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REFORMS OF CORPORATE GOVERNANCE: COMPETING MODELS AND EMERGING TRENDS IN THE UNITED KINGDOM AND THE EUROPEAN UNION

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I. INTRODUCTION

Large public corporations are hierarchical organizations. The Board of Directors is generally at the apex of the hierarchy. Most formal legal authority within the corporation is vested in the Board, although the Board delegates much of its authority to executive officers, who in turn delegate much to middle-level managers, and so on down.

The predominant academic view of corporate law today rests on the principal-agent paradigm. Most corporate law scholarship has continued to analyze corporate law in terms of agency relationships, as based upon the classic Berle-Means-type separation of ownership and control under a dispersed ownership structure. Corporate law places a great deal of authority in the Board. However, the reality is that the CEO wields primacy. The CEO dominated corporate governance system aided in igniting the current economic crisis, wherein many CEOs encouraged corporate practices aimed at short-term share price maximization and ignored long-term risks.

Corporate law has mechanisms to hold boards accountable for gross misuse of their authority. However, those mechanisms are quite limited due to the shareholders’ collective action. Corporate law must balance authority against accountability, but most of the time, in the United States, corporate law strikes that balance in favor of authority. Many corporate law scholars have argued for corporate law reforms that give more strength to legal accountability mechanisms, such as shareholder voting, shareholder bylaws, or derivative suits. One of the essential normative questions in

corporate law is how the market should balance authority against accountability.

Berle and Means are still correct. The status quo in a modern public corporation is not traditional shareholder primacy, team production, or director primacy. Rather, it is CEO domination. If boards, prior to the financial crisis, had successfully monitored serious events, such as the recent financial crisis, by relying on independent information, they might have been able to challenge their CEOs and executive officers to increase the long-term well-being and value of their corporations. The interests of not only shareholders but also other corporate constituencies and that of the public would be far better served with shareholder primacy. Corporate governance reform must focus primarily on promoting the long-term well-being of the corporation, balancing constituencies’ interests, and ensuring accountability. There are various approaches to achieving such goals.

This paper considers the implications of the enlightened shareholder value model and other reforms made in the United Kingdom (U.K.) and the European Union (E.U.), and proposes corporate law reforms that give more strength to accountability mechanisms. Part II describes and analyzes two views of the corporation: the agency model and the team production model. It explains why the team production model offers a false account of current reality, and then moves to the director primacy model. Part III discusses the functions of a public corporation. Independent monitoring boards currently cannot discover any serious problems with the business decisions of executive officers because independent directors inevitably rely heavily on corporate officers for information used in monitoring tasks. This also holds true for the director primacy model and the team production model. Part IV proposes a corporate governance reform that is embodied in the enlightened shareholders value model, which was a part of the 2006 U.K. Companies Act and other reforms made in the United Kingdom and the E.U.; this suggests that the Board should promote the long-term well-being of the corporation, balancing constituencies’ interests and ensuring accountability.

II. BACKGROUND: TWO VIEWS OF THE CORPORATION

The current discussion related to policy issues on corporate law is based on the economic theory of the firm. Depending upon how
we analyze such theories, there are two primary perspectives: the agency model and the team production model. Whereas the former emphasizes the principal-agent relationship between shareholders and managers, the latter brings other non-shareholder constituencies into consideration. These models are analyzed in a descriptive and normative light.

A. AGENCY THEORY

The agency view dominates most corporate law scholarship today. In 1932, Adolf Berle and Gardiner Means were the first to empirically identify the strong separation of ownership between shareholders and managers’ control in large U.S. corporations. They argued that most public corporations are not operated in the interests of their owners, the shareholders, but in the interests of their agents, the managers. Around the 1970s, legal scholars developed the theory of the firm, based on the economic theories of Ronald Coase and other forerunners, which focused primarily on efficiency and the firm’s role as a device for minimizing transaction costs within production processes. According to the “nexus of contracts model,” which is now the dominant corporate law theory, a firm is made up of various explicit and implicit contracts among a firm’s constituencies. In other words, the firm is a complex “aggregate of various inputs acting together to produce goods or services.” While Michael Jensen and William Meckling emphasized the nature of the firm as a nexus of contracts—a center of coordination of productive factors consisting of explicit and implicit contracts—the nature of

1 See Adolf A. Berle & Gardiner C. Means, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).
2 See id. at 124.
the firm as a legal entity is not explained under the terms of the theory. The nexus at the center of Jensen and Meckling’s firm is a mere legal fiction; it is “not an individual” and has no real independent existence.\textsuperscript{7} Jensen and Meckling then focused on agency costs, which the upper-level managers created (who are charged with doing as the principal’s request).\textsuperscript{8} The agency costs represent conflicts of interest between shareholders, which consist of monitoring costs, bonding costs, and residual losses that contractual mechanisms cannot entirely eliminate.\textsuperscript{9} The nexus of contracts theory has been influential in shaping corporate law theory over the past three decades.\textsuperscript{10}

This theory is not truly a theory of the firm at all because it “says nothing about why firms exist or what kind of activity is undertaken by a certain firm.”\textsuperscript{11} Rather, it is only a theory of agency costs within certain types of firms, including corporations.\textsuperscript{12} If a corporation is really no more than a nexus of contracts under the theory, there should be no need for corporations or corporate law. If the notion of corporations is not necessary, there is no need for the law to create and support them. Thus, the nexus of contracts theory has been argued outside of the theory of the firm and as a descriptive model for corporate law scholars.

However, the nexus of contracts theory argues that corporate law represents several default contracts that permit the involved parties to opt out of these relations through agreement.\textsuperscript{13} Consequently, its proponents assert that corporate law should be mostly non-mandatory to provide private parties with the opportunity to spontaneously order

\begin{itemize}
  \item \textsuperscript{7} Jensen & Meckling, supra note 5, at 311; Stephen M. Bainbridge, \textit{Abolishing Veil Piercing}, 26 J. CORP. L. 479, 485 (2001) (“[T]he firm is not a thing, but rather a nexus or web of explicit and implicit contracts.”).
  \item \textsuperscript{8} See Jensen & Meckling, supra note 5, at 311.
  \item \textsuperscript{9} Id. at 310-11.
  \item \textsuperscript{10} See, e.g., Easterbrook & Fischel, supra note 6, at 1–39 (discussing the corporate contract); Thomas S. Ulen, \textit{The Coasean Firm in Law and Economics}, 18 J. CORP. L. 301, 318–27 (1993) (discussing the importance and impact of the nexus-of-contracts theory).
  \item \textsuperscript{12} See Oliver Hart, \textit{An Economist’s Perspective on the Theory of the Firm}, 89 COLUM. L. REV. 1757, 1763–65 (1989).
  \item \textsuperscript{13} Ulen, supra note 10, at 322.
\end{itemize}
their affairs as they deem appropriate. Thus, the proponents of the nexus of contracts theory have emphasized the non-mandatory nature of corporate law, and they have counseled against changes to the status quo based on the contractual nature of that status quo.

Leading contractarians also adopt the traditional “shareholder primacy” argument that shareholders, as the firm’s residual claimants, are assumed to act as the ultimate principals in agency contracts that hire the firm’s productive resources, thereby establishing the nexus that makes up the firm. Directors and officers are treated under such contracts as contractual agents of the shareholders, with fiduciary obligations to maximize shareholder wealth. Thus, according to the nexus of contracts theory, shareholders retain a privileged position among the various contracting parties that constitute the firm, while the interests of non-shareholder constituencies remain subordinated. However, it is generally acknowledged that shareholder wealth maximization is itself only a norm of corporate behavior, rather than a legal rule. Indeed, neither case law nor corporate statutes impose on directors and officers an obligation to maximize shareholder wealth. Even in Delaware, whose corporate code is less amenable to stakeholder interests than many other state corporate statutes, management’s decision-making is not required to maximize shareholder wealth, nor are shareholders’ interests the only ones that justify management’s decisions. Moreover, the Delaware courts have held that directors and officers have a fiduciary duty to act in the best interests of the corporation,

14 Id. at 324.
15 Id. at 322–23 (discussing the overall impact of the theory).
17 Id. at 548.
18 Id.
21 See Fisch, supra note 19, at 652 (observing that Delaware’s corporate statute is silent both with respect to the standard by which board decisions are evaluated and with respect to the stakeholders, whose interests may legitimately be taken into account).
and not only in the interests of the shareholders. The courts also state that fiduciary duties are owed to “the corporation and its stockholders.” Consequently, courts will not second-guess directors’ business judgment that is based on concerns about employees, communities, and other non-shareholder constituencies without finding a clear breach of fiduciary duty.

The nexus of contracts theory has attracted considerable critique, wherein it is premised on the assumption of the “Coasean World” of an ideal market comprised of perfectly rational economic decision-makers. Moreover, as stated above, a necessity for corporations or corporate law is uncertain under the theory, because the theory is only a theory of agency costs and a corporation is no more than a nexus of contracts. Certainly, the fundamental corporate governance structures and mechanisms that Berle-Means-type corporations in the United States adopted are conceived as static and uniform. However, the corporate governance structures in public corporations vary, and thereby, there is no ideal stock market as well.

B. TEAM PRODUCTION THEORY

Generally, under state corporate statutes, shareholders alone enjoy voting rights, information rights, and the right to bring derivative suits. In a series of articles, Margaret Blair and Lynn Stout have developed a team production theory of corporate law wherein they argue that the Board’s role is not to solely act for the shareholders’ interests; rather, its role is to act as a mediating hierarch, balancing the interests of the various corporate constituencies.

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22 See Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (overruled on other grounds by Brehm v. Eisner, 746 A.2d 244, 254 (Del. 2000)).

23 Arnold v. Soc’y for Sav. Bancorp, Inc., 678 A.2d 533, 539 (Del. 1996); see also, Loft, Inc. v. Guth, 2 A.2d 225, 238 (Del. Ch. 1938); (aff’d sub nom. Guth v. Loft, Inc., 5 A.2d 503 (Del. 1939)).


I. DESCRIPTION OF THE THEORY

Like the nexus of contracts theory, the team production model views the firm as a series of relationships between various constituencies. While arguing that the Board of Directors serves as the ultimate authority in assigning responsibilities, mediating disputes, and distributing profits, Blair and Stout do not claim that the goal of the corporation should be shareholder wealth maximization. Instead, the corporation is made up of all constituencies who are responsible for the business of the enterprise, and the directors have a responsibility to all of these constituencies in the corporate enterprise. Blair and Stout argue that “the way in which corporate law actually works in practice is consistent with the notion that directors are independent hierarchs whose duties run chiefly to the corporate entity itself and only instrumentally to all of its constituencies.” Thus, directors are not mere agents because “they are not subject to direct control or supervision by anyone,” including the shareholders, while also a unique form of fiduciary who most closely resemble trustees.

Crucially, control over the firm’s assets is not actually given to shareholders but to the legal entity of the firm itself. Team members submit to the hierarchy and the ownership on their own, as this is beneficial for them. Blair and Stout argue that shareholders are not the only residual risk bearers within a corporation. Additionally, other corporate constituencies who are also the residual risk-bearers frequently make firm-specific investments—for example, employees specialize their human capital. Such investments are obviously essential for the creation of value in the firm. Therefore, it

26 Id. at 254 (asserting the team production approach is “consistent with the ‘nexus of contracts’ approach”).
27 Id. at 251.
28 See id. at 253.
29 Id. at 289.
30 Id. at 290-91.
31 Id. at 274 n.57.
32 Id. at 278.
34 See id. at 418. (“Creditors, managers, employees—even suppliers, customers, and communities—also make firm-specific investments that tie their economic fortunes to the firm’s fate”.)
seems appropriate and necessary for team members who make firm-specific investments to delegate exclusive authority to the Board of Directors as a mediating hierarch to organize the firm’s inputs, distribute its outputs, and resolve interest conflicts among the team members.\textsuperscript{35} In a more descriptive manner, each team member charges the Board of Directors with (1) mediating among the conflicting interests of all the constituencies and (2) protecting all constituencies’ return on their respective investments from post-investment opportunistic behavior by other constituencies.\textsuperscript{36} The Board of Directors is not a team member and must be independent of any of the team members,\textsuperscript{37} which implies that the Board has no expectation of sharing in the value that the team created. Given the firm-specific investments the team members made, the Board serves similarly to a trustee\textsuperscript{38} (“trusted mediator”\textsuperscript{39}) or fiduciary\textsuperscript{40} for the entire firm, but it remains insulated from any direct team member control. As “mediating hierarchs” standing among all constituencies, including shareholders, directors are to assume the task of balancing conflicting interests and, if necessary, rearranging production factors.\textsuperscript{41} Thus, Blair and Stout interpret the Board’s duty to serve the interests of the corporation not as shareholder interest, but as the aggregate welfare function.\textsuperscript{42} 

2. \textbf{Precursor of the Theory}

Blair and Stout’s team production model is deeply dependent upon the works of Alchian and Demsetz, and Rajan and Zingales for a new school of corporate law and economics based on the theory of the firm.\textsuperscript{43} Blair and Stout discuss the principal-agent and property rights approaches and draw comprehensively on the work of Alchian

\textsuperscript{35} Id. at 421.
\textsuperscript{36} See id. (Because the team members cede control over “team specific inputs and surplus that results from team production,” to the Board of Directors, the team members charge and entrust the Board of Directors with these duties).
\textsuperscript{37} Id. (“It is essential that the hierarch remains free from the command and control of any of the team members”).
\textsuperscript{38} Blair & Stout, supra note 25, at 291.
\textsuperscript{39} Blair & Stout, supra note 33, at 408.
\textsuperscript{40} Blair & Stout, supra note 25, at 291.
\textsuperscript{41} Blair & Stout, supra note 33, at 421.
\textsuperscript{42} Blair & Stout, supra note 25, at 288–89.
\textsuperscript{43} See id. at 265-69
and Demsetz in conceptualizing the firm as a method for coordinating production. Then, they move on to consider the work of Holmstrom, Tirole, and Rajan and Zingales in developing their own team production model.

“With team production it is difficult, solely by observing total output, either to define or determine each member’s contribution to this output of the cooperating inputs.” In accordance with Alchian and Demsetz, for team production to be successful, several contributors must put forth investments of resources, in certain circumstances, in which the team’s created value is observable. However, it is difficult to define the contribution of each to this value. A difficulty arises in designing payment schemes as to how to counteract the incentives of the team members to shirk since the rewarding is not made on the basis of actual individual contributions. Alchian and Demsetz argue that monitoring and sanctioning generally counteract shirking incentives within team production. Individuals have an incentive to free ride on the contributions of others, which is disadvantageous for the whole team. The monitor would be entitled to retain all of the team’s produced value, after compensating the other team members for their contributions with fixed rewards, which input markets determine. The residual claimant provides the monitor with appropriate incentives to assemble a productive team and pay close attention to the other team members’ contributions. Alchian and Demsetz maintain that one of the essential characteristics of firms is that they solve the problem of shirking through the introduction of a centralized contractual agent, that is, an owner-manager or a manager.

44 Id. at 265-66.
48 Alchain & Demsetz, supra note 6, at 779.
49 Id.
50 Id.
51 Id. at 779-81.
52 Id. at 781-83.
53 Id. at 779-81.
54 Id. at 781-83.
55 Id. at 779-81.
who is equipped with the capability of monitoring and the right to sanction the behavior of all team members.56

One difficulty with Alchian and Demsetz’s model is that shareholders in a large public corporation do not, in fact, play such an active role as the monitor and residual claimant that the model predicts. Another problem with the model is that it does not consider the problems associated with firm-specific investments.57 As Blair and Stout argue, the public corporation is not a “nexus of contracts,” but a “nexus of firm-specific investments,” wherein “several different groups contribute unique and essential resources to the” firm, and each group finds “it difficult to protect its contribution through explicit contracts.”58 Further, the firm-specific investments, once made, become well sunk in the firm.”59 These investments reduce the team members’ mobility,60 and therefore expose the contributors “to opportunistic exploitation by other team members.”61

Assuming that the firm is made up of firm-specific investments, Rajan and Zingales developed a theory of the firm based on the property rights approach in terms of power and access to resources.62 They further discuss the risks of underinvestment associated with firm-specific investments: any party not in control of firm-specific investments has an incentive to under invest thereby avoiding a controlling party, while firm-specific investments may make it less lucrative to sell the property rights to a third party.63

3. CRITIQUE

Blair and Stout developed their team production model to serve both positive and normative purposes.64 They contend that the team

56 Id.
57 Blair & Stout, supra note 25, at 275; see also, e.g., Rajan & Zingales, supra note 47; Oliver E. Williamson, Calculativeness, Trust, and Economic Organization, 36 J. L. & ECON. 453 (1993).
58 Blair & Stout, supra note 25, at 275.
59 Id. at 276. See infra text accompanying notes 64-69.
60 Id. at 277–79 (observing participants having made firm-specific investments as “‘stuck’ in the firm”).
61 Id. at 276.
62 Rajan & Zingales, supra note 47.
63 Id. at 406-11 (relaxing the assumption that the value of an asset for other uses increases at least somewhat with specific investments).
64 Blair & Stout, supra note 25, at 288–289.
production model better reflects the law’s approach to the corporation as directors left alone to manage the corporate affairs.\textsuperscript{65} According to Blair and Stout, however, the team production model requires the Board of Directors to serve all constituencies, rather than the shareholders alone.\textsuperscript{66} They also argue that the model is a better positivist approach—in that a board balances interests among various constituencies in practice—as well as a better normative approach.\textsuperscript{67} In fact, U.S. corporate law gives directors remarkable discretion to sacrifice shareholders’ interests in favor of management, employees, and other non-shareholder constituencies.\textsuperscript{68} Further, statutes in over half the states expressly allow boards to weigh non-shareholder interests for takeover threats.\textsuperscript{69} Directors have broad discretion to adopt takeover defenses, which allows them to promote other constituencies’ interests over short-term shareholder wealth maximization.\textsuperscript{70} The team production model offers incentives for all team members and describes the fundamental contracting problem that corporate law attempts to resolve.\textsuperscript{71} However, the team production theory attracted considerable criticism directed at its descriptive and normative claims.\textsuperscript{72}

In terms of the descriptive claim, criticism of the team production theory indicates that boards of directors are not in fact independent; in reality, management often dominates them even in

\textsuperscript{65} \textit{Id.} at 287-319.
\textsuperscript{66} \textit{Id.} at 288.
\textsuperscript{67} \textit{Id.} at 290-92.
\textsuperscript{68} \textit{Id.} at 327-28 n.208.
\textsuperscript{69} \textit{See id.} at 303-04 n.144 (stating that twenty-eight states allow directors to consider non-shareholder interests); Lawrence E. Mitchell, \textit{A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes}, 70 TEX. L. REV. 579 n.1, 587 n.33 (1992) (listing the statutes).
\textsuperscript{70} \textit{See Fisch, supra} note 19, at 651.
\textsuperscript{71} Blair & Stout, \textit{ supra} note 25, at 327-28.
corporations with a majority of non-management directors. Moreover, critics claim that Blair and Stout overlook the impact of the stock market. Boards cannot ignore the impact due to fluctuation in the stock prices. The theory depends upon the Board’s independence and neutrality with respect to potentially conflicting interests between shareholders and non-shareholder constituencies. Blair and Stout assert that corporate law reflects their argument that it vests the directors with the exclusive power to manage the corporation and insulates them from shareholder interference or any other team member. The greater concern is whether boards actually function as the team production model says they should; in reality, a strong preference for short-term share price maximization binds directors because this is what most institutional shareholders want. Thus, the problem with the team production model is that boards are not in fact independent at all and do not have board discretion, and directors do not and cannot behave the way the theory says they should.

Under U.S. corporate law, however, shareholders alone enjoy voting rights, information rights, and the right to bring derivative suits. Blair and Stout argue that, although shareholders alone have the right to elect directors, this does not impair the Board’s independence because the very large number of shareholders means that voting in most public corporations is a “meaningless rite.” The argument is not persuasive in terms of a normative claim, although the reality is such as they argue. Furthermore, it is doubtful that the team production model provides the Board with any incentive to

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73 Coates, supra note 72 at 845-47.
74 Id. at 849.
75 See Henry G. Manne, Mergers and the Market for Corporate Control, 73 J. Pol. Econ. 110 (1965) (arguing that boards and managers have an incentive to maximize the stock price, independently of any legal duty to do so, because a depressed stock price makes the corporation a potential takeover target and thereby jeopardizes the incumbent directors’ and managers’ positions).
76 See generally Blair & Stout, supra note 33, at 416-18 (detailing the relationship between shareholders and non-shareholders).
77 Id. at 423-24.
78 Id. at 428-30.
80 Blair & Stout, supra note 33, at 409 n.10.
81 Id. at 434.
perform its duties conscientiously.\textsuperscript{82} Therefore, from the normative aspect, Blair and Stout’s argument is controversial.

\textbf{C. Tentative Conclusion—Director Primacy}

From the normative and positive aspects, the nexus of contracts model is slightly ahead of the team production model. However, in terms of the discretionary powers of the Board of Directors, the director primacy model is somewhat further ahead. Proponents of the director primacy model claim that boards must be mostly free of shareholder interference to serve shareholder interests.\textsuperscript{83}

Stephen Bainbridge draws upon the theory of the firm (in contrast to the team production theory but in accordance with the nexus of contracts theory), arguing that shareholders alone, as opposed to other stakeholders, are the appropriate beneficiaries of director fiduciary duties.\textsuperscript{84} According to the director primacy model, directors are ultimately responsible for shareholder wealth maximization, rather than promoting stakeholder interests,\textsuperscript{85} and the interests of shareholders should prevail over those of any other constituencies.\textsuperscript{86} Additionally, directors (rather than managers, shareholders, and stakeholders) are completely responsible for control over the corporation.\textsuperscript{87} Bainbridge recognizes that directors are in the role of “Platonic guardians,” that is, a form of trustee similar to the philosopher kings in Plato’s Republic.\textsuperscript{88} Under the director primacy theory, the focus is not on a firm’s nature as a nexus of contracts; rather, Bainbridge argues that the firm has a nexus of its contracts which is a board of directors well-equipped with the ultimate “power of fiat.”\textsuperscript{89} He argues that the powers of the Board of Directors are original and undelegated, and that neither shareholders

\begin{itemize}
  \item \textsuperscript{82} Meese, \textit{supra} note 72, at 1665-66.
  \item \textsuperscript{83} See Kostant, \textit{supra} note 72, at 693-94.
  \item \textsuperscript{84} Bainbridge, \textit{supra} note 7, at 550.
  \item \textsuperscript{85} \textit{Id.} at 572.
  \item \textsuperscript{86} \textit{Id.} at 577-85.
  \item \textsuperscript{87} \textit{Id.} at 550.
  \item \textsuperscript{88} \textit{Id.} at 550-51, 560; see also Stephen M. Bainbridge, \textit{The Board of Directors as Nexus of Contracts}, 88 \textit{Iowa L. Rev.} 1, 8 & n.28 (2002) (referring to the Board again as a “sui generis body”).
  \item \textsuperscript{89} \textit{E.g.}, Bainbridge, \textit{supra} note 16, at 554-60.
\end{itemize}
nor courts should weaken the Board’s decision-making authority.\textsuperscript{90} The Board negotiates with and hires the various factors of production or “capital.”\textsuperscript{91} Thus, the Board of Directors, not shareholders, is—and should be—in control of the corporation, exercising almost unconstrained authority to ensure corporate decision-making efficiency.

Bainbridge argues that there is a core tension between the Board’s authority and the responsible exercise of such authority; shareholder voting rights are one of the mechanisms that hold directors accountable.\textsuperscript{92} An increase in shareholders’ right to review board decisions might weaken the core of corporate governance and shifting the power of decision-making to shareholders is undesirable in itself in accordance with director primacy.\textsuperscript{93} As a positive matter, Bainbridge contends that the director-centered model of the firm matches both modern corporate practice and the structure of most state laws (particularly Delaware, the dominant model).\textsuperscript{94} As noted above, however, director primacy might also face difficulties because of CEO domination and performance of some functions required under corporate governance. Part III addresses such functions and the reality in which the shift of authority to the independent board has weakened boards. Thus, CEOs find themselves in an extremely powerful position.

### III. MONITORING AND MANAGEMENT FUNCTIONS

This part first addresses the functions that corporate law asserts a board of directors should perform and then argues that a board of directors, in a large public corporation, is ineffective for performing such functions. Boards of public corporations primarily have two areas: monitoring the activities of the corporate executives and managing the corporation’s business affairs.\textsuperscript{95} The Board’s

\begin{itemize}
  \item \textsuperscript{90} Bainbridge, supra note 4, at 11-12 (stating shareholder wealth maximization is the law in the United States).
  \item \textsuperscript{91} Bainbridge, supra note 16, at 560.
  \item \textsuperscript{92} \textit{Id.} at 555-60.
  \item \textsuperscript{93} \textit{Id.} at 557-59.
  \item \textsuperscript{94} \textit{Id.} at 568-74; \textit{see also} Bainbridge, supra note 4, at 105-53 (providing an extensive discussion of director primacy’s role within the law).
  \item \textsuperscript{95} \textit{Compare}, Kelli A. Alces, Beyond the Board of Directors, 46 WAKE FOREST L. REV. 783, 790–805 (2011) (discussing the dual monitoring and management functions of the modern board), with STEPHEN M.
management responsibilities essentially involve making the final decision on major issues, such as issuing dividends, pursuing mergers and acquisitions, and the like. In contrast, the Board’s monitoring responsibilities primarily involve appointing the CEO and evaluating the management team. A public corporation’s Board of Directors has various degrees of autonomy and control in relation to the corporation’s CEO.

Modern corporate law includes the notion of a “monitoring” board, which usually requires the Board to have independent directors. “Independent” directors are assumed to have little or no personal or financial relationship with the firm. Part-time, or independent directors, are arguably never equipped to make corporate policy or manage the corporate business. Will they be ill-equipped in the context of monitoring? Melvin Eisenberg challenged the insider-dominated boards of the day and argued that the modern board should serve as an independent monitor that works to protect shareholder interests. Eisenberg asserted that there is one function that the Board can perform better than any other corporate group: “Selecting, monitoring[,] and removing the members of the chief executive’s office.” Through the notion of the monitoring board, Eisenberg tried to change the reality so that it was not the Board, but the executives who actually managed the

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BAINBRIDGE, CORPORATE GOVERNANCE AFTER THE FINANCIAL CRISIS 49–50, 61 (2012) (indicating that the literature identifies three functions for the public board: (1) monitoring and disciplining management, (2) providing advice and guidance to managers, and (3) providing a network of useful political and business contacts.).

96 Alces, supra note 95, at 798.


98 Bainbridge, supra note 16, at 559-60 (from a legal perspective, any control a CEO has is delegated from the Board to the CEO – the Board ultimately retains control.). See also DEL. CODE ANN. tit. 8, § 141(a) (2013).


100 Melvin Aron Eisenberg, Legal Models of Management Structure in the Modern Corporation: Officers, Directors, and Accountants, 63 CALIF. L. REV. 375, 387 (1975).


102 Id. at 170.
corporation. By the end of the 1970s, the ideal board became a monitoring board rather than a merely nominal body. If a board is free of conflicts of interests—that is, free of ties to the CEO—then it is ideal for the Board to monitor the CEO’s performance. Thus, Eisenberg’s innovative notion of the independent monitoring board now dominates corporate governance.

Therefore, the independent board monitors executive officers, including CEOs, to ensure that they run the corporation for the benefit of the shareholders. Indeed, increasing Board independence has been the key to corporate governance reform for the past three decades. In designing a monitoring board for a public corporation, federal and state laws, as well as public listing rules, have required that only “independent” board members be allowed to perform certain functions. After the Enron and WorldCom scandals, the Sarbanes-Oxley Act of 2002 effectively required an independent audit committee. Furthermore, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 stipulated that public corporations must have independent audit and compensation committees. The rules of the Securities and Exchange Commission (SEC), the New York Stock Exchange (NYSE), and the National Association of Securities Dealers Automated Quotations (NASDAQ) influenced most large public corporations to have a majority of independent directors on the full board and on several oversight committees. However, these reforms have not improved

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103 Id. at 140.
105 See also Bainbridge, supra note 4, at 53.
106 Roberta S. Karmel, Should a Duty to the Corporation Be Imposed on Institutional Shareholders?, 60 BUS. LAW. 1, 17 (2004) (describing the ALI’s Corporate Governance Project).
board performance, which some commentators have pointed out.110 Thus, in terms of the efficacy of corporate governance, repeated regulatory efforts to increase board independence have unfortunately proved futile or even counterproductive.

First, the independent monitoring board has been criticized for being ineffective at performing even the most basic monitoring function.111 Directors inevitably rely heavily on executive officers for the information they use in monitoring tasks.112 Moreover, directors from outside the corporation or the industry only have limited channels to obtain the corporation’s or the industry’s inside information, and therefore have to depend heavily on executive officers for information about the corporation and the industry. Furthermore, they have limited time, expertise, and attention to devote to conducting the corporation’s business affairs. Ironically, the shift to the independent board has weakened boards and, moreover, placed the CEO in an extremely powerful position in a corporation.

Directors are at a disadvantage in monitoring executive officers, because they cannot avoid relying heavily on those officers for the information they use to monitor themselves. This problem with the monitoring structure became apparent particularly during the recent financial crisis.113 Independent monitoring boards could not discover any serious problems with the business decisions that executive officers were making and, thus, could not prevent the collapse of

111 Fisch, supra note 97, at 268–70.
112 Alces, supra note 95, at 795.
113 See generally Lisa Fairfax, Government Governance and the Need to Reconcile Government Regulation with Board Fiduciary Duties, 95 MINN. L. REV. 1692 (2011).
financial firms. As Lawrence Mitchell pointed out, the CEO can easily manipulate or suppress the information provided to the Board because the position is typically the sole, or nearly sole, source of information for the Board.\footnote{Lawrence E. Mitchell, \textit{Structural Holes, CEOs, and Informational Monopolies: The Missing Link in Corporate Governance}, 70 BROOKLYN. L. REV. 1313, 1350 (2005).} Thus, most boards are rather passive, because CEOs dominate the Board and employ their power in their own interests.\footnote{Charles M. Elson, \textit{Director Compensation and the Management-Captured Board – The History of a Symptom and a Cure}, 50 SMU L. REV. 127, 127 (1996). See generally Laura Lin, \textit{The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence}, 90 NW. U. L. REV. 898, 898–903, 913–17 (1996) (cataloging the many ways in which CEOs dominate outside directors).} If the Board remains passive, there is no one who actively questions and challenges the CEO’s or management’s decisions. If boards had successfully monitored serious events, such as the recent financial crisis, and relied on their independent information, they might have been able to challenge the CEOs and management on the long-term wisdom of these decisions. It is difficult to provide independent directors with strong incentives to monitor executive officers more carefully.\footnote{Ronald J. Gilson & Reiner Kraakman, \textit{Reinventing the Outside Director: An Agenda for Institutional Investors}, 43 STAN. L. REV. 863, 875 (1991).}

In terms of management function, most boards of modern public corporations are now composed of mostly independent directors; however, it has been general practice for the CEO to serve as the chairman of the Board of Directors.\footnote{See Robert W. Hamilton, \textit{Corporate Governance in America 1950–2000: Major Changes But Uncertain Benefits}, 25 J. CORP. L. 349, 351 (2000).} That means the CEO sets the Board’s agenda and calls board meetings. In most instances, the work of inside directors is most important to the Board’s management function, because they know more about the day-to-day business of the firm as well as its relationship with the various corporate constituencies. As noted above, the Board must rely heavily on inside directors for information and judgment, and the Board’s independence may, paradoxically, obstruct its ability to make independent business decisions. Independent directors are ill-equipped to second-guess the decisions of the CEO and the
management team. Further, outside directors may avoid asking complex questions and presenting strategic alternatives. Thus, the independent board is not well-equipped to make final decisions and must rely heavily on the information and judgment of others who are more involved in the everyday business of the corporation.

Therefore, it is not assumed to be the outside board members but the executive officers who work most directly and closely with various constituencies and perform the mediation function in the firm. Contrary to the claims of the team production model, boards of most public corporations do not serve as independent mediators of conflicting interests between shareholders and other stakeholders. The Board does not and cannot perform a meaningfully independent role in significant decision-making. Senior officers, through the interaction of corporate constituencies with the firm’s managers, largely decide the day-to-day business of the corporation. Even if a corporation moves to the adoption of supermajority independent boards, the CEO, paradoxically, continues to be the significant decision-maker in the modern public corporation. Corporate governance theory generally ignores this reality, at least for public corporations.

The team production model assumes that directors actively and continuously mediate among the various interests of shareholder, labor, management, community, and any other stakeholders. As some commentators point out, mediating among corporate constituencies “requires a solid operational knowledge of the rights each party has” in relation to the corporation and of the corporation’s corresponding obligations. However, the modern part-time board member simply is not expected to take such an active role in management. While in the real world, senior officers know much more about such a role than the Board does and often negotiate the firm’s contracts on its behalf; the Board must rely heavily on senior officers for independent monitoring to adjust and mediate the

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118 Gilson & Kraakman, supra note 116, at 889 (observing that outside directors rarely exercise their judgment today, not only because they lack the time and the incentives to do so but also “because board meetings are dominated by a management ethos of forced collegiality and agreement”).

119 Id.

120 Alces, supra note 95, at 801.
different claims of different constituencies. In sum, independent directors are ill-equipped to serve as mediators of diverse and conflicting corporate constituency interests. Thus, the mediator of such constituency interests, if any, is not the Board but the CEO, even if the Board is assumed to mediate between corporate constituencies under the team production theory. Therefore, it may be unconvincing to argue that the Board is in a particularly good position to perform the mediation function. Hence, the team production model might not signify the reality in the firm. Additionally, in the real world, director primacy might also face the same difficulties for the same reason of CEO domination.

IV. A PROPOSAL FOR CORPORATE GOVERNANCE REFORMS: ENLIGHTENED SHAREHOLDER VALUE MODEL

One of the key tensions within any system of corporate governance is the necessary trade-off between authority and accountability. In that case, the underlying issue in corporate governance is the need for balance between the authority granted to directors and accountability for the directors’ actions which shareholders seek. Bainbridge also argues that there is an inherent “tension between authority and accountability” under the director primacy model, such that when shareholders provide capital to a

\[121\] See, e.g., Anne Tucket Nees, Who’s the Boss? Unmasking Oversight Liability within the Corporate Puzzle, 35 DEL. J. CORP. L. 199, 251 (2010).

\[122\] Additionally, as noted in Part III, the team production theory opposes the structure of modern U.S. corporate law in which shareholders alone enjoy the right of electing directors and the corporate objective of shareholder wealth maximization.

\[123\] See Bainbridge, supra note 16, at 567, 569 (regarding the Board as both the ultimate monitor and a body that exercises fiat in the corporation).

\[124\] E.g., Stephen Bainbridge, Bruner on Director Primacy and Other Pure Theories of Corporate Governance, businessassociationsblog.com (Sept. 4, 2007), http://www.businessassociationsblog.com/lawandbusiness/comments/brunerondirectorprimacyandotherpuretheoriesofcorporategovernance/ (stating that corporate governance reflects the balancing of “two competing values” – “authority and accountability,” which are “ultimately irreconcilable”).

corporation they implicitly contract for the directors to pursue shareholder wealth maximization.\textsuperscript{126} Thus, we first have to discuss whether the governance structure ensures that the accountability will be appropriate for the Board’s authority.

Another factor to consider is that the economic crisis exposed substantial issues which stemmed from the connection of CEO compensation incentives with short-term gains. This problem has become more serious due to the passivity of modern public boards, which simply obey the CEO’s decisions and accept the information he/she provides. The corporate governance structure must be reformed to read just such an incentive structure in favor of the long-term well-being of the corporation. George Dent argues that shareholder rights must be expanded to achieve the goal of addressing the issue of CEO domination.\textsuperscript{127} However, transferring power from CEOs to shareholders will not necessarily solve this problem. Proposals to increase shareholder power are criticized for being ineffective and inadequate partly because shareholders are at an informational disadvantage and partly because they tend to be indifferent to their voting power and to another kind of shareholder power, such as derivative suits and information rights.\textsuperscript{128} If the goal of corporate governance reform is to increase the long-term well-being and value of the corporation, some shareholders may have a short-term bias that prevents CEOs from effectively achieving this long-term goal.

As noted above, independent mediators of conflicting interests in most public corporations are not a board of directors but CEOs. In a normative light, the Board should still serve as both a monitor for mediating constituencies’ interests in relation to the CEO and as a manager that makes a final decision on fundamental corporate issues through considering such constituencies’ interests. The team production theory has provided the perspective that the Board of Directors should assume the role of a mediating hierarch among all

\textsuperscript{126} Bainbridge \textit{supra} note 16, at, 605, 573 (arguing the key to corporate governance lies in maintaining the proper balance of authority and accountability).


\textsuperscript{128} See, \textit{e.g.}, Bernard S. Black, \textit{Shareholder Passivity Reexamined}, 89 \textit{Mich. L. Rev.} 520 (1990) (this is often referred to as a collective action problem).
constituencies, including shareholders. Thus, this theory presents a substantial opportunity for balancing constituencies’ interests under corporate governance. Incidentally, the director primacy model is concerned with the allocation of power within the firm, but has little to say about how that power is to be used other than requiring that it be used to maximize shareholder wealth.\textsuperscript{129}

I propose that any corporate governance reform must focus primarily on promoting the long-term well-being of the corporation, balancing constituencies’ interests, and ensuring accountability (or transparency). In light of this goal, I will examine a proposal for corporate governance reforms, that is, the “enlightened shareholder value” (ESV) approach and the director’s reporting, which are currently accepted in the United Kingdom.

\textit{A. The U.K. Companies Act 2006}

The U.K. Companies Act 2006 (the Act) attempts to reconcile shareholders’ primacy with companies and with other long-term and stakeholder concerns.\textsuperscript{130} This legal duty requires directors to promote the long-term success of the corporation for the benefit of the shareholders as a whole, but in doing so, directors must consider the list of stakeholder interests described in section 172(1) of the Act.\textsuperscript{131} This is referred to as the ESV approach\textsuperscript{132} of corporate governance, which merges elements of the shareholder primacy and stakeholder models. The Company Law Review (CLR), which

\textsuperscript{129} See Bainbridge, \textit{supra} note 16, at 792 (contrasting Blair & Stout, Bainbridge states he did not approach the Board of Directors from a perspective framed by the question “what does the Board do?” in developing the director primacy model.).

\textsuperscript{130} See \textit{also} Paul L. Davies, \textit{Enlightened Shareholder Value and the New Responsibilities of Directors} (Oct. 4, 2005), http://law.unimelb.edu.au/__data/assets/pdf_file/0014/1710014/94-Enlightened_Shareholder_Value_and_the_New_Responsibilities_of_Directors1.pdf (arguing the ESV approach is not very different from a shareholder approach).

\textsuperscript{131} See \textit{Companies Act 2006}, c. 46, § 712 (U.K.).

worked on the Act, accepted the concept of the ESV as a fundamental principle in corporate governance.133

1. **Directors’ Fiduciary Duty**

The core of the ESV principle is embodied in section 172 of the Act, which defines the fiduciary duties of directors:

“(1) A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to

(a) the likely consequences of any decision in the long term,

(b) the interests of the company’s employees,

(c) the need to foster the company’s business relationships with suppliers, customers, and others,

(d) the impact of the company’s operations on the community and the environment,

(e) the desirability of the company maintaining a reputation for high standards of business conduct, and

(f) the need to act fairly as between members of the shareholder who is interested in the long-term well-being and performance of the corporation and its social and environmental impact.134

The “enlightened shareholder” is the yardstick for a hypothetical shareholder who is interested in the long-term well-being and performance of the corporation and its social and environmental impact.135 Under this ESV approach, directors, who are ultimately required to promote shareholder interests, must consider the factors that affect the company’s relationships and performance. The fundamental elements of the ESV model are: (1) an explicit focus on long-term shareholder value as the goal of the corporation and (2) a requirement that directors consider the impact of their decisions on extended stakeholder constituencies’ interests that are referred to in section 172 to promote the success of the corporation, however, on

134 Id. at 591.
the premise that no change in the corporate decision-maker (i.e., the Board) and no transfer of shareholders’ voting rights to other stakeholders is made at all.\textsuperscript{136} In terms of the last premise, under the Act, directors remain directly accountable only to shareholders, and the Board is maintained as the decision-making authority of the corporation.\textsuperscript{137} Thus, the Act defines shareholders as the sole corporate constituency entitled to elect directors, bring derivative suits, and authorize interested transactions.

The CLR took the view that directors’ duties should be formulated in terms of the notion that shareholder value depends upon directors’ successful management through their consideration of the corporation’s relationships with other constituencies.\textsuperscript{138} Hence, although section 172 of the Act, which includes the ESV approach, initially defines the scope of directors’ duties, it also indicates what shareholders’ interests should be and how they should be addressed.\textsuperscript{139} “Under this approach, directors must primarily focus on promoting the best interests of shareholders”; however, they must also consider the interests of other key constituencies as long as such consideration promotes the success of the corporation for the benefits of its shareholders.\textsuperscript{140} A major concern here was whether to uphold the notion of the shareholder primacy approach or whether a “pluralist approach” to corporate governance should be substituted for this approach.\textsuperscript{141} Contrary to the claims of the ESV approach, the “pluralist approach” proposes that directors should consider all relevant constituencies’ interests equally, which include those of shareholders, and that directors should give primacy to non-shareholder constituencies, even sacrificing shareholders’ interests in

\begin{itemize}
\item[\textsuperscript{137}] See generally COMPANIES ACT 2006, supra note 131.
\item[\textsuperscript{138}] See Keay, supra note 133, at 579.
\item[\textsuperscript{139}] See Andrew Keay, Enlightened Shareholder Value, The Reform of the Duties of Corporation Directors and the Corporate Objective, LLOYD’S MAR. COM.L. Q. 335, 339 (2006); see also Keay supra note 135, at 2, 18.
\end{itemize}
case of a conflict in interests between shareholders and non-shareholders.\textsuperscript{142} Although the CLR recognized the merits of the stakeholder approach, it did not recommend its adoption and finally chose a modified model, which is the ESV model.

2. NARRATIVE REPORTING

The U.K. has expanded the scope of the directors’ narrative reporting requirement through the directors’ business review. In section 417(2) of the Act, the statutory objective of the business review is declared, which holds that directors, not the corporation, are required to compile a business review to inform shareholders of the corporation and help them assess and evaluate how the directors have performed their duty under section 172.\textsuperscript{143} Thus, the Act requires directors in public corporations to recognize and report on the non-exhaustive list of factors specified in section 172(1) as part of the comprehensive disclosures to investors.\textsuperscript{144} The business review must include “a fair review of the company’s business, and a description of the principal risks and uncertainties facing the company.”\textsuperscript{145} Further, it must be “a balanced and comprehensive analysis” of the corporation’s financial performance as well as the main trends and factors likely to affect the future development and performance of the listed corporation’s business.\textsuperscript{146} Specifically, the business review for a listed corporation must include information about the corporation’s environmental impact, employees, social and community issues, and essential contractual arrangements.\textsuperscript{147} The analysis in the business review must be based on both financial and non-financial key performance indicators (KPIs).\textsuperscript{148} The narrative reporting in the directors’ business review in the United Kingdom possibly goes further than the narrative reporting system in the United States, which is more focused on financial performance. The tendency toward expanded directors’ narrative reporting has been

\textsuperscript{142} Id.

\textsuperscript{143} See Companies Act 2006, c. 46, § 417(2) (U.K.).

\textsuperscript{144} Id. at § 417 (however, companies subject to the small companies’ regime are exempted from the business review requirement).

\textsuperscript{145} Id. at § 417(3)(a)-(b).

\textsuperscript{146} Id. at § 417(4)-(5).

\textsuperscript{147} Id. at § 417(5) (if the business review does not include the relevant information, it must include a statement detailing which kind of information is not contained therein.).

\textsuperscript{148} Id. at § 417(6).
increasing, and the U.K. government in early 2012 proposed a revision of the directors’ business review in section 417 of the Act. The directors’ business review is now replaced with a “strategic report,” which is the new narrative reporting requirement.\(^{149}\)

Thus, in August 2013, the Companies Reform Regulations 2013 amended the Act which implements the strategic report and the directors’ report (instead of the annual directors’ statement) to replace the directors’ business review in the now superseded section 417 of the Act.\(^{150}\) All U.K. corporations, except those that are “small,” are required to produce a strategic report, as well as a directors’ report, within their annual report. The strategic report is to cover the same material as the old business review, such as, in the case of listed corporations, principal risks and uncertainties, and KPIs. The new strategic report, in relation to strategy and business model, the gender of the directors, senior managers, employees of the corporation, and human rights issues and policies, requires listed corporations to provide additional disclosures.\(^{151}\)

As seen from sections 172, 417, and 414A-D of the Act, the U.K. corporate law reforms require boards to justify their decisions in terms of long-term shareholder value and stakeholder interests, and to disclose risks impacting stakeholders.\(^{152}\) By doing so, the U.K. has made management at least indirectly accountable to stakeholders. The factors listed in section 172(1) and the strategic report and directors’ report, which requests compliance with such sections, will allow directors to defend any bona fide business decision aimed at promoting the success of the corporation.\(^{153}\) However, section 463 of the Act causes a director to be liable for compensating the

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\(^{149}\) See Companies Act 2006, c. 46, § 414A (U.K.) (In August 2013, the Companies Reform Regulations 2013 amended the Companies Act 2006, which implements the Strategic Report and the Directors’ Report (instead of the Annual Directors’ Statement) to replace the directors’ business review in the now superseded section 417 of the Act.); see § 414C(2)(4) (the Strategic Report now incorporates the former requirements of the superseded directors’ business review in section 417 of the Act, as well as a description of the company’s strategy, business model, and gender diversity on the Board.).

\(^{150}\) Companies Act 2006, supra note 149, at § 414A.

\(^{151}\) Id. at §414C(8).

\(^{152}\) Id. at §§ 172, 417, 414(A)-(D).

\(^{153}\) Id. at § 172(1); Companies Act 2006 (Strategic Reports and Director’s Report) Regulations 2013 S.I. 2008/393, (§ 414C(1)) (U.K.).
corporation for any of its own losses if the director knowingly makes an untrue statement or dishonest omission in a director’s report, statement, or summary financial statements. In sum, the U.K. approach aims to enhance directors’ accountability through compliance with such sections and to simultaneously push corporations in the direction of greater social responsibility.

V. OTHER PROGRESS

In 2010 the Financial Reporting Council (FRC) published The U.K. Corporate Governance Code (the “Code,” as updated in 2014), which sets out standards of good practice for listed corporations on board composition and on development, remuneration, shareholder relations, accountability, and audit. Additionally, in 2011 the FRC published the “FRC Guidance on Board Effectiveness”. The guidance is intended to assist companies in applying the principles of the Code, which relates primarily to Sections A and B that deal with the leadership and effectiveness of the Board, per Listing Rule 9.8.6. In the case of a listed company, its annual financial report must include (1) a statement of how the listed company has applied the Main Principles set out in the Code in a manner that would enable shareholders to evaluate the application of the principles, and (2) a statement as to whether the listed company has complied with all relevant provisions set out in the Code or has not complied with all relevant provisions set out in the Code. If the company has not complied with all relevant provisions, it must include a statement setting out those provisions with which it has not complied and the

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157 See FINANCIAL REPORTING COUNCIL, GUIDANCE ON BOARD EFFECTIVENESS (2011).
159 See FINANCIAL REPORTING COUNCIL, supra note 157, at 9.8.6 (5) and (6).
company’s reasons for non-compliance. This means the Listing Rules apply the so-called “comply or explain” rule.

VI. E.U. CORPORATE REFORM

In addition to the U.K. movement, there is E.U. corporate reform. The Council of the European Commission adopted Directive 2013/34/EU on large companies’ disclosure of non-financial information. If a company is large (i.e., listed and non-listed, but having more than 250 employees), the Board must prepare a management report containing the analysis including both financial and non-financial key performance indicators relevant to the particular business, including information relating to environmental and employee matters.

According to E.U. Directive 2014/95/EU, which amended the said Accounting Directive, the Board must disclose information to the extent necessary for an understanding of the undertaking’s development, performance, position and impact of its activity, relating to environmental, social and employee matters, respect for human rights, anti-corruption and bribery matters. Moreover, large listed companies shall also disclose information regarding the diversity of the Board. The required disclosure must also include a description of the company’s pursued policy related to the above-mentioned matters, the results of these policies, and the risks related to these matters, and how the company manages those risks. The objective of the Directive “is to increase E.U. companies’ transparency and performance on environmental and social matters, and therefore, to contribute effectively to long-term economic growth

160 FINANCIAL REPORTING COUNCIL, THE UK CORPORATE GOVERNANCE CODE, supra note 156.
162 Id.
164 See Article 20 (g) of Directive 2014/95/EU.
165 See European Commission Memoranda, supra note 163. See also Article 29a of Directive 2014/95/EU.
and employment. More transparency will help companies better manage the opportunities and non-financial risks. These directives are aimed at complementing the narrative reporting regulations in the United Kingdom. "Through complying with the narrative reporting regulations, as mentioned above, U.K. listed companies will be disclosing specific information on the companies’ strategy, business model, human rights and gender diversity in their strategic report, and providing information on greenhouse gas emissions in their directors’ report."

Expansion of the disclosure of financial and non-financial information and the narrative reporting system that has been adopted in the United Kingdom and the E.U. are helping increase the accountability and transparency of the decision-making process in terms of considering multi-stakeholder interests. The recent progress in this regard should be positively evaluated in terms of corporate governance.

A. Applicability of the ESV Approach to U.S. Corporate Law

Is it acceptable under U.S. corporate law that directors are able to or must consider the interests of other constituencies besides shareholders? Is such consideration in conflict with the notion of shareholder wealth maximization?

Under Delaware law, the fiduciary duty of loyalty requires directors to act in the best interests of the corporation and its shareholders, and most states have the same or almost the same statutes. However, under U.S. corporate law, directors should also consider the interests of other corporate constituencies to the extent that those interests meet the best interests of the shareholders. Thus, the above description is like the ESV approach used in the United States.

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166 See European Commission Memoranda, supra note 163.
167 Id.
169 Id.
Kingdom. Einer Elhauge’s argument will serve as a useful framework for addressing the above questions.

Elhauge argues that managers have, and should have, discretion under corporate law to sacrifice profits in the public interest, especially the interests of non-shareholders. Elhauge observes that “the law has never barred corporations from sacrificing corporate profits to further public interest goals that are not required by law,” and that the existence of managerial discretion to sacrifice profits in the public interest is rather socially desirable. Additionally, this would be true even if the objective of corporate law were shareholders’ profits maximization because it inevitably entails the business judgment rule. According to Elhauge, the business judgment rule in effect leaves managers with latent discretion to sacrifice profits in the public interest, which discretion Elhauge argues is socially desirable. Thus, the business judgment rule protects most managerial decisions that involve potential shareholder–stakeholder conflicts of interest. In support of his argument, Elhauge points to the so-called constituency statutes that many states enacted which authorize managers explicitly to consider the interests of non-shareholder constituencies and the American Law Institute’s Principles of Corporate Governance, which authorize boards of directors to devote a reasonable amount of resources to “public welfare, humanitarian, educational, and philanthropic purposes,” even if the conduct either yields no economic return or

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172 Elhauge, supra note 171, at 744.

173 Id. at 763.

174 Id. at 738–40.

175 Id.

entails a net economic loss.\textsuperscript{177} Further, Elhauge refers to Delaware case law on takeovers, particularly \emph{Unocal Corp v. Mesa Petroleum Co.},\textsuperscript{178} which he observes confirmed explicitly that shareholders’ interests are not a controlling factor.\textsuperscript{179} According to Elhauge, “under the business judgment rule, courts are extraordinarily willing to sustain managers’ decisions that apparently sacrifice profits (at least in the short run) on the grounds that they may conceivably maximize profits (at least in the long run).”\textsuperscript{180} More or less any decision to sacrifice profits has a conceivable link to long-term profits; therefore, this suffices to give managers substantial de facto discretion to sacrifice profits in the public interest.\textsuperscript{181} Elhauge further argues that when managers sacrifice profits in the public interest, they are often maximizing the shareholders’ welfare.\textsuperscript{182} Consequently, he suggests that maximizing shareholder welfare is not the same thing as maximizing shareholder profits.\textsuperscript{183}

The United States and the United Kingdom have the same structure of dispersed share ownership and well-developed securities markets and depend upon a similar stock market for corporate control. Moreover, in both countries, stock ownership has become increasingly concentrated in institutions such as mutual funds or pension funds. Indeed, there are many reasons why such a stakeholder-oriented regulatory shift is unlikely. Per some commentators, key differences between the dominant institutional investors in the United Kingdom (i.e., pension funds) and the United States (i.e., mutual funds), as well as the two countries’ regulatory environments, make stakeholder-oriented corporate reform less likely in the United States.\textsuperscript{184} However, I do not believe these differences are crucial to introducing the ESV approach to the United States.

Moreover, the regulatory framework for the exercise of shareholders’ corporate governance role in the United Kingdom is

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\item[177] Elhauge, \textit{supra} note 171, at 763–66 (citing 1 Am. Law Inst., Principles of Corporate Governance: Analysis and Recommendations § 2.01(b)(3) (1992)).
\item[178] \textit{Id.} at 764–65 (citing \textit{Unocal Corp. v. Mesa Petroleum Co.}, 493 A.2d 946, 955 (Del. 1985)).
\item[179] \textit{Id.}
\item[180] \textit{Id.} at 770–71.
\item[181] \textit{Id.}
\item[182] \textit{Id.} at 785.
\item[183] \textit{Id.} at 783.
\item[184] Ho, \textit{supra} note 136, at 79–80.
\end{thebibliography}
much more empowering as compared to the United States.\textsuperscript{185} The
enhanced narrative reporting regime proposed in the United
Kingdom has the objective of making a significant impact on the
exercise of shareholders’ corporate governance role in monitoring,
scrutiny, and engagement. However, I am not suggesting that we
should enhance shareholders’ role in corporate governance by
achieving the narrative reporting regime and finally moving on to
shareholder primacy. Structural issues such as short-termism and the
reliance on capital market gains, rather than long-term corporate
value, caused the shareholders’ failure of engagement. Many
institutional shareholders delegate investment management to asset
managers, and their short-termism relationships with asset managers
contribute to the short-term prospects of investment management. I,
rather, contend that the narrative reporting regime would ensure
accountability for directors’ actions, particularly, the market’s
monitoring function and market discipline, which would ultimately
improve corporate governance. Moreover, such narrative reporting
would enhance the communication between the Board and the CEO,
and the corporation and all stakeholders thereby helping solve the
asymmetric information problem.

There might be criticisms to my argument explained above,
which has focused on structural issues such as directors’ short-
termism, which caused the recent financial crisis. First, there might
be skepticism that narrative reporting is useful in avoiding such a
crisis. One commentator argues that the enhancement of corporate
disclosure in narrative reporting would not likely have any significant
impact on investor behavior, in terms of shareholder engagement,
because investors probably use such disclosure not for engagement
(especially institutional shareholders) but for trading decisions.\textsuperscript{186}
However, assuming that we cannot completely change CEO
domination and asymmetric information, the capital market must
change in terms of socially responsible investment, and the
enhancement of the norm of the ESV and the disclosure supporting
such norm would surely lead to improvement in the accountability

\textsuperscript{185} Christopher M. Bruner, \textit{Corporate Governance in the
Common-Law World: The Political Foundations of Shareholder

\textsuperscript{186} See Iris H-Y Chiu, \textit{Reviving Shareholder Stewardship: Critically
Examining the Impact of Corporate Transparency Reforms in the UK}, 38
\textit{Del. J. Corp. L.} 983, 1009–1011 (2014) (arguing that narrative reporting
may be criticized as being too subjective and qualitative).
and sustainable growth of corporations, which would in turn lead to shareholder engagement. As noted above, I support the director primacy model wherein the Board is in control of the corporation. Hence, exercising almost unconstrained authority to ensure corporate decision-making efficiency. Second, there might a question whether the ESV approach and narrative reporting infringe on the Board’s traditional role as a central decision-maker with the ultimate “power of fiat,” which corporate law affords the Board, because the Board’s discretion might be constrained to some extent to perform fiduciary duty in terms of the ESV approach and disclosure of nonfinancial information. However, the said framework would be intended not to empower shareholders or enhance shareholder activism, but to ensure the accountability of the directors, who have broad discretion. Under the ESV model, directors still have broad discretion regarding which interests of constituencies they consider and how they consider such interests.

To avoid a future financial crisis corporate governance reform must focus primarily on promoting the long-term well-being of the corporation, balancing constituencies’ interests, and ensuring accountability and transparency. For these purposes, I argue that a combination of the ESV approach and the narrative reporting system as used in United Kingdom would be a more effective approach to address this problem. In terms of the norm, however, we should retain the director primacy model rather than the team production model, as we have to deal with the reality that boards depend heavily upon CEOs for corporate information, although they must perform a monitoring function. There are difficulties in overcoming such a dilemma between director primacy and CEO domination. In sum, it is incorrect to assume that only a board that is made up of independent or outside directors can monitor well because the way in which the monitoring function works within a corporation is different for each corporation. Globalization trends related to communication between corporation and stakeholders, including investors, will no doubt increase “transparency.”

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187 Id.
188 See Gordon, supra note 104, at 1505–09.
189 See, e.g., David Walker, A Review of Corporate Governance in UK Banks and Other Financial Industry Entities, 10 (2009) (explaining that the UK government has proposed corporate transparency reforms in order to support shareholders’ stewardship role).
performance improvement, the E.U. believes that requiring the disclosure of non-financial information will lead to long-term corporate value. Such a notion and system are sufficiently applicable to the U.S. model of corporate governance.

VII. CONCLUSION

The current environment where corporations and the global economy operate presents an important opportunity for reform.\textsuperscript{190} It is in society’s best interest to focus corporate governance reform on enhancing the long-term health and value of the corporation. The director primacy model struggles with the Board’s practical capacity to deviate from shareholder interests and the shareholders’ capacity for autonomous action. The team production model is criticized for shareholders’ capacity to discipline the Board through autonomous action.\textsuperscript{191} There is no single overriding theory, and strict adherence to any pure theory would not prove helpful. In fact, “the social and economic roles of the public corporations are so diverse and far-reaching that we cannot expect any single concept to serve us well in all contexts.”\textsuperscript{192}

From the perspective of corporate reform, we must ensure that the functions that public corporations are expected to perform under corporate governance will work well as such. I have pointed out above that the shift to the independent board, which has weakened the Board as a monitoring body, has caused a problem. However, my proposal of promoting the long-term well-being of the corporation, balancing constituencies’ interests, and ensuring accountability and

\textsuperscript{190} See e.g., Bruce E. Aronson, Japanese Corporate Governance Reform: A Comparative Perspective, 11 Hastings Bus. L. J. 85 (2015). In 2014, the Japanese Diet passed a bill amending the corporate law. According to the amended corporate law, no outside directors are mandatory in a corporation with a board of corporate auditors, which is adopted in a vast majority of listed corporations. If the corporation lacks outside directors, the directors in such a corporation must explain in a shareholders’ meeting why it is reasonable for the corporation to have no outside directors at all. This is often explained such that Japanese corporate law follows the UK style of the “comply or explain” principle. Such an explanation provision is set forth not in corporate law but in the listing regulation.

\textsuperscript{191} Christopher M. Bruner, Corporate Governance Theory and Review of Board Decisions, 62 UCLA L. REV. DISC. 87, 89 (2014).

\textsuperscript{192} Id.
transparency seems to be still ineffective for addressing this problem. We must keep in mind that the Board should not perform the monitoring function on its own. The stock market, gatekeepers, and social norms must supplement corporate governance, and boards must perform it. The narrative reporting that is currently expanding in the United Kingdom and the E.U. might help enhance the monitoring function that the stock market can perform. If a third-party organization were to valuate such directors’ narrative reporting, which I would recommend, then such a new gatekeeper would work for corporate governance. Role allocation is necessary for ensuring the monitoring function for a corporation.

193 See generally John C. Coffee, Gatekeepers: The Role of the Professions in Corporate Governance (2006) (“all boards of directors are prisoners of their gatekeepers.”).

194 See Melvin A. Eisenberg, Corporate Law and Social Norms, 99 Colum. L. Rev. 1253, 1253-1292 (1999) (discussing the role of social norms in several key areas of corporate law, including fiduciary duties, corporate governance, and takeovers). See also Robert Cooter & Melvin A. Eisenberg, Fairness, Character, and Efficiency in Firms, 149 U. Pa. L. Rev. 1717, 1721 (2001) (arguing that firm-specific fairness norms promote efficiency).