Corporate governance in the UK – contrasted with the US system[1]

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1. Introduction

Who governs UK companies and how well do they do it? The immediate response that most people would give is the board of directors and they operate largely in their own self-interest. Few people would see shareholders as being at the helm. The one exception is takeovers when shareholders get the upper hand.

The difficulties of shareholder activism are illustrated by the activities of Phillips and Drew in 1998. Despite perceived poor performance, the management of some of the companies, in which they had large shareholdings, stubbornly remained in place.[2] As a result, Phillips and Drew actively used their holdings to encourage hostile takeovers. In the case of Marley, the buildings and materials group, Phillips and Drew approached John Mansfield, a much smaller company than Marley, and pledged their holding of 24.9% in a forthcoming hostile bid. They also agreed to invest 1.5 million pounds in Mansfield if their bid failed. The hostile bid for Marley produced a series of competing bids, and large profits for the fund managers. What is striking about this case is the inability of financial institutions to effect changes in control in manifestly poorly performing companies and that in the end Phillips and Drew had to stimulate a takeover market to achieve this.

What underlies this perception of passive governance is the highly dispersed nature of share ownership in the UK. As has been by now well documented, in comparison with virtually every Continental European country, Far Eastern and South American country, the UK has exceptionally dispersed ownership (see La Porta et al. (1999)). In most countries a high proportion of companies have single majority shareholders in even the largest quoted companies. However, dispersal of ownership in the US is comparable to that in the UK. The US is therefore a particularly important country against which to compare UK governance because, unlike Continental Europe and most of the rest of the world, the underlying structure of its capital markets and companies is similar.

Corporate governance in the UK does not rely on active shareholders ...

In a paper with Luc Renneboog (2001) we document the structure of ownership of UK companies, we examine how well governance functions in rectifying management of poorly performing firms, and we draw contrasts with the US. The main observations on which we expand in the subsequent sections are:

- While ownership is dispersed in the UK in comparison with most other countries, coalitions of 5 shareholders can on average control more than 30% of outstanding equity.
- There is little evidence that shareholders in practice exercise this potential to exert control.
- The single most important holders of large blocks are insiders (directors) who use their holdings to resist outside intervention.
- Boards play a weak role in corporate governance. Non-executive directors do not in general perform a disciplinary function. An important exception is when the role of CEO and chairman are separated.
- In addition to an active takeover market, there is a market in blocks of shares.
- Neither hostile takeovers nor markets in share blocks are associated with the disciplining of the

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[2] See the article in The Financial Times, The ABC of management performance, according to P&D, December, 1998.

management of poorly performing firms, with the exception of holdings held by industrial companies.

These observations stand in some contrast to those reported in the US:

- Boards of directors are important in disciplining management. Non-executive directors play an important role in this process.
- Disciplinary takeovers and the market in share blocks in the US are both associated with poorly performing companies.

In the absence of active shareholder involvement, governance in the UK relies on financial constraints. We find that:

... but on financial constraints

- Management is more likely to be replaced in poorly performing companies that have poor financial ratios.
- There is a high level of (distressed) new equity issues by poorly performing UK companies. These are associated with a high level of managerial changes.

What can explain these differences, notwithstanding the similar structures of the two countries' capital markets? We believe that legal rules and regulation play a key role. There are two areas where we believe that regulatory differences between the UK and US are particularly significant: fiduciary responsibilities of directors and protection of minorities, in particular in relation to takeovers and new equity issues. The former are significantly weaker and the latter significantly stronger in the UK than in the US, leading to a reliance of governance in the UK on financial constraints relative to boards.

In section 2 of this paper, we describe the performance of the takeover market and the extent to which managerial changes are related to poor performance. In section 3 we describe the results of the research into UK governance mechanisms. In section 4 we explore how governance outcomes in the US and UK might be explained in terms of differences in legal and regulatory rules and we discuss how recent events in the US have altered our perception of corporate governance.

2. Market for corporate control

In this section on the takeover market we discuss three questions:

– Do takeovers increase shareholder value?
– What role do hostile takeovers play in disciplining poorly performing management?
– Do targets underperform prior to being acquired?

Do takeovers increase shareholder value?

In Table 1 below, we show the results of a recent paper by Loughran and Vijh (1997) for a large sample of takeovers in the US that took place over the period 1970–1989. They measure the returns from a buy and hold strategy for shareholders of the target over the announcement period of the takeover and up to 5 years subsequent to the consummation of the merger. For the purposes of calculating returns, it is assumed that the shareholders of the target purchase shares in the bidder when the offer is accepted, at a price that reflects any bid premium. The excess returns around the announcement date, i.e. the bid premium, are about the same in mergers as in tender offers, 25.8% versus 24.5%. However, after 5 years the cumulative returns to shareholders in the merged firm has hardly changed from 25.8% to 29.6% i.e. there are virtually no abnormal returns to the acquiring firm over this period. In contrast, the returns in tender offers have improved dramatically from 24.5% to 126.9%, suggesting large post merger gains, in excess of those anticipated on announcement. All

Table 1
Cumulative excess returns of 516 US merging firms from the bid announcement to 5 years post merger in the period 1970 to 1989

	No.	Announcement Period	Year 1	Year 2	Year 3	Year 4	Year 5
		%					
Mergers	419	25.8	28.5	24.0	20.9	30.4	29.6
Tender offers	97	24.5	42.2	48.4	69.6	81.6	126.9

Announcement period begins 2 days prior to the announcement date and ends with the effective date of the acquisition.
Loughran & Vijh (1997).

these returns are after the deduction of returns on a suitable benchmark, thereby measuring 'excess' or 'abnormal' returns.

The authors' explanation for the difference in tender offers and mergers is 'that tender offers, which are often hostile to incumbent managers, may create additional value as new managers are appointed. In the case of mergers, that are friendlier and enjoy the co-operation of incumbent management, the additional value creation is less likely to occur.' (Page 1787).

Table 2 provides a measure of performance for a large sample of UK takeovers by Higson and Elliot (1996) that took place over the period 1975 to 1990. The abnormal returns are calculated after deducting the returns of a benchmark consisting of a sample of non-merging companies of equivalent size to the merging companies. The bid premium to target shareholders averages 37.5%, although it is larger in hostile bids, at 42.7%, compared with 36.6% for friendly bids. Bidders do far less well earning abnormal returns of about 0.43% or 1.3% on a value weighted basis. Thus, there are substantial gains to shareholders from takeovers but virtually all the gains accrue to the target. The long run returns of these takeovers are roughly breakeven on an equal weighted basis, although value weighted returns of 12% suggest that larger acquisitions, relative to the bidder, perform better than smaller ones.[3]

Role of hostile takeovers in disciplining poorly performing management

Although only 15% of all acquisitions in the sample, hostile takeovers comprise 40% of the largest 100 takeovers. Not only are the announcement returns i.e. the bid premium, to target shareholders higher in hostile takeovers, but the long-term performance of the combined company, subsequent to the merger, is better: 12.8% over 24 months compared with 1.33% for the top 100.

[3] Note that these long run returns do not include the bid premium.

Table 2
Long-term performance for a sample of 722 UK takeovers in the period 1975 to 1990

	Announcement month		Abnormal returns in 3 years post merger
	Bidder %	Target %	%
Abnormal returns: equal weighted	0.43	37.5	0.83
Value weighted	1.3	33.2	12.0

Higson and Elliot (1996).

Franks and Mayer (1996) made a detailed study of 80 hostile takeover bids in the UK in 1985–1986. Like Higson and Elliot, they found much larger bid premiums for successful tender offers where management opposed the bid, compared with friendly bids: 29.8% compared with 18.4%. In opposed bids there was also a very high degree of management replacement after the bid. On average, 90% of the target board was replaced compared with only 50% in friendly bids. They attributed the higher bid premiums in hostile takeovers to larger merger benefits rather than to lower returns to bidders.[4]

Are takeovers about the acquisition of underperforming companies?

If the market for corporate control is about replacing weak management, we might expect evidence that the targets of hostile takeovers are on average underperforming companies; however, UK evidence suggests little underperformance prior to the bid. For example, over the five-years prior to the bid, targets of hostile takeovers appreciated by only – 0.14% per year; these returns included both dividends and capital gains. The returns are virtually zero. The equivalent performance of the non-merging sample is + 0.14%, again close to zero. Shorter periods show somewhat worse performance for targets of hostile bids, but still not very poor performance.[5]

In the UK hostile takeovers are more profitable for shareholders, although the target may not have been underperforming

The main research findings for the UK are that takeovers in general are good for shareholders, although most of the gains accrue to the target.[6] Hostile takeovers look even more profitable and this may be attributable to a greater willingness to change management and make other more radical

[4] Hostile takeovers may also be effective as a threat to managers. Thus, performance may be affected even in the absence of a bid.
[5] Using another benchmark consisting of dividend changes, the authors found confirmation that the majority of targets of hostile takeovers were not poor performers.
[6] Accounting studies show somewhat different results to share price studies. Meeks (1977) compares the accounting return on assets of the merging firm both before and after the event. They find much lower returns post-merger, and attribute the lower return to losses on the acquisition. A study by Ravenscraft and Scherer (1987) in the US shows similar results. A study by Healy, Palepu and Ruback (1992) show that when you convert the accounting rates of return to economic rates of return there are gains to merging.

changes. However, the targets of hostile takeovers do not show evidence of past poor performance. Targets look to be average, or slightly below average, performers in comparison with other quoted companies.

Experience with US takeovers appears different in one important respect. A study on hostile takeovers by Martin and McConnell (1991) found higher bid premiums in hostile than in friendly takeovers, and that takeovers, which led to the replacement of the top manager in the target, tended to underperform their non-merging industry counterparts prior to a bid. Shareholders of such targets suffered abnormal returns of – 15.4% compared with + 4.4% for targets, which were non-disciplinary. They concluded that 'the takeover market plays an important role in controlling the non-value maximising behaviour of top corporate managers.' (page 671). Thus, the US market operates more like a market for corporate control than the UK market.

US studies show that hostile takeovers improve value through managerial change

Another study of US hostile takeovers by Bhide (1989) uses a different methodology to examine the issue of whether hostile takeovers improve value through managerial change. He examined case studies of the restructuring activities that followed 47 US hostile takeovers attempted between 1985–1986 and compared them with a randomly selected group of friendly takeover transactions. He found that hostile transactions were characterised by added value in the acquisition process whereas friendly acquisitions showed little evidence of synergies. The latter were largely well managed companies and its management was largely left in place.

Even if takeover markets function well as a market for corporate control they appear to be especially expensive when the sole or prime objective is managerial replacement or the correction of managerial failure. The costs of changing control are high and are significantly affected by takeover regulation protecting minorities and the transaction costs of acquisition.[7] Also, shareholders may benefit on average from mergers, but there is evidence that the risk of failure is high. For example, in assessing the returns to shareholders on the announcement of bids about 46% of bidders lose value, notwithstanding that on average bidders gain.

[7] Changes in large share block ownership in Germany are associated with much smaller bid premiums to sellers of about 10% than in the UK. Also, non-selling shareholders received virtually no gains from the transaction (see Franks and Mayer (2001)). They explain these differences in terms of the lower level of legal protection for minority shareholders, the lack of effective takeover rules, and the lower level of merger benefits. Their results suggest significant private benefits to large shareholders in Germany.

3. How are poorly performing companies restructured in the UK?

If hostile takeovers do not provide the mechanism for restructuring poorly performing companies, how are those companies restructured? In this section we summarise a study by Franks, Mayer and Renneboog (2001) of under performing UK companies and investigate the incidence of managerial changes and their influences.

We collected data on ownership, performance, capital structure and board structure for the period 1988–1993. We chose 250 companies randomly from all LSE quoted companies and an additional 50 poorly performing companies, defined as those performing in the lowest decile of share price performance during the period 1988–1991.

We address two questions:

How much managerial change is there in poorly performing companies?

What are the influences on managerial change? (i) large outside shareholdings, (ii) non executive directors, (iii) high leverage giving rise to new financing and encouraging intervention by shareholders and creditors, and (iv) sales of large share stakes performing like a market for corporate control.

Another important question that is not addressed is the extent to which particular forms of intervention lead to better subsequent performance.

Board turnover and performance

We used 5 different measures of (poor) performance including abnormal share price returns, dividend cuts/omissions, after-tax cash flow margins, after-tax rates of return on book equity, and earnings losses. Table 3 shows various measures of board turnover related to abnormal share price returns. Only for very poor performance, as measured by the worst decile, i.e. decile 1, is there a strong relation between board turnover and per-

Table 3
Average board turnover annualised over 3 years for firms in different deciles of share price performance

Boad turnover	Worst decile: 1 %	Decile 5 %	Best decile: 10 %
Executive directors	21.1	8.1	6.9
Non-executive	7.4	4.2	4.8
CEO	28.8	11.6	10.4
Chariman	15.8	7.2	5.9

formance. For example, for the three-year period following the year of poor performance there is an annual rate of turnover of executive directors of 21.1% or 63% over three years for decile 1. The turnover of the CEO is even higher, with a cumulative rate of 86.4% over three years or an average annual rate of 28.8%. Only for one other decile, decile 2, is there significant management turnover; for other below average performing deciles, 3 and 4, the level of managerial change is little different from that of average performing companies.[8]

Types of ownership and concentration of ownership

In this section we briefly describe ownership in the UK quoted share markets. This shows the level of concentration of ownership and that with coalitions of shareholders, the often-cited monitoring problems arising from dispersed ownership might be substantially mitigated. We also compare the level of concentration with that in US markets.

UK capital markets are relatively dispersed by international comparison. For example, more than 85% of large German quoted companies have a single blockholder with more than 25% of the voting equity.

In our UK sample, the largest single shareholding averages about 15%, and for the five largest shareholdings it averages 30–35% depending upon the year. These numbers are similar to the US, where Demsetz and Lehn (1985) find an average ownership of the five largest shareholders of 24.8% for the average firm in the Fortune 500 compared with 33% for our UK sample. However, the level of concentration does vary with the size of company.

[8] The average size of board is 9.3, and the average proportion of non executive directors is 40%, and the CEO is combined with Chairman in 32.9% of cases.

This may be important since smaller companies tend to have greater representation in the worst performing deciles. This is illustrated in Table 4 where the worst and best performing companies are shown to have much smaller equity capitalisations than average performing companies, i.e. decile 5. Average performing companies are more than twice as large as best performers, and are about six times larger than companies in the worst performing decile.

Using the largest shareholding as one metric of concentration, it is 11.0% for average performers, i.e. decile 5, compared with 16.9% for the sample of worst performers, i.e. decile 1. This difference mainly reflects lower insider ownership by directors, which is 6.8% among average performers compared with 15.3% among poor performers. Thus, the pattern of insider ownership explains a large part of differences in the concentration of ownership among firms of different size and performance. Our results suggest that the size of insider ownership plays an important role in protecting or entrenching management from change when performance is poor.[9]

Insider ownership by directors tends to protect management from change when performance is poor

The two largest types of shareholders are institutional shareholders and insider shareholders, i.e. directors. Industrial shareholders are also significant.

The pattern of share blocks is not static in our sample. There is a significant market in share stakes. For example, there are 82 sales of stakes greater than 10% for the period 1991–1993, and this constitutes an annual turnover rate of 9%. We explore the extent to which sales of blocks are

[9] Results are similar for the US. Insider holdings can be used to entrench management.

Table 4
Concentration of ownership by performance of firms in different deciles

	Worst decile: 1 %	Decile 5 %	Best decile: 10 %
Largest shareholding	16.9	11.0	17.1
Sum of all large shareholdings	42.4	30.5	45.9
Institutions	17.9	17.2	17.4
Industrial companies	5.8	4.8	6.2
Families	3.5	0.9	4.7
All directors	15.3	6.8	17.6
Market cap. (mill. £)	132	993	408

influenced by performance and lead to managerial changes.

High leverage and managerial change

An important question explored in this study is the extent to which high leverage and the need for new financing may explain managerial changes among poorly performing companies. Table 5 explores this question. We show that where poorly performing companies are not highly levered there is a comparatively low level of managerial turnover, whereas where similarly performing companies have high leverage there is a high level of managerial change.

We calculate cumulative executive board turnover and CEO turnover for a sample of poorly performing companies in the lowest decile of share price performance for at least 1 year in the period 1988-1993. Board turnover is ranked by quartile of interest cover, with quartile 1 containing companies with the lowest interest cover, and quartile 4 those with the highest cover. Board turnover is accumulated over 3 years.

High gearing in addition to poor performance leads to high board turnover

We find that cumulative executive board turnover is highest at 67.2% for companies with the lowest interest cover. For companies with the highest interest cover the cumulative board turnover is about one half, at 34.3%. It should be stressed that the performance of companies in different quartiles are the same. Statistics for cumulative CEO turnover show the same relation – low interest cover is correlated with high turnover. A similar relation holds when we use other definitions of gearing. Thus, for the same poor performance, companies with high leverage have much higher board turnover than companies with low gearing. This suggests that the relation between performance and board turnover shown in Table 3 may be driven by a combination of high gearing and poor performance and not poor performance on its own.

Table 5
Executive board turnover and CEO turnover for a sample of poorly performing companies ranked by quartile of interest cover

Interest cover:	Cum. executive turnover %	Cum. CEO turnover %
Quartile 1 (Lowest)	67.2	69.6
Quartile 2	44.6	59.3
Quartile 3	45.4	55.9
Quartile 4 (Highest)	34.3	24.2

Board turnover is accumulated over 3 years.

The importance of high leverage fits with the view attributed to Jensen (1989) that high gearing is good for corporate governance because poor performance causes management to default on its loan obligations and to seek renewal of facilities from lenders who are better at monitoring management than shareholders.

To investigate the role of shareholders and creditors in firms with high gearing, we analysed 34 case studies of poorly performing companies. In 28 cases the CEO or Chairman resigned, or both resigned. In 18 cases or about 54% of the sample new equity finance was raised. The question that we investigated was the extent to which managerial change was related to the provision of new equity financing and was triggered by shareholders and (or) creditors.

Interviews with senior management at some of the largest fund managers suggested that although they might intervene where there was very poor performance, in the face of management opposition, they were likely to avoid confrontation because of the dislike of any consequent publicity and the problems of co-ordinating other shareholders. However, it was a very different story when the poor performer required new finance: "it comes to a crunch when companies raise additional finance" or "it all unpicks when a company needs new money".[10]

More formal regression results confirm that although there is a strong relation between performance and board turnover, concentration of ownership and the category of owner play a limited role in the disciplining of management. The exceptions are inside ownership, which is used to entrench existing management, and industrial companies, which acquire stakes in poorly performing companies and precipitate high executive board turnover. Capital structure is important in explaining high levels of board turnover and the significance of new equity issues points to an important role for shareholders in disciplining boards of poorly performing companies when they are forced to seek additional equity. Board structure has little influence on overall executive board

[10] These interviews were carried out in 1997–8.

turnover but is important in the CEO regression with separation of the position of CEO and chairman leading to higher CEO turnover. Boards are therefore instrumental in dismissing CEOs in response to earnings losses or dividend cuts. To achieve wider board restructuring, investors require the leverage of external finance provided by high debt levels.

4. What might explain differences between outcomes in the US and UK?

There are three respects in which the exercise of corporate control is quite different in the UK and US. First, in the US, Weisbach (1988) reports a closer relation of CEO turnover to performance in firms where non-executive directors dominate the board. Also, Gilson (1990) and Kaplan and Reishus (1990) find that non-executive directors of poorly performing companies lose reputation and are frequently unable to find replacement positions. In the UK, we found no evidence of disciplining by non-executive directors; indeed, the relation is negative between the proportion of non-executives and board turnover. However, there is a strong association between CEO turnover and separation of the positions of chairman and CEO; separation seems to play an important role in CEO turnover.

Second, we find that takeover markets, and hostile takeovers in particular, in the UK are not significantly related to poor performance. In addition, we find no significant relation between managerial disciplining and large outside share blocks held by financial institutions, individuals, families and non-executive directors. The one exception involves purchases of share blocks by industrial investors where we report higher board turnover with poor performance. In some contrast in the US there is strong evidence in the US that hostile takeovers are related to poorly performing targets. A study by Bethel et al. (1998) reports that purchases of share blocks by 'active investors' are targeted on poorly performing companies. Also, Holderness and Sheehan (1988) find that when their majority blocks trade, there is substantial management turnover and stock prices increase. Thus, in both countries, changes in share blocks by active investors perform a disciplinary function, although the definition and size of active investors in the US is considerably broader than that in the UK.

Third, we find that financial structure and new financing are particularly significant influences on board turnover in the UK. We are not aware of any US study reporting this relation.

What could explain these differences? We argue that legal rules or regulation could play an important role.

Fiduciary responsibilities of directors

Powers to enforce fiduciary responsibilities of directors in the UK are weak. Stapledon (1996) records that although directors in the UK owe their companies 'fiduciary duties of honesty and loyalty, and a duty of care and skill', in practice 'actions to enforce the duties of directors of quoted companies have been almost non-existent' (pp. 13–14). Parkinson (1993) states "Historically, the standard of diligence set by the courts has been comically low, as can be seen from the cases concerning failure to supervise fellow directors and managers who turn out to have been defrauding the company" (page 98). All this might explain why directors of UK companies perform more of an advisory than a monitoring role.

In the UK, powers to enforce fiduciary responsibilities of directors are weak

In the US, directors (both executive and non-executive) have a duty of care to shareholders and they can be sued for failing to fulfil fiduciary responsibilities. However, in reviewing lawsuits in the 1960s to 1987, Romano (1991) concludes that shareholder litigation is a weak, if not ineffective instrument of corporate governance. One important exception is block ownership, where she finds that "for blockholders who are not insiders, litigation can be a valuable mechanism to redirect corporate policy" (page 80).

Minority protection

The 1989 Companies Act requires that share blocks in excess of 3% must be disclosed. Where there is a controlling firm, the Stock Exchange lays down specific rules concerning the controlling shareholding and transactions with related parties. For example, a majority of the directors of the board of the subsidiary must be independent of the parent firm. Shareholders have to be notified about transactions with the parent firm and their approval has to be sought in advance with the related party abstaining from voting on the transaction.

Minority shareholders are also protected in the UK by the City Code on Takeovers and Mergers. The Code requires that any person accumulating 15% or more of the voting rights of a firm must declare his intentions about making a takeover, and those acquiring 30% must offer to purchase all remaining shares at the highest price paid by the acquirer for the target over the previous twelve months. Also, a 25% minority of shareholders can block particular forms of new equity issues and mergers, and new issues have to be made in the form of rights issues where they exceed 5% of share capital.

The US is different from the UK by allowing transactions to be imposed on an unwilling minority but ensuring that the minority is adequately protected in objective market value terms. Protection of investors, especially minorities, is primarily the concern of the courts. For example, Delaware courts in the US approved a discriminatory share buyback by Unocal against Boone Pickens, who was a large shareholder attempting a coercive takeover (Herzel and Shepro, 1990). There is no US equivalent of the UK Takeover Code requiring full bids for companies to be made. However, there is extensive State legislation discouraging takeovers, and companies implement more defence mechanisms than are permitted in the UK (Miller (1998)).

Minority protection is greater in the UK; in the US it is primarily the concern of courts

Rights Issue Requirements

Differences in minority protection are particularly pronounced in relation to new equity issues. In the UK, the association of corporate governance with new equity finance revolves crucially around the investment banks and underwriters that organise the issue. The Companies Act of 1985 states that seasoned new equity issues by companies must be in the form of rights issues and that if shareholders fail to take up their rights, the rights may be sold for the shareholder's benefit.[11] The Act also describes the circumstances under which pre-emption rights may be disapplied. It requires a super majority vote by shareholders of at least 75% on each and every occasion an equity issue is to be made.

In the US, companies frequently obtain shareholders' agreement to drop pre-emption rights. Such agreement does not have to be renewed on each occasion the firm makes a rights issue as in the UK. Brealey and Myers (1996) suggest that 'the arguments [by management] for dropping pre-emption rights do not make sense' (p. 405). Our results imply that managers have incentives to drop pre-emption rights so as to allow issues of equity to be made to new shareholders at a discount to the equilibrium price, thereby diluting existing shareholder wealth. The discount would be in exchange for implicit or explicit agreements to new shareholders to leave existing management in place.

Thus while superficially the capital markets of the UK and US are similar and both have common law legal systems, there are subtle but important differences in regulation. These place greater burdens on directors in the US than in the UK but more protection of minorities in takeovers, share block purchases and new equity issues in the UK. They make control by large shareholders more difficult and expensive in the UK than in the US but facilitate control when new financing is sought in new equity issues. Consistent with this, we have reported that corporate governance in the UK relies more heavily on financial factors and new financing, and less on boards, non-executive directors and large shareholders.

What is the significance of this difference? Is it the case that the UK has evolved arrangements that are different from those in the US but perform similar functions? We would argue caution in concluding that the governance arrangements in the UK and US are close substitutes. Reliance on financial constraints and distress implies that governance in the UK is primarily restricted to the very worst performing companies. This is consistent with the observation that it is only the very worst performing companies in the UK that appear to display unusually high board turnover. It suggests a slow response of UK corporate governance to the emergence of poor performance.

The implication is that the greater protection of minority investors in the UK may have come at a price. It facilitates the operation of securities markets and encourages wider participation by investors but it may discourage active corporate governance by large shareholders and markets in corporate control.

[11] These pre-emption rights are recognised in European Community law.

An alternative view is that governance procedures in the UK and US are not static and evolve in response to past performance. Capital markets are constantly responding to past inefficiencies and governance may be no exception to this rule. Under this interpretation changes in legal rules are unnecessary, and we might expect to see improved governance procedures reflected in more recent data. One study by Dahya, McConnell and Travlos (2002) finds a stronger negative relation post Cadbury between top management turnover and corporate performance, and that increased sensitivity of turnover to performance was concentrated among firms that adopted the Cadbury Committee's recommendations.

5. More recent events

How should recent events in the US affect our views of governance in the two countries? There are two important questions: Where was the failure of governance? And, what is the best way of rectifying the failure? In the case of Enron the failure appears to be more the result of serious conflicts of interest between the auditor and the company. It is less easy to judge the extent to which non-executive directors did not exercise sufficient care. In this regard, it will be important to see how the US courts are prepared to evaluate the business decisions of the non-executive directors. In the past they have largely avoided such an approach, citing 'the business judgement rule', in which the courts decline to judge management's business management.

However, there does seem one area where non-executives may have influenced the current crisis of governance. They designed remuneration policies for management that were supposed to align the interests of management and shareholders. Often those packages were very asymmetric; that is, large rewards were given for success and there was little financial penalty for failure. Thus, they did not mimic entrepreneurs who lose large amounts of capital when they experience failure. Dow and Raposo (2002) have shown that when executive remuneration is very asymmetric and large, i.e. has large upside with little downside, chief executives will choose much riskier strategies and less profitable ones from the point of view of shareholders. In this respect, the excesses of the past few years may be less a question of whether the board should have spotted the error, and more a question of the incentives given to management to choose grand strategies which were not in shareholders' interests.

Given these excesses, what should be done? One view might be to let the markets respond. Shareholders do not like losing large parts of their capital, and in the face of such losses they will evolve changes in governance that will provide remedies for the failure. A very different view is that there is a serious market failure and institutional shareholders have little incentive to devise the right kind of innovations in governance. This interpretation of the problem suggests more regulation.

Asymmetric remuneration packages for managers give the wrong incentives

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