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Stewardship in the Interests of Systemic Stakeholders: Re-conceptualizing the Means and Ends of Anglo-American Corporate Governance in the Wake of the Global Financial Crisis

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Introduction: Corporate Governance in Crisis? An Opportunity to Re-think the Ends and Means of Governance

"The business of business is business."

– Milton Friedman[1]

"In its broadest sense, corporate governance is concerned with holding the balance between economic and social goals and between individual and communal goals. The governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align as nearly as possible the interests of individuals, corporations and society."

– Sir Adrian Cadbury[2]

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1. Widely attributed to Friedman, this well-known phrase may have been derived from a statement in his book, which states, "there is one and only one social responsibility of business–to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud." Milton Friedman, Capitalism and Freedom 133 (1962).

2. Sir Adrian Cadbury, *Foreword* to Stijn Claessens, *Corporate Governance and Development*, International Finance Corporation (2003), http://www.ifc.org/wps/wcm/connect/7fc17c0048a7e6dda8b7ef6060ad5911/Focus_1_Corp_Governance_and_Development.pdf?MOD=AJPERES.

The recent global financial crisis has been described as a "perfect storm of economic conditions."[3] In dissecting the anatomy of this disaster, commentators have highlighted numerous factors, from global trade imbalances, to financial market innovation, and the poverty of free market ideology.[4] Amidst the discussion of such macro-environment factors, attention has turned toward the key micro factor in the crisis: the *failure of corporate governance*, and in particular the Anglo-American model, to curb excessive risk-taking and protect the interests of the financial system and wider economy.[5] As Sullivan notes: "The current crisis can be best understood as a crisis of governance rather than an inherent failure of markets or capitalism itself."[6]

The financial crisis thus compels us to re-examine current Anglo-American paradigms of corporate governance across two key planes: i) the *ends* of corporate governance – *viz,* for what purpose and in whose interests is the company governed, and ii) the *means* of governance – whether the current mix of strategies involving directors and shareholders is adequate. The central thrust of this thesis is that the *ends* of governance must be expanded past maximizing shareholder value to include the interests of financial and economic stability, and that the *means* of governance - *viz,* the roles and responsibilities of directors and shareholders – must be re-calibrated in the light of this larger objective. Broadly, this includes changes to board composition, structure and duties; as well as increasing the responsibilities of shareholders. Collectively, directors and shareholders are both to be seen as *stewards* for the wider system's stake in the company.

The balance of this discussion proceeds as follows. Part I argues that the ends of corporate governance must be expanded to include the protection of the economic and financial system (the "systemic stakeholder" model). The leading competitor of this wider paradigm, the shareholder value maximization model, is first questioned, before the systemic stakeholder model is justified on a risk-based model of stakeholding. Part II proceeds to analyze how current corporate governance mechanisms – the board of directors and shareholders – are insufficient to protect the interests of systemic stakeholders, and explains how particular failures of board composition, structure and duties, as well as a lack of shareholder responsibility, were facilitative of the financial crisis. My critique is sensitive to the differences in the US and UK models of corporate governance, yet will show how each is

3. Martin Lipton, Steven A. Rosenblum, Karessa L. Cain, *Some Thoughts for Boards of Directors in 2009,* Wachtell, Lipton, Rosen & Katz 1, 1 (Dec. 8, 2008), www.wlrk.com/docs/ThoughtsforDirectors2009.pdf.

4. *See A Regulatory Response to the Global Banking Crisis*, The Turner Review, Mar. 2009, at 1, 11-14 (discussing issues contributing to the 2008 global financial crisis); *see generally* Joseph E. Stiglitz, Freefall: Free Markets and the Sinking of the Global Economy (2010) (same).

5. Suzanne Young & Vijaya Thyil, *A Holistic Approach to Corporate Governance: Lessons from the Financial Crisis and the Way Forward*, *in* Corporate Governance and the Global Financial Crisis: International Perspectives 365, 365 (William Sun, Jim Stewart, David Pollard eds., 2011).

6. Rodney Sullivan, *Finance Briefing: The Crisis is One of Governance*, Financial Times (Aug. 2, 2009, 06:02 PM), http://www.ft.com/intl/cms/s/0/58109850-7f4f-11de-85dc-00144feabdc0.html#axzz2qhgaF21V.

particularly deficient. Part III then suggests how corporate governance can be reformed in order to safeguard the interests of systemic stakeholders against excessive corporate risk-taking. These reforms include:

1. re-composing the board to emphasize competence as well as independence, and enhancing diversity;
2. re-structuring the board to include new board structures and ideas of network governance to facilitate integrated risk management;
3. re-invigorating board duties to encompass oversight responsibility for risk management; and
4. re-conceiving the role of shareholders to emphasize responsibilities to corporate stakeholders.

It is concluded that the financial crisis has offered an opportunity for a holistic re-appraisal of the ends and means of Anglo-American corporate governance, one which we must seize in order to ensure that our legal regimes and regulatory structures remain dynamically relevant and responsive to the needs of our time.

I. RE-THINKING THE ENDS OF CORPORATE GOVERNANCE – EXPANDING THE PARADIGM TO INCLUDE PROTECTION OF SYSTEMIC STAKEHOLDERS

The goal of corporate governance should go beyond furthering the interests of *shareholders* to include protecting the interests of *systemic stakeholders.*[7] A systemic stakeholder is a socio-economic actor who may not be *immediately* connected to the company through its usual nexus of contracts (for example, employees, suppliers and customers); but who nonetheless has *extended* connections to the company (for example, financial firms via links such as payment and settlement systems).[8] Accordingly, the protection of systemic stakeholders equates to the protection of the stability and sustainability of the economic and financial system, its ability to facilitate and enhance economic processes, manage risks and absorb shocks.[9] In more tangible terms, it is thus proposed that corporate governance mechanisms must go beyond only *maximizing shareholder value* to also *minimizing systemic risk* –the risk that a company's actions may have widespread negative repercussions on other social and economic actors due to the interconnectedness between the firm and the economy.[10]

7. *See infra* Part I.A and related notes.

8. James Bullard, Christopher J. Neely, and David C. Wheelock, *Systemic Risk and the Financial Crisis: A Primer*, FEDERAL RESERVE BANK OF ST. LOUIS REVIEW, September/October Part 1 2009, 403 at 408, *available at* http://research.stlouisfed.org/publications/review/09/09/part1/Bullard.pdf.

9. Eddy Wymeersch, *Corporate Governance and Financial Stability* 1 (Ghent Univ. Fin. Law Inst. Working Paper No. 2008-11), *available at* http://ssrn.com/abstract=1288631.

10. Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193, 202–04 (2008) (discussing systemic risk from institutional and market perspectives).

This section can be summarized as follows: firstly, I contrast the two main paradigms of corporate governance – shareholder and stakeholder models, demonstrating how they diverge on the question of "In whose interests should the company be governed?" Secondly, I point out how the shareholder paradigm is fundamentally flawed – its usual justifications based on agency, residual claimant and ownership theories are mistaken; nor does the shareholder paradigm promote economic efficiency – instead it may lead to short-termism and economic instability; nor is the shareholder paradigm as ubiquitous as it is made out to be. Thirdly, I justify the argument that corporate governance should protect the interests of systemic stakeholders on a risk-based conception of stakeholding. Further, I address four main objections to the systemic stakeholder paradigm – i) that it applies only to financial firms and has no corporate governance implications for non-financials, ii) that the protection of systemic stakeholders is the province of other regulatory regimes apart from corporate governance, iii) that protection of systemic stakeholders is far too broad and unverifiable an objective for corporate governance, and iv) that the protection of systemic stakeholders mutually excludes the pursuit of profit maximization and hence is damaging to the survival of the firm. It is concluded that the *ends* of corporate governance – its raison d'être – must include the protection of the economy and financial system.

A. *Paradigms of Corporate Governance: Shareholder versus Stakeholder Models*

In whose interests should the company be governed? The two paradigmatic models of corporate governance, shareholder value maximization and stakeholder theory, provide sharply contrasting answers to this question. The shareholder-oriented view holds that the corporation is formed from a nexus of private contracts, a *private* entity whose primary purpose is to maximize shareholder wealth.[11] The contrasting view is stakeholder-oriented: positing that the company has *both public and private roles,* thus behoving it to be managed in the interests of a broader range of stakeholders, including employees, consumers, and the wider public.[12]

The polarities of these two paradigms of corporate governance are clearly reflected in legal instruments as well - the UK Hampel Report of 1998 clearly tends towards shareholder primacy, stating that: "[T]he importance of corporate governance lies in its contribution both to business prosperity and to accountability. . .But the emphasis on accountability has tended to obscure a board's first responsibility—to enhance the prosperity of the business over time. . ."[13] In contrast, the OECD Principles of Corporate Governance state that

11. Virginia E. Harper Ho, "*Enlightened Shareholder Value*"*: Corporate Governance Beyond the Shareholder-Stakeholder Divide*, 36 J. CORP. L.J. 59, 71 (2010) (discussing stakeholders under corporate law).

12. *Id.*

13. Sally Wheeler, *Board Composition and Female Non-Executive Directors*, in THE FUTURE OF FINANCIAL REGULATION 272, 273 (Ian MacNeil & Justin O' Brien eds., 2010).

policy and regulation should provide firms with "incentives and discipline to minimize the divergence between private and social returns and to protect the interests of stakeholders."[14]

B. The Shareholder Value Maximization Paradigm Questioned

1. Agency and Residual Claimant Theories Do Not Solely Support Shareholder Value Maximization

Agency Theory

One of the most common justifications for the idea that the company should be governed solely in the interests of shareholders is *agency theory*, which starts with the Berle-Means observation that as countries industrialize and develop their markets, ownership and control of companies become separated. In the light of this separation, owners (as principals) appoint managers (as agents) to control the company on their behalf.[15] However, as Jensen and Meckling point out, there are conflicts of interest between the principals and agents, because managers would want to act in their own self-interest by extracting benefits from the company or pursuing self-aggrandizing projects[16] Such opportunistic behaviour results in agency costs to the company, which include the losses in corporate value to principals.[17] Shareholder primacy theorists reason that the very purpose of corporate governance law is to reduce such agency costs – *viz,* to protect the interests of vulnerable principals against opportunistic agents. Accordingly, because shareholders are such principals, corporate law should be geared towards promoting their interests.

The fallacy in the reasoning of shareholder primacy theorists lies *not* in the idea that corporate governance mechanisms should protect the interests of principals vis-à-vis agents – which is a correct insight; but that shareholders are the *only* principals for whom corporate law should act. While the separation of ownership and control undoubtedly creates one type of agency problem, multiple agency problems can arise in the context of the company. As Alexander, Dhumale and Eatwell point out, agency problems "arise because responsibility for decision making is directly or indirectly delegated from one stakeholder group to another in situations where stakeholder groups have different objectives and where complete information that would allow the first group to exert control over the decision

14. MAGDI ISKANDER & NADEREH CHAMLOU, CORPORATE GOVERNANCE: A FRAMEWORK FOR IMPLEMENTATION—OVERVIEW 4 (1999).

15. MICHAEL C. JENSEN, FOUNDATIONS OF ORGANIZATIONAL STRATEGY, (1998); *see also* JEAN TIROLE, THE THEORY OF CORPORATE FINANCE 15 (2006) (discussing corporate governance and the separation of ownership and control).

16. *Id.*

17. *Id.*

maker is not readily available."[18] For example, agency problems regularly arise between majority (controlling) shareholders as agents and minority (non-controlling) shareholders as principals; or between controlling shareholders as agents and non-controlling stakeholders as principals (such as creditors, employees and customers).[19] As such, shareholders are not the only vulnerable constituency which corporate law must protect. Recently, the economic system has itself been recognized as one such vulnerable principal – because excessive risk-taking by the company can impose wider agency costs (or "negative externalities") on society in the form of economic losses, financial destabilization, and more intangible repercussions on the social fabric.[20]

Residual Claimant Theory

The shareholder primacy theorist might further buttress her argument by contending that shareholders are not simply vulnerable principals; but that they are a unique type of principals: *residual claimants*. According to this theory, the company should be governed solely in the interests of shareholders because they alone have a financial stake in the company not protected by explicit contracts (a "residual interest"). Unlike employees and creditors whose interests are explicitly protected by contract, the shareholders' dividend depends on the company's success, and they alone bear risks from discretionary decisions made by the company.[21]

The assumption that shareholders are the sole residual claimants of the firm has been pointed out to be false. Firstly, commentators have highlighted the existence of *implicit contracts,* where other stakeholders such as employees make firm-specific investments that are not necessarily protected by formal contracts, such as where a company enters into an implicit understanding with its employees that a good faith effort will be made to pay out significant bonuses in addition to lower fixed wages.[22] Another example from continental Europe is where employees are implicitly promised certain monetary benefits upon the termination of their contracts.[23] In such cases, employees have financial stakes in the company that depend on the value of the firm, which are unprotected by contract – thus they bear the risks of

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18. Kern Alexander, Rahul Dhumale, John Eatwell, Global Governance of Financial Systems: The International Regulation of Systemic Risk 243 (2006).

19. Reinier Kraakman et al., The Anatomy of Corporate Law: A Comparative and Functional Approach 35-36 (2d ed. 2009).

20. Richard W. Painter, Wulf A. Kaal, *Initial Reflections on an Evolving Standard: Constraints on Risk Taking by Directors and Officers in Germany and the United States*, 40 Seton Hall L. Rev. 1433, 1450-51 (2010).

21. Bernard S. Sharfman, *Enhancing the Efficiency of Board Decision Making: Lessons Learned From The Financial Crisis of 2008*, 34 Del. J. Corp. L. 813, 827–28 (2009).

22. *Id.* at 828.

23. J. Matthijs de Jongh, *Are Shareholders the Only Residual Claimants?*, The Defining Tension (Dec. 7, 2009), http://www.thedefiningtension.com.

bad corporate decisions. In the context of the financial crisis, another group of residual claimants has been identified: the wider public, which does not have its interest in economic stability protected by any form of legal contract and has to incur the costs to the economy of excessive risk-taking by bailing out dysfunctionally-governed corporations such as AIG, to the tune of over US$180 billion worth of issued loans and guarantees on AIG debt and derivatives contracts.[24] Given that the public's finances are directly affected by the failure of systemically-linked companies, residual claimant theory would likewise countenance taking the interests of the economy into account.

2. The Ownership Concept of Shareholding is Misleading

Another justification for the company to be governed in the interests of shareholders is the common perception that shareholders own the company. The company itself is seen as a species of private property, capable of being owned.[25] Analogizing from proprietary concepts, Eisenberg has argued that shareholders possess most incidents of ownership, for example the "rights to possess, use, and manage, and the rights to income and to capital."[26] In contrast, while creditors, customers, suppliers and the wider public may have various rights and interests in the company, they do not have the same measure of *proprietary* interest; hence their interests are permanently subordinated to that of shareholders.[27]

The assumption that shareholders are owners, whose interests the company should solely take into account, is highly questionable – albeit intuitively appealing and deeply-rooted. Bainbridge points out that what shareholders own is *stock*, which represents but a proportionate claim on the company's net assets in the event of liquidation; the right to a pro rata share of dividends subject to declaration by the board of directors; and limited electoral rights.[28] Importantly, shareholders' ownership of stock does not entitle them to use or possesses corporate property, irrespective of whether the shareholder has a majority or minority interest, or whether shareholders are acting individually or collectively.[29]

Further, Ireland and Sealy have emphasized that shareholder ownership is a legal fiction that is far out of touch with the economy reality of how shareholders operate in modern day capital markets.[30] Shareholders today largely hold a diversified basket of securities as passive investors "standing *outside* the company and the production

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24. JOHN W. CIOFFI, PUBLIC LAW AND PRIVATE POWER: CORPORATE GOVERNANCE REFORM IN THE AGE OF FINANCIAL CAPITALISM 3–4 (2010).

25. STEPHEN M. BAINBRIDGE, CORPORATE GOVERNANCE AFTER THE FINANCIAL CRISIS 234–36 (2012).

26. Melvin A. Eisenberg, *The Conception That the Corporation is a Nexus of Contracts, and the Dual Nature of the Firm*, 24 J. CORP. L. 819, 825 (1999).

27. *Id.*

28. *See* Bainbridge, *supra* note 25, at 234-36.

29. *Id.*

30. Paddy Ireland*, Company Law and the Myth of Shareholder Ownership*, 62 MOD. L. REV. 32, 33 (1999).

process."[31] In comparison with debenture holders, for example, while their legal characteristics may seem distinguishable (debenture holders having rights to being repaid with interest; while shareholders having rights to dividends), the economic reality is that both are treated as securities in the corporate sector of the economy offering different kinds of risks and returns.[32] Shareholders, like debenture holders, are simply "money capitalists. . .[d]isinterested and uninvolved in management, and, in any case largely stripped (in law as well as in economic reality) of genuine corporate ownership rights."[33]

Finally, the idea of shareholding as ownership falls prey to a common mistake in reasoning - what Bainbridge terms the "reification" fallacy.[34] Behind the fiction of legal personality, a company is not a *thing* capable of being owned or a mere collection of assets; but an aggregate of "relationships between the people who have various stakes in the enterprise",[35] including, *inter alia,* shareholders who provide initial equity capital, creditors who provide debt capital, and employees who provide labour. It would be fallacious to reason that this set of relationships, commonly described as a nexus or web of explicit and implicit contractual relationships, is reducible to an object of property.[36] Reification – treating an abstraction as the real thing – is a semantically-useful shorthand for attributing responsibility in both common parlance and in law; but on the other hand, it unhelpfully obscures the reality that shareholders are but one set of stakeholders in a complex web of interconnected relationships that make up the company.[37]

3. Shareholder Value Maximization Can Exacerbate Short-termist Pressures and Is Not Always Economically Desirable

It has been contended that the shareholder value maximization model is the most economically-desirable model of corporate governance. Hansmann and Kraakman, in their influential, albeit controversial, article "The End of History for Corporate Law", argue that countries such as America, which adopted the shareholder primacy model, have shown much stronger economic performance than countries that tend towards other models, such as German and French economies, which tend towards a more stakeholder-oriented view.[38] Further, they assert that shareholder-oriented models have competitive advantages over firms adhering to

31. *Id.* at 42.
32. *Id.* at 47.
33. *Id.*
34. BAINBRIDGE, *supra* note 25, at 235. *See also* Stephen M. Bainbridge, *Unocal at 20: Director Primacy in Corporate Takeovers*, 31 DEL. J. CORP. L. 769, 776 (2006).
35. *Id.* at 234–36.
36. *Id.*
37. *Id.* at 235.
38. Henry Hansmaan & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 450 (2001).

other models because they can access equity capital at a lower cost, enabling them to penetrate new product markets more quickly, leading to greater economic returns in aggregate social welfare.[39]

These assertions, made in 2000, have been left bare in the wake of the 2009 financial crisis, which has demonstrated that a shareholder-centric view can lead to short-termist corporate strategies, which are ultimately destabilizing for the entire economy. As Cioffi notes: "One of the troubling paradoxes [of the financial crisis] is that pro-shareholder legal reforms adopted throughout the world intensified the incentives for short-termism, excessive risk taking, and managerial rent seeking.[40] The crisis could not have become so devastating if corporate governance regimes had effectively protected and promoted the long-term interests of the shareholders and stakeholders."[41] Indeed, shareholders are seen to have *precipitated* the crisis rather than being unfortunate victims of it.[42]

To elaborate, the problems with shareholder-centrism began in the later part of the 20th century, with the rise of what commentators call "financial capitalism" – the increasing role of financial markets, actors, institutions and motives in the operation of the domestic and international economy.[43] With financialization, a new set of shareholders entered the scene and began to influence corporate governance – institutional investors such as pension funds and retail funds, and investors with short-term time horizons such as hedge funds and private equity.[44] These investors were less concerned with long-term value maximization of particular firms than with maximizing the earnings of a basket of securities denoting equity or debt interests in various companies. This financial motivation drove the expansion of stock markets and the creation of new financial products used for speculative investment, where capital markets would allow quick entry and exit into the equity interest of a firm, regardless of what it might entail for the long-term health of any one company.[45] For example, in 2006, shares of NYSE-listed companies turned over at a rate of 118% - every share of stock being traded on average at least once during that year, an evident sign of speculation.[46] The support

39. *Id.* at 450–51.

40. CIOFFI, *supra* note 24, at 206.

41. *Id.*

42. *See, e.g.*, Charlotte Villiers, *Has the Financial Crisis Revealed the Concept of the 'Responsible Owner' to Be a Myth?*, *in* THE FUTURE OF FINANCIAL REGULATION 287 (Iain MacNeil & Justin O'Brien eds., 2010) (questioning whether shareholders bear responsibility for the financial crisis because "they could have been more diligent, supervised [their] agents better, and ensured that executive remuneration reflected real performance and long-term thinking.").

43. *See* MARKUS KALLIFATIDES ET AL., CORPORATE GOVERNANCE IN MODERN FINANCIAL CAPITALISM: OLD MUTUAL'S HOSTILE TAKEOVER OF SKANDIA 4 (2010).

44. *Id.* at 5.

45. Nadelle Grossman, *Short-Term Fling or Long-Term Commitment: Board Duties in a New Era*, BEPRESS.COM 7–8 (March 2009), http://works.bepress.com/cgi/viewcontent.cgi?article=1002 &context=nadelle_grossman.

46. *Id.* at 8.

given by shareholders to short-termist corporate strategies was enhanced by the fact that governments (particularly in the US) gave implicit guarantees to large companies which were "too big to fail" – thus shareholders would favour excessive risk that increased potential returns because they discount losses that taxpayers would potentially bear.[47]

The negative repercussions on the economy of short-termist strategies favoured by shareholders are clearly demonstrated by the financial crisis. Shareholders of US financial firms supported the acquisition of mortgage-backed securities (MBOs) and collateralized debt obligations (CDOs), securities whose payments derive from mortgage loans and mixed pools of receivables, respectively.[48] These investments were tied to the short-term increase in housing prices rather than any sustainable increase in long-term economic value. Once home prices plummeted in 2008, borrowers defaulted on their loans - loans which backed the MBOs and CDOs - such that financial firms lost much of the value of their assets.[49] Unfortunately, these losses were not isolated but had effects on the wider economy: credit markets began to dry up, making it difficult for enterprises to acquire debt-financing, start-up capital and R&D funding – the lifeblood of corporate growth.[50] Without thriving businesses, the ripple effects extended to increasing unemployment and lower economic growth overall. This explication of the links between shareholder-centrism and the financial crisis thus demonstrates that governing the corporation solely in the interests of shareholders is not always conducive to economic growth; and as the crisis indicates, may in fact be inimical to sustainable economic development.

4. The Ubiquity of the Shareholder Value Maximization Model Is Questionable

One final argument for shareholder primacy is its ubiquity and inevitability.[51] Hansmann and Kraakman famously assert that the shareholder-centric view dominates business, government and legal elites in key commercial jurisdictions, and that with the current emergent consensus, global convergence towards this paradigm is inevitable, hence "the end of history for corporate law."[52]

The first objection one might raise is that even if shareholder-centrism *is* the case in reality, this does not mean that it *should be* the ideal paradigm of corporate governance. Thus one may argue that Hansmann and Kraakman have attempted to

47. Tom Baker & David Moss, *Government as Risk Manager*, *in* NEW PERSPECTIVES ON REGULATION 87, 94 (The Tobin Project et al. eds., 2009). *See also* Bainbridge, *supra* note 25, at 11.

48. Grossman, *supra* note 45, at 34.

49. *Id.* at 34–35. *See also* Stiglitz, *supra* note 4, at 14.

50. Stiglitz, *supra* note 4, at 27–28.

51. Hansmann & Kraakman, *supra* note 38, at 449–51 (contending that the shareholder-oriented model achieved ubiquity because alternative models failed, and because the forces of logic, example, and competition demonstrated its superiority).

52. *Id.* at 449–50.

draw normative justification for the shareholder-centric paradigm from merely descriptive premises, the fallacy of deriving an "is" from an "ought".

Secondly, one can object that shareholder-centrism correctly reflects the reality of corporate law as it stands in the world today. No small number of commentators have accurately pointed out that explaining the state of corporate governance in a one-dimensional paradigm is flawed, missing out on the diversity of corporate governance paradigms across jurisdictions, such as the existence and persistence of the German co-determination model which institutionally includes stakeholders such as employees on the supervisory board.[53] Further, as Puchniak observes, the assumption of inevitability misses the fact that corporate governance "adapt[s] to fit its ever-changing environment."[54] American corporate governance, the supposedly paradigmatic example of shareholder-centrism, has in fact moved toward certain aspects of the Japanese main bank model, for example with the rise of American institutional shareholders who resemble Japanese stable shareholders under the main bank model.[55] Indeed, other aspects of US corporate governance indicate that it has also adopted characteristics of a stakeholder-centric model. For example, commentators note the rise of non-shareholder constituency statutes in at least thirty states, which permit or require directors to consider the impact of their decisions on non-shareholding stakeholders.[56] Pennsylvania, for one, allows directors to consider the effect of their decisions not just on shareholders, but on "employees, suppliers, customers and creditors of the corporation, and upon communities."[57] Such statutes are inconsistent with a pure shareholder primacy norm and suggest a degree of stakeholder-orientation.

C. *The Systemic Stakeholder Model Justified*

While we may effectively conclude that shareholder value maximization is not supportable by agency, residual claimant, or ownership theories; and that it is not economically desirable, nor ubiquitous and inevitable, we do need a justifiable alternative paradigm. It is argued that this paradigm should be a systemic stakeholder model, where the ends of corporate governance should go beyond furthering the interests of shareholders to include the protection of the interests of systemic stakeholders: socio-economic actors who may not be *immediately*

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53. Franklin A. Gevurtz, *The Globalization of Corporate Law: The End of History or a Never-Ending Story?*, 86 WASH. L. REV. 475, 489–90 (2011). *See generally* LAY HONG TAN ET AL., CORPORATE GOVERNANCE OF LISTED COMPANIES IN SINGAPORE (2006).

54. Dan W. Puchniak, *The Japanization of American Corporate Governance? Evidence of the Never-Ending History for Corporate Law*, 9 ASIAN-PAC. L. & POL'Y J. 7, 69–70 (2007).

55. *Id.* at 25–33.

56. Antony Page, *Has Corporate Law Failed? Addressing Proposals for Reform*, 107 MICH. L. REV. 979, 988 (2009). *See also* Robert Sprague & Aaron J. Lyttle, *Financial Crisis: Impetus for Restoring Corporate Democracy*, 2010 MIDWEST ACAD. LEGAL STUDIES IN BUS. 1, 10, http://ssrn.com/abstract=1529733.

57. 15 PA. CONS. STAT. ANN. § 1715(a)(1) (2013).

connected to the company through its usual nexus of contracts but who nonetheless have *extended* connections to the company.[58] To put it another way, the goal of corporate governance mechanisms must go beyond only *maximizing shareholder value* to also *minimizing systemic risk*: the risk that a company's actions may have widespread negative repercussions on other socio-economic actors in the economic or financial system.[59]

1. The Financial System and Economy Qualify as Stakeholders Under a Risk-based Model of Stakeholding

The basic idea of a "stakeholder" whose interests the company should take into account was articulated as early as 1932 by E. Merrick Dodd Jr., who argued that a company's "[p]ower over the lives of others tends to create on the part of those most worthy to exercise it a sense of responsibility", and that this "sense of responsibility toward employees, consumers, and the general public may thus come to be regarded as the appropriate attitude to be adopted by those who are engaged in business."[60] As Kershaw observes, Dodd's basic insight is that large companies will wield tremendous power and influence over the lives of all members of society, whether in providing goods, services or employment, and accordingly, with this power comes the responsibility to act in the wider interests of society.[61]

While Dodd's basic insight has been refined subsequently by various theorists,[62] one of the more compelling and influential conceptions is Max Clarkson's risk-based model of stakeholding. According to Clarkson, the key to defining a stake in a company is whether one has an economic interest at risk in the firm[63] – thus this includes, but is not limited to, shareholders (who risk the loss of their investment), creditors (who risk default on their loans), and employees (who risk dismissal or under-compensation). Because these actors have stakes in the company, they

58. Bullard, *supra* note 8, at 407–09.

59. *See generally* Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193 (2008).

60. E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145, 1157, 1160 (1932).

61. DAVID KERSHAW, COMPANY LAW IN CONTEXT: TEXT AND MATERIALS 223 (2009).

62. For example, Evan and Freeman argue for a theory of 'Kantian capitalism', citing Kant's notion that people should be treated as an end and never a means, thus the welfare employees, consumers and the wider public should equally be the ends of enterprise. R. EDWARD FREEMAN, ET AL., STAKEHOLDER THEORY: THE STATE OF THE ART 214 (2010).

63. Specifically, Clarkson defines stakeholders as people who "bear some form of risk as a result of having invested some form of capital, human or financial, something of value, in a firm." Andrew Keay, *Stakeholder Theory in Corporate Law: Has It Got What It Takes?*, 9 RICH. J. GLOBAL L. & BUS. 249, 259 (2010) (quoting Max B. E. Clarkson, *A Risk-based Model of Stakeholder Theory* (The Ctr. for Corporate Soc. Performance and Ethics, Working Paper, 1995)). *See also* Deborah Vidavier-Cohen, *Taking a Risk: Max Clarkson's Impact on Stakeholder Theory*, 38 BUS. & SOC'Y 39, 39 (1999), *available at* http://bas.sagepub.com/content/38/1/6.citation.

therefore have claims on how it should allocate resources under its control.[64]

One of the key advantages of a risk-based conception is that it is neither over-inclusive nor under-inclusive. Other theories which define a stakeholder as any group or individual who can affect or is affected by the firm are subject to the charge of being overbroad – based on such conceptions, even entities that have no clearly identifiable interests such as the natural environment, would also be considered a stakeholder.[65] At the same time, it avoids being restricted to unduly narrow definitions which include only those actors who have immediate and contractual interactions with the company (for example, customers, suppliers and employees).

Based on Clarkson's risk model, one can reason that the financial system or economy itself is a stakeholder in the company. For example, a large financial firm is generally linked with the financial system through a web of financial relationships and through its participation in capital markets.[66] Because of these interconnections, there exists the risk that losses to one firm will set in motion "a series of successive losses along a chain of institutions or markets comprising a system."[67] This is known as *systemic risk* – "the risk of a chain reaction of falling interconnected dominos."[68] For example, in the payments network, the Board of Governors of the US Federal Reserve has emphasized that systemic risk can occur if a financial firm participating in a payments network is unable to settle its net debt position, which would in turn result in the institution's creditors being unable to settle their commitments.[69] This ripple effect may extend even to depository institutions not participating in the network, and to the real (non-financial) economy consequently.[70] Thus, if risk is the touchstone of stakeholding, it follows that systemic risk behoves the company to take into account the interests of systemic stakeholders. In a particularly striking metaphor, the ex-governor of the Bank of England, E.A.J. George, described the fates of the company and the financial system as being "tie[d]. . .like mountaineers, so that if one falls off the rock face others are pulled off too."[71]

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64. Keay, *supra* note 63, at 256 ("All those who contribute critical resources to the corporation should benefit. So, rather than the corporation working to create value for shareholders, the stakeholder theory adheres to the idea that the corporation works towards creation of value for all stakeholders. Furthermore, it is fundamental to stakeholding that organisations are managed for the benefit of, and accountable to, all stakeholders.").

65. Eric W. Orts & Alan Strudler, *The Ethical and Environmental Limits of Stakeholder Theory* 12 Business Ethics Quarterly 215, 218 (2002).

66. Bullard, *supra* note 8, at 408.

67. George G. Kaufman & Kenneth E. Scott, *What is Systemic Risk, and Do Bank Regulators Retard or Contribute to It?* 7 Indep. Rev. 371, 372 n. 3 (2003).

68. *Id.*

69. *Id.*

70. Dodd, *supra* note 60, at 1156.

71. Kaufman & Scott, *supra* note 67, at 373.

2. Objection 1: Is the Systemic Stakeholder Model Relevant Only to Financial Firms?

One may counter that the above-mentioned argument - that the financial system and economy are stakeholders - applies solely to financial firms. Hence, its corporate governance implications are limited and this thesis should perhaps be confined to the corporate governance of banking institutions. It is acknowledged that the problem of systemic risk is especially acute in financial firms.[72] As various commentators have pointed out, the degree of interconnectedness within the financial system is heightened because of interbank loan and deposit markets, and payment and settlement systems.[73] Heremans explains that "the banking system contains powerful propagation mechanisms that can amplify small initial shocks as they are much more interconnected than is the case in other sectors of the economy."[74]

Non-Financial Firms Undertaking Non-Financial Activities Can Also Present Systemic Risks

However, to presume systemic risk is a problem only in the financial sector is myopic – all large industrial and commercial companies pose some degree of risk to the wider economic system were they to fail.[75] Levitin gives the example of the failure of a large aerospace manufacturer, which would cause losses not just to counterparties such as parts suppliers and airlines that have paid in advance for aircraft; but would have ripple effects on airlines' ability to cater to the demand for air travel, and the efficiency of global transportation as a whole.[76] Similarly, the failure of a large commercial company such as US.

Wal-Mart would result in massive economic dislocations, because Wal-Mart is not only a major buyer of products from thousands of companies, but also creates an entire value-chain of logistics businesses between manufacturers, warehouses, and stores.[77] Thus, non-financial firms which are strategically and systemically

72. *Id.*

73. Ross Levine, *The Corporate Governance of Banks: A Concise Discussion of Concepts and Evidence* 2 (Global Corporate Governance Forum, Paper No. 3, 2003), *available at* http://www.ifc.org/wps/wcm/connect/0fa1e18048a7e589a23fe76060ad5911/DP_3_CG_of_Banks_Levine_2003.pdf?MOD=AJPERES. *See also*, Andrea Polo, *The Corporate Governance of Banks: The Current State of the Debate* 2 (Universitat Pompeu Fabra Faculty of Economic and Business Sciences, 2007), *available at* http://ssrn.com/abstract=958796 and Vasile Corcis & Maria Cristina Ugureanu, *Why are Banks Special? An Approach From the Corporate Governance Perspective* 56 (University Iasi Economic Series, Paper No. 54, 2007), *available at* http://ssrn.com/abstract=1090291.

74. Dirk Heremans, *Corporate Governance Issues for Banks: A Financial Stability Perspective* 5 (Katholieke Universiteit Leuven Center for Economic Studies, Working Paper No. 07.07, 2007) *available at* https://lirias.kuleuven.be/bitstream/123456789/120504/1/Dps0707.pdf.

75. Adam J. Levitin, *In Defense of Bailouts*, 99 Geo. L. J. 435, 453–54 (2011).

76. *Id.* at 353.

77. *Id.*

important to fuelling the economic engine can be as vital to the economy as financial institutions.

Non-Financial Firms May Act Like Financial Firms and thus Present Systemic Risks

Additionally, firms that may appear to be non-financial in nature (that is, non-banking or insurance-type firms) are often plugged into the financial markets and regularly participate in financial activities. A common example would be vehicle manufacturers and major retailers which have affiliated sales and financing arms, enabling them to undertake transactions such as credit-sales where the primary element of the transaction – the sale – is accompanied by a financial intermediation function.[78] General Motors, while primarily involved in vehicle manufacturing, is closely affiliated with Ally Financial (previously General Motors Acceptance Corporation), which supports the manufacturing and sales arm of General Motors by providing auto financing, insurance and mortgage services.[79] Thus it is difficult to draw the line between firms that are purely financial and those that are purely commercial or industrial.[80]

Furthermore, such non-financials which undertake financial activities can consequently present a huge systemic risk to the wider economy. Perhaps the most egregious example of this is Enron. Enron, which began life as a transporter of natural gas, subsequently desired to transform itself into a pure financial intermediary where it would create a proprietary marketplace and match up energy producers, carriers and users; as well as provide risk management products in the form of derivative contracts which covered its customers' exposure to price risks.[81] Enron's derivative business evolved into a speculative trading arm and was one of the major sources of market and credit risk to the firm, placing bets on rising energy prices which ultimately failed.[82] Bratton explains that "Enron collapsed the same way banks routinely collapsed in days before deposit insurance. It did so because it had largely succeeded in realizing Skilling's [the Enron CEO] vision of becoming a financial institution."[83] Further, Enron's interconnections with the entire energy industry, financial markets and society (through employment and pensions) meant that its excessive risk-taking threatened the wider economy. As Merson points out: "[I]f Enron had continued to succeed making ever-rising profits by amoral means. . .then shareholders' interests may have been served with the denial of every other conceivable interest as the company continued to hike prices by exercising monopoly power, destabilising essential energy and other services, creating

78. *Id.* at 454.
79. *Id.*
80. *Id.*
81. William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275, 1288 (2002).
82. *Id.* at 1289.
83. *Id.* at 1360.

volatility in markets that undermined the prospects of continuing normal business in other industries, and damaging people's lives as a result."[84] Thus, it is clear that large interconnected non-financials which are significantly involved in financial activities can present systemic risks.

Finally, the argument that all large companies - and not just financial institutions - should be cognizant of risks to the system, derives additional support from corporate governance reforms in the wake of the financial crisis, which generally apply to large listed companies – whether or not they are financial institutions.[85] For example, although Sir David Walker's initial mandate by the UK government was to review the governance of banks and other financial institutions, the UK Financial Reporting Council eventually imported substantial parts of the Walker recommendations into its 2009 Review of the Combined Code of Corporate Governance, emphasizing that the corporate governance implications from financial institutions' failures to manage systemic risk apply to non-financial institutions as well.[86]

Thus, it is submitted that the systemic stakeholder model should apply to all *public listed companies*, whether or not they are financial institutions. The basis for excluding private and non-listed public companies is that these firms may vary considerably in size, and thus their "too big to fail" potential may not always be clear and present. On the other hand, public listed companies have to meet minimum market capitalization standards – for example, the NYSE requires US$150 million based on its "Assets and Equity" test for global market capitalization.[87] The size of the company thus serves as a fairly accurate proxy for its economic presence, and accordingly, the potential risk it presents to the system were it to collapse.

3. Objection 2: Should Systemic Stakeholders be Protected by Regulatory Regimes Other than Corporate Governance Law?

Some commentators agree that the interests of systemic stakeholders are important, and that systemic risk should be reduced, but take the position that this objective is not within the purview of corporate law. Corporate law should simply be a tool for maximizing shareholder interests, while the separate objective of controlling risks to the system can be achieved by putting in place banking or financial regulations,

84. Rupert Merson, Rules Are Not Enough: The Art of Governance in the Real World 101 (Profile Books, LTD., 2010).

85. *See generally*, Corporate Governance in the Wake of the Financial Crisis 1–39 (United Nations Conference on Trade and Development 2010), *available at* www.unctad.org/isar.

86. Financial Reporting Council, 2009 Review of the Combined Code: Final Report 10–11 (Dec. 2009).

87. *U.S. Listing Standards*, NYSE Euronext (Jan. 14, 2014, 3:31PM), http://usequities.nyx.com/regulation/listed-companies-compliance/listings-standards/us.

such as capital requirements.[88] Along the same lines, Hansmann and Kraakman have previously asserted a parallel position with respect to stakeholders such as workers and consumers, who are allegedly protected by health and safety law, and product liability law, respectively.[89]

This reasoning is fallacious because it assumes that banking or financial regulations can completely curb risk to systemic stakeholders. For example, Gevurtz points out that capital requirements to curb excessive risk work only to a limited extent.[90] Capital requirements, in the context of financial firms, are legal obligations on firms to hold a certain amount of retained earnings, reserves, and amounts received for common and preferred stock, as a percentage of the firm's total assets – in order to provide a cushion to insure that a firm can still meet its obligations to depositors despite losses in its investment and lending portfolio.[91] However, such requirements only *mitigate* the consequences of excessive risk-taking, rather than *curbing* risk-taking behaviour. In fact, capital requirements may in fact perversely produce an incentive to take greater risks to ensure a higher return on investments, since more capital is set aside to cushion possible losses.[92] Furthermore, it is unclear whether capital requirements are sufficient to meet obligations owed to creditors (in the banking setting, depositors) given many investors' short-term horizons, which would predispose them toward risk-taking way in excess of capital cushions. As Guvertz puts it: "The mathematics of banking is such that unless one makes the capital requirement so large as to undercut the banking function altogether, investments that are not in the interest of depositors still may make sense for the shareholders despite the risk to capital. Compounding this problem is the fact that the cost of a bank's collapse may be systemic damage to the broader economy, which could even exceed the depositors' losses."[93]

Furthermore, claiming that the problem of systemic risk is one of financial regulation mistakenly conveys the impression that defective corporate governance had no part to play in the financial crisis. Indeed, the root problem of excessive risk-taking can be attributed to the behaviour of directors and shareholders, the controlling agents of the company. As Kirkpatrick explains, lapses in board oversight and risk management, not to mention remuneration structures which incentivized short-termism, were major contributing factors to the crisis.[94] It follows

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88. *See* Franklin A. Gevurtz, *The Role of Corporate Law in Preventing a Financial Crisis: Reflections on In re Citigroup Inc. Shareholder Derivative Litigation* 23 GLOBAL BUS. & DEV. L. J. 113, 123 (2010).

89. Hansmann, *supra* note 38, at 442.

90. Gevurtz, *supra* note 88, at 123.

91. *Id.*

92. *Id.*

93. *Id.* at 125.

94. Grant Kirkpatrick, THE CORPORATE GOVERNANCE LESSONS FROM THE FINANCIAL CRISIS 2 (OCED Steering Group on Corporate Governance, 2009).

that where failures in corporate governance contribute to systemic risk, corporate law must be re-calibrated to address these issues.

Finally, acknowledging the necessity of financial regulation does not mean that corporate governance has no role to play – instead of being *mutually exclusive*, both regulatory regimes can be *mutually reinforcing*. Examples of such mutually-reinforcing governance regimes proliferate all spheres of corporate activity, across many jurisdictions: public investors, for one, are usually protected from corporate exploitation by a dual regime of private enforcement devices (shareholder lawsuits for misrepresentations) as well as public enforcement (criminal sanctions or quasi-criminal penalties).[95] Specifically, in the aftermath of the financial crisis, Young and Thyil have proposed a "holistic approach" which includes multiple and overlapping governance mechanisms: from firm-specific corporate codes of ethics which informally shape corporate culture; to the public corporate governance framework under national corporate governance codes or listing rules; and the outer layer of capital markets regulations which at the minimum promotes disclosure and reduces informational asymmetries, in order to facilitate the workings of a robust market for corporate control.[96] The point to emphasize is that corporate governance law and financial or banking regulations are highly complementary tools – the former regulates opportunistic behaviour of corporate actors; while the latter is largely concerned with protecting firms' asset cushions - yet both can work in tandem to safeguard the firm from potential failure and prevent it from posing risks to the system.

4. Objection 3: Is the Goal of Protecting Systemic Stakeholders Over-broad and Unverifiable?

Another objection to the idea that companies should take into account the interests of the economic system is that this goal is far too broad for corporate governance mechanisms to take into account, and accordingly, it would be difficult to verify if directors and shareholders are indeed acting in the interests of systemic stakeholders. For example, Kerr argues that taking the national economy's interests into consideration goes far beyond the constituencies normally recognized as stakeholders, such as employees, suppliers, creditors, and the local community where business is located.[97] It is hard to conceive of the idea of stakeholding extending to "the entire economic health of the nation."[98]

95. *See* Jensen, *supra* note 15, at 294–298.

96. *See* Stiglitz, *supra* note 4, at 365.

97. *Stakeholder Analysis*, THE WORLD BANK GROUP, http://www1.worldbank.org/publicsector/anticorrupt/PoliticalEconomy/stakeholderanalysis.htm (last visited February 13, 2014).

98. J. E. Kerr, Note, *The Financial Meltdown of 2008 and the Government's Intervention: Much Needed Relief or Major Erosion of American Corporate Law? The Continuing Story of Bank of America, Citigroup and General Motors*, 85 ST. JOHN'S L. REV. 49, 108 (2011).

While this writer would acknowledge that taking the interests of the economy into account extends the paradigm of stakeholding considerably, it is argued that this paradigm is not over-broad to the extent that it becomes unverifiable. Firstly, it is re-emphasized that systemic stakeholders, whose "stake" lies in the fact of their exposure to systemic risk posed by the firm, do not include every conceivable stakeholder – it excludes, for example, competitors, the media, social activists, and the natural environment; constituencies that other stakeholder models routinely attempt to include.[99] Indeed, Max Clarkson, the founder of the risk-based conception of stakeholding, himself recognized that "[s]takeholder theory should not be used to weave a basket big enough to hold the world's misery."[100]

Furthermore, the protection of systemic stakeholders, while at first glance seemingly an unverifiable objective, is actually quite susceptible to concretization, both qualitatively and quantitatively. The key proxy for the protection of systemic stakeholders is the degree to which a company presents *systemic risks* to the economy. This can be measured by either a "too big to fail" or "too interconnected to fail" test: the former looks at an aggregate of factors including an institution's size relative to the national or international marketplace, and market share concentration;[101] while the latter looks at the likelihood of a medium-term negative impact to the larger economy of an institution's failure to be able to continue its ongoing business, taking into account the institution's activities and the economic multiplier of all other commercial activities dependent specifically on that institution.[102] These are not just theoretical formulae that companies cannot apply – in fact, the "too interconnected to fail" test has been used both in the past and in the recent financial crisis by the US Federal Government in considering whether an institution should get bailout funding.[103] It is contended that the same kind of analysis can be undertaken by companies themselves in calibrating their risk management and other corporate governance mechanisms.

Indeed, in comparison with the objectives of other variants of stakeholder theory, minimizing systemic risk is far more tractable a goal. For example, taking a corporate social responsibility paradigm of stakeholder theory, the oft-cited goals of ensuring "ethical conduct" and "ecologically-responsible conduct" have to be measured on multiple dimensions – this makes the pursuit and verification of objectives a lot more intractable in comparison with systemic risk, which can to some extent be measured by quantitative metrics.[104] As Eddy Wymeersch, the

99. ROBERT PHILLIPS, STAKEHOLDER THEORY AND ORGANIZATIONAL ETHICS 119 –134 (2003).

100. *Id.* at 119.

101. Josh Rothman, *Too Connected to Fail*, THE BOSTON GLOBE (Aug. 8, 2012, 02:09 PM) http://www.boston.com/bostonglobe/ideas/brainiac/2012/08/too_connected_t.html.

102. *Systemic Risk Defined*, Property Casualty Insurers Association of America, www.pciaa.net/reg-reform (last visited Jan. 2014).

103. *Id.*

104. *See* R. EDWARD FREEMAN, STAKEHOLDER THEORY: THE STATE OF THE ART 119 (2010).

former Chairman of the Committee of European Securities Regulators, observes: "The financial stability objective [of corporate governance] is less elusive than e.g. [sic] social corporate responsibility."[105] Thus the apparent breadth and unverifiability of the systemic stakeholder objective is less of a problem than commonly perceived.

5. Objection 4: Does the Systemic Stakeholder Model Imply that Shareholder Value Should Not Be Maximized At All?

Some may contend that stakeholder models are completely incompatible with shareholder value maximization, and that any decisions taken in favour of stakeholders will necessarily be damaging to the company's (and not just the shareholders') interests. For example, Milton Friedman champions the view that if directors elect to keep open a plant to protect the interests of employees and the local community when the plant is consistently making a loss, then the plant would be forced to shut down in the long-term.[106]

It is argued that the systemic stakeholder paradigm is fully compatible with the long-term value of the company. The systemic stakeholder paradigm, rather than mutually excluding shareholder value maximization altogether, does take into account the interests of shareholders.[107] For example, one variation of stakeholder theory, the enlightened value maximization paradigm, accepts that the company should be governed in the interests of all stakeholders; but that long-term shareholder value maximization provides a good proxy for the goal of protecting all stakeholders.[108] Under this version of stakeholder theory, the interests of shareholders and the wider community of stakeholders are not mutually exclusive: pursuing the long-term value of the company necessarily implies protecting the *sustainability* of enterprise. Thus, this would require that corporate governance takes into account any risks that the company may be imposing on the wider financial and economic system, which would threaten both the convergent interests of the company and the economic community that it is dependent on for long-term survival.[109] Ultimately, while pure shareholder primacy focuses on the interests of shareholders alone, the systemic stakeholder view takes into account both

105. E. Wynmeersch, *Corporate Governance and Financial Stability* at 3, (Financial Law Institute Working Paper 2008-2011), *available at* http://ssrn.com/abstract =1288631.

106. M. Friedman, *The Social Responsibility of Business is to Increase its Profits*, THE NEW YORK TIMES MAGAZINE, Sep. 13, 1970, at 33; (cited in D. KERSHAW, COMPANY LAW IN CONTEXT, 339-340). (Oxford Uni. Pres., 2009).

107. V.H. Ho, *Enlightened Shareholder Value: Corporate Governance Beyond the Shareholder-Stakeholder Divide* at 62, http://ssrn.com/abstract=1476116 (last visited Jan. 28, 2014).

108. M. Jensen, *Value Maximization Stakeholder Theory, and the Corporate Objective Function*, 7 EUR. FIN. MGMT. 297, 299 (2001).

109. *See* Gevurtz, *supra* note 88, at 151, 154.

shareholders and other stakeholders in the system, and attempts to integrate their interests holistically.

II. DEFICIENCIES IN THE MEANS OF CORPORATE GOVERNANCE - THE FAILURE OF THE BOARD OF DIRECTORS AND SHAREHOLDERS TO PROTECT SYSTEMIC STAKEHOLDERS AND THEIR CAUSAL LINKS TO THE FINANCIAL CRISIS

Building on Part I, in lieu of the conclusion that the *purpose* of corporate governance is to serve both shareholders as well as the interests of the financial system and wider economy, the discussion proceeds to analyze how well the key *means* of corporate governance – the board of directors and shareholders – has functioned in achieving this objective. It is contended that both the board and shareholders have failed in protecting systemic stakeholders, and that this failure to guard against systemic risks precipitated the crisis. The balance of this section proceeds as follows: Part II.A briefly discusses the role of corporate governance in the crisis from a general angle; II.B – II.D discuss the particular failings of the board of directors – categorizing them under the headings of defective composition, structures, and duties; and II.E discusses the particular role of shareholders in facilitating poor corporate governance. The perspective taken is that of Anglo-American corporate governance, given that the US and UK were the focal points of the financial crisis.

A. The Role of Corporate Governance in the Financial Crisis

On one view, corporate governance demonstrated no deficiencies; nor was it causative of the 2009 financial crisis. This is the position adopted by Cheffins, who argues that corporate governance has improved significantly in the last decade, with many financial firms demonstrating indicators of good governance – boards with high numbers of independent directors, the establishment of risk and audit committees, and greater shareholder involvement in corporate activities.[110]

The opposing view, supported by this writer, counters Cheffins by arguing that there has been a more “fundamental systemic failure” of corporate governance[111] - such that what is *traditionally* seen as indicators of good governance, such as independent boards or shareholder empowerment, are in fact the *wrong means* of guarding against risks to the system. As the discussion proceeds to demonstrate, much of our conventional wisdom regarding director independence, board diversity, risk management structures and board duties is misconceived or overly myopic; in assuming that governance mechanisms designed to protect shareholders

110. *See generally* Brian R. Cheffins, *Did Corporate Governance Fail During the 2008 Stock Market Meltdown? The Case of the S&P* 500, BUS. LAW. Vol. 65, No. 1.

111. SUN, STEWART & POLLARD, CORPORATE GOVERNANCE AND THE GLOBAL FINANCIAL CRISIS: INTERNATIONAL PERSPECTIVES 4–6, (Cambridge U. Press 2011).

from managerial agency costs work equally well in guarding against risks to systemic stakeholders. Consequently, this lack of foresight contributed to poor corporate governance which precipitated the financial crisis.

B. Deficiencies in Board Composition: Sacrificing Competence for Independence and a Lack of Diversity

1. Sacrificing Competence for Independence

The board of directors is traditionally understood to straddle a dual function: to manage the company as well as to monitor the performance of executives.[112] In the US, the Section 8.01(b) of the Model Business Corporation Act (MBCA) provides that the business and affairs of the corporation are to be managed under the direction of the board;[113] while Art. 3 of the UK Model Articles of Association for Public and Private Companies provides that the directors are responsible for the management of the company's business.[114] At the same time, it is a truism that the board is not obliged to run the company on a day-to-day basis and instead takes a supervisory role most of the time by establishing plans and monitoring performance.[115]

However, due to the need to ensure un-conflicted supervision of executives, Anglo-American corporate governance law has shown a steady trend towards emphasizing the monitoring role of directors, reflected in an increasing focus on having qualitatively higher standards for independence and quantitatively more independent directors on boards and committees.[116] It is partly due to this over-emphasis on independence that the need for financial expertise was relegated to a secondary priority, thus weakening the ability of boards to understand the financial difficulties their companies were mired in during the run-up to the crisis.[117]

To elaborate, the impetus towards independence accelerated in the early 2000s, following the Enron and WorldCom scandals, which demonstrated that previous requirements for independence were insufficiently stringent or detailed. For example, as Elson points out, despite the fact that Enron had 13 *formally* independent non-executive directors on a board of 15 members, various relationships between these directors and the company rendered their alleged independence more of a facade; such as long tenures (more than 15 years), and

112. *See* Kraakman et al., *supra* note 19, at 56.

113. *Id.*

114. The Companies (Model Articles) Regulations, 2008, S.I. 2008/3229, art. 2, ¶ 3 (U.K.).

115. Kraakman et al., *supra* note 19, at 66.

116. *See* Kirkpatrick, *supra* note 94, at 66, 79.

117. *See* Merson, *supra* note 84, at 22 ("In a report published in September 2008, the Association of Chartered Certified Accountants wrote. . .[t]he use of overly compex financial products, which thwarted effective supervisory control, and the unethical advancement, at the point of sale, of loans to people with little realistic hope of repaying them shows a lack of basic corporate governance.").

substantial fees (over US $350,000 per year worth of stock options), which caused directors to become more acquiescent to management.[118] As the US Congressional Hearings preceding the passing of the Sarbanes-Oxley Act (SOX) found, these directors of scandal-ridden companies had "extensive social and professional ties with corporate officers and their fellow directors that compromised their ability to be impartial and undermined their ability to provide an adequate check on directors."[119]

In response, Anglo-American corporate governance standards of independence were raised. Firstly, the *required number* of independent directors on boards and board committees was increased. For example, SOX required the NYSE Listing Rules to provide for a majority of independent directors on the board and an audit committee comprising solely of independent directors.[120] Secondly, the *definition of independence* was given more rigour to foreclose opportunities for conflicts of interest to arise. The 2003 UK Higgs Report on "The Role and Effectiveness of Non-Executive Directors" took to task the earlier definition of "independence" in the 1998 UK Combined Code of Corporate Governance, criticizing it for being insufficiently specific.[121] Thus it further supplemented the definition of independence by specifying various relationships and circumstances which would compromise independence, including, *inter alia*: material business relationships; status as a former employee (within 5 years of terminating employment); the receipt of any sort of remuneration apart from a director's fee; and holding cross-directorships or having significant links with other directors through involvement in other organizations.[122]

This increasing focus on independence – a knee-jerk response to corporate scandals, was actually creating a long-term problem that would manifest itself in the financial crisis. The problem, as stated by Kershaw, is that of the "independence-knowledge trade-off";[123] the broader the definition of independence, the more difficult it becomes to find individuals who are willing to serve on the board and who have a firm understanding of the company and its industry. While independent non-executive directors ensure *un-conflicted monitoring,* they do not necessarily ensure *informed management* or even *effective oversight* (since they may

118. C. Elson, *The Enron Failure and Corporate Governance Reform*, 28 WAKE FOREST L. REV. 855, 871 (2003).

119. Lisa M. Fairfax, *The Uneasy Case for the Inside Director*, 96 IOWA L. REV. 127, 149 (2010) (internal citations omitted).

120. NYSE Listed Company Manual, § 303A.01, *available at* http://www.nyse.com/pdfs/section303A_Final_rules.pdf ("Listed companies must have a majority of independent directors. *Commentary*: Effective boards of directors exercise independent judgment in carrying out their responsibilities. Requiring a majority of independent directors will increase the quality."). *See also* Sharfman, *supra* note 21, at 59–60.

121. KALA ANANDARAJAH, CORPORATE GOVERNANCE: PRACTICE AND ISSUES, 109–112 (Academy Publishing, 2010).

122. *See* Anandarajah, *supra* note 121, at 109–112.

123. *See* Alexander et. al, *supra* note 18, at 244.

lack understanding of the company to the point where they do not know how to look out for "red flags").[124] As Kershaw observes, a "broad definition of independence effectively takes a risk that the pool of advisory talent will continue to be deep enough"[125] – a poor gamble, as illustrated by the 2009 crisis.

In the context of the financial crisis, the problem was that stringent definitions of independence made it difficult for financial institutions to find independent directors who had sufficiently deep expertise in the industry, since the relevant pool of experts with such financial knowledge is naturally concentrated and limited to those who have had employment experience in the industry – so-called "insiders."[126] A report by Guerra and Thal-Larsen[127] quotes headhunters as stating that "one of the unintended consequences of SOX is that its emphasis on independence rules out from board positions a lot of people who knew about this [financial] business."[128] This translated into many of the boards of crisis-hit financial institutions having insufficient expertise: Kirkpatrick notes that at eight US major financial institutions, two-thirds of directors had no banking experience, yet were sitting on highly technical board committees covering audit and risk - precisely due to the independence requirements.[129] In the same vein, Sharpe points out that the board members of Merrill Lynch and Citigroup, although having prestigious degrees and other qualifications, lacked meaningful accounting and financial expertise to effectively monitor the activities of investment banks.[130]

To compound the problem, it was not just the case that stringent definitions of "independence" in the listing rules and corporate governance codes naturally excluded competent individuals; it was that the need for independence became *the* touchstone of good governance such that "the emphasis on objective indicia of conflicts dominated the selection process to the exclusion of the indicia of basic competence and good judgment."[131] As US-based empirical studies demonstrate, companies increasingly began to focus on negative checklists of conflicts, relegating positive lists of qualifications to secondary importance, in choosing board members.[132] As Bainbridge puts it, independence became a "fetish" in itself[133] -

124. *Id.*

125. *Id.*

126. *See* Kirkpatrick, *supra* note 94, at 81.

127. F. Guerra and P. Thal Larsen, *Gone by the Board: Why the directors of big banks failed to spot credit risks*, Financial Times, (June 16, 2008).

128. *Id.*

129. Kirkpatrick, *supra* note 94, at 79–80.

130. Nicola F. Sharpe, *Rethinking Board Function in the Wake of the 2008 Financial Crisis*, 5 J. of Bus. & Tech. L. 99, 109 (2010).

131. Bainbridge, *supra* note 25, at 104.

132. Kirkpatrick, *supra* note 94, at 81.

133. *Id.* at 81–82.

resulting in a lack of knowledge just as dangerous to corporate health as the conflict of interest problems in the previous wave of corporate scandals.[134]

While this imbalance between independence and competence can be attributed to Anglo-American corporate governance as a whole, it may be qualified that the problem is less acute in the UK context. Based on Grant Thorton's research findings commissioned by the FRC,[135] the latter concluded that sectoral experience and industry-related experience amongst directors on the boards of a selection of FTSE 350 companies had increased by about 7% from 2002 onwards (the year before the independence provisions were introduced), thus suggesting no loss of competence as a result of the more rigorous independence requirements.[136] With due respect to the Thorton review, one may argue that these findings are inconclusive: competence could arguably have increased *even more* had there been no over-emphasis on independence. Further, looking at the absolute figures, even with the increase, sectoral experience and industry experience were 30% and 59% respectively, numbers which do not inspire much confidence in the ability of the board to effectively monitor and manage large complex companies.[137] Nonetheless, it is possible that competency problems are less acute in the UK as compared with the US, given that the majority of criticisms stem from US commentary.

2. Lack of Diversity and Problems of "Group-think"

Notwithstanding the over-emphasis on formal criteria for independence, the objectivity of the board has yet been compromised by a lack of diversity and more subtle behavioural dynamics which undermine effective independent judgement by individual directors who may meet all the stringent requirements for independence. In a thought-provoking report entitled "Did Board Configuration Matter? The Case of US Subprime Lenders,"[138] Maureen Muller-Kahle and Krista Lewellyn find that firms in the in financial industry which had less gender-diverse boards were prone to greater subprime lending and excessive risk-taking, based on survey of 74 US-based publically-traded firms over a nine-year period.[139]

The lack of women points toward a more fundamental flaw in boardroom composition – a lack of diversity which can exacerbate problems of "group-think."[140] "Group-think" refers to a collective cognitive bias which impedes the

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134. Klaus J. Hopt, *Corporate Governance of Banks after the Fin. Crisis*, MAX PLANCK INSTITUTE FOR COMPARATIVE AND INT'L PRIVATE LAW, 4–5 (Aug. 29, 2011), http://ssrn.com/abstract=1918851.

135. Fin. Reporting Council, *supra* note 86, at 15.

136. *Id.*

137. *Id.*

138. M. Muller-Kahle & K. Lewellyn, *Did Board Configuration Matter? The Case of US Subprime Lenders*, 19 CORP. GOVERNANCE: AN INT'L REV. 405 (2011).

139. *Id.*

140. K. Johnson, *Addressing Gaps in the Dodd-Frank Act: Directors' Risk Management Oversight Obligations*, 45 U. MICH. J. L. REFORM 55, 55 (2011).

effectiveness of deliberative, group decision-making processes.[141] As Johnson notes, group-think can lead boards of directors in systemically significant financial institutions to "perilous consequences, including enterprise risk management failures, insolvency, or market disruption."[142]

One specific example of group-think is what behavioural economists call "structural bias" – a cognitive problem which impedes a director's ability to exercise objective judgment in circumstances which involve persons with whom the director has relational ties.[143] Since board members are generally selected from a small pool of candidates who often participate in similar educational and professional circles, sharing many affiliations – what some commentators have termed an "old boys' network"[144] – it is often the case that these relational ties cause individual directors to abandon their perceptions regarding a particular issue and adopt an opinion that reflects the group consensus, rather than engage in rigorous debate to generate the benefits of deliberative decision-making.[145]

These problems of group-think are compounded by the lack of women in the boardroom. Singh, Terjesen and Vinnicombe report that only 15% of Fortune 500 boards have a woman on the board.[146] In the FTSE 250, the percentage of female non-executive directors fell from 9% in 2007 to 8.7% in 2008, part of a consistently low historic trend of female participation in the boardroom.[147] Branson's recent 2011 global survey on female directors reveals that this is a ubiquitous problem across many jurisdictions: while the overall European average is 11.7% female representation, Germany reports 7% (on *supervisory*, and not *managing,* boards), while the US stands at 15.2%.[148] The state of female participation is not much better in the Asia-Pacific: Australia leads with 10.6%, while New Zealand follows with 9.3%, and Hong Kong at 8.9%.[149] While it would certainly stretch logic to attribute the financial crisis to the lack of female directors, the financial crisis can be said to have highlighted a deeper root problem in board composition – a lack of diversity, and accordingly, objective judgment in the dynamics of group decision-making.

141. *Id.*

142. *Id.* at 103.

143. *Id.* at 104.

144. Lewellyn & Muller-Kahle, *supra* note 138, at 408.

145. Johnson, *supra* note 140, at 104–105.

146. Lewellyn & Muller-Kahle, *supra* note 138, at 408.

147. Wheeler, *supra* note 13, at 276.

148. Douglas M. Branson, *Women on Boards of Directors: A Global Snapshot*, University of Pittsburgh School of Law, 1 (Feb. 2011), http://ssrn.com/abstract=1762615.

149. *Id.* at 2.

C. Deficiencies in Board Structure: Lack of Risk Management Structures, Un-integrated Approaches and Informational Deficiencies

1. The Lack of Risk Management Structures

Risk management refers to the process by which the board of directors defines a company's strategies and objectives so as to strike an optimal balance between growth and related risks.[150] Such risks include operational risks – risks of faulty controls, fraud and human error; market risks – risks in the trading books of debt and equity instruments linked to changes in the market; and credit risk – risk that a change in the credit quality of a counterparty would affect the firm's own value.[151] It is important to stress the interconnection of these risks to *systemic* risk: in simple terms, the more a firm is exposed to operational, market and credit risk; and the larger and more interconnected it gets, the more the firm poses a risk to the entire financial system and economy if its operational, market or credit risks materialize in ways that adversely affect the firm. Risk management thus seeks to detect, assess and respond to such risks by avoidance (refraining from certain risk-laden transactions), transferring risk through hedging, or mitigating risks through responsive control measures.[152]

There is no question that risk management by boards was insufficiently robust and a major contributor to the financial crisis. For example, a 2008 Towers Perrin survey of CFOs reveals that 72% of surveyed companies had under-developed risk management processes, and 62% considered poor risk management to be a major contributor to the financial crisis – attributing even more blame to boards' risk management failures than the inherent complexity of financial products (which 55% of respondents considered the major factor).[153]

Where exactly lay the fractures in risk management systems? Certainly, while risk models and stress testing failed due to mistaken technical assumptions, there exists a more pervasive corporate governance dimension in the failures of risk management.[154] Firstly, many firms involved in the 2009 financial crisis had poor risk management structures. Several commentators have pointed out how previous reforms such as SOX-mandated internal controls focussed primarily on financial reporting and disclosures, for example SOX S.302 which provides for CEO and

150. *Enterprise Risk Management—Integrated Framework Executive Summary*, COMMITTEE OF SPONSORING ORGANIZATIONS OF THE TREADWAY COMMISSION, 1 (Sept. 2004), http://www.coso.org/documents/coso_erm_executivesummary.pdf.

151. Bainbridge, *supra* note 25, at 166.

152. *Id.* at 166–67.

153. Michelle M. Harner, *Ignoring the Writing on the Wall: The Role of Enterprise Risk Management in the Economic Crisis*, 5 J. OF BUS. & TECH. L. 45, 49 (2010).

154. Blanaid Clarke, *'Corporate Governance' an Oxymoron? The Role of Corporate Governance in the Current Banking Crisis*, *in* THE FUTURE OF FINANCIAL REGULATION 253, 261 (Iain MacNeil & Justin O'Brien eds., 2010).

CFO certification of the accuracy of annual and quarterly reports.[155] Consequently, companies missed the forest for the trees – failing to recognize that such internal controls were but a subset of risk management in the broader context.[156] Furthermore, the structure of Anglo-American board committees tends to place risk management under the jurisdiction of the audit committee, which as Fanto observes may have been over-worked in the light of its pre-existing compliance requirements.[157] Thus board structures did not place sufficient emphasis on proper risk detection and monitoring.

2. Un-integrated Risk Management

Secondly, even *with* such board structures, some firms demonstrated a deeper problem of un-integrated and un-embedded risk management. To put it another way, many firms took a "silo", as opposed to comprehensive and coordinated, approach to risk management.[158] Harner gives the example of UBS, where each group within the organizational structure did have a given role to play in the risk management process, but the board failed to coordinate or monitor the groups.[159] The division of tasks – for example between CRO, CFO and corporate counsel, was meant to facilitate division of labour and specialization, but instead resulted in a segregated approach to risk management where no one, in particular the board charged with the responsibility of oversight, had sufficient understanding of the company's total risk exposure.[160] These deficiencies demonstrate that merely putting in place risk committees and CROs may not sufficiently address the need for firm-wide integrated risk management.

3. Structural Holes in Information Transmission and Processing

Additionally, one major reason for the lack of an integrated risk management system is the absence of upward information flows. In Pirson and Turnbull's analysis, the problem lies with the *hierarchical structure of the board*.[161] The argument is that while risks originate in one part of the organization lower down the corporate hierarchy (such as the sales department), the actual management of the risks is to be carried out by another part further up the chain of command – the

155. Kirkpatrick, *supra* note 94, at 79.
156. *Id.*
157. *Id.*
158. Harner, *supra* note 153, at 50.
159. *Id.*
160. *Id.*
161. *See generally* Michael Pirson & Shann Turnbull, *Towards Humanistic Governance? How Network Governance Structures Can Support Better Decision Making and Risk Management*, FORDHAM U. SCH. OF BUS. (Sept. 19, 2010), http://ssrn.com/abstract=1679450.

board of directors.[162] One commonplace example of this informational dynamic is the party game of "telephone", which illustrates how the meaning of a message can get very confused after being related through a chain of individuals. Pirson and Turnbull assert that, based on a theoretical model of 50% accuracy retention, information conveyed from workers through the mid-level and senior management can ultimately lose over 90% of its original content by the time it reaches the board of directors.[163] While these arguments may seem to rest too heavily on theory, the authors do point to significant informational failures during the financial crisis to buttress their case: for example, the Lehman Brothers bankruptcy report highlights that the board was unaware of several critical pieces of information regarding the firm's dire risk position, such as the fact that several high-risk bridge equity deals had been excluded from Lehman's risk appetite usage calculations, which would have taken it over its risk appetite limit in 2007.[164] Also, several employees down the corporate hierarchy were known to have reported their concerns over excessive risk-taking to senior managers and the external auditors, though these reports were not made available to the board.[165] As such, it is asserted that "communication failure is more likely the principal cause of the crisis."[166]

Pirson and Turnbull's argument parallels another earlier analysis – Lawrence Mitchell's theory of structural holes and informational monopolies.[167] According to Mitchell, the board faces a fundamental structural problem: given that corporate personnel are organized into distinct networks with no ties, the actor who can bridge two distinct networks can attain control over the flow of information.[168] Thus, because the board consists primarily of outside directors with no networks in the firm, it becomes open to the CEO to bridge this "structural gap" and exploit it to his advantage.[169] Mitchell cites the example of Enron to demonstrate how Skilling exploited the structural gap between the outside directors of the board and employees further down the corporate chain to stem any possibility of negative information being transmitted upward.[170] Mitchell's analysis adds another dimension to Pirson and Turnbull's, by suggesting how information may not only be lost *inadvertently* going up the corporate ladder, but also *deliberately* where strong CEOs desire to opportunistically restrict the flow of information to the

162. *Id.* at 10.

163. *Id.* at 10–11.

164. Michael Pirson & Shann Turnbull, *Corp. Governance, Risk Mgmt., and the Fin. Crisis – An Information Processing Review*, FORDHAM U. SCH. OF BUS., 6–8 (Dec. 11, 2010), http://ssrn.com/abstract=1723782.

165. *Id.*

166. Pirson & Turnbull, *supra* note 161, at 9–10.

167. *See generally* Lawrence E. Mitchell, *Structural Holes, CEOs, and Informational Monopolies: The Missing Link in Corporate Governance*, 70 BROOK. L. REV. 1313 (2005).

168. *Id.* at 1321.

169. *Id.* at 1346.

170. *Id.* at 1352–53.

board.[171] Indeed, Mitchell's analysis is directly relevant to the financial crisis. One egregious example is that of the former Lehman CFO, Chris O'Meara, who did not want the board to know that Lehman was approaching the firm-wide risk appetite limit, as the analysis by his subordinates demonstrated.[172] Thus he removed the limit from the standard chart presented to the board, a clear illustration of an actor exploiting an informational gap.[173] Accordingly, these analyses suggest that hierarchical boards may not be in the best position to receive and process information pertaining to firm risks.

D. Deficiencies in Board Duties: Insufficient Liability for Oversight Failures

The problem of defective risk management is exacerbated by an enervated duty of care in the field of risk monitoring, a problem especially pertinent in US case law. It is evident that "[p]otential legal liability also influences corporate conduct."[174] Thus, in addition to poorly-designed board structures, a lack of legal liability for directors can be said to have facilitated board failures of oversight in risk management. It must be emphasized that the duty of care that is in question here is not that of *decision-making* (which involves commercial judgments and is in appropriate cases protected by the business judgement rule which precludes hindsight review of directors' actions); but rather the duty of *monitoring* – that of ensuring that the company has the necessary systems in place to ensure accurate and timely information, and to respond accordingly when these systems show "red flags."[175]

In what particular way is the architecture of this duty of monitoring deficient? The key problem in American jurisprudence is that the Delaware courts have presently *excluded* oversight responsibility for business risks from the scope of a director's duty of care, as held in *Re Citigroup Inc. Shareholder Derivative Litigation (Citigroup)*.[176] According to the *Citigroup* court, while directors do have a general duty of monitoring, which cover *legal* risks such as fraud; this duty does not extend to managing commercial (for example, credit, market, operational and systemic) risks.[177]

This unduly narrow duty of monitoring fails to safeguard against excessive corporate risk-taking which threatens systemic stability. For example, in *Citigroup*, the financial firm's directors were *not* held personally liable to ensure that systems were in place to manage Citigroup's risk to the subprime mortgage market – though it was clear that Citigroup's marketing of collaterized debt obligations (CDOs), a

171. *Id.* at 1314.
172. Pirson & Turnbull, *supra* note 164, at 6–8.
173. *Id.*
174. Pirson & Turnbull, *supra* note 164, at 53.
175. *See* Eric J. Pan, *A Board's Duty to Monitor*, 54 N.Y.L. SCH. L. REV. 717, 722–23 (2010).
176. 964 A.2d 106 (Del. Ch. 2009).
177. *Id.* at 126.

form of derivate security consisting of repackaged pools of lower rated securities, heavily exposed Citigroup to market, credit and operational risk in the region of US$55 billion.[178] Given Citigroup's systemic importance, the risks to the firm meant that systemic interests were implicated as well.[179]

Further, as Bainbridge points out, the distinction between risk management and legal compliance is not entirely sustainable, since the latter is but a subset of the former.[180] As stated by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), compliance with regulations is one of four broad categories of enterprise risk management, along with effective use of resources, reliable disclosures and pursuit of strategic goals.[181] For example, the WorldCom accounting fraud, which involved losses of US$11 billion, may be seen as a failure of accounting controls as well as a broader failure of operational risk management – part of the board's wider duties to manage enterprise risk of all forms.[182] Thus, the unprincipled line-drawing by US courts between legal compliance and commercial risk management in the delineation of directors' duties of monitoring represents another instance of corporate governance's failure to protect the system from excessive risk-taking by the company.

E. Abdication of Shareholders' Responsibilities

As suggested above,[183] institutional shareholders had a key role to play in facilitating the financial crisis. In fact, a very recent study by Erkens, Hung and Matos[184] based on a dataset of 296 financial firms from 30 countries at the centre of the crisis demonstrates that firms with higher institutional ownership experienced worse stock returns during the crisis period because institutional shareholders encouraged more risk-taking.[185] This risk-taking is accompanied by short-termist strategies which are not conducive to long-term corporate growth – for example, hedge funds often attempt to drive up short-term earnings at the expense of long-term results by

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178. Stephen M. Bainbridge, *Caremark and Enterprise Risk Management*, 34 J. CORP. L. 967, 978 (2009).

179. Bainbridge, *supra* note 178, at 978.

180. *Id.* at 981.

181. *Enterprise Risk Management – Integrated Framework Executive Summary*, COMMITTEE OF SPONSORING ORGANIZATIONS OF THE TREADWAY COMMISSION, 3 (Sept. 2004), http://www.coso.org/documents/coso_erm_executivesummary.pdf.

182. Vivek Sharma, *Worldcom Debacle – A Case Study in Risk Management*, SACHING.COM (Oct. 15, 2011, 4:54 A.M.), http://www.saching.com/Articles/Worldcom-Debacle-A-Case-Study-in-Risk-Management-10387.html.

183. *See supra* Part I.B.iii.

184. David H. Erkens, Mingyi Hung, & Pedro Matos, *Corporate Governance in the 2007-2008 Financial Crisis: Evidence from Financial Institutions Worldwide*, 18 J. CORP. FIN. 389 (2012).

185. *Id.*

cutting research and development, or moving revenues from future periods into current accounting periods.[186]

The short-termist strategy is justified on the dubious economic theory of the Efficient Capital Markets Hypothesis, which asserts that stock prices accurately capture the fundamental economic values of companies and that any increase in stock price must reflect an equivalent increase in value, whether in the short or long-term.[187] In reality, the premises of this theory are highly questionable – it assumes that investors have all relevant information about the long-term value of a firm, an assumption that rarely plays out in reality. For example, in the context of the financial crisis, investors did not have complete appreciation of the probability of the housing market crash, given that the risk of such an outcome was an "unknown unknown" – a high impact, rare-event risk.[188] Thus, the corporate values of many financial firms were in reality over-inflated due to the "irrational exuberance" of institutional investors caught up in the euphoria of the housing bubble, while not taking into account the longer-term risks to the company and the financial system.[189]

The excessively risky and short-termist corporate strategies encouraged by institutional shareholders represent a clear defect in the architecture of corporate governance. Specifically, they suggest that institutional shareholders do not appreciate that their position of influence in companies entails responsibilities as well as rights.[190] Such responsibilities were emphasized in UK Corporate Governance as early as 1992, in the widely-respected Cadbury Report which identified institutional shareholders as having fundamentally important power, given the weight of their votes, to influence the standards of corporate governance.[191] Similarly, the UK National Association of Pension Funds has previously articulated that "share ownership also gives rise to governance responsibilities. . .directed towards the enhancement of long-term shareholder value and the wider economic benefits which this should also engender."[192] The long-standing failure of institutional investors to take these pronouncements into account thus facilitated excessive risk-taking at the cost to the economy.

186. Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 STAN. L. REV. 1255, 1290–91 (2008).

187. *Id.*

188. *Id.*

189. Grossman, *supra* note 45, at 19.

190. *See* Villiers, *supra* note 42, at 290–91.

191. *Id.*

192. CHARLOTTE VILLIERS, THE FUTURE OF FIN. REGULATION 287, 291–92 (MacNeil & O'Brien, eds. 2003).

III. REFORMING CORPORATE GOVERNANCE – RE-CONCEPTUALISING THE ROLES AND RESPONSIBILITIES OF THE BOARD OF DIRECTORS AND SHAREHOLDERS

A. The Underlying Principle of Reform: Both Directors and Shareholders as "Stewards for Systemic Stakeholders"

Given the aforementioned problems of defective board composition, structures and duties, and shareholder irresponsibility, it is submitted that reforms are in order. It is argued that the corporate governance paradigm underlying these reforms is that of *stewardship for the system as a stakeholder in the company* – that is, *both* directors and shareholders have responsibilities to play in governing the company, not only for its internal stakeholders but its external socio-economic stakeholders as well.

Currently, there exists an ongoing debate on the correct means of corporate governance between those who take a "director primacy" and those who take a "shareholder empowerment" view.[193] Those in the former camp take the position that shareholders lack incentives to gather information necessary to participate actively in decision making and rational shareholders would be apathetic given that the opportunity cost of making informed decisions is significant – hence the need for the board of directors as a centralized decision-making body.[194] The latter "shareholder empowerment view" emphasizes that the directors often shirk or self-deal, such that shareholder involvement is necessary to constrain such agency costs.[195]

The problem with this debate is that it has started from the premise that maximizing shareholder value is the ends of the company and consequently, narrowed the means of corporate governance into a binary, mutually-exclusive fix – either directors or shareholders should govern the company. This unhelpful debate can be transcended once we see that the ends of the company include other stakeholders, in particular the interests of the economy and financial system. Accordingly, the roles of board of directors and shareholders can be re-conceptualized to meet these ends in a way that involves both enhancing the board and also giving shareholders responsibilities in the governance of the company. At the conceptual level, I suggest that both directors and shareholders can be seen as "stewards". The role of directors as stewards draws from Donaldson and Davis' work which emphasizes the benefits of facilitative authority structures.[196] This has also been reflected in UK corporate governance to some extent – the Cadbury

193. Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735 (2006).

194. *Id.*

195. *Id.*

196. *See generally* Lex Donaldson & James H. Davis, *Stewardship Theory or Agency Theory: CEO Governance and Shareholder Returns*, 16 AUSTL. J. MGMT. 49 (1991).

Report expressly describes directors as having "stewardship" responsibilities.[197] On the other hand, influential shareholders, in particular institutional shareholders, are increasingly been seen as stewards as well – as the non-profit think tank Tomorrow's Company notes, institutional shareholders may be viewed as "universal owner[s who] own[s] a small[,] but representative fraction of most of the companies in an economy, [hence] their ability to satisfy their fiduciary duties depend on the economy's overall efficiency and performance."[198] Thus, institutional shareholders have responsibilities *vis a vis* the wider economy as well. Indeed, the UK FRC has recently implemented a "Stewardship Code" for institutional investors, highlighting the need for their accountability to all corporate stakeholders.[199] It is submitted that the convergence of this "stewardship" label for directors and institutional shareholders is not merely coincidental – rather, it reflects a slowly growing consensus that both directors and shareholders have responsibilities to the sustenance of long-term corporate value and the interests of the wider economy.

The balance of this section proceeds by examining how board composition, structures and duties, as well as shareholders' responsibilities, can be enhanced to safeguard against systemic risks. Where relevant, I examine some of the steps taken by the UK and US in response to the financial crisis, to determine if they effectively remedy the defects in corporate governance which contributed to the financial crisis. Where insufficient, I suggest additional measures, including observations on their viability.

B. Re-composing the Board:

1. Striking the Right Balance Between Competence and Independence

In the US, the primary reform vehicle, the Dodd-Frank Wall Street Reform and Consumer Protection Act, does not tackle the problem of excessive focus on independence in any way.[200] In contrast, the UK has been more proactive in this respect, addressing this issue in its 2009 Review of the Combined Code.[201] However, the UK Financial Reporting Council's (FRC) response was limited to including a new provision stating that: "The board and its committees should have the appropriate balance of skills, experience, independence and knowledge of the

197. *See* Villiers, *supra* note 43, at 290.

198. *Tomorrow's Owners Stewardship of tomorrow's company*, Centre for Tomorrow's Company (Oct. 2008), http://tomorrowscompany.com/tomorrows-owners-stewardship-of-tomorrows-company.

199. *See infra* III.E; *see generally The UK Stewardship Code*, Fin. Reporting Council (Sept. 2012), http://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Stewardship-Code-September-2012.pdf.

200. *Corp. Governance in the Wake of the Fin. Crisis*, United Nations Conference on Trade and Dev., 29–32 (Oct. 2010), http://vi.unctad.org/digital-library/?task=dl_doc&doc_name=582-corporate-go.

201. Fin. Reporting Council, *supra* note 86.

company to enable them to discharge their respective duties and responsibilities effectively."[202]

This response, while having the correct intention to ensure the balance between competence and independence, does not strike this writer as a particularly robust reform. It does not give any guidance on the definition of an "appropriate balance", without which compliance cannot be ascertained. Thus there would not even be anything to comply with or explain away; further diluting the already muted enforcement regime in the UK context, which relies on private "comply or explain" enforcement rather than the threat of de-listing or regulatory sanctions for non-compliance.[203]

How then should the competence factor be enhanced? It is proposed that the UK could go one step further in its 2010 Corporate Governance Code by annexing a list of "best practice" competence indicia from various industries, to provide some measure of guidance for directors. These industry-specific criteria can be readily found in guidelines provided by industry regulators, but are seldom reflected in national corporate governance codes which state competence requirements at too high a level of generality. For example, in response to the financial crisis, financial regulators of various countries such as the Irish Central bank have increased "fitness and probity" standards for board members of financial institutions.[204] These standards are still general enough to reflect the diversity of financial firms, but provide more guidance given the particular needs of the financial industry. Drawing from this experience, it is suggested that corporate governance regulators could collect these guidelines or best practice indicia from various industries and annex them as a reference to the relevant code provision on board composition, perhaps in a tabulated manner so as to compare competency requirements across industries. Again, it is important to emphasize that this proposal does not mean to promote a "one-size-fits-all" approach to industry-specific corporate governance – for example, within an "experience" criterion for competency, a range of years could be specified which differs from industry to industry. At the same time, it is meant to provide clearer guidance for prospective directors. Also, by incorporating these best practice guidelines into the corporate governance code instead of leaving them as legally-unenforceable industry-specific suggestions, these guidelines at least become backed by the UK "comply or explain" regime, ensuring greater corporate accountability for boardroom competency.[205] The US, given that its regime relies on mandatory NYSE listing rules, may find that mandating competency requirements

202. *The UK Corp. Governance Code*, Fin. Reporting Council, 6 (Sept. 2012), http://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Stewardship-Code-September-2012.pdf.

203. *Id.* at 4.–5.

204. *See generally Fitness and Probity Standards (Code issued under Section 50 of the Cent. Bank Reform Act 2010)*, Cent. Bank of Ir. (2011), http://www.centralbank.ie/regulation/processes/fandp/Documents/Fitness%20and%20Probity%20Standards%20(final)%2030%20November%202011.pdf.

205. Fin. Reporting Council, *supra* note 86.

under the threat of de-listing constitutes too heavy-handed an approach. Thus, it could adapt this proposal to suit its particular regime, for example issuing such competency guidelines from the NYSE as non-binding suggestions, rather than incorporate them into their mandatory listing rules. This would at least emphasize the need for greater industry-specific competency, a problem which has been overlooked until the outbreak of the recent crisis.

2. Introducing Diversity and Objective Judgment into the Boardroom

To counter the problems of group-think, the solution should not just be to increase formalistic criteria for "independent" directors – firstly, this would exacerbate problems of insufficient competency as discussed above; and secondly, this would not improve the psychological and cognitive dynamics of the boardroom. One solution is to focus on increasing *diversity* as a measure of better deliberative decision-making in group settings. In diversifying boards, one of the more pressing concerns relates to the lack of female directors. Empirical studies have demonstrated that increasing female participation in the boardroom can meet the need for "cognitive conflict" in group decision-making, *viz*, task-oriented differences in judgment that can generate discussion and improve the quality of decisions.[206] For example, a 2007 McKinsey survey revealed that companies with a higher proportion of women on their management committees were 47% more profitable.[207]

To enhance gender diversity on boards, one can take a softer approach by recommending the need for a more balanced gender mix on boards; or a more stringent approach which actually mandates quotas for female participation. The former approach is adopted by the UK FRC in its 2009 Review of the Combined Code, which recognized the benefits of gender diversity in reducing group-think and thus amended its supporting principles regarding appointments (B.2 of the current UK Corporate Governance Code) to state that: "The search for board candidates should be conducted, and appointments made, on merit, against objective criteria and *with due regard for the benefits of diversity on the board, including gender*" [emphasis mine].[208] The second method of introducing quotas for female participation is being actively considered by the European Parliament. In fact, the EU Parliament has, in July 2011, already given EU businesses an ultimatum to voluntarily increase female participation from the current 10% to 30% by 2015, with the ultimate objective of achieving 40% female representation by 2020 on the

206. Lewellyn & Muller-Kahle, *supra* note 138, at 408.

207. *Launch of the Singapore Board Gender Diversity Report 'A Focus on the Female Factor'*, MINISTRY OF SOCIAL AND FAMILY DEVELOPMENT (Oct. 25, 2011), http://app.msf.gov.sg/PressRoom/LaunchSingaporeboardgenderdiversityreport.aspx.

208. Fin. Reporting Council, *supra* note 202, at 12.

boards of large EU listed companies.[209] If the voluntary measures fail to have substantial effect by 2012, the EU Parliament would table legislation to introduce a mandatory quota of 40% female participation.[210]

Comparing the two approaches, this writer finds the softer approach preferable. I echo the UK FRC's concern that the quota-based method of introducing diversity is too prescriptive[211] – it fails to give sufficient leeway for an individual firm's makeup, for example where the firm requires more financially-competent directors, who so happen to be male. The kind of "quick-fix" solution promulgated by the EU Parliament may also cause problems in transition – either requiring that boards increase their numbers to include more women; or substitute current male members with more women. In either case, the solution would dramatically alter board composition in too precipitate a fashion, and may sacrifice experienced male members at the altar of a new obsession with "diversity". Furthermore, as Branson points out, quota laws may result in female executives becoming "fast-tracked", such that boardrooms would end up being populated by unqualified and figurehead female directors – a solution which militates against the true spirit of diversity, which is to include meaningful opposing perspectives.[212]

Thus, it is suggested that the need for diversity be introduced into corporate governance codes as an aspirational provision, with corporate governance regulators giving guidelines of a target level of participation within a specified time frame – but without being backed by the threat of a mandatory quota. Another variation of the "soft" approach which may have slightly more "teeth" is the use of "certificate and pledge programs". These pledges, which require public companies to add women to their boards if they have voluntarily subscribed to the pledge, have proven to be quite effective: as Branson highlights, 110 of the largest Dutch companies (including Shell, Phillips, and Heineken) have signed up and followed through the pledges, contributing to an increase in female board representation from approximately 7% in 2006 to 20.9% in 2010.[213] The key factor for the success of these pledge programs rests on firms' reputational capital, which incentivizes their participation (for example, major Dutch companies would not want to be seen publically as being discriminatory), and also compels their implementation of the promised level of female representation. At the same time, the pledge system is far less onerous than a quota system – thus it may be a useful "mid-way" solution

209. Valentina Pop, *EU parliament backs female quotas for top corporate jobs*, EU OBSERVER (July 7, 2011, 9:25 AM), http://euobserver.com/institutional/32598.

210. *Id.*

211. *Feedback Statement: Gender Diversity on Boards*, FIN. REPORTING COUNCIL, 4 (Oct. 2011), https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Feedback-Statement-Gender-Diversity-on-boards.aspx.

212. Branson, *supra* note 154, at 9.

213. *Id.* at 10–11.

between mandatory female representation and unenforceable aspirational standards.

C. Re-structuring the Board: New Board Structures and Network Governance to Facilitate Integrated Risk Management

Given the problems of structural deficiencies, informational loopholes and un-integrated risk management, the regulatory response has not been particularly strong. In the US, the Dodd-Frank Act mandates the creation of board-level risk management committees, but only for publicly-traded bank holding companies and those non-bank financial services companies supervised by the Federal Reserve.[214] As Bainbridge observes: "The federal forbearance reflected in these modest developments is rather surprising given the significant role of risk management failures in the crisis."[215] The UK's response has been almost similar: the FRC has likewise refrained from suggesting the establishment of board risk committees for all companies, limiting them to financial institutions (as originally suggested in the 2009 Walker Review).[216] Instead, for all companies, the FRC has inserted a very general provision in the 2010 UK Corporate Governance Code emphasizing the risk management responsibilities of the board (C.2),[217] supplemented by a requirement to conduct an annual review of the effectiveness of all risk management controls (C.2.1).[218]

The limitation of risk management committees to financial firms is flawed insofar as it fails to recognize that risk management issues arise routinely at non-financial companies, which if sufficiently large or interconnected, can pose a risk to the economic system as well. Kirkpatrick highlights the fact that risk management is not unique to financial companies, citing the 2006 example of Airbus which invested massively in developing the A380 aircraft, a project which involved substantial exchange rate risk and significant payments to customers in the event of late delivery.[219] Airbus' board under-estimated these risks and failed to manage them, such that when significant production delays materialized, Airbus' directors were taken by surprise.[220] Hence, simply requiring boards of non-financial

214. Peter O. Mülbert & Ryan D. Citlau, *The Uncertain Role of Banks' Corp. Governance in Systemic Risk Regulation*, UNIV. OF MAINZ – CTR. FOR GERMAN AND INT'L LAW OF FIN. SERVS. AND FACULTY, 24 (July 14, 2011), http://ssrn.com/abstract=1885866.

215. Bainbridge, *supra* note 25, at 176.

216. Fin. Reporting Council, *supra* note 86.

217. *See* Fin. Reporting Council, *supra* note 202, at 18 ("The board is responsible for determining the nature and extent of the significant risks it is willing to take in achieving its strategic objectives. The board should maintain sound risk management and internal control systems.").

218. *See id.* ("The board should, at least annually, conduct a review of the effectiveness of the company's risk management and internal control systems and should report to shareholders that they have done so. The review should cover all material controls, including financial, operational and compliance controls.").

219. Kirkpatrick, *supra* note 94, at 76.

220. *Id.*

companies to implement and review risk management processes, without at least requiring a minimum core of basic structures, is insufficient. Furthermore, these reforms fail to tackle head-on the deeper issues of informational loopholes and un-integrated risk management.

Thus, this writer proposes reforms at two levels: i) the inclusion at the minimum, of separate risk committees chaired by independent CROs, and ii) more far-reaching reforms involving new structures of "network governance", to increase information flows throughout the firm and facilitate the integration of firm-wide risk management.

The inclusion of separate risk committees chaired by independent CROs can make a significant difference in firm performance during crises – as the report of the internationally-constituted Senior Supervisor's Group shows, firms that fared best during the crisis were the ones with board oversight of risk in the form of a high-level committee, which served as a locus for firm-wide monitoring of risks.[221] Other empirical studies on the financial crisis have also concurred on the need for CROs – for example, Bolton found that firms with a CRO enjoyed higher profitability and suffered fewer loan losses during the crisis.[222] A further step may even involve the recruitment of outside risk-management experts to provide independent reviews of the adequacy of a firm's risk-management practices, in the same way that the audit committee relies on outside accounting firms to review the company's financial statements.[223] This would ensure that board risk committees would not solely have to rely on internal "experts", who may be constrained to de-emphasize potentially "bad" news when the firm is making a lot of profit from undertaking risky activities at a point in time.[224]

Additionally, risk management needs to be integrated at a firm-wide level. The primary foundation for integration is better communication and coordination between the board and other actors in the firm. Accordingly, the channels for exchange of information need to be improved. One suggestion is to install parallel communication channels to improve the supply of information to boards.[225] As Pirson and Turnbull point out, this proposal draws from the common-sense insight that additional communication channels allow for cross-checking and

221. *Observations on Risk Management Practices during the Recent Market Turbulence*, SENIOR SUPERVISORS GROUP (Mar. 6, 2008), http://www.newyorkfed.org/newsevents/news/banking/2008/SSG_Risk_Mgt_doc_final.pdf.

222. Hussein Tarraf, *Literature Review on Corp. Governance and the Recent Fin. Crisis*, SOC. SCI. RES. NETWORK (Dec. 27, 2010), http://ssrn.com/abstract=1731044.

223. James Fanto, *Anticipating the Unthinkable: The Adequacy of Risk Management in Finance and Environmental Studies*, 44 WAKE FOREST L. REV. 731, 744–745 (2009).

224. *Id.*

225. Michael Pirson & Shann Turnbull, *Corporate Governance, Risk Management, and the Fin. Crisis: An Info. Processing View*, 19 CORP. GOVERNANCE: AN INT'L REV. 459, 463 (2011).

supplementation of missing information flows, in the same way that courts require corroboration of testimony by independent witnesses.[226]

How would such parallel communication channels be instituted? It is suggested that a model of network governance be adopted, where the board of directors is connected to various sub-boards representing various stakeholders in the firm, for example, an employee assembly and creditor's council.[227] The former would relay employee-generated information concerning solvency or operational risks to the firm, while the latter can advise the board on issues pertaining to liquidity, market, and credit risks.[228] While this proposal may seem to involve a radical change to board structures, it is not without precedent. Hansen and Spitzeck cite evidence that cooperative banks, some of the few financial institutions to fare well during the crisis, consistently engaged their workers, suppliers, and customers in the governance process.[229] Further, large companies such as HP and Shell are known to use stakeholder councils in advisory capacities and to gain strategic "on the ground" insight into their operations.[230]

By improving information flows through institutionalizing network governance, the board moves significantly closer to integrating risk management at a firm-wide level. With the board receiving multiple sources of information regarding its risk position, it is then able to generate a quicker and more coordinated firm-wide response to an increase in its risk profile.[231] Also, proper stress-testing can be carried out on a wider range of scenarios, to identify and pre-empt risks early on.[232] Thus network governance can facilitate the integration of risk management structures and processes.

D. Re-invigorating Board Duties: Intensifying and Clarifying Oversight Responsibilities

Given that US law currently fails to extend a director's obligation of monitoring to business risks, an expansion of directorial responsibility is in order. However, in pitching the standard and scope of this responsibility to monitor risk, one must be cognizant of the opposing policy consideration that risk management is a young discipline and that courts must be not seen as imposing liability on directors for a failure to adopt a *specific model* of risk management, lest they curb the evolutionary market processes by which optimal best practices emerge.[233]

226. *Id.*
227. *Id.* at 466–67.
228. *See id.* at 467.
229. *Id.* at 463.
230. Pirson & Turnbull, *supra* note 161, at 12.
231. Kirkpatrick, *supra* note 94, at 69.
232. *Id.* at 69–70.
233. Bainbridge, *supra* note 178, at 982.

It is proposed that liability for breach of the duty to monitor risks be pitched at the standard of gross negligence: i) either utterly failing to implement any risk management structures or controls,[234] or ii) having implemented them, being grossly negligent in failing to oversee its operations, *viz,* failing to take note of red flags raised by the system in place. With respect to ii), the factors taken into account to determine whether a director is put on notice by a red flag include a) the potential harm to the company, b) the source of the red flag, and c) the frequency of the red flag.[235] For example, with respect to potential harm, a director's oversight responsibility would be more intensely engaged by a red flag regarding a $10 billion loss, as opposed to a $2 million loss. This would shield directors from liability for insignificant losses and unlikely risks; and focus directors' attention on risks that would put a reasonable director on notice.[236] With respect to the source of the red flag, inside reports showing under-capitalization, over-valuation or over-exposure to risk would be given more weight than outside sources, for example opinion pieces written by financial analysts.[237] The frequency of the red flag is also a key indicator – passivity in the face of repeated exposures to a problem is suggestive of the dereliction of oversight duty. For example, in *McCall v Scott*,[238] Bainbridge notes that signs of corporate employees' health care fraud were repeatedly raised to the board, including audit discrepancies, reports by investigative journalists, and even criminal investigations in six different states – all of which the board consistently failed to take into account in discharging its oversight duties.[239] Thus, this proposal aims to encompass management of risks within the scope of directors' oversight responsibilities, in order to better safeguard against excessive risk-taking which threatens systemic stability; yet without placing the standard of care at too high a level which would be onerous for directors and potentially chill the development of risk management best practices.

E. Re-conceiving the Role of Shareholders: From Rights to Responsibilities

Given that the current problem is that of a lack of institutional shareholder responsibility in encouraging high-risk and short-termist strategies, reforms in the US geared further towards *empowering* shareholders, rather than conferring *responsibilities* on them, seem to be missing the point. As Bruner notes: "What is certainly surprising . . . is that policy makers . . . would seek to empower the very

234. *See In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 971–72 (Del. Ch. 1996).

235. *See* Anne Tucker Ness, *Who's the Boss? Unmasking Oversight Liability Within the Corporate Power Puzzle*, 35 DEL. J. CORP. L. 199, 239–244 (2010) (describing a similar fact intensive test to determine the existence of red flags in regard to the conscious disregard of director duties.).

236. *Id.* at 240–41.

237. *Id.* at 242.

238. 239 F.3d 808 (6th Cir. 2001).

239. Bainbridge, *supra* note 178, at 987.

stakeholder group whose incentives are most skewed toward the kind of excessive risk-taking that led to the crisis in the first place."[240]

One such misconceived reform, as pointed out by various commentators,[241] is the provisions of the US Dodd-Frank Act which promote proxy access for shareholders in the hopes of encouraging more vigilant monitoring of managers and prudent risk management - under the SEC Rule 14a-11, shareholders holding 3% of the company's shares for more than 3 years can now nominate a director and place this nominee alongside nominees of the incumbent board, which provides a mechanism for shareholders to put their nominees on the ballot at the expense of the company, rather than incur the considerable personal expense of conducting a proxy contest.[242] However, given the short-termist and self-interested tendencies of some institutional shareholders, the Dodd-Frank Act may end up having the "potentially pernicious effects" of allowing larger shareholders with proxy access to use the threat of a proxy fight as leverage to extract private benefits form a corporation – for example, to use the proxy as a "megaphone" for the shareholders' causes or to pursue idiosyncratic corporate governance changes that may not be ultimately beneficial for the company.[243]

Thus, the better approach would be to instil shareholder responsibilities, rather than expanding shareholder rights. Accordingly, I discuss two proposals to expand shareholder responsibilities: i) a more "extreme" proposal to confer fiduciary duties on all activist investors; and ii) a less radical proposal, recently implemented by the UK FRC, to confer a list of responsibilities on institutional shareholders in a "Stewardship Code", backed on a "comply or explain" basis (as is the case with the current UK Corporate Governance code).[244] Ultimately, this writer finds the second proposal more workable.

The former proposal, as advocated by Anabtawi and Stout,[245] would imbue all shareholders with latent fiduciary duties to the firm and their fellow shareholders; which would be triggered whenever a particular shareholder – whether or not formally capable of controlling a board's decisions through voting rights – manages to *exert an influence* on the company's actions with regard to an issue in which the

240. Christopher M. Bruner, *Corp. Governance Reform in a Time of Crisis*, 36 J. CORP. L. 309, 310 (2010).

241. *See* Paul Rose, *Regulating Risk by 'Strengthening Corporate Governance'*, OHIO STATE UNIV., MORITZ COLLEGE OF LAW, 29 (June 25, 2010), http://ssrn.com/abstract=1630122 (describing the Dodd Frank corporate governance provisions as potentially pernicious and likely to affect little change on investor behavior or risk management); Martin Lipton *et al.*, *A Crisis Is a Terrible Thing to Waste: The Proposed "Shareholder Bill of Rights Act of 2009" Is a Serious Mistake*, 1 (May 12, 2009), http://www.wlrk.com/webdocs/wlrknew/WLRKMemos/WLRK/WLRK.16657.09.pdf (stating that "the suggested provisions of the [Dodd Frank] Act threaten to encourage the opposite of its stated goal.").

242. Rose, *supra* note 241, at 10.

243. *Id.* at 20–21.

244. *The UK Stewardship Code*, FIN. REPORTING COUNCIL (July 2010), http://www.frc.org.uk/FRC-Documents/FRC/The-UK-Stewardship-Code.aspx.

245. Anabtawi & Stout, *supra* note 186, at 1294–96.

shareholder has a personal material interest.[246] As long as the shareholder's influence is a "but for" cause of some corporate transaction or strategy, that would amount to an exercise of shareholder control.[247] Thus, investors with short-term horizons such as hedge funds, which commonly seek to influence board decisions on ordinary business decisions, such as the sale of dormant assets or the decrease of capital expenditures,[248] would be obligated to consider the interests of all other stakeholders and shareholders in the firm. While this proposal is admirable in principle, as it aims at protecting long-term corporate value and the interests of the financial system and wider economy, it would open the door to increased litigation over the highly indefinite meaning of shareholder "control" or "influence"; and is a recipe for disastrous shareholder to shareholder litigation over potentially any issue in which various blocks of shareholders do not agree.

A more acceptable solution to conferring responsibilities on institutional shareholders would be the UK Stewardship Code, a proposal first initiated by the UK Institutional Shareholders' Committee and supported by the 2009 Walker Review.[249] The code endows institutional investors with certain governance responsibilities, in the interest of improving long-term returns to shareholders and wider benefits to stakeholders, as well as reducing the risk of catastrophic outcomes to the system.[250] For example, Principle 4 states that "[i]nstitutional investors should establish clear guidelines on when and how they will escalate their activities as a method of protecting and enhancing shareholder value."[251] In the supporting guidance, instances where escalation and intervention are suggested include "risks arising from social and environmental matters."[252] Thus, the Stewardship Code encourages institutional investors to adopt a systemically-sustainable approach to investing, and to be accountable to all corporate stakeholders in the exercise of their voting powers. Further, unlike the previous proposal to impose duties on all activist shareholders, enforceable via litigation, the Stewardship Code is premised on a less onerous and more flexible "comply or explain" model, such that smaller institutional investors which are unable to, for example, report to companies on their voting activities (Principle 7) as regularly as bigger institutions, would not be forced to "comply" but can "explain" why their resources may constrain their ability to carry out their stewardship obligations.[253] As Heineman suggests, the US should seriously consider adopting a similar proposal: "[The Stewardship Code] is

246. *Id.*

247. *Id.* at 1295.

248. Grossman, *supra* note 45, at 26.

249. Ben W. Heineman, *A Stewardship Code for Inst. Investors*, BLOOMBERG BUSINESSWEEK (Jan. 19, 2010), *available at* http://www.businessweek.com/managing/content/jan2010/ca20100119_228745.htm.

250. Fin. Reporting Council, *supra* note 244, at 1.

251. *Id.* at 7.

252. *Id.*

253. *Id.* at 1–2, 9.

the most detailed attempt to date to give institutional and regulatory form to the belief that shareholders are part of the solution, not part of the problem, and that they have not just a right, but a duty, to engage with the companies in which they invest."[254]

Conclusion

The advent of the global financial crisis has challenged our ideas of corporate governance. Specifically, it has forced us to re-think whether we are content with a paradigm of corporate governance which serves solely the interests of shareholders, or also the interests of the system that the corporate is embedded in. Accordingly, we are also compelled to re-think whether our current corporate governance mechanisms are apt to achieve these wider goals of systemic stability.

While much of the current legal literature on post-crisis corporate governance does include proposals for reform, there is yet to be a study that begins from first principles to re-think the foundational purposes of corporate governance, and logically flowing from that, the means to achieve these purposes. This paper has attempted to do so by positing and defending a systemic stakeholder model for all public listed companies, where the interests of the economy and financial system are to be taken into account such companies. Flowing from this understanding of the ends of corporate governance, it has been argued that fundamental changes must be introduced to re-compose and re-structure the board, while increasing duties and responsibilities for directors and institutional shareholders. Collectively, the roles of directors and shareholders should be re-conceptualized as stewards for the system's stake in the company. It is the hope of this writer that this provides a coherent paradigm, or at least the germ of an idea, for the revision of Anglo-American corporate governance in the wake of the financial crisis.

254. Heineman, *supra* note 249, at 2.