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SESSION I: THE ROLE AND MAIN FUNCTIONS OF THE BOARD IN CORPORATE GOVERNANCE
PART A: EXPERIENCE IN OECD COUNTRIES

CORPORATE GOVERNANCE: LEGAL AND MARKET MECHANISMS IN TRANSITION ECONOMIES

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1 *Transition countries wishing to attract either capital or business need to ensure that potential investors have confidence in the market. Part of that confidence comes from knowing that the country's companies are well managed, and that there is a legal regime in place that can and will insist that good management practices are enforced. The discussion here draws on the experience of the United Kingdom, particularly in relation to boards of directors.*

Corporate governance is not a term of art. It encompasses all of the various mechanisms designed to ensure that a corporate organisation pursues only those objectives for which it was set up, and pursues them in a way which embodies best business practices. Here the focus is solely on the legal regulation of boards of directors, even though there are a myriad of other options for legal and non-legal regulation of corporate governance. The reforms being undertaken in Western democracies can perhaps serve as guides to emerging economies.

Different Western democracies have opted for quite different forms of regulation in this area. Here the focus is on the UK (or Anglo-American) approach. By definition, this is a model forged from liberal, capitalist, free-market practices, yet it has also incorporated lessons learned from civil law jurisdictions, and has also adopted more interventionist practices in the interests of protecting both the markets and individual players.

1. The importance of regulating board-level corporate management

The reasons why Western democracies are so preoccupied with board-level management are not hard to divine. The corporate form has become the preferred mechanism for conducting business. Companies contribute enormously to the economic and social well-being of a country. Indeed, the largest companies wield enormous economic, social and even political power.[2] Few if any individuals are left untouched by their activities. The compelling conclusion is that better-managed companies will produce benefits for all; hence the prevailing focus on corporate management, especially the corporate management function provided by boards of directors.[3] Because of this, all economies are likely to be legitimately concerned with the regulation of boards of directors. A sound financial and capital market demands confidence in the state's ability to regulate and enforce its laws; in addition, investors need to know that their interests

[1] The views expressed in this paper are those of the author and do not necessarily represent the opinions of the OECD or its member countries. This paper is subject to further revision.
[2] Of the world's 100 largest economies, 50 are companies and 50 are states.
[3] In the United Kingdom alone, the past ten years have seen publication of the Cadbury, Greenbury and Hampel Reports (all reports from government-sponsored private committees). The proposals from these committees are now enshrined in the Combined Code (Appendix to the London Stock Exchange Listing Rules). The Law Commission produced a report on company directors: Law Commission, *Company Directors: Regulating Conflicts of Interest and Formulating a Statement of Duties* (No. 261, 1999). The Department of Trade and Industry (DTI) announced a comprehensive review of the whole of company law (DTI, *Modern Company Law for a Competitive Economy* (1998) and The Company Law Review Steering Group has, accordingly, produced a number of consultation documents, including *Modern Company Law for a Competitive Economy: The Strategic Framework* (Feb. 1999); *Modern Company Law for a Competitive Economy: Developing the Framework* (March 2000);and, most recently, *Modern Company Law for a Competitive Economy: Completing the Structure* (Nov. 2000).

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are protected from abuse by self-interested or uninterested boards of directors. Moreover, it is well recognised that new, fast-moving markets provide both incentives and opportunities for deficient – and even fraudulent – management practices. In these markets, effective, and visibly effective, mechanisms for the regulation of board-level management are critical.

2. Different options for the regulation of boards of directors

If the aim is to raise the standard of board-level management within companies, then the law seems to have open to it three broad routes: imposing demanding legal duties upon directors and backing those duties by efficient and effective sanctions mechanisms; compelling disclosure of companies' and directors' activities; and requiring compliance with particular decision-making structures within the company. All three routes are integral to the most effective functioning of the law in this area, although they are listed here in their perceived order of importance. Of course, non-legal pressures also contribute enormously to the raising – or lowering – of corporate governance standards. Market pressures, including the threat of bad publicity, shareholder and general public activism, and domestic and international competition, can all provide incentives for particular modes of board behaviour, some desirable, others not.

If regulation is to be effective, then it must also recognise national business practices and expectations. Different countries have different ways of doing things. Among Western economies it is well-recognised that Japan and Germany have quite different corporate governance regimes from the United Kingdom and the United States. Notwithstanding this, all four countries have strong and successful economies. Moreover, it is increasingly recognised that the national context influences the impact of adopted rules.[4] It follows that when transition economies are devising corporate governance strategies, they need to be sensitive to context. There are many models to choose from, and many ways of adapting and refining them.

As well as country differences, corporate governance regimes need to be sensitive to company differences. The same mechanisms are unlikely to work for both large multinationals and small local businesses. Furthermore, once all these country and company differences have been accommodated every regulatory regime needs to ensure that its specific rules are clear, comprehensive and comprehensible, and that any breaches will be easily and efficiently remedied.

2.1 Compulsory disclosure regimes

The benefits of compulsory disclosure regimes are widely and enthusiastically accepted. This is the prime mechanism provided by the law to assist *markets* to more effectively implement their own special mechanisms for corporate governance regulation. Instinctively it is appreciated that if companies and directors are obliged to make full and formal disclosure of their various activities and functions then the occurrence of abuses is likely to be minimised. The fear of discovery is a powerful motivator. Moreover, any breaches which do occur are more likely to be pursued and remedied. If close supervision by independent monitors (e.g., by the stock exchange and the securities market regulator, by non-executive directors, and perhaps also by powerful institutional shareholders) is added to this disclosure regime, then the risk of breach is likely to fall still further. Compulsory disclosure is also likely to inspire "good" behaviour, not just deter the bad. These simple ideas underpin much of the input of corporate governance reformers in the United Kingdom this decade.[5] The general idea is that "forewarned is forearmed", and the various regimes are all designed to give appropriate information to the relevant interested parties. The Organisation for Economic Cooperation and Development (OECD) Principles of

[4] See, e.g., J. Kay and A. Silberston, "Corporate Governance" *National Institute Economic Review, Vol.* 84 (1995).
[5] See n. 3 above.

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Corporate Governance also recognise the central importance of effective and efficient disclosure regimes.[6]

Disclosure regimes can be implemented in various guises.[7] The stock exchanges of most countries have mandatory rules imposing continuing general disclosure obligations,[8] and specific disclosure obligations in relation to new offerings of securities. The aim of these regimes is to maintain confidence in the market, and to create a level playing-field for investors and other market participants. The potential sanctions for non-compliance include de-listing, a very effective threat which creates its own incentive for compliance.

All companies are generally also required to provide the general public with full, accurate and verified information about certain aspects of the company's operations. The aim is to put those who are about to invest in the company – in any way – in a position to assess the company's business before they commit themselves, and to enable those who have already invested to keep track of the company's continuing performance. In the United Kingdom this form of public disclosure is made by registering certain documents at Companies House, and current UK reform proposals are set to increase still further the disclosure required from public and large private[9] companies.[10] These most recent proposals mark a formal recognition of the increasing interest of a wide range of stakeholders in corporate functions and activities. The OECD Principles of Corporate Governance reflect a similar objective.[11]

So strong is the intuitive allegiance to the value of disclosure regimes that it is inconceivable that they could be done away with. Nevertheless, one of the current challenges of modern law reformers is to balance the perceived benefits of a system of compulsory disclosure against the mounting costs of compliance. In addition, greater efforts are needed to ensure that the information provided is intelligible to those it is intended to assist. The battle is between brevity and simplicity on the one hand, and accuracy on the other. As well as these cost-benefit issues relating to the form and content of mandatory disclosure, transition countries drafting their own regimes need to address the issue of effective enforcement. A well-drafted scheme on the statute books which is routinely ignored or evaded by companies and their boards of directors is probably even worse for market confidence than having no scheme at all. Although the disclosure regimes of the United Kingdom and the United States are regarded as tolerably well enforced, the European experience confirms that enforcement can prove problematic.[12]

2.2 Regulation of decision-making structures within the company

There is a widely held perception that some of the problems associated with corporate management can be traced to the structure of the board. For example, if the board of directors has the power to determine board remuneration, there is an inevitable general suspicion that excessive salaries may be paid. The biases can also be more subtle. In the United Kingdom the shareholders have the right to elect and

[6] OECD, *Principles of Corporate Governance*, SG/CG(99)5 1999) (available at www.oedc.org), Principle IV, states that 'The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.' Also see Principle V on the responsibilities of the board, and the Annotations to both these Principles.

[7] See P L Davies, *Gower's Principles of Modern Company Law, chs 19-21* (6th ed., 1997).

[8] In the United Kingdom these obligations are contained in the Stock Exchange's *Listing Rules*: see especially chs 9-16.

[9] The suggested level is an annual turnover of £500 million.

[10] Directors will be required to produce a mandatory Operating and Financial Report (OFR), designed to provide a full account of the performance and direction of the company's business, including a review of achievements, trends and strategic direction and also a report on the company's wider relationships, risks and opportunities, and social and environmental impacts, where these are relevant to an understanding of the business: Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: The Strategic Framework* (Feb. 1999), paras 2.16-2.18; *Modern Company Law for a Competitive Economy: Completing the Structure* (Nov. 2000), paras 3.1-3.4, 3.32-3.42.

[11] OECD, *Principles of Corporate Governance*, SG/CG(99)5 (OECD, Paris, April 1999) (available at www.oedc.org), Annotations to Principle IV A.2 suggest that 'in addition to commercial objectives, companies are encouraged to disclose policies relating to business ethics, the environment and other public policy commitments.' Also see Principle III on the role of stakeholders in corporate governance.

[12] Responding to criticism of European transparency regimes, the European Commission passed a Transparency Directive in 1993 . However, it is widely conceded that this Directive has achieved little, if anything.

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remove[13] the directors. A reasonable assumption in these circumstances is that directors may be easily persuaded to make corporate decisions which favour the shareholders to the detriment of other interested groups, especially the employees. Even within the general body of shareholders, minority shareholders may feel that their interests are overshadowed by the greater influence of the better-represented majority.

Since one of the goals of corporate governance best practice is to ensure the fair treatment of interested groups,[14] the issue demands a considered response. The mechanism usually chosen to address the problem is that of regulating decision-making *structures or procedures*, not regulating outcomes. Regulating outcomes is usually far too difficult in the corporate context. Moreover, the selected decision-making structures may not even be compulsory; they may simply be recommended as best practice, with the incentive to conform provided by mandatory disclosure of compliance. This is the way the UK Combined Code (discussed below) operates.

For a long time Anglo-American corporate law did little or nothing in this regard. It left interested parties to negotiate for better mechanisms if they could, and, if they could not, to seek out the few legal remedies available for provable injustices.[15] German[16] corporate law was always perceived to provide a starkly contrasting model. It provided for a two-tier board (a management board and a supervisory board), with compulsory employee representation on the latter[17] and, often, in practice, creditor representation as well (admittedly restricted to large creditors, such as banks). The perception, at least from the outside, was that such a structure was likely to produce a more balanced treatment of the various vested interests in the company, and yet the United Kingdom was not keen to adopt a similar framework.[18]

Now, however, matters have changed a little – although only a little – in the United Kingdom. Although there are still no statutory provisions mandating particular forms of board structure, voluntary codes of practice have been introduced for public companies.[19] As well as these codes, there is also statutory provision for certain decisions to be approved by the shareholders in general meeting before the company can commit itself to the proposed course of action. Such special consent is needed for those transactions where it seems likely that directors might act in a self-interested way to the detriment of the general good of the company and its shareholders.[20]

Transition countries contemplating the potential advantages in regulating the structure and composition of boards of directors will appreciate that any regulation must be specifically designed to address the principal pressure points in their own system. These pressure points are largely determined by the dominant legal structure of the companies being regulated. In both the United States and the United Kingdom large companies are typically widely held; elsewhere in the developed world, such companies

[13] This right of removal is given by statute, and operates regardless of any private arrangements to the contrary: Companies Act 1985 sec. 303.
[14] See OECD, *Principles of Corporate Governance*.
[15] The statutory "unfair prejudice" provisions were designed to afford relief in the worst of these cases, but the relevant sections have been restrictively interpreted by the courts, so that shareholders in public companies are now unlikely to be successful in pursuing relief: Companies Act 1985 sec. 459.
[16] And, similarly, Austrian, Belgian and Netherlands law.
[17] Contrast this with the very weak UK legislative provision simply requiring board of directors to "have regard" to the interests of the company's employees: Companies Act 1985 sec. 309.
[18] In the late 1970s the European Commission embarked on an extensive programme of harmonisation, as permitted by the Treaty of Rome, Article 54(3)(g). The focus has been directed largely at public companies and the degree of success has been mixed. For example, no agreement has yet been reached on the Draft Fifth Directive on the structure of public companies. The German model, which formed the basis for the initial proposals on this Directive, failed to command support and has now been revised to provide a much-watered-down menu of options.
[19] The Combined Code, appended to the London Stock Exchange *Listing Rules*. These guidelines suggest, for example, that boards of public companies should contain a greater proportion of independent non-executive directors (in the United States such directors typically form over half of the board), and that these independent non-executive directors should be in the majority on the sub-committees responsible for determining matters related to director nomination, director remuneration and company audit.
[20] See Companies Act 1985, Part X, regulating substantial property transactions between the company and its directors, as well as certain issues related to remuneration of the directors.

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generally have a dominant shareholder, be it an individual or the state or a bank.[21] This difference profoundly influences the issues to be addressed. Where companies are closely held, the emphasis typically shifts from shareholder-focused governance institutions to a broader set of devices for managing the issues of ownership and control. For example, in many countries where companies are closely held, Germany aside,[22] legislators have found it unnecessary to specifically regulate the composition of boards of directors. The dominant shareholder is seen as providing an effective monitoring function. Transition countries may feel this is a more appropriate model, although the pattern of shareholder ownership does appear to be diversifying even in countries where the closely held company has been the traditional model.

2.3 Specific regulation of management: directors' duties

To raise the standard of board-level management, the regulatory framework should provide for the legal imposition of minimum standards of conduct to which directors must adhere. The higher these minimum standards, the better the general level of corporate governance. And the better the general level of corporate governance, the better things will be for all, it is assumed. Accordingly, directors in Western economies are now subjected to a raft of legal obligations designed to improve their contributions to the management of the corporate enterprise.[23] This is 'hard' law: legal duties are backed by enforceable sanctions.

One of the principal challenges in this area is to balance the desire to impose high standards of conduct on directors against the risk of deterring potentially good directors from accepting the role, thereby stifling successful and beneficial entrepreneurial activity. Another is to articulate in a simple, comprehensible and comprehensive way precisely what is expected of directors. The duties described below apply to all directors of all companies, regardless of the size of the company, the type of business it conducts, and the age and experience of its managers. However, clearly this does not and cannot mean that precisely the same is expected of directors managing mullet-national corporate giants and directors managing the corner grocery store. The importance of corporate context is also well recognised in the OECD Principles of Corporate Governance. There, unlike the United Kingdom the responsibilities of boards of directors are set out very succinctly. All of the matters which, in the United Kingdom are regarded as critical are articulated in one provision and one sub-provision.[24] In considering the UK regime, it is useful to divide the relevant obligations imposed on directors into four broad but distinct classes.

(i) Formal restrictions on directors' activities

Directors are required to adhere strictly to statutory and constitutional requirements, and to any restrictive terms in their personal contracts of appointment. In most cases, breach of these requirements exposes the director to claims for compensation from the company for any loss the company may have suffered as a consequence. Where the breach is a breach of the statutory regime, criminal sanctions may also be imposed. However, in the UK directors are rarely pursued for these breaches, except where the breach relates to disclosure requirements imposed by statute. These disclosure requirements are regarded as so important that directors can be disqualified for persistent failures in this area.[25]

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[21] R. LaPorta, F. Lopez-de-Silanes and A. Shleifer, "Corporate Ownership Around the World", *Journal of Finance* Vol. 54 p.471 (1999). Banks are seen as having a particularly important role in corporate governance in Western Europe, but not elsewhere in the developed world.

[22] The Netherlands, Belgium and Austria also provide for employee representation on supervisory boards. In the United Kingdom and the United States such representation as there is generally arises form employee share ownership schemes.

[23] In the United Kingdom most but not all of these specific obligations applying to directors are imposed by the general law, not by explicit provisions in the Companies Act 1985.

[24] OECD, *Principles of Corporate Governance*,, Principle V A. ("Board members should act on a fully informed basis, in good faith, with due diligence and care, and in the best interests of the company and its shareholders") and V D.4 ("The Board should … [monitor and manage] potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions").

[25] See the Company Directors Disqualification Act 1986. Disqualification can, of course, be ordered for many other forms of failure by directors.

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(ii) Directors' duties of care and skill

Directors must exercise due care and skill in carrying out their management functions. This duty is simply one manifestation of the general duty of care imposed on all individuals in conducting their activities. However, two specific matters have caused concern in the corporate context for much of the history of this duty.

First, it is quite difficult to say what sort of conduct is negligent when directors are carrying out their management functions, at least when the conduct is neither grossly negligent nor fraudulent. Companies are set up to take risks; directors are employed because they are good at this – they are entrepreneurs. The fact that a company makes a loss, or even fails totally, is not of itself indicative that its directors have been negligent in the management of the company's affairs. To date the United Kingdom has resisted calls for the introduction of a statutory 'business judgement rule', as operates in the United States and several other countries. Such a rule would confirm that directors who make loss-generating decisions reasonably, after collecting all the appropriate evidence, and after appropriate consultation and evaluation, will not be found guilty of negligence in the management of the company, and so will not be held liable to compensate the company for the losses suffered.

The other related issue is that the standard of care imposed is commonly perceived as too low to be effective in regulating directors. Historically, very few directors were ever found liable in negligence for the corporate losses which resulted from what appeared to be clear mismanagement of the company's business.[26] To overcome this problem within the United Kingdom, the current law reform programme proposes to introduce a statutory statement of the duty which will ensure that directors adhere to a minimum, objectively assessed, reasonable standard of care. If directors have even greater skills or knowledge than this minimum requirement, then they will be expected to use those greater skills for the benefit of the company and the standard of care in those circumstances will be assessed subjectively. [27]

(iii) Directors' duty to act in good faith and for proper purposes

This next duty often seems less intelligible outside common law jurisdictions than within them, yet the more highly developed and widely accepted civil law conception of a duty to act in good faith covers the same territory in a different manner. In common law systems, this duty requires directors to act honestly in the interests of the company, and to use their powers solely for proper purposes. At first glance this duty would seem to ask little of directors that more positive duties could not demand equally well; moreover, it would seem inordinately difficult to prove a breach of the duty since it appears to demand an insight into the mind and motivations of the director.[28]

It is difficult to advise transition countries on the benefits associated with incorporating this particular duty into their corporate governance rules and the best manner of any such incorporation. In the United Kingdom the current reform proposals advocate adoption of a statutory statement of the rule, which insists that "a director must exercise his powers honestly and for proper purposes".[29] This stark statutory statement offers no specific guidance to the courts; courts will need to make their own assessments of what should count as a breach. If this degree of judicial discretion is unacceptable in transition countries, then an alternative approach is to recognise that the duty finds its most important application in the context of corporate take-overs; in other circumstances, affected parties can often rely on alternative

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[26] See e.g., *Re City Equitable Fire Ins Co* [1925] Ch. 407.

[27] The format will follow that of Insolvency Act 1986 sec. 214, although with simplified wording. The OEDC Principles of Corporate Governance do not make specific mention of directors' duties of care and skill – perhaps regarding theses duties as encompassed by the general law – but the thrust of Principle V, dealing with the responsibilities of the board, makes it clear that careful and considered management of corporations is internationally regarded as essential to corporate governance best practices.

[28] And in practice this has proved to be the case: it is inordinately difficult to prove a breach unless no reasonable director could have acted in such a fashion except for improper purposes, or unless there is clear evidence of such a purpose. Nevertheless, the duty still serves an important function.

[29] Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: The Strategic Framework* (Feb. 1999), para. 3.40.

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protective regimes. Transition countries might therefore consider it preferable to insert specific provisions limiting the discretionary powers of directors to advance or inhibit potential take-over bids for the company.

(iv) Directors' duties of loyalty – fiduciary duties not to profit

This final duty imposed on directors is another equitable duty, but also a fiduciary duty. Equity typically saw fit to impose onerous obligations on anybody who had undertaken to exercise a discretion in managing the affairs of another. The gist of the obligation is to require loyalty. In the corporate context this fiduciary duty of loyalty is designed to deter directors from acting in ways which might prejudice the interests of their company. Directors are not allowed to favour their own interests over their duty to the company when the two are in conflict; nor are they allowed to use their positions to make a secret profit. If they do, then any profits they make must be handed over to the company. This disgorgement remedy is a powerful disincentive to breach.

These fiduciary rules are necessary because, in granting directors the power to protect and advance the interests of their company, directors are also necessarily given the opportunity to do the exact opposite. The company cannot be adequately protected from this risk by the laws of contract, tort or abuse of power rules. The fiduciary duty of loyalty is designed to fill this void. It is the breach most often alleged when a company decides to sue its directors: an appearance of disloyalty, rather than active disloyalty, is sufficient to constitute a fiduciary breach; the director's carefulness, or good faith are irrelevant. Moreover, the company need not have suffered any loss, but it can nevertheless claim all the profits gleaned by the defaulting director from the breach.[30]

It is clear from this that the duty of loyalty demands self-denial: certain attractive opportunities are open to all bar the director, unless, of course, the company grants its fully informed consent. The danger in allowing otherwise is that the director will be swayed by personal interest rather than by duty.[31] When the policy behind the rule is considered, certain situations are clearly "risky": for example, a director's use of corporate confidential information for personal gain; or transactions between the company and one of its directors. However, the difficulty is to find a balance between compelling directors to act exclusively for the benefit of the company by denying them the possibility of taking a personal benefit from any available opportunities and allowing the most productive and efficient - but fair - use of resources by all the players in the market. How to define these boundaries has been a major concern of the law.[32]

The current UK reform proposals really provide little of assistance to transitional countries in dealing with these practical difficulties. Although there is a proposal for a statutory statement of the relevant duty, the statement affords no assistance in addressing the critical difficulties identified here.[33] The judiciary will still be left with the precisely the same problems in judging the boundaries between acceptable and unacceptable activity by directors. The same is true of the OEDC Principles of Corporate Governance. These Principles do not specifically identify this form of disloyal activity as unacceptable; instead, they simply require disclosure of the relevant facts to the shareholders.[34] To Anglo-American eyes, this does not seem to go far enough unless there is a remedy open to shareholders who object to the conduct revealed to them in accordance with this disclosure principle. And if a remedy *is* to be made available, then the difficulties of defining the boundaries between acceptable and unacceptable conduct will need to be addressed. It seems impossible to do this by statutory statement of an absolute rule; the

[30] *Regal (Hastings) Ltd v. Gulliver* [1967] 2 A.C. 134n, at pp.144-5 *per* Lord Russell.
[31] *Bray v. Ford* [1896] A.C. 44, at pp.51-2 *per* Lord Herschell.
[32] See e.g., R. P. Austin, "Fiduciary Accountability for Business Opportunities", in P. D. Finn, ed., *Equity and Commercial Relationships* ch.6 (1987); G. Jones, "Unjust Enrichment and the Fiduciary's Duty of Loyalty" (1968) 86 L.Q.R. 472; *Peso-Silver Mines Ltd v. Cropper* [1966] S.C.R. 673, (1966) 58 D.L.R. (2d) 1 (SCt Canada).
[33] See Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: Developing the Framework* (March 2000), para 3.40.
[34] OECD, *Principles of Corporate Governance*, Principle II C.

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huge variety of possible fact patterns make it inevitable that the courts will have to exercise discretion. But a regime which allows breaches of the law to be assessed by a judiciary exercising discretion is clearly only acceptable if the judiciary commands the confidence of the country's citizens.

These, in outline, are the four principal duties owed by directors to the companies they manage. When transition countries are considering the merits of adopting these four duties in their own legislative regimes, the UK experience suggests that the first two duties – the duty of strict compliance and the duty to act with care and skill – are relatively easily incorporated into statute. The second two duties – the duty to act honestly and for proper purposes and the duty to act loyally - are not. Yet these second two duties appear more important in promoting confidence in the corporate governance regime. These duties aim to limit the potential for directors to abuse the enormous discretionary power which they wield.

3. Regulation of boards of directors: enforcement mechanisms

A regulatory regime will not be successful unless it has efficient and effective enforcement mechanisms. By and large the corporate governance duties imposed on directors are duties owed solely to the company; only the company has the right to sue for their breach. This can be problematic if the wrongdoing directors are themselves in control of the company. The shareholders must then be given some mechanism to obtain a remedy for the wrongs done to the company. The UK system has, at present, a very arcane system of common law regulation of this issue, which is designed to protect companies from unwarranted interference in the proper management of the company, but to allow wrongs to be remedied effectively.[35] However, this is to be replaced by a statutory regime for a derivative action in an effort to enhance the enforcement mechanisms in this area.[36] Transition countries contemplating a similar statutory provision need to be sensitive to the potential damage to corporate activity that can be caused by over-active litigious shareholders wanting the company to pursue different objectives. The objective of any legal regulation in this area must be to allow the board free rein in managing the business; the shareholders' right to intervene in the company's name must remain conditional on *improper* board practices. Beyond this, if the shareholders are to enforce these duties then they must be in a position to have access to intelligible information from which they can infer that such duties have been breached; they must also have some incentive to pursue the company in court.[37] The first issue harks back to the importance of disclosure obligations. Effective and efficient disclosure is crucial to effective corporate governance.[38]

It is universally recognised that even the best designed regulatory rules will be worthless in improving corporate governance if the rules are not effectively enforced. Effective enforcement demands a properly functioning, credible, national civil and criminal justice system. Law on the statute books which is not translated into law in practice counts as nothing. In truth, this must often be the difficult starting-point for emerging economies and the goal for transition economies. Reforms focusing on enforcement are recognised as often both more important and more difficult than reforms focusing on changes to the letter of the law.

[35] This is known as "the rule in *Foss v Harbottle*", (1843) 2 Hare 461.

[36] Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: Developing the Framework*, paras 4.129-4.139 (March 2000), relying on the earlier work of the Law Commission, *Shareholders' Remedies*, Law Com No 246, Part 6.

[37] This is not addressed here, but the greatest disincentive to action by shareholders is the burden of legal costs. Various mechanisms for reducing this disincentive have been mooted, but none adopted.

[38] Clearly the state, too, has an interest in some parts of this governance regime. It, too, needs to be in a position to monitor activity and pursue wrongdoers, imposing disqualification orders and criminal sanctions where appropriate.

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4. Conclusions

Corporate governance covers an enormous field. It involves the full set of relationships between a company's board, its management, its shareholders and its other stakeholders. Poor governance undermines confidence in the markets and so can hold the whole financial system hostage. If companies are to attract and retain long-term capital from a large pool of investors, they need credible and recognisable corporate governance arrangements. It is essential that certain minimum standards of conduct are imposed on corporate managers, and imposed in a way which ensures that the rules are comprehensible, that breaches are easily detectable, and that sanctions are effectively and efficiently enforced. The goal is to provide a regime which imposes sufficient, but not excessive regulation. The regime must work and be seen to work if it is to inspire confidence in the country's markets.

Transition countries wishing to attract either capital or business need to ensure that potential investors have confidence in the market. Part of that confidence comes from knowing that the country's companies are well managed, and that there is a legal regime in place that can and will insist that good management practices are enforced. The discussion here draws on the experience of the United Kingdom, particularly in relation to boards of directors.

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Different Western democracies have opted for quite different forms of regulation in this area. Here the focus is on the UK (or Anglo-American) approach. By definition, this is a model forged from liberal, capitalist, free-market practices, yet it has also incorporated lessons learned from civil law jurisdictions, and has also adopted more interventionist practices in the interests of protecting both the markets and individual players.

1. The importance of regulating board-level corporate management

The reasons why Western democracies are so preoccupied with board-level management are not hard to divine. The corporate form has become the preferred mechanism for conducting business. Companies contribute enormously to the economic and social well-being of a country. Indeed, the largest companies wield enormous economic, social and even political power.[39] Few if any individuals are left untouched by their activities. The compelling conclusion is that better-managed companies will produce benefits for all; hence the prevailing focus on corporate management, especially the corporate management function provided by boards of directors.[40] Because of this, all economies are likely to be legitimately concerned with the regulation of boards of directors. A sound financial and capital market demands confidence in the state's ability to regulate and enforce its laws; in addition, investors need to know that their interests are protected from abuse by self-interested or uninterested boards of directors. Moreover, it is well recognised that new, fast-moving markets provide both incentives and opportunities for

[39] Of the world's 100 largest economies, 50 are companies and 50 are states.

[40] In the United Kingdom alone, the past ten years have seen publication of the Cadbury, Greenbury and Hampel Reports (all reports from government-sponsored private committees). The proposals from these committees are now enshrined in the Combined Code (Appendix to the London Stock Exchange Listing Rules). The Law Commission produced a report on company directors: Law Commission, *Company Directors: Regulating Conflicts of Interest and Formulating a Statement of Duties* (No. 261, 1999). The Department of Trade and Industry (DTI) announced a comprehensive review of the whole of company law (DTI, *Modern Company Law for a Competitive Economy* (1998) and The Company Law Review Steering Group has, accordingly, produced a number of consultation documents, including *Modern Company Law for a Competitive Economy: The Strategic Framework* (Feb. 1999); *Modern Company Law for a Competitive Economy: Developing the Framework* (March 2000); and, most recently, *Modern Company Law for a Competitive Economy: Completing the Structure* (Nov. 2000).

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deficient – and even fraudulent – management practices. In these markets, effective, and visibly effective, mechanisms for the regulation of board-level management are critical.

2. Different options for the regulation of boards of directors

If the aim is to raise the standard of board-level management within companies, then the law seems to have open to it three broad routes: imposing demanding legal duties upon directors and backing those duties by efficient and effective sanctions mechanisms; compelling disclosure of companies' and directors' activities; and requiring compliance with particular decision-making structures within the company. All three routes are integral to the most effective functioning of the law in this area, although they are listed here in their perceived order of importance. Of course, non-legal pressures also contribute enormously to the raising – or lowering – of corporate governance standards. Market pressures, including the threat of bad publicity, shareholder and general public activism, and domestic and international competition, can all provide incentives for particular modes of board behaviour, some desirable, others not.

If regulation is to be effective, then it must also recognise national business practices and expectations. Different countries have different ways of doing things. Among Western economies it is well-recognised that Japan and Germany have quite different corporate governance regimes from the United Kingdom and the United States. Notwithstanding this, all four countries have strong and successful economies. Moreover, it is increasingly recognised that the national context influences the impact of adopted rules.[41] It follows that when transition economies are devising corporate governance strategies, they need to be sensitive to context. There are many models to choose from, and many ways of adapting and refining them.

As well as country differences, corporate governance regimes need to be sensitive to company differences. The same mechanisms are unlikely to work for both large multinationals and small local businesses. Furthermore, once all these country and company differences have been accommodated every regulatory regime needs to ensure that its specific rules are clear, comprehensive and comprehensible, and that any breaches will be easily and efficiently remedied.

2.1 Compulsory disclosure regimes

The benefits of compulsory disclosure regimes are widely and enthusiastically accepted. Instinctively it is appreciated that if companies and directors are obliged to make full and formal disclosure of their various activities and functions then the occurrence of abuses is likely to be minimised. The fear of discovery is a powerful motivator. Moreover, any breaches which do occur are more likely to be pursued and remedied. If close supervision by independent monitors (e.g., by the stock exchange and the securities market regulator, by non-executive directors, and perhaps also by powerful institutional shareholders) is added to this disclosure regime, then the risk of breach is likely to fall still further. Compulsory disclosure is also likely to inspire "good" behaviour, not just deter the bad. These simple ideas underpin much of the input of corporate governance reformers in the United Kingdom this decade.[42] The general idea is that "forewarned is forearmed", and the various regimes are all designed to give appropriate information to the relevant interested parties. The Organisation for Economic Cooperation and Development (OECD) Principles of Corporate Governance also recognise the central importance of effective and efficient disclosure regimes.[43]

[41] See, e.g., J. Kay and A. Silberston, "Corporate Governance" *National Institute Economic Review,Vol.* 84 (1995).
[42] See n. 3 above.
[43] OECD, *Principles of Corporate Governance*, SG/CG(99)5 1999) (available at www.oedc.org), Principle IV, states that 'The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.' Also see Principle V on the responsibilities of the board, and the Annotations to both these Principles.

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Disclosure regimes can be implemented in various guises.[44] The stock exchanges of most countries have mandatory rules imposing continuing general disclosure obligations,[45] and specific disclosure obligations in relation to new offerings of securities. The aim of these regimes is to maintain confidence in the market, and to create a level playing-field for investors and other market participants. The potential sanctions for non-compliance include de-listing, a very effective threat which creates its own incentive for compliance.

All companies are generally also required to provide the general public with full, accurate and verified information about certain aspects of the company's operations. The aim is to put those who are about to invest in the company – in any way – in a position to assess the company's business before they commit themselves, and to enable those who have already invested to keep track of the company's continuing performance. In the United Kingdom this form of public disclosure is made by registering certain documents at Companies House, and current UK reform proposals are set to increase still further the disclosure required from public and large private[46] companies.[47] These most recent proposals mark a formal recognition of the increasing interest of a wide range of stakeholders in corporate functions and activities. The OECD Principles of Corporate Governance reflect a similar objective.[48]

So strong is the intuitive allegiance to the value of disclosure regimes that it is inconceivable that they could be done away with. Nevertheless, one of the current challenges of modern law reformers is to balance the perceived benefits of a system of compulsory disclosure against the mounting costs of compliance. In addition, greater efforts are needed to ensure that the information provided is intelligible to those it is intended to assist. The battle is between brevity and simplicity on the one hand, and accuracy on the other. As well as these cost-benefit issues relating to the form and content of mandatory disclosure, transition countries drafting their own regimes need to address the issue of effective enforcement. A well-drafted scheme on the statute books which is routinely ignored or evaded by companies and their boards of directors is probably even worse for market confidence than having no scheme at all. Although the disclosure regimes of the United Kingdom and the United States are regarded as tolerably well enforced, the European experience confirms that enforcement can prove problematic.[49]

2.2 Regulation of decision-making structures within the company

There is a widely held perception that some of the problems associated with corporate management can be traced to the structure of the board. For example, if the board of directors has the power to determine board remuneration, there is an inevitable general suspicion that excessive salaries may be paid. The biases can also be more subtle. In the United Kingdom the shareholders have the right to elect and remove[50] the directors. A reasonable assumption in these circumstances is that directors may be easily persuaded to make corporate decisions which favour the shareholders to the detriment of other interested groups, especially the employees. Even within the general body of shareholders, minority shareholders may feel that their interests are overshadowed by the greater influence of the better-represented majority.

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[44] See P L Davies, *Gower's Principles of Modern Company Law, chs 19-21* (6th ed., 1997).

[45] In the United Kingdom these obligations are contained in the Stock Exchange's *Listing Rules*: see especially chs 9-16.

[46] The suggested level is an annual turnover of £500 million.

[47] Directors will be required to produce a mandatory Operating and Financial Report (OFR), designed to provide a full account of the performance and direction of the company's business, including a review of achievements, trends and strategic direction and also a report on the company's wider relationships, risks and opportunities, and social and environmental impacts, where these are relevant to an understanding of the business: Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: The Strategic Framework* (Feb. 1999), paras 2.16-2.18; *Modern Company Law for a Competitive Economy: Completing the Structure* (Nov. 2000), paras 3.1-3.4, 3.32-3.42.

[48] OECD, *Principles of Corporate Governance*, SG/CG(99)5 (OECD, Paris, April 1999) (available at www.oedc.org), Annotations to Principle IV A.2 suggest that 'in addition to commercial objectives, companies are encouraged to disclose policies relating to business ethics, the environment and other public policy commitments.' Also see Principle III on the role of stakeholders in corporate governance.

[49] Responding to criticism of European transparency regimes, the European Commission passed a Transparency Directive in 1993 . However, it is widely conceded that this Directive has achieved little, if anything.

[50] This right of removal is given by statute, and operates regardless of any private arrangements to the contrary: Companies Act 1985 sec. 303.

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Since one of the goals of corporate governance best practice is to ensure the fair treatment of interested groups,[51] the issue demands a considered response.

For a long time Anglo-American corporate law did little or nothing. It left interested parties to negotiate for better representation if they could, and, if they could not, to seek out the few legal remedies available for provable injustices.[52] German[53] corporate law was always perceived to provide a starkly contrasting model. It provided for a two-tier board (a management board and a supervisory board), with compulsory employee representation on the latter[54] and, often, in practice, creditor representation as well (admittedly restricted to large creditors, such as banks). The perception, at least from the outside, was that such a structure was likely to produce a more balanced treatment of the various vested interests in the company, and yet the United Kingdom was not keen to adopt a similar framework.[55]

Now, however, matters have changed a little – although only a little – in the United Kingdom. Although there are still no statutory provisions mandating particular forms of board structure, voluntary codes of practice have been introduced for public companies.[56] As well as these codes, there is also statutory provision for certain decisions to be approved by the shareholders in general meeting before the company can commit itself to the proposed course of action. Such special consent is needed for those transactions where it seems likely that directors might act in a self-interested way to the detriment of the general good of the company and its shareholders.[57]

Transition countries contemplating the potential advantages in regulating the structure and composition of boards of directors will appreciate that any regulation must be specifically designed to address the principal pressure points in their own system. These pressure points are largely determined by the dominant legal structure of the companies being regulated. In both the United States and the United Kingdom large companies are typically widely held; elsewhere in the developed world, such companies generally have a dominant shareholder, be it an individual or the state or a bank.[58] This difference profoundly influences the issues to be addressed. Where companies are closely held, the emphasis typically shifts from shareholder-focused governance institutions to a broader set of devices for managing the issues of ownership and control. For example, in many countries where companies are closely held, Germany aside,[59] legislators have found it unnecessary to specifically regulate the composition of boards of directors. The dominant shareholder is seen as providing an effective monitoring function. Transition countries may feel this is a more appropriate model, although the pattern of shareholder ownership does appear to be diversifying even in countries where the closely held company has been the traditional model.

[51] See OECD, *Principles of Corporate Governance*.
[52] The statutory "unfair prejudice" provisions were designed to afford relief in the worst of these cases, but the relevant sections have been restrictively interpreted by the courts, so that shareholders in public companies are now unlikely to be successful in pursuing relief: Companies Act 1985 sec. 459.
[53] And, similarly, Austrian, Belgian and Netherlands law.
[54] Contrast this with the very weak UK legislative provision simply requiring board of directors to "have regard" to the interests of the company's employees: Companies Act 1985 sec. 309.
[55] In the late 1970s the European Commission embarked on an extensive programme of harmonisation, as permitted by the Treaty of Rome, Article 54(3)(g). The focus has been directed largely at public companies and the degree of success has been mixed. For example, no agreement has yet been reached on the Draft Fifth Directive on the structure of public companies. The German model, which formed the basis for the initial proposals on this Directive, failed to command support and has now been revised to provide a much-watered-down menu of options.
[56] The Combined Code, appended to the London Stock Exchange *Listing Rules*. These guidelines suggest, for example, that boards of public companies should contain a greater proportion of independent non-executive directors (in the United States such directors typically form over half of the board), and that these independent non-executive directors should be in the majority on the sub-committees responsible for determining matters related to director nomination, director remuneration and company audit.
[57] See Companies Act 1985, Part X, regulating substantial property transactions between the company and its directors, as well as certain issues related to remuneration of the directors.
[58] R. LaPorta, F. Lopez-de-Silanes and A. Shleifer, "Corporate Ownership Around the World", *Journal of Finance* Vol. 54 p.471 (1999). Banks are seen as having a particularly important role in corporate governance in Western Europe, but not elsewhere in the developed world.
[59] The Netherlands, Belgium and Austria also provide for employee representation on supervisory boards. In the United Kingdom and the United States such representation as there is generally arises form employee share ownership schemes.

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2.3 Specific regulation of management: directors' duties

To raise the standard of board-level management, the regulatory framework should provide for the legal imposition of minimum standards of conduct to which directors must adhere. The higher these minimum standards, the better the general level of corporate governance. And the better the general level of corporate governance, the better things will be for all, it is assumed. Accordingly, directors in Western economies are now subjected to a raft of legal obligations designed to improve their contributions to the management of the corporate enterprise.[60]

One of the principal challenges in this area is to balance the desire to impose high standards of conduct on directors against the risk of deterring potentially good directors from accepting the role, thereby stifling successful and beneficial entrepreneurial activity. Another is to articulate in a simple, comprehensible and comprehensive way precisely what is expected of directors. The duties described below apply to all directors of all companies, regardless of the size of the company, the type of business it conducts, and the age and experience of its managers. However, clearly this does not and cannot mean that precisely the same is expected of directors managing multi-national corporate giants and directors managing the corner grocery store. The importance of corporate context is also well recognised in the OECD Principles of Corporate Governance. There, unlike the United Kingdom the responsibilities of boards of directors are set out very succinctly. All of the matters which, in the United Kingdom are regarded as critical are articulated in one provision and one sub-provision.[61] In considering the UK regime, it is useful to divide the relevant obligations imposed on directors into four broad but distinct classes.

(i) Formal restrictions on directors' activities

Directors are required to adhere strictly to statutory and constitutional requirements, and to any restrictive terms in their personal contracts of appointment. In most cases, breach of these requirements exposes the director to claims for compensation from the company for any loss the company may have suffered as a consequence. Where the breach is a breach of the statutory regime, criminal sanctions may also be imposed. However, in the UK directors are rarely pursued for these breaches, except where the breach relates to disclosure requirements imposed by statute. These disclosure requirements are regarded as so important that directors can be disqualified for persistent failures in this area.[62]

(ii) Directors' duties of care and skill

Directors must exercise due care and skill in carrying out their management functions. This duty is simply one manifestation of the general duty of care imposed on all individuals in conducting their activities. However, two specific matters have caused concern in the corporate context for much of the history of this duty.

First, it is quite difficult to say what sort of conduct is negligent when directors are carrying out their management functions, at least when the conduct is neither grossly negligent nor fraudulent. Companies are set up to take risks; directors are employed because they are good at this – they are entrepreneurs. The fact that a company makes a loss, or even fails totally, is not of itself indicative that its directors have been negligent in the management of the company's affairs. To date the United Kingdom has resisted calls for the introduction of a statutory 'business judgement rule', as operates in the United States and several other countries. Such a rule would confirm that directors who make loss-generating decisions reasonably, after collecting all the appropriate evidence, and after appropriate consultation and

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[60] In the United Kingdom most but not all of these specific obligations applying to directors are imposed by the general law, not by explicit provisions in the Companies Act 1985.

[61] OECD, *Principles of Corporate Governance*,, Principle V A. ("Board members should act on a fully informed basis, in good faith, with due diligence and care, and in the best interests of the company and its shareholders") and V D.4 ("The Board should … [monitor and manage] potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions").

[62] See the Company Directors Disqualification Act 1986. Disqualification can, of course, be ordered for many other forms of failure by directors.

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evaluation, will not be found guilty of negligence in the management of the company, and so will not be held liable to compensate the company for the losses suffered.

The other related issue is that the standard of care imposed is commonly perceived as too low to be effective in regulating directors. Historically, very few directors were ever found liable in negligence for the corporate losses which resulted from what appeared to be clear mismanagement of the company's business.[63] To overcome this problem within the United Kingdom, the current law reform programme proposes to introduce a statutory statement of the duty which will ensure that directors adhere to a minimum, objectively assessed, reasonable standard of care. If directors have even greater skills or knowledge than this minimum requirement, then they will be expected to use those greater skills for the benefit of the company and the standard of care in those circumstances will be assessed subjectively.[64]

(iii) Directors' duty to act in good faith and for proper purposes

This next duty often seems less intelligible outside common law jurisdictions than within them, yet the more highly developed and widely accepted civil law conception of a duty to act in good faith covers the same territory in a different manner. In common law systems, this duty requires directors to act honestly in the interests of the company, and to use their powers solely for proper purposes. At first glance this duty would seem to ask little of directors that more positive duties could not demand equally well; moreover, it would seem inordinately difficult to prove a breach of the duty since it appears to demand an insight into the mind and motivations of the director.[65]

It is difficult to advise transition countries on the benefits associated with incorporating this particular duty into their corporate governance rules and the best manner of any such incorporation. In the United Kingdom the current reform proposals advocate adoption of a statutory statement of the rule, which insists that "a director must exercise his powers honestly and for proper purposes".[66] This stark statutory statement offers no specific guidance to the courts; courts will need to make their own assessments of what should count as a breach. If this degree of judicial discretion is unacceptable in transition countries, then an alternative approach is to recognise that the duty finds its most important application in the context of corporate take-overs; in other circumstances, affected parties can often rely on alternative protective regimes. Transition countries might therefore consider it preferable to insert specific provisions limiting the discretionary powers of directors to advance or inhibit potential take-over bids for the company.

(iv) Directors' duties of loyalty – fiduciary duties not to profit

This final duty imposed on directors is another equitable duty, but also a fiduciary duty. Equity typically saw fit to impose onerous obligations on anybody who had undertaken to exercise a discretion in managing the affairs of another. The gist of the obligation is to require loyalty. In the corporate context this fiduciary duty of loyalty is designed to deter directors from acting in ways which might prejudice the interests of their company. Directors are not allowed to favour their own interests over their duty to the company when the two are in conflict; nor are they allowed to use their positions to make a secret profit. If they do, then any profits they make must be handed over to the company. This disgorgement remedy is a powerful disincentive to breach.

[63] See e.g., *Re City Equitable Fire Ins Co* [1925] Ch. 407.

[64] The format will follow that of Insolvency Act 1986 sec. 214, although with simplified wording. The OEDC Principles of Corporate Governance do not make specific mention of directors' duties of care and skill – perhaps regarding theses duties as encompassed by the general law – but the thrust of Principle V, dealing with the responsibilities of the board, makes it clear that careful and considered management of corporations is internationally regarded as essential to corporate governance best practices.

[65] And in practice this has proved to be the case: it is inordinately difficult to prove a breach unless no reasonable director could have acted in such a fashion except for improper purposes, or unless there is clear evidence of such a purpose. Nevertheless, the duty still serves an important function.

[66] Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: The Strategic Framework* (Feb. 1999), para. 3.40.

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These fiduciary rules are necessary because, in granting directors the power to protect and advance the interests of their company, directors are also necessarily given the opportunity to do the exact opposite. The company cannot be adequately protected from this risk by the laws of contract, tort or abuse of power rules. The fiduciary duty of loyalty is designed to fill this void. It is the breach most often alleged when a company decides to sue its directors: an appearance of disloyalty, rather than active disloyalty, is sufficient to constitute a fiduciary breach; the director's carefulness, or good faith are irrelevant. Moreover, the company need not have suffered any loss, but it can nevertheless claim all the profits gleaned by the defaulting director from the breach.[67]

It is clear from this that the duty of loyalty demands self-denial: certain attractive opportunities are open to all bar the director, unless, of course, the company grants its fully informed consent. The danger in allowing otherwise is that the director will be swayed by personal interest rather than by duty.[68] When the policy behind the rule is considered, certain situations are clearly "risky": for example, a director's use of corporate confidential information for personal gain; or transactions between the company and one of its directors. However, the difficulty is to find a balance between compelling directors to act exclusively for the benefit of the company by denying them the possibility of taking a personal benefit from any available opportunities and allowing the most productive and efficient - but fair - use of resources by all the players in the market. How to define these boundaries has been a major concern of the law.[69]

The current UK reform proposals really provide little of assistance to transitional countries in dealing with these practical difficulties. Although there is a proposal for a statutory statement of the relevant duty, the statement affords no assistance in addressing the critical difficulties identified here.[70] The judiciary will still be left with the precisely the same problems in judging the boundaries between acceptable and unacceptable activity by directors. The same is true of the OEDC Principles of Corporate Governance. These Principles do not specifically identify this form of disloyal activity as unacceptable; instead, they simply require disclosure of the relevant facts to the shareholders.[71] To Anglo-American eyes, this does not seem to go far enough unless there is a remedy open to shareholders who object to the conduct revealed to them in accordance with this disclosure principle. And if a remedy *is* to be made available, then the difficulties of defining the boundaries between acceptable and unacceptable conduct will need to be addressed. It seems impossible to do this by statutory statement of an absolute rule; the huge variety of possible fact patterns make it inevitable that the courts will have to exercise discretion. But a regime which allows breaches of the law to be assessed by a judiciary exercising discretion is clearly only acceptable if the judiciary commands the confidence of the country's citizens.

These, in outline, are the four principal duties owed by directors to the companies they manage. When transition countries are considering the merits of adopting these four duties in their own legislative regimes, the UK experience suggests that the first two duties – the duty of strict compliance and the duty to act with care and skill – are relatively easily incorporated into statute. The second two duties – the duty to act honestly and for proper purposes and the duty to act loyally - are not. Yet these second two duties appear more important in promoting confidence in the corporate governance regime. These duties aim to limit the potential for directors to abuse the enormous discretionary power which they wield.

3. Regulation of boards of directors: enforcement mechanisms

[67] *Regal (Hastings) Ltd v. Gulliver* [1967] 2 A.C. 134n, at pp.144-5 *per* Lord Russell.

[68] *Bray v. Ford* [1896] A.C. 44, at pp.51-2 *per* Lord Herschell.

[69] See e.g., R. P. Austin, "Fiduciary Accountability for Business Opportunities", in P. D. Finn, ed., *Equity and Commercial Relationships* ch.6 (1987); G. Jones, "Unjust Enrichment and the Fiduciary's Duty of Loyalty" (1968) 86 L.Q.R. 472; *Peso-Silver Mines Ltd v. Cropper* [1966] S.C.R. 673, (1966) 58 D.L.R. (2d) 1 (SCt Canada).

[70] See Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: Developing the Framework* (March 2000), para 3.40.

[71] OECD, *Principles of Corporate Governance*, Principle II C.

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A regulatory regime will not be successful unless it has efficient and effective enforcement mechanisms. By and large the corporate governance duties imposed on directors are duties owed solely to the company; only the company has the right to sue for their breach. This can be problematic if the wrongdoing directors are themselves in control of the company. The shareholders must then be given some mechanism to obtain a remedy for the wrongs done to the company. The UK system has, at present, a very arcane system of common law regulation of this issue, which is designed to protect companies from unwarranted interference in the proper management of the company, but to allow wrongs to be remedied effectively.[72] However, this is to be replaced by a statutory regime for a derivative action in an effort to enhance the enforcement mechanisms in this area.[73] Transition countries contemplating a similar statutory provision need to be sensitive to the potential damage to corporate activity that can be caused by over-active litigious shareholders wanting the company to pursue different objectives. The objective of any legal regulation in this area must be to allow the board free rein in managing the business; the shareholders' right to intervene in the company's name must remain conditional on *improper* board practices. Beyond this, if the shareholders are to enforce these duties then they must be in a position to have access to intelligible information from which they can infer that such duties have been breached; they must also have some incentive to pursue the company in court.[74] The first issue harks back to the importance of disclosure obligations. Effective and efficient disclosure is crucial to effective corporate governance.[75]

It is universally recognised that even the best designed regulatory rules will be worthless in improving corporate governance if the rules are not effectively enforced. Effective enforcement demands a properly functioning, credible, national civil and criminal justice system. Law on the statute books which is not translated into law in practice counts as nothing. In truth, this must often be the difficult starting-point for emerging economies and the goal for transition economies. Reforms focusing on enforcement are recognised as often both more important and more difficult than reforms focusing on changes to the letter of the law.

4. Conclusions

Corporate governance covers an enormous field. It involves the full set of relationships between a company's board, its management, its shareholders and its other stakeholders. Poor governance undermines confidence in the markets and so can hold the whole financial system hostage. If companies are to attract and retain long-term capital from a large pool of investors, they need credible and recognisable corporate governance arrangements. It is essential that certain minimum standards of conduct are imposed on corporate managers, and imposed in a way which ensures that the rules are comprehensible, that breaches are easily detectable, and that sanctions are effectively and efficiently enforced. The goal is to provide a regime which imposes sufficient, but not excessive regulation. The regime must work and be seen to work if it is to inspire confidence in the country's markets.

[72] This is known as "the rule in *Foss v Harbottle*", (1843) 2 Hare 461.

[73] Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: Developing the Framework*, paras 4.129-4.139 (March 2000), relying on the earlier work of the Law Commission, *Shareholders' Remedies*, Law Com No 246, Part 6.

[74] This is not addressed here, but the greatest disincentive to action by shareholders is the burden of legal costs. Various mechanisms for reducing this disincentive have been mooted, but none adopted.

[75] Clearly the state, too, has an interest in some parts of this governance regime. It, too, needs to be in a position to monitor activity and pursue wrongdoers, imposing disqualification orders and criminal sanctions where appropriate.

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