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Board Accountability in Corporate Governance

Andrew Keay

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Board Accountability in Corporate Governance

Within corporate governance the accountability of the board of directors is identified as a major issue by governments, international bodies, professional associations and academic literature. Boards are given significant power in companies, and as a consequence it is argued that they should be accountable for their actions. Drawing on political science, public administration, accounting and ethics literature, this book examines the concept of accountability and its meaning in the corporate governance context. It examines the rationale for making boards accountable, and outlines the obstacles and drawbacks involved in providing for accountability.

The book goes on to examine how current mechanisms for ensuring accountability are assessed in terms of fairness, justice, transparency, practicality, effectiveness and efficiency, before discussing the ways that accountability might be improved. Andrew Keay argues that enhanced accountability can provide better corporate governance, helping to reduce the frequency and severity of financial crises, and improve confidence in company practice.

As an in-depth study of a key element within the exercise of authority and management in corporate entities, this book will be of great use and interest to researchers and students of corporate governance, business and management, and corporate social responsibility.

Andrew Keay is Professor of Corporate and Commercial Law at the University of Leeds, UK.

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Preface

It is undoubtedly true that accountability is a critical matter in most areas of life today, and not least in corporate governance. Within corporate governance the accountability of the board of directors has been identified as a major issue by governments, specially appointed committees addressing corporate law and corporate governance issues, international bodies, professional associations and the academic literature. Boards are given significant power in companies and as a consequence it is said that they should be accountable for their use of that power. This is particularly the case with respect to public companies. It is on these companies that this book is focused.

The book endeavours to examine most issues that relate to board accountability. Of particular focus in the book is: the meaning of accountability in the corporate governance context; the rationale for making boards accountable; the identity of the accountee (to whom is the board accountable?); for what are boards accountable; how are boards made accountable; the obstacles to and drawbacks of providing for accountability; the balance between accountability and authority.

Whilst my own discipline is law I have sought in this book to engage in what would be referred to by some as 'inter-disciplinary' and others as 'trans-disciplinary' studies because corporate governance spans many disciplines. Having sought to do this, I have probably emphasised the law, again because of my background.

The emphasis in the book is on Anglo-American companies, but there is some discussion of issues that affect most companies and issues peculiar to companies in traditions other than the Anglo-American tradition, and particularly those in two leading economies, namely Germany and China. For the most part, I have not attempted to deal with details of the law in many of the areas considered as that would derogate from the direction of the book, which is meant to be theoretical and broad in outlook.

I have in places given examples of legislation or case law to illustrate and develop points. This tends to be concentrated on the UK and the Commonwealth of Nations (often in the past referred to as 'the British Commonwealth'), but there is also a significant reliance on American legislation and cases, where appropriate. Because of my background I have drawn on many occasions on Australian law and practice.

Parts of Chapters 2 and 4 draw on two articles that I have had published. First, 'The Framework for Board Accountability in Corporate Governance' (2015) *Legal Studies* and I am thankful to the publisher, John Wiley and Son for permitting me to use some of the contents of the article. Second, I am thankful to Lexis-Nexis (Australia) for permitting to use parts of 'Exploring the Rationale for Board Accountability in Corporate Governance' (2014) 29 *Australian Journal of Corporate Law* 115.

I have several people to thank. I am grateful to Professor Joan Loughrey, my highly valued colleague in the Centre for Business Law and Practice at the University of Leeds, for permitting me to draw on our joint article, 'The Framework for Board Accountability in Corporate Governance' (2015) *Legal Studies*. I also thank her for discussing issues of accountability with me on numerous occasions. The fruit of our discussions has, I am sure, found its way into the pages of the book. I am grateful to Dr Marc Moore for allowing me to read his research and for the discussions I have had with him on several occasions concerning accountability as they have helped me to forge some ideas. I wish to thank the School of Law at the University of Leeds for granting me study leave to assist me to undertake the research for, and to write, the book. Finally, I thank Katie Carpenter for commissioning the work on behalf of Routledge, and Mark Sapwell for liaising with me on behalf of the publisher.

I have endeavoured to state the law as at 30 November 2014.

Andrew Keay
December 2014

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1 Introduction

There is no doubt that corporate governance is a matter that constitutes an important aspect of commercial life today. While the term 'corporate governance' was only coined in the past 30 years, it has been of crucial concern to the commercial world ever since companies started to trade.[1] This book deals with corporate governance, but its primary focus is on one element of it, namely accountability. But accountability in corporate governance can be a reference to the accountability of the company to society or other stakeholders, the accountability of managers to boards or the accountability of the company's board of directors. It is on the last one that the book focuses. The other applications of accountability are also important but warrant a separate treatment.

The importance of corporate governance is made more significant because of the fact that companies are of great consequence in the world of today. They have a great impact on the lives of most people in the world and they have an influence over just about all that we do. Companies that are profit-making undertake a crucial role as the most important institutions for social wealth creation in capitalist economies.[2] Companies provide us with goods and services, employ us, and provide benefits to communities. The influence of the company has led some to claim that it is one of the greatest inventions of humans and because of its existence there has been unimaginable progress of society.[3]

1 In economics it is even traced back to the time of Adam Smith (circa 1776): R. Adams, B. Hermalin and M. Weisbach, 'The Role of Boards of Directors in Corporate Governance: A Conceptual Framework and Survey', (2010) 48 *Journal of Economic Literature* 58 at 96

2 M. Blair, 'For Whom Should Corporations Be Run?: An Economic Rationale for Stakeholder Management', (1998) 31 *Long Range Planning* 195 at 195. Also, see Business Sector Advisory Group, *Corporate Governance: Improving Competitiveness and Access to Capital in Global Markets*, April 1998, chaired by Ira Millstein, Report to the OECD, at 1. Available online at www.keepeek.com/Digital-Asset-Management/oecd/industry-and-services/corporate-governance-improving-competitiveness-and-access-to-capital-in-global-markets_9789264162709-en#page1 (accessed 7 April 2014).

3 J. Micklethwait and A. Wooldridge, *The Company: A Short History of a Revolutionary Idea* (New York, Modern Library, 2003), at xv; T. Lin, 'The Corporate Governance of Iconic Executives', (2011) 87 *Notre Dame Law Review* 351 at 352.

The aim of this chapter is simply to introduce the topic with which the book is concerned.

Companies

It is trite to say that companies are a critical part of the commercial environment. While there are other vehicles through which to conduct businesses, such as partnerships, the company, in one form or another, is the most used structure invoked by businesses around the world for running their activities.[4] Companies are a powerful and very successful instrument for generating wealth and prosperity, and have become a key element of modern society.[5] It has been said that they are the most important organisation in the world.[6] In the United States, companies account for nearly 100 per cent of all national output.[7] The fact is that for well over a century the company has been 'one of the primary institutions of capitalism'[8] and has developed as a frequently used vehicle for the ownership and control of property, the accumulation of capital and the organisation of production.[9] But the company is also the primary vehicle for the conduct of businesses in countries that are not regarded as capitalist in orientation. The power and influence of companies has led some commentators to regard large companies as public institutions with public obligations.[10] These companies have considerable resources to enable them to influence public policies by way of lobbying, sponsoring research, controlling elements of the media, sponsoring political parties and agreeing to establish new branches, offices or factories.[11]

I digress at this point to say that, generally speaking, I use the word 'company' which is the normal term used in the UK and parts of the Commonwealth.

4 O. Couwenberg, 'Corporate Architecture and Limited Liability', (2008) 4 *Review of Law and Economics* 621 at 622.

5 Canadian Democracy and Corporate Accountability Commission, *Canadian Democracy and Corporate Accountability: An Overview of Issues* (Toronto, Canadian Democracy and Corporate Accountability Commission, 2001), at iii and 5. Available online at http://aix1.uottawa.ca/~cforcese/other/commissionpaper.pdf (accessed, 29 March 2014). Also see, L. Canals, 'Rethinking the Firm's Mission and Purpose', (2010) 7 *European Management Review* 195 at 201.

6 J. Micklethwait and A. Wooldridge, *The Company: A Short History of a Revolutionary Idea* (New York, Modern Library, 2003), at xv.

7 R. Estes, *Tyranny of the Bottom Line: Why Corporations Make Good People Do Bad Things* (1996), at 86, and referred to in C. Bagley and K. Page, 'The Devil Made Me Do It: Replacing Corporate Directors' Veil of Secrecy with the Mantle of Stewardship', (1999) 16 *San Diego Law Review* 897 at 899.

8 J. McCahery, S. Picciotto and C. Scott, 'Introduction: Corporate Control: Changing Concepts and Practices of the Firm', in J. McCahery, S. Picciotto and C. Scott (eds), *Corporate Control and Accountability* (Oxford, Clarendon Press, 1993), at 2.

9 Ibid.

10 For example, L. Mitchell, 'Preface', in L. Mitchell (ed.), *Progressive Corporate Law* (Boulder, Westview Press, 1995), at xiii.

11 P. Sikka, 'Corporate Governance: What About the Workers?', (2008) 21 *Accounting, Auditing and Accountability* 955 at 958.

However, I do use the term 'corporation' quite frequently. The term is generally used in the United States, Canada and Australia. Foreign words indicating an incorporated body are translated into English around world as either company or corporation. While the two terms meant different things historically, they have come to mean the same kind of entity, one incorporated under the law, and so nothing will usually turn on which term is used.

The company is popular for a variety of reasons, such as the fact that those who own shares in companies enjoy limited liability and that tax benefits might be available. Some have regarded the company as one of the best systems that humankind has ever designed.[12] Companies have been found to be useful when a business is producing, on a regular and organised basis, goods or services, because in undertaking these tasks it is normal to need a wide variety of inputs, including financial resources, risk-bearing services and decision-making.[13] The company is regarded as being well suited to achieving this as it avoids the costs associated with market transactions involving individuals; the company is able to deal with all of the transactions and this reduces transaction costs and is more economically efficient. Ronald Coase, the renowned economics theorist, took the view that the company permits the collection of various resources, such as capital and labour, without the need to negotiate the terms for each and every use of the resources.[14] Once a company is established it can repeat this for later transactions, and this is beneficial as it reduces the transaction costs.

What is often seen as being attractive about companies is that, as indicated above, the shareholders enjoy limited liability. That is, shareholders are only liable to pay up the money that they owe on the shares that they have agreed to take. Thus, they can know the extent of their liability. This concept it is one of two fundamental principles of corporate law. The other is that the company is a legal personality and entity that is separate from the shareholders and directors. Hence, generally speaking, the shareholders and the directors cannot be liable to others for what the company does or does not do. This is, of course, subject to the possibility that a legislature or a court might provide that directors are liable for certain actions of their companies.[15]

There are various kinds of companies. In most countries the most common type is the private company, as it is known in the UK and many other places. It is referred to in different ways in different countries, such as the closely held corporation in the US or the proprietary company in Australia. These types of companies are small and are usually marked by the fact that the owners of the

12 R. Tricker, *Corporate Governance – Principles, Policies and Practices* (Oxford, Oxford University Press, 2009), at 8.

13 L. Putterman, 'Ownership and the Nature of the Firm', (1993) 17 *Journal of Comparative Economics* 243 at 245.

14 See R. Coase, 'The Nature of the Firm', (1937) 4 *Economica* 386.

15 An example in UK law is s. 214 of the Insolvency Act 1986, which can make directors liable for the liabilities of their companies where they have engaged in what is known as 'wrongful trading'.

company, or at least those with the major shareholding in the company, control the company. This is because the shareholders either are the directors of the company or they nominate the directors of the company. And it is the directors of companies who control the affairs and direction of the company. More will be said about this below.

In most countries, legislation provides for the incorporation of larger companies that are variously known as public companies in the UK and most Commonwealth countries, joint stock companies in China and other descriptors in other places.

Companies are often parts of complex corporate groupings operating in several sectors of industry and commerce, and consisting of many layers of subsidiary companies.[16] They have a professional management and a sophisticated organisational structure. There are many public companies around the world that are huge and their very size means that they have a significant influence on not only individuals, but also on industries and nations. In 2000, the Institute for Policy Studies released a study that showed that of the world's 100 largest economic entities, 51 were corporations and 49 were countries,[17] and 22 American corporations had market capitalisations at the end of the 1990s that were greater than the gross domestic product of 22 countries, countries that included reasonably significant economies such as Spain and Poland.[18] More recently, the figures suggest that the number of companies in the world's 100 largest economic entities has in fact increased to 52.[19]

Public companies in countries that adopt Anglo-American corporate law and governance have tended to be characterised by the concept of ownership without control.[20] This is because the shareholders do not have control of their companies. Control resides with the directors. These companies have historically had a dispersed shareholding with no one shareholder having control of the company. While shareholding in the US and the UK is not as widely dispersed as it once was, it is still rare for one shareholder to have such a substantial shareholding that he or she is able to control the company. Even in countries that

16 A. Keay, *The Corporate Objective* (Cheltenham, Edward Elgar, 2011), at 2–3.

17 S. Anderson and J. Cavanagh, 'Top 200: The Rise of Corporate Global Power', Institute for Policy Studies, 2000. Available online at www.ips-dc.org/downloads/Top_200.pdf (accessed 11 February 2015), and referred in Australian Parliamentary Joint Committee on Corporations and Financial Services, *Corporate Responsibility: Managing Risk and Creating Value* (June 2006), at para 2.39. Available online at www.aph.gov.au/binaries/senate/committee/corporations_ctte/completed_inquiries/2004–07/corporate_responsibility/report/report.pdf (accessed 30 May 2014).

18 G. Morgenson, 'A Company Worth More Than Spain', *New York Times*, 26 December 1999, at 1, and referred to in L. Mitchell, *Corporate Irresponsibility* (New Haven, Yale Press, 2001), at 2.

19 S. Anderson *et al.*, *Field Guide to the Global Economy* (2005, 2nd edn), at 69, and referred to by K. Greenfield, 'Defending Stakeholder Governance', (2008) 58 *Case Western Reserve Law Review* 1043 at n 4.

20 This is actually a problem that has existed for in excess of 400 years and is often seen as the key problem in company law: K. Hopt and P. Leyens, 'Board Models in Europe – Recent Developments of Internal Corporate Governance Structures in German, the United Kingdom, France and Italy', [2004] 1 *European Company and Financial Law Review* 135 at 136.

adopt something that is closer to German corporate law, where there are many fewer shareholders overall and more large shareholders, known as blockholders, shareholders in many of these companies are not able to exert control, or, at least, unlimited control, over the company's affairs. As a result there is concern about how companies are governed.

All companies, whether they are large or small, multinational or local, play a fundamental, multidimensional and evolving role in promoting economic growth.[21] It has been said that 'the corporation provides the legal framework for the development of resources and the generation of wealth in the private sector'.[22] However, large companies do not merely have an influence on economic affairs; their influence, and particularly that of large public companies, has such a reach that they can affect aspects of social and political life as well as economic life.[23] These companies own large amounts of land and other major assets, enter into contracts, borrow money and employ large numbers of people. Because of their power and influence, these companies are able to exert significant influence over what happens in local communities and in the administration of national affairs, and their decisions can determine the rate of growth of particular sectors of business.[24] There are some larger companies that provide public services, such as telecommunications, water, electricity and gas, that are absolutely fundamental to people's lives. Thomas Donaldson[25] has noted that 'large corporations are capable of influencing mainstream societal events and this power is not only economic, but social and political'.[26] One can point to instances of companies operating at a level that is 'beyond that of national law',[27] and acting so as to influence government policy and law-making.[28]

A company comes to life when it is incorporated at the behest of its corporators. Incorporation is an action of the state by which a company is registered. On

21 Department of the Treasury (Australia), *Submission 134*, p. 1, and referred to in Para. 2.34 of the Australian Parliamentary Joint Committee on Corporations and Financial Services, *Corporate Responsibility: Managing Risk and Creating Value*, June 2006. Available online at www.aph.gov.au/binaries/senate/committee/corporations_ctte/completed_inquiries/2004–07/corporate_responsibility/report/report.pdf (accessed 30 May 2014).

22 *Teck Corporation v Millar* (1972) 33 DLR (3d) 288 at 314 per Berger J.

23 S. Bottomley, *The Constitutional Corporation* (Aldershot, Ashgate, 2007), at 3; C. Kaysen, 'The Corporation: How Much Power? What Scope', in E. Mason (ed.), *The Corporation in Modern Society* (Cambridge, MA, Harvard University Press, 1970 reprint), at 99; D. Votaw, 'The Mythology of Corporations' (1962) (Spring) 4 *California Management Review* 58 at 68.

24 Ibid., Kaysen, at 92.

25 *Corporations and Morality* (Englewood Cliffs, NJ, Prentice Hall, 1982), at 7.

26 For further discussion concerning the political nature of a large company, see S. Bottomley, 'From Contractualism to Constitutionalism: A Framework for Corporate Governance', (1997) 19 *Sydney La Review* 277, and his subsequent monograph, *The Constitutional Corporation* (Aldershot, Ashgate, 2007).

27 S. Wheeler, *Corporations and the Third Way* (Oxford, Hart Publishing, 2002), at 10, and referring to F. Johns, 'The Invisibility of the Transnational Corporation: An Analysis of International Law and Legal Theory', (1994) 19 *Melbourne University Law Review* 893.

28 J. Parkinson, *Corporate Power and Responsibility* (Oxford, OUP, 1993), at 19.

incorporation the company is a legal entity. It can do most things that a human being can do at law, such as enter into contracts, own property, take legal action as a claimant (and also be the subject of legal action as a defendant/respondent) and employ persons. The company is a legal person that is separate in law from its directors and shareholders, and this is the case even where the company only has one director and shareholder, as is the case with many private companies.

Boards and management

It is trite to say that companies governed by Anglo-American corporate law are governed by both the general meeting of shareholders and the board of directors,[29] with both being regarded as organs of the company, but typically, today, companies legislation or the company's articles of association (by-laws) will vest the board of directors, elected by the shareholders at a general meeting, with very broad general management powers,[30] many of which are then delegated to company managers and officers.[31] The fact is that shareholders have no interest in managing the company even if they possess significant information about it and its line of business.

In some jurisdictions, such as the US, the UK and Australia, where directors have been given wide-ranging powers, they alone can exercise them, and the only action that the shareholders might be able to take is to pass a special resolution to amend the articles; the shareholders cannot interfere in the exercise of the management power except in very limited circumstances.[32] In some places, such as the US, not even a unanimous vote of shareholders can control the directors.[33] Bernie Sharfman actually refers to the very wide powers of the board granted by legislation in the US as 'staggering'.[34] The consequence, according

29 Boards have certainly been a critical element of the company form since they were first employed: S. Watson, 'The Significance of the Source of the Powers of Boards of Directors in UK Company Law', [2011] *Journal of Business Law* 597 at 601.

30 For example, in the US, see Delaware General Corporation Law §141(a) (2009) and Model Business Corporation Act §8.01 (2008), in New Zealand, see s. 128 of the Companies Act 1993; and in Australia, see s. 198A of the Corporations Act 2001. For a jurisdiction which depends on the articles, see the UK, The Companies (Tables A-F) Regulations 1985 SI 1985/805 Table A Art 70, and The Companies (Model Articles) Regulations 2008 SI 2008/3229 reg 2 and sch 1 Art 5 (private companies); reg 4 and sch 3 Art 5 (public companies).

31 Susan Watson argues that it is not of significance whether the powers are provided for in the articles as opposed to a statute: 'The Significance of the Source of the Powers of Boards of Directors in UK Company Law', [2011] *Journal of Business Law* 597 at 599. For a legislative delegation, see s. 130 of the Companies Act 1993 (NZ).

32 *John Shaw & Sons (Salford) Ltd v Shaw* [1935] 2 KB 113 at 134; *NRMA v Parker* (1986) 4 ACLC 609 at 613–614; *Auer v. Dressel* (1954) 118 NE 2d 590 at 594 (NY). See, *Automatic Self-Cleansing Filter Syndicate Co Ltd v Cunninghame* [1906] 2 Ch 34 at 44; *Ashburton Oil NL v Alpha Minerals NL* (1971) 123 CLR 614. Also, see Article 3 of The Companies (Model Articles) Regulations 2008 SI 2008/3229.

33 S. Bainbridge, *The New Corporate Governance* (Oxford, OUP, 2008), at 34.

34 B. Sharfman, 'What's Wrong with Shareholder Empowerment?' (2012) 37 *Journal of Corporation Law* 903 at 904. But the Association of Chartered Certified Accountants in the UK has taken the view that boards have less control than is often asserted: ACCA, 'Creating Value Through Governance – Towards a New Accountability: A Consultation', February 2014, at 14. Available online at www.accaglobal.com/content/dam/acca/global/PDF-technical/corporate-governance/tech-tp-cvtg.pdf (accessed 21 May 2014).

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