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Why criminal sanctions still matter in corporate governance

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***I.C.C.L.R. 133 Introduction**

The general concern about the adequacy of self-regulation as a mode of policing corporations has once again come to the forefront of the corporate governance debate following the current economic crisis. Irresponsible lending to individuals who cannot afford to repay loans has resulted in the near collapse and nationalisation of banks such as Northern Rock and Bradford & Bingley in the United Kingdom and Fannie Mae and Freddie Mac in the United States.¹ Once again, the Government has had to intervene to prevent an economic crisis, by nationalising failing financial institutions to avoid them falling into liquidation.

Government intervention in the regulation of markets, particularly through the use of criminal sanctions, has not been popular in recent years. The use of criminal sanctions to regulate business activities is generally perceived as being an overreaction that is likely to discourage directors from taking the risk that is necessary to run a business, thereby slowing down economic growth and interfering with profitability. It is frequently argued that criminal sanctions are not necessary in the regulation of business and corporate governance in particular. Among the arguments made against the use of criminal sanctions in corporate governance is the procedural argument which perceives the use of criminal sanctions as being an expensive way of enforcing regulation,² which has a high burden of proof and as such is prohibitive to those seeking remedies for expropriation, as shareholders are required to demonstrate the director's culpability.³ In addition, it is argued that criminal sanctions cannot provide restitution to shareholders and employees who have lost their jobs.⁴ On top of that, the use of criminal sanctions is likely to result in over-deterrence of prospective directors, making them risk averse which is detrimental to the long-term benefit of the company.⁵ Others simply claim that not everyone is deterred by the criminal sanction⁶ and therefore using criminal sanctions will not deter a self-interested director.

However, government intervention, hitherto a mechanism of last resort, would now seem to be an inevitable consequence of the failure of markets to regulate themselves, and the only method likely to guarantee at least a modicum of financial stability during the current crisis. Stability is important as the success of any economy in the 21st century lies in its ability to create and maintain successful corporations. The survival and long-term profitability of corporations is no longer a private interest which merely affects those who deal with the corporation at a primary level, for instance investors, but also a public interest affecting the welfare of stakeholders such as employees to whom it provides jobs and pensions. When financial scandals occur, employees stand to lose their livelihoods not only in the form of jobs but also of life-long pensions. The Government therefore has a responsibility to ensure that employees as well as other stakeholders of the corporation are protected from the fraudulent acts of managers who do not act in the best interests of the company. The success of the corporation is therefore a public interest that, to a certain degree, ought to be protected through state regulation.

This article considers the role of law in corporate governance, as legislation is one of ***I.C.C.L.R. 134** the key ways in which the Government has intervened in previous crises, such as Enron in the United States. The focus of this article is an investigation into whether government intervention in corporate governance through criminal sanctions is necessary and to what extent it affects the ability of directors to perform their entrepreneurship function of risk-taking. This article begins by addressing the function of national legislation in corporate governance, which might be thought of as hard law, as contrasted with the soft law of the various City codes of practice, and then explains how criminal sanctions apply to the corporate environment.

The role of law in corporate governance

Corporate governance is concerned with the separation of ownership and control that results when a company is publicly listed and therefore has too many owners who cannot all control the company at once, and as such, they hire professional managers to do so. Owing to the separation of ownership and control, a problem may arise where the directors of the company are more interested in acting in their own interests as opposed to the interests of the company. As a result, corporate governance has been defined as:

“... the system through which those involved in the company's management are held accountable for their performance, with the aim of ensuring that they adhere to the company's proper objectives”.⁷

It is generally accepted that the law plays a key role in corporate governance⁸ particularly in the provision of shareholder protection and the reduction of expropriation that is the result of the separation of ownership and control.⁹ The critics of the role of law in corporate governance dispute its importance on the basis that the role which hard law and criminal sanction actually play in influencing the day-to-day behaviour of directors and their companies has been vastly overestimated and their role in corporate governance, is at best, only minimal.¹⁰

Nonetheless, the countervailing argument that even an insignificant amount of legal pressure on corporate decision-making will be beneficial by serving to curb the excesses of risk-taking and the irresponsible granting of credit is now gaining ground after being out of fashion for many years. The present economic crisis has seen the traditional perceived orthodoxy of self-regulation challenged on a number of fronts. Recent studies highlight the beneficial effects that the law may have in serving to regulate the financial system and claim its role to be more significant in corporate governance than has been previously acknowledged. An instance is La Porta et al.'s work, which states that securities law matters in corporate governance as financial markets cannot prosper when left to market forces alone.¹¹ Even so, it remains unclear if there is a particular type of law that is of superior importance to the realisation of good corporate governance. To find out how law matters in corporate governance, it is important to start by considering the objectives it is aiming to achieve.

According to the shareholder theory, the general aim of corporate governance is to improve how the company is run and managed so as to achieve the desired returns for investors.¹² The stakeholder theory of corporate governance also adopts this view but qualifies it by adding that the interests of stakeholders must be taken into account--it is not about solely maximising *I.C.C.L.R. 135 investor returns.¹³ For present purposes, the term investors will be used to refer to both shareholders and creditors.¹⁴ Corporate governance is therefore concerned with giving investors incentives to finance the company by solving the agency problem that results from separation of ownership and control.¹⁵ The law through private law mechanisms such as contract law, company law and labour law provides a solution to the agency problem and in effect encourages investors to finance the company.

Private law mechanisms

Private law mechanisms can be defined as the legal mechanisms that regulate the relationship between individuals such as, in the case of corporate governance, the law of contracts, company law and labour law. It is important to examine the effectiveness of private law mechanisms in corporate governance because the agency theory upon which the shareholder model of corporate governance is based views the firm as a nexus of contracts.¹⁶ According to the nexus of contracts theory, companies are nothing more than a collection of contracts between the different parties involved in the company. These include shareholders, directors, employees, suppliers and customers among others.¹⁷ The contract that this article is concerned about, in devising a solution to the agency problem, is that between directors and shareholders. Within this contract the managers of the firm are “agents” and shareholders are the “principal”. The principal delegates the day-to-day running of the company, including the decision-making in the company, to the agents, and the role of the underlying contract is to specify the role of the agents and how returns are to be divided between the agents and the principals.¹⁸ This article will now review the literature on private law mechanisms with the aim of assessing their effectiveness in preventing managerial expropriation.

Contract law

Contract law is the mechanism through which contracts between investors and the company are protected as contract law governs the relationship between the principal and the agent. Contract law solves the agency problem by specifying the role of the agent and the shareholders to ensure that agents do not waste time in pursuing projects that are not in the interests of the company. However,

the problem with this type of contracting is that not all future eventualities are foreseeable and therefore complete contracts are impossible to achieve.¹⁹ Consequently, investors have to give the agents the right to make decisions that were unforeseen at the time of contracting and managers therefore end up with substantial residual control rights and discretion on how to allocate them. As the agents have control of the company and the discretion on how to spend the investors' money, this creates an opportunity for managerial expropriation because agents do not necessarily make decisions that are in the best interests of the principal.²⁰

In addition to traditional employment contracts, contract law has tried to align the interests of managers and shareholders through the use of incentive contracts. The advantage of incentive contracts is that they are usually long term and managerial benefits normally depend on the performance of the contract. Through the long-term nature of the incentive contract, managerial interests are aligned with those of shareholders by ensuring that they take into account the long-term effect of their decisions on the company. If the firm's performance has improved, management will be entitled to incentives such as share ownership and stock options. Secondly, incentive contracts play a dual role in providing managerial discipline by acting as a sanction that triggers the dismissal of management if the company's performance is low and as a sanction that withdraws potential earnings from the managers when the company underperforms.²¹ In this way, incentive contracts give managers an incentive to act ***I.C.C.L.R. 136** in the shareholders' best interest. However, some studies show that incentive contracts are still vulnerable to managerial expropriation as managers become short-termist in their decision-making and do not consider the long-term interests of the company, and after a certain level of ownership directors may try to manipulate their work to fit into the pay structure.²² Incentive contracts therefore do not completely solve the agency problem. One may argue that legal enforcement of contracts may be the solution to managerial expropriation and excessive risk-taking at the expense of investors.

In jurisdictions where ownership is dispersed, such as the United Kingdom,²³ the free-rider problem limits the effectiveness of contracts as a solution to the agency problem. As the cost of bringing a derivative action is likely to outweigh any benefit that the shareholder is likely to derive from such an action, shareholders are unlikely to come together to bring legal action since shareholders have the option of selling on their shares with ease owing to the dispersed ownership structure of public listed companies in the United Kingdom and the liquidity in the market. In addition, studies have shown that the courts in the United States and the United Kingdom are not efficient in enforcing contracts between shareholders and managers as the contract requires much interpretation.²⁴ Additionally, the use of the "business judgment rule" prevents the courts from second guessing decisions made in the board room²⁵ and makes them more likely to support the decisions of management.

Therefore contract law only succeeds in theoretical terms by providing a basis upon which companies can be formed and a foundation upon which issues of corporate governance can be discussed. As a control mechanism, contract law is quite limited as it is easily susceptible to managerial expropriation owing to the fact that complete contracts are difficult to achieve. In addition, control mechanisms that are facilitated through the law of contract such as incentive contracts are only successful to an extent but also vulnerable to managerial entrenchment, with managers changing their objective to suit the short-term goal of attaining the incentive as opposed to the long-term goal of acting in the company's long-term interest. The main weakness of the contract mechanism as a means for monitoring directors lies in its enforcement as the courts are unwilling to scrutinise the business decisions underlying contracts.

Company law

Once the underlying contract between the principal and the agent is secured, the property rights resulting from the contract that has been formed have to be protected. Private law protects property rights through company law.

Company law plays an important role in the organisation of property rights²⁶ as it is through recognition as legal persons in law that companies are able to perform transactions in the name of the shareholders. Company law provides a solution to the agency problem by defining the duties of the members of the company and specifying the liability of the members of the board in the event of default in the performance of their duties. In this way company law acts as a mediator between opposing interests within the company through the provision of mandatory rules such as the articles of incorporation and corporate byelaws which define the role of the firm.²⁷ As such, the power relations within the firm are defined while avoiding more direct modes of intervention such as state

ownership and bureaucratic control of finance and credit.²⁸

However, company law in the United Kingdom and the United States is permissive with a few mandatory rules.²⁹ While the permissive nature of corporate law provides the flexibility that is necessary for the effective management of business³⁰ it also creates opportunities for expropriation. As the courts are reluctant to deal with managerial expropriation,³¹ except in ***I.C.C.L.R. 137** extreme cases owing to the business judgment rule, management expropriates the company less directly through excessive consumption of perquisites through legal acts such as decision-making on the board which favours the short-term interests of the company.³² Since directors' duties are not defined in detail in the employment contract or specifically in law, that is, in relation to the business of the company, the directors by focusing on their short-term interests appear to be acting in the interests of the company and therefore at no fault. Although the law empowers shareholders with the right to vote as a means of removing disloyal directors, studies have shown that shareholders in the United Kingdom are not exercising their voting right effectively.³³ Even where shareholders are willing to exercise their legal right to vote, shareholder voting rights may be expensive and difficult to enforce.³⁴

Therefore, while company law provides the necessary flexibility to facilitate the maximisation of shareholder value by allowing directors to take risks and defining the relationship between members of the company, company law is still limited in how far it can prevent managerial expropriation and excessive risk-taking. The main difficulty lies in making a distinction between business risks and self-interested acts of management. Company law does not give much guidance on this. This limits the ability of company law to effectively protect shareholders as it is difficult for shareholders to prove to the court that the director in question was not acting in the company's interests.

Labour law

The third private law mechanism that affects corporate governance is labour law.³⁵ Labour law governs the relationship between workers and the firm by defining the rights of workers, the conditions under which they are hired and fired and their role in terms of the degree in which they can participate in the boards of companies. In addition, labour law is important for corporate governance as it affects the structure of the firm and how decisions within the firm are made. In jurisdictions where labour law is strong, workers are more likely to participate on the board and therefore affect decisions, and vice versa.³⁶

As the central problem in corporate governance is the separation of ownership and control, for private law to be an effective corporate governance control mechanism it has to protect shareholders from consequences of the agency problem such as excessive risk-taking by management. As workers want to keep their jobs in the long term, their representation on boards as monitors ensures that directors are not short-terminist in their decision-making. This in turn increases shareholder value. However, public companies in the United Kingdom tend to have a strict separation between labour relations and firm management³⁷ and this is reflected in their boards, where worker participation is limited.³⁸ Companies are hostile to employee participation on boards as stakeholder interests may prevail over the interests of shareholders. A point of concern is whether shareholders are better off if employees participate in the affairs of the company. On the one hand, allowing workers to participate in the company is likely to make them feel more worthwhile to the company and motivate them to be more productive. On the other hand, in the short term, profits may have to be sacrificed in lieu of long-term shareholder value. As monitors of management, it has been argued that worker participation on the board only works well when they consist of a third of the board.³⁹ If employees hold half the seats on the board, they would veto corporate planning until their consent was obtained.⁴⁰ In addition, it is rare to find workers who act as board representatives and remain loyal to fellow employees. Experience with participation in the state-owned steel industry in the United Kingdom has shown that a process seems to take place in which worker representatives take on management colouring, and their activities become increasingly supportive of management strategies and goals.⁴¹

***I.C.C.L.R. 138** Generally, labour law in the United Kingdom provides limited protection for workers and as a result workers have a less direct role on the board.⁴² Allowing worker participation within boards is seen as having the potential of reducing shareholder value and workers are, by and large, not seen as being effective monitors of management as their allegiance to their fellow workers normally changes on appointment to the board when they start to support the directors that they are supposed to be monitoring.

Market mechanisms

The market for corporate control

The market for corporate control solves the agency problem through market forces such as the labour market for directors and competition within the stock market. The availability of labour gives management the incentive to maintain good corporate governance practice so as to stay competitive in the stock market. Through takeovers well-performing companies acquire underperforming companies and replace poorly performing management, thereby increasing shareholder value. Takeovers are seen as being an effective market disciplinary mechanism because in addition to losing their jobs managers of the target company also risk losing their reputation, making them unable to stay competitive in the labour market.

However, the downside of using takeovers to solve the agency problem is that takeovers may not happen that often. Research shows that takeover activity has steadily reduced since the 1980s.⁴³ A second drawback to relying on the market for corporate control to solve the agency problem is that takeovers are expensive and they require managers to significantly deviate from the performance of their duties for them to work properly.⁴⁴ Such deviations may not always benefit investors, for instance where the directors concentrate on providing guidance to shareholders on the merits of the offer of the predator company and put the running of the company on hold, leading to a loss in shareholder value. The guidance provided by the directors in this during takeovers may also not be independent and directors may advise shareholders in such a way that ensures that they continue to keep their jobs. To strengthen the effectiveness of the takeover, current law in the United Kingdom prohibits anti-takeover practices by providing that directors must ignore their personal circumstances and not engage in any action which may result in shareholders being denied the opportunity to decide on the merits of the offer.⁴⁵ Despite these provisions, demonstrating a director's self-interest still remains a hurdle for the aggrieved shareholder owing to information asymmetry problems. Management will, in most cases, be more informed than the shareholders on the business of the company. As such the market for corporate control is not always an effective mechanism in solving the agency problem and the consequences of the self-interested behaviour of directors.

Board structure mechanisms

In recent years, board structure mechanisms have been introduced through corporate governance codes to monitor the behaviour of directors so as to prevent agency costs such as expropriation and excessive risk-taking. A significant number of board mechanisms have been adopted to improve the loyalty and independence of directors. These include the separation of the role of the chief executive officer from that of the chairman and the introduction of non-executives in boards of public listed companies.

It is generally thought that to have one person occupying both the chief executive officer and chairman of the board roles is to concentrate too much power in one person's hands thereby creating a greater chance for managerial expropriation. There is limited evidence on whether chief executive officer/chairman duality influences a director's loyalty or independence. Among this evidence is research which shows that shareholders prefer to invest in companies where the positions of the chief executive and chairman are separate⁴⁶ as this provides for greater independence in decision-making and therefore a reduction in agency costs.⁴⁷ However, there is also evidence which suggests that separation of the positions of the chief executive and the chairman in the United Kingdom and the United States has no significant effect on governance as splitting ***I.C.C.L.R. 139** these roles has not resulted in better firm performance or in better decision-making by firms.⁴⁸ This suggests that it is unclear whether separating the role of the chief executive and the chairman has any effect on a director's loyalty, for instance the prevention of subtle forms of loyalty violations such as the making of secret profits by taking up corporate opportunities. The separation of the positions of the chief executive and the chairman may, however, provide an environment in which independent decisions can be made and blatant acts of self-interest such as excessive risk-taking can be prevented as the chairman's role is limited to that of directing the company while the chief executive is in charge of implementing that direction, thereby providing a monitor for the chairman's decisions.

In addition to splitting the roles of chief executive and chairman, non-executive directors have been introduced as a board structure mechanism to monitor directors.⁴⁹ The requirement that boards have non-executive directors has been emphasised in subsequent corporate governance reviews in the United Kingdom.⁵⁰ Research has shown that the presence of non-executive directors tends to reduce the managerial consumption of perquisites.⁵¹ This implies that having non-executive directors on the board makes management more loyal to shareholders. On top of reducing the consumption of

perquisites, studies have also found that around the days following the appointment of non-executive directors firms report significant positive excess returns, suggesting that the introduction of non-executive directors enhances managerial loyalty and improves shareholder value.⁵² However, not all studies have reported positive results following the introduction of non-executive directors. Some studies highlight a negative relationship between non-executive directors and firm performance⁵³ while others show that higher proportions of outside directors are not associated with superior board performance, but are associated with better decisions concerning issues such as acquisitions, executive compensation and chief executive officer turnover.⁵⁴ Therefore whether the presence of non-executive directors on the boards of companies is good for company performance remains an open question. However, one has to agree that the presence of non-executive directors on boards is important for perception because directors in companies with non-executive directors make less self-interested and risky decisions as they have to be accountable to non-executive directors.

It is now fitting to discuss how public law mechanisms can strengthen private law mechanisms, takeovers and board structure mechanisms in solving the agency problem in corporate governance.

Public law mechanisms

To effectively evaluate the role of public law mechanisms in corporate governance, it is important to recapitulate the limitations of private law mechanisms and board structure mechanisms as possible solutions to the agency problem.

The main limitation of private law mechanisms is that they rely on the shareholder for enforcement. In addition, factors such as the collective action problem, the lack of clarity in the scope of fiduciary duties and the reluctance of the courts to intervene in conflicts within the company hamper this remedy. The law is therefore not an effective control mechanism in corporate governance, as courts will only intervene in straightforward cases where there is a serious breach of investors' rights, such as outright theft by managers.⁵⁵

When private law fails to provide a solution to the agency problem, the market for corporate control acts as a "court of last resort".⁵⁶ A *I.C.C.L.R. 140* review of takeovers and board structure mechanisms demonstrated that they suffer from similar limitations. Although takeovers do not rely on the shareholder for enforcement, as is the case with private law mechanisms, their effectiveness is limited by the low frequency of takeover activity. With regard to board structure mechanisms, it remains unclear whether separating the role of the chief executive and the chairman has any effect on a director's loyalty. In addition, incorporating non-executive directors on the board was found to have little effect on shareholder value. This suggests that neither takeovers nor board structure mechanisms effectively deal with expropriation or excessive risk-taking in companies as the enforcement problem remains and there is hardly any evidence to show that the introduction of market-based board structure mechanisms has any effect on a director's loyalty. This exposes the company to the possibility of expropriation and creates an environment where management cares less about the effects of excessive risk-taking, as they are not loyal to the company.

An effective corporate governance mechanism would therefore have two characteristics: first, it would be easy to enforce and secondly, it would have the ability to secure the loyalty of the directors of the company and therefore deter them from expropriation and excessive risk-taking.

Public law mechanisms⁵⁷ strengthen enforcement and secure a director's loyalty by enabling a shareholder to bring a claim individually, therefore overcoming the collective action problem; for instance, where the shareholder has been denied information by the company, a derivative action is not necessary as failure to disclose company information and insider trading is a criminal offence in the United Kingdom which is enforced through the use of criminal sanctions in the form of regulatory penalties.⁵⁸ The use of regulatory penalties makes it cheaper for the shareholder to bring a public law claim since it does not always have to involve lengthy court proceedings as the standard of liability is strict, unlike in civil litigation where the shareholder has to demonstrate that on the balance of probabilities the director in question expropriated the company or took too much risk. Even if a shareholder were to be willing to do this, courts are often reluctant to discuss the internal affairs of the company, such as the details of decision-making within the board. In addition, the use of regulatory penalties overcomes the collective action problem which hampers the effectiveness of the market for corporate control as a disciplinary mechanism. Public law is therefore necessary in corporate governance as it provides shareholders with a remedy that is easy to enforce.

On top of solving the enforcement problem, an advantage of public law as a corporate governance

mechanism is that it avails more sanctions to shareholders. Bringing a claim in criminal law or securities regulation avails criminal penalties as a remedy to the shareholder, which may not be available through civil litigation. Criminal penalties have the benefit of taking away the benefit from expropriation as well as deterring agents from excessive risk-taking as this could not only result in the payment of a fine, which private law mechanisms can enforce, and the loss of income, which the market for corporate control can effect. The criminal sanction deters because it removes the agent from circulation, through incarceration, and involves reputation costs which render the agent unable to compete in the labour market.

Research has confirmed that criminal sanctions are the only mechanism that can protect investors from large-scale fraud or theft. "Every country uses harsh criminal punishments" to deal with cases like Enron and Parmalat.⁵⁹ This suggests that criminal punishment is a generally accepted way of protecting shareholders from expropriation and risk-taking in corporate governance.

***I.C.C.L.R. 141 Conclusion**

This article has explained the importance of criminal sanctions in the achievement of good corporate governance. Although the law plays a significant role in the protection of investors, private and non-law mechanisms have generally been ineffective in achieving investor protection and shareholder value. This article suggests that corporate governance can only be achieved by solving the agency problem through minimising agency costs that can result through opportunities for expropriation by insiders and excessive risk-taking in companies. Consequently, criminal sanctions are necessary in corporate governance as private law mechanisms and non-law mechanisms are inefficient⁶⁰ in protecting investors from expropriation and excessive risk-taking as they are the only mechanism that can take away the benefits of expropriations as well as deter insiders from expropriation and irresponsible acts of excessive risk-taking. As such, government intervention in corporate governance is not only desirable, but it is a basic necessity as it is only through the use of criminal sanctions that the disclosure and responsibility that is necessary for developing a financial market can be secured. Therefore government intervention in the present economic crisis should not be criticised; rather, it should be commended.

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1. See generally, P.T. Larsen and J. Croft, "Hand of State Returns to Tiller of Commerce", *Financial Times*, October 14, 2008; "Fannie and Freddie's 10 steps to nationalisation", *Financial Times*, September 10, 2008.
 2. X. Tang, "Revision of Laws and Corporate Governance in China: With the treatment of tunneling as an example" (2006), Paper presented at the Symposium on Corporate Governance in East Asia: Culture, Psychology, Economics and Law, Berkeley Centre for Law, Business and the Economy.
 3. C. Coglianese, T.J. Healey, E.K. Keating and M.L. Michael, "The Role of Government in Corporate Governance" (John F. Kennedy School of Government, Harvard University, 2004), pp.17-24.
 4. Coglianese et al., "The Role of Government in Corporate Governance" (2004), pp.17-24.
 5. R. Baldwin, "The New Punitive Regulation" (2004) 67(3) *Modern Law Review* 351.
 6. Coglianese et al., "The Role of Government in Corporate Governance" (2004), pp.17-24.
 7. See generally, J. Parkinson, *Company Law and Stakeholder Governance* (1997).
 8. See R. La Porta, F. Lopez-de-Silanes and A. Shleifer, "What Works in Securities Laws?" (2006) 61(1) *Journal of Finance* 27; R. La Porta, F. Lopez-de-Silanes, A. Shleifer and R.W. Vishny, "Legal Determinants of External Finance" (1997) 52(3) *Journal of Finance* 1149 and A. Shleifer and R. Vishny, "A Survey of Corporate Governance" (1997) 52(2) *Journal of Finance* 774.
 9. The most influential study on the relationship between law and corporate governance systems has been La Porta et al.'s 1997 study, which found that civil law countries had low levels of investor protection while common law countries had high investor protection: see La Porta, Lopez-de-Silanes, Shleifer and Vishny, "Legal Determinants of External Finance" (1997) 52(3) *Journal of Finance* 1149. In addition, La Porta et al. have found that using legal reform to reduce tunnelling is crucial in promoting financial and economic development. See, generally, S. Johnson, R. La Porta, F. Lopez-de-Silanes and A. Shleifer, "Tunneling" (2000) 90(2) *American Economic Review* 22.
 10. There is a range of critical literature on the role of law in corporate governance. Among the critics are Braendle, who disagrees with the significance of law on the validity of the index used to determine the findings of La Porta (1997), and Coffee, who disputes La Porta's 1997 index on the grounds of accuracy as opposed to the underlying argument that law has a role in corporate governance. See U.C. Braendle, "Shareholder Protection in the USA and Germany--On the Fallacy of LLSV" (2006) 7(3) *German Law Journal* 266 and J.C.

- Coffee, "Do Norms Matter? A Cross-Country Evaluation" (2001) 149(6) *University of Pennsylvania Law Review* 2154.
11. La Porta, Lopez-de-Silanes and Shleifer, "What Works in Securities Laws?" (2006) 61(1) *Journal of Finance* 27. Djankov et al. go further and propose the anti-self-dealing index, a revised version of the anti-director index, in which they find that using securities law to measure shareholder protection works well in predicting stock market outcomes, but securities law may not be an appropriate measure to use in predicting corporate governance outcomes. Djankov et al., however, conclude that the law's effectiveness in regulating self-dealing in corporate governance is fundamental to shareholder protection. See S. Djankov, R. La Porta, F. Lopez-de-Silanes and A. Shleifer, "The Law and Economics of Self-Dealing" (NBER, Working Paper, 2006), p.40.
 12. See generally, Shleifer and Vishny, "A Survey of Corporate Governance" (1997) 52(2) *Journal of Finance* 741.
 13. See generally A. Keay, "Ascertaining the Corporate Objective: An Entity Maximisation and Sustainability Model" (2008) 71 *Modern Law Review* 663 for a detailed discussion on stakeholder theory.
 14. La Porta et al. classify investors as including shareholders and creditors; see, generally, R. La Porta, F. Lopez-De-Silanes, A. Shleifer and R. Vishny, "Investor Protection and Corporate Governance" (2000) 58(1) *Journal of Financial Economics* 3. Although generally a significant number of creditors are investors, it is important to point out that not all creditors will be investors in the company. The term "investor" is used in this article to refer to those who have advanced money, supplies or services to the company, in the expectation that they will get a return, regardless of whether they are shareholders of the company or creditors.
 15. See generally, Shleifer and Vishny, "A Survey of Corporate Governance" (1997) 52(2) *Journal of Finance* 741.
 16. See, generally, M.C. Jensen and W.H. Meckling, "Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure" (1976) 3 *Journal of Financial Economics* 305.
 17. See, generally, Jensen and Meckling, "Theory of the Firm" (1976) 3 *Journal of Financial Economics* 305; F.H. Easterbrook and D.R. Fischel, "The Corporate Contract" (1989) 89 *Columbia Law Review* 1416.
 18. See generally, Jensen and Meckling, "Theory of the Firm" (1976) 3 *Journal of Financial Economics* 305.
 19. Shleifer and Vishny, "A Survey of Corporate Governance" (1997) 52(2) *Journal of Finance* 737.
 20. Jensen and Meckling, "Theory of the Firm" (1976) 3 *Journal of Financial Economics* 305.
 21. Shleifer and Vishny, "A Survey of Corporate Governance" (1997) 52(2) *Journal of Finance* 737.
 22. Riley and Ryland argue that when share options are the means of pay, directors may manipulate their work to fit into the pay structure. See generally, C. Riley and D. Ryland (eds), *Directors' Remuneration: Towards some Principles of Substantive Procedural Review* (London: Cavendish Publishing Ltd, 1995). There is also evidence that when incentive contracts are effective, after attaining a certain level of ownership, management start to become self-interested. Short and Keasey, however, show that managerial entrenchment interests begin to contradict shareholder interests when managerial ownership reaches 12%. See H. Short and K. Keasey, "Managerial Ownership and the Performance of Firms: Evidence from the UK" (1999) 5 *Journal of Corporate Finance* 79.
 23. M. Faccio and L.H.P. Lang, "The Ultimate Ownership of Western European Corporations" (2002) 65 *Journal of Financial Economics* 365.
 24. Shleifer and Vishny, "A Survey of Corporate Governance" (1997) 52(2) *Journal of Finance* 737.
 25. M.J. Roe (ed.), *Explaining Western Securities Markets* (2005).
 26. N. Fligstein and N. Choo, "Law and Corporate Governance" (2005) 1 *Annual Review of Law and Social Sciences* 61.
 27. J.W. Cioffi, "Governing Globalisation? The State, Law and Structural Change in Corporate Governance" (2000) 27(4) *Journal of Law and Society* 573.
 28. Cioffi, "Governing Globalisation?" (2000) 27(4) *Journal of Law and Society* 573, 575.
 29. Cioffi, "Governing Globalisation?" (2000) 27(4) *Journal of Law and Society* 573, 578.
 30. Coglianese et al., "The Role of Government in Corporate Governance" (2004), pp.5-15.
 31. Shleifer and Vishny, "A Survey of Corporate Governance" (1997) 52(2) *Journal of Finance* 737.
 32. Shleifer and Vishny, "A Survey of Corporate Governance" (1997) 52(2) *Journal of Finance* 737.
 33. J. Solomon, *Corporate Governance and Accountability*, 2nd edn (England: John Wiley & Sons, 2007).
 34. Shleifer and Vishny, "A Survey of Corporate Governance" (1997) 52(2) *Journal of Finance* 737.
 35. On labour law and its effect on corporate governance, see generally B. Ahlering and S. Deakin, "Labour Regulation, Corporate Governance and Legal Origin: A Case of Institutional Complementarity?" (Centre for Business Research, University of Cambridge, 2005).
 36. Cioffi, "Governing Globalisation?" (2000) 27(4) *Journal of Law and Society* 573, 578.
 37. Cioffi, "Governing Globalisation?" (2000) 27(4) *Journal of Law and Society* 573, 578.
 38. In Europe, on the other hand, they have workers' councils or stronger trade unions, which encourage greater worker participation within the board.
 39. See generally, B. Cheffins, *Company Law: Theory Structure and Operations* (1997), Ch.12.
 40. See generally, Cheffins, *Company Law* (1997), Ch.12.
 41. See generally, Cheffins, *Company Law* (1997), Ch.12. The argument that employees take on management colouring is not without its critics. The management colouring argument is therefore only true of out-of-office management-employee relations. See Cheffins, *Company Law* (1997), Ch.12. The management colouring argument has recently been advanced by Riley, who points out that some of the members will usually have mentally graduated to their new "supervisory-board member" status and become independent of their past concerns as employees. See C.A. Riley, "Controlling Corporate Management: UK and US initiatives" [1994] *Legal Studies* 244.
 42. See generally, Cioffi, "Governing Globalisation?" (2000) 27(4) *Journal of Law and Society* 573.
 43. Cioffi, "Governing Globalisation?" (2000) 27(4) *Journal of Law and Society* 573, 588-589.
 44. A. Cuervo, "Corporate Governance Mechanisms: A Plea for Less Code of Good Governance and More Market Control" (2002) 10(2) *Corporate Governance: An International Review* 84.
 45. S. Robinson, "United Kingdom: Getting the Deal Through" [2007] *Corporate Governance* 212.

46. A.K. Borokhovich, R. Parrino and T. Trapani, "Outside Directors and CEO Selection," (1996) 31(3) *Journal of Financial and Quantitative Analysis* 337.
47. E. Fama and M.C. Jensen, "Separation of Ownership and Control" (1983) 26 *Journal of Law and Economics* 301, 315.
48. On the UK, see N. Vafeas and E. Theodorou, "The Association between Board Structure and Firm Performance in the UK" (1998) 30 *British Accounting Review* 383. On the US, see J. Brickley, J. Coles and G. Jarell, "Leadership Structure: Separating the CEO and the Chairman of the Board" (1997) 3 *Journal of Corporate Finance* 189.
49. The UK's 2006 Combined Code in s.1A.3 requires that the board should include a balance of executive and non-executive directors so that no individual or group of individuals can dominate decision-making on the board.
50. This issue of non-executive directors in the UK was first addressed in the Higgs Report of 2003 which was the UK's response to scandals such as Enron and Parmalat which had occurred owing to the presence of ineffective non-executive directors on the companies' boards. The Higgs Report dealt with the role and effectiveness of non-executive directors and proposed an increase in the proportion of non-executive directors on the board to at least half of the board. The issue of non-executive directors was further dealt with in the Tyson Report of 2003 which focused on the recruitment and development of non-executive directors. Non-executive directors have since been included as a board structure mechanism within the UK. Section 1 A.3.2 of the Combined Code states that at least half the board, excluding the chairman, should comprise of non-executive directors determined by the board to be independent.
51. J.A. Brickley and C.M. James, "The Takeover Market, Corporate Board Composition, and Ownership Structure: The Case of Banking" (1987) 10(1) *Journal of Law and Economics* 161.
52. S. Rosenstein and J.G. Wyatt, "Inside Directors, Board Effectiveness and Shareholder Wealth" (1997) 44 *Journal of Financial Economics* 229.
53. A. Agrawal and C.R. Knoeber, "Firm Performance and Mechanisms to Control Agency Problems between Managers and Shareholders" (1996) 31(3) *Journal of Financial and Quantitative Analysis* 377.
54. B.E. Hermalin and M.S. Weisbach, "Boards of Directors as an Endogenously Determined Institution: A Survey of the Economic Literature" (2003) 9(1) *Economic Policy Review--Federal Reserve Bank of New York* 7.
55. Shleifer and Vishny, "A Survey of Corporate Governance" (1997) 52(2) *Journal of Finance* 737.
56. Fama and Jensen, "Separation of Ownership and Control" (1983) 26 *Journal of Law and Economics* 301, 313-314.
57. Public law is the law governing the relationship between the individual and the state.
58. An examination of the Companies Act 2006 reveals that directors' duties have been codified by setting them out in statute, with a significant amount of criminal sanctions to facilitate their enforceability. The criminal sanctions in question differ from the remedies for the enforcement of directors' duties in that they are imposed for the breach of regulatory offences such as the violation of administrative matters pertaining to disclosure, such as filing of the relevant documents, the time-frame for disclosure as well as the extent of the disclosure. Examples of criminal sanctions that are in place to enforce regulatory offences in the Companies Act 2006 can be found in s.162(7) for failure to keep a register of directors where the criminal sanction is a fine not exceeding level 5 and 1/10 of level 5 for continued default and s.162(8) for refusal of inspection of register where the criminal sanction is an order for specific performance through which the court may compel an immediate inspection of the register. There are stark differences in the use of criminal sanctions in corporate governance in the US and the use of criminal sanctions in UK corporate governance. While criminal sanctions in the US Sarbanes-Oxley Act have more of a punitive role, those in the Companies Act 2006 take on a preventative/regulatory role, which is to ensure that management does not hinder the achievement of good corporate governance. Notable also is the introduction of progressive penalties for criminal regulatory offences, for instance, liability on summary conviction to a fine not exceeding level 5 and 1/10 of level 5 for continued default for failure to maintain a register under s.162(7) of the Companies Act 2006. This allows for judicial discretion in sentencing depending on the severity of the crime.
59. Djankov et al., "The Law and Economics of Self-Dealing" (NBER, Working Paper, 2006), p.40.
60. This term is used literally and not in the economic sense where efficiency is defined in terms of costs.