A MODEL FOR THE ROLE AND EFFECTIVENESS OF
THE NON-EXECUTIVE DIRECTORS

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DEDICATION

This thesis is dedicated to my mother and father.
ABSTRACT

The subject of this thesis is the role and the effectiveness of the role of non-executive directors. The main objective of the thesis is to create a legal model that applies to the non-executive directors and enhances their role, in order to achieve the corporate governance goals including controlling the management of the company, reducing agency costs and mitigating the problems arising from the separation of ownership and control.

The thesis critically analyses the role of non-executive directors by using the different ‘hard law’ and ‘soft law’ sources applicable to the non-executive directors, and by referring to major corporate governance theories related, such as the separation of ownership and control, and the agency costs.

The analysis found that the corporate governance reforms do not enhance the role and the effectiveness of the role of the non-executive directors, as the reforms focus on the structure of the board directors and the appointment of independent non-executive directors, but do not deal efficiently with the actual performance of the non-executive directors.

The thesis proposes a legal model to apply to non-executive directors which ensures the quality of the actual work of the non-executive directors. The proposed legal model takes in consideration that modern corporate governance role of the non-executive directors and provides an enforcement method through a panel specialized in the cases regarding the non-executive directors.
ACKNOWLEDGMENT

Completing my PhD degree is probably the most challenging activity of my first 34 years of my life. The best and worst moments of my doctoral journey have been shared with many people. It has been a great privilege to spend several years in the Faculty of Law at the University of Leicester, and its members will always remain dear to me. My first debt of gratitude must go to my advisor, Dr. Daniel Attenborougu, he patiently provided the vision, encouragement and advise necessary for me to proceed through the doctoral program and complete my thesis. I want to thank Dr. Daniel for his motivation, enthusiasm and immense knowledge, his guidance helped me. In all the time of research and writing of this thesis, I could not have imagined having a better advisor and mentor for my Ph.D. study.

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TABLE OF CONTENTS

Dedication .......................................................................................................................... ii
Abstract ............................................................................................................................... iii
Acknowledgment ............................................................................................................... iv
Table of Contents ............................................................................................................... v

CHAPTER ONE: INTRODUCTION

A- The Separation of Ownership and Control Theory ..................................................... 7
B- Directors’ Duties .......................................................................................................... 11
C- NEDs in the UK Non-Statutory Regulatory Reforms ................................................... 13
D- Research Aims and Objectives ................................................................................... 16
E- The Framework .......................................................................................................... 18

CHAPTER TWO: DIRECTORS’ DUTIES AND THE MODERN ROLE OF NEDs

Introduction ...................................................................................................................... 20
A- General Background ................................................................................................... 22
B- Duty to Promote the Success of the Company ............................................................. 30
C- The Duty of Skill, Care and Diligence ....................................................................... 36
Conclusion ...................................................................................................................... 56
CHAPTER THREE: NEDs IN THE CORPORATE GOVERNANCE CONTEXT

Introduction .................................................................................................................. 58

A- Different Methods that Aim to Control Companies’ Managers ................................. 60

A-1 Shareholders Democracy ....................................................................................... 61
    A-1-a Re-election ....................................................................................................... 62
    A-1-b Modifying the articles of association .............................................................. 62
    A-1-c The removal process under section 168 .......................................................... 63
    A-1-d Derivative claim ............................................................................................. 63
    A-1-e Analysis ........................................................................................................ 64

A-2 The Market Forces .................................................................................................. 66

A-3 The Reputational Factors ...................................................................................... 67

A-4 The Need for NEDs’ Active Involvement as a Part of the Corporate Governance Structure ............................................................................................................. 68

B - NEDs in Different Major Jurisdictions .................................................................... 72

C- The Code’s Approach in Regards to the Case of NEDs .............................................. 85

C-1 NEDs’ Independence ............................................................................................. 86

C-2 Defining the Role of NEDs in the Code .................................................................. 92

C-2-a The role of NEDs on the audit committee ............................................................ 95
    C-2-a-i The role of the audit committee on the financial reporting process .......... 95
    C-2-a-ii Internal auditor ......................................................................................... 100
    C-2-a-iii Risk management and internal controls .................................................... 101

Conclusion .................................................................................................................. 103

CHAPTER FOUR: THE MONITORING AND MANAGEMENT ROLES OF NEDs

Introduction .................................................................................................................. 104

A- Different Points of View on the Dual Roles of NEDs .............................................. 106

B- The Implications of the Delegation of Powers ......................................................... 109

C- Defining the Monitoring Role .................................................................................. 113

D- Monitoring through the Involvement in the Decision making and Strategizing Process .................................................................................................................... 117

D-1 The Levels of NEDs’ Involvement ....................................................................... 120

E- Achieving Accountability ....................................................................................... 125

E-1 Creating Accountability and NEDs’ Behaviour Inside the Boardroom .............. 130

Conclusion .................................................................................................................. 136
CHAPTER FIVE: NEW MODEL FOR NON-EXECUTIVE DIRECTORS

Introduction 138

A- The Need for a Panel to Govern the Role of NEDs 140

B- Analogy with the Takeovers and Mergers Panel 143

C-The Proposed Panel Structure and Function 146
  C-1 Summary of the Panel’s Powers and Tools 147
  C-2 Summary of the Main Governance Code Compliance Rules 150
  C-3 The Work of the Panel Committees and Executive 150
    C-3-a The Code Committee and the Governance Code 151
    C-3-b The Executive 155
    C-3-c The Compliance Committee 156
      C-3-c-i Controlling the delegation of powers through the Compliance Committee 157
        aa- Controlling the formal delegation of authority 157
        bb- Controlling the steps of the decision making process 159
      C-3-c-ii The composition of the board of directors 161
        aa- The size of the board 162
        bb- The required skills 164
        cc- The independence of NEDs 165
        dd- Integrating female NEDs 169
        ee- The method of appointment by the Panel’s Executive 174
    C-3-d The Hearings Committee 174
    C-4 How will the Panel’s Measures Improve the Work of NEDs? 179

D- The Model and the State Intervention 180

E- Exporting Corporate Governance 183
  E-1 The UK as a Corporate Governance Exporter 184
  E-2 Jordan as a Corporate Governance Importer 187

Conclusion 190

CHAPTER SIX: CONCLUSIONS

Conclusions 191
LIST OF REFERENCES

Table of Cases
  UK Cases
  US Cases

Table of Statutes
  UK Statutes
  US Statutes
  Official Documents
  Non-Statutory Reports

BIBLIOGRAPHY

Books
  Edited Books

Articles
  Newspaper Articles
  Websites
  Other
CHAPTER ONE: INTRODUCTION

Many legal systems perceive the role of non-executive directors (NEDs)\(^1\) as a solution for a variety of corporate governance problems.\(^2\) Moreover, the role of NEDs is perceived by investors as the mainstay of good corporate governance and guarantee of the integrity and accountability of companies.\(^3\) Therefore, the appointment of independent NEDs who can bring an independent judgment to the companies’ boards has become a universal practice.\(^4\)

In the UK, the modern role of NEDs was introduced through regulatory reforms presented and designed by the Cadbury Report of 1992.\(^5\) The Cadbury Report aimed to rebuild the investors’ confidence in the financial system after the failures of Maxwell, BCCI and Polly Peck,\(^6\) which came in response to the failure of major companies, mainly BCCI and Maxwell, which raised concerns about financial reporting and accountability. The Cadbury Report further sought to enhance the position of the board of directors by integrating NEDs and independent NEDs.\(^7\)

The high profile company scandals taking place in the last two decades, in addition to the latest financial crisis, focused widely on the role of NEDs.\(^8\) The scandals and failures which were surrounded with wrong or poor management led to disastrous failures and made the public, academics and regulators question the efficiency of the performance of NEDs as monitors over the actions of the management and the company, and protectors for the shareholders and stakeholders’ interests.\(^9\) These concerns focused on directors’ duties in serving as a retrospective

\(^{1}\) Referred to hereinafter all through this thesis as NEDs.
\(^{3}\) T Clarke ‘The Contribution of Non-Executive Directors to the Effectiveness of Corporate Governance’ (1998) 3(3) Career Development International 118.
\(^{4}\) ibid.
\(^{7}\) The Cadbury Report 4.11.
\(^{9}\) M Harner ‘Corporate Control and the Need for Meaningful Board Accountability’ (2009) 94 Minnesota Law Review 542. See also, M Fields & P Keys ‘The Emergence of Corporate Governance from Wall St. to Main St.:
A decade after the establishment of the Cadbury Report, the role of NEDs became a centre of attention through new corporate governance reforms in different jurisdictions, which took place in response to high-profile corporate scandals on the two sides of the Atlantic; such as the collapses of Enron and the ‘new economy’ star companies such as WorldCom, Tyco and Adelphia in the US and Parmalat in Italy. The scandals were surrounded by accounting frauds and senior executives’ mismanagements, and caused a loss of confidence in corporate governance systems, raising the question of serious faults in that system.

The collapses had a catastrophic effect on the markets, economies, governments and investors. The collapsed corporations did not give any early signs of the problems they had, instead their statements used to be signs of strong performance. For example, the dramatic collapse of one of USA’s top fortunate companies in December 2001 (Enron) was the largest bankruptcy in the US history, which also led to the collapse of Arthur Andersen, one of the best accounting companies in the US. One year before the collapse, Enron announced a profit of $979 million. Enron tried to hide its losses by creating Special Purpose Entities (SPEs), as they tried to show that any losses were covered by a third party while in reality, SPEs were merely a part of Enron, and the losses were not covered. Arthur Andersen, the US accounting company used to provide Enron’s with internal and external auditing services, was approved to use high

15 Catanach & Catanach (n13) 1057.
accounting schemes, and approved Enron’s self-dealing.\textsuperscript{16} However, after it was known that SEC made an enquiry in regards to Enron’s accounting, Arthur Andersen shredded numerous documents related to Enron.\textsuperscript{17}

The board of directors of Enron was aware of many fraudulent transactions, and the NEDs were sued due to their reckless approval of the fraudulent transactions, and due to their awareness of the impropriate and high risks of the elements of Enron’s business.\textsuperscript{18}

WorldCom was the largest internet traffic carrier in the world operating in almost 65 countries.\textsuperscript{19} In 2001, the company announced operating income of $3.51 billion on revenues of $35.18 billion.\textsuperscript{20} In the summer of 2002, the company filed for bankruptcy due to massive financial frauds.\textsuperscript{21} Before the WorldCom collapse, much false misleading information was presented, which raised concerns about the integrity of the financial analyst reports of Arthur Andersen; the external auditors of WorldCom.\textsuperscript{22} The board of directors did not help to oversee the audit process and the financial statements. The directors were sued for failure to monitor the company’s actions; in particular, they had signed the registration forms for the plan 401 which violated the Employee Retirement Income Security Action Act of 1974.\textsuperscript{23}

The Parmalat Group was a great complex of sixty eight companies, controlled directly or indirectly by Parmalat S.P.A, which was the main controlling company and the main supplier of milk and dairy food business among the group.\textsuperscript{24} Direct reason behind the collapse of Parmalat was a number of bonds issued, as the company issued a bond of Euros150 million followed with another bond of Euros 200 million. However, Parmalat’s CFO assured that the company is

\textsuperscript{18} Mark Newby v Enron Corporation et al 258 F.Supp.2d 576 (2003).
\textsuperscript{20} In Re WorldCom Inc Erisa Litigation 354 F. Supp.2d 423 (2005) 437.
\textsuperscript{21} ibid 451.
\textsuperscript{22} In Re Worldcom, Inc Erisa Litigation 263 F.Supp.2d 745 (2003).
\textsuperscript{23} ibid.
paying its debits by cash only. Later, in June 2003, it appeared that Parmalat has launched a new bond, while they tried to hide the reality of that bond, and tried to show that this bond was for buying old bonds, but the numbers of the bonds did not match, and the actual amount remained unknown.\textsuperscript{25} Financial operations held by the group of Parmalat were later hidden, and the assets of the group disappeared in the worldwide network of Parmalats’s 260 company.\textsuperscript{26} The board of directors of Parmalat were sued for contributing to giving false representation and structuring transactions that operated to defraud Parmalat’s investors.\textsuperscript{27}

The atmosphere of corporate failure raised the need for corporate governance reforms. The main reforms of the US were presented in the sarbanes-Oxley Act 2002,\textsuperscript{28} while the UK established the Smith Review on audit committees\textsuperscript{29} and the Higgs Review of the role and effectiveness of non-executive directors 2003.\textsuperscript{30}

A few years after the wave of scandals of Enron and other companies, the latest financial crisis took place. The latest financial crisis, which started in 2007, is perceived to be worse than that of the great depression, which occurred in 1929 on global scale,\textsuperscript{31} and is said to be the worst crisis the UK ever witnessed.\textsuperscript{32} The effects of the crisis were severe, and the UK government had to bail out banks at a cost of £850 Billion.\textsuperscript{33} In response to the crisis, the UK issued the Walker Review of Corporate Governance in UK Banks and Other Financial Industry Entities.\textsuperscript{34}

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{26} C Cherubini & P Zei ‘Parmamalt: A Lesson for the Future?’ (2004) 1(2) International Corporate Rescue 63.
\item \textsuperscript{27} In Re Parmalat Securities litigation 375 F.Supp.2d 278 (2005).
\item \textsuperscript{28} Public Company Accounting Reform and Investor Protection Act, the Sarbanes-Oxley Act 2002.
\item \textsuperscript{29} Audit Committees Combined Code Guidance, the Smith Review 2003.
\item \textsuperscript{30} Review of the role and effectiveness of NEDs, the Higgs review 2003. (will be referred to hereinafter through this thesis the ‘Higgs Report’)
\item \textsuperscript{34} A Review of Corporate Governance in UK Banks and Other Financial Industry Entities, The Walker Review, 2009.
\end{itemize}
\end{footnotesize}
Several reasons have been identified for the crisis, such as the mispricing of risk, the employment of irresponsible lending practices and the failure to manage the risk. However, management and boards of directors could not detect or prevent these events. Although there are several reasons for the abovementioned; nevertheless, the weakness of corporate governance systems is considered a direct cause to the problem. The most important example of the company failures in the latest financial crisis was the collapse of Lehman Brothers in the US. Lehman Brothers filed for bankruptcy on the 15th September 2008, which was a dramatic collapse of the fourth largest independent investment bank in the US, the US government refused to bailout the bank, while a year prior Lehman Brothers had reported revenue of $60 billion.

The collapse of Lehman Brothers was surrounded by a misrepresentation of the actual financial situation of the company. Lehman Brothers used to cover the debt of $50 of its balance sheet at the end of every quarter by replacing the debt with cash in the repurchase market. Lehman Brothers also took high risks to achieve their growth policies; breaching their risk policies, the board of directors and the legal gatekeepers failed to take any action to correct the management behaviour. Moreover, analysts also showed that the management of Lehman Brothers did pay large amounts of performance based compensation which were large enough to cover the losses of their initial holdings.

42 Boamah (n40) 16.
Close to the start of the financial crisis, the problems regarding the Northern Rock bank erupted, and the bank announced losses of £1.4 billion in 2008.\footnote{The BBC, available at, \url{http://news.bbc.co.uk/1/hi/in_depth/business/2008/northern_rock/default.stm} (last accessed 30\textsuperscript{th} June 2013).} The Bank asked for help from the Bank of England, which agreed to bail out the Bank in 13\textsuperscript{th} September 2007.\footnote{The BBC, available at, \url{http://news.bbc.co.uk/1/hi/business/6994099.stm} (last accessed 30\textsuperscript{th} June 2013).} However, on 17\textsuperscript{th} February 2008, the government announced that Northern Rock Bank was to be nationalized, as the two private proposals to take over Northern Rock did not provide sufficient offers to cover losses to the taxpayers.\footnote{The BBC, available at, \url{http://news.bbc.co.uk/1/hi/business/7249575.stm} (last accessed 30\textsuperscript{th} June 2013). See also, H Shin ‘Reflections on Northern Rock: The Bank Run that Heralded the Global Financial Crisis’ (2009) 23(1) Journal of Economic Perspectives101.}

In respect of corporate governance and the behaviour of management and the board of directors, there are several problems that may be highlighted. The main problem was the lack of a clear strategy and the risk taking of the company, and they had to oversee the risk management and remuneration system that fits for their risk policy. Moreover, the board of directors had insufficient mechanisms to monitor the implementation of the strategies adopted. A further reason given was the incentives schemes provided, which increased the risk taking of the companies and preferred short term profits over long term profits.\footnote{Kirkpatrick (n38) 66.}

Executive remunerations are one of the functions of the board of directors, where the board should decide on remunerations for the management that reflect the performance of the company. However, the financial crisis showed otherwise, as the remunerations of the executive directors were too high, and did not reflect the financial performance of the company; instead it was ‘rewards for failure’.\footnote{ibid 72.} For example, the scandal of the remuneration of the Royal Bank of Scotland’s former CEO represents a vivid example of the directors’ remuneration problem. The decision of early retirement of Sir Fred Goodwin has doubled his pension package from £8 million to £16, raising waves of protest among major shareholders of Royal Bank of Scotland. The package came in October 2008, after the huge losses the bank suffered.\footnote{J Treanor ‘Fred Goodwin’s Pension Package Under Fire from Top Shareholders’ The Guardian (London, 29 March 2009).}
Therefore, it is argued that this cycle of corporate failures and reforms raised the need for further examination of the efficiency of the role of NEDs, and the efficiency of the corporate governance regulatory framework which designs and governs the role of NEDs. As will be explained in this chapter, NEDs are subject to directors’ duties of the Companies Act 2006, and they are subject to the UK Corporate Governance Code. However, before moving to the directors’ duties and the Code, this section will first refer to the separation of ownership and control theory and its implications, which constitutes the basic theory for the need for the NEDs’ role.

This chapter will be structured as follows; Section (A) on the separation of ownership and control theory. Section (B) on the directors’ duties applicable to NEDs. Section (C) on NEDs in the UK non-statutory corporate governance regulations. Section (D) on the aims and objectives of this research while section (E) is on the framework of this research.

A- The Separation of Ownership and Control Theory

The US witnessed a corporate revolution between 1880s and 1930s, changing the ownership structure of the companies from concentrated ownerships to widely dispersed ownerships. The number of companies with dispersed ownerships was limited. However at the beginning of the 20th century, the change towards the dispersed ownership structure accelerated, due to a wave of mergers which made the owners of the companies either to sell out their full equity rights or to sell large parts of their equity rights, which left them with small non-controlling shareholding. Moreover, these mergers were usually financed partially through public shares, which resulted in dispersing the share ownership among a wide range of investors.

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50 Companies Act 2006 s. 170-177 (Hereinafter referred to through the thesis as ‘CA 2006’).
51 The UK Corporate Governance Code, 2012. (referred to hereinafter and through the thesis by the ‘Code’).
situation led to the rise of professional and skilled managerial organ to run the company instead of the families.\textsuperscript{53}

The same situation took place in the UK later than the US. In the UK the signs of dispersed ownership became clear around the 1950s, as the percentage of companies controlled by a controlling shareholder dropped from one third to one fifth of the companies. Moreover during the 1960s, the number of family controlled companies dropped to become almost swept away in the 1980s.\textsuperscript{54}

The emergence of successful managerial class, which owned little or no shares in these companies, led these companies to the opening of new markets for the industries of rail and telegraph. This opening of the new markets led to the emergence of new managerial companies, which took funds from investors to exploit these markets. During the 20\textsuperscript{th} century, the managerial company became the major player in many of the world’s large economies.\textsuperscript{55}

In 1932, Berle and Means\textsuperscript{56} declared that the American economy was dominated at that time by 200 non-financial companies, and that there are greater possibilities of domination in the future due to the increasing corporate size and centralization. They announced that within these large companies, with dispersed ownership structure, there would be a reduction in the powers of the shareholders, and a gradual increase in the managers’ authority. The extreme level of this shift in the power was when the company became under the management control, particularly when the decision making became dominated by those managers, who had an insignificant shareholding in the company. On the other hand, it is difficult for the shareholders, due to the fact that they were dispersed,\textsuperscript{57} to control the company through voting stock.\textsuperscript{58}

\textsuperscript{53} Cheffins (n52) 89.
\textsuperscript{54} ibid 90.
\textsuperscript{55} A Dignam & J Lowry Company Law (6\textsuperscript{th} edn Oxford University Press Oxford 2010) 374.
\textsuperscript{56} A Berle & R Means The Modern Corporation and Private Property (The Macmillan company, New York 1947) 1.
This situation is not problematic insofar as the managers are running the company in parallel with the owners’ interests, but the problem arises if the managers of the company run the company aiming to achieve personal interests that are not consistent with the interests of the owners. There are always possibilities that managers will deviate from the goals of the company and the goals of the shareholders. Shareholders investing in companies aim to gain the highest profit possible of their business, and want to ensure that the company is run in the best way to achieve this goal parallel to rational risk.

On the other hand, managers might seek personal profit, and aim at different objectives from those of the company. Managers would rather prefer the maximization of the size of the business rather than promoting industry. The policy of seeking growth of the business might be at the expense of investing in competing projects that may increase the profits and shareholders’ returns; instead this may decrease returns and cause a drop in share price. In these cases, the option that shareholders would do is to sell their share. Dodd argues that there is a need for establishing methods to control and prevent managers’ wrong doings and self-interest seeking behaviour.

The examples of cases of company scandals and failures aforementioned in this chapter constitute vivid examples and evidence of the conflict of interest between the shareholders and the company’s managers. As shown in the aforementioned examples, companies’ managers committed fraudulent behaviours, which shareholders and the public in general were not able to detect, moreover companies’ managers were able to manipulate the financial statements and show profits at times when the companies suffered deep losses. In addition, those managers in many cases were able to absorb the company’s profits by receiving very high remunerations, which in some cases could have covered the company’s debts.

61 The Modern Corporation and Private Property (n59) 114.
62 ibid.
64 Company Law (n55) 273.
However, the relationship between the company’s managers and the shareholders could be interpreted through agency theory. Agency theory interprets the relation between the shareholders and the management as a contractual relationship, where the first party; the shareholders ‘the principal’ engages the second party; the managers ‘agent’ to perform services on his behalf, which requires the principal in this case to delegate some of his decision authority to the agent. However, in this case, there are always possibilities that the agent will not always act in the best interest of the principal, and might take decisions for his personal interest rather than the interest of the principal. Moreover, the principal might take measures to limit the possible divergence from his interests by establishing incentive schemes for the agent and by setting monitoring methods, which will also have costs; these costs are referred to as agency costs.  

In this respect, Eisenberg argued that the board of directors, which is elected by the shareholders, and includes members who are independent of executive directors, is the most suitable organ for monitoring company managers. The approach of Eisenberg has been adopted by the report of the American Law Institute on corporate governance, provided that the monitoring role has been the most important function of the board of directors. Therefore the conflict of interest between shareholders and managers, and reducing agency costs are the main reasons for the monitoring role of NEDs, as well as the roles of other monitoring methods like auditors. Therefore the monitoring function aims to prevent executive directors from running the company in their own interests, rather than in the interest of shareholders.


69 Jensen & Meckling (n66) 305, 311.

B- Directors’ Duties

As members of the board of directors, NEDs are subject to directors’ duties codified for the first time in Chapter Two part 10 of Companies Act 2006.\(^{71}\) This thesis will focus on the duty to promote the success of the company,\(^{72}\) and the duty of skill, care and diligence,\(^{73}\) as these two duties apply to every action a NED takes, and courts usually refer to in assessing the performance of NEDs.\(^{74}\) The duty to promote the success of the company serves as the main and most wide ranging duty that applies to all decisions taken by the NED. The duty is built on the duty to act in good faith. The duty to promote the success of the company requires directors to take their decisions in good faith, and according to what they think will promote the success of the company as a whole.\(^{75}\)

The duty of skill, care and diligence requires a director, when performing his role as a role member, to meet the minimum objective standard of the duty of skill, care and diligence, which is the standard of duties expected from a director occupying his position, taking into consideration the size and the business of the company. The duty will also take into consideration the specific knowledge, experience and skills that the director has, but this will only operate through the minimum objective standard.\(^{76}\)

The white paper on modernising company law aimed from the codification to make directors’ duties clearer to directors and to those trying to hold them into account, and to define directors’ duties in line with the standards of best practice by encouraging directors to aim for long term returns instead of short term returns, as well as to take into account the interests of

\(^{71}\) CA 2006, Chapter Two Part 10.
\(^{72}\) CA 2006, s 172.
\(^{73}\) CA 2006, s 174.
\(^{74}\) See- infra ch 2 s C.
\(^{76}\) P Davies Gower and Davies’ Principles of Modern Company Law (8\(^{th}\) edn Sweet & Maxwell London 2008) 491.
other stakeholders such as employees, suppliers, customers and others affected by the company’s commercial practice.77

In terms of corporate governance, strengthening the liability of NEDs is one of the methods used to enhance NEDs’ performance of their role.78 However, as will be shown in the analysis of this chapter, the goal of enforcing the corporate governance role of NEDs through the directors’ duties is not achieved, and this is evident from the very limited number of cases against NEDs.79

It is suggested in this thesis that the problem in regards to enforcing the role of NEDs through directors’ duties is not the substance of the duties themselves; as the current duties, especially the duty of skill, care and diligence, provide good standards to be applied to the case of NEDs. Nevertheless, this thesis suggests that the problem in regards to enforcing the corporate governance role of NEDs through the directors’ duties is in the lack of definition of NEDs, their roles and responsibilities, especially that CA 2006 defines NEDs only as directors, without referring to them as NEDs, and without referring to their role.80 This situation made it difficult for the courts to assess the performance of NEDs in accordance with a defined role.81

The second chapter of this thesis will refer to a number of cases filed against NEDs. However, these cases do not show a wide recognition by the courts of the wide corporate governance role of NEDs, which shows that enforcing the corporate governance role of NEDs through directors’ duties is difficult. Therefore, this thesis does not challenge the quality of the duty of skill, care and diligence. However, this thesis is concerned to find a mechanism that ensures the application of the directors’ duties on NEDs, based on a clear definition of NEDs and their responsibilities.

78 Armour & Mc Cahery (n12) 367.
79 See- infra ch 2.
80 CA 2006 s 250.
81 See- infra ch 2 s C.
C- NEDs in the UK Non-Statutory Regulatory Reforms

It has been mentioned above that NEDs are now part of the UK corporate governance framework, as well as the US and other countries. The Cadbury Report 1992, which came in response to the concerns of the general public regarding market failure, regulated the roles of NEDs through self-regulatory approach. The Cadbury Report provided a voluntary code of best practice to be adopted by the companies.

The Cadbury Report recommended the appointment of NEDs and independent NEDs to the board of directors, requiring boards of directors to appoint at least three independent NEDs. The approach of Cadbury depends directly on the agency theory, which focuses on enhancing the board structure through the appointment of independent NEDs, the notion is that independent NEDs due to their independence will not behave as subordinates of the CEO, and will be able to act as a referee on the board, and bring independent views to different matters of the company.

The Cadbury Report was followed by other corporate governance reports, such as the Greenbury, Hampel, Walker and other reports. However the most important report in regards to NEDs was the Higgs Review on the Role and Effectiveness of the NEDs. The Higgs Report recommended that independent NEDs should comprise at least half of the board of directors.

82 See- infra ch 3 s B.
85 The Cadbury Report.
86 The Cadbury Report 4.11.
89 Committee on Corporate Governance, the Hampel Report 1998.
91 For the UK corporate governance reports, please visit: <http://www.ecgi.org/> (last accessed 30th June 2013).
92 The Higgs Report s 9.5.
The outcome of the different UK corporate governance reports is embodied in the UK Corporate Governance Code 2012, the ‘Code’. The Code designs the corporate governance role for NEDs. According to the Code, NEDs must monitor and scrutinize the actions of the company’s management, and they are supposed to participate in setting the company’s strategy. The Code also requires the NEDs to sit on several board subcommittees. In doing so, the NEDs are supposed to monitor the company’s audit process and check the risk management and internal control systems, set the top management remunerations and nominate the new directors to sit on the board.

However, this thesis identifies different problems and shortcomings within the current corporate governance framework and the Code, in dealing with the case of NEDs. In consistency with the agency theory approach, as aforementioned, the Code focuses on the board structure and the appointment of NEDs and independent NEDs presuming that the existence of NEDs and independent NEDs on the board will suffice for establishing control over the board decisions and the CEO, which will make the management of the company accountable to the board of directors.

Nevertheless, this thesis suggests that this reliance on board structures through the appointment of NEDs and independent NEDs does not suffice for ensuring that NEDs will perform their role. Firstly, because the old NEDs or the non-management officers in the old UK company practice used to play a very passive role, which makes it difficult to expect NEDs to change this old passive behaviour to a proactive monitoring behaviour within this short time.

Those board members appointed to the traditional UK boards were usually appointed for the purposes of reputation, and they were not meant to participate in managing the company or monitoring the management. In this regards, Professor Janet Ulph argues that a change in the culture and mentality of NEDs is required to upgrade the role of NEDs from being in a

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93 The Code.
95 See- infra ch 3 s C.
subordinate position to the executive into taking an active role in checking over the actions of the company.\(^{96}\)

The other reason that makes it difficult to rely only on the independence factor of NEDs, as an assurance that NEDs will perform their corporate governance role, is that NEDs are considered independent according to the independence criteria provided in the Code, nevertheless it is suggested that there is no criteria that can ensure the independence of NEDs. There are several social and psychological factors that affect the independence of NEDs, and their ability to act through their time of service on the board independently from the management and from the other board members.

These problems start from the appointment of NEDs, where NEDs are usually appointed with the influence of the company’s CEO, who will usually choose NEDs from the CEO’s network and friends, and will choose the characters that will fit with his board, his business approach and views. Therefore, those NEDs will owe their appointment to the CEO, which will make it very unlikely that they will oppose the views and proposals of the CEO.\(^{97}\)

Other social and psychological problems are referred to as the ‘cognitive’ biases. Cognitive biases suggest that a NED will tend to oppose and cancel the views of other directors on the board, thinking that such behaviour will lead to better decisions. Nevertheless, this kind of behaviour might lead the NED to depart from the rational choice model. In addition to ‘cognitive biases’ there are other problems referred to as the ‘herding reasons’ which suggest that a decision maker would follow the actions of other directors rather than taking his decision according to his personal beliefs.\(^{98}\) Moreover, the group thinking of the board of directors would help the board members to avoid disturbing the unanimity surface of the board.\(^{99}\)

Moreover, according to the theory of the ‘escalating commitments’, the long term service of the NEDs on the board of directors would also affect the objectivity of NEDs. The theory

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\(^{97}\) See- *infra* ch 3 s C-1.


suggests that once NEDs approve the decisions of the management, they become committed to these decisions and they will not dispute it the following year, and they are most likely to make their future decisions compatible with the old ones. The abovementioned social and psychological factors that impair the independent judgment of NEDs will be explained thoroughly in Chapter Three of this thesis.

In addition to the abovementioned problems, in regards to the independence of NEDs, another shortcoming in the current Code is the weak drafting of the Code, which makes the actual roles and responsibilities of the NEDs unclear. The Code requires NEDs and independent NEDs to perform the dual management and monitoring roles, however the Code does not entail, to any degree of particularity, how the roles are supposed to be performed; the current drafting uses very general terms, ignoring the sophisticated steps and dynamics of the steps of decision making.

Therefore, as will be argued in Chapters Three and Four of this thesis, ensuring the effectiveness of the role of NEDs requires the creation of an effective enforcement mechanism that focuses on the actual performance of NEDs, especially insofar as the current enforcement mechanism provided by the Code is the ‘comply or explain’ method, which only covers the compliance with the board structures and the appointment of NEDs but not the actual performance of NEDs.

D- Research Aims and Objectives

This research aims to examine and analyse the modern role of NEDs in the UK corporate governance system, through referring to the Code and the corporate governance reforms. The research will refer to the separation of ownership and control theory, and the agency theory as the basic theories for explaining the need for the NEDs’ corporate governance role.

100 J Macey Corporate Governance: Promises Kept Promises Broken (Princeton University Press New Jersey) 58.
101 See- infra ch 3 s C-1.
102 See- infra ch 4.
The research aims to assess the role and performance of NEDs, compared to the main goals of the NEDs’ corporate governance role, such as controlling the company’s CEO and top management, and ensuring the accountability of the management to the board of directors, and the main goal of controlling the company in general, through controlling the companies decisions, audit process, risk management and top management’s remunerations.

The research further seeks to identify the determinants and factors required to ensure the good performance of NEDs to their corporate governance role.

In addition, a goal of the thesis is to analyse the framework of the laws and regulations which NEDs are subject to, aiming from this analysis to identify any shortcomings in the framework, which affect the performance of NEDs, in order to provide solutions for these shortcomings in the new model for the NEDs which will be proposed in this thesis.

The main objective of this thesis is to enhance the position, role and performance of NEDs on the company’s board of directors, to make them perform an effective corporate governance role, in order to make NEDs control the companies’ managers and the conflicts of interests between companies’ managers and the shareholders and to reduce the agency costs.

In addition, the thesis has the objective of creating a regulatory framework which is able to overcome the problems of the current corporate governance framework that NEDs work within. This proposed new regulatory framework should enhance the roles, responsibilities and performance of NEDs.

Moreover, this thesis, in analysing the theories, laws and regulations that determine the work of NEDs will create new focused directions for further research to be added to this research, in order to enhance the position of NEDs on the company’s board.
E- The Framework

As has been explained in this chapter, this thesis analyses the effectiveness of the role of NEDs within the UK corporate governance framework. The main goal of the thesis is to suggest a new model for the NEDs, in order to enhance their position and enable them to meet their corporate governance responsibilities. In order to do so, this thesis will analyse the laws, regulations and theories which relate and determine the NEDs roles and responsibilities, starting with the directors’ duties of CA 2006, and the recommendations of the Code, and the basic theories applicable to NEDs, and most importantly, the separation of ownership and control theory and the agency theory. The research will depend on a wide range of primary and secondary resources. The secondary resources in this thesis will focus on the legal journals, in addition to journals from other sciences mainly management.

The thesis will be divided into six chapters, including this introductory chapter and chapter six, which is the conclusion.

Therefore, Chapter Two will analyse directors’ duties, particularly the duties to promote the success of the company and the duty of skill, care and diligence. The chapter does not challenge the quality of the standards of this duty. Nevertheless, it will focus through studying a number of key cases on the NEDs, on identifying the courts approach in regards to NEDs

The third chapter will critically analyse the role of NEDs within the UK corporate governance framework. It will analyse the Code’s approach in regards to NEDs, and the application of the agency theory in regards to the reliance on the integration of NEDs, independent NEDs and the board structures. The chapter will also refer to the integration of NEDs into different types of boards in different jurisdictions.

The fourth chapter will critically analyse the dual monitoring and management roles of NEDs, and define the role of NEDs in the decision making steps of the company, in order to define the best type of NEDs’ involvement in the decision making steps, which could achieve an effective monitoring and management roles.
On the basis of the analysis, the findings and the identified obstacles and shortcomings of the chapters from one to four, the fifth chapter will propose a new model to govern and regulate the role of NEDs in the UK. The proposal will take into account overcoming the different obstacles in the current UK corporate governance system, in order to upgrade the position of NEDs in the future into an effective corporate governance player in the UK corporate governance system and in other jurisdictions, due to the influence of the UK corporate governance system over a wide range of other jurisdictions.

The sixth chapter is the conclusion, which will provide the final remarks of this research and recommend further future research that could benefit from the case of NEDs.
CHAPTER TWO: DIRECTORS’ DUTIES AND THE MODERN ROLE OF NEDs

Introduction

The first chapter highlighted the severe consequences and the contribution of the weak corporate governance mechanisms to companies’ failures, and also referred to the latest financial crisis which affected almost all the world. The previous chapter presented the basic theories and the background behind the need for NEDs’ involvement as a major corporate governance player and as a core element in the UK corporate governance model. The chapter referred to the main laws and regulations that govern the role of NEDs in the UK corporate governance system, and pointed out that NEDs are subject to the non-statutory corporate governance reforms represented in the Code, and subject to the CA 2006 which includes the codified directors’ duties in part 10 Chapter 2 s. (170-177), in addition to the common law duties. This chapter analyses the directors’ duties of CA 2006 and common law, and its fitness in assisting the effectiveness of the NEDs’ corporate governance role.

Directors’ duties represent the enforcement of NEDs’ obligations retrospectively, through litigation, while corporate governance is concerned with the managerial qualities of the companies. There are different methods to ensure the application of the corporate governance standards. In this respect, lawyers tend to focus on directors’ duties; particularly, duty of skill and care as a method to ensure managerial quality. Directors’ duties are firstly supposed to design behavioural expectations, which are how we expect directors to behave. And secondly, they are supposed to serve as a stick or deterrent element which holds the directors liable for failure, in order to meet their behavioural expectations.

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1 See- Ch 1.
2 See- Ch 1.
3 CA 2006 Part 10 Chapter 2 s170-177.
4 See infra s (C).
7 ibid.
The importance of directors’ duties and private enforcement increases in countries with dispersed ownerships such as the UK and the US, as in these countries companies’ managers gain excessive powers, which makes the need for methods to control companies’ managers a major issue.\textsuperscript{9} Today, directors’ duties are under the spotlight again, especially after the recent financial crisis, which renewed emphasis on company directors’ duty to practice oversights.\textsuperscript{10} Several scholars have attributed the rise of the crisis, in part, to the weakness of oversight liability standards,\textsuperscript{11} which raised controversy regarding the definition and enforcement of directors’ duties.\textsuperscript{12}

This chapter will analyse directors’ duties, which applies to executive directors and NEDs, by referring to cases and judicial decisions related specifically to NEDs. The chapter will consider the basic duty to promote the success of the company, and the duty to act with skill, care and diligence, as both duties are the most wide ranging duties which apply to all actions and decisions made by the NEDs. Moreover, the chapter will place particular emphasis on the duty of skill, care and diligence, as the duty sets the standard of performance required of NEDs in practicing their role. This chapter does not seek to change the directors’ duties codified in CA 2006; nevertheless, it will argue that there is a need for courts to better understand and recognise the modern corporate governance role of NEDs.

This chapter will be structured as follows; section (A) will be a general background, which will firstly highlight the background of the directors’ duties, and secondly will focus on the importance of directors’ duties in enhancing the performance of NEDs. Section (B) will be on the duty to promote the success of the company codified in s. 172 of CA 2006. Finally, and most importantly, Section (C) will be on the directors’ duty of skill, care and diligence codified in s. 174 of CA 2006.

\textsuperscript{11} ibid 445.
\textsuperscript{12} J Coulton & S Taylor ‘Directors’ Duties and Corporate Governance: Have We Gone Too Far?’ (2004) 14(1) Australian Accounting Review 17.
A- General Background

Directors’ duties were originally developed by courts of equity in analogy to the rules applying to trustees.\(^{13}\) For example in the case of *Charitable Corporation v Sutton*,\(^ {14}\) Lord Hardwick held ‘committee-men’ or directors of the charitable corporation liable for ‘breaches of trust’. The dominant view for interpreting the origin of this concept is that more than a hundred fifty years ago, most companies were unincorporated and established by a deed of settlement, with no official recognition; therefore, at that time, directors were trustees in the full technical sense. This concept persisted even after the general incorporation, when companies owned properties in their own right.\(^ {15}\)

Len Sealy comments that the continued presence of the old label is due to the lack of other interpretations of the position of director, and his duties in the limited legal vocabulary. The difference between the trustee in the strict meaning, where the property of others is vested in him for the benefit of others, was not defined separately until the expression fiduciary was accepted in the nineteenth century; differentiating true trust from other relationships including the relation between a director or a promoter and his company.\(^ {16}\)

Fiduciary duties are trust principles which directors’ liability is traditionally based on; however commercial practice identified differences in the role of directors and the role of trustees.\(^ {17}\) Some of these differences were recognised by the courts; for example in the case of *Re Kingston Cotton Mill (No.2)*,\(^ {18}\) Vaughan Williams provided that ‘a director is in no sense a trustee’.\(^ {19}\) Nevertheless, Bacon V-C in the case of *Re Exchange Banking Co, Flitcroft’s*\(^ {20}\) provided that ‘they are trustees and nothing else’.\(^ {21}\) Len Sealy commented that both judges are correct, but each of them is looking at one half of the picture.\(^ {22}\)

\(^{13}\) P Davies *Gower and Davies’ Principles of Modern Company Law* (8th edn Sweet & Maxwell London 2003) 477.


\(^{15}\) L Sealy ‘The Director as a Trustee’ (1967) 25(1) The Cambridge Law Journal 83.

\(^{16}\) ibid 86.

\(^{17}\) ibid.

\(^{18}\) [1986] 1 CH 331.

\(^{19}\) ibid 345.

\(^{20}\) (1882) 21 ChD 519.

\(^{21}\) ibid 525.

\(^{22}\) Sealy (n15) 86.
Both directors and trustees are required to control funds for the benefit of other beneficiaries.\(^{23}\) Trustees have to protect the fund and they should manage it in the best interest of the beneficiaries.\(^{24}\) In doing so, the discretion of a trustee is limited by the law of trust or by court practice, which prescribes and fetters his activities within the limits of proper course, where he should be careful to avoid unnecessary risks.\(^{25}\)

On the other hand, despite the number of similarities between trustees, there is a significant difference, namely that directors manage a separate legal entity that is distinct from its members, and that directors run companies in their nature as commercial ventures, and they should run it with entrepreneurial spirit which generally allows them to take risks to some degree.\(^{26}\) Therefore, businesses are supposed to be run according to the judgment of the directors as businessmen, while courts were not competent or willing to assess their discretion, in this sense, directors are not obliged to avoid the risks, but to decide on the worthiness of the risk taking.\(^{27}\)

Therefore, directors’ duties codified in Chapter 10 part 2 of CA 2006\(^ {28}\) could be divided to duties of loyalty developed by courts of equity on the fiduciary principles bases, and the duty of skill and care which developed mainly on the principles of the law on negligence.\(^{29}\) While the first requires a director to be loyal to his company, the second, which is the duty of skill and care, requires a director to be competent when acting as a director.\(^{30}\)

However, the position of NEDs witnessed development on two levels. In the last one hundred years, the position of NEDs developed in the case law, as courts increased the

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\(^{23}\) ibid.  
\(^{25}\) Sealy (n15) 89.  
\(^{26}\) D Arsalidou The Impact of Modern Influences on the Traditional Duties of Care, Skill and Diligence of Company Directors (Kluwer Law International London) 90, 91.  
\(^{27}\) Sealy (n15) 89.  
\(^{28}\) CA 2006 s. 170-177.  
\(^{29}\) Gower and Davies’ Principles of Modern Company Law (n13) 488.  
\(^{30}\) Company Law in Context Text and Material (n8) 290.
expectations of NEDs’ behaviour, through the duty of skill, care and diligence. In terms of the other dimension, the role of NEDs developed through the business best practice and the non-statutory corporate governance reforms, which are currently embodied in the Code and the other non-statutory reports. It is important to highlight this development, in order to assess the consistency between the two dimensions, which is one of the objectives of this chapter.

The norm in British corporate practice was that companies are run by boards, which consist wholly or largely of managing directors. Meanwhile, NEDs in their old traditional role, were not relied on as an oversight and controlling element on the board and the company, and they were not supposed to be independent; as NEDs in the UK were supposed to be united in their view and policy with their managing colleagues, and to appear to the public and shareholders as a united governing unit. In the case of conflicts inside the board, the minority directors were supposed to resign, as Britain was not in favour of ‘coalition-boards’.

Moreover, it was very common in the UK to appoint nobles to serve as directors on the board. These people used to lend their names to corporations to influence the public towards the company, by giving good reputation to the board that has aristocrat members, this kind of directors were called guinea-pigs as they were used to take their fees in guineas. Other directors were appointed to the board after their removal from the managerial level. In other cases, there were kinds of directors who are different from the aforementioned type ‘guinea-pigs’, but they are directors who can participate in the decision making; such directors usually represent large clients. They were appointed as a complement to large clients, but they were expected under the UK company practice to serve as silent watch-dogs or watch-dogs who are not meant to bark.

At the judicial level, courts in the beginning of the century used to accept the inactivity of NEDs, as will be explained in section (C) of this chapter. Moreover, courts emphasised that

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31 See- infra s (C).
32 For the UK corporate governance reports, see- <http://www.eegi.org/> (last accessed 30th June 2013).
33 Gower and Davies’ Principles of Modern Company Law (n13) 317.
35 A Rubner The Ensnared Shareholder: Directors and The Modern Corporation (Macmillan London 1965) 58.
36 ibid.
37 See- supra s (C).
NEDs may be appointed to the board with ignorance of the main business of the company, and that they did not have to take any definite role in running the company’s matters. This proposition is evident in the case of *Re Brazilian Rubber Plantations and Estates Ltd*, which will be explained in section (C) of this chapter.

However, as will be featured in section (C) of this chapter, courts changed their approach regarding NEDs through several cases, indicating that NEDs should not take a passive role on the board and the company, as was the case in the abovementioned *Brazilian Rubber* case. This development was by increasing the expectations of the role of NEDs through increasing the expected standard of NEDs’ performance, which could be achieved by linking the expected standard to the minimum standard expected of a NED serving on the same size of the company, as well as taking into consideration any additional skills that the particular NED possesses. This proposition was adopted in the case of *Re D’Jan of London Ltd*, and other cases which will be explained in section (C) of this chapter.

From the other dimension, the corporate governance role of NEDs also developed requiring NEDs to perform a challenging role and to participate in building the corporate strategy, to scrutinize the performance of management in order to ensure that the management actions are in the best interests of the corporate goals and objectives, and to ensure the soundness of the internal control and risk management systems.

The effectiveness of the corporate governance self-regulatory system requires the imposition of legal duties and sanctions on the individual participants of the company, in order to ensure that those individual participants such as managers, auditors and NEDs do actually comply with their corporate governance roles. In regards to ensuring the compliance of NEDs

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38 [1911] 1 Ch 425.
39 See supra s (C).
40 [1994] 1 BCLC 561 (ChD).
with their corporate governance role, scholars usually refer to the need to apply directors’ duties with wide interpretation, this ensures that NEDs do monitor the management and the business.\textsuperscript{44}

For example, some corporate scandals might have been avoided, or at least mitigated, if the directors took an active position on the companies’ boards; however ensuring the active involvement of NEDs requires effective application of directors’ duties, especially the duty of skill, care and diligence.\textsuperscript{45} Nevertheless, in practice, the duty of skill, care and diligence does not seem to have achieved this purpose, and it is more like a toothless tiger.\textsuperscript{46}

In order to enforce the role of NEDs through directors’ duties, there must be a definition of responsibilities.\textsuperscript{47} At least theoretically, the board of directors has the powers to manage the company; however the board of directors delegates the managerial powers to the management and lower management.\textsuperscript{48} Accordingly, the board of directors continues to have an undefined role, as the CA 2006 case law does not define the role of the board at any level of particularity.\textsuperscript{49} Different questions arise due to the delegation of powers. The most important question is the extent to which the board of directors is responsible for the company performance, and how far are they allowed to rely on the management in taking their decisions. Moreover, do they have to supervise the management when executing the policies and the daily management?

One of the most difficult questions in the company is whether the board has a duty to prevent harm to the company.\textsuperscript{50} In this respect, another difficult question arises as to whether directors are liable for failure to respond to signs of wrong doing, or illegality, as in this case the


\textsuperscript{45} E Nowicki ‘Director Inattention and Director Protection Under Delaware General Corporation Law Section 102 (b)(7) A Proposal for Legislative Reform’ (2008) 33 Delaware Journal of Corporate Law 695.


\textsuperscript{47} ibid 206.

\textsuperscript{48} Part (2) Regulation (5) The Companies (Model Articles) Regulations 2008.

\textsuperscript{49} Griggs & Lowry (n46) 206.

\textsuperscript{50} Pan (n44) 209-210.
liability for the directors is regarding what they failed to do. The courts difficulty in this context is to assess whether the board should have done something instead of remaining silent.\(^{51}\)

A further problem is regarding the company mismanagement, especially in the cases where the mismanagement is not associated with the conflicts of interests or personal gain of the directors. Historically, directors’ fiduciary duties used to deal with the problems related to directors defrauding the company. However, most of the company failures which occurred in the latest financial crisis did not show that the NEDs were involved in illegal activities and financial manipulation, instead the problem was in the boards’ performance in controlling risk management programs, and it was one of the main reasons contributed to the financial crisis.\(^{52}\)

This was the case in the UK, where directors’ incompetence and mismanagement were the major cause of the crisis, mainly due to adopting reckless risk taking policies that contributed to the massive bank losses.\(^{53}\) For example, the difficulties that the Royal Bank of Scotland faced, and required partial taxpayer bailout support, were due to a series of bad decisions taken immediately in the years before the financial crisis, most importantly, the acquisition of ABN AMRO in 2007 and the capital raising in 2008. However, the FSA’s close supervisory investigation of RBS assured that these bad decisions did not involve lack of integrity by any individual, or any fraudulent or dishonest activities committed by any individual.\(^{54}\)

In the Case of Northern Rock, the treasury committee report on Northern Rock ‘The Run on the Rock’ described the board of directors of Northern Rock as the principal authors of difficulties that Northern Rock suffered since August 2007, accusing the board of directors of adopting a reckless business model, that was excessively reliant on wholesale funding.\(^{55}\) Northern Rock applied an expansionary lending policy that was successful as long as there were

\(^{51}\) ibid.
\(^{52}\) Petrin (n10) 437.
\(^{54}\) FSA closes supervisory investigation of RBS page 1.
no problems on the funding side, ignoring the potential risks if the market became less liquid.\textsuperscript{56} Nevertheless, there was a lack of insurance to cover the troubles that Northern Rock faced.\textsuperscript{57}

Two observations may be made in regards to the previous two UK examples, Northern Rock and Royal Bank of Scotland. The first is that the boards of the two companies showed incompetent performance, and adopted reckless decisions that led to massive financial losses to the companies. The second observation is that up until today, no litigation cases were filed against the board members of the two companies; rather, the new board of Northern Rock was advised not to take any legal action against the former directors, as the there are no sufficient grounds to prove negligence against the former directors.\textsuperscript{58}

Referring to the argument of Kraakman as aforementioned in this section, which calls for a widely interpreted duty of directors that covers the different actions of the individual participants of the company, it is suggested that the application of the directors’ duties, especially the duty of skill, care and diligence should be analysed in order to see whether this duty could cover the corporate governance expectations of the role of NEDs.

As agents, directors stand in a fiduciary relationship with the company, as they are agents carrying on the business on behalf of the principal ‘shareholders’. Therefore they owe fiduciary duties or duties of loyalty to the company, in addition to the duty of skill, care and diligence.\textsuperscript{59}

Before the codification of the directors’ duties in CA 2006, directors’ duties were found in:

‘…in a confusing and compendious mass of case law and the occasional statutory measure.’\textsuperscript{60}

\textsuperscript{56} ibid 14.
\textsuperscript{57} ibid.
\textsuperscript{59} CA 2006, s 174.
\textsuperscript{60} L Roach ‘The Legal Model of the Company and the Company Law Review’ (2005) 26 Company Lawyer 98.
The white paper\textsuperscript{61} explained the need for codification as follows:

\textit{‘The Company Law Review Steering Group concluded that the law on this matter had become unclear both for directors themselves and for those trying to hold them to account. Furthermore, the Review Group expressed the opinion that the law ought to be revised to bring it into line with the existing best practice, encouraging directors to look beyond maximising short term returns to institutional shareholders toward longer term and to recognise the roles that relationships with other stakeholders, such as employees, suppliers, customers and others affected by the company’s commercial activities, play in the success of the company’}\textsuperscript{62}

Directors’ duties of Chapter Two part 10 s.(170-177) of CA 2006 applies to all directors, regardless of whether they are executives or NEDs. This section aims to define the duties and liabilities of directors, in order to assess the outcome in accordance with the corporate governance standards and requirements, and to check whether the current duties are fit for the purpose especially regarding NEDs, and whether these duties can work as an incentive for NEDs to perform an effective role. Moreover, in the absence of a definition of NEDs and their role, the section aims to clarify the expectations of courts regarding NEDs’ role and involvement in the company’s affairs in order to assess this in the following chapters, in relation to the corporate governance standards.

The following subsections will discuss the two main basic duties regarding NEDs. The first will be the duty to promote the success of the company, which is the basic duty for directors, and the most wide ranging duty which applies to every action that a NED takes. The second will be the duty of skill, care and diligence, which has developed the expectations of the NEDs’ standard of performance over the last century. The following subsections will explain the statutory duties, and also refer to common law duties and related cases.

\textsuperscript{61} See- ‘Modernizing Company Law’ White Paper Sixth Report Session 2002-03.

\textsuperscript{62} ibid 10.
B- Duty to Promote the Success of the Company

The directors’ fiduciary relationship of trust and confidence places them under a duty of loyalty as a primary obligation. The purpose of the duty is to control the human weakness. In the case where the personal interest of the agent’s conflicts with the fiduciary obligation, the duty obliges the agent to act for the benefit of the principal. The fiduciary duties traditionally included the ‘no conflict’ and ‘profit rules’. In addition, directors have a duty of strict compliance, which means they need to act within the terms of their appointment, and they have to comply with the memorandum and articles of association of the CA 2006.63

This section will discuss the duty to promote the success of the company of s.(172) of CA 2006 as the basic loyalty duty for directors, which applies to all decisions taken by the directors. The duty to promote the success of the company could count as the successor of the basic duty to act ‘bona fide’, as the phrase to act ‘bona fide’ in the interest of the company is reflected in the wording of s. (172). The duty counts as the fundamental duty of directors, and the other duties mentioned in Chapter Two of Companies Act 2006 are mostly applications to the core duty, and this is shown clearly in the duty of s.(175),64 which requires directors to avoid conflicts of interest.65

The duty to promote the success of the company is codified in s. 172 (1)66 of the CA 2006 as follows:

‘(1) A director of a company must act in a way he considers, in good faith, and most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to-
(a) the likely consequences of any decisions in the long term,
(b) the interests of the company’s employees,

64 CA 2006, s 175.
65 Gower and Davies’ Principles of Modern Company Law (n13) 506.
66 C A 2006, s 172 (1).
(c) the need to foster the company’s business relationships with suppliers, customers and others,
(d) the impact of the company’s operations on the community and the environment,
(e) the desirability of the company maintaining a reputation for high standards of business conduct, and
(f) the need to act fairly as between members of the company."67

The duty requires directors to take their decisions in ‘good faith’ according to what they think, not what the court thinks, and this will most likely promote the success of the company.68 The duty in its current wording did not seem to bring significant change from the old common Law duty which provided to act in ‘good faith’ and in what directors believed is in the best interest of the company; especially that it has always been a core requirement to act in ‘good faith’ and to ‘promote the success of the company’69. This is what was provided in several cases, for example the case of Aberdeen Railway Co v Blaikie Brothers70 where Lord Cranworth Stated:

‘A corporate body can only act by its agents, and it is of course the duty of those agents so to act as best to promote the success of the corporation whose affairs they are conducting’.71

A further example is the case of Re Smith & Fawcett Ltd,72 which provided:

‘They must exercise their discretion bona fide in what they consider- not what a court may consider- is in the interest of the company…’.73

67 ibid.
70 Lee (n63) 328 (citing Aberdeen Railway Co v Blaikie Brothers).
71 ibid 329 (citing Aberdeen Railway Co v Blaikie Brothers).
72 [1942] Ch. 304.
73 ibid 306.
If the directors provided unequivocal evidence that they acted honestly and according to what they believed is in the best interest of the company, then the court will consider their act in good faith. However, a director needs to convince the court that he honestly believed that his action was in the best interest of the company.Yet, for the court to decide that a director has breached his duty to act in good faith is not simple; for example, even if the court does believe that a director did not act as honest men of business should act, this is not in itself a sufficient evidence that the duty to act in good faith has been breached. In the case of *Extrasure travel Insurance Ltd v Scattergood*, the directors’ decision caused severe losses to the company, and the court did not believe that at the time, they honestly believed that the transfer of the money was in the best interests of *Extrasure*, but this was not sufficient evidence to prove that directors had breached their duty to act in good faith. Paul Davies believes that it is not easy to prove that directors have breached their duty to act in good faith; as he noted:

‘This is because it is very difficult to show that the directors have broken the duty of good faith, except in egregious cases or cases where the directors, obligingly, have left a clear record of their thought processes leading up to the challenged decisions.’

The main addition in s. 172 (1) was the requirement of directors to act ‘for the benefit of its members as a whole’, and listed the different categories of stakeholders and issues that a director should care about when taking decision, including the duty of directors to recognise the success of the company in the long term. According to the Company Law Reform 2005, the new duties of directors should be up to date in terms of modern business needs. It was emphasized that:

‘The CLR proposed that the basic goal for directors should be the success of the company for the benefit of its members as a whole; but that, to reach this goal, directors

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74 *Gower and Davies’ Principles of Modern Company Law* (n13) 512.
75 ibid 512.
76 2002 WL 31599760.
77 *Gower and Davies’ Principles of Modern Company Law* (n13) 510.
78 CA 2006 s. 172 (1).
79 CA 2006 s. 172 (1).
80 CA 2006 s. 172 (1) a.
will need to take a properly balanced view of the implications of decisions over time and forester effective relationships with the employees, customers and suppliers, and in the community more widely. The government strongly agrees that this approach, which the CLR called the “enlightened shareholder value”, is most likely to drive long-term company performance and maximize overall competitiveness and wealth and welfare for all.\textsuperscript{82}

This interpretation of the proposition leaves the primary duty for a company director is to maximize the value for a company’s shareholders, especially insofar as directors have always owed their duty to the company, as the enforceability of the duties is through the company, either through the board or its members.\textsuperscript{83} Nevertheless, the approach finds that the best way to achieve this goal is by considering the different relationships of the company with the different stakeholders, such as employees, customers, suppliers creditors and others, aiming to place emphasis on the long term performance of the company and not only the short term, as expressed in the aforementioned s. 172 (1) (a). Therefore the application of this duty means that directors’ main duty revolves around shareholders’ interests. Nevertheless, in doing so, they should have regards to the other stakeholders of the company, meaning that stakeholder interests come through practicing the duty to promote the success of the company for the members as a whole.\textsuperscript{84} Therefore, it appears that it is left to the directors’ discretion to decide on whether to take into consideration the interests of the other groups.\textsuperscript{85}

Moreover, CA 2006 did not define the term ‘success’ or how success could be measured. The term success is a blurred term, which does not show what conduct is required from directors to count as success.\textsuperscript{86} The success of the company may refer to what the objectives of the company are, as they are drafted in the company’s articles. This may include financial, strategic

\textsuperscript{82} Company Law Reform White Paper March 2005, para (3.3).
\textsuperscript{83} P Loose, M Griffiths & D Impey The Company Director: Powers Duties and Liabilities (10\textsuperscript{th} edn Jordan Publishing Ltd London 2008) 285.
or other, and in some cases, it could be non profitable in the cases of non-profit companies. The explanatory notes of CA 2006 provided on the decision as to what will promote the success of the company as follows:

‘The decisions as to what will promote the success of the company, and what constitutes such success, is one for the director’s good faith judgment. This ensures that business decisions on, for example, strategy and tactics are for the directors, and not subject to decision by the courts, subject to good faith.’

Article 172 (1) required directors to promote the success of the company; however the CA 2006 duty did not bring significant change to the old duty from this angle, as both duties leave discretionary power to the directors to act on what they believed at the time was in the best interest of the company. The approach was the close to the approach of the case of Re Smith & Fawcett [1942] Ltd.

The impression taken from the drafting and application of the duty to promote the success of the company is that the duty gives the directors wide discretionary powers to take their decisions. Firstly, the ‘good faith’ requirement is not subject to a reasonable test, (except in very exceptional circumstances) and the decision is according to what the director thinks, not what the court thinks is in the best interest of the company. Secondly, s. 172 (1) does not define ‘success’, which leaves the decision regarding strategy planning and tactics to the directors in what they see will best serve for the companies’ objectives.

The duty also requires directors to take into consideration the consequences of the decisions on the long term, meaning as explained by the Company Law reform Bill, aiming for long term profit and performance of the company over the short term profit. The preference of short term profit over long term profit has been referred to as one of the problems that

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87 Keay (n69) 15.
88 Explanatory Notes to Companies Act 2006.
89 ibid para 327.
90 In Re Smith and Fawcett Limited (n72).
91 CA 2006 s 172 (1) a.
contributed to the financial crisis. Managers usually prefer short term profit to long term profit, as long term profit does not show their success at the time of their service. Instead, the fruit of adopting long term profit policies usually appears at the time of the successor managers. Moreover, managers’ remuneration packages are linked to the performance of the company at the time of their service. Therefore it will be more profitable for the managers to aim for short term profit for the company. The preference for short term profit is not adopted not only because of the managers’ preference, but also because of shareholders’ pressure.

However, different obstacles arise regarding the obliging of the board of directors and the NEDs to make their decisions in accordance with the long term profit policies, rather than short term. The first is that the duty only mentioned the phrase ‘long term’ without defining long term profit not even in a broad definition, not to mention that the definition of the long term profit is very difficult. Meanwhile, the other problem of holding directors liable for the breach of the duty is to establish that they have not acted in good faith, which is again and as aforementioned a difficult task.

Therefore, in applying the abovementioned discussion of the duty to promote the success of the company to the case of NEDs and particularly their modern corporate governance role, which requires them to take an active position on the company and to act in accordance with the corporate governance best practice, the duty does not seem to have a significant influence. Although the duty to act in ‘good faith’ and the old duty to act ‘bona fide’ and the applications of the duty served historically for the cases of directors defrauding the companies’ assets or making secret or illegal profits. Nonetheless, the modern problem, as aforementioned, is in the cases where companies suffer of economic losses, resulting from poor management and without the existence of illegal activities, conflict of interest or personal gain.

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93 See supra Ch 1.
95 Keay (n69) 24.
96 ibid.
97 ibid.
The basic need to establish the fact that the director did not act in good faith in order to hold a director liable for poor management is difficult, especially if the director really believed at the time that he was acting in good faith. Nevertheless, what is required for the case of NEDs and their modern role is to incentivise the NED to take an active position on the board and the business, and in doing so, to be competent and to perform according to the standards of business best practice. Moreover, although the duty targeted some up to date corporate governance problems, which is the need to encourage directors when taking their decisions to take in consideration the ‘long term’ profit of the company and the ‘success’ of the company, the lack of clear definitions of the two terms leaves the door open for wide range of interpretations and makes it difficult to enforce them. In application to the latest corporate problems in the UK, such as the Northern Rock and Royal Bank of Scotland, there seems to be no suggestion of bad faith in the two cases.

C- The Duty of Skill, Care and Diligence

Traditionally, the duty of skill, care and diligence is formulated on broad principles rather than detailed rules,\(^98\) which according to Vanessa Finch has given remarkable freedom to company directors to run the company incompetently.\(^99\) Although the standard of performance required of NEDs according to the duty of skill, care and diligence has been codified and settled in CA 2006 s.174, this duty does not entail the required role of NEDs to any degree of particularity. The duty has been historically formulated with executive directors in mind, rather than NEDs, and built on the view that NEDs had no serious role to perform on the company, and their role is only decoration, and aims to promote the company’s image.\(^100\)

This section analyses through case law the development of the duty of skill, care and diligence applicable to NEDs, and the standard of conduct required from NEDs according to the duty of skill, care and diligence. However, this section suggests that the different key cases related to NEDs do not formulate a pattern of behaviour which could entail a corporate governance role of NEDs. As will be explained in this section, during the twentieth century, the


\(^{100}\) Gower and Davies’ Principles of Modern Company Law (n13) 489.
duty of skill, care and diligence is developed from setting undemanding standards of conduct from NEDs to more demanding standards; nevertheless, case law does not show particularly what the required role of NEDs is.

Cases at the beginning of this century showed that courts did not require NEDs to practice due diligence before approving the management decisions and plans, neither did it require NEDs to bring special skills to the board. Instead, courts adopted the view that business cannot go on without trust, and therefore NEDs do not need to check over and investigate before approving management decisions as long as they had no reason to suspect the integrity of the employees or managers in charge. For example, in the case of Dovey v Cory\textsuperscript{101} the liquidator’s appeal against the Court of Appeal decision was dismissed on the grounds that the defendant director was not liable to depend on the chairman and the general manager’s statements, as he had no reason to doubt their honesty. Therefore, NEDs did not have to examine the details of the accounting records of the company, as long as they had no reason not to trust the managing directors and those who were in charge.

In another case, Re Brazilian Rubber Plantation and Estates Ltd\textsuperscript{102}, the court accepted that the NED board members could serve on the board with complete ignorance of the nature of the main business of the company, and they are not obliged to take any definite part in the conduct of the company’s business, as J Neville stated:

\textquote{A director’s duty has been laid down as requiring him to act with such care as is reasonably to be expected from him, having regard to his knowledge and experience. He is, I think, not bound to bring any special qualifications to his office. He may undertake the management of a rubber company in complete ignorance of everything connected with rubber, without incurring responsibility for the mistakes which may result from such ignorance;}\textsuperscript{103}

\textsuperscript{101} 1901 WL 11278.
\textsuperscript{102} Re Brazilian Rubber Plantations & Estates Ltd (n38).
\textsuperscript{103} Re Brazilian Rubber Plantations & Estates Ltd (n38) 437.
The previous two cases advanced the proposition that NEDs are not required to take an active role on the board; neither are they obliged to bring special expertise to the board. Therefore, according to the previous two cases, the leadership and management of the company were completely the management’s responsibility, while the role of the rest of the board of directors was completely ornamental and inactive, and they were excused for relying on the management’s views without investigation.

A few years later, Romer J. changed the previous approach regarding the standard of the directors’ duty of skill, care and diligence required of directors through the case of *Re City Equitable Fire Insurance Co Ltd*. The case was raised by the liquidator of an insurance company against the board members of the company for losses that were mainly caused by the fraud of the managing director. The board members were not involved in the fraud; nevertheless, the liquidator aimed to hold them liable for approving investments and loans for the payment of dividends out of capital. Two of the directors were found to be ‘negligent’; however, they were saved by the exclusion clause of the company’s articles.

Romer J commented as follows:

'It is indeed impossible to describe the duty of directors in general terms, whether by analogy or otherwise. The position of a director of a company carrying on a small business is very different from that of a director of a railway company. The duties of a bank director may differ widely from those of an insurance director, and the duties of a director of one insurance company may differ from those of a director of another. In one company, for instance, matters may normally be attended to by the manager or other members of the staff that in another company are attended by the directors themselves. The larger the business carried on by the company the more numerous, and the more important, the matters that must of necessity be left to the managers, the accountants and the rest of the staff...In order therefore to ascertain the duties that a person appointed to the board of an established company undertakes to perform, it is necessary to consider not only the nature of the company’s business but also the manner in which the work of

104 [1925] 1 Ch 407.
the company is in fact distributed between the director and the other officials of the company.\textsuperscript{105}

In the previous case, the court changed its view regarding inactive directors, and did not accept the approval of the board members on the payment of dividends out of capital. In this case, the court considered differentiating between the different businesses and the different roles of directors within different companies. Romer J. linked the duties of the director to the role that the director undertakes to perform, and according to the way that the tasks are distributed among the director and other employees of the company. The general understanding of the outcome of the City Equitable Fire case was that directors’ duties are built on a subjective standard\textsuperscript{106}, which means that the standard of conduct required by NEDs is built on the directors’ personal skills, without requiring a minimum objective standard of skills and experience of the NEDs.\textsuperscript{107} This understanding was later applied by the courts for long.\textsuperscript{108}

Merely requiring NEDs to meet a subjective standard will make it very difficult to hold NEDs liable,\textsuperscript{109} as the subjective standard will assess the NEDs only on the skills they possess. Therefore, if their skills are low, they will be excused for their incompetence. Moreover, they will not be required to give enough attention to the company’s matters, and they will be allowed to follow the management’s views without enough investigation.\textsuperscript{110}

More recent cases have shown a change in the courts’ proposition regarding the directors’ duty of skill, care and diligence, and required directors to play a supervisory role on the boards of directors. In the case of Dorchester Finance v Stebbing\textsuperscript{111} the court did not accept that directors with accounting experience were inactive and completely dependent on auditors. The two NEDs rarely visited the company; instead, they used to sign blank cheques and leave them for the executive director to sign. The executive director misused the blank cheques and made

\begin{thebibliography}{11}
\bibitem{105} ibid 427.
\bibitem{106} Gower and Davies’ Principles of Modern Company Law (n13) 489.
\bibitem{108} ibid.
\bibitem{110} Finch (n99) 200.
\bibitem{111} [1989] BCLC 498 (ChD).
\end{thebibliography}
unrecoverable loans. The two NEDs were liable for insufficient supervision over the executive directors of the management.\textsuperscript{112}

As Foster J stated:

‘For a chartered accountant and an experienced accountant to put forward the proposition that a non-executive has no duties to perform, I find it quite alarming… The signing of blank cheques by Hamilton and Parsons was in my judgment negligent, as it allowed stebbing to do as he pleased. Apart from that, they not only failed to exhibit the necessary skill and care in the performance of their duties as directors, but also failed to perform any duty at all as directors of Dorchester. In the Companies Act 1984 the duties of a director whether executive or not are the same.’\textsuperscript{113}

In the abovementioned \textit{Dorchester Finance v Stebbing} case, the court applied a higher standard than that of the \textit{Re City Equitable Fire Insurance Co Ltd} case. However, the court in this case benefitted from the fact that the two defendant NEDs were chartered accountants, which made the court increase the level of expectations of the two NEDs.\textsuperscript{114}

Following to the abovementioned \textit{Dorchester Finance case}, the courts went for a clearer approach for the duty of skill and care and regarding inactivity of directors. Lord Hoffman, suggested that the degree of skill and care required of directors should be according to section 214 of the Insolvency Act 1986, which requires NEDs to meet a minimum objective standard in addition to the subjective standard. The minimum objective standard is based on the knowledge and experience expected from a director serving in his position, while the subjective standard refers to the particular skills, knowledge and experience that a director possess if this experience is higher than that which is expected by the objective standard.

\textsuperscript{112} ibid 505.
\textsuperscript{113} ibid.
Lord Hoffmann referred to this approach in several cases. In the case of *Norman v Theodore Goddard*,115 Lord Hoffmann accepted in principle that the degree of skill, care and diligence of directors is according to s. 214(4) of the Insolvency Act 1986116. Another case, the case *Re D’Jan of London Ltd*,117 concerns a director who signed an insurance proposal that was not filled properly because the director depended on an agent who he had trusted to fill it in. This error enabled the insurance company to repudiate their insurance liability for the event of fire. Lord Hoffmann again referred to s. 214 of I.A (1986)118 and held that the director did not exhibit at sufficient standard of skill or reasonable diligence required; therefore he is in breach of his duties to the company.

In another case, *Bishopsgate Investment Management Ltd (in liq) v Maxwell (No 2)*119 Lord Hoffmann referred to the change of Law regarding directors’ duties and the change of public attitude to corporate governance. As Hoffmann provided:

‘In the older cases the duty of a director to participate in the management of the company is stated in very undemanding terms. The law may be evolving in response to changes in public attitudes to corporate governance, as shown by the enactment of the provisions consolidated in the Company Directors Disqualification Act 1986. Even so, the existence of the duty to participate must depend upon how the particular company’s business is organized and the part which the director could reasonably have been expected to play.’120

In this case, the court held that the director had no interest in the management and affairs of the company, as he attended only few meetings, and when he did so, he did not pay enough attention to the company’s business. It was also held that the director was in breach of his duties towards the company, because he signed transfers for no consideration, since his brother has

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116 Insolvency Act 1986 s 214 (4).
117 *Re D’Jan of London Ltd* (n40).
118 Insolvency Act s 214 (1986).
120 ibid 264.
signed before him.\textsuperscript{121} What is important in this case is that the court recognised that the Law is moving towards the public attitude to corporate governance, which is a step towards the recognition of the increasing demands of the role of NEDs.

Other examples that contributed to the case of NEDs could be taken from Australia, especially that Australian jurisdiction shares the UK with high similarities as it applies common Law. In this regard reference is made to the case of AWA v Daniels,\textsuperscript{122} and the subsequent appeal case Daniels v Anderson.\textsuperscript{123} In this case, the courts adopted modern interpretation of the responsibilities of NEDs, this approach goes into more details of the work of NEDs based on the role of NEDs according to the UK Corporate Governance Code. The case concerns a company called AWA Ltd, which employed the employee Koval to manage the foreign exchange operations, Koval’s activities caused the company a loss of $50 million. At the time, the external auditors were Delloitte Haskins & Sells, the auditors issued two audit reports, that none of them fully disclosed the activities of Koval to the board of AWA; however, the audit mentioned defects in the internal audit system. The NEDs were sued for contributory negligence regarding the losses that the company suffered from.\textsuperscript{124}

The court provided that the definition of the role of NEDs is:

\begin{quote}
‘
\begin{enumerate}
\item Directors are under a continuing obligation to keep informed about the activities of the corporation.
\item Directors are under a duty to monitor managers and practices to determine whether business methods were safe and proper.
\item Directors should maintain familiarity with the financial status of the company by a regular review of its financial statements and this may, in turn, give rise to a duty to enquire further into matters revealed by the statements.
\end{enumerate}
\end{quote}

\textsuperscript{121} ibid 261.
\textsuperscript{122} (1992) 7 ACSR 759.
\textsuperscript{123} (1995) 37 NSWLR 438.
\textsuperscript{124} AWA (n122) 832.
\textsuperscript{125} Daniels (n123) 503-504.
The New South Wales Court of Appeal provided that NEDs owe the duty to take reasonable care in performing their role. The court also provided that a NED who accepts being appointed to a company, undertakes the responsibility of understanding the nature of the duty he is supposed to perform. Such a duty differs according to the size of the company whose board he serves on, and the skills he possesses. The duty requires the NED to act collectively with others to manage the company. The court also restricted the delegation of board duties, and held that the board including NEDs has a duty to control the management regardless of the size of the company, moreover the court stressed that NEDs need to ensure that they have the required means to audit the management of the company, in order to ensure that the company is well run.

The case of AWA v Daniels is considered a good step in the right direction, as according to this case, NEDs will always be required to be familiar with the company’s business, and they need to satisfy the level of professional management, moreover NEDs will not be excused for relying on others when taking their decisions. However, the duty of care as applied in the abovementioned AWA v Daniels makes it clear that there is no agreed formula to explain precisely what the role of NEDs is, nevertheless the duty of care will depend on the function of each NED, and according to the facts of each case. However, after the ruling of Daniels v Anderson, NEDs will be advised that they cannot hide behind their lack of knowledge of the company’s affairs.

On February 26 1995, England witnessed the collapse of Barings Bank. The collapse of the oldest and one of the most distinguished English investment banks occurred because of the actions of one man, Nick Leeson. Nick Leeson was a clever derivatives trader for Barings Bank, based in Singapore, where Barings had established a promising trading operation. In 1993 he was appointed to become a general manager of Barings Futures Singapore (BFS). In that year,

126 ibid 505.
127 ibid.
129 Daniels (n123) 505.
130 The Impact of Modern Influences on the Traditional Duties of Care, Skill and Diligence of Company Directors (n26) 142.
131 ibid 143.
Leeson gained £10 million, which is around 10% of Barings’ total for that year. Later, the prices of stocks in Japan suffered great losses, which affected Barings trade, as Barings suffered huge losses. Moreover, Leeson tried to cover the losses and strengthen the trade again by asking for more money from the headquarters in London, which he was given. Unfortunately he suffered greater losses.\textsuperscript{132} The Barings collapse has shown that there was a lack of good supervision and internal control, which proved that even highly estimated banks like Barings may also suffer weak risk management procedures.\textsuperscript{133}

Although the Barings case is related to the executive directors, rather than the NEDs, the directors held liable in the case were executive directors, but not NEDs.\textsuperscript{134} The author of this thesis suggests that the collapse of Barings was not due to NEDs’ negligence because the negligence and wrong doings, as will be explained below, took place within the lower management and the managerial hierarchy, and Leeson’s activities were supposed to be supervised by the managers, who are higher than Leeson rather than the NEDs. Nevertheless, this case is mentioned here to highlight the court’s view in regards to the powers delegated from the board to the management. These views apply to executives and NEDs. Moreover, the views of the court in regards to the delegation of powers have been referred to in other cases, as will be shown in this section, which makes it worth highlighting.

In the case of \textit{Re Barings Plc (No 5)}\textsuperscript{135} the Secretary of State accused the three defendant executive directors of failure in management in relation to Leeson’s activities, which proved the incompetence of the three directors, who were disqualified accordingly. The court indicated several points regarding the breach of the duty to monitor Leeson’s activities. Tuckey and the management committee did not check the risk limits on Leeson’s trading.\textsuperscript{136} And they failed to respond to several danger signals.\textsuperscript{137} Baker, who was directly responsible for the trading of Leeson, failed to ‘look in detail’ at the trading of Leeson, and the way he was achieving extraordinary profits, he was aware that there were no risk limits over Leeson’s trading, and

\textsuperscript{132} J Brook ‘The Barings Collapse: A Regulatory Failure, or A Failure of Supervisions’ (1996) 22 Brooklyn Journal of International Law 735.
\textsuperscript{133} ibid 735-736.
\textsuperscript{134} Deakin (n109) 533.
\textsuperscript{136} ibid 511.
\textsuperscript{137} ibid 522 -528.
failed to set the system to monitor Leeson’s risk.\textsuperscript{138} He also ignored risk signals regarding Leeson’s trading.\textsuperscript{139} Baker and Gamby failed to ensure that Leeson’s trading and settlement roles were separated,\textsuperscript{140} while Gamby failed to install the appropriate systems for settlement which could have detected and brought the problem to his attention.\textsuperscript{141}

In the Barings case, Jonathan Parker J. provided the following in regards to the delegation of powers and the directors’ responsibilities to supervise and remain informed, Jonathan Parker J. general statement applies to the whole board of directors, whether they were executives or NEDs:

\begin{quote}
(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.\textsuperscript{142}

(ii) Whilst directors are entitled (subject to the articles of association of the company) to delegate particular functions to those below them in the management chain, and to trust their competence and integrity to a reasonable extent, the exercise of the power of delegation does not absolve a director from the duty to supervise the discharge of the delegated functions.

(iii) No rule of universal application can be formulated as to the duty referred to in (ii) above. The extent of the duty, and the question whether it has been discharged, must depend on the facts of each particular case, including the director’s role in the management of the company.\textsuperscript{143}
\end{quote}

In the two abovementioned points (ii) and (iii), Jonathan Parker J. sets a main rule that the delegation of powers does not absolve the directors of their duty to supervise the delegated functions. The proposition of Jonathan Parker J. assures the duty of NEDs to monitor the delegated functions. However, this does not mean that the NEDs must be guarantors that

\textsuperscript{138} ibid 537, 573.
\textsuperscript{139} ibid 539, 553-554, 561.
\textsuperscript{140} ibid 574, 595.
\textsuperscript{141} ibid 582, 589, 598.
\textsuperscript{142} ibid 489.
\textsuperscript{143} ibid.
everything must go well in the company, as employees and subordinates might behave negligently, and NEDs might not discover this on time. This is not evidence that NEDs actually behaved negligently. However, the test here will be to see whether the NEDs, as board members, have ensured that there are good internal control systems in place.\textsuperscript{144}

In \textit{Re Continental Assurance Company of London plc (in Liquidation)}\textsuperscript{145} the liquidator took action against the CEO and five NEDs for wrongful trading under Insolvency Act 1986 s.214. The directors of Continental Assurance decided that they should continue to trade, although the company at that time had to go into insolvency due to the losses the company suffered. However, they followed the opinion of the finance director and the auditors, who said that the company was not insolvent. Therefore, action was taken against the directors for failing to recognise that the company was applying inappropriate accounting methods, and failing to recognise that the company was insolvent.\textsuperscript{146}

The court dismissed all the liquidators’ claims against all the directors.\textsuperscript{147} The court found that the NEDs had no intention to continue trading while the company was insolvent; however they trusted the opinion of the finance director.\textsuperscript{148} Therefore, the court provided that NEDs are not required to have special knowledge in accountancy, but they need to have sufficient knowledge related to the company’s business:

‘Although the managing director of a company had a general responsibility to oversee the activities of the company and the non-executive directors were under a duty to monitor the performance of the executive directors, the duty of directors generally was not to ensure that the company got everything right, but simply to exercise reasonable care and skill up to the standard which the law expected of a director of the sort of company concerned, and up to the standard capable of being achieved by the particular director concerned. In particular, the responsibilities of non-executive directors did not

\textsuperscript{144} Gower and Davies’ \textit{Principles of Modern Company Law} (n13) 493.
\textsuperscript{145} [2001] BPIR 733.
\textsuperscript{146} ibid.
\textsuperscript{147} ibid para 426.
\textsuperscript{148} ibid para 107.
go so far to require them to overrule the specialist directors, like the finance director, in their specialist fields.' \(^{149}\)

Park J also provided that if the NEDs of Continental Assurance were held liable to pay millions of pounds to the liquidator, many skilled and well advised NEDs would refrain from accepting the post of a NED on any board. \(^{150}\) In this regard, Andrew Keay commented that only the most irresponsible directors are found liable for wrongful trading. \(^{151}\)

According to the abovementioned Continental Assurance Case, the responsibility of NEDs does not go beyond continuous and careful monitoring; however, the continuous and careful monitoring does not require the NEDs to seek special advice on how to apply sophisticated insolvency predictions models. \(^{152}\) The continuous and careful monitoring according to the court means that the NEDs are informed, and they take into account this information provided to them. \(^{153}\)

The case of *Equitable Life Assurance Society v Bowley and Others*, \(^{154}\) is an interesting one regarding directors’ duty of skill, care and diligence, and the case of NEDs and their functions. Equitable Life Assurance Society sued former NEDs and executive directors for the adoption of the deferential terminal bonus policy (DTBP) in 1993. The case included two main points related to negligence, which are; first, failing to take legal advice regarding the validity of (DTBP), second, in the years 1999 and 2000, after the problem was known and the legal advice was received, failing to reduce bonuses and to inform the current and prospective policy holders of the potential costs to equitable life regarding the guaranteed annuity option (GAO) if the company loses the Hyman litigation. However, Equitable Life lost the case against Hayman, which exposed the company for the losses of pound 1.5 billion. Although the litigation collapsed,


\(^{150}\) Re Continental Assurance Company of London plc (in Liquidation) (n145) para 110.


\(^{152}\) Bachner (n149) 302, 303.

\(^{153}\) Keay (n151) 449.

\(^{154}\) [2003] EWHC 2263 (Comm).
the case raised several crucial points regarding the application of the duty of skill, care and diligence on NEDs.\textsuperscript{155}

The Report of the Equitable Life Enquiry made by Lord Penrose described the role of NEDs on the board of Equitable Life as inadequate, as they failed to understand the financial situation of the society, and they were largely dependent on the chief executive:

\textit{‘The board at no stage got fully to grips with the financial situation faced by the Society: information was too fragmented, their collective skills were inadequate for the task, and there were no effective arrangements for ensuring that there was detailed examination of, and onward reporting to the board on actuarial reports. Equitable’s non-executive directors were so wholly dependent on actuarial input from the executive and in particular from the chief executive / actuary that they were largely incapable of exercising any influence on the actuarial management.’}\textsuperscript{156}

The court referred to the duty of skill, care and diligence according to the standard of the Re D’Jan of London Limited, as aforementioned in this section. However, the court pointed out that there is wide agreement regarding the duties owed by NEDs:

\textit{‘There is a considerable measure of agreement about the duty owed by a non-executive director to a company.’}\textsuperscript{157}

Nevertheless, the courts’ concern was the definition of the role and functions of the NEDs, for which the court said that the directors’ duties did not have any specific answer:

\textit{‘But this test provides no answer to the question what are the “functions” of a non-executive director of a company such as Equitable?’}\textsuperscript{158}

\textsuperscript{155} ibid.
\textsuperscript{157} Equitable Life Assurance Society (n154) 836.
\textsuperscript{158} ibid.
The court, in assessing what is required of NEDs, referred to the case of *Re Barings Plc (No 5)* and particularly to the summery given by Jonathan Parker J, as aforementioned in this section, which recognises the duty of the directors to oversee the management and the delegated functions.\(^{159}\)

The court confirmed its view regarding the duty of the board to oversee the delegated functions by disagreeing with the statement provided in the case of *Re City Equitable Fire*, regarding the delegation of power and the reliance of the NEDs on the management, as Romer J, provided in the case of *Re City Equitable Fire* that:

>`In respect of all duties that, having regard to the exigencies of business, and the articles of association, may properly be left to some other official, a director is, in the absence of grounds for suspicion, justified in trusting that official to perform such duties honestly.`\(^{160}\)

The court, in the case of *Equitable Life*, found that this statement does not represent the modern law, and referred to the corporate governance debate regarding the role of the NEDs, and provided that the Law in regards to the extent which NEDs can rely on executive directors and other officials on the company is developing, and that NEDs are supposed to bring independent judgment and to supervise management.\(^{161}\)

The importance and contribution of the *Equitable Life* case is that it provides a step forward for the court’s recognition of the corporate governance role of NEDs, which requires NEDs to oversee the business, and does not allow them to completely rely on the management or

\(^{159}\) ibid.

\(^{160}\) ibid 837.

\(^{161}\) ibid.
other offices.\textsuperscript{162} The Equitable Life case contributes to making the supervisory function of NEDs into a legal responsibility.\textsuperscript{163}

Another very recent Australian case, \textit{Australian Securities and Investments Commission v Healey (ASIC v Healey)},\textsuperscript{164} introduced an advanced approach regarding the duties of the board of directors to approve the financial statements. The case was filed by the Australian Securities and Investment Commission (the ASIC) against the CEO, CFO, the NED chairman and five other NEDs of the Centro group of companies.\textsuperscript{165} The defendant directors were sued for breach of their duty of skill, care and diligence owed to the Centro group of companies, and for approving the consolidated financial accounts for the Centro group of companies of the financial year that ends in June 2007, which included incorrect information regarding the debt of $1.5 billion, classifying the debt as non-current liabilities, while they were current liabilities, and for failing to disclose US$ 1.75 billion in guarantees.\textsuperscript{166} Middleton J ruled that each of the directors failed to practice the required standard of skill, care and diligence by failing to take the necessary steps to comply with the financial reporting standards of the Corporation Act 2001 of Australia, in reviewing and approving the financial statement of Centro group.\textsuperscript{167}

The court emphasized the fundamental importance of the financial statements to shareholders and the market, and provided that this was the reason it needed to be approved by the board of directors,\textsuperscript{168} describing the directors as the ‘\textit{final filter}’.\textsuperscript{169} The court pointed out that the central question was whether directors of public listed entities are required to apply their own mind, and to review carefully the financial statements and directors’ report, to ensure the consistency between the information provided and the directors’ knowledge of the company’s

\textsuperscript{162} E Ferran ‘Directors’ Liability for Unlawful Dividends’ (2011) 70(2) Cambridge Law Journal 324. See also, M Sweeny-Baird ‘The Role of the Non-Executive Director in Modern Corporate Governance’ (2006) 27(3) Company Lawyer 78.
\textsuperscript{164} [2011] FCA 717.
\textsuperscript{165} ibid.
\textsuperscript{166} ibid 9.
\textsuperscript{167} ibid 24.
\textsuperscript{168} ibid 10.
\textsuperscript{169} ibid 582.
affairs, and that there are no material matters hidden, or that there are material matters should be known to them.\textsuperscript{170}

The court also pointed out that directors should read carefully the financial statements, and provided that:

\begin{quote}
‘Such a reading and understanding would require the director to consider whether the financial statements were consistent with his or her knowledge of the company’s financial position. This accumulated knowledge arises from a number of responsibilities a director has in carrying out the role and function of a director. These include the following: a director should acquire at least a rudimentary understanding of the business of the corporation and become familiar with the fundamentals of the business in which the corporation is engaged; a director should keep informed about the activities of the corporation; whilst not required to have a detailed awareness of day-to-day activities, a director should monitor the corporate affairs and policies; a director should maintain familiarity with the financial statements; a director, whilst not an auditor, should still have a questioning mind’\textsuperscript{171}
\end{quote}

The defendant directors argued that they relied on the ‘Board Audit and Risk Management Committee’ and on the professional advice received from Centro’s auditors.\textsuperscript{172} However, the court provided that a director may rely on others to assist them in discharging their responsibilities, and to an extent can also depend on the process they have installed. Nonetheless, this is not exactly the case regarding the financial statements. The court continues that the drafting of the financial statements is the management responsibility. However the rational of directors’ role in checking and approving the financial statements is to get them involved in the process and practice to the expected degree of responsibility. Therefore, the delegation of some tasks to others does not absolve the general obligation upon directors. Therefore, each of the directors should undertake the responsibility of reading and understanding the financial

\textsuperscript{170} ibid 13.
\textsuperscript{171} ibid 17.
\textsuperscript{172} ibid (273,564).
Accordingly, the director’s protesting that they have relied on the advisors’ reports which appeared to have errors was not accepted by the court, as the court ensured that the directors should have detected the errors themselves.\(^{174}\)

The *ASIC v Healey* case provides a very advanced understanding of the role of NEDs, as the case does not limit the role of NEDs in monitoring the strategic decisions and deciding on executive remunerations. Instead, the *ASIC v Healey* case requires the NEDs to act like a proactive professional, who is supposed to show a reasonable level of competence in understanding the company’s financial affairs.\(^{175}\)

As previously mentioned, duty of skill, care and diligence is codified in section 174 of Chapter Two of CA 2006, providing:

\[
(1) \text{A director of a company must exercise reasonable care, skill and diligence.} \\
(2) \text{This means the care, skill and diligence that could be exercised by a reasonable} \\
\text{diligent person with-} \\
\text{(a) the general knowledge, skill and experience that may reasonably be expected of a} \\
\text{person carrying out the functions carried out by the director in relation to the company,} \\
\text{and} \\
\text{(b) the general knowledge, skill and experience that the director has.}\text{'}^{176}
\]

The duty means that the standard of a director’s performance, when performing his role as a member of the board, must at least meet the minimum standard of skill, care and diligence of the abovementioned s. 174 of CA 2006. Limb (a) of the s. 174 requires all directors to meet a minimum objective standard of duties. Limb (b) requires a subjective standard of care that considers the knowledge, skill and experience that the particular director has. However, the subjective standard operates only through the objective standard, meaning that a director must meet the minimum objective standard of limb (a), and if the director has additional higher skills

\(^{173}\) ibid 240.  
\(^{174}\) ibid 260.  
\(^{176}\) CA 2006 s 174.
or experience this will require him to meet the higher subjective standard. This brought the duty of skill, care and diligence in line with the duty of wrongful trading under Insolvency Act 1986, which Lord Hoffman referred to in his judgment on the case of Re D’Jan of London Ltd.

The development in the objective standard of the duty of skill, care and diligence brings the objective standard up to the standard required of executive directors in their employment contracts. The standard is a uniform one that applies to all directors, whether executives or NEDs. Nevertheless, what is required of the director will vary according to the job and functions the specific directors perform, which is clear in limb (a):

‘..carrying out the functions carried out by the director’

Therefore, what is required of a director will not be uniform, but instead, will vary from one NED to another according to the functions undertaken, and according the type and size of the company. This means that the assessment of what is required of a director will be according to what is expected of a director in his position, in addition to what specific skill and experience the director has.

The old common law standard for directors’ duties was thought of as low. This development towards a minimum objective standard is thought of as a step forward that helps courts to define the functions of the board, and is supposed not to allow incompetent directors to hide behind their ignorance or inactivity, or escape liability for their weak or non-performance on the board, with scholars saying that the legislative development closes the gaps in the old

177 Gower and Davies’ Principles of Modern Company Law (n13) 490.
178 Insolvency Act 1986 s 214.
179 The Company Director: Powers Duties and Liabilities (n83) 285.
180 Riley (n6) 700.
181 Gower and Davies’ Principles of Modern Company Law (n13) 491.
182 ibid.
183 ibid.
185 Gower and Davies’ Principles of Modern Company Law (n13) 494.
186 The Company Director: Powers Duties and Liabilities (n83) 285.
common law regarding inactivity of NEDs or their duty to supervise, and that inactivity is no longer a choice for NEDs; otherwise, they will be at risk of being held negligent.

However, it is suggested in this thesis that in order for the current duty to function and to hold NEDs liable, there should be a clear definition of the role and functions of the NEDs, which should be clear to the court. Nonetheless, CA 2006 does not explain what is specifically required of NEDs in performing their role, nor does case law give such an explanation with any level of certainty, which creates an obstacle for the courts in measuring the performance of NEDs according to a clear defined role. John Lowry and Lynden Griggs agree with this view.

Courts, through cases, started to move towards defining the role of NEDs, and towards designing wider responsibilities for NEDs, nevertheless the court does not provide a clear definition and recognition of the role of NEDs yet. The courts’ moving towards greater NEDs’ responsibility is due to the application of the minimum objective standard of the duty of skill, care and diligence, which sets a minimum expectation of NEDs’ conduct taking into consideration the size of the company they serve on, and the functions they perform. This is in addition to the application of the subjective standard, which takes into consideration the additional skills that the director might posses.

However, the standard of skill, care and diligence fits better with the role of executive directors, as executive directors have a more clearly defined role and they undertake the daily business matters of the company. On the other hand, NEDs do not perform the daily business of the company, and their role is not quite clear yet, which makes the application of the duty of skill, care and diligence on the NEDs less effective.

The cases provided in this section show reference to the oversight role of NEDs by stipulating that the delegation of powers does not absolve the duty of the NEDs to oversee the

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188 Gower and Davies’ Principles of Modern Company Law (n13) 491.
189 Griggs & Lowry (n46) 206.
190 ibid.
191 Flint (n128) 206.
delegated powers and functions. However, the application of the oversight role of NEDs does not seem to be well defined or settled. For example, in the case of *Continental Assurance* mentioned in this section, the monitoring role of NEDs meant that the NEDs must pay good attention to the information provided to them and act upon, but they were not supposed to question the quality of the information they get, or to investigate beyond the information they received. Moreover, most of the cases presented showed that NEDs were sued for negligence, due to their extremely irresponsible behaviours; such as the signing of blank cheques in the *Dorchester Finance* case. It is suggested that such cases, which involve the highly irresponsible behaviour of NEDs, do not suffice in drawing a pattern that defines the monitoring role of NEDs. In addition, the cases provided in this section do not show reference to important parts of the NEDs’ corporate governance role, such as deciding the executive directors’ remunerations.

Cases against NEDs in the UK have been extremely limited and hardly led to out of pocket compensation.\(^{192}\) However, what is important as well, that after the latest severe financial crisis, no signs of litigation against NEDs are looming in the horizon.\(^{193}\) For example, as aforementioned in this chapter, companies such as Northern Rock and the Royal Bank of Scotland did not show fraudulent activities; instead the problems were mainly problems of weak management and bad decisions that proved to be unwise and caused the companies’ massive losses. The decisions could be subject to the duty of skill, care and diligence; however, until the present day, no litigation started nor are there any signs that it will start any time soon. This raises the question regarding the application of the duty.\(^{194}\)

However, the abovementioned cases do not show clear negligence such as the cases provided in this section; neither do these cases involve fraudulent behaviour. Nevertheless, these cases involved disastrous decisions that led to catastrophic results.\(^{195}\) This situation raises the question regarding board’s decisions that did not involve obvious manipulation and illegal


\(^{193}\) Loughrey (n58) 2.

\(^{194}\) ibid 18.

\(^{195}\) ibid.
activities, and whether courts will deal with such decisions.\textsuperscript{196} However, it is suggested that courts do not have the sufficient business background to deal with such situations.\textsuperscript{197}

In this context, reference is made to the aforementioned \textit{AISIC v Healey} case, as mentioned in this section, and the comment of John Lowry, that NEDs’ standard of conduct should be equal to that of a pro-active professional, who must show reasonable level of competence to understand the company’s affairs.\textsuperscript{198}

According to the abovementioned pro-active professional standard, this thesis inspires a new standard to be applied to the role of NEDs. As explained in this section, courts upgraded the standard of conduct required from NEDs, by not accepting the inactivity of NEDs. Inactivity was referred to in the cases where NEDs had no role to play on the board, and did not have to bring any special expertise to the board. However, not accepting inactivity was referred to in the cases where NEDs were held liable for approving manipulated decisions or accounts, or approving illegal decisions. This thesis refers to the pro-active professional NED as the NED who can add positive input to the board, and can enhance the monitoring and strategy roles of the board, by adding his high professional skills to company’s decisions and matters. It is suggested that this approach will positively enhance the quality of a company’s decisions.

\textbf{Conclusion}

Gower stated:

\begin{quote}
‘As business world comes to expect higher standards, the Law should develop in step. What has handicapped legal development so far has been the failure of the courts to recognize that ‘directing’ is becoming a profession with developing standards of expertise.’\textsuperscript{199}
\end{quote}

\begin{footnotes}
\textsuperscript{196} Petrin (n10) 437.
\textsuperscript{197} Riley (n6) 697.
\textsuperscript{198} Lowry (n175) 259.
\textsuperscript{199} Finch (n99) 202 (citing Report of the Commission of Enquiry in Company Law of Ghana (1961)).
\end{footnotes}
In applying Gower’s statement on the case of NEDs in the UK by assessing the development of the standards of directors’ duties and its application in the courts, compared to the standards of best practice related to NEDs, we may see that the development of the business standards goes beyond the courts recognition of the modern role of NEDs. The corporate governance is concerned with the managerial qualities, as mentioned at the beginning of this chapter. However, the courts’ application of the directors’ duties does not go as far as the managerial qualities; rather, the application of directors’ duties on the role of NEDs concerns mostly bluntly negligent or illegal behaviours, which does not cover the quality of NEDs’ performance from the business perspective.

Lord Hoffmann provided that over the years, the standard of skill, care and diligence required from directors have been raised, reflecting the business practice of each era. However, it is suggested that the current application of the directors’ duties needs improvement in order to meet the business expectations of this era. This development starts by recognising the corporate governance role of NEDs by the court, and such recognition must be achieved by defining NEDs as pro-active directors.

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200 Riley (n6) 697.
CHAPTER THREE: NEDs IN THE CORPORATE GOVERNANCE CONTEXT

Introduction

The previous chapter analysed directors’ duties and liabilities as a retrospective method that aims to ensure that directors perform their role.¹ This chapter concerns the role of NEDs within corporate governance structures. Corporate governance structures work as an enforcement mechanism that enforces NEDs’ obligations prospectively.² As mentioned in chapter one, the separation of ownership and control theory, and the conflicts of interests between the owners and the managers, along with the inability of shareholders to control the board of directors, have made disciplining companies managers ‘...the central goal of corporate governance...’³.

The Cadbury Report aimed to enhance the accountability of the management to the board of directors,⁴ and to limit the unfettered powers of the management. In order to do so, the Cadbury Report and the Code rely on the ‘independence’ factor, particularly the independence of NEDs from executive directors and corporate officers, and on the ability of NEDs to bring objective views to the board.⁵ The idea is that independent NEDs will have less knowledge and information about the business, and less involvement compared to the executive directors or the non-independent NEDs.⁶ The intended outcome is for a higher standard of decision-making as well as the curbing of excessive risk-taking at board level.

The Cadbury Report sought to enhance the effectiveness of the board by focusing on the board’s structure.⁷ Therefore, the Cadbury Report integrated the modern role of NEDs into the corporate governance reforms through requiring NEDs and independent NEDs to serve on the

¹ See- supra Ch 2.
⁴ See generally the Cadbury Code.
⁷ J Solomon Corporate Governance and Accountability (2nd edn John Wiley & Sons Ltd West Sussex 2007) 77.
unitary board of directors, and on the board subcommittees.\textsuperscript{8} The objective for the NEDs and the independent NEDs is to monitor the management and to take an advisory or managerial role, which requires NEDs to support the management with their advice and participate in setting the companies’ strategy,\textsuperscript{9} as the Cadbury Report provides in section (4.1):

‘Every public company should be headed by an effective board which can both lead and control the business’\textsuperscript{10}

High expectations are built on the role of independent NEDs to perform effective monitoring over the executive directors, as well as corporate officers, to the extent that their role is described as a corner stone of the one tier board system.\textsuperscript{11} On the other hand, some scholars argue that NEDs are incapable of achieving their corporate governance goals; Jonathan Macey refers to the capture of the CEO to the board of directors, which he described as being acute to the extent that it is not realistic to build a system of corporate governance depending on the board of directors to improve corporate performance and control corporate deviance.\textsuperscript{12}

However, this chapter argues that the UK corporate governance prospective approach for enhancing the monitoring role of the board through integrating independent NEDs is ineffective. The Code’s approach is based on an assumption that NEDs due to their independence will take a strong monitoring position on the board; and therefore, they will control the management and decision making. Nevertheless, this chapter finds that there are social and psychological factors that create bias in the boardroom, and that these biases undermine the independent judgment of NEDs. Moreover the chapter argues that the Code defines the role of NEDs in very general terms, which does not entail specific actions to be taken by the NEDs to fulfil their monitoring role.

\textsuperscript{12} Corporate Governance Promises Kept Promises Broken (n6) 55.
Therefore, this chapter suggests that the approach of the Code should move to a new approach, which provides enforcement mechanisms for the role of NEDs. It is also suggested that the new approach should take into consideration defining the role of NEDs in clearer terms, which entail more specifically the responsibilities of NEDs on the board, and how these responsibilities should be practiced.

Before assessing the effectiveness of the Code’s approach in regards to NEDs, this chapter will first explain the need for NEDs’ involvement in the corporate governance system, by referring to the insufficiency of other means of controlling the company’s managers, such as the shareholder democracy. The chapter will also look at the integration of NEDs through different board structures in different jurisdictions.

Therefore, this chapter will be divided into three main sections; section (A) concerns the different methods that aim to control the company’s managers, while section (B) discusses the integration of NEDs into different types of boards, in different jurisdictions, while Section (C) concerns the approach of the Code in regards to NEDs.

A- Different Methods that Aim to Control Companies’ Managers

The consensus narrative suggests that controlling companies’ managers is the main goal of corporate governance.  

13 This section shows that although there are several mechanisms that aim to control companies’ managers, these solutions are nevertheless imperfect and inherently unreliable, which leaves a significant requirement for an effective mechanism to control the conflict of interests between shareholders and management. Therefore, this section argues that there is a need for the NEDs’ involvement through the insider corporate governance mechanisms, in order to establish effective control over companies’ managers.

This section will be divided into the following subsections: A-1 on shareholders democracy, A-2 the market forces, A-3 the reputational factors, A-4 the involvement of NEDs within the UK corporate governance system.

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13 Nolan (n2) 415.
A- 1 Shareholders Democracy

As investors, rational choice theory would suggest that shareholders aim from their investment in the company to gain the maximum profit possible of their business, and that the company is run in the best way, to achieve this goal parallel to rational risk.14

The law has vested original power in the hands of shareholders, as they have control over the company15 based on the articles of association and the statutory power to appoint and remove directors through the general meeting.16 The most common legal interpretation of the relation between shareholders and directors is the principal-agent relationship, which describes shareholders as the ‘principal’, and directors as the ‘agents’ who should run the company on behalf of the principal.17 The case of Shaw & Sons (Salford) Ltd v Shaw18 ruled that shareholders cannot seize the powers delegated to the board of directors without amending the articles of association, it is asked what can shareholders do if they are not satisfied with the performance of the board of directors, or if the board of directors is not running the company in the best interest of shareholders?

The CA 2006, as will be explained in this section, provides several legal actions that shareholders can take to discipline and deter company managers. As averted to, this principally centres on powers that shareholders can utilize through the annual general meeting. Authors like Lucian Bebchuk19 and Demetra Arsalidou20 place great reliance on the aforementioned legal methods as good grounds for shareholders activism. However, it is argued that these legal methods face practical obstacles that prevent shareholders from practicing these legal methods

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18 [1935] 2 K.B.
and fulfilling an effective monitoring role on the board of directors, which leads to the conclusion that the board of directors remains the controlling power over the company, and that shareholders are unable to effectively practice the power they are given by law to control the company. The following subsections will mention the legal methods given by CA 2006, which are given to shareholders to prove their control over the company. These methods are: re-election, modification of the articles of association, removal of directors and derivative actions:

**A-1-a Re-election**

Shareholders can use their voting power in the annual general meeting to reject the re-election of unwanted directors. In practice, it has been proved not to be easy to have the requisite majority to vote for the replacement of unwanted directors, especially that substantial shareholders who can control the vote do not use their power to replace directors. This situation has led to describing company management as a hierarchy, rather than a democracy, and to describe shareholder voting as a ‘ceremony designed to give veneer legitimacy to managerial power.’

**A-1-b Modifying the articles of association**

Under section 303 of CA 2006, shareholders representing 10% of paid-up capital up or more can call for an extraordinary meeting, by a special resolution of a majority of at least 75% of the company’s shares voted at the general meeting, amend the articles of association and restrict powers given to a director or directors.

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21 Davies (n14) 2.
23 ibid 663.
24 ibid.
25 CA s 303.
26 Keay (n22) 664.
A-1-c The removal process under section 168

Under section 168 of CA 2006\textsuperscript{27}, shareholders can by an ordinary resolution remove a director, or even remove all the board of directors at once.\textsuperscript{28} This process must be taken through a legal process that starts with the call for an extraordinary meeting according to s. 168 (1) of CA 2006\textsuperscript{29}, which requires the meeting to be requested by shareholders representing 10% of paid-up capital. Notice should be given to the company to inform the company of the intention for the removal resolution 28 days before the meeting. s. 168 of The Companies Act 2006 is a mandatory rule which cannot be waived by companies’ articles of association.\textsuperscript{30}

A-1-d Derivative claim

Applying the \textit{Salomon v Salomon} case\textsuperscript{31} and the separate legal personality principle means it is only the company that can act on behalf of the company, which means that only the company can take legal proceedings against any person that caused harm to the company; therefore, shareholders will not be able to take legal proceedings on behalf of the company.\textsuperscript{32} This position is also assured by case law, as in the case of \textit{Foss v Harbottle},\textsuperscript{33} which is now replaced by the derivative claim actions under CA 2006. Part 11 of CA 2006 gave the power to individual shareholders to take action on behalf of the company, giving a number of exceptions to the abovementioned \textit{Foss} case.\textsuperscript{34}

The application of part 11\textsuperscript{35} of the Act requires a shareholder who is taking the action against director/directors to show a prima facie case, with written evidence, and the court in this respect will see whether there is a good reason for the proceedings or not, and in case there are, the court will allow the proceedings to go to the second stage.

\begin{itemize}
\item \textsuperscript{27} CA s 168.
\item \textsuperscript{28} Keay (n22) 671.
\item \textsuperscript{29} CA s 168(1).
\item \textsuperscript{30} Keay (n22) 671.
\item \textsuperscript{31} Salomon v A Salomon & Co Ltd [1897] A.C. 22.
\item \textsuperscript{32} Arsalidou (n20) 206.
\item \textsuperscript{33} (1843) 2 Hare 461.
\item \textsuperscript{34} Arsalidou (n20) 206.
\item \textsuperscript{35} CA 2006 Part 11.
\end{itemize}
A-1-e Analysis

Shareholders are investors who seek to maximize their wealth; therefore the aim of disciplining directors is to ensure that directors are managing the company in the best interest of shareholders’ investment goals. Accordingly, they will not take action to discipline directors if this action will cause them financial loss that might even override the benefits to be gained from the action taken. In regards to the aforementioned options provided by CA 2006, several observations may be given:

Firstly, aside from the last option, which is the derivative action under part 11 of the Act, the first three options cannot be taken by shareholder/shareholders with a small number of shares alone, as the Act requires strong voting powers to enable active shareholders to take the action they are aiming at, whether to oppose re-election or to remove directors which requires a majority vote, or for amending the articles, which requires a special resolution. Moreover, the Act requires the representation of shareholders who own not less than 10% of paid-up capital to call for an extraordinary meeting, for the purposes of amending the articles or removing directors.

Secondly, in referring to the previous point, shareholders might be able to undertake any of the first three aforementioned options by building a coalition. However, building a coalition may face several problems starting from the difficulties of co-ordinating between shareholders and bearing the costs. Nevertheless, dividing the costs between shareholders may also be problematic. Moreover, the process of building the coalition might take a long time, especially if the goal of the coalition is to remove a director; for example Professors Bernard Black and John Coffee, in their empirical research, gave an example of the coalition built in the case of Great Western Resources 1992, which took one year. The length in building the coalition is more likely to increase the costs of the coalition; nevertheless, some shareholders might choose to sell

36 Arsalidou (n20) 205.
37 Keay (n22) 659.
38 ibid.
39 ibid.
their shares and exit the company, which is likely to leave the corporate governance problem unresolved. Moreover, the length of the process gives the chance to the board to speak to the shareholders and convince them that the company’s situation is satisfactory, which might make them leave the coalition.\textsuperscript{40}

Thirdly, although part 11 of the Act gave the right to an individual shareholder to take legal proceedings in the name of the company against directors, Demetra Arsalidou considers this development good grounds for shareholders activism, and going further saying that the last financial crises could have been avoided if shareholders had been more active, which could have led to avoiding mistakes.\textsuperscript{41}

From a legal point of view, Demetra Arsalidou provides a logical opinion. However, there are other practical problems that weaken dependence on shareholders as monitors on companies’ directors. One important problem an activist shareholder might face in taking legal proceedings against the company is the costs of legal action, and this situation might even urge him to sell his share rather than taking legal proceedings.\textsuperscript{42} Nevertheless, the benefit of legal action might be outweighed by the harm caused to the reputation of the company, which can cause a severe drop in share price.\textsuperscript{43}

Furthermore, examples of major corporate scandals have proved that the companies might seem healthy to the public but have massive internal problems that have been hidden from the public, and in fact, need an expert who can access the company’s management and auditing system to detect the problem. For example, the dramatic collapse of Enron\textsuperscript{44} took place despite the company being ranked as one of USA’s top fortunate companies in December 2001,\textsuperscript{45} Enron tried to hide they suffered losses by creating Special Purpose Entities (SPE’s).\textsuperscript{46} Arthur Andersen, the US accounting company, used to provide Enron’s internal and external auditing

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{41} Arsalidou (n20) 209.
\item \textsuperscript{42} Keay (n22) 678.
\item \textsuperscript{43} Arsalidou (n20) 209.
\item \textsuperscript{45} CA Mallin Corporate Governance (Oxford University Press Oxford 2004) 2, 3.
\item \textsuperscript{46} Catanach & Catanach (n44) 1057.
\end{itemize}
\end{footnotesize}
services, and approved Enron’s self-dealing.\textsuperscript{47} Therefore, it is argued that shareholders often do not have practical access to information in order to know what is going on in the board, which makes them unable to monitor the business and the management.\textsuperscript{48}

However, some scholars argue that if shareholders’ empowerment might give dominance to institutional shareholders over major decisions, they might have interests that are not identical to those of minority shareholders, and might take decisions that do not take into consideration the long term benefit of the company.\textsuperscript{49}

To conclude, although shareholders have the legal power to appoint and remove directors, and have the power over the board through general meetings and their ability to call for extraordinary meetings for the purposes of amending the articles of association through a special resolution, the Act also gives powers to the shareholders to take derivative action against directors. It is argued that the dependence on shareholder activism to discipline companies’ directors is in practice ineffective, because of several aforementioned practical problems that stand as obstacles.

\textbf{A-2 The Market Forces}

Market forces are regarded as one of the methods to control companies and the performance of managers. Henry Manne, in 1965, provided that vibrant markets could serve as control over weak management, for the reason that managers will always try to give their best performance and make best investment of the assets of the company, in order to avoid takeovers by other companies which can make them lose their jobs.\textsuperscript{50}

\footnotesize
\begin{itemize}
  \item \textsuperscript{47} C Elson & C Gyves ‘The Enron Failure and Corporate Governance Reform’ (2003) 38 Wake Forest Law Review 858.
  \item \textsuperscript{50} H Manne ‘Mergers and the Market for Corporate Control’ (1965) 73(2) Journal of the Political Economy 110, 119.
\end{itemize}
In efficient markets, weak companies cannot hide, as the figures will show whether a company is performing poorly. The indicators for this start from the company’s share price and the relevant accounting data. All this information is available to the outsiders, analysts, other companies and venture capitalists who watch the company. The acquirers, in this case could acquire the shares of the poorly managed company at a depressed price that reflects the company’s poor performance. If the acquirer succeeds, he will take the necessary measures to enhance the performance of the company, and these measures will usually include changing management.\(^5\)

However, other authors argue in favour of providing legal protection for investors, and argue that the good corporate governance systems are corporate governance systems that provide legal protection for investors and do not rely entirely on inherently fallible market forces.\(^6\)

In the cases provided in Chapter One\(^7\) of this thesis in regards to the examples of companies’ failures, companies did not show any indication of weak management. Indeed, in the case of Enron, just prior to the collapse, Enron’s share price was high and the company was rated as one of the top ten companies in the US. Therefore market control is not the solution for examples from the type of Enron.

A- 3 The Reputational Factors

Reputational factors are regarded as one of the solutions to mitigate the effects of agency problem and reduce agency costs, particularly insofar as managers for reputational reasons will aim to manage the company efficiently and to maximize the return of the investment for investors.\(^8\) Reputational factors are said to be the motive for the board members and the NEDs to aim to perform a better job, as they will be caring about building their reputation.\(^9\)

\(^5\) Corporate Governance Promises Kept Promises Broken (n6) 119.
\(^7\) See- supra Ch 1.
\(^8\) Shleifer & Vishny (n52).
In the case of companies’ managers, the explanation of the reputational factor is that managers always prefer to build a good reputation in the market by giving returns to the investors, as the managers are usually interested in raising funds in the future, and thus, they are interested in building a reputation of good investments in order to persuade future investors to invest in the projects that they run. However, some papers showed that managers usually aim to build their reputation by repaying their short term loans.

Nevertheless, the problem that arises here is in the case where investment returns are higher than the potential funds raised. In this case, it is very likely that the managers will not be willing to pay back their investors. There are arguments that reputational factors could be an important element for managers to perform well; however this is not the sole reason for their performance, as it plays among other factors that aim to protect the assets of the company.56

A- 4 The Need for NEDs’ Active Involvement as a Part of the Corporate Governance Structure

The author of this thesis argues that the failure of the aforementioned solutions emphasizes the importance and the need for the role of NEDs within the corporate governance mechanisms, in controlling companies’ managers. The importance of NEDs comes from their unique position in the company because they serve on the board alongside the executive directors, which make them close to the information and decision making,57 and have less conflict of interests compared to the executive directors.58 Meanwhile, the importance of corporate governance in relation to the NEDs is that it provides the framework which NEDs perform within, especially that these frameworks aims to ensure that NEDs perform their role in a prospective method.59 However, as argued in this chapter, the corporate governance approach

59 Nolan (n2) 414.
of the UK needs improvement, in order to work effectively in ensuring that NEDs perform their actual role.

Some of the main goals of corporate governance that are related to this thesis are reducing agency costs,\(^{60}\) controlling companies’ managers,\(^{61}\) ensuring the soundness of the financial statements\(^{62}\) and protecting investors’ investments.\(^{63}\) There are different approaches and definitions for the scope and the goals of corporate governance.\(^{64}\) The narrow approach sees that corporate governance is concerned only with the relationship between the company and its shareholders.\(^{65}\) This approach mostly concerns lawyers, and finds that every action of the company’s management or board of directors or else that is deviant from the company goal of maximizing the shareholders wealth is against good corporate governance. This situation may be interpreted in relation to the agency relationship between company shareholders, and is described as ‘agency costs’.\(^{66}\)

A further approach sees that corporate governance is concerned with all the relationships and contributors to the corporation, not only the shareholders and the management, going further to the employees, customers, suppliers, bondholders and others, this approach is based on the ‘stakeholder’ theory.\(^{67}\) However, Jill Solomon argues that the different aspects of corporate governance are linked to management quality, providing:

> ‘...I have found from my research that one reason ‘good’ corporate governance, as well as corporate social responsibility, are linked significantly to good corporate financial performance is its link with management quality.’\(^{68}\)


\(^{61}\) Nolan (n2) 414.


\(^{64}\) Corporate Governance Promises Kept Promises Broken (n6) 2. See also, S Turnbull ‘Corporate Governance: Its Scope, Concerns and Theories’ 181. See also, R Smerdon A Practical Guide to Corporate Governance (3rd edn Sweet & Maxwell London 2007) 1.

\(^{65}\) Corporate Governance and Accountability (n7) 12.

\(^{66}\) Corporate Governance Promises Kept Promises Broken (n6) 2.

\(^{67}\) Corporate Governance and Accountability (n7) 12.

\(^{68}\) ibid.
From an economic perspective corporate governance may be defined as:

‘Corporate governance is a field in economics that investigates how to secure or motivate efficient management of corporations by the use of incentives mechanisms, such as contracts, organizational designs and legislation. It is often limited to the question of improving financial performance for example, how the corporate owners can secure or motivate that the company managers will deliver a comparative rate of return’.

Accordingly, corporate governance aims to enhance the financial performance of the company; a good corporate governance goal improves the quality of management and strategies of the company, which in return gives better value and return for shareholders and more attention to company stakeholders.

In addition to the economic definition, there are many definitions of corporate governance. Nonetheless, the focus here will be on definitions related to control, monitoring, leadership and management aspects of corporate governance, such as the definition of Parkinson, Cadbury Report and OECD Corporate Governance Code.

Parkinson provides a widely popular built on a shareholders oriented approach:

‘the process of supervision and control intended to ensure that the company’s management act in accordance with the interests of shareholders’.

The Cadbury Report 1992 provided a very focused definition:

‘the system by which companies are directed and controlled’.

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69 A Practical Guide to Corporate Governance (n64) 1.
70 Corporate Governance and Accountability (n7) 14, 15.
71 ibid 13.
73 The Cadbury Code s 2.5.
The Cadbury definition referred to corporate governance by the term ‘system’, which refers to the internal structure of the company, and which includes the board of directors and the board subcommittees, in addition to the audit, financial reporting, internal control and the laws and regulations related. The term ‘control’ refers to disciplining the company and ensuring that the company is run according to best business practice. This side of corporate governance evolved due to calls from the public and the market for disciplining companies’ behaviour, for example the executive directors’ remunerations. Finally, the term ‘direct’ refers to drawing up the company’s broad strategies that should return with benefit to the company and shareholders.

Moreover, the OECD refers to corporate governance consistent with definitions of the Cadbury Report and Parkinson:

‘Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined.’

The definition of the OECD refers to the company’s structure, the means of achieving the company’s goals and ensuring the effective monitoring over the company’s performance.

There is wide agreement that boards of directors play a significant corporate governance role, and are responsible for the governance of their companies. Their role is categorised as a part of the internal governance structure of the company, as they have direct access to the two other axes of the corporate governance triangle; the managers and the shareholders.

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74 A Practical Guide to Corporate Governance (p64) 2.
76 OECD Corporate Governance Code, preamble 11.
The board of directors is responsible for hiring, dismissing and compensating the executive directors, and assessing the performance of the executive directors,\(^{81}\) they also monitor and ratify the important decisions of the company;\(^{82}\) the monitoring role is a vital function of the board of directors.\(^{83}\)

The dominance of the executive directors over the board has been a main issue in the UK reforms.\(^{84}\) Therefore, the UK reforms sought increasing the number of NEDs on the board in order to control the dominance of the executive directors,\(^{85}\) and to increase executive directors’ accountability to the board of directors.\(^{86}\)

**B- NEDs in Different Major Jurisdictions**

The integration of outside board members, preferably independent, to participate in directing the company, whether as equal members of the unitary board or by serving on a separate supervisory board like the dual board systems, has become a universally agreed on practice.\(^{87}\) After the catastrophic collapse of Enron, many industrial countries reviewed their corporate governance regimes, aiming to solve any deficiencies in their corporate governance systems that could lead to any similar misbehaviours to those happened in Enron\(^{88}\) as will be explained in this section, the role of NEDs took a large share of the reforms, whether by enhancing their independence and increasing the number of the independent NEDs on the

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\(^{80}\) Aguilera (n79) 39.


\(^{82}\) Fama & Jensen (n77) 311.


\(^{85}\) ibid.

\(^{86}\) Aguilera (n79) 39.

\(^{87}\) T Clarke ‘The Contribution of Non-Executive Directors to the Effectiveness of Corporate Governance’ (1998) 3(3) Career Development International 118.

boards, or by giving them roles on the board’s subcommittees, such as the UK, or by improving different board styles options for the companies to adopt, such as Italy and France.

Board structures in different jurisdictions constitute the main corporate governance aspect that affects the role and character of NEDs. The main distinction in terms of board types is the one-tier or unitary board represented in the Anglo-American corporate governance system of the UK and the US, and the two-tier or dual board system represented mainly in Germany. This division is also applied through many European Countries; some countries like Ireland and Spain apply the one tier board structure, while others such as Austria and Switzerland apply the two-tier board structure, while in France, Italy and Belgium, they apply a mixed system.

Non-executive directors can be called in different names from one jurisdiction to another; “not-interested”, “independent”, “outside”, “non-employee” and “disinterested”, or ‘supervisory’. However, although these terms seems to be talking about the same thing, but there are some differences between them especially when it comes to their role.

This section will analyse various examples of incorporating NEDs on the different board models in different jurisdictions, in order to better benefit from highlighting the other examples in understanding the UK board model and the role of NEDs within it, and in order to contribute to the purpose of this thesis, which is to create a new model for UK NEDs by inspiring or eliminating ideas from other jurisdictions.

Therefore, this section will first refer to the one-tier board model of the UK and the US, but highlighting the differences between the two, especially regarding board composition of both

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89 See- The Higgs Report.
91 Corporate Governance (n45) 93.
92 Corporate Governance and Accountability (n7) 78.
96 Clarke (n94) 4.
countries, where the US boards consist usually of supermajority independent members while the UK board is in comparison a balanced board. The section will also refer to the German board model as the main example of the two-tier board model, and show the differences regarding the character and responsibilities between the UK NEDs and the members of the supervisory board in Germany. This is in addition to referring to France and Italy as an example of countries that give the choice to companies to choose between different board models but by highlighting the default models which have a domestic touch in both countries.

The US and the UK share the same board style. In the unitary board of the UK and the US, the company has a single board of directors, which is elected by the shareholders. The board consists of executive and NEDs, and is responsible for the company’s actions, and they work to achieve the same goals. The board of directors has sub-committees, and therefore, is also referred to as board committee system. Both jurisdictions focus on the independence of independent NEDs and on giving them a vital role on the board, and the board subcommittees.

The board of directors is legally responsible for appointing and dismissing senior management. The board of directors must also ensure that there is adequate internal control and audit systems, and ensure that there is good information flow. However, the most important role of UK NEDs and outside directors in the US is to monitor the performance of the management and the company’s activities, and to set the companies’ strategies.

Although the UK and the US share the same board style, and they share substantial similarities, there are differences that are worth highlighting. A major difference between the two boards is that the US boards usually consist of supermajority independent outside

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98 Corporate Governance (n45) 94.
100 ibid.
102 ibid.
103 ibid 172, 173. See also, Davies (n9) 6.
104 Aronson (n99) 52.
directors, while the UK boards are more balanced boards, consisting of NEDs, independent NEDs and executive directors. Understanding the two different approaches requires a study of the rise of the modern UK and US boards, which explains the process that created the distinction between the different types of NEDs.

Historically, US companies used to be run by the board of directors elected by shareholders. However, due to the growing complexity of business, it became clear that the board of directors is not able to take care of running the company directly, and instead the board had to delegate the responsibility of managing the companies’ affairs to specialized managers. Delegating the managerial powers to manage board members created the first distinction on the board calling the managing board members as insiders, while the non-manage board members as outsiders, this type of board was described as a cooperative or advisory board.

Later, due to the growth of the number of shareholders, creating a dispersed ownership structure, the US boards became less capable of monitoring the management, and they lacked the incentive to do so. In the 1960’s, the need for an effective monitoring changed the role of the board of directors from cooperative advisory boards to monitoring boards, to independent monitoring boards. Therefore, due to the calls for integrating directors who can fulfil a monitoring role, the role of the independent directors emerged in the US in the 1970s as a part of the US corporate governance system.

In the late 1970’s, a further distinction arose between the different types of board members, firstly distinguishing between ‘management’ and ‘non-management’ directors, considering a former officer or employee as a ‘managerial’ director, while the ‘non-
management’ directors are split into either independent non-management directors, or affiliated ‘non-management’ directors referring to the directors who has economic or personal ties with the company such as commercial and investment bankers, lawyers and any other director who provides goods or services to the company. Later in the 1980’s and 1990’s, different panels and committees stressed that boards of directors should consist of a majority of independent directors, identifying the independent director by the director who is free of any ‘…significant relationship with the corporation’s senior executives’. Currently, US boards consist of supermajority independent directors with only one or two insiders, out of typically 9 to 11 board members.

In the UK, the process under which the role of NEDs and independent NEDs rose was shorter than that of the US. As previously mentioned in Chapter Two, UK companies used to be run by managers while the rest of the board members did not have any significant role or influence over the management of the company. Therefore, the main distinction between executive directors, NEDs and independent NEDs was introduced to the UK boards in 1992 by the Cadbury Report as a part of the UK corporate governance reforms.

The Cadbury report required only a minimum of three NEDs, including the fact that one of them must be the chairman of the company and at least two of them must be independent. The Cadbury report did not provide independence criteria, but only provided that independent NEDs should be independent of management, apart from their fees and shareholding. The reliance on NEDs and independent NEDs increased after the scandals of Enron and WorldCom, through the Higgs Review, which came parallel to the Sarbanes-Oxley Act in the US. The Higgs Report came with major developments, increasing the participation of independent NEDs on the board requiring at least half of the board of directors to comprise of independent NEDs,

\[\text{References:}\]
114 ibid 1479.
115 ibid 1481.
117 See- supra Ch 2.
118 The Cadbury Report. See also, Davies (n9) 6.
119 The Cadbury Report s(4.11).
120 ibid s(4.12).
121 The Higgs Report s(4.9).
122 ibid (9.5).
with providing a definition or criteria for NEDs’ independence which includes a list of financial and family relationships that if a NED has, he will not be considered independent.\textsuperscript{123}

By studying the composition of the boards in the US and the UK, the writer of this thesis suggests that the UK boards have an advantage over the US boards. The reason for this is that the modern US boards consist of supermajority independent board members with only few managers such as the CEO and CFO.\textsuperscript{124} On the other hand, the UK board is a mixed or a balanced board, composed from executive directors, NEDs and independent NEDs.\textsuperscript{125} Therefore, composition of the UK boards allows NEDs who do not fit with the independence criteria to sit on the board, such as former employees and managers. This type of NEDs seems to be like the aforementioned ‘managerial’ directors or affiliated ‘non-management’ directors of the old US boards.\textsuperscript{126} The rationale for the UK approach is to benefit from the information, skill and expertise that the insider directors have, and to create an atmosphere of openness, trust and effective dialogue on the board.\textsuperscript{127}

Despite the aforementioned difference in the board structure between the UK and the US, the Higgs Report increased the similarities between the US and UK boards by recommending a role for a senior independent director to open channels with shareholders and to chair the NEDs’ meetings in the absence of the chairman,\textsuperscript{128} moreover following the NYSE listing rules, the Higgs Report required NEDs’ meeting without the executive directors and the chairman.\textsuperscript{129}

Nevertheless, splitting the roles of the CEO and the chairman remains as a difference between the boards in the two countries.\textsuperscript{130} The UK corporate governance reforms focused on splitting the roles of the CEO and the chairman,\textsuperscript{131} in order to create an independent leadership of the board, so as to achieve stronger independent monitoring over the management.\textsuperscript{132} On the
other hand, in the US, the split in the roles of the chairman and CEO was not a significant issue in the US corporate governance reforms; instead the focus was on the integration of a large number of independent directors, providing a leading role for the ‘lead’ independent director.\textsuperscript{133} Needless to say, another difference between the two systems is the UK corporate governance trademark, the soft ‘comply or explain’ approach,\textsuperscript{134} which makes the UK system different from the US which applies rigid rules.\textsuperscript{135}

The differences between the UK system and the German system seem to be more significant than the differences between the UK and the US boards. Unlike the UK, boards of directors of German public companies are split into two-tiers; the supervisory board ‘\textit{Aufsichtsrat}’, and the management board ‘\textit{Vorstand}’.\textsuperscript{136} The main characteristic of the dual board system is the personal and organizational split between the management and supervisory boards.\textsuperscript{137} The functions and duties of each board are distinguished.\textsuperscript{138} The separation of the two boards in Germany is built on statutory regulations,\textsuperscript{139} while the non-statutory regulations followed recently in 2002, amended in 2006, as supplementary regulations.\textsuperscript{140} As will be explained below, there are several differences between the UK NEDs and the German supervisory board members in regards to their responsibilities and character.

While in the UK, executive and NED members of the single tier board are responsible for leading and controlling the company,\textsuperscript{141} Germany separates the responsibilities between the

\textsuperscript{133} ibid.
\textsuperscript{134} The Code ‘comply or explain’ (1).
\textsuperscript{135} Aronson (n99) 42.
\textsuperscript{137} K Hopt & P Leyens ‘Board Models in Europe-Recent Developments of International Corporate Governance Structures in Germany, the United Kingdom, France and Italy’ (2004) 1(2)European Company and Financial Law Review 141.
\textsuperscript{139} Hopt (n93) 227-230.
\textsuperscript{141} The Code s(A).
management and the supervisory boards.\textsuperscript{142} The management board is entrusted to operate the company and to set the long term goals and guidelines of the company, which means they typically do not have to adhere to the orders of shareholders or the supervisory board.\textsuperscript{143} On the other hand, the role of the supervisory board is not as clear as the role of the management board.\textsuperscript{144} The supervisory board appoints and dismisses the management board members and monitors their performance.\textsuperscript{145} In addition, the supervisory board deals with strategic decisions.\textsuperscript{146} Nevertheless, supervising the management actions remains their main function,\textsuperscript{147} as the supervisory board is the main monitoring tool in the hands of shareholders.\textsuperscript{148}

The controlling function of the supervisory board over the management includes monitoring the management’s compliance with the law and articles of association and business strategies.\textsuperscript{149} Nevertheless, the monitoring role of the German supervisory board is on the management, and not on the company,\textsuperscript{150} which is contrary to the UK approach, where NEDs as members of the one-tier board are responsible for monitoring the management and the company.\textsuperscript{151}

The supervisory board approves the annual accounts.\textsuperscript{152} An advantage in the German supervisory board arises regarding the audit process, where the system allows the members of the supervisory board to have complete independence of management in performing their audit role.\textsuperscript{153} However, the internal control is one of the management board responsibilities, with a growing tendency for increasing the approval rights of the supervisory board.\textsuperscript{154}

\begin{footnotesize}
\begin{enumerate}
\item Jungmann (n140) 433.
\item ibid.
\item Hopt & Leyens (n137) 141.
\item Jungmann (n140) 432.
\item Corporate Governance and Accountability (n7) 78.
\item Jungmann (n140) 433.
\item ibid 435.
\item Hopt & Leyens (n137) 141.
\item ibid.
\item The Code (A.1).
\item ibid.
\item Hopt & Leyens (n137) 147.
\end{enumerate}
\end{footnotesize}
A major difference between the one-tier board in the UK and the two-tier board in Germany is the characteristics of the supervisory board members, compared to the UK NEDs. The composition of the German two-tier board is influenced by the stakeholder approach,\(^{155}\) German company Law requires the supervisory board members to be chosen by shareholders, where up to half of the seats should be chosen by labour,\(^{156}\) as the Law obliges companies with more than 500 employees to represent the employees on the board.\(^{157}\) The system does not allow simultaneous membership;\(^{158}\) therefore the composition of the supervisory board is based on the theory of co-determination and labour representation,\(^{159}\) which means that labour and capital co-determine the company’s actions through the process of selecting and dismissing the management.\(^{160}\)

On the contrary, independent NEDs in the UK need to meet the independence criteria of the Code.\(^{161}\) The UK approach finds that a NED will not be considered independent if he represents a significant shareholder, while due to the co-determination the supervisory board members can be dependent on shareholders and business partners.\(^{162}\) This situation raises major questions regarding independence, objectivity and conflicts of interests.\(^{163}\) Moreover, the supervisory board usually has a representative of banks or their investment branches; this situation may raise conflicts of interest due to the creditor relationship between the bank and the company.\(^{164}\)

Moreover, a very common practice on the German boards is to offer seats for former managers on the supervisory board. For example, the chairman of the management board usually

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\(^{156}\) Hopt (n93) 227-229.

\(^{157}\) Davies (n9) 14.

\(^{158}\) Jungmann (n140) 432.

\(^{159}\) Zhao (n136) 501.

\(^{160}\) ibid.

\(^{161}\) The Code (B.1.1).


\(^{163}\) Hopt & Leyens (n137) 143.

\(^{164}\) ibid.
switches and takes the chairmanship of the supervisory board.\textsuperscript{165} In this respect, the German Corporate Governance Code does not provide a definition or criteria for independence, instead the Code only requires limiting the number of former executive on the supervisory board into two members, and banning former management board members from becoming the chair of audit committee.\textsuperscript{166}

In terms of skills, the problem with the labour co-determination is that within large companies the number of labour representatives on the supervisory board could be up to ten out of twenty or twenty one members, this situation prevents the German system from requiring particular knowledge or special expertise, beyond the minimum level of financial literacy, as the workforce and unions might not have the adequate candidates.\textsuperscript{167}

The major goal of splitting the two boards is to separate the monitoring function from the management function, which is supposed to reduce the influence of the management over the supervisory board members.\textsuperscript{168} The German approach is very strict, as members of each of the two boards are not allowed to serve on the other,\textsuperscript{169} and the supervisory board members are not allowed to be directly involved in managing the company, unless it is decided by the articles of association for example through the approval of specific types of transaction.\textsuperscript{170} Nevertheless, separating the supervisory board from the management board could be at the expense of the quality of information that the supervisory board gets, as they do not get to obtain enough information directly from the management board, which could make it difficult for them to have a full view of the company’s situation.\textsuperscript{171}

Other European countries, such as Italy and France, provided different board styles for companies to choose from. The two countries offer the option of adopting a one-tier board, built on the Anglo-American board style, which employs NEDs and independent NEDs, or the two-tier built on the German system which splits the board into a management and supervisory

\begin{thebibliography}{9}
\bibitem{ibid} ibid.
\bibitem{ibid 144} ibid 144.
\bibitem{ibid 145} ibid 145.
\bibitem{Zhao (n136) 500} Zhao (n136) 500.
\bibitem{ibid} ibid.
\bibitem{Jungmann (n140) 432} Jungmann (n140) 432.
\bibitem{Hopt & Leyens (n137) 147} Hopt & Leyens (n137) 147.
\end{thebibliography}
boards.\textsuperscript{172} Co-determination is also applied on the French two-tier board, and employees are supposed to constitute up to one third of the supervisory board,\textsuperscript{173} but not applied on the Italian supervisory board, as the supervisory board of Italy is chosen exclusively by the shareholders, and there is no requirement of stakeholders’ representation.\textsuperscript{174}

However, an interesting aspect regarding board structures in Italy and France is the third board style option provided in both countries, which is the default board model, built on the one-tier board in France,\textsuperscript{175} and half way between the one-tier and two-tier boards in Italy.\textsuperscript{176} As will be explained below, both countries added their own touch on the default board models which made them differ from the basic UK one-tier and German two-tier boards.

The French system took steps towards the UK system, in regards to employing independent NEDs\textsuperscript{177} and splitting the role of the chairman and the CEO.\textsuperscript{178} In France, the developments provided by the New Economic Regulations 2002, to the traditional one-tier board, aimed to clarify the differences between the role of the board of directors, the CEO and the chairman,\textsuperscript{179} as the traditional one-tier board had the power to manage the company vested in the chairman, with limited control by the board,\textsuperscript{180} while the new developments gave the option to the boards to split the functions of the CEO and chairman.\textsuperscript{181}

If the roles of the chairman and CEO are split, the powers of the chairman will be reduced, as the general management of the company will be vested in the CEO,\textsuperscript{182} and will

\begin{footnotesize}
\begin{itemize}
\item Millet-Reyes & Zhao (n172) 286.
\item Herbert (n90) 659.
\item Herbert (n90) 663.
\item Herbert (n90) 659.
\item Storck (n178) 42.
\item Herbert (n90) 659.
\item ibid 659, 660.
\end{itemize}
\end{footnotesize}
represent the company,\textsuperscript{183} while the chairman’s role will be organizational and operational, such as ensuring the management is working efficiently, and ensuring that the directors are in a position to perform their role, and that they have enough information,\textsuperscript{184} nevertheless the chairman would still have indirect influence as he decides the number of meetings and sets the agenda, and might also be the head of some committees.\textsuperscript{185}

In regards to employing independent NEDs, the French system is moving towards the approach of the UK Corporate Governance Code, requiring independent directors to be free from any relationship with the company, or the management that would influence his independent judgment,\textsuperscript{186} the Principles of Corporate Governance of October 2003 also provides a set of relationships that impairs the independence of the director.\textsuperscript{187} The Code also focuses, in addition to the independence of the directors, on the skills and competence of the appointed directors.\textsuperscript{188} According to the developments, the board of directors is responsible for setting the company’s directions, and supervising the application of the company’s strategies, in addition to practicing checks and controls.\textsuperscript{189}

However, the French approach differs from the UK approach first in the number of NEDs on the board, as in France the independent board members should constitute from one third to half of the board of directors,\textsuperscript{190} while in the UK at least half of the board members must be independent NEDs,\textsuperscript{191} and the French Code also moved towards raising the number of the independent directors on the board subcommittees, requiring the compensation committee to have a majority of independent directors and the audit committee to have two thirds of independent directors,\textsuperscript{192} which is also less than the UK requirements. In addition, unlike the UK

\textsuperscript{183} Storck (n178) 44.
\textsuperscript{184} Herbert (n90) 659.
\textsuperscript{185} Storck (n178) 45.
\textsuperscript{186} Herbert (n90) 663.
\textsuperscript{187} Hopt & Leyens (n137) 157.
\textsuperscript{188} ibid.
\textsuperscript{189} Storck (n178) 45.
\textsuperscript{190} Hopt & Leyens (n137) 158.
\textsuperscript{191} The Higgs Report (9.5).
\textsuperscript{192} Hopt & Leyens (n137) 158.
board, the board of directors is not empowered to act on behalf of the company, and their actions as representatives of the company are not binding.\textsuperscript{193}

In the default board model of Italy, the company will have two boards; the board of directors and the board of auditors.\textsuperscript{194} The board of auditors is composed of at least three chartered accountants\textsuperscript{195} while the board of directors consists of executives and NEDs proposed by the chairman by the blockholder,\textsuperscript{196} both boards are elected by the shareholders in the general meeting.\textsuperscript{197}

The board of directors holds and oversees the managerial functions,\textsuperscript{198} which means that they will have the monitoring and management conflict.\textsuperscript{199} The board of auditors monitors the company and the management,\textsuperscript{200} this gives the board of auditors a role that is close to the role of the UK NEDs.\textsuperscript{201} The board of statutory auditors checks the compliance of the management decisions with the relevant laws and regulations, and is responsible for reviewing internal control systems, the administrative and the accounting systems, they can also notify the authorities of any irregularities, and moreover they can give orders to the company’s employees.\textsuperscript{202}

By comparing the NEDs’ involvement on the different types of boards on different jurisdictions, this thesis suggests that NEDs could be more beneficial to the company by serving on the UK unitary board. The reason behind this argument is based on the argument of this thesis provided in Chapter Four, namely that NEDs, by becoming involved in the decision making process, will benefit the company with their expertise, and will be more capable of controlling the decision making of the company. Moreover, NEDs, by serving on the unitary board will have a wider responsibility as they will be responsible for monitoring the board and the company in general.

\textsuperscript{193} ibid 157.
\textsuperscript{194} Ghezzi & Corrado (n174) 11.
\textsuperscript{195} A Melis ‘Corporate Governance in Italy’ (2000) 8(4) Corporate Governance: An International Review 353.
\textsuperscript{196} ibid 352.
\textsuperscript{197} Melis (n176) 77.
\textsuperscript{198} ibid.
\textsuperscript{199} ibid.
\textsuperscript{200} Ghezzi & Corrado (n174) 11.
\textsuperscript{201} Melis (n176) 77.
\textsuperscript{202} ibid 80, 81.
C- The Code’s Approach in Regards to the Case of NEDs

As was previously mentioned in Chapter One of this thesis, the Code requires the NEDs to perform a wide corporate governance role on the board, the board subcommittees and the company in general. According to the Code, NEDs are supposed to monitor the management and the business. In addition, NEDs according to the Code are required to participate in developing the company’s strategic plans. Moreover, the Code requires the NEDs, through sitting on the board’s subcommittees, to monitor the audit process, to check the risk management and the internal control systems, to decide the remunerations of the top management and to lead the process of the appointment of new board members through the nomination committee.²⁰³

As explained in Chapter One of this thesis, the role of NEDs is based on the need to control the conflict of interest between the management and the shareholders, which arose as a consequence of the separation between ownership and control.²⁰⁴ Therefore, the UK corporate governance approach sought appointing NEDs and independent NEDs to the board, the rationale of the UK corporate governance approach is that NEDs due to their independence of management, will be able to monitor and control the management and their actions, and will also be able to control the company’s decisions.²⁰⁵ The approach of the Code focused almost completely on the board structures and the appointment of NEDs to the board, as a method to enhance the monitoring role of the board, and in doing so, the Code provided an enforcement mechanism through the ‘comply or explain’²⁰⁶ principle for ensuring the companies’ compliance with the Codes’ recommendations in regards to the board structures and NEDs’ appointment.²⁰⁷

Nevertheless, this thesis argues that the Code’s approach in regards to the case of NEDs is ineffective, and cannot achieve the goal of controlling the management and the company’s

²⁰³ See- supra Ch 1 s B. See also, the Code general information.
²⁰⁶ The Code s (B).
decisions. This ineffectiveness is due to two reasons; the first is the Code over relies on the independence factor, assuming that if a NED is independent according to the independence criteria of the Code, he will perform his corporate governance role. Nevertheless, as will be explained in this section, there is no criteria that can assure the independence of NEDs, as there are different social and psychological biases that affect the independence of NEDs. The second reason is that the Code does not effectively define the role of NEDs; instead the Code defines the role of NEDs in very general terms which do not entail how they are going to perform their role in practice. In addition to the two aforementioned reasons, the Code does not provide an enforcement mechanism to ensure that NEDs will perform their role.

This section will be divided into two subsections; the first concerning the independence of NEDs and the Code’s reliance on the agency approach, which relies on improving the board structures as an effective method for controlling the company’s management, while the second is on the design and drafting of the role of NEDs in the Code, which as will be argued, is very vague drafting, and does not entail what the responsibilities of NEDs are, which makes their role on the company and the board passive. In order to analyse and clarify the weak definition of the role of NEDs, the second subsection will analyse the role of NEDs on the audit committee, to provide a vivid example of the weakness of the Code definition.

C-1 NEDs’ Independence

As previously mentioned in Chapter One of this thesis, the approach of the Code is based directly on the agency theory approach. Therefore, the approach of the Code focuses on improving the board structure, through appointing NEDs and independent NEDs to the board. The idea behind the appointment of NEDs and independent NEDs is that NEDs, due to their independence of management, will not be biased, and will not behave as subordinates of the CEO, therefore they will be able to bring an independent judgment to the board, and they will be able to act as independent referees, and accordingly they can establish control over the company’s CEO and other officers. This high reliance and expectations built on NEDs’

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208 Jensen & Meckling (n60) 308.
209 Bathala & Rao (n207) 60.
independence gives the wrong impression that an ‘independent’ NED is synonymous to ‘trustworthy’ NED.\textsuperscript{210}

However, several scholars have doubted the efficiency of the monitoring model based on the appointment of independent NEDs. For example, Larry Ribstein provides that boards’ independence did not help in preventing past mismanagement and frauds.\textsuperscript{211}

Other scholars have built their opinions on empirical research, and several authors have doubted the benefits of having a majority of independent NEDs on the boards of directors.\textsuperscript{212} For example, Hamid Mehran said that he did not find any relation between board compositions ‘insiders and outsiders’ and the firm performance.\textsuperscript{213} April Klein pointed out that there is no positive relation to prove that board composition improves firm performance,\textsuperscript{214} and he provides that replacing insider directors with independent directors would not be for the benefit of the firm.\textsuperscript{215}

Sanjai Bhagat and Bernard Black also provided in their empirical research article that there is no correlation between board independence and the long-term performance of the company, and have suggested a different interpretation of the role of non-executives. This includes the argument that the directors which are purported to be independent cannot be truly independent of management, due to the CEO capture of the board of directors,\textsuperscript{216} especially because the definition of independence used is simple and differs from one study to another, and cannot guarantee independence.\textsuperscript{217} Moreover, the studies indicate that independence only is not

\textsuperscript{210} Daniele (n205) 317.
\textsuperscript{214} Klein (n212) 300.
\textsuperscript{215} ibid 301.
\textsuperscript{217} Daniele (n205) 326.
enough to enhance the performance\textsuperscript{218} of the NED since other factors are also important for the board members such as the incentives.\textsuperscript{219}

However, it is suggested that Independence of NEDs is an issue that should be analysed from the social-psychological factors,\textsuperscript{220} as the objectivity of the board may be influenced by different behavioural factors, which reflects on the quality of decision making, such as conflicts of interests, “cognitive biases”, dominance of CEO, anchored attitudes, weak knowledge and information, the atmosphere at the boardroom and other factors.\textsuperscript{221} The aforementioned factors have the potential to cause bias on the decisions of the individual directors. This kind of bias has a negative impact on the quality of the functional role of independent NEDs, and therefore on their monitoring role and the quality of decision-making of the board of directors.\textsuperscript{222}

In the context of directors and their job at the board, Donald Langevoort describes independence thus:

\begin{quote}
“Independence” is a subjective concept that connotes a willingness to bring a high degree of rigor and skeptical objectivity of the evaluation of company management and its plans and proposals\textsuperscript{223}
\end{quote}

Behavioural economics recognised several pervasive cognitive errors that bias decision making. These biases could result in systematic behaviour that departs from the rational choice model.\textsuperscript{224} The individual directors assume that their departure from rationality and cancelling each other opinions will at the end serve the rational choice of the group.\textsuperscript{225}

\textsuperscript{218} ibid.
\textsuperscript{219} Black & Bahgat (n116) 267.
\textsuperscript{220} O Marnet ‘Bias on the Boardroom’ (2011) 2(3) International Journal of Behavioural Accounting and Finance 238.
\textsuperscript{221} ibid.
\textsuperscript{222} ibid 242.
\textsuperscript{225} \textit{The New Corporate Governance in Theory and Practice} (n224) 95.
Stephen Bainbridge provides several reasons for this behaviour. The first is the herding reason, which suggests that a decision maker would imitate the actions of others instead of taking his decision according to his information and own thoughts. Several reasons may be provided to explain this behaviour; one of them is following the crowd when taking a decision which could benefit his reputation even if the actions fail.\textsuperscript{226} A further reason is that directors, who consider themselves as having less information and knowledge regarding the decision the board is about to take, would prefer to follow their other colleagues’ decisions since they have better knowledge and information.\textsuperscript{227}

A further important problem that affects decision making is the “groupthink” phenomenon; Irving Janis explored and analysed the group decision making and provided:

\textit{‘When groupthink tendencies become dominant, the members try to avoid saying anything that might disturb the smooth surface of unanimity that enables the members to feel confident that their policies are correct and bound to succeed’}\textsuperscript{228}

The problem with the “groupthink” on the board of directors is that it lowers the quality of the decision making, as it would prevent directors from practicing critical thinking or suggesting alternatives for a particular proposal; moreover, the group will be selective in gathering information. This “groupthink” will be directed by the CEO, which will try to lead the group towards the decision he desires.\textsuperscript{229}

The board of directors is responsible for appointing and assessing executive directors. Once these directors have been chosen, observed and promoted, the board of directors will become committed to and responsible for these executives, which makes it unlikely for them to be independent from these managers that they are supposed to monitor after that.\textsuperscript{230} Once a director decides to trust the CEO, he may be reluctant to change his initial views, and will try to

\begin{flushleft}
\textsuperscript{226} ibid 96.  \\
\textsuperscript{227} ibid.  \\
\textsuperscript{229} \textit{The New Corporate Governance in Theory and Practice} (n224) 99.  \\
\textsuperscript{230} \textit{Corporate Governance Promises Kept Promises Broken} (n6) 58.
\end{flushleft}
interpret any new information in a way that supports his initial original view, as the director will try to interpret the new information he gets in favour of the initial views of the CEO. The explanation for this behaviour is that when people make voluntary commitment to a person, they subconsciously try to maintain and justify their original view, and oppose different events and information that could change this.

The long term relationship between the board and the CEO will also affect the objectivity of the board regarding executives’ actions. The theory of ‘escalating commitments’ suggests that when the board of directors starts to agree and approve the executives’ decisions, they will become loyal to these decisions. Once decisions are made and defended, they will affect future decisions, as future decisions are more likely to become compatible with earlier decisions. The suggestion is that once the ideas and beliefs are embedded in the minds of the board of directors, it is very unlikely that the board will change these beliefs. Beliefs are described as positions; once someone challenges those beliefs it is like criticizing their positions.

Directors accepting the position of a board will automatically alter their personal views with the views of the executive directors, and these views will become internalized in the directors, which could influence their objectivity. Moreover, once the board builds an initial positive views of management, these views become ‘anchored’ and it is not easy to change these views in the future.

A NED, before deciding to join a board, will decide whether to trust the senior management of the company, provided that most NEDs are successful people and will have their own perspectives. They would prefer to have minimal information about the company in order to build up their decision without having to go through a complex decision. Instead, they prefer to

232 ibid.
233 Corporate Governance Promises Kept Promises Broken (n6) 58.
235 Corporate Governance Promises Kept Promises Broken (n6) 58.
236 ibid 59.
rely on initial impressions, rather than going through the different details of the business. Social psychology refers to this behaviour by “schema”. The application of this suggests that directors will try to build a favourable impression of the top management, built on their impressive records, and by looking at the reputation of the gatekeepers such as the auditors, without going through the details of the company’s matters and as long as the NED does not find obvious problems floating on the surface. Moreover, as was mentioned before, the CEO would in practice appoint the NED. Social psychology provides that they are likely to build favourably those who assist their objectives.

The problem of the capture of the executive directors over the board of directors in the UK is old, and was represented clearly in traditional UK boards, which used to be dominated and run by executive directors, while the role of the rest of the board was mostly giving good reputation to the company, and they were not supposed to oppose the executive directors’ policies; instead, they should appear as a united board in front of the public.

The main problem is that NEDs face a trade-off between the monitoring role and the quality of the managerial role. Executive directors will be more cooperative and share information with the NEDs, and NEDs will have better knowledge of the business issues which enables them to take a more successful management role. On the other hand, their involvement in the management role with their executive colleagues will affect their objectivity and will cause board capture.

The appointment of NEDs may be influenced by the CEO. Although the decision is formally for the shareholders; however, the CEO will informally decide the NEDs who will serve on the board, and will choose the NEDs who will be the best fit for their board.

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237 O’Connor (n231) 1250.
238 J Cox & H Munsinger ‘Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion’ (1985) 48(3) Law and Contemporary Problems 92. See also, O’Connor (n231) 1250.
239 O’Connor (n231) 1250.
240 See supra Ch 2 s A.
243 Corporate Governance Promises Kept Promises Broken (n6) 57.
Accordingly, it is suggested that there is no criteria which can eliminate all the relations that would vitiate the independence of directors, as it is hard to anticipate all the provided criteria that could cover all factors that may create a conflict of interest.\textsuperscript{245} However, it is suggested that the independence criteria may help in eliminating some significant relations that could create conflict of interests; therefore, the difference which the independence criteria brings, is that the independent NED will be less likely to have a conflict of interest, but that there is no assurance that he will be immune to bias.\textsuperscript{246}

Therefore, it is suggested that the approach of agency theory and the Code in regards to NEDs’ independence should change, and the independence factor should be regarded as an assisting factor. Moreover, it is argued that due to the incapability of the independence factor to ensure a good performance of NEDs, there is a need to establish an enforcement mechanism for the role of NEDs. However, as argued in chapter two, the primary step for enforcement is defining the responsibilities of those subject to the enforcement.\textsuperscript{247} Therefore, the next section will analyse the Code’s definition of the role of NEDs.

\textbf{C-2 Defining the Role of NEDs in the Code}

This subsection argues that the Code does not provide a clear definition of the role of NEDs. Instead, the Code defines the role of NEDs in very general terms, and defines their role in a passive manner, which does not provide a clear allocation of responsibilities to the NEDs, and does not provide specific functions for NEDs to practice in order to fulfil their monitoring role.

As will be explained in this subsection, the thesis distinguishes between the three levels of definitions in terms of the roles and responsibilities of NEDs. The first level is the broad theoretical level, while the second defines the NEDs’ role in broad terms as it is defined in the


\textsuperscript{246} Newcomb (n58) 411, 426.

\textsuperscript{247} See- infra Ch 2.
Code, while the third level defines their role with clear functions and clear allocation of responsibility.

This subsection will analyse the drafting of the role of NEDs in the Code, to emphasise the weakness of the definition of the NEDs’ roles and responsibilities. The subsection will also analyse the role of NEDs on the audit committee in depth, due to the sophistications of the role of NEDs on the audit committee. The subsection will also refer to the weak drafting of the management and monitoring roles of NEDs; nevertheless, the full analysis of the dual roles of NEDs will be provided in next chapter.

To explain the abovementioned, the role of NEDs on the theoretical level may be described as ‘control’ over the company, the company’s managers and the decision making. The role of NEDs may also be described as monitoring, which refers to monitoring the actions of the management, and monitoring the business in general. Moreover, their role may be described in terms of ‘accountability’, which refers to making the company’s management accountable to the board. In addition, their role may be described as ‘strategizing’, which refers to the role of NEDs in participating in building the company strategy.

At the next level, the Code translates the abovementioned theoretical definitions into the drafting of the Code. Therefore, the Code provides a wider set of definitions of the role of NEDs on the board and the board subcommittees. This wider set of definitions reflects the abovementioned theoretical definitions and objectives of the role of NEDs according to the details of the company’s structure and business.

The Code defines the main role of NEDs as:

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249 Hillman & Dalziel (n248) 385.


251 Judge & Zeithaml (n75) 766.
'As part of their role as members of a unitary board, non-executive directors should constructively challenge and help develop proposals on strategy.'\(^{252}\)

In doing so,

'Non-executive directors should scrutinise the performance of management in meeting agreed goals and objectives and monitor the reporting of performance. They should satisfy themselves on the integrity of financial information and that the financial controls and systems of risk management are robust and defensible. They are responsible for determining appropriate levels of remuneration of executive directors and have a prime role in appointing and, where necessary, removing executive directors, and in succession planning.'\(^{253}\)

It is suggested that the abovementioned provision provides a broad definition of the role of NEDs on the company and on the board, which does not clearly define the responsibilities of NEDs. The Code uses very general terms and phrases to describe the role of NEDs, such as ‘scrutinize’, ‘satisfy themselves’ and ‘have a prime role’. These terms do not indicate that the abovementioned tasks are NEDs’ responsibilities, as the impression given is that these roles are the responsibilities of other players in the company, while the role of NEDs is only to check and observe.

Moreover, the Code does not explain how NEDs perform the monitoring and management roles, which will be explained and analysed in the next chapter.\(^{254}\) The monitoring and management roles of NEDs are very sophisticated, due to the sophistication of the decision making steps.\(^{255}\) Nevertheless, the Code does not refer or explain whether NEDs should be involved in these steps or should they only be observing and scrutinizing the decisions of the management.

\(^{252}\) The Code s(A.4).
\(^{253}\) The Code s(A.4).
\(^{254}\) See infra Ch 2.
\(^{255}\) Fama & Jensen (n77) 303.
However, in order to explain the abovementioned view more explicitly, the next section will analyse the role of NEDs on the audit committee, to highlight the vagueness of the Code’s drafting.

C-2-a The role of NEDs on the audit committee

The audit committee is one of the board of directors subcommittees consisting of at least three independent NEDs; at least one of the three members must have recent financial expertise. Unless there is a separate risk management and internal control committee, the audit committee takes the role of risk management and internal control committee. The following will be divided into two subsections; the first is on the role of the audit committee in the financial reporting process, while the second will be on the role of audit committee on the risk management and internal controls.

C-2-a-i The role of the audit committee on the financial reporting process

The first objective of the committee is to ensure the soundness of financial statements. The audit committee is regarded as a positive contribution to the corporate governance process, and a key corporate governance mechanism, and described by the Treadway Commission of the US as critical to the financial reporting integrity. Nevertheless, the effectiveness of Audit Committee in enhancing the integrity of the financial statements lacks empirical support, and the research in the UK regarding the audit committee activities is slim. The following will analyse the work of audit committee regarding the financial reporting and the external auditor, and the internal audit.

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256 The Code s (C.3.1).
257 The UK Corporate Governance Code 2010, s C.3.2.
Corporate collapses and scandals have ostensibly shown a clear lack of correspondence between audited accounts and the real financial situation of the company before the collapse. They have also often demonstrated that financial statements have been vague for years prior to the collapse of the organization. This indicates that the external auditor had accepted, without investigation, the opinions of managers, especially the opinions of dominant CEOs. The audit committee aims to reach a reliable and transparent financial statement by ensuring that external auditors are doing a good job, by ensuring their independence, and their access to the company’s accounts and financial information.

The work of the audit committee is based on the assumption that enhancing the independence of the external auditor will positively reflect on the quality of financial reporting, and on the assumption that audit committees consisting of independent NEDs will enhance the independence of the external auditor.

Regarding the second assumption, namely that audit committees consisting of independent NEDs will enhance the independence of external auditors, the Corporate Governance Code provides that the audit committee should:

‘… review and monitor the external auditor independence and objectivity…’

And,

‘… develop and implement policy on the engagement of the external auditor to supply non-audit service…’

263 Wolnizer (n261) 45, 49.
265 The Code s(C.3.2).
266 The Code s(C.3.2).
In addition, the audit committee should recommend the appointment and re-appointment of the external auditor:

‘...to make recommendations to the board, for it to put to the shareholders for their approval in general meeting, in relation to the appointment, re-appointment and removal of the external auditor and to approve the remuneration and terms of engagement of the external auditor...’\(^\text{267}\)

However, specifications and details of the tasks to be performed by the audit committee members are not set out in any UK regulation. Instead, the Code uses very stretching and general terms that leave the specific jobs of the independent NEDs members of the committee open-ended. The Code explains the role of the committee in terms such as ‘review’ and ‘monitor’.\(^\text{268}\) But what do these terms mean in practice? This ambiguity leaves the duties of the audit committee independent NEDs unclear, and uneasy to define and judge. The Code instead defines the purpose and goals of the audit committee, the composition of the committee and the skill and independence of NEDs, without going into details about the work of the committee and the specific tasks of the independent NEDs as audit committee members.

The audit committee should have regular meetings with the external auditor and the CFO,\(^\text{269}\) and meet at least once a year with the internal and external auditors but without management.\(^\text{270}\) Committee members are also allowed to stay in touch outside the meetings with the key people of the company’s corporate governance, including the Chairman CEO, CFO, the head of the internal audit and the external auditor.\(^\text{271}\) This situation is supposed to open up a direct channel of communication for the external auditor with the audit committee to help in the case of conflict or pressure from the management about accounting policies or other issues.\(^\text{272}\)

\(^{267}\) The Code C.3.2.
\(^{268}\) Spira (n260) 182.
\(^{269}\) Guidance on Audit Committees the Smith Guidance 2005 s 2.8.
\(^{270}\) ibid s 2.10.
\(^{271}\) ibid s 2.11.
\(^{272}\) Spira (n260) 182.
Nevertheless, it is unclear what the role of NEDs is in this process. Moreover, it is difficult to judge in practice whether this method is effective. It is suggested that the dynamics between external auditors and executive directors make it difficult for the audit committee to have a significant influence in this case.\textsuperscript{273} Moreover, the channel of communication is contingent upon the external auditor’s willingness to use it, and upon the assumption that there is no misfeasance or conspiracy between the executive management and the external auditor.

According to the Cadbury and Smith reports, the essence of the work of the audit committee is the independent judgment of the members of the independent NEDs, and that they should practice their independent judgment on the issues considered by them.\textsuperscript{274} Practicing independent judgment by the audit committee on the issues considered by the committee will include many issues such as assessing the auditing policies\textsuperscript{275} and other issues that are more complicated, such as the financial records and statements.\textsuperscript{276} Practicing independent judgment should be built on clear knowledge of the issue they are considering, and clear accurate facts and documents.\textsuperscript{277} However, the Code does not explain what powers NEDs have once they figure any irregularities in the financial records and statements.

In order to incorporate independent judgment into the audit committee, members must conduct a questioning process in order to obtain the necessary information to assess the quality of financial reporting, and make recommendations to the board regarding the approval of the annual financial statement.\textsuperscript{278} To fulfil a successful questioning process, audit committee members must be challenging and should be sceptical of the information\textsuperscript{279} provided to them. Their central role is described to be ‘…asking awkward questions.’\textsuperscript{280}

\textsuperscript{273} ibid.
\textsuperscript{274} P Woodlock ‘Building Effective Audit Committee’ (2006) 17(4) The Journal of Corporate Accounting and Finance 52.
\textsuperscript{275} Wolnizer (n261) 60.
\textsuperscript{276} ibid.
\textsuperscript{277} ibid.
\textsuperscript{279} Spira (n260)184.
\textsuperscript{280} ibid.
However, this process will face serious obstacles. First, it is doubtful that independent NEDs can always provide an accurate and reliable judgment on financial statements and records, so as long as there is possibility that these statements could be manipulated and manufactured by other people like the CEO, CFO and the internal auditor.\textsuperscript{281} Second, many NEDs do not understand their oversight role\textsuperscript{282} on the audit committee; instead, they will be reluctant to reject a scheme provided by the CEO, because they feel that they are causing trouble on the company.\textsuperscript{283}

The question that rises here is what will make NEDs perform a challenging role, even if he or she is assumed to be independent? This situation suggests that there should be an incentive to make NEDs take the role opposing the will of management.\textsuperscript{284} Finally, even if an audit committee member is not satisfied with the audit scheme of the company, his only choice will be to resign, which is considered a nuclear weapon against the company as once the resignation is announced, share price will drop and the company, who he is there to help, will be the first to lose.\textsuperscript{285}

Audit committees do not do any auditing;\textsuperscript{286} neither do they have any specific powers to ensure its control over the audit process. Therefore, due to the abovementioned constrains on the work of the audit committee, it is suggested that expecting the audit committee to guarantee the soundness of financial reporting is misplaced; instead it is suggested that the audit committee in its current form is the weakest link in the audit process.\textsuperscript{287}

\textsuperscript{281} Wolnizer (n261) 60.
\textsuperscript{283} Spira (n260) 184.
\textsuperscript{284} ibid.
\textsuperscript{285} Guidance on Audit Committees the Smith Guidance 2005 s 14. See also, Spira (n260) 180, 185.
\textsuperscript{287} ibid.
C-2-a-ii Internal auditor

The audit committee is also required to monitor and review the internal audit function, and in the case of companies that do not have internal audit function, the audit committee should consider annually whether there is a need for an internal audit function, and to make recommendations to the board in this regard. In practical terms, the committee should monitor the internal audit procedures, which includes coordinating the efforts of the internal and independent auditors to ensure that there is maximum coverage and minimum duplication. However, as abovementioned, the role of the audit committee in regards to the internal audit function is passive, as their role is only to review and make recommendations to the board.

Internal auditing may play an effective role in contributing to corporate governance, especially the fact that internal audit is now closely associated with internal control. The internal audit could play a vital role in assisting the board and the audit committee with information. As aforementioned, audit committee members are independent NEDs who do not attend to the affairs of the company on a daily basis, so their eyes and ears in the company are the internal audit which should provide them with the necessary information and reports to perform their job and make more informed decisions.

Nevertheless, the link between the internal auditor and the CEO and CFO is strong, as the internal auditors work closely with the CFO and the management, and there is always fear of pressure from the management on internal auditors to prevent the issuing of a critical report and to prevent critical information from reaching the audit committee or board.

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288 The Code s(C.3.2).
289 The Code (C.3.5). See also, Guidance on Audit Committees the Smith Guidance 2005 s 4.9.
293 Adamec (n291) 43.
294 Green & Falk (n290) 1242.
The Smith Report recommended further arrangements (which are not adopted by the Code yet) to ensure the independence of the internal auditor, which is the requirement of the audit committee’s approval for the appointment or termination of the head of the internal audit,\textsuperscript{295} which would protect the internal auditor from the management pressure and possible threats of termination or bias due to appointment. Moreover, for the same purpose of avoiding the pressure of management over the internal auditors, there are also recommendations by the head of Securities and Exchange Commission in the US that the internal audit staff should not be supervised by top financial or accounting executives of the company; instead, they should be supervised by the audit committee.\textsuperscript{296}

C-2-a-iii Risk management and internal controls

The Code of Corporate Governance requires the board of directors to set internal controls which enable risks to be managed and assessed.\textsuperscript{297}

In section C.2, the Code provides:

‘The board is responsible for determining the nature and extent of the significant risks it is willing to take in achieving its strategic objectives. The board should maintain sound risk management and internal control systems’\textsuperscript{298}

‘The board should at least annually, conduct a review of the effectiveness of company’s risk management and internal control systems and should report to shareholders that they have done so.’\textsuperscript{299}

The Code of Corporate Governance also requires the audit committee to conduct internal control and risk management duties, in case it is not reviewed by the board of directors or separate board subcommittee:\textsuperscript{300}

\textsuperscript{296} Green & Falk (n290) 1242.
\textsuperscript{297} Code A.1.
\textsuperscript{298} Code C.2.
\textsuperscript{299} Code C.2.
\textsuperscript{300} Code C.3.2.
‘…Review the company’s internal controls and, unless expressly addressed by separate board risk committee composed of independent directors, or by the board itself, to review the company’s internal control and risk management systems…’\textsuperscript{301}

Internal control is a system that acts to prevent fraud and incompetence,\textsuperscript{302} while risk in a financial context refers to losses caused by fraud and incompetence.\textsuperscript{303}

By the time risk management developed, it is managed through:

‘…the accountability mechanisms of financial reporting, audit and internal control…’\textsuperscript{304}

The role of NEDs in respect to internal control and risk management is designed to ensure that there is a good system in place,\textsuperscript{305} and to review the effectiveness of the system regularly.\textsuperscript{306} Nevertheless, it is submitted that no framework can guarantee that risk will be completely eliminated from corporate decision making.\textsuperscript{307} Therefore, NEDs cannot guarantee that fraud will not happen or eliminate risks completely. For example, in the scandal of Societe Generale, which, a trader who knew the policing system of the bank was able to manipulate the system and go beyond his trading limits to cause the bank a loss of Euros 4.9 billion.\textsuperscript{308}

On the internal controls level of the company, internal control has a high importance for NEDs to perform their role, as internal control is essential to ensure that there is timely and accurate internal financial information, which enables the NEDs to perform their role and take their decisions based on accurate and timely information.\textsuperscript{309}

\textsuperscript{301} The Code (C.3.2).
\textsuperscript{302} Page (n292) 646. See also, G Dionne & T Triki ‘Risk Management and Corporate Governance: The Importance of Independence and Financial Knowledge for the Board and the Audit Committee’ (2005) Available at www.ssrn.com 29.
\textsuperscript{303} Page (n292) 646.
\textsuperscript{304} ibid 656.
\textsuperscript{305} The Code (C.2).
\textsuperscript{306} The Code (C.3).
\textsuperscript{307} Page (n292) 646.
\textsuperscript{309} The Code (C.2).
Therefore, it is suggested that NEDs can play a vital role, which is also a practical role in terms of the internal control and risk management system, and it is also suggested that NEDs could have a more involved role by requiring the NEDs to participate in setting or approving the internal control and risk management systems, rather than only reviewing the system as drafted by the Code.

Therefore, according to the analysis in this section, it is suggested that the definition of the role of NEDs in the Code is very vague, and does not entail clear responsibilities for NEDs. This vagueness makes it difficult to use the Code as a measure for assessing the performance of NEDs.

Conclusion

It is suggested that the UK corporate governance system should adopt a new approach in regards to the case of NEDs. This new approach should adopt measures that lie beyond reliance on NEDs’ independence. Instead, it is suggested that the UK corporate governance approach should take into consideration providing an enforcement mechanism for the role of NEDs. However, enforcing the role of NEDs requires defining the roles and responsibilities of NEDs in clear terms, as the current Code defines the role of NEDs in very general terms.

In order to reach a clearer definition of the role of NEDs, the next chapter will analyse in depth the meaning and application of the management and monitoring roles of NEDs.
CHAPTER FOUR: THE MONITORING AND MANAGEMENT ROLES OF NEDs

Introduction

The previous chapter analysed the role of NEDs in the corporate governance context and UK corporate governance reforms. The chapter defined the UK approach in regards to NEDs, and defined their role on the board and the board’s subcommittees, while it further, criticized the overreliance on the independence factor of NEDs, arguing that the independence of NEDs is not an assurance that NEDs will perform their role and undertake their responsibilities. The chapter also argued that the dependence on the board structures and the appointment of independent NEDs is not an effective solution, unless this solution is supported by an enforcement mechanism to ensure that the NEDs will actually perform their role.¹

The next chapter will propose a new model for NEDs. The new model will take into consideration creating an enforcement mechanism to ensure that NEDs will actually perform their role on the board and the board subcommittees.² Nevertheless, it is suggested that the primary step for creating an enforcement mechanism for NEDs is a clear definition of the role of NEDs.³ The Code defines two broad roles for NEDs, which are the monitoring and the management roles;⁴ nonetheless the Code does not define the two roles to any degree of particularity, nor does it explain how the two roles are supposed to be performed in practice.⁵ However, the two roles of NEDs are subject to wide debate among scholars, as some argue that the role of NEDs should be restricted to monitoring only, while others believe that NEDs perform a better role if they combine the two roles.⁶

This chapter aims to analyse and resolve the debate on the dual role of NEDs, and aims to define more clearly the monitoring and management roles of NEDs, in order to take that into consideration suggesting an enforcement mechanism for the role of NEDs in the next chapter.

¹ See- Ch 3 s C.
² See- Ch 5.
³ See- Ch 2.
⁴ See- infra ss A and C.
⁵ The Code s (A.1).
⁶ See- infra s A.
After defining the role of NEDs, the chapter will define the gap between the definition of the role of NEDs and the actual performance of NEDs. This chapter further argues that NEDs should keep the dual roles; indeed the chapter argues that the NEDs’ effective involvement in the strategy and decision making process leads to effective monitoring, and argues that the monitoring and management roles are better performed when the NEDs participate in the early steps of the decision making process, not only when they ratify the decisions presented to them by the management.\(^7\)

The analysis of this chapter will take place at several stages. The chapter starts by discussing the different points of view regarding the dual roles of NEDs. Next, and as a primary step in understanding and analysing the dual roles of NEDs, the chapter will analyse the consequences of the delegation of powers from the board to the management, and will define accordingly the steps of the company’s decision making. Following this, the chapter will analyse the different definitions of the monitoring role of NEDs, and will conclude that both the monitoring and management roles of NEDs aim to control the decision making of the company. Consequently, the following section will analyse the participation of NEDs in the strategy and the decision making process, concluding that the effectiveness of the monitoring relies on the effectiveness of NEDs’ participation in the strategy and decision making process.

After defining the expected role of NEDs, in practicing the monitoring and management responsibilities, the chapter moves to the next level of this analysis, namely achieving accountability. The chapter will measure the actual performance of NEDs on the board of directors, to the monitoring and management role expected of NEDs as defined in this chapter.\(^8\) After referring to many examples of interviews with NEDs, the chapter then argues that not all NEDs are always willing to undertake their monitoring and management responsibilities, moreover many of them do not effectively participate in the early steps of the decision making, which requires a mechanism to be found to ensure the NEDs’ participation in the early steps, in particular, since courts usually recognise only the ratification step of the decision making process, but do not recognize the early stages of the decision making process.

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\(^7\) See infra s D.

\(^8\) See infra s E.
This chapter is structured as follows; Section (A) will consider the different points of view on the dual roles of NEDs. Section (B) will discuss the implications of the delegation of powers from the board to the management, and discuss the decision making steps of the company. Section (C) defines the monitoring role of NEDs. Section (D) analyses the methods of achieving monitoring through the effective participation in the strategy and the decision making steps. Section (E) will be on achieving accountability.

A- Different Points of View on the Dual Roles of NEDs

Boards with large number of executive directors are boards that are more oriented towards management, while those with a large number of NEDs are supposed to be oriented towards monitoring. In the case of UK corporate governance, although the Code requires NEDs to participate in a managerial role, but the direction is towards giving priority to the monitoring role, as the Code requires at least half of the of the board members to be independent NEDs.

The UK corporate governance reports provide that there is tension between the monitoring and management roles of the board of directors, particularly in the case of NEDs, who are supposed to monitor the management and the business objectively. Nevertheless, subsequent reports endorse the Cadbury Report approach, and prescribe that the NEDs should maintain a dual role in the unitary board structure. For example, The Hampel Report in paragraph (3.8) provides that NEDs should keep the monitoring and strategy planning roles and contribute to the management with their expertise. Further, the Higgs Report also defended the approach in paragraph (4.3), providing that there are no convincing reasons for shifting towards a dual board system. Finally, the recent Walker Review also points out that a unitary board is

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10 The Code s A.
11 Review of the Role and Effectiveness of Non-Executive Directors 2003, the Higgs Review, s 6.1.
12 The Cadbury Report ss 4.10, 4.11.
13 The Committee on Corporate Governance 1998, the Hampel Report s 3.8.
14 Review of the Role and Effectiveness of Non-Executive Directors 2003, the Higgs Review, s 4.3.
more efficient, as it provides a better opportunity to exchange views between executive and NEDs.\(^{15}\)

In respect of the tension between the two roles of the board, some scholars argue that NEDs role should be restricted to monitoring only. For example, Richard Nolan argues that the two roles of NEDs will create ambiguity, whereas, the role of independent NEDs should be focused on monitoring, and they should be free of any conflicting pressures that might affect the efficiency of their work.\(^{16}\) He argues, moreover, that with the weak role played by shareholders in enforcing directors’ duties in terms of the management, independent NEDs should take this role, focusing on the monitoring role and enforcing directors’ duties in regards to the management.\(^{17}\)

In their article, Ezzamel and Watson argued that the monitoring and management roles expected of NEDs are essentially incompatible.\(^{18}\) They further state that the Cadbury Report missed an opportunity to improve the monitoring role of NEDs, and that their recommendations are unlikely to have a significant impact on the UK corporate governance.\(^{19}\) In addition, there are views that NEDs’ participation in strategy is ineffective. For example, Joseph Rosenstein argues that NEDs should not have a high level of involvement in the decision making process, provided that most effective organizational strategies generate from the interaction between the CEO and his key subordinates, and the role of NEDs in the strategy process is to replace the CEO if after some time his strategy did not show competence.\(^{20}\)

Nevertheless, some arguments express doubt as to the efficiency of the whole monitoring model. For example, Jonathan Macey finds the reliance on the board of directors as a monitoring

\(^{15}\) A Review of Corporate Governance in UK Banks and other Financial Industry Entities 2009, the Walker Review s 2,14.


\(^{17}\) ibid.


\(^{19}\) ibid 56.

mechanism is misplaced, arguing that NEDs can only be as honest as the managers that they are supposed to monitor. Donald Langevoort believes that the monitoring role should not be over regulated and over relied on. Instead he argues that the monitoring role should be limited in the cases where there are transactions that have only conflicts of interests.

Contrary to the views of the strict monitoring approach supporters, there are views that find the role of the board of directors is in fact wider than merely monitoring, and some arguments find that NEDs should support the board with advice, and develop strategies alongside the board members. Modern organizational theory emphasizes that corporate success is a prerequisite in defining corporate mission, and defining the strategy to achieve it. This role is now at the heart of the role of the board and NEDs, to be fulfilled in interaction with management.

Supporters of a managing role approach believe that undue focus on the monitoring role creates a rift between executive and non-executive directors, which will enable the CEOs to seize the information from the NEDs, and which in turn will paralyse the monitoring function, as even if the NEDs were truly independent of management, they will not be able to monitor without information. On the other hand, building a good relation between executive directors and NEDs will encourage the executive directors to share their information with NEDs, and this will enable them to oversee the decisions of the management. Annie Pye also provides that the board of directors should participate in directing the company, which includes more than merely monitoring or developing a strategy; rather, the view is that the board of directors should run the organization as a whole. William Douglas’s view is that directors from outside the management

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21 Corporate Governance: Promises Kept, Promises Broken (n9) 57.
25 ibid 1434.
27 ibid 242.
should benefit the board with their expertise, and supervise the management by planning financial and commercial policies.\textsuperscript{29}

In addition to the above, Violina Rindova argues that NEDs’ involvement in strategy will make good use of their problem-solving capabilities, which can apply to a variety of contexts. Their expertise is best employed when NEDs perform alongside with the CEO.\textsuperscript{30} Moreover, Michael Goold and Andrew Campbell highlight three useful strategic roles for NEDs, starting from the process whereby strategy is made, to responding to the most critical commercial and strategic questions, to practicing strategic control through defining the top strategic goals.\textsuperscript{31}

**B- The Implications of the Delegation of Powers**

In order to analyse the dual role of NEDs on the board, this section will refer to the delegation of powers from the board to the management and will refer to the implications of this delegation on the decision making steps and on the role of NEDs.

As mentioned in Chapter Two\textsuperscript{32} according to Part (2) Regulation (3) The Companies (Model Articles) Regulations 2008,\textsuperscript{33} managerial powers are vested in the board of directors, who has the right to delegate these powers to an executive director or a committee to run the company.\textsuperscript{34} The need to delegate the board’s powers is mainly related to reasons of efficiency,\textsuperscript{35} as boards of directors cannot deal with the daily matters of business, especially insofar as businesses nowadays are highly complex, and need full time managers who can take fast decisions that cannot necessarily wait for board meetings.\textsuperscript{36} Some major decisions will still

\textsuperscript{32} See- \textit{supra} Ch 2.
\textsuperscript{33} Part (2) Regulation (3) The Companies (Model Articles) Regulations 2008.
\textsuperscript{34} Part (2) Regulation (5.1.a) The Companies (Model Articles) Regulations 2008.
\textsuperscript{35} PL Davies \textit{Gower and Davies’ Principles of Modern Company Law} (8th edn Sweet and Maxwell London 2008) 476.
require the consent of the whole board, such as new major investments or the sale of one of its divisions, in addition to other decisions such as issuing or buying shares or capital reduction.\textsuperscript{37}

Nevertheless, it is very common in large companies for a delegation of powers to give CEOs wide discretionary powers and authority to take decisions on very significant matters without proper reference to the board.\textsuperscript{38} Such a delegation of powers causes a problematic situation, which was not solved, due to the misuse of management of the unfettered powers delegated to them.\textsuperscript{39}

The implication of the delegation of powers requires the board of directors to appoint CEOs\textsuperscript{40} and decide on their pay; they should also assess their performance, so as to check whether they are performing well and according to the company’s objectives and strategy, and to decide whether to keep or remove them.\textsuperscript{41} The board of directors is responsible for making board resolutions built on accurate information.\textsuperscript{42}

However, the actual situation shows otherwise. As mentioned in the previous chapter, there are many reasons which suggest that the role of NEDs and the board of directors do not conform to what they are expected to do. A common problem within large companies is that CEOs dominates the entire board, known as the management capture of the board of directors, and they have unfettered powers over the business which prevents NEDs from fulfilling the abovementioned tasks.\textsuperscript{43} There are several reasons for board capture. For instance, the management and the CEO are more likely to have higher knowledge of the company’s matters, and in consequence, they can have improved access to information when compared to the board of directors. Indeed, management can control the data flow and information that reach the board of directors.\textsuperscript{44}

\textsuperscript{37} ibid.
\textsuperscript{38} Gower and Davies’ Principles of Modern Company Law (n35) 372.
\textsuperscript{39} ibid.
\textsuperscript{40} Company Law in Context Text and Material (n36) 227.
\textsuperscript{41} ibid.
\textsuperscript{42} ibid.
\textsuperscript{43} See- Ch 3 s C.
\textsuperscript{44} See- Ch 3 s C-1.
When speaking about agency problems, scholars usually refer to management, whilst ignoring the board of directors, as if the boards were the handmaiden of management.\textsuperscript{45} Therefore, one of the main objectives of the Code is the desire to place the CEO within a legal framework of accountability to the board.\textsuperscript{46}

In this respect, as this chapter involves defining the management and monitoring roles of NEDs, it is suggested that it is important to refer to the work of Fama and Jensen 1983,\textsuperscript{47} which clarifies the decision making steps of the management and the board of directors. Fama and Jensen analyse the steps of the decision making process among the agents of the company as a part of the central contracts of the organization.\textsuperscript{48}

Fama and Jensen divide the decision making of the company into four main steps:

\begin{itemize}
  \item 1. initiation- generation of proposals for resource utilization and structuring of the contracts;
  \item 2. ratification- choice of the decision initiatives to be implemented;
  \item 3. implementation- execution of ratified decisions; and
  \item 4. monitoring- measurement of the performance of decision agents and implementation of rewards.\textsuperscript{49}
\end{itemize}

They then categorise the initiation and implementation into ‘decision management’ while ratification and monitoring into ‘decision control’.\textsuperscript{50} According to Fama and Jensen, the effective control over the decisions of the company requires separating ratification and monitoring from the initiation and implementation. However, this is only to a limited extent, as an individual decision agent can be involved in the management of some decisions and the control of other decisions, but without giving the same individual the ultimate management and decision control

\textsuperscript{45} Company Law in Context Text and Material (n36) 227.
\textsuperscript{46} Gower and Davies’ Principles of Modern Company Law (n35) 372.
\textsuperscript{48} ibid 302.
\textsuperscript{49} ibid 303.
\textsuperscript{50} ibid 304.
over the same decisions.\textsuperscript{51} Without such a division between decision management and decision control, residual claimants will have little protection against opportunistic actions of agents.\textsuperscript{52} Therefore the role of NEDs according to Fama and Jensen is within the ‘decision control’ where they ratify and monitor decision process.

Berghe and Baelden refer to the abovementioned decision making steps of Fama and Jensen, nevertheless they suggest splitting the initiation step into two steps; the first is the generation of ideas and proposals and the second is the selection of these ideas to be presented for ratification.\textsuperscript{53} They suggest that NEDs who participate in generating ideas and proposals are more involved in the strategic role of the board, as they do not just ratify and monitor, but they also participate in the selection of ideas and proposals which gives them a greater strategic role.\textsuperscript{54} The effectiveness of the role of the board and the NEDs requires the discretion of the individual top managers to be restricted in decision making.\textsuperscript{55} This requires the board of directors and the NEDs to have sufficient knowledge to do so; therefore, the board needs to include the managing board members to sit on the board of directors in order to enhance the board knowledge and information of the company’s matters.\textsuperscript{56} In addition, the board must include NEDs who are supposed to hold the majority of the board seats, and should carry out the functions that have the major agency problems between shareholders and the management, such as setting the executives remunerations and hiring and firing top managers.\textsuperscript{57}

Nevertheless, as will be argued in the next two sections, the translation of the abovementioned decision making steps in defining the dual role of NEDs is not straight forward, and does not distinguish the monitoring and strategy roles in the same manner abovementioned, indeed a broad definition of monitoring could cover more steps than the steps of the abovementioned ‘decision control’.

\begin{thebibliography}{9}
\bibitem{51} ibid.
\bibitem{52} ibid 306.
\bibitem{54} ibid.
\bibitem{55} Fama & Jensen (n47) 314.
\bibitem{56} ibid.
\bibitem{57} ibid 315.
\end{thebibliography}
C- Defining the Monitoring Role

At the level of the corporate governance reports and the Code, the managerial role is the role of NEDs to develop proposals on strategy and to play an advisory role on the board, which implies advising the management and supporting the management with the knowledge and expertise that NEDs are supposed to bring to the board. The Code and the corporate governance reports neither provide a definition of the monitoring role of NEDs; nor provide a particular mechanism for practicing the monitoring role, nor define the distinction or the line between the monitoring and management roles.

The author of this thesis argues that the monitoring function of NEDs could be seen from different scopes. The narrow scope definition defines monitoring in accordance with Fama and Jensen’s decision making steps. This describes the role of NEDs as ratifiers of the decisions made by the management, and controllers by monitoring the application of the implementation of these decisions. According to Fama and Jensen, the monitoring role of NEDs only represents the final step of the decision making, which is to monitor and oversee the implementation of the decision which already has been made.

Another scope refers to some actions which are usually described as a monitoring function, such as, monitoring and evaluating the work of the CEO, rewarding the CEO and top management, in addition to appointing, dismissing, and setting the succession plan of the CEO, and as aforementioned monitoring the strategy implementation.

The monitoring role of NEDs is also regarded as a part of the internal control mechanisms, as the internal control mechanism is designed to ensure optimal company

58 The Code A.1, A.4.
60 The Code A.1, A.4.
62 Fama & Jensen (n47) 303.
performance. In this regard, Walsh and Seward describe the monitoring role of NEDs as follows:65

‘The normal conduct of business affairs then is based upon a continuous cycle of a board’s assessment of firm performance; its attributions of the cause of that performance; the implementation of various internal controls, occasional corporate restructurings…’66

Nevertheless, the author of this thesis suggests that understanding and defining the monitoring role of NEDs require reference to the theories of corporate governance, and the reasons which triggered the need for NEDs to monitor. The monitoring role of NEDs is directly built on agency theory.67 In this regard, NEDs’ primary function is to monitor the actions of managers on behalf of shareholders,68 aiming to prevent unsupervised managers from behaving opportunistically.69

Consequently, the monitoring role of NEDs aims to prevent managers from taking decisions that affect the shareholders negatively,70 which falls within the good governance main outcome, as good governance aims at ensuring good quality of the decisions made by the board of directors.71 One of the best examples of weak company decisions taken by the board of directors is that of the Enron catastrophe, as explained in Chapter One.72 It is suggested that the monitoring role of NEDs should be interpreted in a wider scope which covers their responsibility for the quality of the decisions made by the company.

66 ibid.
67 Fama & Jensen (n47) 303.
72 ibid 243.
The company’s destiny is decided by its top decisions, as the top decisions can be referred to as the decisions taken by the board of directors or the management to commit the company resources, on behalf of the company.\textsuperscript{73} Although top decisions might be isolated from one to another, the different decisions collectively define the different policies of the company, starting from competitive strategy, risk management policies, executive succession and CEO remunerations, which makes them altogether define the corporate governance of the company.\textsuperscript{74} Therefore, it is argued that the definition of the monitoring role of NEDs should be from a wide perspective which refers to the overall responsibility of the quality of the decisions made by the company, as these decisions collectively decide on the destiny and direction of the company.

In the light of the abovementioned, Berghe and Baelden refer to the monitoring from the wider perspective providing:

‘…monitoring role of the board involves more than ensuring the accuracy of financial information and the adequacy of internal controls… monitoring means that you regularly evaluate a situation and act upon this evaluation in order to get reasonable assurance that you are in control of the situation.’\textsuperscript{75}

The key word used by Berghe and Baelden is the term ‘control’. The term ‘control’ is an important term as it is used as a description of the monitoring role of NEDs.\textsuperscript{76} The meaning of the term control is very wide, and translating the term ‘control’ on the role of NEDs in monitoring the decision making means the power of the NEDs to initiate, terminate or constrain the decisions.\textsuperscript{77}

Accordingly, the controlling role of NEDs could be classified into two types; the first being the ‘literal control’ which refers to the power of NEDs to make key decisions of the company, and the second the control through their ‘power to constrain’ which refers to their

\textsuperscript{73} M Useem & A Zelleke ‘Oversight and Delegation in Corporate Governance: Deciding What the Board Should Decide’ (2006) 14(1) Corporate Governance 3.
\textsuperscript{74} ibid.
\textsuperscript{75} Berghe & Baelden (n53) 681.
\textsuperscript{76} Hillman & Dalziel (n63) 384.
\textsuperscript{77} E Herman Corporate Control, Corporate Power: A Twentieth Century Fund Study (Cambridge University Press Cambridge 1981) 17.
power to limit, constrain or veto the choices of the management without participating in the decisions themselves.\textsuperscript{78}

However, it is suggested here that there is a strong link between the monitoring and strategizing roles of NEDs. As abovementioned, the monitoring role of NEDs is defined from the lens of the NEDs’ overall responsibility of the quality of the company’s decisions, and their responsibility of practicing control over the company’s decisions. On the other hand, the company strategy according to the popular definition of Mintzberg is ‘\textit{a pattern in a stream of decisions}\textsuperscript{79}'. Accordingly, what constitute the strategy of the company are the different decisions taken by the company. Therefore, the quality of the company’s decisions means that there is good monitoring in place, and there is good strategy.

Moreover, the same term ‘\textit{control}' is referred to in describing the other side of the role of NEDs which is the strategy or management role. Scholars placed the blame for the catastrophic governance failures of the financial crisis on the NEDs’ weakness in practicing effective strategic ‘\textit{control}' role by failing to get directly involved in defining the context, application and content of strategy.\textsuperscript{80} This situation prompted significant public concern and shareholder activism towards enhancing corporate accountability, raising the calls for an increased role of the board of directors in strategic decision making.\textsuperscript{81} Therefore, this is another strong link between the monitoring and management roles, as the two roles aim for controlling the decision making process.

Therefore this section argues that the monitoring role of NEDs is their overall responsibility for the decisions made by the company; nevertheless the question that remains unanswered here is whether they should do so through getting involved in the decision making process, or whether they should only practice their powers in constraining the choices of the

\textsuperscript{78} ibid 17, 19.
management. This question will be analysed in the next section. The next section argues that the participation of NEDs in the early decision making steps is the best way for NEDs to control the decision making of the company.

**D- Monitoring through the Involvement in the Decision Making and Strategizing Process**

In literature there is a wide agreement on the hypothesis, which the writer of this thesis agrees with, namely that NEDs’ participation in strategy leads to better company performance. On the other hand, there are points of view arguing that strategy develops at business unit level, while the role of the board and NEDs is to set the parameters which draw the borders for the strategy. Accordingly, the views regarding NEDs’ involvement and contribution to strategy could be categorized into the ‘passive’ and ‘active’ approaches. The passive approach finds that the role of NEDs in developing strategy is weak, while the active approach finds NEDs as independent thinkers, who actively participate in shaping strategies.

The points of view regarding the NEDs’ participation in strategy could also be categorized into three schools of thought; the first is the traditional school which sees the NEDs’ role as protecting the shareholders by practicing control over the management, this school finds that strategy is the role of CEO, therefore NEDs role is to only review, analyse and provide advice to the CEO and ratify his decisions. The second school argues that NEDs should participate in formulating and implementing strategies. Their role is to review and evaluate the managerial strategy proposals, this school does not suppose NEDs to develop new strategies, but they might propose amendments to the strategies presented to them. Their contribution to the strategy development is through challenging the managerial assumptions on strategy. The third school requires NEDs to go beyond the ‘control’ role by getting more involved in the strategy

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84 Hendry, Kiel & Nicholson (n82) 34.
making, by building partnership with the CEO. Therefore their role will require them to initiate and develop strategic proposals without limiting them to ratification.\textsuperscript{86}

Myles Mace’s view of the contribution of NEDs to the strategy fits with the first school, as he argued through two studies, where he conducted the first in the late 1960s, that the role of NEDs in the strategic planning process has been for long passive and not well defined, strategies were usually developed by management, and presented to the board for ratification, while NEDs were hardly involved in preparing the strategic plan, and any amendments they suggested during ratification process were too late to be useful.\textsuperscript{87} The role of the NEDs was only advisory but not of a decision making nature, and that the management was the CEO domain, while the NEDs advice hardly led to revising the CEO’s strategy. He further argued that the research he conducted ten years later did not show any significant change to the previous position.\textsuperscript{88}

William Boulton argued that the growing pressure of litigation does not allow boards and NEDs to merely perform their traditional legitimizing role, instead it is causing transitioning towards more active roles such as auditing and directing the company, including the involvement in the strategic role.\textsuperscript{89} Therefore, proponents of an enhanced NED strategizing role, which fits with the second school abovementioned, call for the board of directors and NEDs to take responsibility beyond the mere approval of top management strategic proposals, so as to move towards setting the strategic direction and making sure that the strategy is successfully executed.\textsuperscript{90}

Goodstein, Gautem and Boeker, in addition to Judge and Zeithmal, support the third school of thought, suggesting that the role of NEDs in strategy should be from a decision making

\textsuperscript{86} S Zahra ‘Increasing the Board’s Involvement in Strategy’ (1990) 23(6) Long Range Planning 109, 110.
\textsuperscript{87} J Siciliano ‘Governance and Strategy Implementation: Expanding the Board’s Involvement’ (2002) 45(6) Business Horizons 34.
\textsuperscript{90} Kim, Burns & Prescott (n80) 730.
nature, through taking non-routine resource allocation decisions, and adopting important environmental changes.\textsuperscript{91}

Kenneth Andrews provides that the active involvement of NEDs in strategizing and decision making was delayed due to five obstacles; the first, it was perceived that the NEDs are only supposed to monitor the process of strategy but not to formulate it. Second, lack of understanding of what is meant by corporate strategy. Third, the CEO believes that the principal role of NEDs is to select, support and replace him/her. Therefore, CEOs are usually hesitant to enlarge the NEDs’ strategic role. Fourth, the lack of time at the side of NEDs, which makes them hardly informed about the strategic recommendations which they have to evaluate and approve. Fifth, the risky nature of the central decisions which will determine the company’s faith after ten or twenty years.\textsuperscript{92}

At the level of theory, the theoretical and empirical agreement on how do NEDs contribute to strategy is weak.\textsuperscript{93} Zahra and Pearce argue that Agency theory and the steps of decision making process provided by agency theory do recognize a role of NEDs in defining the companies’ mission and setting a plan for implementing and controlling the selected strategy.\textsuperscript{94} Nevertheless, Zahra and Pearce also provide that there is little documentation provided by agency theorists to support their view of the role of boards and NEDs in strategy.\textsuperscript{95} Moreover, McNulty and Pettigrew provide that agency theory does not explain the strategic role of NEDs as a controlling mechanism over managers.\textsuperscript{96}

However, the strategic role of NEDs is too complex to be interpreted under one single theory,\textsuperscript{97} and the participation of NEDs in ‘decision management’ and in strategy formulation

\textsuperscript{91} J Goodstein, K Gautam & W Boeker ‘The Effects of Board Size and Diversity on Strategic Change’ (1994) 15 Strategic Management Journal 242. See also, Judge & Zeithaml (n81) 771.
\textsuperscript{95} ibid 303.
\textsuperscript{96} McNulty & Pettigrew (n80) 50.
and implementation is still understudied.\textsuperscript{98} Nevertheless, in regards to the abovementioned different points of view, and in regards to the suggestion that there is no one theory to define the NEDs’ involvement in strategy, the next subsection will move towards a more practical examination of the NEDs’ involvement in strategy and decision making, in order to define which type of involvement achieves better monitoring, control and quality of decisions.

D-1 The levels of NEDs’ Involvement

To redefine the purpose of this subsection, this subsection aims to examine in more depth the different definitions of the NEDs’ involvement in the strategy and the steps of the decision making process, in order to specify which type of involvement contributes more for controlling the companies’ decisions, and controlling the company’s CEO, in addition to improving the quality of the company’s decisions, which at the end will achieve better monitoring and strategy performance of NEDs.

David Nadler categorizes board types according to the board and NEDs’ involvement in strategy to five types; the first is the passive board which is the traditional board, with very low involvement and low accountability, and its main role is to ratify management decisions. The second is the certifying board, which relies on NEDs’ participation and credibility to shareholders. In this type of board, NEDs’ role is to ensure that the business is well run and that the CEO meets the company’s requirements. The engaged board is when NEDs and management work as partners, and where NEDs give support and advice to the CEO. The intervening board is when NEDs become deeply involved in the management, and this is common in times of crisis. The operating board which represents very deep ongoing involvement of NEDs in the management, and takes an effective role in the key decisions for the management to implement. This type is when the management has expertise but the NEDs provide them with broader views.\textsuperscript{99}

\textsuperscript{98} ibid 627.
To understand the nature of NEDs’ participation in strategy according to the abovementioned categories of board of directors, this subsection will explain the involvement into levels. Zahra and Pearce refer to NEDs’ strategic role as the level of attention NEDs give to the different elements of the strategy process, which covers developing the company’s mission, strategy conception, and implementation of strategy.\(^\text{100}\)

Nevertheless in practice defining the NEDs’ level of attention and involvement in strategy is difficult.\(^\text{101}\) In this respect, Philip Styles classifies NEDs’ involvement according to two types, distinguishing whether NEDs’ role is the formation or evaluation of decisions, nevertheless even within the formation and evaluation levels there are degrees of involvement.\(^\text{102}\) In the formation of decisions the role of NEDs could start from working with management, defining the strategic direction to merely ratifying management proposals.\(^\text{103}\) On the evaluation side NEDs might either probe the evaluation of resource allocation provided by management or accept it as presented by the management.\(^\text{104}\)

On the formation steps, McNulty and Pettigrew referred to the difference between ‘taking decisions’ and ‘making decisions’. ‘Making decision’ is the full process of the decision. However, in cases where the decisions develop at the management level, and get presented to the board for ratification, after these decisions were manipulated by the management, the role of the board will be ‘taking decisions’, which makes the board as merely a legitimizing institution, as their role will be to ratify decisions made elsewhere.\(^\text{105}\)

Relying on the difference between ‘taking decisions’ and ‘making decisions’ McNulty and Pettigrew differentiated between three types of NEDs’ involvement in the strategy process; ‘taking strategic decisions’, ‘shaping strategic decisions’ and ‘shaping the content, context and

\(^\text{100}\) Zahra & Pearce (n94) 165.
\(^\text{101}\) Stiles (n83) 631.
\(^\text{102}\) ibid.
\(^\text{104}\) Stiles (n83) 631.
\(^\text{105}\) McNulty & Pettigrew (n80) 52.
conduct of strategy’.\textsuperscript{106} The efficiency of the different types aforementioned according to McNulty and Pettigrew depends on the ability of NEDs to influence strategy with their ideas and choices, beyond merely approving the proposals of management.\textsuperscript{107}

McNulty and Pettigrew refer to taking strategic decisions by the cases when NEDs’ role is limited to approving, disapproving or referring to capital investment or asking for amendments to the proposals introduced to them by the management.\textsuperscript{108} While they refer to shaping strategic decision by a process that engages both executives and NEDs, which takes place straight before the approval or ratification step. This communication between the CEO and the NEDs could be when the CEO provides the NEDs with a preliminary paper before the approval step, or when the CEO consults the NEDs informally outside the boardroom. In this case, the influence of the NEDs is not limited to the final approval of the capital investment decision.\textsuperscript{109}

In shaping the content and context of strategy, NEDs are supposed to influence the conditions inside and outside the boardroom by encouraging the management to think strategically. In this type of strategizing, the NEDs’ influence the proposals that will be presented to the board for ratification.\textsuperscript{110}

The abovementioned discussion on the NEDs’ involvement in the decision making steps makes the argument of this chapter vivid and robust. This chapter argues that a deep involvement of NEDs in the decision making steps, achieves better monitoring and control, and it achieves better strategies. Referring to the classification of the decision making steps, the decision taking style gives the management full control of the decision, as they will have the knowledge and the information, and they can manipulate the information presented to the board, which makes the role of NEDs to only ‘rubber stamp’ the decision, as they will receive worked out decisions, and they will not have the relevant information to be able to make any changes to the proposals of

\textsuperscript{106} ibid 55.  
\textsuperscript{107} ibid.  
\textsuperscript{108} ibid 56.  
\textsuperscript{109} ibid 58.  
\textsuperscript{110} ibid 62.
management. Therefore, it is argued that if NEDs can effectively participate in the decision making, they will impose control over the company, and the management possible misbehaviors.

On the other hand, when NEDs participate in the decision making process from the early steps, they will have the relevant knowledge and information about the decision which will make NEDs take more rational decisions that are built on information and good analysis. Such a rational process helps NEDs to predict the consequences and the probabilities of success of the decision they made. Therefore, it is argued that if NEDs can effectively participate in the decision making process, they will consequently impose control over the company, and the management possible misbehaviours.

The deep participation of NEDs in the decision making process, will enrich the companies decisions, with the information and data which NEDs have in regards to the competitive industries, and in addition, they can positively influence the decisions due to the high skills they have. Moreover, they can, with their expertise, guide the CEO within the worldwide competitive conditions.

In terms of the implementation stage, the implementation of company’s strategy has been regarded as the domain of management, due to the expertise and information they have to implement the strategy. Nevertheless, it is seen as highly important to have an effective role for NEDs in the strategy implementation process, first to fulfil their fiduciary requirement to oversee the business, which requires them to understand and be aware of how is the strategy they agreed upon is implemented and whether it is meeting the goals, and second, to benefit from the NEDs’ expertise as they usually have industrial expertise and they can operate in accordance to the internal and external conditions of the company.

111 Berghe & Baelden (n53) 683.
114 Zahra (n86) 110-111.
115 Siciliano (n87) 34.
116 M Brauer & Schmidt (n103) 652.
117 ibid.
The formulation and implementation steps of the company’s strategy may be described as tightly linked and interrelated and work in a cyclical manner, which makes it difficult to separate formulation from implementation or to draw the boundary between them as strategies emerge and develop through a series of decisions and actions. In practice, in leading the planned strategy, NEDs must articulate their intentions precisely, and then work on implementing their plans through collective actions. To do so, NEDs must form a detailed plan in the forms of budgets and schedules.

According to Mintzberg, the measure by which the success of strategy should be assessed is the intended strategy. Nevertheless, the outcome of the strategic implementation could differ from the intended strategic path. Therefore, the role of NEDs requires them to support the implementation process of the strategy by setting the measures, milestones and the time frame. Later on, if NEDs realize that the implemented strategy came out significantly different from the intended strategy, they should intervene to correct the path which strategy is performed upon.

As this thesis aims to develop a new model to enhance the NEDs’ performance, it is important to point out the methods which the strategy of the company develop within, in order to take into consideration these methods in the suggested model in the next chapter. In this regards Paula Jarzabkowski provides that the strategy process takes place in two different methods; the first method is the ‘interactive’ strategy, which occurs through face to face interaction between the top management, and the rest of the company members, including the NEDs. The second method is the ‘procedural’ strategizing which takes place through the formal administrative structure and practice which the strategy flows through within the company.

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120 Mintzberg & J Waters (n79) 259.
121 Mintzberg (n79) 945, 947.
122 Kim, Burns & Prescott (n80) 730.
123 Mintzberg (n79) 945, 947.
125 ibid 82.
Using the distinction made by Jarzabkowski of the two methods of strategizing Hendry, Kiel and Nicholson argue, which the author of this thesis agree with, that the two methods are needed to build successful and continuous strategizing.\(^{126}\) They argue that successful and continuous strategizing requires a high level of interactive work between NEDs and the management, within high procedural and administrative frame.\(^{127}\) This type of strategizing means that there is no imbalance of power between management and the board; indeed power distribution is reciprocal, and means that NEDs contribute to the strategic direction and can ensure that it is implemented through the high structural legitimacy.\(^{128}\)

Therefore, the suggested model in the next chapter will take this into consideration, creating a system that ensures the NEDs’ involvement in the decision making process, through an interactive behaviour and within a procedural framework.

This section explained and analysed the types of NEDs’ involvement in the decision making process, and argued that NEDs perform a better role, and undertake their responsibilities of monitoring and strategy better when they become more effectively involved in the decision making of the company. However, the next step will seek to achieve the accountability through the NEDs’ performance of their role; in doing so, the next section will analyse the behaviour of NEDs, measured to their expected role in the decision making process.

**E- Achieving Accountability**

Accountability is ‘... a central concept in understanding social actions,’ and is described as the foundation stone of modern companies,\(^{129}\) and central to effective corporate governance.\(^{130}\) Accountability could be defined as:

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\(^{126}\) Hendry, Kiel & Nicholson (n82) 48.

\(^{127}\) ibid.

\(^{128}\) ibid.

\(^{129}\) Roberts, McNulty & Stiles (n23) 10.

'To be accountable for one’s activities is to explicate the reasons for them and to supply the normative grounds whereby they may be justified'\textsuperscript{131}

Since the old days of merchant traders, corporate accountability has been a concern which all countries have to deal with.\textsuperscript{132} The focus in achieving accountability was on four main methods; board structures, ownership, regulations and social pressure,\textsuperscript{133} which can also be categorized into two contexts, the outer context, which refers to the social, economic, political and competitive environment, and the inner context, which refers to factors within the company such as structure, power, political context, and culture.\textsuperscript{134}

In this context, the board of directors is one of the central elements of corporate governance reforms.\textsuperscript{135} The board of directors is considered the key factor for ensuring the accountability of directors to shareholders and accountability of corporate employees and management to the board of directors,\textsuperscript{136} as the board of directors is referred to as the formal link between the shareholders of the company and the management.\textsuperscript{137} Advocates of enhancing the accountability in the company decision making focused on the NEDs’ role in strategic decisions making,\textsuperscript{138} and on the role of NEDs and independent NEDs for making the CEO accountable to the board.\textsuperscript{139}

Accountability is discussed as board role expectations, measured against the different board theories.\textsuperscript{140} Nevertheless, there is no preferable definition or way to define corporate

\textsuperscript{133} ibid.
\textsuperscript{135} R Aguilera ‘Corporate Governance and Directors Accountability: an Institutional Comparative Perspective’ (2005) 16(s1) British Journal of Management 39.
\textsuperscript{136} Roberts, McNulty & Stiles (n23) 10.
\textsuperscript{137} D Forbes & F Milliken ‘Cognition and Corporate Governance: Understanding Boards of Directors as Strategic Decision-Making Groups’ (1999) 24(3) Academy of Management Review 491. See also, Aguilera (n135) 44.
\textsuperscript{138} Judge & Zeithaml (n81) 766.
\textsuperscript{139} Aguilera (n135) 40.
\textsuperscript{140} Huse (n131) 66.
governance or board accountability. The question that arises here is how could the accountability in the case of NEDs be studied and assessed?

Studies focused on the input variables such as board composition to the output variables such as board performance; however, this approach has been criticized for not providing a direct link or evidence to the insider board process which might link the input with the output.

The author of this thesis is of the opinion that a better way to analyse and measure the role and contribution of NEDs in achieving accountability, is examining and assessing the actual behaviour of NEDs, and the behavioural dynamics and processes in the boardroom. Scholars suggest that studying the behavioural process of the board members and NEDs creates better understanding of the strategy shaping and strategic decisions. Therefore, studying the accountability of NEDs requires opening the ‘black box’ of the boardroom to study the actual NEDs’ and board behaviour, and analysing the formal and informal decision making culture, structures and norms, and to examine the interactions inside the boardroom.

Defining the theoretical basis for studying the board and NEDs’ accountability, from the angle of behavioural dynamics, requires distinguishing between two lines of studying the accountability of the board and NEDs; the first line is studying the external factor, which starts from the basic corporate governance theoretical basis, such as the separation of ownership and control, agency theory and the need to control companies managers, which aims overall to ensure that the company is well run and to avoid corporate mismanagements which led in the past to corporate scandals. In this context of the strict application of agency theory accountability is mostly used to refer to monitoring and control. The second line is the internal perspectives which look at the board as a linking and administrative mechanism which links the company to

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141 ibid 68.
144 Ees, Gabrielson & Huse (n143) 310.
145 Huse (n131) S72.
146 ibid S71.
147 Roberts (n130) 1548.
the external environment. This approach goes beyond the borders of agency theory, and assumes a collaborative role for NEDs and higher participation in the strategy formation.\textsuperscript{148}

Therefore scholars who call for a study of NEDs’ role and the behavioural expectations argued that studies should go beyond agency theory, which focuses on the control side of the work of NEDs rather than their collaboration role.\textsuperscript{149} Instead, scholars referred to other theories such as stewardship theory\textsuperscript{150} and resource dependence theory,\textsuperscript{151} these theories require NEDs to practice more collaboration role rather than limited control role, as the base theories for analysing and measuring the NEDs’ behaviour.\textsuperscript{152}

In the context of the abovementioned theories regarding the control and collaboration roles of NEDs, the author of this thesis emphasizes that the control role of NEDs should not be underestimated, instead the author suggests that a good role of NEDs should not be limited to control or collaboration, and also suggests that their role is most effective if they practice effective control, to ensure human limitations through discipline, and practice the collaborative role to foster individual aspirations.\textsuperscript{153}

In their research Roberts, McNulty and Stiles analysed the behavioural dynamics of the board of directors and provided that:

‘…we argue that it is the actual conduct of the non-executive vis-a-vis the executive that determines board effectiveness. Non executives can both support the executives in their leadership of the business and monitor and control executive conduct.’\textsuperscript{154}

\textsuperscript{148} Huse (n131) S71.
\textsuperscript{151} Nicholson & Keil (n149) 589.
\textsuperscript{153} Sundaramurthhey & Lewis (n150) 407.
\textsuperscript{154} Roberts, McNulty & Stiles (n23) 6.
They also argue that what creates accountability in the boardroom is the behaviour of NEDs individually and collectively, and their contribution to strategy and performance. They provide that there is a wide range of behaviours that contribute to accountability such as:155

‘...challenging, questioning, probing, discussing, testing, informing, debating, exploring, encouraging...’156

They provide suggested types of characteristics and behaviours for NEDs describing that as follows:

‘...engaged but non-executive, challenging but supportive and independent but involved’157

Roberts, McNulty and Stiles differentiated between accountability and creating accountability.158 Creating accountability could be described as bridging the gap between the actual role of NEDs and their expected role.159

Fulfilling the goal of this section of assessing the effectiveness of the NEDs requires defining the criteria which their performance will be measured upon.160 As mentioned before in this section there is no one way to define the accountability of NEDs. However, at this stage the author of this thesis defines the expectations of the role of NEDs according to the previous analysis of the role of NEDs in this chapter, which requires NEDs to participate in the early stages of the decision making. Therefore the next subsection will analyse the behaviour of NEDs inside the boardroom, and measure it against the definition of NEDs’ participation in the strategy process as provided in the previous section.

155 ibid.
156 ibid.
157 ibid.
158 ibid 6, 12.
159 Huse (n131) S65.
E-1 Creating Accountability and NEDs' Behaviour Inside the Boardroom

As previously mentioned in section (E), creating accountability is about enhancing the performance of NEDs to meet their role expectations. It was also suggested that assessing the accountability of NEDs needs deep analysis inside the boardroom which assesses the actual behaviour of NEDs. It was also mentioned that there is no particular criteria or theory which defines the required NEDs’ behaviour. Thus, this subsection will refer to the outcome of the analysis of section (D) to define required behaviour by which NEDs’ performance should be assessed. The analysis of this subsection focuses on two dimensions; the first is how do NEDs actually see their role, and how willing are they to be deeply involved in decision making and strategizing, the second, is whether measures of ‘hard law’ and ‘soft law’ are successful in making NEDs take an effective role in decision making.

Different scholars, researching boards’ behaviour through qualitative studies based on interviews with board members, came up with different results regarding the boards and NEDs’ levels of involvement in strategy, which show that different boards have different levels of involvement in strategy, and different directors have different contributions and understanding of their strategy role. For example; Henke found through his research that boards do contribute and influence strategy through participating in the decision making. Nevertheless, they do not realize they are doing so,161 which makes their contribution come in a non-coherent manner.162 In another example, Stephen Hill found through his study that NEDs showed a wide perception of their role, where they found that they are the protectors of shareholders, and therefore they have to monitor the performance of the executives, which means they have to challenge their assumptions, he also provides that they bring breadth of vision brought to the board.163

On the contrary, Rosenstein found through his study that good strategies come from the interaction between the CEO and his key subordinates, while the strategic role of NEDs is

162 Ibid 93.
limited to hiring the CEO and firing him if he does not achieve the strategic goals within a reasonable period of time.\textsuperscript{164}

Before moving to the examples of interviews selected from different qualitative researches, it is important to define the role expectations desired in order to be used as the measure which the NEDs’ behaviour will be assessed upon. The analysis of section (D) emphasized that NEDs should play an active role in the decision making and strategizing process, which means that they should be involved in the early planning stages, and they should also participate in generating ideas, and then selecting the ideas to be presented to the board for ratification. This role, is close to the description provided by McNulty and Pettigrew ‘shaping the content and context of strategy’ and fits with description or operating boards provided by Nadler, and continuous strategizing style provided by Hendry, Kiel and Nicholson.\textsuperscript{165}

The following quotations are selected from different researches, which represent interviews with board members, describing how NEDs do see their role in the decision making process.

A chief executive doubted the ability of NEDs and the board to create strategy, providing:

‘[the board] can challenge as to whether the process is in place [and the] process is a good process ...[that] will lead to an output which can be deemed by the board to be the strategy that we are following. I do not think the non-executive directors can easily propose what the strategy should be... I do not think the non-executive director can ever be in the position to create [the strategy].’\textsuperscript{166}

In similar vein, a NED provided that creating strategy is the executives’ job, which NEDs are not expected to step in:

\textsuperscript{164} Rosenstein (n20) 33.  
\textsuperscript{165} Hendry, Kiel & Nicholson (n82) 48.  
\textsuperscript{166} McNulty & Pettigrew (n80) 53.
‘I do not think you can normally expect the non-executive directors to come forward with great wealth-creating ideas for the board... it would be marvelous for that to happen... there is a fine line, but a clear line- the non-executive must not do the executives job. Otherwise, the board ceases to function, and the executive rightly resents that and then it becomes a disaster... it is not the non-executives directors’ duty to devise a strategy, but it is to see that there is one in place.’\textsuperscript{167}

Another board member also finds the strategy as the CEO job, and the NEDs are not directly involved in strategy:

‘It is the CEO that is responsible for setting and achieving the measurable results. As a member of the board you can work closely with the CEO, you get information sent to you and you can request any information you want about the business. But you are still one step removed from the business so you don’t have any level of direct involvement’\textsuperscript{168}

A NED provided that the involvement of NEDs will depend on how far the executives will allow him to be:

‘...any non-exec is only as good as the executive will allow him to be. I will tell you now that any executive can kid any non-exec to do virtually anything. If he is really strong-willed, and he has the facts, and so forth, it is jolly difficult for you to find-out as a non-exec. You have to assume the executive, who are a team, support each other.’\textsuperscript{169}

A NED provided, when talking about the company he served on its board, that when the company took a different route from its core business causing disastrous results, the CEO managed to make the board to go through the same road again.\textsuperscript{170}

\textsuperscript{167} ibid 54.
\textsuperscript{168} Kemp (n103) 66.
\textsuperscript{169} McNulty & Pettigrew (n80) 60.
\textsuperscript{170} Stiles (n83) 642.
‘It took us (the non-executive directors) a lot of convincing that we should go down this road again. We were sure the market wouldn’t like us doing this. I remember the chief executive had to go away and refine the proposal and sell it to us again, taking into account all our doubts.’\(^\text{171}\)

Another NED provided an extreme view:

‘NO, IT’S ABSOLUTELY NONSENSE!! The outside perception of non-executive is that they can safeguard the company and make sure everything goes well—that’s rubbish!’\(^\text{172}\)

On the other hand, a NED and part-time chairman finds that the approval of ratification does not always mean that it is a ‘rubber stamp’, but it just means that the decision was framed well enough to gain board acceptance:

‘It is like many of these things in decision-making… you have to get approval, but you always get it. So then people say “well what is the point, its rubber stamp”. But it is not, because the decision itself will be framed knowing that that approval has to be obtained. If you did not have to have that, the decision could take a different form; it could be more capricious. You cannot be capricious in a decision, if, in the end, you have to explain it.’\(^\text{173}\)

A CEO provided a different point of view, showing that NEDs were capable of participating in the company’s strategizing and management to direct the business according to their view:

‘with [name of company] when I [the chief executive] arrived … the non-execs were pretty much determined that we needed to get out of certain businesses and consistently

\(^{171}\) ibid.
\(^{172}\) Demb & Neubauer (n132) 15.
\(^{173}\) McNulty & Pettigrew (n80) 59.
brought it up till we did so. So they can have a view and influence board, but I have to say it is pretty rare to find that happening…"174

A CEO provided that the board gave a lot of attention to the definition and vision of the long-term strategy:

‘Strategy is an area where the board pay a lot of attention, prompting is, in terms of the importance of having a clearly defined strategic vision, and the need to continuously go through the process of determining what our long-term strategy is.’175

Adrian Cadbury, in talking about his experience as a chairman, provides that the term ‘NED’ does not reflect his contribution to the business, as he carried very wide responsibilities on the business:

‘Although I was a non-executive in the sense of not issuing management instructions of any kind, I do not think that the label ‘non-executive’ would have been helpful either internally or externally. My main job was as a chairman of the company in which I had spent my working life, and so I carried more responsibility for the business that the tag ‘non-executive’ would have implied.’176

Finally, a NED provided that a NED should not stay outside and work as a policeman, instead they should get involved and understand the business in order to be able get the knowledge and fulfil their job:

‘I think the concept of a non-executive sitting outside, knowing nothing about the business, acting as a policeman is completely wrong. They would not even know what to police. It seems to me important that non-executives do get involved in understanding the business as much as possible. I see directors, executive or non-executive, as equal- under the Law they are equal. How can non-executives be remotely equal if they are sitting out

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174 ibid 54.
175 ibid 63.
176 Demb & Neubauer (n132)15.
here somewhere, without knowledge, sort of critiquing what is happening. Without knowledge critique is impossible.'\(^{177}\)

According to the abovementioned interviews, the boards’ and NEDs’ involvement in strategy and decision making differs from one to another. While some NEDs find that the strategy process is their domain, others find that strategy is the domain of the management while they do not have a positive role to play. Moreover, some NEDs submit to the domination of the CEO, and to the information advantage which the CEO has.

Therefore, it is argued that there is high subjectivity in regards to the NEDs’ involvement in the decision making process. This subjectivity depends first on the willingness of the NEDs themselves to participate in the decision making process.

This subjectivity is also in regards to the CEO and the top executives’ behaviour, as the screening of strategic options is usually made at the executive committee level, the executive committee is at some level of decisions allowed to take the decision without referring to the board, and on some other occasions obliged to refer to the board for ratification,\(^{178}\) as explained before in section (B).\(^{179}\) At the level of executive committee, the committee will accept, reject or refer the strategic plan. Therefore, if the decision requires the board ratification, it will mean that it survived the executive committee level, and now it is presented to the board with full defence of the executive committee. This situation means that the board and the NEDs’ participation in the decision making process is subject to the cooperation of the management, particularly if the management decides not to involve the NEDs in the early stages of the decision making, the NEDs will be very likely not to have knowledge and awareness of the full picture about the decision and their role will be most likely a ‘rubber stamp’.\(^{180}\)

\(^{177}\) Roberts, McNulty & Stiles (n23) 13.
\(^{178}\) Stiles (n83) 638.
\(^{179}\) See- infra s B.
\(^{180}\) Stiles (n83) 638.
In this context, it is important to refer to the directors’ duties\textsuperscript{181} analysed in chapter two of this thesis.\textsuperscript{182} Directors’ duties apply to NEDs equally as it applies to the executives, nevertheless, the case analysis presented in chapter two of this thesis shows that what courts see in regards to NEDs is the ‘ratification’ step, whereas courts hardly referred to the role of NEDs in the early decision making steps, specially that the early decision making steps are very difficult to trace. In addition, courts hardly hold NEDs liable for the decisions taken at the executive committee level.

Therefore, it is important for the purposing of this thesis, and for finding a model that enhances the role of NEDs, to differentiate between the early steps of the decision making, and the actual moment of taking the decision which is the ratification. Therefore, it is suggested that there is a need to establish a mechanism for improving the role of NEDs, this mechanism should aim for ensuring the involvement of NEDs at the early steps of the decision process such as the steps of generating and selecting the ideas since these steps shape the strategic proposals presented to the board for ratification.

\textbf{Conclusion}

The extra focus on the oversight role of NEDs might be on the expense of the other roles.\textsuperscript{183} It may be argued that good monitoring needs strong control by the NEDs, and is essentially related to the quality of the strategic decisions of the company, as strategizing by itself is a form of monitoring. The ultimate goal of corporate governance is the quality of the top decisions made by the company. These decisions might be isolated from one to another; nevertheless, the different decisions collectively define the different policies of the company, starting from competitive strategy, risk management policies, executive succession and CEO remunerations, which make them altogether define the corporate governance of the company.\textsuperscript{184}

\begin{flushright}
\textsuperscript{181} CA 2006, s 170-177.
\textsuperscript{182} See Ch 2.
\textsuperscript{183} Daily, Dalton & Cannella (n152) 375.
\textsuperscript{184} Useem & Zelleke (n73) 3.
\end{flushright}
The involvement of NEDs in the decision making is a prerequisite for their effectiveness. Nevertheless, as mentioned before, this involvement should cover the different steps of the decision making, and not only the ratification step. This involvement should include the generation and selection of ideas to be presented to the board, in addition to the ratification, and finally the implementation of these decisions.

However, although the Code requires the NEDs to participate in the strategy making and in developing proposals for strategy, the Code does not provide a mechanism that ensures this involvement, which in practice will leave the involvement of NEDs in the decision making process depend on the circumstances of every board, and on the willingness of the individual and of groups of NEDs to participate.

At the level of ‘hard law’ and the directors’ duties, the law does not recognise the deep involvement of NEDs in the decision making process; instead, courts will look at whether or not NEDs did ratify the decision according to the required level of skill, care and diligence. The next chapter will propose and analyse a possible mechanism that deals with the problems arising from the delegation of powers, and that deals with ensuring the involvement of NEDs at the deep level of the decision making.
CHAPTER FIVE: NEW MODEL FOR NON-EXECUTIVE DIRECTORS

Introduction

It was argued in Chapter One\(^1\) and Chapter Three\(^2\) that NEDs are seen as a solution for many corporate governance problems,\(^3\) and that corporate governance reforms and the Code rely heavily on the role of NEDs. As has also been previously argued, as a consequence of the separation of ownership from control\(^4\) in the modern companies, companies became dominated by strong management which has unfettered powers over running the companies. This management might lead the company in a direction that is different from the company’s objectives, and different from the shareholders’ interests. Along these lines, it is also submitted that the shareholders have very little influence over management choices.\(^5\)

Corporate governance reforms aim to control the management behaviour and to reduce agency costs. In this context, the role of NEDs emerged as monitors over the management on behalf of the financial interests of the shareholders. Corporate governance reforms designed a wide role for NEDs on the board and the board subcommittees, expecting NEDs to monitor the actions of the management, and to monitor the audit process, the risk management and internal controls, as well as the remuneration of top management.\(^6\)

The UK regulatory model provides a ‘self-regulatory’ model for companies, comprising ‘soft’ law rules rather than a strict statutory rule based approach. The measures focus on the board composition as a solution for controlling the company and the management, and depend on the appointment of NEDs and independent NEDs on the board and the board subcommittees. Nevertheless, the reforms and the Code lacked effectiveness to fully ensure that NEDs, through

\(^1\) See- *supra* Ch 1.
\(^2\) See- *supra* Ch 3.
\(^5\) See- *supra* Ch 1 s A.
\(^6\) The Code General information. See also, *supra* Ch 3 s C.
sitting on the board and the board subcommittees, are positively involved in companies’ affairs, by taking a definite part in the decision making process, and in directing the company through its major decisions. Moreover, the reforms failed to take into account the need for a stricter behavioural code or prescriptive measures to ensure that NEDs actually perform their role.\(^7\)

It is argued in this thesis that there is a need to improve the role of NEDs in order to contribute to solving or minimizing the problems arising from the separation of ownership and control. There is also a need to control the conflict of interests between the management and the shareholders, and to reduce the agency costs. Therefore, this chapter proposes a new legal model to govern the role of NEDs. This new model aims to create a system that ensures that NEDs, by sitting on the board of directors and the board subcommittees, will control the company and the management. This may be achieved, through the positive and effective involvement in the company’s major decisions, such as major transactions, long term strategy in addition to decisions to enter new markets or introduce new types of business to the company.

Thus, our priority is to formulate a system that guarantees the effective involvement of NEDs in the decision making process of the board, through controlling the delegation of powers, and to provide an effective enforcement mechanism to ensure that the companies do comply with the measures taken to control the delegation of powers, and to ensure that the NEDs when taking their decisions are taking their decisions to a high standard. Nevertheless, in order to support the abovementioned priority, the proposed model will suggest some improvement to the board structure, by nominating NEDs to be appointed to the board, and requiring the appointment of female NEDs. It also requires specific financial skills of the NEDs appointed to the risk management and internal controls committee and the audit committee.

This chapter proposes a panel\(^8\) to govern the role of NEDs. The Panel is to be established with legislative basis. The idea of this Panel is inspired by the Takeovers and Mergers Panel legislated in Chapter 46 Part 28 of CA 2006.\(^9\) The chapter will explain in detail the methods of the work of the proposed Panel and its effect on the role and performance of NEDs. Therefore,

\(^7\) See- *supra* Ch 3 s C.
\(^8\) Refered to hereinafter as the ‘Panel’.
\(^9\) CA 2006, Chapter 46, Part 28. Refered to hereinafter as the Takeovers Panel.
this chapter will be divided into the following sections: Section (A) will explain the need to establish a Panel to govern the role of NEDs; Section (B) Analogy with the Takeovers Panel; Section (C) provides in detail the work of the proposed Panel and the areas of NEDs’ role which the Panel aims to improve, and how it will enhance the position of NEDs; Section (D) justifies the state intervention provided by the proposed Panel, while Section (E) is on exporting the UK corporate governance.

A- The Need for a Panel to Govern the role of NEDs

Chapter One of this thesis provided many examples of corporate governance failures. These failures showed the weaknesses of NEDs’ performance and inactivity in regards to preventing such failures from taking place. Before moving to the analogy with the Takeovers Panel and the Structure of the proposed Panel, this section will define the areas of failure of NEDs’ work which the Panel aims to improve. As argued in Chapter One, the waves of scandal taking place in the last twenty five years and the latest financial crisis shed light on the role of NEDs, particularly the role of NEDs in controlling the poor or fraudulent management actions which led to these corporate governance failures.

The thesis referred to several company failures that led to corporate governance reforms, such as BCCI, Polly Peck and Barings from the UK. In addition to the failures of Enron, WorldCom and Parmalat, which had massive effects on the US and Europe, the companies lost billions, with usually no warnings or signs of bad performance, these failures harmed the economies, investors, markets, creditors and states. Chapter one also referred to the financial

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10 See supra Ch 1.
13 See supra Ch 1.
14 See supra Ch 2 s C.
crisis which started in 2008, and affected almost the whole world. The Chapter referred to the collapse of Lehman Brothers in the US, as well as the financial problems of Northern Rock in the UK, which erupted just before the financial crisis.

Chapter one of this thesis provided more details about the reasons of the different companies’ failures. However for the purposes of this chapter, the writer of this thesis would like to highlight the main aspects of the scandals’ failures which showed weaknesses of NEDs’ performance, and weakness of the company’s strategies in addition to manipulating investors with false information. The most significant NEDs’ failure was their weakness in controlling the company’s CEO and management, as NEDs failed to limit the unfettered powers of the companies’ executives. Instead, the executives remained in full control of the companies and board of directors. In addition, NEDs failed to influence the strategies of the companies, especially in the latest financial crisis, which showed that companies took irrationally high risks. They also failed to establish appropriate risk management systems. In addition, NEDs were inactive in regards to stopping fraudulent transactions, and failed to raise the red flag regarding false financial statements announced by the companies. Moreover, there were also excessive CEOs’ remunerations decided by the NEDs.

It has been emphasized, through this thesis that the dominant position of the CEO is the main corporate governance problem which NEDs aim to solve. It is suggested that any proposed solution to improve the position of NEDs requires dealing with the delegation of powers from the board of directors to the management. The consequences of the delegation of powers created a problematic situation on two sides; the first is the misuse of the unfettered powers delegated to management; while the second side is that the board of directors remained with a

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19 See- supra Ch 1.
passive, vague and ill defined role after delegating the powers to the management.\textsuperscript{21} However, one might ask; why not solve the problem by seizing the delegation of powers completely and keeping the management of the company as a responsibility of the full board of directors? However, as previously described, the delegation of powers from the board to the management is a necessity, as the complexity of business requires full time management to run the company.\textsuperscript{22} Therefore, it is suggested in this thesis that if the delegation of powers is a prerequisite, then there is a need to find a mechanism to control the delegation of powers.

It is argued that the way to deal with the consequences arising from the delegation of powers requires first finding a mechanism to ensure controlling the delegation of powers from the board to the management. It is also necessary to find a mechanism to ensure the participation of NEDs in the early stages of the decision making process as well as to ensure the quality of NEDs’ performance when participating in the decision making process, through creating an effective enforcement mechanism over the role of NEDs.

Nevertheless, as is also explained in the thesis, the current Code applied to NEDs did not effectively deal with the consequences arising from the delegation of powers.\textsuperscript{23} Moreover, regulations did not provide an enforcement mechanism to enforce the role of NEDs, instead depended on ‘soft’ rules.\textsuperscript{24} In addition, courts and private enforcement did not show efficiency in dealing with NEDs, as the role of NEDs is not defined in CA 2006. Therefore, it was argued in Chapter Two that such a situation made it difficult to use directors’ duties as a behavioural standard for NEDs.\textsuperscript{25}

Hence, the proposed Panel will provide a new model for NEDs, which deals with the consequences of the delegation of powers and focuses on finding a mechanism to ensure the active involvement of NEDs in the board decision making process. Furthermore, the new model will propose enforcement mechanisms in regards to the compliance with the board structures, and the board measures for controlling the delegation of powers, in addition to enforcing the

\begin{itemize}
  \item \textsuperscript{21} See- \textit{supra} Ch 4.
  \item \textsuperscript{22} D Kershaw \textit{Company Law in Context Text and Material} (Oxford University Press New York 2009) 224.
  \item \textsuperscript{23} See- \textit{supra} Ch 4 s B.
  \item \textsuperscript{24} See- \textit{supra} Ch 3.
  \item \textsuperscript{25} See- \textit{supra} Ch 2.
\end{itemize}
actual performance of NEDs. Finally the new model will take into account improvement in the performance of NEDs on the board subcommittees, such as their role on the remunerations committee and their role on the risk management and internal control committee. Moreover, the new model will provide suggestions for enhancing the board structure in regards to the appointment of NEDs, as well as in regards to the integration of female NEDs.

**B- Analogy with the Takeovers and Mergers Panel**

The idea of the proposed Panel, as explained before, is inspired by the Takeovers and Mergers Panel, regulated in Chapter 46, Part 28 of CA 2006. The reason behind this inspiration is that as argued before, the case of NEDs requires a model that can deal with the business nature of the role of NEDs and can provide effective enforcement of their role. In the case of mergers and takeovers, the Takeovers Panel provides a very efficient example to be adopted for the case of NEDs, as will be explained in this section.

A major similarity in the background for the need for the Takeovers Panel and the need for a panel for the case of NEDs is that in the case of the former, the Takeovers Panel emerged after public scandals arising from some takeover cases.\(^2^6\) This shows that there was a problematic situation where common Law was incapable of establishing a system of takeover regulations which ensures that the takeover serves as an effective method for ensuring managerial accountability to shareholders.\(^2^7\) In the case of NEDs, introducing NEDs was through the Cadbury Report which was driven by corporate governance failures. However, the author of this thesis argues that the systemic failures in the corporate governance of large public limited companies, that took place in the twenty years after establishing the Cadbury Report, show that courts and the Code failed to create a system that forces NEDs to perform their expected role, which raises the need for establishing an effective system to govern the role of NEDs.

\(^{2^6}\) T Shea ‘Regulation of Takeovers in the United Kingdom’ (1990) 16(89) Brooklyn Journal of International Law 90.
The Takeovers Panel is an independent body. Its membership comprises of people coming from major financial and business institutions, in addition to members nominated by major bodies, such as the Association for Financial Markets in Europe, the Association of British Insurers, the British Bankers Association and other bodies. The Takeovers Panel main mandate is to issue and administer the City Code on Takeovers and Mergers. The Takeovers Panel has a legislative basis in CA 2006; nevertheless, it used to be described, and could be still described as a self-regulatory model due to its independent nature, and its full authority over issuing and administrating the Takeover Code and due to its composition which comprises of representatives of financial and business institutions, in addition to the main feature of the Panel for Takeovers and Mergers, which is that it takes decisions in the case of takeovers and mergers, instead of the court.

The system provides several advantages. For example, it provides flexibility and speed when compared to the application of statutory act. Such system allows the application of the spirit, and the letter of the Takeover Code taking in doing so a wider range of circumstances, while it also gives the option of resolving problems before or during the transaction, moreover it gives flexibility in regards to updating the Takeover Code, in addition to the low cost. The author of this thesis suggests that the position and performance of NEDs will improve if the proposed panel for NEDs can achieve similar advantages to those of the Takeovers Panel. Therefore, as will be shown in the next section, the proposed panel closely maps the sources and contours of the Takeover Panel.

The Takeover Panel works with a wide legislative authority provided in section 942 of CA 2006. This gives it the authority to do anything it considers necessary to perform its

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28 The City Code on Takeovers and Mergers, 1. Hereinafter, the ‘Takeover Code’.
30 The Takeovers Code 1.
33 Shea (n26) 91.
34 Companies Act 2006 Ch 46 Part 28 s 942.
functions, and gives it the authority to delegate its functions to committees or subcommittees, and to an officer or member staff.\textsuperscript{35} CA 2006 Chapter 46 Part 28 also empowers the Takeovers Panel to make rules over a very wide range of matters related to takeovers mergers.\textsuperscript{36}

The Takeovers Panel comprises of up to 35 members. The Takeovers Panel appoints the chairman and up to three deputy chairmen, in addition to up to twenty members. Those members are appointed through the recommendation of its nomination committee. Furthermore, as mentioned before, there are seats out of the 35 to be appointed by other bodies related to the financial industry.\textsuperscript{37} The proposed model for NEDs, as will be shown in the next section, will adopt almost the same approach and composition.

The Takeovers Panel has two committees\textsuperscript{38} and the executive.\textsuperscript{39} The Code Committee represents a range of shareholders, corporate practitioners and represents the interests of the panel regulated community. Up to 12 members of the Code Committee are appointed by the Takeovers Panel. The Code Committee designs the rules of the Takeovers and Mergers Panel, and is solely responsible for keeping the Takeover Code up to date. In order to update the aforementioned Takeover Code, the Code Committee takes into consideration market developments, and refers to previous cases that the Takeovers Panel considered, in addition to wide range of sources.\textsuperscript{40}

The Takeover Code provides a significant difference to the UK Corporate Governance Code,\textsuperscript{41} as the former provides clear rules to be used as term of reference for the decisions and sanctions taken by the Executive and the Hearings Committee of the Takeovers Panel. On the other hand, the Corporate Governance Code provides guidelines drafted in stretching language, which makes it difficult to use these guidelines as a reference for legal enforcement. Moreover, the Takeover Code clearly defines companies, transactions and persons which are subject to it.\textsuperscript{42}

\begin{thebibliography}{99}
\bibitem{35} Companies Act 2006 Ch 46 Part 28 s 942.
\bibitem{36} Companies Act 2006 Ch 46 Part 28.
\bibitem{37} The City Code on Takeovers and Mergers 4.a.
\bibitem{38} The City Code on Takeovers and Mergers 4.
\bibitem{39} The City Code on Takeovers and Mergers 5.
\bibitem{40} The City Code on Takeovers and Mergers 4.b.
\bibitem{41} The UK Corporate Governance Code, General Information.
\bibitem{42} The City Code on Takeovers and Mergers 3.
\end{thebibliography}
and also provides clear disciplinary powers, sanctions and remedies to be practiced by the Executive if there has been a breach of the Takeover Code provisions.\textsuperscript{43} However, the abovementioned elements of the Takeover Code are missing in the current Corporate Governance Code, which is drafted in a broad language, and does not provide appropriate mechanisms to enforce it.

As enforcement is the main feature of the proposed model for NEDs, the code to be provided by the proposed model will have a different approach from the UK Corporate Governance Code, and a very close approach to the Takeover Code, as the proposed code will define its scope as a regulator over the NEDs, and will define the areas of NEDs’ role to be subject to the proposed code whether in regards to compliance, in the case of the board composition and the delegation of powers, or in regards to other roles such as the remunerations, risk management and internal controls.

C- The Proposed Panel Structure and Functions

The proposed model suggests establishing a ‘Panel’ to govern the role of NEDs. The proposed Panel is highly similar in the basis, structure and powers to the Takeovers Panel. The Panel is to be established with legislative basis, by integrating new provisions to CA 2006 to provide for establishing the Panel and giving it wide authority over regulating the NEDs. The main role of the proposed Panel is to establish, administer and enforce a Governance Code\textsuperscript{44} for NEDs. The authority of the Panel involves designing the board of directors and the appointment of NEDs and independent NEDs to the board, in addition to defining the roles and responsibilities of NEDs, and to provide the method to ensure companies’ compliance with the proposed Governance Code. It also involves providing the means for enforcement to ensure that NEDs perform their role.

The proposed Panel aims to enhance the monitoring and management roles of NEDs. To do so, the Panel proposes clearer definitions and functions of the role of NEDs in the

\textsuperscript{43} The City Code on Takeovers and Mergers 11.
\textsuperscript{44} Referred to hereinafter the (Governance Code).
Governance Code. The Panel will also provide measures to control the delegation of powers from the board to the management. In addition, the Panel will provide new requirements for the board structure. Moreover, the Panel will provide enforcement mechanisms to ensure compliance with the rules in regards to the board structure, and the delegation of powers, in addition to enforcing the actual role of NEDs. As will be explained through this section, the measures taken by the Panel will improve the performance of NEDs, and will enable them to control the management and the decision making process, as well as to control the business in general. In addition, it is suggested that these measures will improve the quality of the company’s decisions.

C-1 Summary of the Panel’s Powers and Tools

A suggestion for the main article to be integrated into the legislation:

‘[(1) The body known as the Panel on the Role of the non-executive directors “the Panel”
(2) The Panel’s authority is over the top 100 FTSE companies, the panel authority extends to the rest of the listed companies after three years of the passing of this Act.
(3) The Panel may do anything that it considers necessary or expedient for the purpose of, or in connection with, its functions.
(4) The Panel should establish a governance code of conduct to design the role of the non-executive directors, and to design the structure of the board directors and the board subcommittees.
(5) The Panel may establish the required committees to fulfil its role.
(6) The Panel has the full authority to take decisions against the companies and the non-executive directors to ensure the compliance of the companies and NEDs with the rules of its governance code.]’

The reason for having the authority of the Panel primarily over the top 100 FTSE companies is to give the Panel enough time to ensure its capability to work efficiently over a

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limited number of companies, before it extends to the rest of the listed companies. As the Panel appoints two independent NEDs to the companies’ boards, the suggestion here is to give the Panel the time to ensure that there is a wide pool of NEDs with the relevant qualities and expertise before extending to the rest of the companies. Selecting NEDs will be further explained in this section.

The Panel will have the overall responsibility for administering, and managing the Panel’s functions, and for administering and operating the proposed Governance Code. In terms of membership, the members of the proposed Panel and the committees are identical to the members of Takeovers Panel.\(^46\) This is due to the fact that both Panels regulate matters related to the companies’ and directors’ practices. As a ‘self-regulatory’ body, the Panel’s membership will comprise 35 members, who mostly come from major financial and business institutions. The Panel appoints its chairman, and up to three deputy chairmen in addition to up to 20 other members. The rest of the 35 members are appointed by the Association for Financial Markets in Europe, the Association of British Insurers, the Association of Private Client Investment Managers and Stockbrokers, the British Bankers Association, the Confederation of British Industry, the Institute of Chartered Accountants in England and Wales, Investment Management Association and the National Association of Pension Funds.

The Panel will establish three committees and an Executive.\(^47\) The three committees are the Code Committee,\(^48\) which drafts and updates the Governance Code, the Compliance Committee,\(^49\) which ensures the compliance of the company with the measures in regards to controlling the delegation of powers and the design of board structure provided by the Governance Code, and the Hearings Committee,\(^50\) which will see the cases brought against the NEDs for their inactivity, weak or wrong performance. Actions to be brought against NEDs in front of the Hearings Committee can only be brought by the Executive.

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\(^{46}\) The City Code for Takeovers and Mergers 4(a).
\(^{47}\) Referred to hereinafter as the (Executive).
\(^{48}\) Referred to hereinafter as the (Code Committee).
\(^{49}\) Referred to hereinafter as the (Compliance Committee).
\(^{50}\) Referred to hereinafter as the (Hearings Committee)
The decisions of the Hearings Committee are subject to appeal in front of the Panels Appeal Board. The Appeal Board is an independent body comprising 12 members. The chairman and deputy chairmen of the Appeal Board have held high judicial office, and are appointed by the Master of the Rolls. The rest of the members have relevant knowledge and experience in the corporate governance work of NEDs. They are appointed by the chairman of the Appeal Board, or else the deputy chairman. The role of the Appeal Board is to hear and determine the appeals against the rulings of the Hearings Committee; in doing so, the Appeal Board focuses on ensuring that the Hearings Committee rulings, interpretation, and application of the Governance Code are according to the Law. Both, the Executive and the defendant NED have the right to appeal the decisions of the Hearings Committee in front of the Appeal Board.

The Executive has several functions. It can interpret the Governance Code and give consultation and advice to the companies in regards to the application of the Code. The Executive works as a policeman in the system, and so has the power to file the cases against NEDs in front of the Hearings Committee. Moreover, the Executive can send warning to companies for non-compliance with the Code, and can report the non-compliance to the Compliance Committee. Nevertheless, the Executive is not entitled to take measures against the non-complying company, as this is the authority of the Compliance Committee.

In terms of composition, the Code Committee comprises of up to 12 members, that is those Panel members appointed by the Panel. The members represent wide variety of shareholders, and company practitioners, and other bodies who have interests, and are subject to the Panel’s regulations. The Compliance Committee comprises the Panel’s chairman and the Panel’s three deputy chairmen, and up to eight of the members appointed by the Panel, as well as the appointee members of the bodies mentioned above. Meanwhile, the Hearings Committee is similar to the composition of the Compliance Committee, and will be chaired by the Panel’s chairman. The Executive is headed by the Director General, who is usually an officer at the Panel, and has long experience in serving as a chairman of a bank or an investment company, and who has long experience in serving on boards. The rest of the members of the Executive are

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51 Referred to hereinafter as the (Panel’s Appeal Board).
a mixture of employees with different relevant backgrounds and expertise, such as lawyers, accountants, investment bankers and other backgrounds.

**C-2 Summary of the Main Governance Code Compliance Rules**

The Governance Code provides two sets of compliance rules. The first concerns the controlling of the delegation of powers from the board to the management, while the second is regarding designing the board composition. In regards to controlling the delegation of powers, the Governance Code requires limiting the scope of the delegation of powers, by keeping the major decisions subject to the approval of the full board of directors. In addition, in order to ensure that NEDs are engaged in the matters and decisions of the company, the Governance Code requires the Compliance Committee to monitor the agendas of the board meetings, in order to ensure that the board through the year will discuss all the important matters and decisions related to the future of the company.

In regards to the board composition, the Governance Code does not require a specific board size. Nevertheless, the main rules are that half of the board of directors should comprise of independent NEDs. The Governance Code also requires the board to include independent NEDs, three financial experts, and two females, in addition to two of the independent NEDs to be appointed by the Panel through its Executive. However, this does not mean that the board should have at least seven independent NEDs. For example, the two independent NEDs appointed by the Executive could be female independent NEDs, and have financial expertise, which makes the minimum requirement for the number of independent NEDs on the board, three independent NEDs, as the Governance Code requires the board to include at least three independent NEDs, who have financial expertise.

**C-3 The Work of the Panel Committees and Executive**

This subsection explains in details the work and functions of the Panel’s Committee’s and Executive, and shows the positive effects of their functions on improving the performance of NEDs.
C-3- a The Code Committee and the Governance Code

The Code Committee of the Panel is responsible for drafting and updating the proposed Governance Code. The panel conducts this task through regular reviews of the proposed Governance Code and after a process of consultations, taking into account the developments in the relevant sciences, in addition to the past rulings of the Hearings Committee. The flexible nature of the Governance Code gives the chance for the Panel to respond quickly, after corporate failures, by reviewing and updating any specific weaknesses of the Code.

The Governance Code designs all aspects related to NEDs’ role, starting from the board composition and the ratio of independent NEDs, to the roles and responsibilities of NEDs. The Governance Code aims to provide clearer definitions of the role of NEDs in order to make it easier for the NEDs to understand their role, and to make it clearer to the public to assess the performance of NEDs according to clear definitions, and to make it easier for the Hearings Committee to find clear reference when deciding on cases against NEDs.

However, finding a new definition for the role of NEDs that is distinguished from the old terms is not simple, because the current Code uses a wide variety of terms, which will give the impression that every suggested definition is already existent in the current Code, and therefore the proposed Governance Code brings no change. For example, the current Code uses terms such as ‘control’, and requires the board to ensure that the companies’ financial resources are in place, in addition to requiring the board to act in the best interest of the company.\(^{52}\)

Therefore, at a broad level, the Governance Code defines the role of NEDs as their role to monitor and control the company. NEDs are responsible for ensuring sound allocation of the company’s resources, and responsible for the sound financial performance, and well economic being of the company.

The Governance Code defines the monitoring and the control roles as the NEDs’ responsibility for participating and dominating the decision making process of the company.

\(^{52}\) The Code (A.1).
Therefore, the Governance Code stresses that NEDs are responsible for taking decisions, after ensuring that they have all the information, and studying the impacts of the decisions.

The Governance Code includes the NEDs control role, the approval of annual reports, audit plans, the company’s risk criteria, internal controls and executives’ remunerations as part of the decisions that the board is responsible for. The Governance Code also provides that NEDs be responsible for the accuracy of annual reports, as well as for the information provided to the shareholders and the public.

The Governance Code emphasizes the fact that NEDs are responsible for the competence of the company’s decisions. The competence and quality of their decisions are measured according to best business practice. However, the major difference that the Governance Code brings, comparing to the current Code, is that the Governance Code provides a definition of the NEDs’ level of involvement in the abovementioned roles. This definition is to be used as a term of reference for the Hearings Committee when deciding cases against NEDs. This level of involvement is defined in the proposed term ‘pro-active’ involvement. The suggested ‘pro-active’ term refers to the development of the role of NEDs in the case law, and this term provides a higher third level and responsibility for NEDs’ involvement.

To explain the meaning of the term ‘pro-active’ involvement, reference is made to the development of the courts approach in regards to the NEDs’ responsibility. As mentioned in Chapter Two of this thesis, courts changed its recognition of the role of NEDs by not accepting the inactivity of NEDs. Inactive refers to the old position where NEDs did not have a duty to bring experienced judgements to the board, and they were allowed to rely on the views of the management; therefore, they were not liable even when they had only ‘rubber stamped’ the decisions without investigation.53

However, the approach of the courts changed, and inactivity became unacceptable. By referring to the cases mentioned in Chapter Two54 of this thesis, NEDs were liable for approving

53 See- supra ch 2 s C.
54 See- supra ch 2 s C.
decisions that included clear manipulation, clear illegal actions or wrong doings, or cases that involved very extreme negligence. If the old position was described as inactive, it is suggested here that this position should be referred to as active.

However, this active involvement is below the corporate governance level required of NEDs in the proposed Governance Code. The Governance Code approach in this regard takes a step further than the active position, which is the competence of the NEDs’ decisions measured through the best business practice. The proposed pro-active approach means that NEDs on the company must, due to their position on the board, lead the company and take the full responsibility for the soundness and competitiveness of the company’s decisions. In this case, NEDs are not only responsible when they approve manipulated decisions; rather, NEDs will be liable for every decision if this decision does not fit with best business practice, regardless of whether this decision involves manipulation or wrong doing or extreme negligence.

For example, according to the ‘pro-active’ approach, NEDs as board members will be responsible for the weakness of the strategies adopted by the board, or irrational risk taking, or for deciding on high remunerations for the management, which is not based on the company’s success or on the approval of weak internal control systems.

In regards to strategy, the Governance Code provides that NEDs are responsible for the long term success of the company. However, the Governance Code requires NEDs to stipulate how their strategic plans will serve the long term success when defining their broad strategy, and the objectives of the company. Moreover, NEDs are required, when taking strategic decisions, to stipulate in clear terms how these decisions will fit with the abovementioned criteria of the long term success of the company.

Moreover, the participation of NEDs in the strategy process will be defined in steps, starting from their responsibility to participate in generating and initiating the ideas, to the ratification of the decisions, to monitoring the implementation of these ideas. It is suggested that defining the responsibility of NEDs in participating in the early stages of the decision making is very important; firstly, as it ensures that the company benefited from the expertise of the NEDs,
and secondly, because NEDs, after participating in the decision making from the early stages, will not be able to claim in front of the Hearings Committee that they did not know about the decision, or they had no information.

In regards to the roles of NEDs on risk management and internal controls, in order to enhance the work of the committee, the Governance Code firstly requires the risk management and internal controls committee to comprise fully of independent NEDs who are financial experts.

In addition, and most importantly, the risk management and internal controls systems will be regarded as the responsibility of the members of the risk management and internal controls committee. In doing so, the Governance Code helps establishing functional roles and responsibility for NEDs. To explain further, according to the current Code, the role of NED members of the risk management committee, in regards to the risk management and internal control systems is not a primary role, as the committee performs a linkage role between the external auditor and the management. Moreover, their roles are limited to reviewing the already established, approved systems.

On the other hand, the new Governance Code enhances the functional role of NEDs on the risk management and internal controls committee, by making risk management and internal control committee responsible for setting and approving the risk management and internal control systems. This situation makes the risk management and internal control a direct responsibility of the committee members. The Governance Code also stipulates that the risk management and internal control committee is responsible for providing the board with accurate information as to the business, and in a timely manner.

In regards to the audit committee, the Governance Code will require that the audit committee, if different from the risk management and internal controls committee, to comprise of the same composition of the risk management and internal controls committee. The proposed

56 The Code (C.3.2).
code does not bring significant differences in regards to the role of NEDs as members of the audit Committee, as the approval of the annual budgets and the annual report are subject to the approval of the full board of directors; nevertheless the proposed Governance Code requires the audit committee to be responsible for the appointment and dismissal of the internal auditor.

In regards to the role of NEDs in deciding the remunerations of the company’s top management, the proposed Governance Code requires the establishment of a remunerations committee comprising fully of independent NEDs. The remunerations committee has the full authority to decide on the remunerations of the company’s top executives. This makes deciding the remunerations of the NEDs a function of the remuneration committee. In addition, committee members will define the policies and procedures for fixing the company’s executive packages.

C-3-b The Executive

The ‘Executive’ body will adopt the role of police officer to ensure that NEDs are performing their role according to the Governance Code. The Executive works as a claimant or a prosecutor and files the cases against the NEDs in front of the Hearings Committee, building the claims on the breach of the Governance Code and asks for applying the directors’ duties of CA 2006 against the NEDs who are in breach of the Governance Code. In doing so, the Executive works on its own initiative, or according to the complain of any shareholder or shareholders, or a third party or in response to the public pressure. Before taking the proceedings, the Executive must evaluate whether there has been breach of the Governance Code or weak performance of NEDs. The Executive can take such proceedings against the NEDs at any time, without the need for the company to face deep financial troubles or a high probability of failure. The Executive has the power, through the Governance Code, to conduct investigation and to require documents and information of the company.

The other dimension of the Executive’s work is to assist the Compliance Committee by observing the companies’ compliance with the Governance Code. This includes the compliance with the measures to control the delegation of powers, and the compliance with the composition of the board of directors and the board subcommittees. The Executive has to visit the company at
least once a year to check the compliance and application of the rules of the Governance Code. In doing so, the Executive should require information and documents and investigate these documents. In addition to the annual visit aforementioned, the Executive may revisit the company at any other time, according to the Executive’s discretion. Nevertheless, the Executive cannot penalize the company for non-compliance, as the Executive in this case only reports to the Compliance Committee, and can send a warning to the non-complying company to correct areas of breach.

When the Executive files the documents of a company’s breach and presents them to the Compliance Committee, the Company in breach must be present in front of the Compliance Committee to defend its position in regards to the areas of breach. If the Compliance Committee is satisfied that the Company’s conduct constitutes a breach of the Governance Code, the Compliance Committee will send a report to the Financial Services Authority and the London Stock Exchange to withdraw the listing of the company. The company can appeal the Compliance Committee’s decision in front of the Panel’s Appeal Board.

The Executive can give advice to the companies in regards to the interpretation and application of the Governance Code. The Executive also nominates two independent NEDs to be appointed to the boards of the companies, as the companies are obliged to appoint two independent NEDs who are nominated by the Panel, where the Executive undertakes this nomination process. In doing so, the Executive chooses NEDs who have relevant expertise related to the company’s business. Therefore, the Executive will first see the board’s needs for complying with the Governance Code requirements for the board structures. For example, as will be explained later, the Governance Code requires the boards to include two female directors, and to include three financial experts. The appointments and composition of the board of directors will be further explained in the next subsection.

**C-3-c The Compliance Committee**

The Compliance Committee has to monitor the compliance of the companies with the regulations of the Governance Code. The Panel requires the cooperation of the London Stock Exchange, as
the Compliance Committee has to give its written approval to the company in regards to the board composition, and the measures taken to control the delegation of powers and the decision making steps. The approval of the Compliance Committee is a prerequisite for listing the company in the London Stock Exchange, and approval could be withdrawn in cases where the company changes the measures that have been approved before, without the consent of the Compliance Committee.

As mentioned before, the Executive can assist in this process, by reporting to the Compliance Committee, in case the Executive finds any breaches. Nevertheless the Executive does not have the power to approve or disapprove the company’s compliance with the Governance Code.

C-3-c-i Controlling the delegation of powers through the Compliance Committee

The work of the Compliance Committee in regards to controlling the delegation of powers is divided into two main roles. The first is controlling the formal delegation of authority from the board to the management, by checking insider formal delegation of authority from the board to the management, in order to ensure that it does not give unfettered authority to the management, and that it keeps wide range of the top decision subject to the board of directors’ approval. Second, checking whether the company adopts the right board agendas and board calendars which ensure that NEDs are at all times involved in the early stages of the decision making process. This is in addition to ensuring whether the company does take the needed measures for ensuring that NEDs have clear information about the implementation of the company’s decisions.

aa- Controlling the formal delegation of authority

According to Part (2) Regulation (3) The Companies (Model Articles) Regulations 2008,\(^\text{57}\) which replaced Regulation (70) Table (A) Companies Regulations 1985,\(^\text{58}\) managerial

\(^{57}\) Part (2) Regulation (3) The Companies (Model Articles) Regulations 2008.
\(^{58}\) Regulation (70) Table (A) Companies Regulations 1985.
powers are vested in the board of directors, who has the right to delegate these powers to an executive director or a committee to run the company.\textsuperscript{59}

The author of this thesis does not suggest any changes as to the abovementioned Part (2) Regulation (3) The Companies (Model Articles) Regulations 2008. The reason for this is that different companies from different sizes and running different types of business will definitely need different types of authority delegations.\textsuperscript{60} Therefore the current Regulations give space for the needed flexibility for the companies to adopt its own delegation policy, according to its circumstances, and leave the space for taking into account the size of the company and type of business.\textsuperscript{61} What is required here is that the board leaves decisions that involve large amounts of the organization resources\textsuperscript{62} in the hands of the board. However, the Compliance Committee, in assessing the scope of the delegation, will take into account the size of the company; for example, if the company’s value was 5 billion pounds, the delegated authority to the management will be less than a company of 15 million pound value.

In this respect, every company subject to the Panel will have to send its formal delegation of authority decided by the board to the Compliance Committee to review it, and decide whether to approve it or not. Nevertheless, it is suggested that the Compliance Committee should through research define the conditions for deciding what top decisions are. As abovementioned, top decisions may be referred to as the decisions that involve large amounts of the organization resources, which could include large transactions, exploiting some of the company’s assets, or opening business in new markets, or introducing new types of business lines, or selling some of the company’s assets.

There are several benefits to this proposition; first, when the decisions are ratified by the board, it becomes easier to give a reliable evidence for the Hearings Committee to check whether


\textsuperscript{61} ibid 681.

the director took his decision according to the required standard of care, skill and diligence. Second, according to the empirical findings of Berghe and Baelden, more restricted delegation of authority from the board to the management makes the board more involved in the early stages of the decision making including the initiation and generation of ideas, and prevents the concentration of powers in the hands of one person, on the other hand, wider and more excessive delegation will lead to less involvement of the board and the NEDs in the early decision making steps, and will make the powers more concentrated in the hands of one person.63

Finally, it is suggested that once NEDs know that they are going to ratify the decisions, and they might be exposed for liability due to the ratification, they will be more active in obtaining the relevant information to build an informed decision.

bb- Controlling the steps of the decision making process

The process of the work of the board of directors is of fundamental importance in involving NEDs in the decision making process and strategy planning. In particular, the agendas and schedules for the board meetings can be vital in determining what is presented to the board.64 For example, some boards focus on past issues, past financial reports and previous decisions, while in other cases some boards tend to bring real issues to the board for discussion to be discussed by the board, for example bringing to the board issues in regards to important or risky decisions to be taken will open to NEDs the chance to challenge and influence the decision making process, and this will enhance NEDs’ involvement in future decisions.65

The agenda decides what decisions the board will decide on. Some companies use the annual calendaring and the decision protocols, which explain in details what matters will be presented to the board all the year; for example, one meeting will be for the overall strategy of the company, and another will be in regards to the financial statements, another will be in regards to evaluating the CEO and the succession plan. A further meeting will be in regards to the stock

63 L Van den Berghe & Tom Baelden (N60) 681.
64 T McNulty & A Pittegrew ‘Strategists on the Board’ (1999) 20(1) Organizational Studies 68.
65 ibid.
options, and another will be in regards to acquisitions. Nevertheless, there is no particular formula for the agenda, the annual calendaring and the decision protocols. Companies at the beginning of the financial year must submit to the Compliance Committee the agenda and the decision protocols for assessment and approval, while for its part the Compliance Committee needs to ensure that all the important issues will be presented to the board through the year.

The other step in the decision making which the Compliance Committee controls is the implementation of the strategic plan and the decisions taken by the company. The implementation of the strategy starts after the decisions are taken and the strategic plan is set. Assessing the success of the implementation of the strategy is very important in ensuring that the company is on the right track and to ensure the success of the long term goals of the strategy. However, NEDs are not supposed to undertake the implementation of the strategy as this is the role of the management. Nevertheless their role is to have clear information of the implementation of the strategy plan in order to ensure that the strategic goals are met, and if not, they might change the strategic plan for the future or investigate the problems that led to the failure.

It is suggested that there is need to ensure that NEDs have full information about the implementation of the strategy, in order to assist them with continuing a successful strategic role for the following years. In order to do so, without stepping into the province of management, this thesis suggests that board of directors must appoint outside agency to provide the board in timely manner information on the progress of the strategy and whether it is going along with the defined objectives of the ratified strategy. The company must show the Compliance Committee that it has appointed an agency for this purpose.

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67 ibid 6-7.
The abovementioned measures aim to improve the strategizing and monitoring roles of the board, by making them involved in all the decisions and matters that affect the performance of the company. These measures make the board of directors fit with the description of the continuous strategizing board mentioned in chapter four of this thesis.  

C- 3-c-ii The composition of the board of directors

The fundamental difference between the approach of the current Code and the proposed model in regards to board composition is that the current Code relies highly on the board composition, and on the integration of independent NEDs. This is, assuming that the appointment of independent NEDs will by itself solve the different corporate governance problems. On the other hand, the approach of the proposed model towards solving the corporate governance problems is by getting the NEDs deeply involved in the decision making process, by having the authority to ratify greater number of decisions and by getting the NEDs involved in the early stages of the decision making such as the generation and initiation of ideas. If these goals are achieved, NEDs will have a greater chance to control the company and the decision making. Nevertheless, the proposed model also takes into consideration the composition of the board, but as an assisting factor not as the main goal of the model.

It is very difficult to govern all the determinants of the quality of the board and NEDs’ performance, for example the board dynamics, the social and psychological factors, the openness and trust on the boardroom and other factors. It is argued that such factors are difficult to be defined and controlled by law; in addition, they go beyond the criteria of the rating agencies, which adopt check lists depending on board structures in determining the board’s effectiveness.

Nevertheless, this section will discuss some factors that will help to improve the structure of the board, taking into account first that NEDs are not supposed to be controlled by the CEO, although as argued before, any measures to enhance the independence of NEDs might help, but

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71 See- supra Ch 4 s C.
cannot ensure the independence of NEDs. Second, to take into account that what is required of NEDs is to contribute and enhance the quality of the decisions made by the board, therefore will also take into account the skills of NEDs. In addition, this section will take into account the integration of female directors to the board, as this subject is surrounded by a big debate and wide empirical studies. However, this section is not arguing that the suggestions of the board composition present the optimal board composition. Therefore the following will discuss four factors in terms of the board composition: first the size of the board, second the skills of NEDs, third the independence of NEDs, and fourth the appointment of female directors to the board.

**a a- The size of the board**

There are different points of view in regards to the board size. Some are in favour of large boards and others in favour of small boards. Some studies found positive relation between board size and the financial performance of the company,\(^74\) while other studies showed negative relation between the board size and the financial performance of the company. For example, David Yermack found that smaller boards are more efficient, due to his study which found inverse relation between the size of the board and the financial performance of the company.\(^75\) The same results were found by the study of Eisenberg and others.\(^76\)

Scholars looking at the effect of board size on the behavioural dynamics also provided different points of view in regards to the effect of board size. Arguments in favour of bigger boards suggest that larger boards could be a source of knowledge to the company, and are more able to connect with other organizations, and support the company with sources such as customers and clients. In addition, larger boards could bring wider perspective for the company strategy.\(^77\) For example, Forbes and Milliken find that bigger boards could bring more skills, expertise and knowledge to the board. Nevertheless, it has disadvantages, as it is harder to coordinate between the directors, which makes it difficult to make use of their knowledge and

\(^77\) Bainbridge (n74) 43.
expertise. In addition, within larger boards, it is difficult to build interpersonal relationships and cohesiveness.\(^{78}\)

On the other hand, Goodstein and others argued that large boards are less effective in bringing strategic change to the company, and limit the board’s ability to take timely strategic action,\(^{79}\) because of the difficulties to reach consensus on the important decisions.\(^{80}\) Larger boards are criticized for being continuously fragmented, and are unable to collectively work together in order to control the management, which would give the management the opportunity to take advantage of their dispersed situation and dominate the whole board.\(^{81}\)

Even medium size boards are subject to contradictory points of view. The first point of view finds that medium size boards will have none of the benefits of the small boards and large boards, as such boards will not have the benefits of the resources that large boards have, neither will they have the benefits of speed that smaller boards have. On the contrary, other points of view find that medium size boards will have the best of both worlds; since such boards will have the balance between the resources of large boards and the speed of smaller boards.\(^{82}\)

Therefore, in this context of different points of view, it is difficult to suggest a size for the board of directors, although the writer of this thesis is in favour of bringing breadth of knowledge and expertise to the board, nevertheless suggesting an optimal size does not have enough support in research. Therefore, the Panel will leave the issue of the board size flexible to the companies, which would benefit the companies in adopting the board size that fits for their circumstances;\(^{83}\) nevertheless, the emphasis as will be explained in the following subsections will be on the skills of the appointed directors. Therefore, the suggestion for the composition of

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\(^{81}\) Bainbridge (n74) 44.


\(^{83}\) L Van den Berghe & A Levrau (n80) 462.
the board of directors is to be determined by ratio. This ratio requires half of the board to consist of independent NEDs.

**bb- The required skills**

Scholars analyse the skills of directors as a part of the research line on the board diversity. This research line takes into account the age of the director, ethnicity, gender, culture, religion and other attributes of the directors. Nevertheless, in order not to lose focus on the goal of strengthening the decisions made by NEDs, and the accountability of NEDs for the decisions they make, which may expose them to liability, it is suggested that the skill and expertise of the NED are the essential factors needed to achieve this goal.

The skills of directors have no precise definition. Nevertheless, there are many factors that could be taken into consideration when looking at the skills and expertise of the director, starting from their familiarity with the industry, professional reputation and competence and history of business experience. The current Code does require the appointment of NEDs for their skills and expertise. However, such a recommendation is not obligatory due to the non-binding nature of the Code. Nevertheless, the only clear requirement in regards to the skills in the Code is the requirement that at least one NED should have relevant financial expertise.

In regards to the skills required of NEDs, the Panel requires companies to appoint three independent NEDs who are financial experts, due to their role in the audit process, and due to their responsibility for setting the risk management and internal control systems. This idea is inspired by the audit boards in the Italian board system, as explained in Chapter Three of this thesis. The mechanism of compliance with the suggestions on the skills of NEDs will be explained in the final subsection.

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86 The Code s (B.1).

87 The Code s(C.3.1).

88 See- supra Ch 3 s B.
The independence of NEDs is subject to controversial points of view, as will be shown in this subsection. The first critical point in regards to NEDs’ independence is the different roles of the board of directors which the NEDs are supposed to perform. NEDs as board members are supposed to contribute to strategy, as explained in chapter four, and required to provide the management with resources and networks. It is important to refer to the argument of the previous chapter, which provides that the monitoring role is best performed through getting the NEDs involved in the decision making. In this context, the independence of NEDs might not contribute to the other roles such as the strategy role, especially when the independent NEDs decide to practice strict monitoring\(^\text{89}\) rather than participating in the decision making.

Other arguments refer to the intensity of the strict monitoring role, which occurs when the board comprises of a supermajority independent NEDs. There are different points of view in regards to the disadvantages and advantages of having boards comprising a supermajority of independent NEDs to perform intense monitoring;\(^\text{90}\) some arguments built on empirical research find that intense monitoring leads to low level performance in the incidents of acquisition, and weakens company innovation, and find that intense monitoring could be on the expense of building trust between the CEO and NEDs, which makes the CEO hide the information the NEDs need to participate in their strategy role.\(^\text{91}\) Similarly, Adams and Ferreira argue that intense monitoring weakens the cooperation between the CEO and the NEDs in sharing the information and leads to weak advisory role.\(^\text{92}\) Moreover, the Song and Thakor provide that intense monitoring practiced by NEDs through scanning the CEO proposals will make the CEO provide them with unclear or less precise project evaluation information.\(^\text{93}\)

\(^{89}\) Chancharat, Krishnamurti & Tian (n82) 146.  
\(^{90}\) In regards to the intense monitoring abovementioned, the author would like to note here that this style of monitoring means that NEDs would have a role of a watchdog over the management actions, without participation in the management role, which is different from the definition of monitoring provided by the author in the previous chapter, that recognizes the monitoring role as their role in taking high quality decisions.  
\(^{91}\) Chancharat, Krishnamurti & Tian (n82) 146.  
On the other hand, other authors find that the number of independent NEDs on the board, and the intense monitoring are beneficial; as such boards will deter the CEO from proposing poor projects to the board, because these projects will be rejected. Harris and Raviv find that when agency costs are high, the control by independent NEDs is optimal. Matsusaka and others find that independent NEDs have material effect on the company but only when the cost of obtaining the information is low.

As explained in Chapter Three of this thesis, NEDs’ independence is designed to solve a very fundamental problem, which is the control of the management and the CEO over the board of directors, this control of the CEO over the NEDs gave unfettered powers for the CEO over the decision making. Nevertheless, as argued in Chapter Three, the current independence criteria of the Code cannot guarantee the independence of NEDs, first because it is likely that the CEO would influence the appointment of NEDs, second because biases could build up through the time of service of the NED on the board, and third because the advantage the CEO has in regards to information and knowledge of the business will make NEDs follow the CEO views. It is argued not only that the independence criteria of the Code cannot guarantee the NED’s independence, but no criteria can.

Therefore, in order to propose suggestions in regards to NEDs’ independence that can be adopted in this model, several questions need to be answered. First, if no criteria can ensure the independence of NEDs, what is the need for independence criteria? Moreover, if the independence of NEDs is at the expense of the CEO cooperation in regards to information, and at the expense of NEDs’ management and supervisory role, then why appoint NEDs who are independent? Third, if the independence of NEDs is a good remedy for the domination of the CEO, then what is the ratio of independent NEDs to be appointed to the board?

97 The Code (B.1.1)
98 See- supra Ch 3 s C-1.
The answer to the abovementioned questions requires an assessment of the criteria of independence provided by the Code, and an assessment of the number of independent NEDs required to serve on the board.

First, in regards to the independence criteria, it is suggested that such criteria work more to ensure that the NEDs serving on the board are not affiliated with the business rather than independent. Affiliated directors could be referred to as directors who have economic or personal ties with the company such as commercial and investment bankers, lawyers and any other directors who provide goods or services to the company, also could be referred to as the directors who have served on the board for long time.

By looking at the criteria of the Code in section B.1.1, it is found that the first three points only relate to differentiating between a NED who is affiliated with the company and a NED who is not affiliated with the company. This is because the first point requires the NED not have been an employee of the company within the last five years, while the second requires the NED to have had no material business relationship with the company within the last three years, and the third requires the appointed NED not to have had received any additional remuneration apart from a director fee. Moreover, requirement number six requires that the NED not to have been representative of a large stakeholder, and the final requires that the NED had not served on the board for more than nine years. The three abovementioned requirements consider the director as an unaffiliated board member, but do not mean he is independent. However, the fact that a NED is not affiliated is in itself an objective, as it means that the NED is too close to the management.

102 The Code s (B.1.1).
103 The Code s (B.1.1).
In addition to the abovementioned, the Code requires NEDs not to have family ties with the top management, directors or advisors of the company, or to have close ties with other directors through cross directorship.  

The observation to be made here on the first set of factors relates to recruiting NEDs who are not very involved in the business and can bring outside views to the board, which makes those NEDs fit with the description as outsiders or unaffiliated, while the second set relates to personal relationships and family ties, which cannot be limited to these two points. Therefore, such criteria are not an assurance of the independence of the NEDs. Nevertheless as argued before, such criteria could help bringing new blood and views to the board, but the difference between the proposed Panel and the Code is that the Code relies on the independence criteria as an assurance for NEDs’ good performance, while the Panel regards the criteria as a contributor for bringing new views to the board.

Nevertheless, it is important to note that the Code and the criteria did not deal with a main problem that relates to NEDs’ objectivity, which is the influence of the CEO over the appointment of the NEDs, which is a major challenge for enhancing NEDs’ objectivity.

To answer the question in regards to the number of NEDs and independent NEDs, who should serve on the board that fit with the criteria, section B.1 of the Code provides:

‘The board should include an appropriate combination of executive and non-executive directors (and, in particular, independent non-executive directors)…’

Section B.1.2 of the Code provides:

‘…at least half the board, excluding the chairman, should comprise non-executive directors determined by the board to be independent.’

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104 The Code s (B.1.1).
105 The Code s (B.1.1).
106 The Code s (B.1).
107 The Code s (B.1).
The abovementioned sections of the Code do not refer to the directors who are NEDs but not considered independent, nevertheless the writer of this thesis suggests that the interpretation of the silence of the abovementioned section indicates that the board comprises of executive directors, who are the insider to the company, and NEDs which could be categorized into affiliated NEDs, those NEDs are the NEDs who do not fit with the criteria, while the NEDs who fit with the criteria are the unaffiliated NEDs, or are independent, as the Code describes them.

In this regards, there is no suggestion that the ratio of independent NEDs to be appointed to the board should change. This is because such a design allows the appointment of NEDs who are affiliated and have information and knowledge that are valuable to the company, and the appointment of NEDs who are unaffiliated, who can bring new views to the board and have a significant number but not supermajority on the board. This approach fits with the findings of Byrd and Hickman, who find that the appointment of independent NEDs to the board is beneficial, but only as long as their ratio does not exceed sixty percent of the board, whereas in this case, their appointment will be detrimental to the company.\(^{108}\)

However, as argued in Chapter Three of this thesis, a main problem that affects the independence of NEDs is the influence of the CEO over the appointment of the NEDs. Therefore, it is suggested that the Panel through the Executive appoints two independent NEDs on the board of the company. This suggestion will increase the independence of the two NEDs appointed by the Panel, as they will not owe his appointment to the CEO, and therefore will be more willing to oppose the CEO’s actions and proposals.

**dd- Integrating female NEDs**

Integrating women on companies’ boards falls within the debate on the board diversity, which covers gender diversity, character of director, ethnicity, age and other factors.\(^{109}\) Nevertheless, out of the different factors the debate on integrating female directors has more

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support and evidence, as the presentation of women on boards is likely to increase due to the increasing pressure for appointing women on boards. This issue has increasing importance for policy makers, and led to adopting legislative changes in some countries to oblige companies to appoint female directors, such as the case in Norway. According to the law, Norwegian boards must now comprise of 40% women, and in Spain the same requirement will be obligatory in 2015, while other developing countries such as India, China and Middle Eastern countries such as Tunisia and Jordan started to recognize the importance of female integration on the boards.

The debate and the research on integrating female NEDs relate to different interrelated disciplines, such as psychology, Law, management, corporate governance, gender and finance. Nevertheless there is no space in this research to go through all the abovementioned disciplines; this part will focus on the possible benefits that appointing female NEDs may bring to the boardroom and the decision making.

At present, UK boards have no legal obligation under companies’ legislation to appoint female directors. Nevertheless, the corporate governance reviews of the UK recognized that there is underrepresentation of female NEDs. For example, the Higgs Review recognized the low percentage of female NEDs which was only six percent compared to thirty percent for CEO position held by women. In addition, the Tyson Report found that there is a larger layer of women serving on the ‘marzipan’ level of company management, compared to the top rank level. Higgs suggests that this situation results from the posts that women usually serve on, as women usually serve at the human resources department, change management and customer care. Nevertheless, he believes that such roles enrich the employee with skills and experience that are very important for the board.

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112 ibid.
113 ibid.
114 Review of the Role and Effectiveness of Non-Executive Directors, the Higgs Review, s (10:22).
115 The Tyson Report on the Recruitment and Development of Non-Executive Directors, s (VIII.A.).
116 Review of the Role and Effectiveness of Non-Executive Directors, the Higgs Review, s (10:25).
By researching the different studies of scholars on integrating female NEDs to the board, this thesis finds that there is strong evidence that employing female NEDs is beneficial to the board and the decision making. The justification of the previous argument is that female NEDs could contribute to solving the problem of the dominance of the CEO, and the biases on the boardroom, which contributes to better decision making.

Usually, male CEOs tend to influence the appointment of NEDs who are similar to them in gender, age, background and experience; this is a direct reason for the CEO capture over the board of directors. However, we see here the first advantage for the appointment of female NEDs, as female NEDs do not usually come from the same community of the ‘old boys club’, which the male CEO might belong to, this contributes to making female NEDs more independent or less biased.

In the boardroom, homogenous groups do not recognize that they think in the same way, because they have the same values and norms, this makes it more beneficial from this perspective to have diverse board members, and particularly, women may strongly enrich this diversity, due to qualifications and different expertise, and they are likely to have different background outside the business. Such diversity would benefit the decision making.

Moreover, female NEDs’ presence on the board adds better and more civilized atmospheres, and more open environment. In addition they are likely to influence the behaviour of the male directors on the board because women usually get direct to the work in their hands rather than ‘play games’. Moreover, female NEDs are more careful about the details of the

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117 Tersejen, Sealy & Singh (n111) 322.
119 Tersejen, Sealy & Singh (n111) 329.
agenda in front of them, while male NEDs may get carried away with the big agenda, without
giving enough attention to the details.\textsuperscript{122}

Moreover surveys have shown that female NEDs are more committed to board meetings
compared to male NEDs, in addition their presence and commitment to the board meetings
positively influence the commitment of male directors towards attendance.\textsuperscript{123}

In terms of board reputation, Stephen Brammer and others conducted research on
reputational effect of appointing female NEDs to the boards by taking samples from the UK
boards, and found that there is positive reputational effect for the appointment of female NEDs
among the sectors that had direct relation with customers.\textsuperscript{124}

In addition to the abovementioned benefits of appointing female NEDs in regards to the
board and the decision making, there are other benefits outside this context that affect the
position of women in companies in general. This is because a female NED may be a model for
other women within and outside the company. In addition a female NED could ensure the
company’s commitment to attract more females to serve on the company.\textsuperscript{125}

In the UK there is a growing pressure to appoint female directors to the board, especially
as the UK is a part of the European Union, where the European Commission is constantly
promoting the case of appointing female directors. This led the UK to take positive steps by
requiring FTSE 100 to raise the ratio of female directors on the board up to twenty five percent
of the board by 2015.\textsuperscript{126} In the UK, women comprise forty five percent of the work force, and
nearly sixty percent of the graduates but only seventeen percent of the boards’ members.\textsuperscript{127} The
UK Board Index 2012 provided by Spencer Stuart shows that the percentage of female directors
increased in the UK top 150 companies, an increase from 10.5 percent in 2010, to 12.3 in 2011,
and to 15 percent in 2012. Nevertheless, this number remains far from the 25 percent target for the FTSE 100 in 2015.  

However, increasing the number of female NEDs on the UK boards requires mandatory rules, rather than leaving this for the companies, the evidence of this proposition could be taken from comparing the case of the UK with the case of Norway. Here, the ratio of female NEDs increased more rapidly in Norway after the legislative requirement of appointing female directors.  

Nevertheless, the question that is raised here is how many, or what the ratio is of female directors to be integrated into the UK boards. In this regard, studies referred to the problem of tokenism raised by Morten Huse and others, which suggests that when there are only one or two women on the board the male directors will see them as a token, and several social barriers will remain, and deprive the female NEDs from getting familiarized with the board. On the other hand, having three female directors or more, which constitutes a mass within the board, would make the board reach the normalized atmosphere and make the female directors get better chances in performing and bringing their voice to the board. However, appointing a large number of female NEDs should not be at the expense of the skills that the female NEDs possess. Empirical research has shown that the increase in the number of female directors in the UK and Norway did not affect the quality of the appointed females in terms of skills and expertise. Therefore, it is suggested that two of the NEDs appointed to the board should be females. The board might have other female executive members; therefore with the two NED female members, the board will have influence from the female directors on the board.

128 UK Board Index 2012, Current Board Trends and Practices at Major UK Companies, 4.
129 Grosvold, Brammer & Rayton (n109) 355.
131 Grosvold, Brammer & Rayton (n109) 355.
ee- The method of appointment by the Panel’s Executive

The Panel is concerned to improve the independence, skills and expertise of the board of directors. To do so, the Panel through the Executive will appoint two independent NEDs to the board. The Executive will create databases of NED candidates, this databases come mostly of successful NEDs and chairmen from the commercial sector, in addition to some candidates from the leading non-commercial organizations. The executive will include in the database successful accountants, lawyers, traders with domestic and international markets, engineers, marketing experts, as well as other experts from different types of businesses. The first benefit of the appointment of two NEDs is to counter the problem of the CEO influence over the appointment of NEDs. In particular, studies have shown that almost half of the NEDs appointed to the boards are appointed through personal connections, without even an interview.

The Executive, before appointing the two independent NEDs, will look first at the current composition of the board, or the potential NEDs to be appointed through the general meeting. In doing so, the Executive will look at the needed skills, and the missing skills among the current composition. In addition the Executive will take into consideration the Governance Code requirements. After doing this, the Executive may appoint two female independent NEDs, if the board had no female independent NEDs, and if the board needs two female independent NEDs and two financial experts, the Executive will appoint two independent female NEDs who have financial expertise. The Governance Code will take into account the type of business and the required skills for enhancing the board; for example, the Executive will appoint an expert in international markets for a company that has internal trade and business, and if the company is a telecommunications company, the Executive will appoint a telecommunications engineer.

C-3-d The Hearings Committee

The most significant change to the case of NEDs that the Panel brings is the enforcement method through the Panel’s Hearings Committee. The enforcement through the Hearings

132 See the Tyson Report on the Recruitment and Development of Non-executive Directors s (V, VIII).
Committee is out of the scope of the derivative claims of CA 2006, and operates as a separate enforcement mechanism from the court. The reason for this approach is to avoid applying the rules of the court’s permission for proceeding with the claim especially that as aforementioned, the Panel’s understanding of the corporate governance role of NEDs is wider than that of the court; therefore it is suggested to separate the Panel and the Hearings Committee from any constrains from the courts.

The Panel does not penalize the NEDs through imposing sanctions on them. The Panel’s role is to undertake enforcing the corporate governance role of the NEDs, through applying the directors’ duties, especially the duties of skill, care and diligence. The decisions of the Hearings Committee are subject to appeal in front of the Panel’s Appeal Board. Both the Executive and the defendant NED have the right to appeal the Hearings Committee decisions.

The main objective of the Hearings Committee is to upgrade the role of NEDs, from their role to either approve or disapprove the proposals and decisions which the management presents to them, into a new level which is as explained in section (C.3.a) the ‘pro-active’ level. The pro-active level means that NEDs must control the company’s decisions, and requires the NEDs, when taking their decisions, to ensure the quality of those decisions according to the best business practice. Ensuring this quality will require NEDs to use their skills, knowledge, expertise and information to reach competent decisions and reach a level of ‘pro-active’ involvement. Therefore, the Hearings Committee will not look at whether NEDs approved illegal transactions, or manipulated information or not. Instead, the Hearings Committee will look at the competence of the decisions taken by the NEDs from a business perspective.

Therefore the Hearings Committee will hold NEDs liable even just due to the weakness of their decisions. For example, a weak decision could be adopting weak remuneration packages schemes or approving remunerations that are not linked to the company’s performance, or approving an investment which is unsuccessful. However, these weak decisions do not necessarily mean that it led to the failure of the company, indeed the fact that it has caused

133 CA 2006 Part 11.
134 CA 2006 s 170-177.
135 CA 2006 s 174.
financial losses is enough. This takes us from the current benchmark where NEDs are usually liable for approving decisions and annual accounts that have been manipulated to a new benchmark, which is the competence of the decisions from business wise.

However, in the end, what will be applied in the assessment of these decisions are the directors’ duties, and especially the duty of skill, care and diligence. The duty of skill, care and diligence assesses the performance of NEDs according to a minimum objective standard expected of a director serving on the same size of the company, in addition to the subjective standard, which takes into consideration the specific skills and experience which the NED possesses, but only as long as the additional skills that the NED possesses are higher than the minimum skills required by the objective standard.\(^{136}\) In the case of the board composition suggested by the proposed Panel, the level of skills applied is very likely to be above the minimum objective standard, due to the requirement that three of the NEDs serving on the board to be financial experts.

The measures taken by the Panel for controlling the delegation of powers assist the enforcement of the role of NEDs. Restricting the delegation of powers from the board to the management, by keeping the major decisions in the hands of the board of directors, will make the board of directors more exposed to liability, because they will be responsible for ratifying a greater number of decisions. The Hearings Committee will assess whether the decisions that the NEDs took are according to the best business practice. In doing so, the Panel will ensure that NEDs are controlling all the major decisions of the company, and that these major decisions, which decide the destiny of the company, are according to the best business practice. This situation will enhance the accountability of the NEDs to the company, and the control of NEDs over the company and the management.

Moreover, the delegation of powers from the board of directors to the board subcommittees assists the enforcement of the role of NEDs. As aforementioned, the authority to set and decide the risk management and internal control systems, and the authority to decide the top executives’ remunerations will be delegated to the board subcommittees, to take full

\(^{136}\) CA 2006 s(174).
responsibility to those tasks. In this case, the Hearings Committee will regard these tasks as a function of the NEDs who sit on particular committees. This will help the Hearings Committee in allocating these responsibilities to specific NEDs rather than having the responsibility for these actions dispersed among a large number of participants. Furthermore, this delegation of responsibility to specific NEDs will make the Hearings Committee regard those tasks as a specific function to those NEDs, when applying the duty of skill, care and diligence to their case. The role of NEDs on the board subcommittees is a form of increasing the accountability of the board of directors to the shareholders.\(^\text{137}\) Therefore, enforcing the role of NEDs on the board’s subcommittees is considered to be a good development, especially since enforcing the role of NEDs on the subcommittees does not show that it has developed enough yet.

Initiating the cases in front of the Hearings Committee through the Panel’s Executive provides significant advantages in regards to speed and flexibility. The Executive has the power to bring the cases against NEDs on his own initiative, or in response to a complaint from a shareholder or shareholders, or a complaint from a company director, or any of the creditors, or in response to the general public concern. This flexibility of powers of the Executive is very beneficial in regards to the speed in response to any wrong doing that takes place in the company, particularly since the Executive is at all times required to be vigilant in regards to any wrong doing pertaining to NEDs role, once such wrong doing takes place, the Executive can quickly respond through filing a case against the NEDs in question.

Moreover, as shown in Chapter Two of this thesis, cases filed against NEDs usually take place once the company starts facing insolvency or deep financial difficulties while the Executive would file a case against the NEDs before the company reaches this stage of losses. For example, if the Executive detects or receives a complaint that the company is adopting irrational risk policy, which is causing losses for the company, or if the NEDs decide very high, irrational remunerations for the CEO, then the Executive will respond at an early stage, by investigating and then filing a case against the NEDs in question. Such a fast action would

correct the wrong doings of the company for the following years, and prevent such losses from continuing to take place.

It was argued in Chapter Three that shareholders might be reluctant to raise cases against NEDs through the derivative claims of part 11 of Chapter One of the Companies Act 2006, due to the high costs of litigation. These costs could amount to much more than the expected return for the shareholder if the proceedings succeeded. In this case, a shareholder might prefer to sell his shares rather than take an action. In this situation, raising the case by the Executive helps avoiding the abovementioned problem.

Moreover, although CA 2006 provides that the company is run for the benefit of the shareholders, and this proposition has not been challenged in this thesis, nevertheless when the company collapses or faces financial difficulties, the effects might extend to other participants of the company, not just the shareholders, such as the creditors, employees, suppliers and consumers. Even in CA 2006, the interests of the other groups have been identified, although their interests have been recognized through the ultimate goal of maximizing the shareholders’ wealth. Applying this proposition means that the enforcement of the role of NEDs will benefit the shareholders, and this benefit will directly or indirectly serve other participants such as the creditors, employees and suppliers. In addition, as aforementioned, the examples of companies’ failures affected the economies, governments and taxpayers.

Therefore, another advantage that the Panel brings is that the Panel does not restrict the Executive’s right to sue the NEDs, in the shareholders complain, who might in many cases decide not to take an action. Instead, the Executive, as abovementioned, can on his own initiative or in response to the general public concern take action against the NEDs, which will benefit the shareholders and the rest of the participants who will be affected.

138 Companies Act 2006 Part 11, Ch 1.
140 See- supra Ch 2 s B.
142 CA 2006 s 172 (1).
143 See- supra Ch 1.
C-4 How will the Panel’s Measures Improve the Work of NEDs?

The benefits the Panel brings to the case of NEDs may be explained in simple equations. As explained in Chapter One and Three of this thesis, corporate governance main goal is to control the companies’ CEOs and top management. It was also suggested that the quality of the decisions made by the company is the ultimate goal of corporate governance. Together, the two goals could be redefined as controlling the management’s dominance over the company’s decisions and strategies. As argued in Chapter Four of this thesis, the way forward for controlling the management dominance over the company’s decisions must be by ensuring the effective involvement of NEDs in the decision making process.

Therefore, the Panel’s measures focus on removing the obstacles that prevent NEDs from being effectively involved in the decision making process, and providing an enforcement mechanism over the NEDs’ performance, to ensure that the NEDs when performing their role in the decision making process, they do so with high level of performance.

Therefore, the measures taken to control the delegation of powers will ensure that the NEDs are in full control over the major decisions of the company through their power to ratify these decisions. Moreover, the measures taken for ensuring that NEDs participate in the early steps of the decision making will ensure that NEDs, when ratifying the decisions presented to them, they do so according to proper information and knowledge of the specifications of the decision, so they do not only rubber stamp the decision. In addition, early participation in the decision making will enrich the decision with the knowledge, experience and skills brought by the NEDs.

In regards to the board structure, the Panel’s measures aimed to enhance the position of the NEDs, by ensuring that they have the required skills that are pertaining to the business to guarantee that they do have input to the decision making, in addition to requiring financial experts to sit on the audit, and risk management committees, to ensure that they are capable of understanding the audit process, and they are capable of deciding the risk management and internal control systems for the company, and that they can be fully responsible for this task.
Added to that, as argued before, enriching the board with the appointment of at least two female NEDs could create better atmosphere and culture on the board, such an atmosphere would also reduce the possibility of male NEDs to commit wrong doings and frauds. Moreover, the Panel targets the main problem that affects the NEDs’ independence, which is the CEO influence over the appointment of NEDs. In this regard, the Panel nominates independent NEDs to be appointed to the board, which the company has to at least appoint two of them; therefore, those NEDs are not affected by the bias of owing their appointment to the CEO.

However, once the NEDs do participate in the decision making process, they always need to be aware that their misconduct or weak performance will be always subject to legal liability through suing them in front of the Hearings Committee, such measure will improve the skill and performance of NEDs when taking the company’s decisions.

**D- The Model and the State Intervention**

The proposed model introduces a regulatory reform, representing state intervention in the choices of the parties of the company’s contract, which is a debatable matter among corporate scholars. The model provides mandatory rules which design the composition of the board of directors, by controlling the delegation of powers from the board to the management, and designing the board to the board subcommittees, in addition to imposing mandatory methods for the mechanisms of the work for the board of directors. Moreover, the model provides an enforcement mechanism through the Hearings Committee to enforce the actual performance of NEDs. Finally, the model is based on a statutory recognition, giving the Panel wide authority over regulating the NEDs.

Scholars who believe that the company should be governed only by its contract view the company as a contract between its shareholders, and view the role of company law as an extension of contract law, arguing that the shareholders are free to design the contract of their

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company,\textsuperscript{145} and that the company law role here provides a set of contract terms for the shareholders to either adopt, or reject by adopting alternative rules.\textsuperscript{146}

On the other hand, there is a wide recognition among company law scholars, which the writer of this thesis agrees with, that company law must have mandatory rules in addition to voluntary rules.\textsuperscript{147} The reason for this argument refers to the argument provided in Chapter One of this thesis which concerns the need for finding mechanisms to protect the company’s investors and to control the company’s management, in order to make sure that the management does not divert the profits of the company into their own pockets.\textsuperscript{148} In this respect, it was also mentioned in Chapter Three of this thesis that the reliance on the shareholders and the markets did not always work efficiently for controlling the companies’ managers, which as argued, emphasized the need to create effective methods to control the companies’ managers.\textsuperscript{149}

Moreover, the incorporated company enjoys the privilege of limited liability principle, which limits the liability of the shareholders to their shareholding only. This is against the norm that individuals are liable to their debts.\textsuperscript{150} Such a privilege was not given by the company’s contract but by the assistance of the law and the state.\textsuperscript{151} In addition, the limited liability principle resulted in separating the legal personality of the company from the personality of its founders, drawing a sharp line between the two, making the company completely independent of its founders.\textsuperscript{152} Therefore, as long as the incorporation of the company emerges through the Law’s recognition of the principle, and not by the contract, the company law and the state have the authority to interfere in the company’s matters in order to protect the investors and other participants.

\begin{thebibliography}{99}
\bibitem{147} Black (n144) 543. See also, M Eisenberg ‘The Structure of Corporation Law’ (1989) 89(7) Columbia Law Review 1482.
\bibitem{148} See- \textit{supra} Ch 1. See also, F Easterbrook & E Fischel ‘The Corporate Contract’ (1989) 89 Columbia Law Review 1416.
\bibitem{149} ibid.
\bibitem{151} ibid.
\end{thebibliography}

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In addition, the role of the state in regulating companies has old origins. In particular, this issue was raised before and after the Second World War, as there was widespread support for state control and interference in the companies’ affairs to ensure that companies serve the public interests.\(^{153}\)

The legal sources that govern the companies today are not limited to the contract. In this regard, reference is made to the definition of Bernard Black of company law:

‘...corporate law to include laws-whether made by legislators, judges, or regulators-that primarily govern the relationship between a company’s managers and investors’.\(^{154}\)

Therefore, today the contract as a source of governing the company is only skeletal, and instead, statutes and judge made law create the voluminous source of rules that govern the company and the relationship between its participants.\(^{155}\) In addition to the judge made law and statutes, corporate governance also takes place among this matrix as a means of protecting investors’ interests when the legal protection of these investors is weak and needs extra rules to recognise their interests.\(^{156}\)

State intervention in companies’ matters means that the state is imposing laws and regulations on the companies to control the companies, and particularly, controlling and restricting the powers of the management of these companies.\(^{157}\)

In the UK, the case for corporate governance reforms through the ‘self-regulatory’, non-statutory regulations, represented by the Code, and the rest of the corporate governance reports, have been thought of as a substitute for government intervention in companies’ affairs, and will


\(^{154}\) Black (n144) 547.


\(^{156}\) ibid 28, 29, 30.

serve to maximize shareholders’ value. Moreover, the UK approach depends, as argued by Lord Hoffman, on three layers of control; the first is directors’ duties of common law and equity, while the second is the other statutory duties that aim to reinforce the common law duties. The third layer is that of the self-regulatory codes, which are designed to reinforce directors’ duties in the areas that are not suitable for legislation.

However, as argued in Chapter Three of this thesis, the current corporate governance reforms and the Code do not provide enforcement mechanisms to enforce the role of NEDs. On the other hand, Chapter Two argued that the directors’ duties of CA 2006, the old common law and the application of the courts of the duties, did not correspond with the corporate governance role of NEDs.

Therefore, it is argued that today, there is need for the state intervention to establish more effective regulations that can effectively regulate the role of NEDs, which should lead to better control over the companies’ managers and lead for further investor protection. However, in regards to the model proposed in this thesis, it is suggested that the model has the advantages of strictness of legislative intervention in terms of enforcement, and at the same time, the model represents a ‘self-regulatory’ approach, which has the advantages of flexibility in terms of composition, as the Panel as aforementioned is composed of different bodies that represent major businesses and financial institutions, in addition to the other advantages of the ‘self-regulatory’ system, such as the speed and low cost.

E- Exporting Corporate Governance

It has been mentioned previously in this thesis that integrating NEDs into different corporate governance system has become a universally agreed on practice. It has also been stated that NEDs in different jurisdictions serve on different types of board, such as the one-tier,
two-tier and mixed board systems. However, the waves of company and corporate governance failures around the world in the last two decades, in addition to the latest financial crisis, raised serious questions on the effectiveness of the NEDs’ role not only in the UK, but in many jurisdictions around the world. This thesis is concerned with improving the position of NEDs within the corporate governance framework. In order to do so, it has sought to focus on NEDs within the UK corporate governance system, due to the fact that the UK corporate governance system has been exported to the world, and the way to improve the case of NEDs on a global scale is by improving the UK corporate governance framework, which the UK NEDs work within.

This section will be divided into two subsections; the first will explain the status of the UK as a corporate governance exporter, while the second will centre on the case of Jordan as a corporate governance importer.

**E-1 The UK as a Corporate Governance Exporter**

It is argued in this thesis that the UK corporate governance system did not deal effectively with the case of NEDs. Therefore, this chapter proposes a different approach for the case of NEDs to correct the way that the UK corporate governance reforms deal with the case of NEDs. Nevertheless, as will be explained in the following, correcting the UK corporate governance reforms is not only important for the UK, but also for great number of jurisdictions around the globe, because the UK corporate governance system has been exported to these jurisdictions. However, it is suggested that the same elements that helped transporting the current UK corporate governance system still exist; therefore, the new suggested model consisting of the Panel could be also transported to correct the position of NEDs on a global scale.

The Cadbury Report is not the first corporate governance code to be established worldwide. Indeed, the US was the first to issue in 1978, and Hong Kong in 1989.

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162 See *supra* Ch 2.
163 See *supra* Ch 1.
Nevertheless, the establishment of the Cadbury Report in 1992, which introduced itself as a world leader of corporate governance reforms, inspired the issuance of corporate governance codes worldwide. In addition, the adaptation of the Organization of Economic Co-operation and Development the (OECD) to the outcome of the Cadbury, Greenbury and Hampel Reports, and integrating them to the OECD Principles of Corporate Governance issued in 1999 helped exporting the UK corporate governance system to the world. The OECD Principles of Corporate Governance were updated in 2004 and spread to the world, becoming the benchmark of the World Bank assessment of the corporate governance in different countries.

However, this worldwide adaptation and recognition of the UK corporate governance system is not an incident; rather, different factors helped in transporting the system. Firstly, the start of the reforms in the UK through the Cadbury Report was after an assessment to different company failures such as Polly Peck, BCCI and Maxwell’s. Through the assessment, there was identification of the problems that the corporate governance reforms had to deal with at that time, mainly it was finding a mechanism to counter the dominance of the companies’ CEOs through strengthening the role of the boards of directors and the external auditors. The important factor here is that the UK added its own style to the reforms by establishing a committee to review the corporate governance in the UK. This committee, to be chaired by a visionary chairman, reflected the main stakeholders in the committee, then the committee drafts the outcome of the consolations, and finally issues its recommendations through a report.

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166 Aguilera & Cuervo-Cazurra (n164) 377.

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Therefore, the emergence of the Cadbury Committee and other corporate governance committees in the UK resembles the British form of regulations. This British form is described as negotiated regulations, quoting a description which provides that British economic regulations are built on combination of continuity of ideas.\textsuperscript{172} This style of regulations takes place through co-operation between the government and the industries, where solutions are negotiated rather than imposed by the government.\textsuperscript{173}

However, even prior to the scandals, there were deep complicated dynamics that raised the pressure to establish the reforms for over a decade.\textsuperscript{174} These dynamics could be summarized; the privatization of national industries and offering shares to the public, the investment policies, the expansion of the financial press, modern asset values, the increasing proportion of shares held by institutional investors, the changing employment relationship, the increasing number of ethical investment funds, the re-emergence of the left wing in concepts such as communitarianism, the recession which led the Bank of England to view the NEDs as the way forward to more accountable management style and later the scandals, which provided the straw that broke the camel’s back.\textsuperscript{175}

A further reason that led to the global recognition of the UK corporate governance system is the position of London as an attractor for foreign investments.\textsuperscript{176} London is an important location for cross-borders securities trade and fund management. Therefore its disclosure rules set by London’s institutional investors and fund managers are influenced by companies outside the UK.\textsuperscript{177} Indeed, the requirements of social and environmental transparency required in the UK

\begin{thebibliography}{9}
\bibitem{172} Dignam (n 167) 73. See also, S Wilks ‘The Amoral Corporation and British Utility Regulation’ (1997) 2(2) New Political Economy 280.
\bibitem{173} Dignam (n 167) 73.
\bibitem{175} Dignam (n 167) 70 - 73.
\bibitem{176} Aguilera & Cuervo-Cazurra (n164) 417.
\end{thebibliography}
corporate governance system helped the UK to become the global standard of corporate governance.178

Today, the world is living in the aftermath of financial crisis, which led to massive losses to shareholders and governments, and resulted in a freeze of the global market. The financial crisis raised doubts about the efficiency of the current corporate governance systems, and about the effectiveness of the roles of NEDs and the boards of directors.179 Within these global circumstances, it is suggested that the time is suitable for reforming the case of NEDs in the UK through the suggested Panel. Launching the new Panel in the UK will improve the case of NEDs on a global scale, due to the influence of the UK over great number of jurisdictions around the world.

The proposed model does not have the same flexible features of the current governance system, as the model requires legislative intervention and strict rules. However, the case of the UK Takeover Panel, which the proposed model took the idea from, has shown good ability for travelling outside the UK, for example the current Takeover Panel of Australia has been directly influenced by the UK Takeover Panel.180

**E- 2 Jordan as a Corporate Governance Importer**

Countries such as the UK and the US are in a very advanced position in corporate governance. This is because common law countries such as the UK and the US offer more protection to minority shareholders, and these countries have dispersed ownership.181 On the other hand, civil law countries such as continental Europe offer limited protection for shareholders, and have concentrated ownership structure.182 The system of the UK and US governance is referred to as an ‘outsider’ system. Institutional investors in the UK and the US do not hold large and controlling shareholdings, and therefore, they have limited direct control

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178 Williams & Conley (n177) 500-501.
180 Armson (n32) 402.
compared to systems with concentrated ownership and controlling shareholders, which are usually held by either families or holding companies. Such a system with concentrated ownership is referred to as ‘insider’ systems, such as the systems of France and Germany.¹⁸³

In this respect, Jordan stands in a weak position, with a predominant ‘insider’ system, and strong family ownerships, and very weak protection of minority shareholders. Moreover, accountability and transparency are almost non-existent.¹⁸⁴

Corporate governance is vital for Jordan, firstly because Jordan is now moving fast towards privatization in different sectors such as transportation, electricity, water and mining.¹⁸⁵ Secondly, Jordan is considered a transitional economy country, and does not have long practicing financial institution infrastructure to deal with corporate governance issues.¹⁸⁶ Companies’ failures are not only phenomena of large economies, indeed such scandals happen in small economies like Jordan. Jordan suffered from severe company scandals that led to disastrous effects on the Jordanian economy, most importantly the Collapse of Petra Bank in the late eighties, which was the second largest bank in the Kingdom, and constituted the biggest bank collapse in the Jordanian history.¹⁸⁷ Also, in the last decade, a scandal of an information technology company caused a loss of one billion to go missing.¹⁸⁸

Scandals in the Jordanian economy have shown the common irregularities and weaknesses in the corporate governance, such as hiding information, poor internal controls,

¹⁸⁴ J Solomon Corporate Governance and Accountability (2nd edn John Wiley & Sons Ltd West Sussex 2007) 212.
poorly performing boards and in some cases the scandals involved high profile frauds, this situation raises the need for better corporate governance standards.\textsuperscript{189}

Although the abovementioned shows the urgent need for a strong corporate governance system to be applied in Jordan, the adaptation of the OECD corporate governance principles by the Jordanian regulator does not seem to be fully understood. It is suggested that the Jordanian regulatory traditions do not fully grasp the ‘soft’, self-regulatory approach. This misunderstanding of the approach led to the establishment of several overlapping corporate governance codes.

The first observation to be made here is that Jordan regulators copied the OECD Principles of Corporate Governance.\textsuperscript{190} Nevertheless, such adaptation was not surrounded by debate between the regulators and the private sector and this is evident in the Corporate Governance Code for Shareholding Companies Listed on the Amman Stock Exchange, which mentions clearly in the preamble that the their code is a version of the OECD Principles of Governance.\textsuperscript{191}

Moreover, the last few years have witnessed the establishment of three governance codes. In addition to the aforementioned code issued by the Amman Stock Exchange, the Companies Control Department issued the Jordanian Corporate Governance Code 2012,\textsuperscript{192} while the Central Bank of Jordan issued the Corporate Governance Code for Banks in Jordan.\textsuperscript{193} Such a situation indicates a misunderstanding by the government in understanding the concept of the ‘self regulatory’ system. This situation is very confusing for companies; for example, if a bank is registered in Jordan, and has listed shares in the Amman Stock Exchange, such a bank will be subject to three overlapping corporate governance codes.

\textsuperscript{190} Corporate Governance Code for Shareholding Companies Listed in Amman Stock Exchange, 3.
\textsuperscript{191} Corporate Governance Code for Shareholding Companies Listed in Amman Stock Exchange, preamble.
\textsuperscript{192} Jordanian Corporate Governance Code 2012.
\textsuperscript{193} Corporate Governance Code for Banks in Jordan, 2007.
The examination of the content of the three codes shows a deep misunderstanding of the governance principles. For example, the code issued by the Companies Control Department requires half of the board to comprise of NEDs, with only two independent\(^{194}\) NEDs, and requires the audit, remuneration and nomination committees to comprise of a majority independent NEDs,\(^{195}\) this little number of independent NEDs shows that the regulator does not fully grasp the rational of appointing a number of NEDs that could have a strong voice or control over the decision making.

Furthermore, appointing only two independent NEDs and requiring the three board subcommittees to comprise the majority of independent NEDs mean that two independent NEDs will sit on all the board subcommittees. In addition, the codes issued by the Company Control Department and the Amman Stock Exchange contradict in terms of the number of independent NEDs to be appointed to the board, while the first as abovementioned requires two, the later requires one third of the board members to comprise of independent NEDs.\(^{196}\)

Thus, it is argued that the Jordanian system needs a clearer corporate governance system with more direct and binding rules, such as the proposed Panel of this thesis. As such, a robust system will fit easier within the Jordanian regulatory culture.

**Conclusion**

The Panel proposed in this chapter may be considered a new benchmark for the case of NEDs. The Panel approach is based on two factors which are fundamental for achieving effective reliance on the role of NEDs in controlling the company and the management. The first point is that NEDs work better with greater decision making involvement, and the second is that this involvement needs effective enforcement for the role of NEDs. However, establishing the Panel will require legislative amendments to empower and provide the Panel with the required authority.

\(^{194}\) Jordanian Corporate Governance Code 2012, 1.1.b
\(^{195}\) Jordanian Corporate Governance Code 2012, 3.1.
\(^{196}\) Corporate Governance Code for Shareholding Companies Listed in Amman Stock Exchange, Chapter Two, 1.
CHAPTER SIX: CONCLUSIONS

Today the global financial economy is in the process of recovering from the deepest recession since the Second World War. The trigger for the recession was a severe financial crisis which took place in advanced economies, and affected almost the whole world.\(^1\) The crisis was even described as worse than the great depression which occurred in 1929.\(^2\) The effects of the crisis were severe on economies, markets and investors, and made the governments pay billions to bailout the banks.\(^3\) Several problems have been identified as main reasons for the occurrence of the crisis; most importantly the mispricing of risks and the adaptation of irrational risky strategies, the employment of irresponsible lending practices, and in some cases the manipulation of the financial statements, and the very high executives remunerations which were not linked to the companies’ financial performance.\(^4\)

It has been suggested that the abovementioned problems which caused the financial crisis fall within the core responsibilities of the NEDs and the board of directors. Therefore, it has been noted that the latest financial crisis provided a strong evidence on the failure of NEDs in performing their corporate governance role, as they failed to prevent companies from adopting wrong practices and they also failed to influence the companies’ risky strategy, moreover they failed to raise the red flag when the companies’ started to face dangerous financial difficulties.\(^5\)

The companies’ failures, which caused the financial crisis, were only the latest and most recent among waves of companies’ failures that took place in different major economies, in approximately the last two decades. Several examples of these companies’ failures have been given in this thesis, such as Enron, WorldCom, Parmalat, in addition to Maxwell, BCCI and Polly Peck. Most of these failures showed weakness of the corporate governance measures, and more importantly failure of NEDs’ performance.\(^6\) In general, the NEDs in most of the cases have shown passivity in performing their corporate governance role on the board and the board

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\(^{3}\) See-supra Ch 1.

\(^{4}\) See-supra Ch 1.

\(^{5}\) See-supra Ch 1.

\(^{6}\) See-supra Ch 1.
subcommittees, and they have usually approved accounts manipulated by the management or irrational decisions, without investigation and without examination of the effects of these decisions. NEDs were usually reliant on the management.\textsuperscript{7}

It has been mentioned in this thesis that after each wave of companies’ failures, corporate governance reforms took place in the UK and other jurisdictions around the world such as the US and Australia. NEDs have been usually the centre of these reforms, and have been heavily relied on to practice several important corporate governance roles; such as monitoring the management, participating in setting the company’s strategies, appointing the CEO, and deciding the remunerations of the CEO and the top management, in addition to monitoring the audit process, the risk management and internal control systems.\textsuperscript{8}

However, these reforms did not prevent the companies’ failures from taking place, and did not seem to have improved the performance of NEDs even in companies that included high qualified NEDs, and were fully compliant with the corporate governance design of the boards of directors such as the board of Enron. The failure of companies, corporate governance and NEDs raised the need for deep examination of the corporate governance reforms, and for setting laws and regulations which design the role of NEDs. This thesis chose to examine and analyse the UK NEDs, due to the world wide recognition of the UK corporate governance system which was exported to the world.\textsuperscript{9}

The basic theories that interpret the need for the NEDs’ involvement within the corporate governance system of the UK have been referred to in this thesis. The basic theory that has been referred to in this thesis is the separation of ownership and control theory. It has been explained that the rise of the dispersed ownerships in the beginning of the century in the US, and later in the UK, created a situation where shareholders’ ownerships became relatively small, which made it difficult for any shareholder to have enough power to control the company.\textsuperscript{10} Due to the weakness of controlling power of shareholders, and due to the increasing complexity of the

\textsuperscript{7} See- supra Ch 1.
\textsuperscript{8} See- supra Ch1 s C.
\textsuperscript{9} See- supra Ch 1.
\textsuperscript{10} See- supra Ch 1 s A.
nature of the business which the companies were running, shareholders had to submit the powers
to control the companies to highly skilled and professional managers. However, as has been
explained in this thesis, this situation led to the rise of highly skilled managerial class, which
took control over most of the major public companies, and that this situation became the norm
for multinational and major public listed companies.\textsuperscript{11}

This managerial class ended up with very strong and unfettered controlling powers over
the companies. On the other hand, shareholders were left with very weak powers which do not
allow them to influence or control the management of the company. The problem occurs when
those dominant managers run the company, in a direction that takes into consideration their own
interest rather than the interests of the shareholders and the company in general. In this case, the
shareholders will not have the means to control and discipline the behaviour of those managers
due to their weak powers.\textsuperscript{12}

The agency theory provides an explanation for the relation between the shareholders and
companies’ managers. The agency theory interprets the relation between the shareholders and
companies’ managers as a principal agent relationship. Accordingly, the managers are the agents
who run the business on behalf of the shareholders who represent the shareholders in this
relationship. The shareholders as the principal will employ methods for monitoring and
controlling the company’s managers. These monitoring methods cost large amount of money.
Accordingly, and in the light of the separation of ownership and control theory, the role of NEDs
is to monitor the company’s managers and to reduce the monitoring or the agency costs.\textsuperscript{13}

It has been argued that the reliance on the NEDs as a method for controlling the conflicts
of interests between the companies’ managers and the shareholders is a must, due to the
ineffective means of monitoring and controlling the company’s managers.\textsuperscript{14} Several methods for
controlling the company’s managers have been referred to in the thesis, mainly the shareholders’
democracy. However, it has been suggested that shareholders’ democracy is not an effective and

\textsuperscript{11} See- supra Ch 1 s A.
\textsuperscript{12} See- supra Ch 1 s A.
\textsuperscript{13} See- supra Ch 1 s A.
\textsuperscript{14} See- supra Ch 3 s A-4.
reliable means to control the company’s managers, as shareholders’ actions such as the re-
election of directors, modifying the articles of association, and the removal process, cannot be
taken by a shareholder or shareholders with a small number of shares. Indeed, such options
require the shareholders to build coalitions, which usually requires great efforts, takes time and
costs high expenses.\textsuperscript{15}

In regards to the derivative claims, this thesis has suggested that derivative claims usually
require high litigation fees, which would make the shareholder prefer to sell his shareholding
rather than taking the hassle and incurring the expenses of the derivative claim. Moreover, it has
been noted that shareholders’ empowerment might give unfettered dominance for the
institutional shareholders, who in turn might have interests that are different from the interests of
the minority shareholders, and they might take decisions that do not take into consideration the
long term benefit of the company.\textsuperscript{16}

Other methods have been also referred to such as the reliance on the market forces, and
the reputational factors of directors. However, in regards to the reliance on the market forces;
there are many examples of companies’ failures that showed very high profits just a year or less
before the company collapsed, such as Enron and Lehman Brothers. Therefore, the reliance on
the market forces is not effective. In regards to the reputational factors, it has been mentioned
that managers would prefer in some cases to aim for short term profits for building a reputation
of success, rather than aiming for the long term success.\textsuperscript{17}

Accordingly, it has been argued in the thesis that NEDs represent the most potential
successful means to control the company’s managers, this is due to their position on the board of
directors as they sit on the same board with the executive directors, which makes them close of
the decision making, and close to the sources of information needed to control and monitor the
company. Moreover, due to their position as members of the board, they have the potential to
control the company in a prospective manner, by preventing wrong doings before they occur by
vetoing, or influencing the proposed wrong decisions, moreover they can detect the financial

\textsuperscript{15} See- \textit{supra} Ch 3 s A-1.
\textsuperscript{16} See- \textit{supra} Ch 3 s A-1-d.
\textsuperscript{17} See- \textit{supra} Ch 3 ss A-2, A-3.
difficulties which the company is facing on an early stage, and therefore they can raise the red flag rather than reacting after the failure of the company. Moreover, the NEDs will have less conflict of interests if compared to the executive directors.\(^\text{18}\)

It has been explained that due to the fact that the corporate governance non-statutory system does not provide enforcement mechanisms that enforce the actual performance of NEDs, the retrospective enforcement, through the courts and the directors’ duties, have a fundamental importance for governing and enhancing the corporate governance performance of NEDs. Accordingly, the effectiveness of the role of NEDs and the corporate governance system requires the existence of effective directors’ duties, which are interpreted from a wide and modern perspective to cover the modern corporate governance role of NEDs.\(^\text{19}\)

The standard required of NEDs to comply with their common law and CA 2006 directors’ duties has increased through case law\(^\text{20}\) and the codification of the duties in CA 2006.\(^\text{21}\) The duty of skill, care and diligence codified in CA 2006 s 174\(^\text{22}\) provided significant development by requiring the NEDs to meet a minimum objective standard of the duty, which requires the NED to practice their role according to the standard expected of a director serving on the same size of the company, and to carry out the same function of the NED. This requirement is supposed not to allow NEDs to perform incompetently on the board. Moreover, the duty takes into consideration any additional skills that are higher than the skills required by the minimum objective standard, such a requirement would increase the expectations of NEDs who have special skills, expecting from them a higher degree of performance.\(^\text{23}\)

However, it has been argued that the court application of the abovementioned duties on the case of NEDs does not show correspondence with the corporate governance expectations of the role of NEDs. It has been also argued that these duties fit better with the case of executive directors, as long as they have a better defined role since they are supposed to manage the

\(^{18}\) See- supra Ch 3 s A-4.
\(^{19}\) See- supra Ch 2 s A.
\(^{20}\) See- supra Ch 2 s C.
\(^{21}\) CA 2006 s 170-177.
\(^{22}\) CA 2006 s 174.
\(^{23}\) See- supra Ch 2 s C.
company on daily basis, and they have employment contracts with the company which defines their role and the required standard of conduct expected from them. Nevertheless, in the case of NEDs, courts do not seem to fully recognise the role of NEDs on the board, and therefore it has been difficult for courts to require from NEDs to perform a wide corporate governance role.\(^{24}\)

The first evidence which has been provided for this argument is the limited number of cases raised against the NEDs, especially that even after the financial crisis which showed high incompetence of NEDs, there were hardly any cases looming in the horizon.\(^{25}\)

Moreover, most of the cases where NEDs were held liable were cases that involved clear irresponsible and negligent behaviours, or when the NEDs approved illegal decisions or approved manipulated accounts without investigation. However, there is no reference among the cases to the incidents where the NEDs do take decisions that do not show any bad faith included; neither do they show illegality or manipulation. Nevertheless, those decisions have been disastrous to the company, such as the aforementioned examples of Northern Rock, and Royal Bank of Scotland which took place in the late financial crisis. Accordingly, it has been suggested that judges are very likely not to have the sufficient business orientation to be able to judge the competence of such decisions.\(^{26}\)

Therefore, it has been argued that the effectiveness of the application of the directors’ duties on the case of NEDs requires defining the role of NEDs, and the standard of conduct required by NEDs in performing their role, to serve as a reference for the courts to measure the performance of NEDs. However, in this regards reference has been made to the Australian case, *Australian Securities and Investments Commission v Healey (ASIC v Healey)*.\(^{27}\) In this case, the court ruled that the NEDs failed to comply with the standards of skill, care and diligence required, since they approved consolidated financial accounts which included incorrect information.\(^{28}\) However, the directors’ claim that they have relied on the professional advice of auditors did not help them to avoid liability. In this case, the court required the NEDs to act like a pro-active professional, which requires them to show reasonable level of competence in

\(^{24}\) See- *supra* Ch 2 s C.

\(^{25}\) See- *supra* Ch 2 s A.

\(^{26}\) See- *supra* Ch 2 s A.

\(^{27}\) AISC v Healey, [2011] FCA 717.

\(^{28}\) See- *supra* Ch 2 s C.
understanding the companies’ financial affairs.\textsuperscript{29} This definition fits with the definition provided by this thesis of the standard of conduct required from NEDs.

In conclusion, the Code does not serve as an effective regulatory source for regulating the role of NEDs. The Code, which has been shaped according to the agency theory, depends on the board’s structure through appointing NEDs and independent NEDs to the board, building this approach on the assumption that NEDs who fit with the Code’s definition of independence will be able to bring an independent judgement to the board, and will serve as monitors over the management, which will make the management accountable to the board and the NEDs.

However, the thesis has found that this approach is not effective, as independence is a subjective concept, which represents the willingness of the NED to bring sceptical objectivity when assessing the management’s plans and proposals. However, it has been noted that there are different social and psychological factors that impair the independence of NEDs; moreover it has been argued that there are no independence criteria that could ensure the independence of a NED. Furthermore, even if a director was truly independent, the independence does not mean that he will be willing to perform his role; neither does it serve as an incentive to persuade NEDs to perform their expected role.\textsuperscript{30}

Added to that, it has been explained that the independence criteria of the Code serve more for differentiating between an affiliated NED; who has been for example working for the company for long and was appointed later as a NED, and the non-affiliated NED; who has been an outsider to the company and has no social or financial relationship with the company. However, meeting the Code’s criteria of independence does not mean that the NED is actually independent.\textsuperscript{31}

It has been suggested that the board structures is a helpful factor and can add value to the board, as it brings outsider views to the company’s strategy and to the decision making, in

\textsuperscript{29} See- \textit{supra} Ch 2 s C.
\textsuperscript{30} See- \textit{supra} Ch 3 s C-1.
\textsuperscript{31} See- \textit{supra} Ch 5 s C-1-b-ii.
addition it could broaden the variety of skills brought to the board.\textsuperscript{32} However, there are shortcomings in the Code which made the work of NEDs on the board ineffective; firstly because the Code did not define the role of NEDs in any clear terms, as it does not define the responsibilities of NEDs in any clear terms, neither does it provide a definition of the standard of conduct required from NEDs in performing their role. Moreover, the Code did not deal with the problem of the CEO capture over the board and the business, and the CEO control over the information. Finally, the Code is described as toothless, as it does not provide an enforcement mechanism to enforce the actual performance of NEDs. Therefore, the NEDs according to the Code’s design are unable to perform their mentoring role. It has been pointed out that the Code gave attention to the board structures on the expense of focusing on the decision making.\textsuperscript{33}

In order to define the role of NEDs on the board, the dual management and monitoring roles of NEDs have been analysed in depth. It has been explained in the thesis that the monitoring role could be defined from different scopes. The scope of the agency theory defines the monitoring role of NEDs as their role to monitor the implementation of the company’s strategy. However, it has been suggested that the monitoring role of NEDs should be defined from a wider perspective. The wider perspective, as has been suggested in the thesis, defines the monitoring role of NEDs as their responsibility to control the business and the company’s managers. It has been noted that best method to control the business and the company’s managers is by controlling the decision making of the company.\textsuperscript{34}

Therefore, the thesis has identified that the best way to control the decision making of the company is by giving the chance to the NEDs to influence the decision making, and to enable them to have sufficient information about these decisions when they ratify those decisions. Therefore, it has been suggested that the role of NEDs in the decision making process should not be limited to ratifying the decisions proposed by the management, and monitoring the implementation of those decisions. Instead, the role of NEDs should extend to the participation in the early steps of the decision making, such as the steps of generating the ideas, and initiating the proposals to be presented to the board. This role will give the chance to the NEDs first to

\textsuperscript{32} See- supra Ch5 s C-1-b-ii.
\textsuperscript{33} See- supra Ch 3 s C.
\textsuperscript{34} See- supra Ch 4.
improve those decisions with their skills and knowledge, second to enable them to ratify those decisions on an informed basis, rather than merely providing ‘rubber stamp’ to the proposals that have been worked out completely by the management. Therefore, it has been argued that the UK should maintain the unitary board system, as the unitary board system gives better chance for NEDs to participate in the decision making process, which gives them the chance to control the company.35

The thesis has argued that the delegation of powers from the board to the management should be restricted, in order to keep the right to approve the company’s major decisions in the hands of the full board, such as the large transactions and major decisions like working in new types of trade, and entering into new markets. These decisions decide the destiny of the company.

According to what has been mentioned above, the thesis has also argued in this thesis that there is need to establish a new regulatory model to govern the role of NEDs. Therefore, a Panel to govern the role of NEDs has been suggested in this thesis; this Panel is close in its design and approach to the Takeover and Mergers Panel.36 The Panel’s authority will be over the top 100 FTSE companies. The main role of the proposed Panel is to establish, administer and enforce a Governance Code that governs and designs the role of NEDs.37

The suggested Panel is to be established with legislative empowerment, by integrating new provisions to CA 2006 to give the Panel full authority to establish the rules for governing the role of NEDs, and to give the Panel the authority to hear the cases against the NEDs, in addition to empowering the Panel to ensure the companies’ compliance with the rules of the Panel’s Governance Code. The Panel’s authority is over the top FTSE 100 companies. The Panel, due to its legislative empowerment, will establish a Hearings Committee to hear the cases raised against the NEDs, and a Compliance Committee to ensure the companies’ compliance with the measures of the Panel, and a Code Committee to establish and revise the proposed Governance Code, and an Executive body to bring the cases against the NEDs in front of the

35 See supra Ch 4 s D-1.
36 The Panel for Mergers and Takeovers.
37 See supra Ch 5 s C-3.
Hearings Committee. The membership of the Panel and its committees and executive comes from the private commercial sector.\textsuperscript{38}

The Governance Code will provide the rules applicable to NEDs, starting from the definition of the NEDs’ roles and responsibilities, to providing the rules in regards to the appointment of NEDs on the companies’ boards. Moreover, the Governance Code will provide rules for restricting the delegation of powers from the board to the management, and will provide rules for the board meetings.\textsuperscript{39}

The Code Committee mandate is to establish and revise the Governance Code. In doing so, the Code Committee will take into consideration the latest developments in the sciences related to the role of NEDs, in addition to the latest examples of companies’ failures, and the rulings of the Hearings Committee.

The Compliance Committee will monitor the companies’ compliance with the rules of the Governance Code. The approval of the Compliance Committee on the company’s measures taken to comply with the Governance Code is a pre-condition for listing the company in the London Stock Exchange. In regards to compliance, the Governance Code will require the companies to first restrict the delegation of powers from the board to the management, by keeping the right to ratify the major decisions subject to the approval of the board of directors, such as the large transactions, the right to approve the loans and bonds, also the major strategic decisions, such as entering into new types of business or entering new markets. Moreover, the Governance Code will require the companies to adopt annual calendars and agendas for the board meetings, in order to ensure that all important issues of the company are brought to the board for discussion. In addition, the companies subject to the Code will be obliged to recruit agencies to provide the board with assessment of the success of the implementation of the company’s strategies.\textsuperscript{40}

\textsuperscript{38} See- \textit{supra} Ch 5 s C-3.

\textsuperscript{39} See- \textit{supra} Ch 5 s C-3.

\textsuperscript{40} See- \textit{supra} Ch 5 s C-3-c.
In regards to the board composition, the Governance Code requires the board to include at least two female NEDs, in addition the board is required to include at least three financial experts independent NEDs. Two of the independent NEDs will be appointed by the Panel through its Executive. However, the board structure as mentioned here does not mean that the number of NEDs will be at least seven. Indeed the two female NEDs could be the same NEDs appointed by the Panel, and the same female NEDs could be financial experts. However, the Governance Code requires at least half of the board to comprise of independent NEDs.\textsuperscript{41}

The Governance Code requires audit, risk management and internal control committee to comprise at least three financial expert independent NEDs. In addition the Governance Code requires the remunerations committee to comprise at least three independent NEDs.\textsuperscript{42}

The Hearings Committee provides a new enforcement method which is completely distinct of the derivative claims of CA 2006. The Hearings Committee applies the directors’ duties of CA 2006 and will refer to the proposed Governance Code as the reference of the roles and responsibilities of NEDs. The decisions of the Hearings Committee are subject to appeal in front of the Panel’s appeal board.\textsuperscript{43}

The Governance Code defines the role of NEDs firstly as the pro-active professional role. This definition means that NEDs will not be only liable when they approve decisions that have been manipulated by the management or approve decisions which included illegality. Indeed, the definition means that the NEDs will be judged in accordance with the competence of their decisions from the lens of best business practice. Accordingly, NEDs will be liable if they take decisions that appeared later to be disastrous. In this case, the Hearings Committee will assess whether these decisions when taken, were not wise and competent after being measured on the scale of professional managers. However, the Panel is not concerned with the choices of business which the board takes; nevertheless the Panel is concerned with the competence of these decisions.\textsuperscript{44}

\textsuperscript{41} See- \textit{supra} Ch 5 s C-3-c.
\textsuperscript{42} See- \textit{supra} Ch 5 s C-3-c.
\textsuperscript{43} See- \textit{supra} Ch 5 s C-3-d.
\textsuperscript{44} See- \textit{supra} Ch5 C-3-1.
Moreover, NEDs will be supposed to show high competence in reviewing and analysing the financial statements and company’s accounts. Same approach will be applied to the rest of the actions taken by NEDs, such as deciding the executive remunerations, and setting the risk managements and internal control systems.\(^45\)

The Hearings Committee will increase the expectations of the financial expert independent NEDs who serve on the audit, internal control and risk management committee, especially that the expectation of their conduct will rise due to the subjective standard of CA 2006 s 174, which takes into consideration the specific skills which a NED possess if higher than the standard required by the objective standard.\(^46\)

The Panel as has been suggested establishes an Executive body, whose main duty is to bring the cases against NEDs in front of the Hearings Committee. The Executive works separately from the Panel and according to its own initiative, or in response to complaints from the shareholders, or in response to the general public concerns. This flexibility of the work of the Executive will make the NEDs understand at all times that their weak or incompetent performance will make them face trials, and might get them liable, which as has been suggested will improve the standard of their performance.\(^47\)

Explaining the effectiveness of the Panel’s measures for enhancing the role of NEDs is simple. The Panel’s measures allow the NEDs to become in full control of the decision making, by involving them in the early steps of the decision making such as the steps of generating the ideas, and initiating the proposals to be provided to the management. Such measures will give them the chance to influence the decision making with their skills and expertise, and will allow them to have full information before ratifying the decisions. In addition, keeping the major decisions subject to the board’s approval such as the major transactions, will give the NEDs the chance to fully decide the direction and destiny of the company. Moreover, providing fast and

\(^{45}\) See- \textit{supra} Ch 5 s C-3-d.  
\(^{46}\) See- \textit{supra} Ch 5 s C-3-d.  
\(^{47}\) See- \textit{supra} Ch 5 s C-3-b.
effective enforcement through the Hearings Committee and the Executive will ensure that the
decisions taken are highly competent, and are most likely in the best interest of the business.  

Several examples of cases of companies’ failures have been featured in this thesis. It has been suggested that the main cause of these collapses is the misbehaviour of the company’s managers, and the passivity of the board of directors to control the behaviours of those managers. Accordingly, this thesis has identified that the weakness of the application of the directors’ duties gave the chance for the boards of directors to behave in a passive manner. This thesis has noted that NEDs should be liable for supervising the powers delegated from the board to the management. However, the proposed Panel and its approach are capable of dealing with such problems; therefore, they would prevent the occurrence of more companies’ failures, and would prevent further shocks to economies, such as the shock that took place after the collapse of Enron as well as the latest financial crisis.

For example, in the case of Re Continental Assurance Company of London plc (in Liquidation), the NEDs would not have been excused for continuing to trade although the company at the time had to go into insolvency due to the losses the company suffered. The NEDs’ reliance on the finance director would not have been an acceptable excuse for the NEDs not recognising that the company had to stop trading and go into insolvency. In such case, the NEDs would have been liable for not supervising the delegated functions, moreover they would have been liable for not behaving as professional directors’, who by the nature of their role should be able to analyse the company’s financial situation and should have been aware of the insolvency rules.

In the case of Equitable Life Assurance Society v Bowley and Others, the NEDs would have been liable for initially failing to take legal advice before adopting deferential terminal bonuses policy, assuming that taking a legal advice is what a professional director would do in such circumstances. Moreover, they would have been liable for failing to reduce the bonuses

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48 See supra Ch 5 s C-3-b.
49 See supra Ch 1.
after the problem became known, and after they have received the legal advice. In such cases, professional business practice requires them to take into account the legal advice given and to perform accordingly.

In other examples, some companies suffered financial difficulties due to the weakness of the NEDs and board’s performance; however these cases have not been taken to court. For example, in the case of Northern Rock, the board and the NEDs adopted reckless business model that was completely reliant on whole sale funding. The board of directors failed to take into account that their business model will fail once the market becomes less liquid. Although the case did not include any frauds or manipulation, nevertheless if the standard of conduct required by the Panel has been applied, the NEDs would have been held liable for taking unwise and reckless business decision, which caused the company to incur severe losses.\textsuperscript{52}

The previous situation applies to the case of Royal Bank of Scotland, where the bank suffered deep financial difficulties and required partial bailout from the government, due to a series of bad decisions taken by the board. In particular, the acquisition of ABN AMRO and the capital raising in 2008. Although the investigation of the FSA assured that the decisions did not show any lack of integrity by the board members and the NEDs, the NEDs of Royal Bank of Scotland\textsuperscript{53} would have been liable due to their recklessness and failure to analyse the competitiveness and consequences of their decisions on the short and long term, according to the standard of conduct required from NEDs designed by the proposed Panel.

Moreover, it has been observed that the different incidents where NEDs decided extremely high executive remunerations, which are not linked to the company’s financial performance, will no longer be only a subject for public debate; indeed such actions will lead to litigation and will hold the negligent and incompetent NEDs liable.\textsuperscript{54}

It has been explained in this thesis that there is a need to change the culture and the understanding of NEDs to their modern corporate governance role. The application of the legal

\textsuperscript{52} See- \textit{supra} Ch2 s A.
\textsuperscript{53} See- \textit{supra} Ch2 s A.
\textsuperscript{54} See- \textit{supra} Ch1.
model represented in the Panel will change the attitude of NEDs; by raising their understanding of their role from being merely secondary on the board and subordinates to the CEO, into first line responsible NEDs, who are responsible for the success of the financial performance of the company, and responsible for the economic well-being of the company.\textsuperscript{55}

Moreover, NEDs will be fully accountable to the shareholders, and they will ensure the accountability of the management to them. NEDs will be always aware that their failure to perform their role to a high standard of conduct will make them liable. Therefore, since controlling the company and the management is in the essence of their role, they will be more active in ensuring that the company’s managers are performing within the companies’ goals, and in accordance with the best business practice. This situation will ensure the effective control over the company’s management and the business, and will mitigate the problems arising from the conflicts of interests between the company’s managers and the shareholders, which arose originally from the separation of ownership and control. In addition, such position will reduce the agency costs.

Establishing the Panel within the UK jurisdiction will improve the performance of NEDs and the corporate governance system, not only in the UK, but also worldwide, due to the status of the UK as a generator and exporter of the corporate governance regulations. This situation makes establishing the Panel more important today than any day before, as establishing the Panel would improve the effectiveness of the corporate governance systems around the world, and would rebuild the confidence in the financial markets, which are still recovering from the severe financial crisis, and waves of companies’ failures.

\textsuperscript{55} See- \textit{supra} Ch1 s C.
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