are: “(i) Directors have, both collectively and individually, a continuing duty to acquire and maintain a sufficient knowledge and understanding of the company’s business to enable them properly to discharge their duties as directors. (ii) Whilst directors are entitled (...) to delegate particular functions (...) the exercise of the power of delegation does not absolve a director from the duty to supervise the discharge of the delegated function. (iii) No rule of universal application can be formulated as to the duty referred to in (ii) above. The extend of the duty (...) depends on the facts of each particular case, including the directors’ role in the management of the company.”⁵³ Thus it can be seen that the common law duty of care and skill had a generally innovative judicial approach to it over the past years.

The fiduciary duty of directors derives from the fact that they have the control of the assets of a company and are regarded as owing – in analogy with the law of trusts – fiduciary duties in respect of those assets.⁵⁴ The courts have described the fiduciary duty as fundamentally being that of “good faith”.⁵⁵ The classic statement of this duty was held in *Re Smith & Fawcett* that directors should exercise their power “bona fide in what they consider – not what the court may consider – is in the best interest of the company.”⁵⁶ “Good faith” in this context means that directors must be “fair” which is in this context a word with a broad meaning.⁵⁷ A classification of directors’ fiduciary duties could be made under the headings of loyalty, proper purpose, no fetters on discretion, the no-conflict and no-profit rule, the duty to act in accordance to the company’s constitution, and the duty to deal fairly between the different classes of shareholders.⁵⁸ Loyalty refers to the bona fide rule laid out in *Re Smith & Fawcett* not using

⁴⁸ [1992] BCC 14.

⁴⁹ [1993] BCC 646.

⁵⁰ *Re Brian D. Pierson (Contractors) Ltd* [1999] BCC 26, a wrongful trading case.

⁵¹ *Re Produce Marketing Consortium Ltd* [1989] BCLC 520.

⁵² [1999] 1 B.C.L.C. 433.

⁵³ *Ibid.*, 436.

⁵⁴ *Regal (Hastings) Ltd v Gulliver* [1942] 1 All ER 378 establishing that directors are in a fiduciary relationship with their company.

⁵⁵ *Pettet*, Company Law, 177.

⁵⁶ [1942] Ch 304, 306.

⁵⁷ *Pettet*, Company Law, 178.

⁵⁸ *Law Commission*, Company Directors, para. 11.4. (*Hereafter: Law Commission Paper*).

their power to benefit third parties or themselves. The proper purpose duty requires directors to exercise their power for the purpose these powers are conferred. In relation to the allotment of shares, this was laid out in *Howard Smith Ltd v Ampol Petroleum Ltd*.⁵⁹ The duty not to fetter on discretion prohibits directors not to enter into an agreement with a third party as to how they will exercise their discretion. Exception to these rules are only allowed if this would be in the interest of the company.⁶⁰ The no-conflict and no profit rules mean, broadly speaking, that directors should not put themselves into a position where they would get into a conflict of interest⁶¹ or would get some personal benefit or advantage.⁶² An issue under this rule is also the question of business opportunities.⁶³

Other issues arising under fiduciary duties are the considerations of the interests of other parties, namely employees, creditors, persons, to whom the company is a fiduciary, and other constituencies.⁶⁴

Starting in 1998, the Law Commission and the Scottish Law Commission have started to consider “the case for having a statutory statement of the duties of directors to their company (...) including fiduciary duties and the duty of care.”⁶⁵

Looking at other sources of directors’ duties, the company’s constitution (including its memorandum and the articles of association) can establish duties for directors.⁶⁶ For example, duties for the procedure of permitting directors to contract with the company can occur, if the articles of association follow Table A of the Companies Law Act.⁶⁷ Another source of duties is the employment contract of the director, stating any further specific duties.

Those are the sources of directors’ duties, and directors will be held liable if they fail to meet the statutory, common law or contractual duties. The question that arises is where the *Combined Code 1998* fits into this existing legal framework.

Looking at the sources directors’ duties derive from, it has to be concluded that technically speaking, the *Combined Code 1998* does not fit into this legal framework. It does not fall into any category of tools used by Parliament or courts to create or develop law. It is neither a statute, because its development was not an Act of Parliament but rather an initiative of independent regulatory bodies without any power de jure, nor can it be considered as “common law”, because the courts were not involved in its creation. Regarding the *LSE* listing Rules, it only has the status of an Appendix.

Thus, the *Combined Code 1998* stands outside the “classical” legal framework, but takes the “self-regulatory” approach, which will be discussed in the next section.

⁵⁹ [1974] AC 821.

⁶⁰ *Fulham Football Club Ltd v Cabra Estate plc* [1994] 1 BCLC 363.

⁶¹ *Pettet*, Company Law, 178 et subs. on the “no conflict rule”; *Ferran*, Company Law, 169.

⁶² *Gencor ACP Ltd v Dalby* [2000] 2 BCLC 734.

⁶³ *Pettet*, Company Law, 180; *Lawry/Edmunds*, MLR 1998, 515.

⁶⁴ *Mayson/French/Ryan*, Company Law, 513 et subs.; *Pettet*, Company Law, 186 et subs.; *Ferran*, Company Law, 124 and 158 et subs.

⁶⁵ *Law Commission Paper*, iii.

⁶⁶ *Law Commission Paper*, para. 11.18.

⁶⁷ Table A, Art 85.

II. Self-Regulation

The “self-regulatory” approach was the notable fact of all three Committees and their Codes. The technique has its origins in a particular British form of regulation, which is often described by political scientists as “negotiated regulation”. The British tradition of public administration has consistently attached importance to the autonomy of the firm. This has rested on a deep respect for property and the freedom to contract, combined with the legacy of a non-interventionist, minimalist state. In practice, this has translated into an “arm’s-length” regulation and has produced a regulatory style, which is based on accommodation, mutual respect and negotiation.⁶⁸

An earlier example of the technique to rely on self-regulation is “The Takeover Code”⁶⁹ of the City Panel on Takeovers and Mergers. In *Re v Panel on Takeovers and Mergers, Ex parte Datafin*⁷⁰, Sir John Donaldson MR described the Panel as having “no statutory, prerogative or common law powers (...). The Panel is a self-regulating body in the sense that it connotes a system whereby a group of people, acting in concert, uses their collective power to force themselves and others to comply with a code of conduct of their own devising. (Although) lacking any authority de jure, it exercises immense power de facto (...).” Thus, compliance with the City Code became essential.

The UK Listing Authority has traditionally supported the City Code, although it does not form part of the Listing Rules.⁷¹ The Courts have generally expressed approval to the City Code and its administration, and even though a judicial review of a Panel decision is possible, the courts will do this without undermining the position of the Panel’s authority.⁷²

With the *Cadbury Code* relying on self-regulation rather than statutory enforcement the question of advantages and disadvantages, which was discussed in connection with the City Code, came up again.

Critics argued that the self-regulation approach was difficult to enforce and they objected that theoretically it was dangerous to give responsibility to those who are most likely to benefit from weak regimes.⁷³ This concern was drastically put as “the inmates are (not only) running the asylum (but are asked) to design, build and run the asylum”.⁷⁴ Furthermore it was argued that little fear would attach to the implicit threat of *LSE* de-listing for companies failing to disclose their level of compliance with the *Cadbury Code*. This sanction had hardly ever been used and its employment would create problems for investors in selling their holdings. In addition, the result of a research survey on responses to the *Cadbury Code* showed that a majority of fund managers believed that legislation was the only effective route to compliance.⁷⁵ It has to be

⁶⁸ *Dignam*, Co Law 21 (2000), 70 (73).

⁶⁹ *The Panel on Takeovers and Merger*, The City Code on Takeovers and Merger. (Hereafter: *City Code*).

⁷⁰ [1987] 1 QB 815, 824.

⁷¹ FSA, Listing Rules, Ch. 10, Scope of chapter.

⁷² *Pettet*, Company Law, 412.

⁷³ *Ibid.*, 209; *Riley*, Amicus Curiae (issue 1, 1997), 16.

⁷⁴ *Dignam*, Co Law 21 (2000), 70 (74).

⁷⁵ *Finch*, JBL 1992, 581 (584).

noted that this criticism concerning the *Cadbury Code* was mainly raised before the *LSE* amended their Listing Rules and included the compliance statement into their requirements on 1 December 1993.⁷⁶

On the other side there are arguments in favour of a self-regulation approach. The *Cadbury Committee* itself argued that they would “look to” the financial institutions, the bodies supporting the Committee’s work – the *FRC*, *LSE* and the accountancy profession – and even the media.⁷⁷ Pressure should be brought to bear on directors by those who have an interest in the company.⁷⁸ It also indicates the hope that pressure from shareholders will bring about compliance: “We believe that our approach, based on compliance with a voluntary code coupled with disclosure, will prove more effective than a statutory code. It is directed at establishing best practice, at encouraging pressure from shareholders to hasten its widespread adoption, and at allowing some flexibility in implementation.”⁷⁹ Six months later *Sir Adrian Cadbury* said that the method used by the Committee to achieve compliance was by “relying primarily on what can best be described as “market regulation”⁸⁰ to bring about compliance.”⁸¹

Recently, the *Steering Group* has highlighted the general benefits of a self-regulatory approach in the course of their work. It considers a self-regulatory approach as flexible and dynamic in developing requirements responsive to the commercial needs of the market, and as a system that facilitates investments in companies from domestic and overseas investors and enables the U.K. to continue to be an attractive place to do business.⁸²

Another advantage of a “Code” is that it is not a legal document in the sense of an Act of Parliament or Statutory Instrument. This fact has two important consequences: the first is that a Code does not need to be as precise or legalistic in its language as an Act of Parliament. It is not subject to the scrutiny of statutory interpretation nor needs it to cover every possible situation. The second consequence is the speed and flexibility for additions and amendments to cover gaps or provide unforeseen developments without having to wait for a “legislative slot” in a crowded Parliamentary timetable.⁸³

After the *Cadbury Committee* had taken the self-regulatory approach, the *Greenbury*, *Hampel* and *Higgs Committee* followed. The *Hampel Report* does not suggest any changes to the existing law. Instead the Committee stated that they “intend to pass the complete document to the *LSE* so that it can sit alongside the Listing Rules”.⁸⁴ This way the *Hampel Committee* – and recently the *Higgs Report* – followed the path taken by the *Cadbury Committee*.

⁷⁶ Article by Vanessa Finch dated before the *LSE* Listing Rules were amended.

⁷⁷ *Cadbury Report*, para. 3.14.

⁷⁸ *Belcher*, JBL 1995, 321.

⁷⁹ *Cadbury Report*, para. 1.10.

⁸⁰ On the theory of “market regulation” see *inter alia*: *Bradley*, MLR 1990, 170 (171); *Herman*, Corporate Control, 10; *Boyle/Bird*, Company Law, 347. On evidence of how information about corporate government placed in the annual report could produce market response see: *Belcher*, JBL 1995, 321 (324) with numerous references.

⁸¹ *Ibid.*, 321.

⁸² *DTI*, Modern Company Law – Completing the Structure, paras. 12.19-12.24. (Hereafter: *Completing the Structure*).

⁸³ *Morse*, JBL 1991, 509 (511).

⁸⁴ *Hampel Report*, para. 1.23.

III. Compliance with the Combined Code 1998

After discussing the theory of self-regulation, this part of the essay will look at the actual compliance rates surveyed.

With the publishing of the *Cadbury Code*, a Monitoring Sub-Committee was formed to review the compliance with this first Code. Their Report was published on 24 May 1995.⁸⁵ The general opinion after this survey was that the *Cadbury Code* “had met with a high degree of compliance, particularly among the large companies.”⁸⁶ An important factor encouraging compliance was the amendment to the *LSE Listing Rules* requiring the listed companies to “comply or explain”.⁸⁷

In regard to the *Combined Code 1998*, a recent survey⁸⁸ by the Pension & Investment Research Consultants Ltd (PIRC) shows that all companies covered by the survey made an “appliance” and also a “compliance” statement.⁸⁹ Another PIRC survey⁹⁰ of 468 companies from the FTSE 100, the MidCap 250 and the FTSE SmallCap showed that 406 (87 %) companies reported to have separated the roles of the chairman and CEO, 432 (92 %) reported having one third of NEDs on the board with 413 (88 %) claiming that the majority of their NEDs were independent. The *Higgs Report* points out, that among FTSE 100 companies 24 % have chairman who were formerly the CEO of the same company and 5 % have combined CEO/chairmen positions. This practice touches upon the issues and problem addressed under the Code Provision A.2.1.

A general problem with surveys is that some of them only deal with structural aspects of corporate governance without telling how well directors fulfil their duties. A survey taking personal performance review into account was conducted by Hemscott Mori in August/September 2002.⁹¹ This survey shows that 76 % of NEDs never had a personal performance review. In the light of the discussion about the effectiveness, this is a disturbing figure. A KPMG survey arrives at the same figure⁹²; therefore the question of how effective the idea of re-election is when hardly anybody appraises the work of NEDs seems to be very important. But the Hemscott Mori survey shows a much more positive situation in connection with the working environment. According to the survey all NEDs either “tended to agree” or “strongly agreed” having a reasonable understanding of the board’s role, although it could be argued that if they hardly get a performance review, it is difficult for them to have an understanding of the board’s role. Only 7 % did not feel able to speak about issues they would disagree upon with the chairman or CEO, only 4 % felt that there was not an open and honest working relationship on the board. 7 % of the NEDs disagreed that there would be an effective communication between the chairman and the other board members.

⁸⁵ *Committee on the Financial Aspects of Corporate Governance*, Compliance with the Code of Best Practise. (Hereafter: *Compliance Report*).

⁸⁶ *Financial Times*, 25 March 1995, “Cadbury claims high rate of compliance”, 12.

⁸⁷ *Compliance Report*, Introduction, para. 3.

⁸⁸ *Financial Times*, 21 January 2003, “Boardroom shake-up”, 5.

⁸⁹ although only 97.1 % were deemed “satisfactory” by the PIRC standard.

⁹⁰ *de Lacy*, in: *de Lacy* (ed.), *Reform*, 194.

⁹¹ See Fn. 74.

⁹² By KPMG conducted in January 2003, in: *Financial Times*, 24 February 2003, “Big power shift in the boardroom”, 11.

D. “Principle of Corporate Governance” and “Code Provisions” of the Combined Code 1998

I. The “set-up” of the Combined Code 1998

The name “*Combined Code 1998*” can be seen as a “package” consisting of principles and codes⁹³ – although the real meaning of the name is that it is derived from the consolidation of the work of three committees: the *Cadbury*, *Greenbury* and *Hampel Committee* and the existing Codes.

The *Combined Code 1998* consists out of two parts: Part 1 contains the “Principles of Good Governance”; Part 2 contains the “Code of Best Practice”. In Part 1, 17 “Principles of Good Governance” are stated, whereas in Part 2 – the “Code of Best Practice” – those principles are being repeated and “Code Provisions” are being added to most of the principles. These “Code Provisions” are more detailed than the “broader”⁹⁴ principles.

Each Part of the *Combined Code 1998* is again divided into two sections: Section 1 of each Part deals with “Companies” and Section 2 of each Part deals with “Institutional Shareholders”.

According to the Preamble of the *Combined Code 1998*, the respective Section 1 of the two parts of the *Combined Code 1998* will be covered by the “comply and explain statement” required according to the Listing Rules of the *LSE*. Section 2 of both Parts contains no matters to be included within the disclosure requirement of the Listing Rules. This can also be seen when looking at paragraph 12.43A of the Listing Rules, which refers in its subsections (a) and (b) only to Section 1 of the *Combined Code 1998*.⁹⁵

In practice a company has to state within their annual report if they have applied the principles set out in Part 1 (“Principles of Good Governance”), Section 1 and how they have complied with the provisions set out in Part 2 (“Code of Best Practice”), Section 1 and specify and explain their non-compliance with any of those provisions.

Nevertheless the *Hampel Committee* regards Section 2 of the *Combined Code 1998* as an integral part of the recommendations and hopes that the institutional shareholder will voluntarily disclose to their clients and the public the extent to which they are able to give effect to these provisions.⁹⁶

II. The Final Report of the Hampel Committee: Section 1 “Corporate Governance”

The *Combined Code 1998* cannot be understood without taken the *Hampel Report* into account, since the *Combined Code 1998* was to a large extent the outcome of that Report – or at least heavily influenced by the opinion and the attitude of the *Hampel Committee* toward the subject. Therefore, at this stage of the essay, a brief look will be

⁹³ *Pettet*, JIBL 12 (1998), 394 (395).

⁹⁴ *Hampel Report*, para. 1.11.

⁹⁵ Compare Part B, II.

⁹⁶ *Combined Code 1998*, Preamble para. 8.

taken at Section 1 “Corporate Governance”, where the *Hampel Committee* describes its view on the subject, sets out its remit, approach, and definition of corporate governance.

The influence of the *Hampel Report* onto the “Principles of Good Governance” and the “Code of Best Practice” in the *Combined Code 1998* will be taken into account when discussing these sections.

1. *The Report’s Intent, Approach and the Problem of “Box-Ticking”*

Section 1 of the *Hampel Report* starts out by stating the intent of the Committee: “The importance of corporate governance lies in its contribution of both to business prosperity and to accountability. In the UK the latter has been preoccupied much public debate over the last few years. We wish to see this balance corrected.” The *Hampel Committee* felt that through the emphasis on accountability the board’s first responsibility, to enhance the prosperity of the business, has been obscured.⁹⁷

Furthermore, it considered itself being proactive and concerned with the positive contribution which good governance can make. Although it endorsed the overwhelming majority of findings of the *Cadbury* and *Greenbury Reports*, it states that it will comment on matters where they take a different view or which the former committees have not dealt with.⁹⁸

A third issue the *Hampel Committee* dealt with was the phenomenon of “box-ticking”. The *Cadbury* and *Greenbury Code* showed that companies took those principles as sets of prescriptive rules, and shareholders and directors only “ticked the box” next to each principle if they could.⁹⁹ The danger in doing this is that it would “(...) not be difficult for lazy and unscrupulous directors – or shareholders – to arrange matters so that the letter of every governance rule was complied with but not the substance. It might even be possible for the next disaster to emerge in a company with, on paper, a 100 % record of compliance.”¹⁰⁰

The Committee encourages all companies to apply these broader principles with common sense to the varying circumstances. This is also the recommendation for smaller companies that are not able to comply with all principles due to their size.¹⁰¹ The directors of a company should be prepared to review and explain their governance policy just as the shareholder should be flexible in their interpretation and judgement of the directors’ action.¹⁰²

⁹⁷ *Hampel Report*, para. 1.1.

⁹⁸ *Ibid.*, para. 1.7.

⁹⁹ *Ibid.*, paras. 1.11-1.14.

¹⁰⁰ *Ibid.*, para. 1.14.

¹⁰¹ *Ibid.*, para. 1.10.

¹⁰² *Ibid.*, para. 1.11.

2. Defining “Corporate Governance”

a) *The Report’s Definition*

Another issue for the *Hampel Committee* was to define “corporate governance”. The definition is of extreme importance, because the scope of the definition will have a great influence on the issues to be included into the corporate governance discussion and thus on the principles and provision of the *Combined Code 1998* dealing with directors’ duties.

In their Report the *Hampel Committee* “(...) accept(s) the *Cadbury Committee’s* definition of corporate governance as ‘the system by which companies are directed and controlled’.”¹⁰³

b) *Critique*

The discussion about the definition of corporate governance can be traced back to the *Cadbury Report* and although its definition has been adopted and followed ever since, critics are arguing that this it is both a vague and restrictive one, not offering any indication of how or by whom the company is directed and controlled.¹⁰⁴ The *Cadbury Report* explained their definition that the board of directors is responsible for the corporate governance of their company. The responsibilities rest with directors to establish the company’s policies and to supervise how the company is managed. The directors are, in turn, accountable to the shareholders. Auditors have a role of acting as a representative for the shareholders collectively by guarding against financial irregularities and aiming for the directors to provide a “true and fair view” of the company’s performance. As the shareholders supply equity capital to the company, they seek maximisation of their financial return from the company so that the general aim of the system of corporate governance might be to maximise the company’s profit.¹⁰⁵

The *Hampel Committee* also applied the *Cadbury Report’s* definition, which ignores the potential impact of other parties – such as employees, customers, creditors, and the local community – on corporate governance.¹⁰⁶ This attitude of the *Hampel Committee* can already be seen in their statement that the “true safeguards for good governance (lie in the) (...) judgement (...) (of) executive and non-executive directors, shareholders and auditors.”¹⁰⁷

But by concentrating on profit maximisation, the danger of short-termism has not been dealt with¹⁰⁸ and directors may ignore how profits are being made so that the most environmentally sound or socially conscious method is not necessarily chosen.¹⁰⁹

¹⁰³ *Ibid.*, para. 1.15.

¹⁰⁴ *Villiers*, SLPQ 3 (1998), 208.

¹⁰⁵ *Boyle/Bird*, 347.

¹⁰⁶ *Villiers*, SLPQ 3 (1998), 208 (217).

¹⁰⁷ *Hampel Report*, para. 1.14.

¹⁰⁸ *Dignam*, Co Law 19 (1998), 140 (142).

¹⁰⁹ *Villiers*, SLPQ 3 (1998), 208 (217). An example of shareholders interest in environmental and human right issues is that of Shell Transport and Trading where some shareholders sought the establishment of environmental and human right policies procedures within the company: in *Financial Times*, 2 April 1997, “Shell to answer shareholder on ethics queries”, 25, and ability of Shell,

Critics give examples of ways to define the concept of corporate governance more broadly than the *Hampel Committee* has done, including the interests of the other stakeholders.¹¹⁰

The *Hampel Report* explains its position by stating that “(...) the directors as a board are responsible for relation with stakeholders; but they are accountable to the shareholders. This is not a simply technical point.(...) To redefine the directors’ responsibilities in terms of the stakeholders would mean identifying all the various stakeholder groups, and deciding the nature and extend of the directors’ responsibility to each. The result would be that the directors were not effectively accountable to any one since there would be no clear yardstick for judging their performance. This is a recipe neither for good performance nor for corporate success.”¹¹¹ The critics blame the *Hampel Committee* for not having properly examined the “very real debate” which exists within the legal and financial community as to the merits of a stakeholder system.¹¹² On the other hand stresses the *Hampel Report* that “(g)ood governance ensures that constituencies (stakeholder) with a relevant interest in the company’s business are fully taken into account.”¹¹³ But this position is difficult to achieve in practice, when the priority of interest within the corporate governance discussion is put on “profit maximisation”. This shows the discussion of the “classic example of the problem” in Section 309 of the Companies Act 1985.¹¹⁴

The *Hampel Committee* meets the critics who argue that the definition used by them represents the traditional profit-oriented model of corporation with potential towards short-termism by stating that “(t)his does not mean, of course, that directors must run the company exclusively in short term interests of today’ s shareholder. (...) (T)he directors’ duty is to shareholders both present and future.”¹¹⁵ Further, the *Hampel Committee* is arguing that stakeholder relationships are being developed and sustained by the directors to meet their legal duties to shareholders, since the shareholders are interested in the company’s sustained prosperity. But to achieve a long term shareholder value successfully – which means profit maximisation – the directors have to develop and sustain these relationships with the stakeholder.¹¹⁶

Even after the Company Law Review, the attitude in the U.K. company law is likely to stay toward a shareholder value approach, although influenced by stakeholder interests. The *Steering Group* recommends a legislative statement that “(...) sets as the basic goal for directors the success of the company in the collective best of shareholders. But it also requires them to recognise, as the circumstances require, the company’s need to foster relationships with its employees, customers and suppliers, its need to

HSBC Holding and British Gas to ignore stakeholders over environmental and remuneration issues, *Financial Times*, 27 May 1995, “Protest aim at board”, 10.

¹¹⁰ See: *Tricker*, (1993) 1 *Journal of Corporate Governance* 1-3, quoted in *Villiers*, SLPQ 3 (1998), 208 (216); *Sheridan/Kent*, 27 et subs.

¹¹¹ *Hampel Report*, para. 1.17.

¹¹² *Dignam*, *Co Law* 19 (1998), 140 (142). On the discussion on the shareholder v. stakeholder approach see: *Pettet*, *Company Law*, 66 and *Boyle/Bird*, *Company Law*, 358, both with further references.

¹¹³ *Hampel Report*, para. 1.3.

¹¹⁴ *Boyle/Bird*, *Company Law*, 357.

¹¹⁵ *Hampel Report*, para. 1.18.

¹¹⁶ *Ibid.*, para. 1.18.

maintain its business reputation, and its need to consider the company's impact on the community and the working environment."¹¹⁷

III. The Combined Code 1998 Part 1 Section 1: Companies

1. "A.1 The Board"

a) Principle

A.1 Every listed company should be headed by an effective board which should lead and control the company.

This first principle has been taken from the *Cadbury Report*¹¹⁸ and stresses the dual role of the board: to lead and to control the company. It can be seen as the most fundamental principle in the sense that if this is applied properly, everything else should fall into place.¹¹⁹

With this first principle, the *Combined Code 1998* also puts an end to any attempts toward a two-tier board, since this principle assumes a unitary board, that today is almost universal in U.K. companies.¹²⁰ The *Hampel Report* states that there "was little enthusiasm for a two-tier framework" and therefore "overwhelming support for the unitary board."¹²¹

b) Critique

This principle gave rise to the criticism that the *Hampel Committee* just reflected the views of those who surveyed the question between a one-tier and a two-tier structure, instead of properly investigating the issue themselves. The fact that there was no or little enthusiasm for the two-tier structure does not mean for the *Hampel Committee* not to consider any arguments for and against such a structure.¹²²

The discussion on the question of the board structure would to a certain extent vary the directors' duties, but would go beyond the scope of this essay.¹²³

¹¹⁷ *DTI, Modern Company Law for a Competitive Economy: Final Report, Volume I, para. 3.8. (Hereafter: Final Report).*

¹¹⁸ *Cadbury Report, para. 4.1.*

¹¹⁹ *Pettet, JIBL 12 (1998), 394 (396).*

¹²⁰ Note that the Companies Act 1985 does not contain any provision prescribing any set-up of a specific board structure. So long as a company complies with the minimum requirements (number of directors, secretary, financial reporting etc.) the exact mechanism it adopts are a matter for the company alone. Therefore a UK company could establish a two-tier structure without any legal difficulties.

¹²¹ *Hampel Report, para. 3.12.*

¹²² *Dignam, Co Law 19 (1998), 140 (143).*

¹²³ On the ongoing European discussion about this topic see e.g.: *High Level Report, para. 4.1; Hopt/Wymeersch (eds.), Comparative Corporate Governance; Cadbury, Company Chairman, Chapter 4; On worker representation; Cheffins, Company Law, 609 et subs.; Alcock, Co Law 17 (1996), 177.*

c) *Provisions*

The first Principle is followed by six Code Provisions:

- A.1.1 The Board should meet regularly.
- A.1.2 The board should have a formal schedule of matters specifically reserved to it for decisions.
- A.1.3 There should be a procedure agreed by the board for directors in the furtherance of their duties to take independent professional advice if necessary, at the company's expense.
- A.1.4 All directors should have access to the advice and services of the company secretary, who is responsible to the board for ensuring that board procedures are followed and that applicable rules and regulations are complied with. Any question of the removal of the company secretary should be a matter for the board as a whole.
- A.1.5 All directors should bring an independent judgement to bear on issues of strategy, performance, resources (including key appointments) and standard of conduct.
- A.1.6 Every director should receive appropriate training on the first occasion that he or she is appointed to the board of a listed company, and subsequently as necessary.
- These six provisions have largely been taken over from the *Cadbury Code*, although some are amended. A.1.6 is newly added to the Code, but was already considered in the *Cadbury Report*.¹²⁴

(1) *Provision A.1.1*

As the principle A.1 points out, the role of the board is to lead and control the company. But in practice, especially in large companies, many boards delegate their managerial powers to full-time executives. These executives, of whom only some are likely to sit on the board, then make the key policy decisions and supervise the operation of the company on its day-to-day business. Thus, the main role the board plays can be put into two basic categories. First, the board will provide the full-time executives with advice and counsel on matters of corporate policy and strategy. Here, the non-executive, especially the outside directors can play an important role, since they can bring a broader view and fresh perspective to the matter.¹²⁵ Secondly, the board will act as a “watch dog” and monitor the management-team's performance. Ideally, the board will act as an “early warning system” by detecting problems and help to solve them.¹²⁶

But in order to be able to fulfil its main role, it has to be ensured that the board does meet on a regular basis in order to discuss the key issues and also stay informed

¹²⁴ *Cadbury Report*, paras. 4.19-4.20; *Hampel Report*, para. 3.5; *Pettet*, JIBL 12 (1998), 394 (396).

¹²⁵ The role, duties, responsibilities but also problems with the concept of non-executive directors will be discussed in Part D, III. 3.

¹²⁶ *Cheffins*, *Company Law*, 604 et subs.

about ongoing processes. To arrange a number of necessary meetings – which are generally held on a monthly basis¹²⁷ – would have been contrary to the flexible approach the *Combined Code 1998* is taking and would have led to the risk of “box-ticking” for those companies in actual need of more meetings. The number of board meetings has to be in the discretion of the companies according to their size and complexity of topics.

(2) *Provision A.1.2*

This provision guarantees a safeguard for the board. If the board delegates its managerial powers to full-time executives, the provision ensures that those decisions, which are most important for the company, should rest within the direct responsibility of the board¹²⁸, which means that it takes the decision itself. Although there are no statutory guidelines of what the board has to decide, the “most important decision” will be those on the corporate policy and strategy, which lie within the advisory and counselling responsibility of the board as described under provision A.1.1 above.

(3) *Provision A.1.3*¹²⁹

This provision is taken from para. 1.5 of the *Cadbury Code* which already stressed the importance for a director to seek legal or financial advice in order to further his duties.¹³⁰

For a director, especially the non-executive directors (NEDs), whose primary role is the monitoring of the company, it is of vital importance to be legally and financially informed to be able to spot a (maybe hidden or covered) problem or critical situation which may lead to severe business consequences. Thus, to ensure a mechanism to get independent professional advice on such an occasion strengthens their position in relation to the executive managers. But also for an executive director it is important to stay informed in relation with their duties and responsibilities toward the company.

(4) *Provision A.1.4*¹³¹

The Company Act 1985, s. 283, requires all companies to have a company secretary, but does not spell out its duties. These are mainly of administrative nature, in particular ensuring compliance with statutory provision such as disclosure and information requirements and adherence by the board to the proper procedures.¹³² Nevertheless they are not just clerks but officers with extensive duties and responsibilities

¹²⁷ *Dean*, Public Companies, 82.

¹²⁸ Note that the delegation of managerial powers does not lead to an abdication of responsibility, in: *Ferran*, Company Law, 227 et subs.

¹²⁹ This Provision was a change the LSE made to the suggestion of the *Hampel Report*.

¹³⁰ *Cadbury Report*, para. 4.18.

¹³¹ This Provision was a change the LSE made to the suggestion of the *Hampel Report*.

¹³² *Farrar/Hannigan*, Company Law, 361.

and even the authority to enter into contracts on behalf of the company, at least on the administrative side.¹³³

The *Cadbury Code* already established the later provision in its para. 1.6, which the *Combined Code 1998* took over identically, and explained the “key role” of the company secretary to instruct chairman and board on their responsibilities.¹³⁴

The company secretary will play an important role for the NEDs, who might not be as aware and informed about their responsibilities under the rules and regulations to which they are subject as their professional (executive) colleagues.

(5) *Provision A.1.5*

The *Cadbury Report* restricted this provision only to NEDs. But this can be regarded as too narrow, since no differentiation should be made between executive and non-executive directors. The *Hampel Report* also subsumes the executive director under this provision by stating that “an executive director needs to be able to express views to the board which are different from those of the chief executive officer (...).”¹³⁵ By referring to executive directors, the *Hampel Report* and the *Combined Code 1998* do not “overrule” the *Cadbury Code* and its view on NEDs, but broaden the principle, including the executive directors.

(6) *Provision A.1.6*

This provision is new, compared to the *Cadbury Code*. The *Cadbury Report* already stated the desirability of undertaking directors to some form of internal or external training and stressed this in particular for directors with no previous board experience¹³⁶, but no suggestion was taken into the *Cadbury Code*.

The *Hampel Report* agrees to this view for both, directors already on the board as well as newly appointed ones.¹³⁷ For a newly appointed director it is important to receive an introduction to the company and its affairs and issues, for a director on the board it is important to stay trained on eventual changes of the legislative responsibilities.

d) *Critique*

A general criticism is that the *Hampel Report* and thus the *Combined Code 1998* copied too much of the *Cadbury Code* and confined themselves to commenting on the previous Reports and making no attempt to expand or extend those recommenda-

¹³³ *Panorama Developments (Guildford) Ltd v Fidelis Furnishing Fabrics Ltd* [1971] 3 All ER 16, 19.

¹³⁴ *Cadbury Report*, para. 4.25.

¹³⁵ *Hampel Report*, para. 3.6.

¹³⁶ *Cadbury Report*, para. 4.19.

¹³⁷ *Hampel Report*, para. 3.5.

tions.¹³⁸ It is stressed that the *Hampel Report* was a proactive approach, which did not have to deal with the consequences of a specific corporate scandal or insolvency.

The provisions are in themselves correct, but nevertheless critics argue that they “lack teeth and are little more than suggestions with no guidance on how a company could implement them.”¹³⁹

The *Hampel Report* acknowledges that recommendation on formal boardroom procedures by which boards would assess both, their own collective performance and that of the individual, exists but felt unable at that stage to make any recommendation.¹⁴⁰ It remains to be stressed that the *Hampel Report* recognises the importance of the issue.

Another critic argues that the *Hampel Report* has failed to provide models for the behaviour it prescribes.¹⁴¹ An example is being given of the U.S. Security Exchange Committee (SEC) that gave a “meticulous detailed” (SEC Regulation S-K, items 401 and 404) list of the content and format for disclosure requirements relating to directors. There is nothing “magical” about the SEC model the critic says, but emphasises that the *Hampel Report* (and thus also the later *Combined Code 1998*) would have been immediately more usable for those it aimed at, by giving a company director a clearer idea of what good behaviour in detail look like – for example by giving examples in several alternative format.¹⁴² But to include a “meticulous detailed” list on good behaviour would contradict the flexible approach of broad principle.

A problem that arises throughout the provision is the reference to “directors”. This refers to “directors as a whole” and also includes the NEDs into the scope. This is correct insofar, since the law – section 741 of the Companies Act 1985 – does not differentiate between executive and non-executive directors, but raises the question of the exact role of these NEDs. This highly controversial issue will be discussed below under the Principle A.3 dealing with NEDs.

If one exclusively considers the provision, criticism can be brought forward against A.1.5 and A.1.6. The first is rather “vague” and has to be seen in the relation of the various statutes and case law duties of directors when running a company.¹⁴³ The later provision cannot be criticised for its content, but it is questionable in practice.

The survey by KPMG¹⁴⁴ found that more than half of the asked NEDs admitted to inadequate training in key areas. Although training on corporate governance was given to a majority, only 30 % received guidance on how to spot “early warning signals” of failing businesses.¹⁴⁵ It is also important to note that formal training cannot supplement other qualities – such as entrepreneurship, charisma, negotiation skills – that a director needs in order to perform well.¹⁴⁶

¹³⁸ *Dignam*, Co Law 19 (1998), 140 (152); *Riley*, Amicus Curiae (issue 1, 1997), 16.

¹³⁹ *Dignam*, Co Law 19 (1998), 140 (142).

¹⁴⁰ *Hampel Report*, para. 3.13.

¹⁴¹ *Barnard*, Co Law 19 (1998), 110 (112).

¹⁴² *Ibid.*, 110 (113).

¹⁴³ *Pettet*, JIBL 12 (1998), 394 (395); also compare Part C, I.

¹⁴⁴ See Fn. 78.

¹⁴⁵ *KPMG*, LRI (January 2003), 22.

¹⁴⁶ *Villier*, SLPQ 3 (1998), 208 (221).

e) *The Combined Code 2003*

As consequence to these criticism, the *Higgs Report* developed in some parts a more detailed description of the role of different directors involved.¹⁴⁷ This guidance does not form part of the *Combined Code 2003* but is annexed to it as “Related Guidance and Good Practice Suggestions”. The *Higgs Report* has also emphasised the importance of an induction to the board when joining and an evaluation of the performance of the individual directors. Thus A.5.1 of the *Combined Code 2003* recommends “that new directors receive a full, formal and tailored induction on joining the board” and A.6 of the *Combined Code 2003* recommends that “the board should undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors.”

2. “A.2 Chairman and CEO”

a) *Code and Provision*

A.2 There are two key tasks at the top of every public company – the running of the board and the executive responsibility for the running of the company’s business. There should be a clear division of responsibilities at the head of the company which will ensure a balance of power and authority, such that no one individual has unfettered powers of decision.¹⁴⁸

The Code Provision is as follows:

A.2.1 A decision to combine the posts of chairman and chief executive officer in one person should be publicly justified. Whether the posts are held by different people or by the same person, there should be a strong and independent non-executive element on the board, with a recognised senior member other than the chairman to whom concerns can be conveyed. The chairman, chief executive and senior independent director should be identified in the annual report.

Until the appearance of the *Cadbury Code* it had been common for a company to have one individual as both: managing director and chairman, although their position and role is quite different. On the one hand, the managing director – or chief executive director (CEO) – is usually appointed through the articles of the company (Article 84 of Table A) and is being delegated with the powers of the directors to run the day-to-day business of the company.¹⁴⁹ The chairman, on the other hand, should be able to stand back from the daily business to ensure that the board is in full control of the company’s affairs, and he should alert to the company’s obligations to the shareholder.¹⁵⁰ Case law also recognises this difference, for example in *Southern Foundries (1926) Ltd v Shirlaw*: “(...) the two positions, that of the director and of the manager, involve different qualifications, duties and responsibilities.”¹⁵¹ The combination of

¹⁴⁷ *Higgs Report*, Annex C/D, Guidance for NEDs/the chairman.

¹⁴⁸ Principle was changed compared to the *Hampel Report*. Their suggested second sentence to the Principle is now sentence one of the Provision.

¹⁴⁹ *Mayson/French/Ryan*, Company Law, 479.

¹⁵⁰ *Cadbury Report*, para. 4.7.

¹⁵¹ [1940] AC 701, p. 712.

both roles lead to a considerable concentration of power within the board of a company, combining the running of the day-to-day business and its monitoring.

The *Cadbury Report* urged for a separation of the two roles “in principle”¹⁵² but the *Cadbury Code* (only) required “a strong and independent element on the board” in case of a personal unity of both positions.¹⁵³ The *Hampel Report* follows this requirement by stating that “the roles of chairman and chief executive officer are better kept separate (...)” but only regards it as necessary in the largest companies, whereas a lot of other companies have successfully combined the two roles.¹⁵⁴

Although the *Hampel Report* points out that there are cases where a combination is successful, it needs persons, critical enough to reflect their own work and appraise it in the light of keeping the company’s and shareholder’s interests above their own interests. For a director to be able to run the board at the same time as running the day-to-day business, the key to his role is the allocation of his working time. Active involvement in managerial issues has to some extent to be traded off against the independence required to monitor.¹⁵⁵ Thus, a clear division of responsibilities is favourable the more complex and time absorbing the two roles are becoming.¹⁵⁶

The implementation of a “strong and independent non-executive element” is another device to prevent a too powerful chairman and/or CEO. Concerns and problems of the other board members with the chairman and/or CEO can be addressed to this person. This “element” will also become important in situations of potential conflict, e.g. the board wants to take action against either the combined chairman/CEO or against either one of them. One case might be that the board members carry out their monitoring duty and want to replace the combined CEO/chairman. Such an action will be much more easy and clear-cut if there is another strong member on the board to take a lead. Secondly, the question of succession can be taken up by such a NED. It is often problematic for a chairman or CEO to either recognise the point of time to resign or find a suitable successor.¹⁵⁷ Here again the NED could lead the chairman and/or CEO into the right direction.¹⁵⁸

b) Critique

Critics have argued that the *Hampel Report* dilutes the urge of the *Cadbury Report* for a separation to prevent the immense concentration of power.¹⁵⁹ But neither the *Cadbury Code* nor the *Combined Code 1998* dealt with this point. *Sir Cadbury* argued, as mentioned above, that the requirement of separation was not to included into the *Cadbury Code*, because his committee looked at the diversity of companies. The *Hampel Report* is in accordance with this argumentation and thus both Reports and

¹⁵² *Cadbury Report*, para. 4.9.

¹⁵³ *Ibid.*, para. 1.2.

¹⁵⁴ *Hampel Report*, para. 3.17.

¹⁵⁵ *Dean*, Public Companies, 61.

¹⁵⁶ An overview of the discussion on chairman and the chief executive see: *Cadbury*, Company Chairman, chapter 6.

¹⁵⁷ *Financial Times*, 23 January 2003, “The task of handing over the reins”, 12.

¹⁵⁸ *Cadbury*, Company Chairman, 101; see also: *Cadbury Report*, paras. 4.5, 4.6.

¹⁵⁹ *Dignam*, Co Law 19 (1998), 140 (143).

Codes especially consider the situation of small companies. These would have major problems to comply with such a principle. Therefore, it cannot be agreed with this criticism.

Nevertheless, the *Higgs Report* calls for a separation of the CEO and chairman in all cases with a division of responsibilities set out in writing. In addition, the CEO should not become the chairman of the same company and should meet the test of independence at the time of his appointment.¹⁶⁰

More problematic and arguable in the present *Combined Code 1998* is the role and function, the duties and responsibilities of a NED who is supposed to be the “strong and independent non-executive element on the board”.

The discussion on NEDs will be held under the principle A.3.

c) *The Combined Code 2003*

A.2 and A.2.1 *Combined Code 2003* finally require the separation of the roles of the chairman and CEO. There is also no room for an exception. To further establish a clear division of responsibility at the head of the company, the chairman and CEO should set out their responsibilities in writing, for the board to agree to.

3. “A.3 Board Balance”

a) *Code and Provisions*

A.3 The board should include a balance of executive and non-executive directors (including independent non-executives) such that no individual or small group of individuals can dominate the board’s decision.

The Code provision are as follows:

A.3.1 The board should include non-executive directors of sufficient calibre and number for their views to carry significant weight in the board’s decision. Non-executive directors should comprise not less than one third of the board.

A.3.2 The majority of non-executive directors should be independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgement. Non-executive directors considered by the board to be independent in this sense should be identified in the annual report.

The *Combined Code 1998* mentions NEDs in various principles and provisions. Principle A.3 is especially referring to the issue of NEDs, which will be discussed here.

The role, function, duties and responsibilities of NEDs – also referred to as “guides”, “consultants”, “part-time-directors”, “external directors”, “outside directors”¹⁶¹, “special directors”, “business advisers”, “independent directors”, or “watch-

¹⁶⁰ *Higgs Report*, Annex A, paras. 2.1-2.4.

¹⁶¹ ‘External’ or ‘outside’ directors have not had any earlier relationship with the company as opposed to those NEDs, who have formerly sat on the board as an executive director.

dogs” – have evolved gradually over the period of time but have come to prominence largely in the 1980s.¹⁶²

As already mentioned, the problem with discussing NEDs is the fact that they are not defined by law. Section 741 (1) of the Companies Act 1985 only defines “director” as “(...) any person occupying the position, by whatever name called”.

But in practise, a distinction is often drawn between an executive and non-executive director. When a person is appointed as a full-time working director to the board, he will usually enter into a service contract with the company that sets out in detailed terms his role and duties. Typically such contracts will require that person to devote his full attention to managing the company. Full-time working directors are thus often described as “executive directors”, since they carry out extensive executive and management functions within the company such as production, finance, marketing and personnel management roles. In contrary, a director who is not an employee of the company and is required to devote only part of his time to the affairs of the company as an advisory or supervisor is called “non-executive director”. A NED participates fully in the joint deliberations of the board but does not have any executive function in the company’s management.¹⁶³ Another important difference is that an NED does not have a service contract with the company which sets out in detail the terms of his role and duties, since he is not an employee. All this raises one question: “what exactly is their function?”¹⁶⁴

The first initiative to promote NEDs was in 1982 “PRO NED” (Promotion of Non-Executive Directors), that established and issued a “Code of Recommended Practice on Non-Executive Directors” listing the benefits of NEDs to companies and laying down their condition of independence.¹⁶⁵ The PRO NED Code did not contain any new proposals but it was hoped that the publicity attending its launch would make company boards aware of the issue.¹⁶⁶

In 1992, the *Cadbury Report* put forward a statement of function of NEDs. This was seen as “the single most significant (and controversial) element of that Report.”¹⁶⁷ The Report states that NEDs have two particularly important contributions to make to the governance process: the first being to review the performance of the board and the executives and the second taking the lead where potential conflicts of interest arise, without getting detracted from the primary and positive contribution which they are expected to make, as equal board members, to the leadership of the company.¹⁶⁸

The Report’s definition of “independence” was that NEDs should be “independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgement. It is for the board to decide whether this definition is met”.¹⁶⁹ The ideas and recommendations of the

¹⁶² *Seikh*, Co Law 23 (2002), 296 et subs.

¹⁶³ *Bruce*, *Directors Duties*, 4; *Mayson/French/Ryan*, *Company Law*, 451.

¹⁶⁴ *Ferran*, *Company Law*, 217.

¹⁶⁵ For a brief overview on PRO NED: *Jacobs*, JBL 1987, 269 et subs.

¹⁶⁶ *Ibid.*, 269 (272).

¹⁶⁷ *Pettet*, JIBL 12 (1998), 394 (397).

¹⁶⁸ *Cadbury Report*, paras. 4.3, 4.5-4.6, 4.10.

¹⁶⁹ *Ibid.*, para. 4.12.

Report were put into effect through a series of provisions in the *Cadbury Code*.¹⁷⁰ The *Cadbury Code* defines the role of NEDs as “(...) bring(ing) an independent judgement to bear on issues of strategy, performance, resources, including key appointments, and standard of conduct.”¹⁷¹ In addition to the statement of function the *Cadbury Code* specifically endorsed the practice of having remuneration committees comprised mainly or wholly of NEDs to make recommendations on the pay of executive directors and the establishment of audit committees comprised of at least three NEDs to review the management of the companies’ financial operations.¹⁷²

The *Hampel Report* acknowledged that the *Cadbury Report* had raised the profile of the NEDs, but also observed that an unintended side effect had been to overemphasise their monitoring role.¹⁷³ The Report continued by stating that NEDs are normally appointed to the board primarily for their contribution to the development of the company’s strategy and that NEDs should have both, a strategic and a monitoring function.¹⁷⁴

Considering the definition of “independence”, the Report states that it agrees with the definition given by the *Cadbury Report* and that it would not be practicable to lay down more precise criteria for independence. It also agrees that it should be for the board to take a view on whether an individual director is independent.¹⁷⁵

The issue of the board composition was seen by the *Hampel Report* as a possibility to encourage companies to have more diversity on their boards. Most NEDs are executives or former executives of other companies, but looking at the diversity of businesses and size of listed companies there are people from other fields who can make a real contribution to the board. It is also said that in order to be effective, NEDs should make up at least one third of the board.¹⁷⁶ This point was one addition after the *Cadbury Report*, which did not require a certain number of NEDs to be on the board. This recommendation of the *Hampel Report* went into the *Combined Code 1998* as Principle A.3. The *Combined Code 1998* also recommends having a remuneration committee comprised exclusively of NEDs¹⁷⁷, which is another development since the *Cadbury Code*, and an audit committee comprised of at least three NEDs.¹⁷⁸

b) Critique

The role, function, duties and responsibilities of NEDs have attracted a large amount of discussion and criticism. There are a number of issues being discussed: the question of independence, the matter of appointment procedure, the question of quality, the development of a clearer picture of the NEDs’ role and legal responsibil-

¹⁷⁰ *Cadbury Code*, paras. 1.2, 1.3, 2.1-2.4, 4.3.

¹⁷¹ *Ibid.*, para. 2.1.

¹⁷² *Ibid.*, paras. 1.3, 2.1-2.4, 3.3, 4.3.

¹⁷³ *Hampel Report*, para. 3.7.

¹⁷⁴ *Ibid.*, para. 3.8.

¹⁷⁵ *Ibid.*, para. 3.9.

¹⁷⁶ *Ibid.*, paras. 3.14, 3.15.

¹⁷⁷ *Ibid.*, para. 4.11; *Combined Code 1998*, B.2.2.

¹⁷⁸ *Ibid.*, para. 6.3; *Combined Code 1998*, D.3.1.

ity, and how an appropriate balance between the NEDs' strategic and monitoring role can be established and maintained.

Concerning independence, critics raise the question whether it is really possible for a person to be effectively monitoring the executive directors and co-operating with them in the company's strategic development at the same time.¹⁷⁹ Is a NED still capable of fulfilling his monitoring duty when he is very much involved in the company's decision making process, thus losing his broader perspective?

This problem is closely linked to the matter of the appointment procedure, which is set out in Principle A.5.¹⁸⁰ That principle does not overcome the criticism that NEDs are mainly drawn from the same narrow social and business background as the executives with interests in certain vital areas largely coinciding with those of the executive directors.¹⁸¹ The dominance of an internal election process by the board leads unsurprisingly to a selection of NEDs who are sympathetic to the board's view and are unlikely to challenge the executive directors in their position.¹⁸² With the board asking itself "will a NED fit in" or more poignantly "will he cause trouble", critics have called this behaviour as an example of the "job for the boys" approach by only choosing those individuals that "will not rock the boat".¹⁸³ This may also lead to the situation of an NED feeling personally indebted to the executive director which causes an immediate and irreconcilable conflict of interest, since the NED might be unlikely to depart from the inside line determined by the management.¹⁸⁴ Therefore the independence of NEDs is from the outset at risk, especially due to the danger of the NEDs becoming a confidant of a specific board member and particularly the chairman or chief executive, which can erode the objectivity and independence of their thoughts.¹⁸⁵ As NEDs are expected to give objective views, companies have to get away from the common practice of having former executives appointed NEDs.¹⁸⁶

Considering the quality of NEDs the question arises, whether a person other than an actual or former executive director of a company can be expected to have the experience to be an NED. The *Hampel Report* did encourage company boards to select NEDs from a wider variety of backgrounds, but critics point out that it did not indicate which other background it envisaged for these NEDs. Research has shown little optimism in this regard in practise. A survey revealed that 78 % of the respondents considered a top level management role in another company to be the most relevant career background.¹⁸⁷ Suggestions have been made that other independently minded

¹⁷⁹ *Ferran*, Company Law, 219.

¹⁸⁰ Part D, III., 5.

¹⁸¹ *Stratton*, Co Law 17 (1996), 162.

¹⁸² *Esen*, ICCLR 11 (2000), 202 (205); *Proctor/Gilles*, Corporate Governance, 27.

¹⁸³ *Sheikh*, Co Law 23 (2002), 296 (298); *Cadman*, SJ 1995, 346 (347).

¹⁸⁴ *Esen*, ICCLR 11 (2000), 202 (205); *Stratton*, Co Law 17 (1996), 162 (163); *Ferran*, Company Law, 220.

¹⁸⁵ *Cadbury*, Company Chairman, 50.

¹⁸⁶ *Esen*, ICCLR 11 (2000), 202 (205); *Financial Times*, 11 February 1998, "Shell Executive Breaks With Past", 25: Example of the former Shell CEO – Cor Herkstoter – refusing to take up a NED position after his retirement marks an end to the controversial corporate governance practice at Shell.

¹⁸⁷ BDO Binder Hamlyn, "Non-executive Directors – Watchdogs or Advisor", (City Research Association, 1994), quoted in *Villiers*, SLPQ 3 (1998), 208 (220).

parties, such as academics and retired civil servants could also be co-opted as NED to a board, but in practice problems may arise if they lack the real commercial “know how” in dealing with their executive colleagues. Furthermore a person who has not experienced the responsibilities of an executive director at one stage of his working life may be unsuitable as a NED, regarding the complexity of today’s business world. Another tendency, to take elderly or retired directors, might bear the danger that they are past their peak, becoming out of touch and generally their abilities are on the wane.¹⁸⁸

Another consideration linked to the matter of quality is the question on how much time and effort a NED will put into his position. Taking into account that in practice most of the NEDs do hold a full-time executive directorship, the amount of time they are actually able to spend on their NED position is limited.¹⁸⁹ Critics say that it is not only a question of time but also of energy it takes to oppose and fight management decisions or strategy, which results in difficulties for NEDs to organise a reasonable opposition. The chairman of the U.S. Security Exchange Commission puts this problem into the “catchy” phrase: “I don’t care how talented you are, you can’t be a good watchdog if you’re only on patrol three times a year.” In an event of disagreement with a management strategy, the most likely reaction is to resign from the board rather than take a line of action.¹⁹⁰

In relation with the development of a clearer picture of the NED’s role, critics agree that the *Combined Code 1998* has failed to resolve the conflicting roles of NEDs.¹⁹¹ It drafts their role in wide and idealistic terms – such as “independent” (Provision A.1.5), “of sufficient calibre” and “to carry significant weight” (Provision A.3.1) – but there is no further suggestion on how this is to be achieved. As stated above, the *Hampel Report* does discuss the question of a definition of “independence” but concludes that it would not be practicable to lay down more precise criteria for it. Neither does the *Combined Code 1998* give an answer to the question in whose interest the NEDs serve. Are they just acting in the best interest of the company or must they also carry a certain corporate social responsibility, which entails considering the interest of the other “stakeholders” of the company. Organisation like the Chartered Institute of Management Accountants (CIMA) tried to define the role of an NED in a more precise way by concentrating on the situation in smaller boards. The National Association of Pension Funds (NAPF) gave a description from the point of view of an institutional investor and the Hong Kong Institute of Directors set out 12 “basic guidelines” that should govern the roles and responsibilities of NEDs.¹⁹²

¹⁸⁸ *Stratton*, Co Law 17 (1996), 162 (164).

¹⁸⁹ *Proctor/Gilles*, Corporate Governance, 28; *Stratton*, Co Law 17 (1996), 162 (164); *Sheikh*, Co Law 23 (2002), 296 (298).

¹⁹⁰ *Esen*, ICCLR 11 (2000), 202 (204 et subs.).

¹⁹¹ *Proctor/Gilles*, Corporate Governance, 27; *Esen*, ICCLR 11 (2000), 202 (206); *Sheikh*, Co Law 23 (2002), 296 (299).

¹⁹² CIMA, “Non-Executive Directors: Their Value to Management” (CIMA, 2001), Preface; National Association of Pension Funds, “Independent Directors – What Investors Expect” (NAPF, May 9, 2002); Hong Kong Institute of Directors, “Guide for Independent Non-Executive Directors in Hong Kong”, all in *Sheikh*, Co Law 23 (2002), 296 (299 et subs.).

c) *The Combined Code 2003*

Regarding the NEDs, there have been some major changes in the *Combined Code 2003* compared to its predecessor. A.3.2 *Combined Code 2003* establishes a quota of “at least half the board, excluding the chairman” to be independent NEDs. In addition, A.3.1 *Combined Code 2003* gives a definition of “independent”. Although the final decision, whether or not a NED is independent, remains with the board, criterias have been included according to which a NED cannot be considered “independent”. Examples are that he has been an employee within the last five years, has a material business relationship or holds a cross directorship. Another important development is the prohibition for the CEO to go on to become the chairman of the same company, unless the major shareholders have been consulted in advance and the reasons are set out to the shareholders at the time of appointment.¹⁹³

Concerning the quality of NED and the time and effort they put into their work, the *Combined Code 2003* requires the nomination committee to prepare a letter of appointment that includes the expected time commitment. It also requires all newly appointed NEDs to disclose any other significant commitments to the board.¹⁹⁴ With reference to the chairman, A.4.3 prohibits that an individual should be appointed to a second chairmanship of a FTSE-100 company.

Furthermore, the *Combined Code 2003* strengthens the position of the “independent element on the board” by introducing a senior independent director who should be available to shareholders for concerns which cannot be solved in the common way.¹⁹⁵

4. “A.4 Supply of Information”

a) *Principle and Provision*

A.4 The board should be supplied in a timely manner with information in a form of a quality appropriate to enable it to discharge its duties.

The Code Provision is as follows:

A.4.1 Management has an obligation to provide the board with appropriate and timely information, but information volunteered by management is unlikely to be enough in all circumstances and directors should make further enquiries where necessary. The chairman should ensure that all directors are properly briefed on issues arising at board meetings.

The *Hampel Report* points out that the supply of information is vital for the effectiveness of the board and necessary for the directors to fulfil their duties properly. This includes in particular the role the NEDs are playing.¹⁹⁶ Although there is a view that NEDs should face less onerous duties than executive directors, since they inevitably will have less information, the Report disagrees by supporting the retention of com-

¹⁹³ *Ibid.*, A.2.2.

¹⁹⁴ *Ibid.*, A.4.4.

¹⁹⁵ *Combined Code 2003*, A.3.3.

¹⁹⁶ *Hampel Report*, para. 3.4.

mon duties in the interests of the unity and cohesion of the board. The *Hampel Report* regards the fact that English courts have recently tended to take into account such factors as the position of a director and the type of the company to be a helpful recognition of the practical situation.¹⁹⁷

b) Critique

Looking at the discussion led on the role of NEDs before, there is another issue to be raised here in context with NEDs. Critics argue that the monitoring position of NEDs is too dependent on the flow of information from the senior management and the executive directors, those parties which they are supposed to monitor.¹⁹⁸ The *Combined Code 1998* only addresses the whole board as the recipient of the information, rather than the NEDs in particular.¹⁹⁹ If the management is not forthcoming, the NEDs will never know of an issue or a crisis until it may be far too late. The management is in a position to easily withhold vital information or edit unpalatable news. In addition, particularly in the complex modern business environment, decision must be taken within a short period of time – sometimes within a few hours – which might make it impossible to communicate the whole process to a NED if he is not in the company that same day.²⁰⁰ Therefore it is concluded by some critics that too much discretion over the flow of information is still left in the hands of the group that is to be monitored.²⁰¹ But it also has to be taken into account that the NEDs do have a duty to go ahead and make enquiries when and where necessary.

Critics also have taken *Dorchester Finance Co Ltd v Stebbing*²⁰² and its holding, that no distinction is being drawn between the duties of executive and non-executive directors, as an example of the danger of potential liability NEDs get themselves into, when relying on the flow of information of others. With the court's holding, an NED may find himself unjustifiably exposed, being reliant on the executive director for information and yet undertaking the same risks as to liability for breach of his duties.²⁰³

It cannot be agreed to this criticism. Concerning the question of legal duty English courts have recently taken into account the position of directors when judging their common law duties of care and skill, especially in the cases of *Norman v Theodore Goddard* and *Re D'Jan of London Ltd* as shown above. Courts in other common law jurisdictions have taken this development a step further, as the Australian case of *Daniels v Anderson*²⁰⁴ shows. The case arose from fraudulent conduct of an employee of AWA. These frauds were not detected by the auditors of AWA, who therefore were sued by AWA later for negligence. But the auditors had informed the person who was chairman and CEO of certain serious deficiencies in internal control and in the books

¹⁹⁷ *Ibid.*, para. 3.3.

¹⁹⁸ Ferran, *Company Law*, 221.

¹⁹⁹ Proctor/Gilles, *Corporate Governance*, 27.

²⁰⁰ Stratton, *Co Law* 17 (1996), 162 (164); Sheikh, *Co Law* 23 (2002), 296 (298).

²⁰¹ Esen, *ICCLR* 11 (2000), 202 (206).

²⁰² [1998] *BCLC* 498.

²⁰³ Stratton, *Co Law* 17 (1996), 162 (164).

²⁰⁴ (1995) 16 *ACSR* 607, NSW CA.

and records, but the chairman/CEO had failed to pass on this information to the NEDs. The auditors, in defending the claim, argued that there had been contributory negligence by AWA through the executive and non-executive directors. The New South Wales Court of Appeal held that the executive director had been negligent but not the NEDs. The court held that NEDs were justified in trusting officers of the corporation to perform their duty and could rely without verification on the judgement, information and advice of the officers so entrusted. In relation to auditors, if the director appointed a person of good repute and competence to audit the accounts, absent real ground for suspecting that the auditor was wrong, the directors would have discharged their duty to the company. Generally, reliance on others would only be unreasonable when the directors were aware of circumstances that were so plain that no person with any degree of prudence, acting in his own affairs, would have done so.

The *Daniels v Anderson* case can be seen as indicative of how an English court might approach the question of how far it is reasonable for NEDs to place reliance and trust in others. Notwithstanding the general trend towards stricter standards, relying on and trusting others should properly remain a defence for NEDs in appropriate cases, but their role, and personal obligations, as independent mentors will not be discharged by an unquestioning acceptance of information that is presented to them in circumstance where a reasonable person would have been put in inquiry.²⁰⁵ The further development of this issue is therefore within the responsibility of the English courts.

Another problem is the practical problem of how even the most diligent director is supposed to be able to keep track of the vast number of transactions being carried out in dispersed geographical locations of modern companies. If the courts are too severe in their interpretation of what reasonableness requires they will make it difficult for boards to find directors. Here then lies a practical problem in corporate governance.²⁰⁶

To reach a better flow of information, the *Higgs Report* adds a new suggestion by passing responsibility to the company's secretary in order to ensure and facilitate a better flow of information between the board, its committees and between the NEDs and senior management.²⁰⁷

c) *The Combined Code 2003*

The *Combined Code 2003* emphasises the importance of the flow of information by giving responsibility to the chairman for not only ensuring that the directors get accurate, timely and clear information but also to ensure that the directors continually update their skills and the knowledge and familiarity with the company.²⁰⁸ This responsibility also includes the already mentioned induction on joining the board as well as access to independent professional advice.²⁰⁹

²⁰⁵ *Ferran*, Company Law, 229.

²⁰⁶ *Pettet*, Company Law, 177.

²⁰⁷ *Higgs Report*, Annex A, para. 5.4.

²⁰⁸ *Combined Code 2003*, A.5 (Supporting Principle).

²⁰⁹ *Ibid.*, A.5.1-5.3.

5. “A.5 Appointment to the Board”

a) Principle and Provision

A.5 There should be a formal and transparent procedure for the appointment of new directors to the board.

The Code Provision reads as follows:

A.5.1 Unless the board is small, a nomination committee should be established to make recommendations to the board on all new appointments. A majority of the members of this committee should be non-executive directors and the chairman should be either the chairman of the board or a non-executive director. The chairman and members of the nomination committee should be identified in the annual report.

Although the *Cadbury Committee* had recommended a nomination committee for each company²¹⁰, this idea had neither found its way into the *Cadbury Code* nor was it taken up by the *Hampel Report*.

The *Combined Code 1998* only includes a requirement of a nomination committee in a provision. This way it acknowledged the difficulties a small company would have had, since it would not be possible for a small board to establish a separate nomination committee. This provision is another example of taking the position of small companies into account.

The aim of the provision is to ensure, by injecting some objectivity through a majority of NEDs, that the nomination of new directors to the board can be neither dominated by an individual nor any faction of the board.

b) Critique

Apart from the criticism related to the position of NED discussed above, there is another point to be raised under this principle: the *Combined Code 1998* does not indicate what the shareholders can do if they feel unhappy with the choice of a particular person being appointed as NED. As pointed out in the *Hampel Report*, the shareholders do have a right to submit names for consideration²¹¹, but there are no sanctions levied against the company for appointing a “marionette” NED.²¹² Nevertheless this point of criticism is rather weak, since Table A Section 79 allows a director appointed by the board to hold office only until the next annual general meeting (AGM). This is also stated in provision A.6.2 of the *Combined Code 1998*.

c) The Combined Code 2003

The *Combined Code 2003* regulates the appointment to the board in a more detailed way. A.4.1 calls for a requirement to have a nomination committee, which evaluates the balance, skills, knowledge and experience on the board in order to be able to describe the role and capabilities required for a particular appointment. The

²¹⁰ *Cadbury Report*, para. 4.30.

²¹¹ *Hampel Report*, para. 3.20.

²¹² *Proctor/Gilles*, Corporate Governance, 27.

work of the nomination committee should be described in the annual report, including the process it has used in relation to board appointments. To broaden the “pool” of possible director candidates, the nomination committee has to explain, why it has not used an external consultancy nor open advertisement for the appointment of the chairman or a NED.²¹³ A.5 sets the limit of the number of NED positions a fulltime executive director should have to one in a FTSE-100 company.

6. “A.6 Re-election

a) *Provision and Principles*

A.6 All directors should be required to submit themselves for re-election at regular intervals and at least every three years.

The Code Provisions are as follows:

A.6.1 Non-executive directors should be appointed for specified terms subject to re-election and to Companies Act provision relating to the removal of a director, and reappointment should not be automatic.

A.6.2 All directors should be subject to election by the shareholders at the first opportunity after their appointment, and to re-election thereafter at intervals of no more than three years. The names of directors submitted for election or re-election should be accompanied by sufficient biographical details to enable shareholder to take an informed decision on their election.

The principle and the first provision had already been included in the *Cadbury Code*.²¹⁴ Broad support also comes from the NAPF and the Association of British Insurers (ABI) which also expect the directors to submit themselves for re-election.²¹⁵ This regulation also gives the shareholder some control over the board if it has appointed a “marionette” NED, a point of criticism raised under Principle A.5 above.

The required period of three years can be seen as suitable because it is not too long for the shareholder to stay in control in the sense of being able not to re-elect an “unfit” director. It is also a period which shows whether or not an appointment of a member works out as expected. On the other hand, a period shorter than three years would be insufficient since some of this period will be taken up by a director, especially an NED, to get involved with the company’s affairs and the people in it.²¹⁶

The Principle A.6.1 also deals with the problem that NEDs are not employees of the company and therefore do not have a service contract with the company which sets out in detail the terms of their role and duties (compare above under Principle A.3). Thus by appointing them for specified terms shall ensure their duties, term of office and remuneration.²¹⁷

²¹³ *Combined Code 2003*, A.6.

²¹⁴ *Cadbury Code*, paras. 2.3 and 3.1.

²¹⁵ *Hampel Report*, para. 3.21.

²¹⁶ *Cadbury*, Company Chairman, 49.

²¹⁷ See intention of *Cadbury Report*, para. 4.16.

b) *Critique*

The recent survey by KPMG on the appraisal of the work of NEDs gives some doubts as of the effectiveness of the principle of re-election. As described above the re-election should give both, directors and company shareholders, the possibility to evaluate the work and then part with either side if the work does not meet the expectations. But the survey indicates that more than half of the NEDs have never had a formal appraisal of their work.²¹⁸ The question that arises here is on what basis the re-election of NEDs is supposed to take place if their work has never been appraised. And then who should appraise the work of the NEDs, who themselves are supposed to monitor and in a way appraise the executive directors? Should the executive directors appraise the NEDs? This would certainly lead to a peculiar situation, since the best NEDs are the most critical ones. This in return, would have to be acknowledge by the executive director when appraising the NEDs and put in favour for them.

c) *The Combined Code 2003*

The *Combined Code 2003* links the new “Performance Evaluation” to the re-election of NEDs by requiring the chairman to confirm to the shareholders when proposing re-election that, following the formal performance evaluation, the individual’s performance continues to be effective and to demonstrate commitment to the role.²¹⁹ The *Combined Code 2003* also puts a limit to the re-election of the “independent” NEDs since the new definition does not regard a director who has served for more than nine years to be necessarily independent any longer.²²⁰

E. The further development of directors’ duties and the Combined Code 1998

This Part of the essay will give a brief overview of the three major developments in the field of corporate governance in the U.K. between 1998 and today.²²¹

The first and still ongoing development is the Company Law Review, aiming at “a fundamental review of core company law”.²²² The *Steering Group* has produced four overarching consultative documents: in February 1999 “*The Strategic Framework*”²²³, followed in March 2000 by “*Developing the Framework*”²²⁴, in November 2000 by “*Completing the Structure*”²²⁵ and finally in June 2001 by the “*Final Report*”²²⁶. Con-

²¹⁸ See Fn. 78.

²¹⁹ *Combined Code 2003*, A.7.2.

²²⁰ *Ibid.*, A.3.1.

²²¹ Time of writing: May 2003.

²²² See Fn. 6.

²²³ DTI, *Modern Company Law for a Competitive Economy: The Strategic Framework*. (Hereafter: *Strategic Framework*).

²²⁴ DTI, *Modern Company Law for a Competitive Economy: Developing the Framework*. (Hereafter: *Developing Framework*).

²²⁵ See Fn. 68.

²²⁶ See Fn. 103.

cerning the *Combined Code 1998*, I want to refer only to a few, but in relation to this essay most important issues.²²⁷

First of all it has to be noted, that the *Steering Group* regards the *Combined Code 1998* in its “present structure, relying on disclosure of “comply or explain” type, as powerful and entirely consonant with our overall philosophy of relying (...) on effective transparency and market response.”²²⁸ Therefore, there is no threat for the *Combined Code 1998* to be overruled or supplemented by statutory regulation and it will continue to play an important role as a standard of corporate governance in the U.K.

Secondly, there is a tendency towards juridification with the State setting the corporate governance standards by taking over the control of the *Combined Code 1998*. The *Steering Group* proposed a “Company Law and Reporting Commission, (...) responsible for (inter alia) company law and governance (...).”²²⁹ The expert body under this commission would be the “Standards Board”²³⁰, which would be responsible “for keeping the *Combined Code 1998* under review”.²³¹ This way, the State would be in an overall position to take control over the *Combined Code 1998* and the principles regulated therein.²³²

Thirdly, the attempts of the *Steering Group* to reform and codify the directors’ duties. This had been examined in the *Steering Groups* earlier documents²³³ and has led to a recommendation in the *Final Report* for a legislative statement providing a clear re-statement of directors’ duties.²³⁴ A “trial draft” of such a statement is given as Annex C to the *Final Report*.

The last step in this development was the presentation of the White Paper “*Modernising Company Law*” to the Parliament in July 2002.²³⁵ The White Paper points out that further draft clauses will be published for consultation²³⁶, and the final Companies Bill is anticipated for 2004.

The other development was the “*Turnbull Report*”, dealing with Principle D.2 of the *Combined Code 1998*. The *Turnbull Report* attempts to “flesh out” the internal control principle and the related provisions set out in the *Combined Code 1998* and also the *Combined Code 2003*. Since this principle has not been covered in this essay, further reference to the *Turnbull Report* is beyond its scope.²³⁷

²²⁷ On the Company Law Reform in general: de Lacy (ed.), *Reform*, especially chapter 8 by *Riley; Arden*, JBL 2002, 579 et subs.; *Pettet*, chapter 4; *Lawry*, JBL 2002, 472 et subs.

²²⁸ *Final Report*, paras. 3.63, 5.46.

²²⁹ *Ibid.*, para. 5.21.

²³⁰ *Ibid.*, para. 5.38.

²³¹ *Ibid.*, paras. 5.42, 5.43.

²³² To the question of whether this increase of State involvement will undermine the advantages of self-regulation, see *Riley* in: de Lacy (ed.), *Reform*, 187.

²³³ *Law Commission Paper*, Section B; *Developing the Framework*, paras. 3.1-3.85; *Completing the Structure*, chapter 3.

²³⁴ *Final Report*, paras. 3.5-3.11.

²³⁵ Cm 5553-I and II, <www.dti.gov.uk/companiesbill> (visited on 6 February 2004).

²³⁶ *Ibid.*, p. 12.

²³⁷ On the discussion about the *Turnbull Report*: *Braham*, ICCLR 10 (1999), 335 et subs.; *Smerdon*, ICCRL 11 (2000), 248 et subs.

F. Conclusion

The *Combined Code 1998* sets out “Principles of Good Governance” and a “Code of Best Practice” embracing the *Cadbury*, *Greenbury* and *Hampel Committee’s* work to raise and maintain the standard of corporate governance. But is it still suitable to set a standard for a modern corporate governance system, especially for directors’ duties ?

The approach of a self-regulatory code, linked through the “comply and explain” statement to the *FSA Listing Rules*, has proved to be successful. The data given Part C, III. show that the compliance with the *Combined Code 1998* in practice is fairly high in terms of structure, but can be improved in terms of performance review. The great advantage of having a Code is its flexibility, so that dynamic and quick changes can be made in response to the commercial and market needs. This view is also underlined by the *Steering Group* in their *Final Report*.²³⁸

This success of the self-regulatory approach is notable, since in Germany for example, similar attempts to regulate the issues of “insider dealing” and “merger and acquisition” in form of self-regulatory codes have both failed and were codified.

A positive attitude toward self-regulatory codes by the courts can be drawn from an analogy with the City Code. The courts have held in several cases that the City Code “provided strong evidence that the offer was not fairly made”²³⁹ or that the City Code was “a helpful guide to the City’s view of fairness”²⁴⁰. Thus far, the courts have taken the City Code into consideration when dealing with accounting standards. In the fields of corporate governance, the holding of *Bishopsgate Investment Management Ltd v. Maxwell* states that “in older cases the duties of directors (...) are stated very undemanding. The law may be evolving in response to changes in public attitudes to corporate governance.”²⁴¹ This statements suggests that the courts may eventually accept the *Combined Code 1998* in the same way they are accepting the City Code.²⁴²

Considering the content of the *Combined Code 1998*, the conclusion has to be more diverse. The role and duties of directors within the unitary board of a listed company is to lead and to control the company. Decisions and changes taken about the strategic position and activities of the company have to be taken by the board as a whole, including executive and non-executive directors. The unitary board model offers the advantage of being able to combine the inside knowledge of the executive directors with the outside perspective of the NEDs. But here lie very critical points, the *Combined Code 1998* fails to address satisfactorily.

The directors of a company face themselves in “incompatible but very important functions”²⁴³ having to plan and carry out business decisions and at the same time having to monitor. The *Combined Code 1998* strengthens on the one side the position of the NEDs, but nevertheless, their role, function, duties and responsibility have been subject to a lot of criticism. This is due to the failure to give a satisfactory definition of “independence” and lack to give sufficient guidance for the role of NEDs. A strict

²³⁸ *Final Report*, para. 3.63.

²³⁹ *Chez Nico (Restaurant) Ltd* [1991] BCC 736, 751.

²⁴⁰ *Re a Company* [1986] BCLC 382, 389.
[1994] 1 All ER 261, CA, 264.

²⁴¹ *Ferran*, *Company Law*, 223 et subs.

²⁴³ *Esen*, *ICCLR* 11 (2000), 202 (208).

definition of “independence” will help to raise the standard of corporate governance even further. It is very important to properly define and outline the role, function, duties and responsibilities of the NEDs, because a lot of problems and criticism are connected with this. As outlined, the *Combined Code 2003* has made changes into that direction.

Furthermore, the *Combined Code 1998* does not address any directors’ duties toward the “stakeholder” of the company. It favours the “shareholder value” approach over the “stakeholder value” approach. Although the *Hampel Committee* acknowledged that the stakeholder interests should be taken into account for a good governance²⁴⁴ it was not included in any way into the *Combined Code 1998*. The risk of “short termism” to maximise profits remains.

By cementing the unitary board for the U.K., the *Combined Code 1998* ignores the ongoing discussion in Europe about alternative models. Looking at French Law²⁴⁵, the “societas europaea” under EC legislature²⁴⁶ and the recommendation by the High Level Group²⁴⁷, the opportunity for companies to decide their board structure is being introduced or suggested. But the *Combined Code 1998*’s policy is in accordance with the general attitude of the U.K. against continental European systems.²⁴⁸ Nevertheless, it is odd to see that the discussion about the NEDs emphasises their monitoring role more and more, which leads to the establishment of a “quasi-supervisory board” in the way it exists in Germany. To introduce alternative board structure on a voluntary basis is something worth taking into account. Some authors already go as far as to call for a model differing between NED “consultants” and NED “minders”²⁴⁹ or calling for the abolishment of NEDs in their present form altogether and recommending full-time outside directors.²⁵⁰

Regarding the issues of the position of the CEO and chairman and the board balance, further changes have been made by the *Combined Code 2003*.

Dealing with practical issues such as the flow of information and the time invested by NEDs, it has to be ensured that all directors, but especially the NEDs, have at all time the right to get access to all relevant company documents as well as be able to talk to employees and customers. But it is up to the NEDs to go ahead and get the information necessary, instead of waiting for them to be handed to them. Regarding the time a director invests into his position, the *Combined Code 2003* has put a limit to the number of position the chairman and CEO is allowed to have but no reference has been made to NEDs. It would be useful to also put a limit to the number of NED positions a NED should be allowed to have. Even if the NED position is not a full-time position, it does take up a reasonable amount of time. The case of the former Deutsche Bank chairman of the supervisory board, Hermann Josef Abs, who had up

²⁴⁴ *Hampel Report*, para. 1.3.

²⁴⁵ French Law from 1966/67 gives companies the opportunity to choose between a one-tier or two-tier structure.

²⁴⁶ Council Regulation (EC) No. 2157/2001; *Mayson/French/Ryan*, 452.

²⁴⁷ *High Level Group*, para. 4.1.

²⁴⁸ Especially in regard to the discussion about the “Draft Fifth Directive” see: *Du Plessis/Dine*, JBL 1997, 23 et subs.; Other European Corporate Governance Models: *Dean*, Public Companies, chapter 7.

²⁴⁹ *Davidson*, Co Law 21 (2000), 44 (45).

²⁵⁰ *Lord Young* quoted in *Saleikh*, Co Law 23 (2002), 296 (297).

to 120 position on different supervisory boards, lead to a limitation by statute in Germany.²⁵¹ A limitation is therefore the best way of putting an end to the risk of having a person sitting as NED on too many boards and not having the time to properly fulfil his role.

The performance evaluation suggested in the *Combined Code 2003* will build a good basis for a re-election process, since a re-election of a director without an evaluation is rather useless. To widen the pool of suitable candidates for a board position, it is recommended to emphasise the skills and experience of a candidate and not just consider a “name”. Outside agencies may also be of help to get “fresh people” and not just remembered old fellows. This way, more women might be appointed to boards, since there lies a huge potential looking at the fact that only 6 % of executive and non-executive directors are women.²⁵²

Overall it can be concluded that the *Combined Code 1998* has lead the way to a sound system of corporate governance. Nevertheless, the *Combined Code 1998* was not immune to changing commercial and market requirements and had to be kept up to date to remain on its high level.

This was accomplished by the work of further committees and the issuing of the new *Combined Code 2003*. This new version abolishes some of the criticism and concerns related to the *Combined Code 1998* and establishes some significant changes to the system of corporate governance. Parallel to the work of the *Higgs* and *Smith Committees* the *Steering Group* also works on its review of the core company law. But it has to be kept in mind that with each new regulation, the idea of a flexible approach, consisting out of a set of broad principles rather than a hard and fast set of rules, is pushed into the background.

The *Combined Code* is and will be suitable to set a standard for a modern corporate governance system for directors’ duties in the U.K.

²⁵¹ § 100 Subs. 2 Aktiengesetz (Code for joint-stock companies) limits the number to ten.

²⁵² See. Fn. 74.

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