Changing the Culture of Financial Regulation: a Corporate Governance Approach

Thesis submitted in accordance with the requirements of the University of Liverpool for the degree of Doctor in Philosophy by Steven Ronald Cairns

September 2014

For Rhonda and John

Acknowledgements

First and foremost, I wish to express my sincerest gratitude to my supervisors, Dr Rob Stokes and Prof Anu Arora. Their patience and support throughout the entire process has gone beyond what is expected of any supervisory team, and for that I am truly thankful. It is amazing to think that this whole journey began with an email conversation six years ago around a failed bank and an unsuccessful furore into the city. Six years, and a few more grey hairs later, we are at the end of what has been a rollercoaster journey towards completion.

I would like to take this opportunity to thank my partner Sarah Montagu, I am sure it hasn't been easy putting up with me throughout this whole process and her selfless attitude and unconditional support has been the rock that the thesis has been built upon. I love you and couldn't have done it without you.

My gratitude also extends to my friend Bleddyn Davies. I will always appreciate our conversations; they kept me focused on the task at hand.

I want to thank my Nan, Elsie May Nash, who has always believed in me no matter what I have undertaken, and for her steak pies that have gotten me through more than one late night session in the library.

My final, and most important, thanks must go to my parents Rhonda and John. There are no words to express my gratitude to you both for the sacrifices you have made over the years. You have always put the needs of myself and my brothers over your own, which is all any child can wish for from their parents. From long car journeys across the country for rugby matches, to ensuring my fridge is full of 'healthy options.' Whatever you have done you have always put my best interests first and I cannot thank you enough for that. I hope by dedicating this thesis to you both, it will go some way to showing you how grateful I am.

Abstract

The 2007-09 Global Financial Crisis has been described as the greatest crisis in the history of financial capitalism. The failure of the global financial system was triggered by the 'Great American Real Estate Bubble,' however it quickly developed into a global liquidity squeeze that left financial markets at the brink of collapse.

The thesis argues that the general culture of banking prevalent at the time both caused and exacerbated the crisis. The Business Strategies were excessively risky, focusing on short-term gains, at the expense of financial security. It is therefore purported that to mitigate the risks of any future global financial crisis a fundamental change in the culture of banking is needed. Behavioural expectations and norms must be redefined and more prudent strategies inculcated. The thesis will show that the only way to hope to achieve such a cultural shift is to employ a holistic approach, encompassing supervision, regulation and crucially corporate governance mechanisms.

Previous debates within the UK have tended to focus on macro and micro regulatory reform. However, it is purported that it was in many cases, risk monitoring and management practices within financial institutions that dramatically failed. Whilst prudential regulation is important, the thesis will show that it alone is insufficient to change the culture within the financial system; a multi-faceted approach is needed.

The central argument to the thesis will show that corporate governance mechanisms must play a central part in the legal and regulatory response to the Global Financial Crisis, as part of a cohesive package of measures necessary to effect cultural change; it will do this by conducting a case study into the collapse and subsequent nationalisation of Northern Rock Plc.

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Introduction: The Global Financial Crisis 2007-09

The 2007-09 Global Financial Crisis saw the world's financial systems go through what has been described as the greatest crisis in the history of financial capitalism.[1] In short, there was a systematic failure of banking and financial systems across the globe. Whilst the origins of the crisis may be traced back to loosening of lending standards in the US, specifically, in the subprime mortgage market, its impact had quickly spread across the globe.[2] The bursting of the 'Great American Real Estate Bubble'[3] was only the beginning of a global liquidity squeeze, the result of which has seen the collapse and bailout of some of the largest financial institutions in the world. In the US, the Government guaranteed debts to the total of around $2.3-2.8tn. The placing of both Fanny Mae[4] and Freddie Mac[5] into conservatorship can be seen as the apex of the problems, however the bankruptcy of Lehman Brothers, a company with a history stretching back over 160 years, is perhaps the most evocative consequence. In the US, a series of US Treasury bailouts and pledges (beginning in October 2008) have totalled more than $11.6 Tn.[6] To put this into perspective, there has only been one other single event in the past century that has cost more than $1 Tn, after adjusting for inflation, and that was the Second World War.[7]

The UK has fared marginally better, with a support package totalling £1.162 Tn at its peak.[8] The numbers, however, tell only part of the story. There have also been a plethora of public takeovers; intervention by Government through capital injections has resulted in the nationalisation of Northern Rock[9] and Bradford & Bingley.[10] The underwriting of shares by government has also resulted in the ownership of 70% of Royal Bank of Scotland and 43% ownership of Lloyds TSB/Halifax

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[1] Lord Turner, *The Turner Review: A regulatory response to the global banking crisis* (March 2009) Intro.
[2] ibid.
[3] John Coffee 'What went wrong? An initial Inquiry into the causes of the 2008 financial crisis' (2009) 9 JCL 1, 4.
[4] Federal National Mortgage Association.
[5] Federal Home Loan Mortgage Corporation.
[6] Mark Pittman and Bob Ivry, 'U.S. Bailout, Stimulus Pledges Total $11.6 Trillion' *Bloomberg* (24 February 2009).
[7] Heather Connon, 'What it costs to save US banks: WW2, plus the New Deal, plus...' *The Observer* (29 March 2009).
[8] National Audit Office, The Treasury's 2010-11 Accounts: the financial stability interventions (13 July 2011) 4.
[9] February 2008.
[10] September 2008.

Bank of Scotland through the vehicle of the limited company United Kingdom Financial Investments (UKFI).[11]

The Culture of Banking

The subprime mortgage market and the collapse and subsequent bailouts of Fannie Mae and Freddie Mac have caused a knock on effect across the globe.[12] This bubble alone, however, cannot be held as the sole cause of such a catastrophic meltdown; its origins are both numerous and intricate. It has been argued that off the book accounting and the avoidance of disclosure of toxic assets were a cause.[13] Lord Turner, former chairman of the Financial Services Authority, believed rapid credit extension was underpinned by major and continued macro imbalances, in the UK this was funded primarily by private sector inflows, particularly from the US. This import of capital into the UK funded rapid growth of credit, to the point where by 2007 18% of UK mortgage credit was funded through foreign investment purchases of UK credit securities.[14] Further to this, bonus and incentive driven structures that focused on short term profit through raising the share price have also been criticised.[15]

It may be suggested that all of these contributory factors can be clustered around a single, unified cause: a failure in the general culture of banking at the time. This culture encouraged financial institutions to act with a short-term perspective and to make as much profit as possible to the detriment of credit quality and prudence.[16] This short term attitude led investors and shareholders to be accustomed to ever increasing revenues, and returns on equity which hugely outpaced real economic growth rates for a number of years. An obvious example can be seen in the case of Northern Rock. In the years preceding the financial crisis Northern Rock had an annual growth rate of around 20%.[17]Such a rapid rate of growth whilst not in itself an issue, can both cause and reinforce, a culture of excessive risk taking. The attitude of the CEO and senior management to such growth was telling. When interviewed following the crisis it was clear that the directors of Northern Rock saw such growth rates as the norm, and in no way excessive.[18]The banking culture shielded

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[11] http://www.ukfi.gov.uk/.
[12]Applebaum, Binyamin, Carol Leonnig, and David Hilzenrath. 'How Washington Failed to Rein In Fannie, Freddie' *The Washington Post* (14 September 2008).
[13] Financial Services Bill Deb 23 February 2010, col 968.
[14] Turner (n1).
[15] See for example Iris H-Y Chiu, 'Corporate governance in banks - is it special?' (2014) Company Lawyer 161
[16] The de Larosière Group, *The High Level Group on Financial Supervision in the EU* (European Commission, 25 February 2009) 111.
[17] Treasury Committee, *The Run on the Rock Volume II oral and written evidence* (HC 2007-08, 56-II)) Q 452.
[18] Ibid.

itself behind what was perceived as a 'herd mentality'[19], whereby no manager would speak out against the strategies or business models of the banking corporation, even if they suspected that the business model of securitisation as it was applied could not shield the institution from bad credit and excessive risk. This behaviour was considered to be the norm and will be shown to be ingrained in the remuneration structures of the institutions. These business models were excessively risky and which pursued simultaneously by several banks, contributed to the build-up of systemic risk, contagion, and in some cases corporate failure.[20]

The identification of cultural problems focusing on market participants, seeking higher yields, to the detriment of risk assessment, have been highlighted as a key issue following the financial crisis. The Banking Commission recognised a need for a profound cultural change.[21]Mervyn King spoke at length of the need to change the 'culture in the banking industry'[22] before he stepped down as Governor of the Bank of England. His comments were also echoed by Government with Prime Minister David Cameron declaring that there was a need to reform 'an irresponsible banking culture that rewarded short-termism and unmanageable risk-taking.'[23]Calls for reform of banking culture have also been reiterated by the industry with the head of the Institute of Directors, Simon Walker, stating that the current banking culture has 'harmed the reputation of business as a whole' and that 'they should feel deep shame for the damage they have done.'[24] Further cultural failings in banking culture revealed since the financial crisis, have also brought the banking industry into disrepute. The mis-selling of PPI to people who either: did not need it, would not be able to claim on it, or did not know they had been sold it. Fines and claims relating to the mis-selling have resulted in major banks setting aside as much as £3.6 Bn to repay those that were mis-sold.[25] Subsequently the LIBOR rigging scandal was another example of a corrupt culture within the financial system that saw significant fines being handed out to guilty parties.[26] Flaws in banking culture that led to the scandal have been identified by the Hodge Committee.[27]

[19] The de Larosière Group (n 16) 112.
[20] Turner (n1) 88.
[21] Joint Commission on Banking Standards, *Changing banking for good* (2013-14, HL 27-I, HC 175-I).
[22] Mervyn King, Bank of England Financial Stability Report Q&A (29th June 2012) 2.
[23] David Cameron, 'Economy Speech Delivered by David Cameron' (7 March 2013).
[24] Simon Walker, 'Interest rate swap mis-selling and Libor abuse show the need for new blood at the top of the banks' (Institute of Directors Press Release 29 June 2012) accessed at http://www.iod.com/influencing/press-office/press-releases/interest-rate-swap-mis-selling-and-libor-abuse-show-the-need-for-new-blood-at-the-top-of-the-banks [accessed on 23 September 2014].
[25] Lloyds makes extra £375m provision for PPI compensation *BBC* (1 May 2012).
[26] Examples LIBOR UBS were fined £923 Million by the UK, US and Swiss regulators, Barclays Plc were also fined a total of £278 Million and it ultimately cost CEO Bob Diamond his position.
[27] Joint Commission on Banking Standards, *Changing banking for good* (n 21).

The Response

What the crisis has shown is that market discipline alone is not enough to ensure the stability of the financial system. Prudential regulation and rigorous supervision are required to ensure market discipline and protect against excessive risk taking by financial institutions.[28] It should be noted however that formal regulation has been in place within the UK financial system since the Banking Act 1979, and that during the financial crisis the system was far from being unregulated, with a comprehensive regulatory structure set out under the Financial Services and Markets Act 2000. However, it is a fact that global financial services regulation did not prevent, nor even contain the crisis. When placed under the stress of the crisis, the system of regulation was shown to be wholly inadequate. The substantial costs that were borne by society have resulted in much more invasive legislation being passed by governments across the globe to try to prevent, or at least reduce, the economic damage that may occur from a future crisis. The UK is no exception; reforms began with the Banking (Special Provisions) Act 2008 and the Banking Act 2009 to deal with the aftermath of the issues outlined by the failing of Northern Rock and the Special Resolution Regime. Subsequent regulation was introduced under the Financial Services Act 2010. Perhaps the most significant reforms have been introduced under the Financial Services Act 2012. The abolition of the FSA under the Financial Services Act 2012 and the subsequent separation of retail and wholesale banking by the Financial Services (Banking Reform) Act 2013 have made significant changes to the landscape of financial services regulation. The UK has also been subject, along with the rest of the European Union, to an amendment to Basel II, the so called Basel III Accord.[29] These interventions have sought to formalise a restructuring of financial regulation, focusing in particular on reducing systemic risks and mitigating the consequences of institutional failure. The thesis argues, that such measures alone will not be sufficient in effecting cultural change in the business of banking. Since a deficient culture was at the root of the Global Financial Crisis, this is a significant weakness of the response.

The Thesis

Banks need to re-evaluate their core purpose and the values which should define their behavioural expectations and norms. Finance can be a socially and economically useful function but in order to do so, the focus has to be on the real economy, what it does for businesses making investment, and what ultimately it means for the economy. The overriding focus of policy and academic debate

[28] Turner (n1) 47 s. 1.4 (iv).
[29] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC Text with EEA relevance [2013] OJ L 176.

within the UK has been on the nature, scale and need for public policy support and the shape, extent and timing of further regulatory tightening.[30]However it is purported that it was in many cases, risk monitoring and management practices within financial institutions that failed so dramatically.[31]In short, the deficiencies in prudential oversight were accompanied by major governance failures within banks.[32] It is therefore argued that reforms to prudential regulation alone are inadequate to change the current culture within the financial system; a multi-faceted approach is needed. Whilst the new regulatory powers that have been adopted are, on the whole, to be welcomed, formal financial regulation has substantial limitations when addressing the culture within an institution. These limitations can be addressed by improving corporate governance structures. There were many cases where internal risk management was ineffective[33] and where senior management failed to adequately identify and constrain excessive risk taking. A greater reliance on formal corporate governance structures would improve this by altering the general culture imposed within an institution, the culture begins with the Chief Executive and their senior management team. It is the intention of this thesis, therefore, to focus on the ability of corporate governance mechanisms to drive cultural change within banks and thereby reduce institutional and systemic risk. Improvements in the effectiveness of internal risk management and firm governance are essential, and a broader holistic approach including supervision, regulation and corporate governance, is required to change the culture of banking and prevent a reoccurrence of the Global Financial Crisis.

Whilst previous academic commentary has approached individual areas of reform, the original contribution of this thesis is derived from the multifaceted approach that is being adopted that brings together both external financial regulations with internal corporate governance structures in the light of the financial crisis. Analysis of the relevance and applicability of many corporate governance elements has been limited and as such the thesis will demonstrate that many long-standing elements of Company Law, such as fiduciary duties, now codified in the Companies Act 2006, have a significant role to play in the context of financial regulation. The thesis utilises a desk based, doctrinal analysis of the law. It has sought to critically analyse the current regulatory structures and attempted to adopt a holistic approach to regulating the financial system. As stated by the Banking Commission:

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[30] Walker Review, *A review of corporate governance in UK banks and other financial industry entities: Final recommendations* (26 November 2009) 9 and see chapter 1.
[31] The de Larosière Group (n 16) para 122.
[32] Walker (n 30) 9.
[33] Turner (n 1) 89.

> 'Unless measures are taken to ensure that the intentions of those at the top are reflected in behaviour at all employee levels, fine words from the post-crisis new guard will do little to alter the fundamental nature of the organisations they run'.[34]

The Structure of the Thesis

The thesis will begin by engaging with the current academic literature around two key debates post the Global Financial Crisis. Risk based regulation and arguments of financial institutions being 'Too Big To Fail', to show that whilst financial regulation does help there are limitations to its effectiveness. These limitations can be resolved by the application of corporate governance structures, and in particular director regulatory processes, as part of a multifaceted approach. The multifaceted approach will stabilise the behaviour of the directors and market participants within the financial system:

Prudential Financial Regulation: The first chapter will focus on prudential regulation and within that the concept of risk based regulation. Risk based prudential regulation was the main form of regulation used by the FSA during the financial crisis. There is no formal legislation that compels the FSA to adopt a risk based approach to its supervision, nor has the FSA stated categorically why a risk based approach was adopted over any other. The chapter attempts to analyse the reasoning and viability of risk based regulation in a non-zero failure system, reviewing whether capital liquidity is really the best way to mitigate risk within a financial system. As risk based regulation uses a concept of non-zero failure it is important to discuss another central theme to come out of the financial crisis, and that is the concept of 'Too Big To Fail'. During the most recent financial crisis no UK financial organisation was allowed to fail, as an alternative the UK government rescued them via extremely large capital injections. It has been argued that:

> '[A] company is too big to fail when, in order to stave off unacceptable political or economic risks, governments would put taxpayer money at risk to avert the company's failure rather than wind it down in a bankruptcy or resolution proceedings.'[35]

The chapter will conclude with an analysis of the concept of 'Too Big To Fail' and discuss whether the most recent separation of retail and wholesale will resolve the issues. The initial chapter will seek to show that the culture of banking cannot be altered by formal regulation alone and as a result it is necessary to engage in a multi-faceted approach.

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[34] Joint Commission on Banking Standards (n 21) 44, para 137.
[35] Greene et al, 'A closer look at 'too big to fail': national and international approaches to addressing the risks of large, interconnected financial institutions.' (2010) 5(2) Capital Markets Law Journal 118.

The main body of the thesis will focus on showing how Corporate Governance structures are the necessary bridge between market regulation and formal regulation. It will do this by focusing on a number of specific issues within corporate governance. It will begin by focusing on two legal duties the director owes to the company under the Companies Act 2006. It will continue by discussing the utility of the Victorian doctrine of the 'Business Decision Rule', and will conclude by analysing whether remuneration structures could be an aid to good corporate governance.

The Duty of Skill, Care and Diligence: Following the recent financial crisis and the subsequent reports[36] there has been a media and political backlash against some of the incumbent directors of the larger financial institutions. Under s. 174 Companies Act 2006 the director owes a duty of skill, care and diligence to the company. The chapter will analyse a number of recent cases both in the UK and Australia and will purport that there may have been a shift in ideological thinking towards increased scope for liability following the crisis.

The Duty to Promote the Success of the Company: In whose interests should a company be ran? The next chapter will provide an in depth analysis of this question, culminating in a discussion of s.172 Companies Act 2006 with the intention of highlighting some of the major floors in the legislation. The lack of an objective standard of care allowed directors to make risky decisions, whilst the inability of the current provisions to protect the interests of stakeholders to a satisfactory level will also been identified as a significant floor in the current cultural regime.

The Business Decision Rule: The Business Decision Rule[37] is a Victorian common law development whereby the courts will categorically refuse to engage in supplanting their own views on business decisions in lieu of decisions made by directors. The intention of the chapter is to forward a proposition that although the Law Commission categorically refused to place the Business Decision Rule on a statutory footing in 2001, the reality of the matter is that by codifying directors duties under s. 171-177 of the Companies Act 2006 the legislature has created what the author calls the Business Decision Shield. This shield has allowed directors to escape liability; however it is argued that recent developments may have shrunk the scope of the shield for the better. The reduction in the applicability of the Business Decision Shield, it is argued, should improve the current cultural regime.

[36] For example Derrek Higgs, *Review of the Role and Effectiveness of Non-Executive Directors* (London: Department of Trade and Industry, 2003).

[37] The Business Judgment Rule or BJR for short, has also been called the 'Internal management rule' and the 'business decision rule' for the purposes of this article all are considered to be the same.

Remuneration Structures as an aid to Corporate Governance: During the recent financial crisis UK banks were provided with nearly £1.3 Tn in support. During the same time there have been a number of high profile criticisms of remuneration structures. There were two identified issues during the financial crisis: one is the often excessive level of remuneration in the financial sector; the other one is the structure of this remuneration, notably the fact that they induce too high risk-taking and encourage short-termism to the detriment of long-term performance,[38] the development of a so called 'rewards for failure' culture. The chapter will attempt to answer a number of fundamental questions with regards to the make-up and viability of current remuneration practices as an aid to good corporate governance.

Northern Rock, a Case Study: The thesis will conclude with an analysis of the failings of Northern Rock. Northern Rock is a significant example of failures in regulatory and governance structures, as it was the first British bank to enter into significant difficulties during the Global Financial Crisis. In 2007 Northern Rock was hit by a global liquidity squeeze which the Company argued was unforeseen as much as it was dramatic.[39] The failure of the business model of Northern Rock and its subsequent nationalisation produced the first run on a British Bank in over 140 years. The case study will apply the theoretical arguments set out in the thesis to conclude that, had the corporate governance structures been applied more strictly, then this would have resulted in a shift in ideological thinking. This could have potentially mitigated against some of the high-risk, short-termist, decisions made by Northern Rock.

The thesis will conclude by confirming that the use of prudential regulation alone is inadequate to change the current culture within the financial system, a multi-faceted approach is needed. The limitations of prudential regulation can be addressed by improving Corporate Governance structures.

[38] The de Larosière Group (n 16) 117.
[39] Treasury Committee (n 17) 388.

Chapter II: Prudential Financial Regulation: Alone It Is Not Enough to Change Culture

Chapter II: Prudential Financial Regulation: Alone It Is Not Enough to Change Culture

The financial crisis has been a catalyst for an explosion of academic commentary attempting to resolve the issues brought about by such a cataclysmic event. Legal theorists[1], sociologists[2] and economists[3] have all commented on the failings of the current financial system. During the same time governmental bodies have attempted to analyse the failings of the internal[4] and external regulatory structures[5] affecting the financial institutions.

The clear focus of the commentary has been on the development of stronger financial regulatory structures.[6] The UK government has taken dramatic action in recent years to resolve the underlying issues that surfaced during the financial crisis, introducing a twin peaks system of regulation under the Financial Services (Banking Reform) Act 2013 and introducing a new special resolution regime.[7] But it was the abolition of the Financial Services Authority, the regulator of the financial sector within the UK at the time of the global financial crisis that was the most dramatic. The FSA's system of principles based regulation was heavily criticised following the financial crisis, and their abolition saw regulatory supervision returned to the Bank of England. Under the Financial Services Act 2012 two new regulatory bodies have been created, the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA). Alongside these two bodies a third the Financial Policy Committee (FPC) was also established to monitor macro prudential regulation. The abolition of the FSA came following significant criticism[8] by the Coalition government and it is within this backdrop that the government sought to formalise a restructuring of financial regulation, focusing in particular on reducing systemic risks and mitigating the consequences of institutional failure. The chapter will

[1] See for example Javier Ortiz & Tomas Alvarez, 'Corporate governance in financial institutions: recent developments in the European Union' (2011) JIBLR 398, Rosa Maria Lastra, 'Risk-based capital requirements and their impact upon the banking industry: Basel II and CAD III' (2004) JFR & C 225 and Gerry Kounadis,'European Market Infrastructure Regulation and central clearing: a conceptual, legal and compliance perspective' (2014) JIBLR 556.
[2] See for example Gabe Mythen, 'Sociology and the Art of Risk' (2008) 2(1) Sociology Compass 299.
[3] See for example Ulf Nielsson, 'Measuring and regulating extreme risk' (2009) JFR & C 156.
[4] Walker Review, *A review of corporate governance in UK banks and other financial industry entities: Final recommendations* (26 November 2009).
[5] Turner Review, *The Turner Review: A regulatory response to the global banking crisis* (March 2009).
[6]E.g. Gilles Thieffry, 'The impact of Basel III on commodity trade finance: legal and regulatory aspects' (2011) JIBLR 455 Peter Yeoh, 'The challenges and implications of systemic risks for financial regulation' (2010) Comp Law 389.
[7] First through the Banking (Special Provisions) Act 2008 and subsequently the Banking Act 2009.
[8] HM Treasury, *A new approach to financial regulation: the blueprint for reform,* June 2011.

show however, that such measures alone will not be sufficient in effecting cultural change in the business of banking.

When placed under the stress of the crisis, the system of regulation was shown to be wholly inadequate. The current academic debate has focused almost exclusively on the relationship between the regulator and the company, and whilst there has been a large volume of academic literature already focusing on the technicalities of financial regulation,[9] it is purported that this focus has failed to fully consider the role Corporate Governance can play as part of a multi-faceted approach. The chapter intends to highlight the current issues around two key debates post the Global Financial Crisis. Risk based regulation and arguments of Financial Institutions being 'Too Big To Fail', to show that whilst financial regulation does help there are limitations in its effectiveness to mitigate against a culture of short-term gains to the detriment of credit quality and prudence.

Within the financial sector risks are a major issue due to the structure of the sector, as the financial system within the UK is dominated by a small number of large, highly leveraged institutions any failures can have significant macroeconomic consequences. Risk based prudential regulation was the main form of regulation used by the FSA during the financial crisis. The chapter attempts to analyse the reasoning and viability of risk based regulation, and in particular systemic risk as a catalyst for cultural reform. Systemic Risk and its relationship to the concept of 'Too Big To Fail' has been the fundamental debate following the crisis. What the chapter will show is that whilst regulation can resolve macro prudential issues such as systemic risk, it fails to mitigate against the culture of excessive risk taking. The only way this can be achieved is by taking a holistic approach to apply corporate governance mechanisms, alongside prudential regulation to drive cultural change within banks and thereby reduce institutional and systemic risk at the same time.

Risk Based Regulation: Risk as a Theoretical Construct

Risk as a concept is not new, however its origins are a source of academic debate. It has been purported that the term derives from the Italian *Risco,* a derivative of the verb *Riscare* meaning 'to run into danger.'[10] Conversely some theorists believe that its origins come from the Arabic word *Risq* meaning 'riches or good fortune', whilst others point to the Latin *Resegare* which means 'to cut off short.'[11] Some consider the original meaning to have been derived from the Greek *Rhiza* meaning

[9] See for example Stephen Connelly, 'Is it time for a more concrete focus on systemically important financial instruments?' (2014) JIBLR 274, Phoebus Athanassiou, 'The role of regulation and supervision in crisis prevention and management: a critique of recent European reflections' (2009) JIBLR 501.
[10] Gabe Mythen(n 2).
[11] Iain Wilkinson, *Risk, Vulnerability and Everyday Life* (Routledge 2010) 17.

cliff, giving it its first link to its maritime heritage. Whilst sociological definitions can be traced back to Latin origins, the first legal use of the word risk can be found in the Middle Ages and related to maritime insurance; it was during this time that Italian shipping merchants first began to use modern-style insurance contracts as a means to manage business affairs. The earliest recorded examples of such premium insurance contracts were drawn up in Palermo in 1350.[12] As Ewald notes 'At that time, risk designated the possibility of an objective danger, an Act of God, a force majeure, a tempest or other peril of the sea that could be imputed to wrongful conduct.'[13] It is fascinating to note that risk was at the very heart of the financial industry tracing back to its earliest beginnings.

So although it's early origins are in contention the original definition of risk can be quite clearly seen to exclude human fault completely, it sought to quantify natural events and not manmade ones. This theory was to change with the coming of the industrial revolution, the major European superpowers wished to enhance their populations' productivity and to combat social changes brought about by mass urbanisation and industrialisation. As a result the science of probability and statistics descended upon England in an 'avalanche of numbers'[14] during the early nineteenth century. This cascade of numbers brought about a new meaning to the concept of risk, no longer were risks seen as Acts of God but instead risk was also in 'human beings, in their conduct, in their liberty, in the relations between them, in the fact of their association, in society.'[15] This theory of risk, it must be noted, was a neutral concept, denoting the probability of something happening combined with the magnitude of associated losses *or* gains.

By the early 20th Century risk had become a common economic tool for insurance and finance, designed to express possible outcomes of investment decisions for borrowers and lenders. These risks were now calculable through mathematical formulae and were distinct and mutually exclusive from 'uncertainties', a new concept that was also being developed at the time. It is important at this point to differentiate one from the other as this distinction will be important later on. Frank Knight famously made the distinction between Risk and Uncertainty, whereby risk refers to situations in which mathematical probability can be allocated to account for the perceived randomness of outcomes, and uncertainties refer to situations in which randomness cannot be expressed in terms of mathematical problems.[16]

[12] De Roover, 'Early examples of maritime insurance' (1945) 5 Journal of Economic History 172.
[13] François Ewald, 'Insurance and Risks' In Graham Burchell et al (eds), *The Foucalt Effect: Studies in Governmentality* (London: Harvester/Wheatsheaf 1991).
[14] Ian Hacking, 'The Taming of Chance' (CUP 1990).
[15] François Ewald, 'Two infinites of risk' in Brian Massumi (eds) *The politics of everyday fear* (Minneapolis, Minnesota: University of Minnesota Press) 221.
[16] Frank Knight, *Risk, Uncertainty and Profit* (Boston and New York, Houghton Mifflin Company 1921).

With this increase in use by the financial sector the definition once again evolved and 'the fine distinctions between [...] "good risk" and "bad risk "tend to be somewhat lost.'[17]Modern risk is now generally used to relate only to negative or undesirable outcomes. It now refers to the possibility of being affected by adverse outcomes. Risks are hazards or dangers that are indexed to future outcomes.[18] The *Oxford English Dictionary* defines risk as:

(a) A situation involving exposure to danger
(b) The possibility that something unpleasant will happen
(c) A person or thing causing a risk or regarded in relation to risk.

Sociological Theories of Risk

Running congruent to the OED definition of risk three modern theories of risk have developed within social science. These general theories although bordering more on sociological theory than legal theory have the advantage of offering a framework within which the legal results of the use of risk later in the chapter may evolve.

Cultural Theory of Risk: Douglas observes that different cultures base what they perceive to be risky or safe through rituals myths and legal sanctions. Risk is used to establish and maintain conceptual boundaries between self and other, where otherness is ascribed to what is perceived to be culturally different.[19] This theory of risk opens up a much more subjective approach than what has recently been perceived (particularly within the financial sector) to be a mathematical formulae. The classic-modern definition of the measurement of risk of course being: the product of the probability and utility of some future event.

Douglas believes that individuals encounter threats with a pre-existent consciousness of beliefs and assumptions, these presumptions are often linked to a sense of morality. She makes an interesting argument that 'humans pay attention to a particular pattern of disasters, treating them as omens or punishments.'[20] It has been argued that in a situation where there are the potential for numerous dangers and outcomes, the risks that receive the most attention in a particular culture are those that are connected with legitimating moral principles.[21]

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[17] Deborah Lupton, *Risk* (2nd edn, Routledge 2005) 8.
[18] ibid.
[19] Gabe Mythen (n 2) 304.
[20] Mary Douglas, *Risk Acceptability According to the Social Sciences* (New York: Russel Sage Foundation 1985).
[21] ibid 60.

This calls into question the mathematical assumptions the financial sector attaches to risk, although it is possible to differentiate Douglas' work as being focused much more on the individual than any macro-economic decisions taken by a governmental body. Alternatively it could aid in the explanation of some of the adverse political and media effects that have been seen from the recent financial crisis.[22] The causes of the financial crisis are both numerous and extremely complex, however what appears to have been politicised the most are the so called 'bankers bonuses bonanzas' [23] and the morally questionable 'fat cat brokers.'[24] So much so the centrepiece of the Queens most recent address to the nation centred quite specifically on curbing bankers' bonuses[25], not to mention the now infamous tax on 'greedy bankers' bonuses.'

Governmentality Theory of Risk, Foucault did not write explicitly about risk as a concept, it was only after his death, have some academics applied his theory of governmentality to the sphere of risk. Governmentality alludes to the desire of the state to govern risks to the population through various modes of incitement and provocation.[26]

The contemporary theorists claim that the language of risk has been used as a primary technique by government, in so far that when attitudes or behaviours are labelled as 'risk' then efforts are made to conduct people, so that they in turn conduct themselves along a desired course of action and to a particular set of goals wanted by government. Wilkinson gives the example of health promotion campaigns where the intention is to advise people that if they are to minimise the risk of contracting heart disease, then they should avoid eating certain foods.[27] Again we can see a shift from a mathematical theory of risk to a more social theory, where according to the governmentality school, experts use the concept of risk to channel information and to reinforce dominant norms and to stifle political opposition. This is done by generating 'truths' about society that are 'interiorised' by individuals.[28] Governmentality theorists highly criticise governmental ploys, which at first glance allow for the so-called 'freedom of choice,' however on closer inspection reveal that this freedom of choice is redolent with the interests of neo-liberal capitalism.[29] Again this theory of risk is may not be entirely relevant when applied to Financial Risk Regulation as it focuses on the relationship between

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[22] In particular the Shareholder Spring of 2012, see chapter VII.
[23] Edward Fennell, 'Bankers' bonanza bonuses: what can be done about them?' *The Times* (29 October 2009).
[24] 'Bonuses, fat cat brokers and the lack of government action' *The Times* (7 February 2009).
[25] 'Reforms to bankers' bonuses to be centrepiece of Queen's Speech' *The Times* (15 November 2009).
[26] David Denney, *Risk and Society* (London Sage 2005).
[27] Ian Wilkinson (n 11) 54.
[28] Gabe Mythen (n 2) 306.
[29] Ian Wilkinson (n 11) 55.

man and state; it explains how concepts of risk construct particular norms of behaviour which are used to encourage individuals to engage voluntarily in self-regulation in response to these norms.

The Risk Society, The previous two theories of risk concerned the relationship between individual and state, one final theory that has emerged has thrown the debate onto a macro-economic level, ad in doing so poses much more relevance to the financial sector. Ulrich Beck argues that the modern world (and in particular modern science and technology) has created what he defines as a 'Risk Society'.[30] In the risk society the success in the production of wealth has been overtaken by the production of risk.[31] He argues that people living in contemporary western societies are living in a 'risk society.' In this modern society the production of wealth is accompanied by that of risks, which have proliferated as an outcome of modernisation. Beck sees the inability of government to manage these manufactured risks as a signal of a shift in political and social values from a positive logic based on the acquisition of 'goods' to a negative logic established upon the avoidance of 'bads'.[32] He argues that modern societies are exchanging their interests in obtaining the good for a concern to prevent the hypothetical worst case scenario.

If Becks theory is correct then observations would show a shift in macroeconomic regulation away from trying to achieve positive outcomes, being replaced by a desire to prevent what is perceived socially and scientifically to be bad. A cursory glance over the UK statute books supports this idea. For example, following the 9/11 and 7/7 terrorist attacks the UK enacted a series of legislative instruments in an attempt to prevent further terrorist activity.[33] Mythens has already commented extensively on the adoption of risk as a loadstar for regulation in the areas of crime and security;[34] however the Risk Society has not been documented under a financial footing to date. The Financial Services and Markets Act 2000 was the first piece of legislation to adopt a formal risk based form of regulation.[35] Its viability will be explored further in the chapter; as a result it is only necessary to state at this point that the theory does have a practical application to the ongoing debate. Risk as a concept has changed quite dramatically since its disputed inception, its meaning and application have altered over time opening up the debate of different social theories. It is possible however to conclude a number of general themes from these theories of risk.

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[30] Ulrich Beck, *World Risk Society* (Polity Press 1999).
[31] John Adams, *Risk* (6th edn, Routledge 2006) 180.
[32] Ulrich Beck, 'Risk Society: Towards a New Modernity.' (London, Uk: Sage 1992).
[33] See The Anti-terrorism Crime and Security Act 2001, Prevention of Terrorism Act 2005, and the Terrorism Act 2006.
[34] Gabe Mythen (n 2) 308.
[35] Financial Services and Markets Act 2000 s. 2(3).

In modern times risk has become an increasingly pervasive concept of human existence in western societies; [36]

- Risk is a central aspect of human subjectivity;
- Risk is seen as something that can be managed through human intervention;
- Risk is associated with notions of choice, responsibility and blame.

Why Use Risk Based Regulation?

The appetite for the adoption of risk has been shown to benefit from the political ideals of the time, but a belief in political reform alone is not enough to alter a regulatory system. Why then did the regulator choose to use a risk based system of regulation?

As has already been mentioned the OED defines risk as 'a situation involving exposure to danger.'[37] It is this fear of exposure that has prompted the FSA to use formal risk based regulation. In relation to the financial services, risk has been used as a framework for prioritising activities and resources. The ultimate goal of regulation was to prevent further crises, but to do so in an economical way. Regulation addresses significant actual or potential market imperfections and failures, however it has been pointed out regulation is not a free good.[38] As Black notes more recently there has been increased pressure on regulatory activities from central government to be more cost effective in its implementation of resources[39] and to curtail regulatory creep.[40] Regulatory creep is a term that has grown in popularity since the late 1990's, originally a concept derived from the US; it first entered the UK regulatory mind-set with the publication of the Better Regulation Taskforce paper 'Avoiding Regulatory Creep'.[41] The Better Regulation Task Force defined regulatory creep as the process by which regulation is developed, or enforced, in a less than transparent fashion and not in accordance with their five principles of good regulation: proportionality, accountability, consistency, transparency and targeting.[42] The theory is based on a realisation that all regulators work in a limited resources environment, and are required to use resources fully and to the best of their abilities. The result of which, it was believed, was to adopt best practice models form the private sector. One of

[36] Lupton, *Risk* (n 17) 25.
[37] OED Definition.
[38] Carol Sergeant, Risk based regulation in the Financial Services Authority' (2002) 10(4) JFRC 329.
[39] Julia Black, 'The Emergence of Risk-Based Regulation and the New Public Risk Management Regime in the United Kingdom' [2005] PL 512, 513.
[40] ibid.
[41] Better Regulation Taskforce, 'Avoiding Regulatory Creep' (BRTF, Feb 2005).
[42] ibid 3.

the most important best practice models that regulators had been encouraged to adopt was the use of Cost Benefit Analyses, defined as 'a technique of analysing proposed or previously enacted projects to determine whether doing them is in the public interest, or to choose between two or more mutually exclusive projects.'[43]

Clearly the FSA sought to avoid a position of greater regulatory control they defined as regulatory creep. The avoidance of the adoption of intrusive forms of regulation was clearly high on the political agenda at the time as the regulator sought to mitigate against those spiralling costs. It is believed that regulatory creep offers significant disadvantages for both the regulator and the institutions being overseen.

Regulatory creep primarily causes direct costs in the form of greater labour costs within both the FSA, and also the employee payrolls and compliance departments of each individual financial institution.[44] Further to direct employment costs, it is believed that close prudential supervision could lead to an encouragement in increasingly reckless behaviour. It has been argued that increased monitoring by a regulator will lead to institutions forsaking their own risk monitoring procedures in favour of allowing the 'big brother' regulator to pursue risky behaviour. This clearly encourages reckless behaviour by the given investor in an effort to offer the highest return. Such reliance in regulatory monitoring leads to what Alcock defines as 'Internal Corruption.'[45] Alcock considers that close monitoring by the regulator will result in the investor no longer asking if their decisions are "fair" or "right" instead whether the decisions are within the regulatory rules. Finally the costs associated with the increasing in monitoring will normally come at the expense of other objectives of the company such as profit maximisation. The use of risk based regulation theoretically allows regulators to designate regulation towards the highest risk areas of a sector without the need for carte blanche invasive regulation.

Risk Based Regulation and the Financial Services Authority

Following the Financial Services and Markets Act 2000, the concept of risk quickly became the cornerstone of financial regulation. The FSA first stated its intentions to develop what it called a 'risk based' system for regulation in July 1997. During its inception the Chancellor of the Exchequer at the time, Gordon Brown, confirmed the reliance the intention of the FSA to rely on risk:

[43] Richard Zerbe Jr and Allen Bellas, *A primer for benefit-cost analysis* (Edward Elgar 2006).
[44] Alistair Alcock, 'Are financial services over-regulated?' (2003) Comp Law 132.
[45] ibid 137.

> '[The FSA] will adopt a flexible and differentiated risk-based approach to setting standards and to supervision, reflecting the nature of the business activities concerned, the extent of risk within particular firms and markets, the quality of the firms' management controls and relative sophistication of the consumers involved…'[46]

What was interesting to observe that during the financial crisis there was no formal legal requirement that compelled the FSA to adopt a risk based approach to its supervision. Nor had the FSA given any reasoning as to why a risk based approach had been adopted over any other. Perhaps even more interesting to discover is that the word risk was not mentioned a single time during parliamentary debates on the enactment of the Financial Services and Markets Act 2000.[47] So where had this mystical concept of risk developed from? Some commentators believe that it was due to the influence of the first chairman of the FSA, Howard Davies, who was previously Deputy Governor of the Bank of England.[48] The FSA risk framework during the crisis was called the ARROW framework (Advanced, Risk-Responsive Operating FrameWork), and was based loosely on an earlier Bank of England model known as RATE. It is purported that this may well be the case, however it must be taken into context of the time and the possibility must be considered that the switch to an alternative form of regulation may have fitted political needs of the day. Following on from Becks 'risk society' and with it the prediction of the slow development into the mitigation of risk, we can observe this materialising within the regulation of financial services. The Bank of England (BoE) had already begun to develop a risk-based approach to supervision following the collapse of Barings Bank.[49] Following the failings of the regulatory system the BoE foresaw a need to restore regulatory confidence in the aftermath of such a crisis. Risk was at the time an exciting new approach to regulation known as risk was slowly developing into a suitable vehicle for this.[50] The same political pressures were being observed around the same time as the development of FSMA. The Turnbull Report[51] had recently been published, and whilst its criticisms focused mainly on internal management controls it complemented the already established risk based theories of regulation, by encouraging a regulatory style that promoted tight links between company control and risk management. The ideal is that risk is analysed, controlled, communicated and monitored. This built

[46] Gordon Brown, *Better Regulation Action Plan* (May 2005).
[47] See generally Financial Services and Markets Bill Deb November-December 1999.
[48] Black (n 39) 512.
[49] ibid.
[50] Michael Power, *The Risk management of Everything: Rethinking the Politics of Uncertainty* (Demos: London, 2004).
[51] Turnbull Committee, *Internal Control: Guidance for Directors on the Combined Code* (London: Gee Publishing, 1999).

upon earlier corporate governance codes such as the Cadbury Report[52] and the Hampel Report.[53] This theory was enacted into the Financial Services and Markets Act 2000 under s. 2(3):

> In discharging its general functions the Authority must have regards to:-
>
> (a) The need to use its resources in the most efficient and economic way
>
> (b) …
>
> (c) The principle that a burden or restriction which is imposed on a person, or on the carrying on of an activity, should be proportionate to the benefits, considered in general terms, which are expected to result from the imposition of that 'burden or restriction' …

Section 2(3) placed Cost Benefit Analyses[54] under a statutory footing for the first time in financial regulation history. Cost Benefit Analyses were also mentioned directly under s.155 of the Financial Services and Markets Act 2000 which required the FSA to conduct CBA when proposing to make rules.

The FSA and Risk

Since FSMA the FSA used risk to its statutory objectives as the guiding principle around which all its operations were organised and functions exercised.[55] Under risk based regulation the focus of the regulator is not on the potential risks that neither individuals nor the market may face from the actions of firms per se, but instead on the risks the regulator faces in failing to achieve its objectives of protecting the intended beneficiaries of regulation.

Risk in relation to the FSA was defined as the risk that the FSA will fail to achieve its objectives as set out under FSMA.[56] The risk based system of regulation was designed to pick up early warnings of risk, posed to key stakeholders, by regulated financial institutions. This was the first attempt by a UK regulator at pre-emptive regulation. Previously, all new forms of regulation had been retrospective

[52] Cadbury Committee , *Report of the Committee on the Financial Aspects of Corporate Governance* (London: Gee Publishing, 1992).
[53] Hampel *Committee, The Hampel Report on Corporate Governance-Final Report* (London: Gee Publishing, 1998).
[54] Issac Alfon and Peter Andrews, 'Cost-Benefit Analysis in Financial Regulation'(FSA , September 1999).
[55] Joanna Gray, 'Is it time to highlight the limits of risk-based financial regulation?' (2009) 4(1) CMLJ 50.
[56] FSA, *A new regulator for the new millennium* (FSA, January 2000).

following failings in the financial markets.[57]The justifications for the approach were set out by the FSA in their written evidence to the treasury select committee:

> '[O]ur general approach is to regulate in a way which supports competition and innovation in financial markets. We believe that, overall, this approach has served the UK financial markets well. We adopt a risk based approach to our work; that is, we consider the impact of our statutory objectives (including consumer protection and market confidence) if particular problems were to arise in firms, sectors, markets or among consumers. We also consider the probability of such problems actually materialising. Taking these two factors together enables us to make a judgment on what priority to give particular risks, and to allocate appropriate FSA resource to dealing with them.'[58]

The risk based theory of regulation as developed into the ARROW II framework, which refined the earlier ARROW framework. ARROW II was developed by the FSA to ensure regulation took into consideration the risks posed to the FSA in not achieving its statutory objectives. The statutory objectives during the financial crisis were defined under the FSMA 2000 s 3-6 as Market Confidence, Public Awareness, The Protection of Consumers and The reduction of financial crime.

Risk Based ARROW Framework

Under the ARROW framework risk was defined as a combination of impact and probability. The formula:

Risk = Impact of the problem if it occurs X probability of the problem reoccurring.

Under ARROW the regulator would assess the impact that a firm's failure would have on the FSA's objectives. Risk assessment then split the firms into three separate subdivisions dependent on their impact; roughly 95% of the population were held under ARROW small firms and as such are considered low impact. These low impact firms were not subject to a full risk assessment and received much less intensive monitoring.[59]3% were considered to be under ARROW light which was for medium sized businesses.

The final 2% were deemed to be medium sized businesses with a high risk profile. These were the institutions that had the greatest impact on the financial crisis, and in fact only 0.33% of the financial

[57] E.g. Banking Act 1979 was created following the secondary banking crisis of the 1970's, Banking Act 1987 was enacted after the crash of the Johnson Mathey Bank.
[58] FSA, *FSA Memorandum of Written Evidence to the Treasury Select* Committee (FSA, October 2007) para 6.5.
[59] FSA, *Building the New Regulator: Progress Report 2* (FSA, February 2002) Appendix A.

services industry were subjected to ‘Close and Continuous monitoring,’ these institutions were considered to be significant businesses normally formed into groups. They were the institutions that would cause the greatest systemic risks if they were to fall into trouble, and therefore under risk based regulation, deserved of the most of the FSA’s time and resources.

Once the firms’ impact was measured the FSA will assess the probability of that firm causing the FSA to fail to meet its statutory objectives. To assess probability the FSA groups the assessment under ten headings. These headings were intended to take note of the essential components of a firm that was of interest. This included such areas as the inherent risks a firm chooses to take when determining its business model, and how it controls those risks. Both in a direct way and through secondary controls it puts in place. When doing these assessments the FSA used a simple four point scale to rate each of the ten risk groups (High, Medium High, Medium Low and Low). The risks were then aggregated and the FSA took steps to develop some form of risk alleviation programme on the basis of the findings. The final rating was used to give a measure of the overall risk posed to the statutory objectives, these risks were then prioritised and the FSA responded accordingly. Since 2000 the FSA has used its risk operating framework to bridge the gap between its statutory objectives and regulatory activities.[60]

Non-Zero Failure

An important aspect of the FSA’s system of regulation was their belief in creating a non-zero failure system. The key purpose of the FSA’s regulatory regime was to correct market failure. However the FSA did not aim to prevent all failures, or lapses in conduct. This was commonly referred to by the FSA as the ‘non-zero failure’ regime.[61]The non-zero failure approach was implicit in FSMA. The Act states, for example, that consumer protection means ‘securing the appropriate degree of protection for consumers’. It also states that we must have regard to ‘the general principle that consumers should take responsibility for their decisions.’ It does not require the FSA to protect them from all risks.

A zero failure regulatory regime, whilst on the face of it may seem desirable, in reality can have substantial disadvantages within a given market. Over regulation can lead to high compliance costs which may cause stagnation and poor competition particularly in the international markets. The FSA argues that by using a ‘lighter touch’[62] both consumers and businesses will benefit from more competitive markets driving down costs and ultimately prices. However in competitive markets

[60] FSA (n 56) 14.
[61] FSA, *Reasonable expectations: Regulation in a non-zero failure world* (FSA, September 2003) 1.2.
[62] FSA, *The FSA’s Risk-assessment framework* (FSA, August 2006) 2.3.

unsuccessful firms may fail. The possibility of single firm failure is not a sign of market failure nor is it a sign of regulatory failure.[63]

Even following the financial crisis the FSA continued to defend its risk based regulatory approach:

> 'A decision to introduce new requirements must be based on evidence of a market failure and cost benefit analysis that demonstrates that the benefits of intervention outweigh the costs. The FSA's intervention in firms and markets, and direction of resource, must be based on a rigorous and explicit assessment of the risk to the statutory objectives that is presented by the activity concerned. And the FSA's rulemaking, supervisory determinations and enforcement reflect, where possible, a focus on the principles, high level rules and outcomes that encapsulate the FSA's regulatory objectives – rather than addressing per se the detail and process of firms' compliance.'[64]

Has Risk Based Regulation Worked?

In theory risk based regulation appears to be beneficial to the system, it allows for the regulator to monitor the institutions, and apply its limited resources to financial institutions in a way that would enable it to best achieve its statutory objectives; however risk based regulation is no panacea.

The causes of the global financial crisis have already been documented both in this thesis and externally therefore it is not necessary to outline them once again.[65] What is clear however is that during the financial crisis the FSA failed to deliver upon its statutory objectives, in particular its statutory objectives of market confidence[66] and enhancing understanding.[67] Following the crisis this led to an outbreak of unmerciful criticism of the FSA and its role within the financial crisis. The early criticism in particular focused on the inability of the FSA to monitor Northern Rock, a financial institution that entered into serious difficulty at the start of the financial crisis.[68] The House of Commons Treasury Committee for example, stated quite unreservedly that, '...the FSA appears to have systematically failed in its duty as a regulator to ensure Northern Rock would not pose such a systemic risk, and this failure contributed significantly to the difficulties, and risks to the public purse, that have followed.'[69]

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[63] FSA, *Reasonable expectations: Regulation in a non-zero failure world* (n61) 1.10.
[64] FSA, *A regulatory response to the global banking crisis* (FSA DP 09/2, March 2009).
[65] See Chapter I.
[66] FSMA 2000 s. 2(1).
[67] FSMA 2000 s. 2(2).
[68] See Chapter VIII.
[69] Treasury Committee, *The Run on the Rock* (HC 2007-08 56-1 2008) 34, para 66.

It was alleged the FSA failed in its duty to monitor Northern Rock by failing to notice the continuing decline in Northern Rocks share price in a bull stock market.[70] To give some idea of the lack of monitoring skills, Northern Rocks share price fell by roughly a third of its face value in a rising stock market between January and August 2007.[71] Professor Wood gave the most eloquent assessment of the FSA's failure to supervise Northern Rock who when asked by the Select Committee to give his opinion stated: 'The FSA...was asleep on the job; that is manifestly right. A very clear signal of a bank running a big risk is rapid expansion. Northern Rock was giving that signal quite clearly; it really is remarkable that [the FSA] missed it.'[72]

Amid all these criticisms the FSA conducted its own Internal Audit review of the crisis and noted four key failings in their handling of Northern Rock:[73]

1. Lack of supervisory engagement with the firm, in particular the failure of the supervisory team to follow up rigorously with the management of the firm on the business model vulnerability arising from changing market conditions,

2. Lack of adequate oversight and review by FSA line management of the quality, intensity and rigour of the firm's supervision,

3. Inadequate resources specifically dedicated to the direct supervision of the firm

4. Lack of intensity by the FSA in ensuring that all available risk information was properly utilized to inform its supervisory actions.

Gordon Brown in 2005 as then Chancellor of the Exchequer proclaimed that 'the correct modern model of regulation [is] the risk-based approach.'[74] Is he correct? Is this a failing of risk based regulation or a catastrophe that the FSA had no power over stopping and simply had the misfortune of being the regulator at the time? Following the crisis it was clear that risk based regulation was no panacea, there were a number of specific identifiable issues generated which will be discussed further.

[70] ibid 34, para 23-24.
[71] During that period the share price dropped from over £12 to less than £8.
[72] House of Commons Treasury Committee, *The run on the Rock* (n 69) 34, para 22.
[73] FSA, Internal Audit Division Report, 'The Supervision of northern Rock: A lessons Learned Review.' (London March 2008).
[74] Gordon Brown, (n 46).

Risk and Uncertainty

Risk Based regulations are based on the preposition that all of the risks in a given system are identifiable and therefore given specific values for identification. This system breaks down when those risks are indefinable, this is also known as an uncertainty. Risk is a condition where probabilities are assigned to different states of the world and active consideration is given to how good or bad the outcomes are, whereas Uncertainty refers to the idea that planners do not know for certain what the state of the world will be. While they realize that different states of the world may occur, the relative probabilities of these states of the world may be unknown.[75] Potentially, a risk-based framework, whilst attempting to deal with indefinable uncertainties may fail to respond to an unpredictable future. The risk based frameworks are based upon the prediction of a particular type of future: in which certain cause-effect correlations will always be present as standard, or in which certain events are more likely to happen than others. Such frameworks embed within themselves an inherent risk: that the inevitable inability to predict which the frameworks are designed to address, become institutionalised within the framework in such a way that negates their capacity to deal with the very inability they are intended to meet.[76]

This can clearly be observed following the financial crisis, and in particular during the Select Committee Investigation into the Northern Rock crisis.[77] During the investigation the chairman and CEO of Northern Rock, Mr Adam Applegarth, was asked numerous questions with regards to the conduct of his and the regulators monitoring capacities, and in particular:

> [Q] 'Where you aware of the risks to the business at any time? When did you start becoming aware of the risks to the business?'
>
> [A] 'I was fully aware of the risks throughout. We have a Risk Committee and we are continually assessing the risks to the business and stress testing against different risks. We were aware earlier in the year of the risk of tightening in the credit markets and we expected that our good credit quality and our diverse funding platform would stand us in good stead under those circumstances.'[78]

The conversation continued for some time but one question that seemed to be of significance is when informed that his bank was not running at liquidity levels that would have left the bank solvent

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[75] Alan Greenspan, 'We will never have a perfect model of risk' *Financial Times* (16 March 2008).
[76] Black (n 39) 521.
[77] Treasury Select Committee, *Financial Stability and Transparency: Oral and Written Evidence* (HC 999-iii, 16 October 2007).
[78] ibid Q 390.

Mr Applegarth responded: 'We were hit by an unexpected and unpredictable concentration of events.'[79]

Applegarth argued that the effective closure of wholesale money markets that happened in late 2007 could only be described as a phenomenon so far outside a company's control that it was an uncertainty and not a risk. It is quite clearly a major problem that within risk based regulatory frameworks, a low probability, high impact risk can create disaster myopia where low probability risks are discounted altogether as unforeseeable.[80] The result may offer a defence to all under a shroud of 'Uncertainty.' Those that should be held to account are all too happy to render blame at the foot of technology which could not diagnose properly the systemic risks that emerged in the financial sector. A point all too poignant to note given the regulator were extolling the superiority of their instrumental toolkit prior to the crisis.[81]

It is difficult to conclude with certainty whether the problems leading to the financial crisis of 2007-09 were genuine risks or unforeseeable uncertainties, however it is important to note the inherent problem risk based regulation has with high impact, low probability risks. An ex ante forward looking risk assessment cannot cope with the truly unforeseen, unexpected and the uncertain.[82]

Anticipatory Method of Regulation

The benefits and costs of any project will not be known with certainty. At the very least, calculations of costs and benefits are based on estimates, and these estimates will have some degree of imprecision. Following on slightly from Risk/Uncertainty any form of Risk based regulation involves some anticipatory methods in gauging whether a new financial crisis is approaching. So called 'Anticipatorists' believe that this is a sound form of regulation as it allows for ex ante detection and prevention of any possible future crises by the issuing of regular 'financial health checks of potentially dangerous organisations.'[83] This body of theorists also argue that in hindsight disasters can often be interpreted as waiting to happen and this form of anticipatory approach would be most effective in predicting such outcomes. However there is a conflicting body of academics that believe that anticipatory measures are not enough, and the high complexity and uncertainty of markets require the extension of 'just in case' regulation, that is to be implemented either alongside anticipatory regulation or in place of it. As an alternative it has been argued that disasters and

[79] ibid Response by Mr A Applegarth to Q 400.
[80] David Llewellyn, The Northern Rock crisis: a multi-dimensional problem waiting to happen' (2008) JFR & C 35, 41.
[81] Martin Lodge, Risk and Regulation Magazine of the ESRC CARR Financial Crisis Special (December 2008).
[82] Gray (n 55) 58.
[83] Hood et al *Risk Management* in Royal Society, *Risk* (London, Royal Society 1992) 135.

systemic failures only look predictable in hindsight, and that the majority of the cases involve high-dimensional systemic systems whose behaviour is inherently impossible to forecast, because of complexity and the stochastic characteristics of the system they operate within.

The second body of academics, it is purported, may have a stronger argument following the most recent crisis. The FSA under the same Committee as noted above also came under scrutiny as to its inability to detect the problems Northern Rock faced to its statutory objectives. The FSA used advanced tools for risk measurement and assessment however these did not stop the need for emergency liquidity assistance for Northern Rock. When questioned the Chief Executive of the FSA noted,

> '[w]e did completely understand the Northern Rock business model…but I would agree with absolutely is that we did not engage in our supervised process in a way to my satisfaction with regards to the stress testing scenarios, because the stress testing scenarios which they were operating with did not envisage the set of circumstances that transpired in August, which was complete closure to them of all reasonable funding mechanisms, including the repo market.'

However he then continued by saying. 'I have to say, I do not think any reasonable professional would have anticipated that set of circumstances,…'[84] It is the inability to predict every uncertainty no matter how small following on from above that must compel the FSA and any financial regulator (or any regulator using risk as its lodestar for that matter) that must make provisions for so called 'just in case regulation.' Uncertainty, even in the presence of exact cost and benefit calculations, is unavoidable. Further to this Gray makes the point that the questioning undertaken during the Treasury Committee enquiry was being undertaken with hindsight and therefore neither the questioner nor the respondent was looking at the events from the same point in time. Only now with hindsight what looks like the materialisation of a catastrophic risk for the questionnaire, could have equally looked like an unimaginable and unimagined uncertainty when viewed from the respondents point of view.[85]

Acceptable Risk under the Cost Benefit Analysis

At the very heart of risk based regulation is the determination of what an acceptable risk is during the 'Cost Benefit Analysis'.[86] What weight is given to a particular exposure or counter risk measure is

[84] Treasury Select Committee, *Financial Stability and Transparency: Oral and Written Evidence* (n 77) Q 192 Hector Sants Response.
[85] Gray (n 55) 56.
[86] Bridget Hutter, 'The attractions of Risk-based Regulation: accounting for the emergence of risk ideas in regulation,' (ESRC CARR Discussion paper No: 33, 2005).

very difficult to quantify. This was all too apparent even prior to the financial crisis, for example within the field of environmental risk. Under environmental risk analysis there has been serious criticism of the methods of analysis in favour of private sector businesses, as the potential costs are always much easier to calculate than the benefits.[87] Problems with cost benefit analyses have been noted from as early as the Hidden Report[88] following the 1988 Clapham Train Crash that warned of the need to mitigate any risk to safety by the establishment of a 'safety floor.'[89] It is the subjectivity that may cause problems for financial regulators. Lave and Males have noted that CBA and risk-benefit analyses although high on economic efficiency, often score quite low on values of equity, administrative simplicity, public acceptability and risk reduction.[90] The economist Alan Greenspan noted recently 'we will never have a perfect model of risk' as these models do not fully capture irrational 'inane human responses' to market conditions.[91]

The former FSA chairman Howard Davies firmly advocated the use of Cost Benefit Analyses as he believed that, 'regulation, or any form of official intervention [in the financial markets], is only justified in the presence of a substantial market imperfection, and where the cure is not worse than the disease.'[92] However, following an FSA panel on the 20th Feb 2006 the FSA recommended lengthening the supervisory cycle of Northern Rock from 24 months to 36 months, reducing overall supervision. Following this reduction in supervision the FSA failed to notice the subsequent issues surrounding Northern Rock, and ultimately the run on the bank. This was a clear failing by the FSA which the chief executive then went onto later admit.[93] The FSA chief executive admitted there were failings with the probability assessment again noting the difficulty in quantifying what would be deemed an acceptable risk and what would not be. The overreliance on CBA alone was a clear weakness of the risk based system of regulation following the global financial crisis.

Systemic Risk: 'Too Big To Fail'

All of the issues already outlined have questioned the viability of the risk based system of regulation on an academic level. Following the crisis there was one major, identifiable issue that crossed the

[87] Susan Owens, 'The Unified Pollution Inspectorate and Best Practicable Environmental Option in the United Kingdom' (1990) in Nigel Haigh and Francis Irwin (eds), Integrated pollution policy control in Europe and North America (Washington: The Conservation Foundation 1990) And Peter Yeager, *The Limits of Law: The public regulation of private pollution* (CUP 1991).
[88] Anthony Hidden, Investigation into the Clapham Railway Accident (Department of Transport, November 1989).
[89] Hood (n 83).
[90] Lester Lave and Eric Males, 'At risk: the framework for regulating toxic substances.' (1989) 23. Environmental science and Technology 386.
[91] Alan Greenspan, 'We will never have a perfect model of risk' *Financial Times* (16 March 2008).
[92] Howard Davies, 'Why Regulate?' (Henry Thornton Lecture - City Business School, 4 November 1998).
[93] Gray (n 55) 58.

academic divide, recognised by both regulator and academic alike to be the most fundamental issue relating to regulation of the financial sector, that is the problem of Systemic Risk.

Systemic risks are risks over and above those naturally priced and managed by financial intermediaries themselves. They pose a threat to the effective functioning of the financial system as a whole and to the economy more broadly. Systemic financial crises have major economic costs, which extend beyond the losses borne by the shareholders of failing financial institutions. As the FSA's risk based approach to supervision linked the amount of supervisory resource devoted to a firm to the firms' size (or 'impact'), there comes a point whereby the impact on the financial system of a bank failing is too massive, as a result it is no viable to left those financial institutions fail. During the most recent financial crisis, when a large financial institution entered into difficulties they were not allowed to enter insolvency procedures.[94] As an alternative the UK government rescued them via extremely large capital injections and guarantees. This has led to the identification of financial firms that are 'too big to fail,' in that we mean a financial firm that is so integral to the financial system that its failure would have large systemic effects on the industry as a whole.

During the financial crisis the UK government were not alone in ensuring systemically important companies would remain solvent. In September 2008 US authorities concluded that AIG was too big and too interconnected to be allowed to fail due to its huge volume of outstanding derivative contracts with a wide range of counterparties. As a result they staged a bail-out plan which to date is rumoured to be as much as $182.5 billion.[95]

The Bank of England as lender of last resort is expected to offer financial support to aid financial institutions that enter into difficulty. However aiding large financial institutions by offering large capital injections poses some very important questions, which need to be addressed. It has already been stated very clearly by the FSA that the regulator would not work in a non-zero failure framework.[96] The reasons for this are closely linked to the risk based system of regulation and have been noted above. If this is the case then why were so many financial institutions given such capital injections after the FSA had categorically stated they would allow certain institutions to fail?

The failures of Northern rock and the more recent collapse of Lehmann Brothers have shown that the failure of large interconnected, systemically important companies has the possibility of cataclysmic implications on the financial system as a whole. The policy taken by the FSA to rescue

[94] The one exception to this being Lehman Brothers in September 2009.
[95] Hugh Son, 'AIG's Trustees Shun 'Shadow Board,' Seek Directors' *Bloomberg* (13 May 2009).
[96] See, for example, FSA, *Reasonable expectations: Regulation in a non-zero failure world* (September 2003), FSA, *The FSA's Risk-assessment framework* (August 2006).

such a large number of financial institutions was based on an idea that if systemically important banks were allowed to fail in the normal way then potentially catastrophic shocks to financial stability would result.[97]The next part of the chapter aims to discuss the problems of allowing large corporate entities within a regulatory framework based on the concept of risk. Focusing particularly on the FSA policy of non-zero failure and the trade off that is required with systemically important firms.

So What Does 'Too Big To Fail' Actually Mean?

This term has become the central theme for all that seems to have gone wrong during the financial crisis. However we must be absolutely clear what we mean by 'too big to fail', too often critics and politicians have used this term to forward their own political agendas. It is argued that the best example to be found was outlined by Greene:

> '[A] company is too big to fail when, in order to stave off unacceptable political or economic risks, governments would put taxpayer money at risk to avert the company's failure rather than wind it down in a bankruptcy or resolution proceedings.'[98]

Although such a definition is not perfect and it is argued that the financial institution in question must pose some form of systemic risk to the financial system as a whole. Systemic risk has been defined recently by the G20 as a:

> 'disruption to the flow of financial services that is (i) caused by an impairment of all or part of the financial system; and (ii) has the potential to have serious negative consequences for the real economy.'[99]

Further discussions have identified three potential reasons as to why a firm may be of systemic importance and therefore 'too big to fail':[100]

> ***1. Systemic by Size:*** This can be due to a firm's absolute size or in relation to a specific financial market or product in which a firm is particularly dominant.

[97] FSA, *A regulatory response to the global banking crisis: systemically important banks and assessing the cumulative impact* (Turner Review Conference Discussion Paper, October 2009) Para 3.5.
[98] Edward Greene et al, 'A closer look at 'too big to fail': national and international approaches to addressing the risks of large, interconnected financial institutions.' (2010) 5 CMLJ 118.
[99] Staff of the International Monetary Fund and the Bank for International Settlements, and the Secretariat of the Financial Stability Board, *Report to the G20 Finance Ministers and Governors, Guidance to Assess the Systemic Importance of Financial Institutions, Markets and Instruments: Initial Considerations* (October 2009).
[100] FSA Turner Review Conference Discussion Paper, *A regulatory response to the global banking crisis: systemically important banks and assessing the cumulative impact* (DP 09/04, October 2009).

2. Systemic by Inter-connectedness: Interconnectedness can include, inter alia, inter-bank lending, cross holdings of bank capital instruments, membership of payment systems, and being a significant counterparty in a crucial market. The result of interconnectedness can lead to problems of interbank exposures. Interbank exposures can cause a domino effect where the collapse of one firm leads to major losses at others, and then in turn leads to their collapse, this can then trigger a chain reaction.

3. Systemic as a Herd: The market can perceive a group of firms as part of a common group or common exposures to the same sector or type of instrument. A single firm in this group may not be systemic in its own right, but the group as a whole may be. The international nature of global financial institutions must also be taken into account. [101] The cross border operations of a financial institution may lead to a number of institutions that, whilst based in entirely different jurisdictions, have very similar exposures. This may give the illusion of increased diversification whilst at the same time opening up a global system to increased risk.

Once a firm appears to fit into these categories it would appear that they will be identified as 'too big to fail' and are therefore subsequently immune from insolvency proceedings. The status of 'too big to fail' creates a significant moral hazard.[102] If uninsured creditors believe ex-ante that a bank is 'too-big-to-fail' then they can supply funds to the institution at artificially low rates, with no incentive to impose market discipline. Further to this there are significant costs to the financial regulator, if the regulator is expected to save a highly leveraged institution then this will result in the 'socialisation of losses'. And finally there may be a danger that the banks are simply too big for the authorities to rescue, particularly if they are large relative to the home country. An obvious example that came to fruition was in the case of Iceland, but this could theoretically apply just as well to larger economies, like the UK, where total bank liabilities are very large as a percentage of GDP.

The super bank, that being one that is too big for its economy, is one of the largest issues facing global finance. The greatest fear is that a financial institution becomes too expensive to rescue, and whose failure would have significant systemic consequences. Whilst not having been observed in the UK, in Switzerland for example, UBS Switzerland's largest bank, reported liabilities of CHF 1.9 billion in 2008. That is a staggering 5 times Switzerland's GDP, 9 times its federal budget and 10 times its national debt.[103]

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[101] European Commission, *European Financial Integration Report 2009* (January 2010) 37.
[102] Speech by Adair Turner, 'Large systemically important banks: addressing the too big to fail problem,' (2 November 2009).
[103] UBS, 'Annual Report 2008: Balance sheet' (20 May 2009).

Resolution of the 'Too Big To Fail' Conundrum

It is quite clear then that if the current system of risk based regulation is to continue then there needs to be major reforms to the way the PRA now deals with systemically important institutions. The objective of successful reform would be to transfer the external risks away from government and back into the private sector. It is purported that there are three leading theories as to how this may be achieved:

1. ***Living Wills***: Creating an insolvency regime to effectively wind down failing financial institutions in a manner that does not severely disrupt the financial system.

2. ***Narrow Banking:*** Limit the size of the institutions physically or their interconnectedness.

3. ***Increasing Capital/Liquidity Levels:*** Increasing Capital/Liquidity levels will reduce the probability of failure, whilst leaving the scale and span of activities unchanged

Following the financial crisis the FSA agreed that some banks may have become 'too big too fail,'[104] it is now the role of the PRA as the new regulator to monitor the financial sector. If they choose to continue to use a system of financial regulation based on Risk then they must be prepared to realise that a systemically important firm may fail. However the possibility of single firm failure is not a sign of market failure nor is it a sign of regulatory failure, in competitive markets unsuccessful firms may fail. The previous regulator wished to continue to adopt the theorem that it is neither credible nor desirable to adopt a zero failure policy, and it would appear the current regulator is in agreement.[105] As a result the UK authorities must be ready to resolve systemically important firms that enter into difficulty. The key failing that has been evident in the current system is the difficulty that has been posed in allowing systemic institutions to fail smoothly.

1. Living Will

The first method to resolve systemically important firms that enter into difficulties is to produce recovery and resolution plans which set out how their operations would be recovered or resolved in

[104] FSA, 'The failure of the Royal Bank of Scotland: Financial Services Authority Board Report' (FSA, December 2012).
[105] FSA Turner Review Conference Discussion Paper, *A regulatory response to the global banking crisis: systemically important banks and assessing the cumulative impact* (n 100) Annex 1.

an orderly fashion if they were to come into financial difficulty. These plans have become more popularly known as 'Living Wills.'

The objective of their implementation would be to put in place, ex ante, the conditions that would allow a range of options to be defined in advance to either rescue or alternatively wind up a systemically important bank. This is in stark contrast to what has happened following the financial crisis with what appeared to be the only form of resolution being a whole bank bailout. Under the Will the authorities would prepare for the failure of the firm and aim to manage its demise in a controlled manner that limits the cost to creditors, public funds and other systemic disruption.[106]

A resolution strategy would allow a systemic institution to be wound up much more smoothly than has been seen over the past three years; it will reduce the moral hazard quite considerably. If they work properly they will allow the Government to place losses on all creditors of a bank because it will be possible for the bank to fail in an orderly way. This will remove some of the moral hazard, and transfer costs from the general body of taxpayers (through bank bailouts) back into the financial sector.[107]

This first approach has been one of the policies given most support by the market participants, the British Banking Association were keen to point out the benefits of such a plan.[108] Whilst representatives of Barclays and Santander have also voiced support for such a scheme, stating 'Barclays is one of the pilot banks…looking at living wills and resolution…[we] believe that as a result of the generation of living wills it will be possible for banks to fail more smoothly.'[109] and 'We [Santander] have presented our first draft and we will have to interact with the Bank of Spain a bit more in order to fine tune the elements of these living wills,'[110] respectively. A cynic might note that this is highly unsurprising as it is the least intrusive measure that can be adopted by the regulator.

Living wills aid in the resolution of failing institutions but they do not resolve the fundamental problems of a bank that is 'too big to fail'. They will only resolve a systemic failure. It would be as effective as 'closing the stable door after the horse has bolted' in preventing any systemic crises. Systemic failures can only be prevented by early intervention tools that prevent local, regional or global systemic failure. It is argued that living wills may be of some use when a firm fails but they will

[106] ibid.
[107] House of Commons Treasury Committee, *Too important to fail- too important to ignore* (HC 2009-10 261-1) 63, para 145.
[108] BBA, Response to the Turner Review Conference Discussion Paper, (5th February 2010) accessed at http://www.bba.org.uk/content/1/c6/01/72/60/T2_response.pdf [accessed on 16 September 2014].
[109] House of Commons Treasury Committee, *Too important to fail- too important to ignore* (HC 2009-10 261-1) 61.
[110] ibid 61.

not tackle the fundamental problems that a financial institution that has been deemed 'too big to fail.'

2. Narrow Banking Theory: Financial Services (Banking Reform) Act 2013

Following the financial crisis there have been numerous alternative ideas as to how to limit the negative externalities of a failing firm, they range from the complete restructuring of financial institutions on a structural basis, to simply altering current practice. One theory that has gained substantial support in recent times is the separation of retail and trading arms of financial institutions, the so called 'Narrow Banking' approach. Narrow Banking theory purports that separating the utility forms of banking, deposit taking etc which would have justifications for protection under FSA statutory obligations, from the riskier forms of wholesale banking. Fundamentally this would create a new Glass-Seagall concept of narrow banking as seen in the US prior to the 1980's/90s. Professor Kay proposes an extreme narrow banking model, in which banks take in insured retail deposits and provide retail payments systems invest all of their assets in government bonds.[111] This would reduce the size and inter-connectedness of financial institutions making them less systemically important and therefore reducing the risk of larger systemic problems if a firm were to face financial difficulty.

The problems of large interconnected financial institutions has been well documented above and does not need to be reiterated, however there are some arguments against separating/restructuring large financial institutions. In particular there are perceived to be a number of significant benefits to the establishment of large interconnected organisations.[112] The BBA are against such a restructuring as they perceive that

> '[…] requiring large banks to radically alter their business structures may limit their ability to service large global clients and would inevitably increase operating inefficiencies resulting in a further source of cost for end-users.'[113]

Interesting to note Lord Turner spent some time discussing the area, whilst noting that an extreme narrow banking model, with retail banks investing only in government securities, was certainly practical but failed to address the crucial issue of booms and busts in credit supply and as a result,

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[111] John Kay, 'Narrow Banking: the Reform of Banking Regulation (2009) accessed at http://www.johnkay.com/wp-content/uploads/2009/12/JK-Narrow-Banking.pdf [accessed on 17 September 2014].
[112] House of Commons Treasury Committee, *Too important to fail- too important to ignore* (n 107)38.
[113]ibid 38.

could actually increase financial instability. He argued that all the objectives behind such a separation were most definitely desirable but could be achieved much better with the designation of appropriate capital requirements and the use of resolution and recovery plans to drive internal distinctions between retail and trading activities.

> 'It is essential to progress this argument beyond the top line slogans, for or against narrow banking, and get down to details. The extreme narrow banking proposal is clearly doable in practical terms, but I believe could produce a financial system even more vulnerable to instability than the one we have today. In contrast the 'new Glass Steagall' divide is in principle attractive, but arguably best pursued through the capital requirements we place on trading activities rather than through an attempt to write a law prohibiting some activities and allowing others.'[114]

One idea that was forward as an alternative was a form of trade-off between completely restructuring financial institutions, and allowing massive institutions to continue to operate in the same way as they currently did. This was proposed through the establishment of a capital surcharge for systemically important banks, this surcharge would be lower for those groups which go further in the direction of clear legal separation of different activities.[115] It would then give the institutions themselves the option as to whether they wished to either restructure or fund a surcharge that could aid in if the institution entered financial difficulties.

Ultimately this was largely ignored by government in favour of the establishment of retail ring-fencing under the Financial Services (Banking Reform) Act 2013. The Financial Services (Banking Reform) Act 2013 introduced a 'ring-fence' of retail deposits defined as 'core activities' under the act from wholesale or investment trading activities.[116] The intention of the act was to ensure that those banks that are carrying on retail activities will be capable of carrying on the business of providing the core services related to the acceptance of deposits independently of other services in the banking group.[117] The new legislation awards new powers to the PRA to restructure banking groups and divest shares in ring-fenced banks from parent companies.[118] This level of invasive regulation is entirely new and will be interesting to see if the regulator will exercise those powers. The viability of

[114] FSA Press Release, 'FSA chairman says 'no silver bullet' to address 'too-big-to-fail' challenge' (FSA/PN/148/2009 02 Nov 2009).
[115] House of Commons Treasury Committee, *Too important to fail- too important to ignore* (n 107) 38.
[116] Financial Services (Banking Reform) Act 2013 Explanatory notes.
[117] Financial Services (Banking Reform) Act 2013.
[118] ibid s.4(1).

such a provision has been unproven to date, and it will be interesting to monitor the suitability of the legislation over the coming years.

3. Capital Liquidity Requirements

Further to Narrow Banking Theory, an alternative concept is to impose Capital and Liquidity requirements on financial institutions that are systemically important. A banks balance sheet is characterised by three features, Low cash to assets, Low capital to assets and a maturity mismatch. As a result of this at any one point a bank will never hold sufficient cash reserves to honour the convertibility guarantee.[119] Capital requirements have become the principal regulatory response to resolve the problem of the bank's balance sheet structure.[120]

Capital requirements are restrictions put in place by financial regulators for banks and other depository institutions, which determines how much liquidity is required to be held for a certain level of assets. These requirements imposed to ensure that these institutions are not participating or holding investments that increase the risk of default, and that they have enough capital to sustain operating losses, while still honouring withdrawals. The minimum capital is specified as a percentage of the risk-weighted assets of the bank.

Prior to the financial crisis no national regulator sought to monitor the capital liquidity levels of banks deemed systemically important differently from those that were not. Although no legislative impositions had been placed upon systemically important institutions, a general capital requirement had been introduced into the UK financial sector by the Bank for International Settlements in Basel.[121] The rules implemented an amended document known as Basel I; this originally set a ratio of capital to assets of 8%. Further amendments to the 1988 Accord were first published in 2004, known as Basel II[122] the provisions eventually superseded Basel I in 2006. The intention of the amendments were not to raise or lower the overall level of regulatory capital held by banks, but instead to ensure the provisions were more risk sensitive by the encouraging the use of internal systems for measuring risks and allocating capital. It did this by offering more complex models for calculating regulatory capital. In essence it stated that banks holding riskier assets should be required to have more capital on hand than those maintaining safer portfolios.

[119] Lastra (n 1) 226.
[120] ibid.
[121] Enacted in the EU under Council Directive 93/6/EEC of 15 March 1993 on the capital adequacy of investment firms and credit institutions [1993] OJ L 141/1.
[122] 'The International Convergence of Capital Measurement and Capital Standards - A Revised Framework'.

The three essential requirements of Basel II were:

1. Mandating that capital allocations by institutional managers are more risk sensitive.

2. Separating credit risks from operational risks and quantifying both.

3. Reducing the scope or possibility of regulatory arbitrage by attempting to align the real or economic risk precisely with regulatory assessment.

So although it is clear that there are already some capital and liquidity requirements in place the real question is whether increasing capital and/or liquidity requirements would reduce or solve completely the problems of systemically important institutions that are too big to fail.

Following the crisis there has been a clear belief in the benefits of increasing both capital and liquidity requirements.[123] The arguments focus on the belief that if a bank is highly capitalised and with greater levels of liquidity, then the likelihood of them failing, or coming close to failure is greatly reduced.[124]Turner in particular was clearly in favour of increasing capital ratios as he saw the benefits greatly outstrip the costs.

Turner considered that when banks held greater capital levels then they were much less likely, in the face of economic downturn, to have to reduce lending to conserve capital.[125]Further to this he believed that with an increase in liquidity standard it may counteract the boom-bust cycles of markets as Banks facing tougher liquidity standards are less able to grow rapidly in boom years and less likely to have to contract lending to conserve liquidity in the face of collapsing confidence.[126]Turner went as far as demanding such increases in standards:

> 'The direction of travel is clear: the overall level of capital require in the banking system must be significantly increased over time, while liquidity standards must be significantly tightened. These changes are required to create a more stable financial system for the long-term: the challenge now is to determine the precise long-term objective and the appropriate transition path.'[127]

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[123] See for example BCBC, *An assessment of long-term economic impact of stronger capital and liquidity requirements* (BCBC, August 2010).
[124] Turner Review, *The Turner Review: A regulatory response to the global banking crisis* (FSA, March 2009) 4.8.
[125] FSA, *Turner Review Conference Discussion Paper: A regulatory response to the global banking crisis: systemically important banks and assessing the cumulative impact* (FSA, DP 09/4 October 2009) 18.
[126] ibid 32, 4.8.
[127] Ibid 38, 4.28.

It is the belief in the increase in stability that drove Lord Turner to these remarks; his beliefs were supported by other important bodies. The BCBC also found that increasing capital and liquidity requirements reduced both the likelihood and severity of crises.[128]

Although it would appear there are significant benefits to increasing capital liquidity levels, which have been supported by preeminent legal and economic theorists, it is not without some drawbacks. Even prior to the financial crisis there had been much criticism of Basel II with some believing it to have been too costly to implement, complex to understand and prescriptive in its numerous recommendations.[129] Further to this capital is extremely costly and holding more capital means less of a return on equity for banks. Capital that is held in reserve offers a direct detriment to economic output as it may constrain investments which may be required to achieve a sustainable growth rate in line with technical change and population growth.[130] Consequently in both the short and long run this will increase the cost of bank credit.[131] So much so one calculation claims that 'for a large bank with risk weighted assets of Euro 500 Bn, cutting the amount of capital by just 0.5 per cent would save Euro 2.5Bn.'[132]

There have been some studies to assess the severity of the impact of increases in capital adequacy regulations on overall output.[133] Studies have shown that in reality there will only be a small increase in costings, for a 1% increase in capital liquidity ratios overall costs would rise as little as 0.13%. Work in the US has produced similar results; Elliot studied the long-run effect of tightening capital requirements on banks' lending spreads. His work suggests that there will only be a small effect on companies costs.[134] Kashyap, Stein and Hanson also conclude that the long-run costs of increasing capital requirements are likely to be small.[135]

These values are all well and good, but alone they are relatively meaningless. It is difficult to tell whether a cost of 0.13% alone would be a justifiable cost to the financial institution to ensure

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[128] BCBC, (n 123) 8.
[129] Lastra (n 1).
[130] FSA, *Turner Review Conference Discussion Paper: A regulatory response to the global banking crisis: systemically important banks and assessing the cumulative impact* (n 125) para 4.14.
[131] BCBC, an assessment of long-term economic impact of stronger capital and liquidity requirements, August 2010 at 4.
[132] Suiter, J. 'Overhaul of banking rules could cost up to Euro 200m' (2003) Financial times 11th May.
[133] BCBC, *An assessment of long-term economic impact of stronger capital and liquidity requirements* (BCBC, August 2010) 20.
[134] Elliot, 'A further Exploration of Bank Capital Requirements: Effects of Competition from Other Financial Sectors and Effects of Size of Bank or Borrower and of Loan Type.' (2010) The Brookings Institution.
[135] Kashyap et al. 'An analysis of the impact of substantially heightened capital requirements on large financial institutions.' (2010) Working Paper, University of Chicago Booth School of Business and Harvard University.

greater systemic stabilisation. A better indication of the viability would be a discussion of the overall net benefit that would occur from increasing both capital and/or liquidity values.

Studies have shown that there are clear net benefits of increasing capital ratio requirements over the original 8% capital ratio that was suggested by Basel I and II.[136] It must be noted however that this will not continue exponentially and the incremental net benefits will gradually decline to become negative beyond a certain range.

Although it would appear that increasing capital and/or liquidity levels from their current values would offer some very clear benefits to a financial system this area of research has not been without its critics. Several leading academic figures within financial regulation have voiced some concerns over relying too heavily on capital adequacy changes. Professor Kay in particular was adamant that this type of reform would not be suitable:

> '[F]rankly, in saying we need better rules from Basel is just the familiar story, that when the snake oil does not work, people tell you what you need is more snake oil and there ought to come a point at which we say, 'Well, I think we'll try something else instead.''[137]

The House of Commons Treasury Select Committee, although in support of the use of capital liquidity ratios, have been slightly reserved in pointing out that it will never create a zero failure system and that 'capital and liquidity reform will at best ensure a lower probability of default, and a lower loss given the default, for financial firms...However the financial crisis occurred despite repeated attempts to reform capital and liquidity regimes.[138]

In theory the optimal level of capital and liquidity in the banking system should reflect an optimising trade-off between the benefits of reduced financial instability and the costs which may arise from a higher price or reduced volume of credit extension and maturity transformation.[139] Following the information given above we can clearly see that this trend would lead to an increase in overall capital and possibly liquidity ratios for financial institutions.

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[136] BCBC, *An assessment of long-term economic impact of stronger capital and liquidity requirements* (BCBC, August 2010) 30.
[137] Treasury Committee, *Too important to fail- too important to ignore* (HC 2009-10 261-1) 29.
[138] ibid 30.
[139] FSA, *Turner Review Conference Discussion Paper: A regulatory response to the global banking crisis: systemically important banks and assessing the cumulative impact* (n 125) 32, 4.7.

Systemically Important Institutions

There is a strong case for increasing the levels of capital and/or liquidity ratios within financial institutions as a means to reducing the probability of banks that are 'too big to fail' from doing just that. One idea that is being purported along-side a general increase in ratios is the application of the capital (and perhaps liquidity) surcharge to be applied to only systemically important banks, this would of course reduce the probability of them failing but just as importantly would internalise the externality costs which their systemic importance produces. [140]

There was a fairly explicit regulatory philosophy embedded in the Basel II capital adequacy regime, which argued that large-scale financial institutions meant diversification and sophistication, and that both could justify lighter capital requirements. Basel II encouraged banks to invest in risk management and new technologies which in turn under Basel II allowed them to reduce the overall amount of regulatory capital. Using the Advanced Internal Ratings Board (IRB) suggested by Basel II allowed the larger banks to hold capital up to a third lower than standalone standardised approaches.

There is new evidence that suggests that although diversification may protect a large firm against idiosyncratic risk, similar patterns of diversification by many large firms across the world may make the whole system more fragile.[141] It is argued that a large, globally diverse firm may be less likely to fail than a smaller, national firm concentrated on specific customer and products, but its failure is more likely to occur when the whole global system is in crisis and that consequences of its failure may be more serious. The BBA unsurprisingly do not agree with this theory as they do not consider it to be 'borne out by the evidence of the recent financial crisis.'[142]

One idea that has been suggested that may be a form of trade-off between completely restructuring financial institutions and allowing massive institutions to continue to operate in the same way as they currently are is the establishment of a capital surcharge for systemically important banks, this surcharge would be lower for those groups which go further in the direction of clear legal separation of different activities.[143] It would then give the institutions themselves the option as to whether they wished to either restructure or fund a surcharge that could aid in if the institution entered financial difficulties. The FSA purported that this surcharge could be staggered as a continuous and increasing function of measures of systemic importance, avoiding the dangers created by the definition of a

[140] ibid 32, 3.54.
[141] ibid.
[142] BBA, *Response to the Turner Review conference paper* (BBA, 5th Feb 2010) 9.
[143] Treasury Committee, *Too important to fail- too important to ignore* (HC 2009-10 261-1) 30.

specific threshold of systemic importance. Its result would mean that financial institutions had the opportunity to reduce their systemic importance (possibly by following the narrow banking model) as an alternative to incurring the capital liquidity ratio penalty. There is already evidence of something similar in effect. In the environmental sector when large scale risks that are taken they often involve substantial externalities, the environmental sector resolve this by imposing a polluter pay principle. By that what is mean is that those that benefit from the risks bear the full cost of their actions including the externalities.[144] If we apply that to the too big to fail argument the substantial externalities that are imposed by large systemically important institutions can be internalised by a capital surcharge.

Basel III

So there are clear benefits to introducing capital liquidity requirements, and it would appear in the immediate aftermath of the GFC governments have attempted to impose tougher capital standards. Internationally the Basel Committee on Banking Supervision felt it necessary to amend the Basel II framework and to replace it with what is now known as Basel III.[145]Under Basel III further more stringent capital and liquidity rules have been imposed with the intention of strengthening the banking sector against potential failings. Basel III was implemented into the UK by the Capital Requirements Directive.[146]It is not the intention of the piece to scrutinise the specific details of Basel III this has already been commented on by a number of other academics.[147] Some consider the new regulation to be a significant improvement on the current measures, which will lead to a strengthening of the financial sector,[148]whilst others are more highly critical of the real impact of these counter measures.[149] There has been some evidence to also suggest that using complex capital requirements ratios may not necessarily benefit the market.[150]The commentary on Basel III is

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[144]Hood (n 83) 138.
[145] Basel Committee on Banking Supervision, *Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems* (Basel: Basel Committee on Banking Supervision, 2010).
[146] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC Text with EEA relevance [2013] OJ L 176.
[147] See for example Thieffry (n 6), Richard Barfield, Sonja Du Plessis and Patrick Fell, 'Basel III – implications for risk management and supervision' (2011) COB 1, or Bart Joosen, 'Further changes to the Capital Requirements Directive: CRD IV - major overhaul of the current European CRD legislation to adopt the Basel III Accord: (Part 1)' (2012) JIBLR 45.
[148] Barfield ibid 9.
[149] Thieffry (n 6) 459 or Orkun Akseli, 'Securitisation, the financial crisis and the need for effective risk retention' (2013) EBOR 1.
[150] Andy Haldane and Vasileious Madouros, 'The Dog and the Frisbee', Paper presented to the Federal Reserve Bank of Kansas 36th Economic Policy Symposium, *The Changing Policy Landscape*, Jackson Hole, Wyoming (2012).

extensive and as such the author does not consider there a need to reiterate that which has gone before. However what is imperative for the current chapter going forward is the acknowledgement by the regulators that capital requirements are in the forefront of their mindset whilst regulating the financial system. A point affirmed by the Independent Commission on Banking in 2011. The Vickers report[151] once again affirmed the belief in capital requirements with recommendations aiming to reduce the probability and impact of systemic financial crises in the future, by calling for both structural reform (including a retail ring-fence) and enhanced loss-absorbing capacity for UK banks.[152]

Limitations of Financial Regulation

It is important to note that although there are clear possibilities to improvements in regulation there are still limits to what regulation alone (no matter what type) can achieve. No successful regulators can truly be infallible. It is a necessity for firms to conduct themselves with some risk, for if there is no risk within a system, there will be no innovation and firms will not be competitive on either a domestic or international scale. Although it will only be noted in this chapter, it is still imperative that companies internal risk policies are of an adequate standard, to make this possible senior management carry primary responsibility for their actions and their resulting consequences. This responsibility is also shared with non-executive directors (NEDs), shareholders and auditors.[153] The new regulator must work with the internal structures but must not become a substitute for strong Internal Risk structures. It has been previously argued that 'NEDs, in particular, must play a greater role in the oversight of executive management.'[154] Even though there have been significant failings with regards to the regulation of Northern Rock and other financial institutions it must not be forgotten that under principle 2 of the FSA's Principles for Business each institution are still obliged to '…conduct its business with due skill, care and diligence' and by principle 3 to '…take reasonable care to organise and control its affairs responsibly and effectively with adequate risk management systems.' This will be scrutinised in much greater detail in the second half of the thesis.

There is a problem with relying on prudent supervision, supervision is not and will never be perfect, banks will always fail but the question is should they be bailed out?

> 'I think there are enormous dangers if we get it wrong that both regulators will not be good at making these decisions and that in some circumstances we can increase moral hazard. For

[151] Independent Banking Commission, *ICB Final Report Recommendations* (September 2011) 'Vickers Report'.
[152] ibid 7.
[153] FSA, 'A regulatory response to the global banking crisis' (FSA, DP 09/2, March 2009) 11.10.
[154] ibid.

instance, if we have product regulation at retail level there is a danger that the regulator has said, "Trust me that is a good product."'[155]

Conclusion

The chapter has shown that risk based regulation within a non-zero failure system has developed over the past 20 years as the prudential regulatory model. The FSA sought to use risk to avoid a position of greater regulatory control they defined as regulatory creep. By placing risk under a statutory footing under the Financial Services and Markets Act 2000, the concept quickly became the cornerstone of financial regulation. Risk based regulation perceived to offer the best balance between supervision and market innovation; however the Global Financial Crisis exposed some of its major floors. The House of Commons Treasury Committee stated quite unreservedly that, '...the FSA appears to have systematically failed in its duty as a regulator to ensure Northern Rock would not pose such a systemic risk, and this failure contributed significantly to the difficulties, and risks to the public purse, that have followed.'[156]The system of risk based regulation fuelled the general culture of banking at the time. The dichotomy between acting in a non-zero failure and the development of the institution that was 'Too Big To Fail' quickly became the most identifiable issue to stem from the crisis. Recognised by both regulator and academic alike to be the most fundamental issue relating to regulation of the financial sector, which is the problem of Systemic Risk. However it is purported that it was in many cases, risk monitoring and management practices within financial institutions that dramatically failed.[157]The deficiencies in prudential oversight were accompanied by major governance failures within banks.[158] It has been shown that improvements in regulatory structure alone cannot bridge these gaps and it is only by taking a broader holistic approach including supervision, regulation and corporate governance, can we change the culture of banking and prevent a reoccurrence of the Global Financial Crisis. Whilst risk based regulation may resolve macro prudential issues such as systemic risk, alone it is not enough to drive cultural reform. The main body of the thesis will now show that a multifaceted approach will stabilise the behaviour of the directors and market participants within the financial system.

[155] Treasury Select Committee, *Financial Stability and Transparency: Oral and Written Evidence* (n 77) Q 488.
[156] Treasury Committee, *The Run on the Rock* (HC 2007-08 56-1 2008) 34, para 66.
[157] The de Larosière Group, *The High Level Group on Financial Supervision in the EU* (European Commission, 25 February 2009) para 122.
[158] Walker (n 30) 9.

Chapter III: Corporate Governance as a Vehicle for Cultural Change

Chapter III: Corporate Governance as a Vehicle for Cultural Change

Central to the thesis is the argument that addressing formal regulatory structures, based on debates around Risk and 'Too Big To Fail', is by itself, an inadequate response to the Global Financial Crisis. Corporate Governance has a significant and much overlooked, role to play in effecting lasting change by reforming the culture of banking. The following chapters explore the viability of corporate governance structures as a means to alter the business models and culture within the modern company, and more specifically financial institutions. The thesis will analyse the failings of the current Corporate Governance system and explore whether the framework in place aided in the control of executive power or exacerbated the issues. The thesis will further highlight how Corporate Governance can form a significant part of the response to the Global Financial Crisis in effecting change to banking culture.

Corporate Governance and Financial Crises

Corporate Governance reform and financial crises have gone hand in hand for the past 300 years. Beginning with the South Sea Bubble of the 1700s,[1] crises have been the catalyst for reformation of

[1] Whilst the historical development of the company is outside the remit of this thesis interested readers may wish to consult the following: Buckland, & McNair, *Roman Law and Common Law: A Comparison in Outline* (CUP 1965), Armand DuBois, *The English Business Company after the Bubble Act 1720-1800,* Julius Goebel ed. (The Common Wealth Fund, 1938), Jean Du Plessis, 'Corporate law and corporate governance lessons from the past: ebbs and flows, but far from "the end of history ...": Part 1' (2009) Comp Law 5, Jean du Plessis, 'Corporate law and corporate governance lessons from the past: ebbs and flows, but far from "the end of history": Part 2' (2009) Comp Law 71 and Colin Cooke, *Corporation, Trust and Company* (Manchester

corporate regulation. The start of the 20th Century saw the stock market crash of 1929 and the subsequent great depression trigger an explosion in academic debate as to the role of the company and its directors, led by the classic Berle Meane debate in Harvard Law Review.[2]The UK has not escaped crises either, beginning with the secondary banking crisis in the 1970's, to the fall of the Johnson Mathey Bank in 1986 and the subsequent collapses of Bank of Credit and Commerce International and Barings Bank in the early 1990s.[3] Each was a springboard in the development of new corporate governance structures. The results of the 2008 crisis have been no different. Public and political pressure has been placed on government to act in response to the perceived failings of the regulatory and governance structures in place. During this time of continuous change the law surrounding the corporation has seen a great map of interlinking laws, regulations and voluntary codes put in place in the hope to satisfy the perceived objectives of corporate governance of the time. It is the intention of this thesis to unpick these changes and critically analyse their viability in the 21st Century global market.

Definitions of Corporate Governance

To do this it is important to outline exactly what we mean by corporate governance, a task much easier said than done, as there is no one single definition of corporate governance. In fact, the literature reveals no less than forty separate and individual definitions of what is meant by the term corporate governance. The etymology of the words corporate and governance can be traced and derived from ancient Greek and Latin. Corporate is a derivative of the Latin word *corpus* meaning body and from that derives the Latin verb *corporate* to form into one body, and from that *corporation* represents a body of people.[4]The word governance on the other hand is developed from Latinised Greek *gubernatio* meaning management or government, and this comes from the ancient Greek *kybernao* to steer, to drive. Clarke purports that the etymological origin of the concept of corporate governance 'captures a creative meaning of collective endeavour that defies the contemporary inclination to place a passive and regulatory emphasis on the phrase.'[5]

Alongside this emphasis on corporate governance as a passive, regulatory matter, it is suggested that a further crucial element, evident from the etymology, is the notion of collective endeavour: A group of people working together as one. In essence, this highlights the cultural nature of corporate

University Press 1950) 81.

[2] See for example the Berle-Dodd debate as discussed in Chapter s.174.

[3] See generally, Peter Ellinger, Eva Lomnicka and Hare, Ellinger's Modern Banking Law (5th edn, OUP 2010) 31; Anu Arora, 'The statutory system of the bank supervision and the failure of BCCI' (2006) JBL 487.

[4] Thomas Clarke, 'International Corporate Governance: A Comparative Approach' (Routledge 2007) 1.

[5] ibid.

governance and is suggestive of the role corporate governance can play in effecting cultural change within institutions, such as banks.

Whilst the etymology describes a clear focus towards monitoring of the culture of business, the difficulty in giving a single definition for corporate governance in modern literature is that governance does not fit neatly into any single academic discipline. As such different scholars will place differing emphasis on what is important in the terms of corporate governance, for example economists are more interested in defining corporate governance through the lens of Resource Allocation Theory. Economists use Corporate Governance as a means of defining 'how business corporations allocate resources and returns.'[6]Williamson defines corporate governance as an institutional framework in which the integrity of the transaction is decided.'[7] Resource Theory has also been considered by economists at the World Bank as 'the organizations and rules that affect expectations about the exercise of control of resources in firms.'[8]Resource theory and the like are largely ignored by legal academics that focus instead on the relationship between Supervision, Control and Accountability. The main focus of legal scholarship on corporate governance has focused on three theories of corporate governance: Agency Theory, Stewardship Theory and the Market Theory, all of which will be discussed throughout the thesis and as such do not require an in-depth analysis at this point.

Collective Endeavour

Whilst scholars have all clearly focused on different variables within the concept of corporate governance, the theory of collective endeavour permeates through all of these ideas. This has been visible as far back as some of the earliest works on the area.[9] The term 'corporate governance' first gained prominence when it was used in The Independent Director by Robert Tricker.[10] He described corporate governance as being:

> 'concerned with the way corporate entities are governed, as distinct from the way businesses within those companies are managed. Corporate Governance addresses the issues faced by

[6] Mary O'Sullivan, 'Corporate Governance and Globalization' (2000) American Academy of Political Science 570 ANNALS, 153.
[7] Oliver Williamson, *'The Mechanisms of Governance'* (Oxford University Press 1996) 11.
[8] World Bank, '*Building Institutions for Markets: World Bank Development Report'* (2002) 68.
[9] Arthur Knight, 'The Aims and Objectives of Corporate Bodies' (Institute of Chartered Secretaries and Administrators, 1979) and Kenneth Midgley 'To Whom Should the Board be Accountable...and for What?' (Institute of Chartered Secretaries and Administrators, 1979).
[10] Robert Tricker, 'Corporate Governance' (Gower, Aldershot 1984).

boards of directors, such as the interaction with top management, and relationships with the owners and others interested in the affairs of the company.'[11]

Once again the cultural shift as a vehicle for corporate governance can be identified pervading the definition. The most widely accepted legal definition of corporate governance can be found in the OECD Principles of Corporate Governance, and once again a definition focusing on corporate culture can be identified:

> '[c]orporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined.'[12]

It is important to note that corporate governance is an international issue, and as such, in discussing corporate governance it must be considered that there may be international factors that may not have been in the mind-set of the Anglo-American body corporate. Whilst corporate structures do differ on an international scale it is purported that the concepts collective identity and culture can be traced throughout the international texts and reports.

In Europe a series of governmental reports have highlighted a necessity The Belgian Cardon Report on Belgian listed Companies stated 'Corporate governance refers to the set of rules applicable to the direction and control of a company.'[13] In Germany the Berlin Initiative Code defines Corporate Governance as 'the legal and factual regulatory framework for managing and supervising a company.'[14]Perhaps most evocatively in Italy corporate governance is described in the sense of cultural norms, traditions and patterns of behaviour.[15]

Further afield in Australia there have been attempts to define corporate governance in the wake of corporate collapses, in particular the collapse of the insurance company HIH Ltd.[16]

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[11] ibid.
[12] OECD, OECD Principles of Corporate Governance (OECD Revised 2004).
[13] Cardon Report, Corporate Governance for Belgian listed Companies (December 1998) para 2 English translation accessed at http://www.ecgi.org/codes/documents/cbf_dec1998_en.pdf [accessed on 23 September 2014].
[14] Berlin Initiative Group, German Code of Corporate (June 2000) Preamble, English translation accessed at http://www.ecgi.org/codes/documents/gccg_e.pdf [accessed on 23 September 2014].
[15] Preda Code, Report & Code of Conduct (October 1999) paragraph 2 'Corporate Governance, in the sense of the set of rules according to which firms are managed and controlled, is the result of norms, traditions and patterns of behaviour developed by each economic and legal system. . . .' English translation accessed at http://www.ecgi.org/codes/documents/gccg_e.pdf [accessed on 23 September 2014].
[16] HIH Royal Commission, Background Paper 11 *Directors' Duties and Other Obligations under the Corporations Act* (November 2001), at *http://www.hihroyalcom.gov.au.*

> 'Corporate governance refers generally to the legal and organisational framework within which, and the principles and processes by which, corporations are governed. It refers in particular to the powers, accountability and *relationships* [emphasis added] of those who participate in the direction and control of a company.'[17]

Yet again focusing on the idea of relationships shows the permeation of cultural reform throughout the notion of corporate governance. The thesis purports that corporate governance mechanisms are required to drive cultural change within banks and thereby reduce institutional and systemic risk.

Whilst the new regulatory powers described in the previous chapter have been welcomed prudential financial regulation has substantial limitations when addressing the culture within an institution. These limitations can be addressed by improving Corporate Governance structures. There were many cases where internal risk management was ineffective[18] and where senior management failed to adequately identify and constrain excessive risk taking. The main body of the thesis will focus on showing how Corporate Governance structures are the necessary bridge between market regulation and formal regulation. It will do this by focusing on a number of specific issues within corporate governance. It will begin by focusing on two legal duties the director owes to the company under the Companies Act 2006. It will continue by discussing the utility of the Victorian doctrine of the 'Business Decision Rule', and will conclude by analysing whether remuneration structures could be an aid to good corporate governance.

[17] ibid.
[18] Turner (n 1) 89.

Chapter IV: The Duty of Skill, Care and Diligence

Chapter IV: The Directors' Duty of Skill, Care and Diligence

Under agency theory a company is run by a director for the benefit of the members of that company. The directors themselves, in the majority, do not own the company and as a result do not incur any significant risk when making decisions with regards to the company. What then is there to stop a director acting in any way they choose, and potentially to the detriment of the company? One way to resolve this issue is through the tort of negligence. If a director acts in a way that is tortiously negligent, is there any way to bring accountability to said director for his actions? The law surrounding the liability of directors for negligent acts is an ever changing and complicated system that has evolved with the changing nature of the role of the director themselves. The next chapter intends to track this changing nature, and with it, the standards of care expected of any director, be it executive or non executive.

The chapter will begin by analysing the establishment of the classic role of the director developed from the historical ideal of an amateur of good standing in the community; the evolution of the director will then be tracked through the past two centuries, culminating in the modern professional purveying over multi billion pound global company groups. During this period the shift from a subjective standard of care following *Re City Equitable Fire* will be replaced by a dual test first instigated by s.214 of the Insolvency Act 1986, and then proposed by Hoffman LJ in a series of cases in the early 1990's. After Hoffman LJ's tests are analysed, the chapter will continue by tracking the subsequent legislative process and codification under s.174 of the Companies Act 2006. Following the recent financial crisis and the subsequent reports,[1] there has been a media and political backlash against some of the incumbent directors of the larger financial institutions. The chapter will analyse a number of recent cases both in the UK and Australia, and will purport that there may have been a shift in ideological thinking towards increased scope for liability following the crisis. It is the intention of the piece to conclude by forming an argument as to the viability of s.174 of the Companies Act 2006 as a means of altering the corporate culture and, in particular, its ability to hold non-executive directors of major financial institutions liable for inaction in the face of powerful executive directors.

19th Century Amateur Director of 'Good Standing'

The modern idea of a director is very different from historical depictions. The development of the professional director has historical foundations in the amateur of 'good standing in the community.'[2] During the 19th Century, a gentleman of good standing would lend his name and with it his reputation to enhance the prestige of a company, these directors had very little expected of them in relation to the running of the company. The original duties of skill and care that a director was expected to observe were born out of this period of a well meaning amateur. The role of a director has now shifted to that of a professional nature, with directors now responsible for safeguarding the long-term wellbeing of his company, and in doing so, the director must observe governance standards with regard to his conduct.

Historically, the directors' duty of skill, care and diligence was to be found within the common law and, as already mentioned, enshrouded firmly in the concept of a Victorian gentleman director.[3] Directors were often appointed to the boards of companies purely based upon their social standing; this was done to increase the prestige of the company without any expectation on the director who often saw their appointment as a hobby rather than any formal employment. The directors duty was not based on any real expectation of professionalism, and was built on 19th Century jurisprudence around 'trustees' or quasi-trustees'.[4] Treating them as such, freed directors from liability for

[1] For example Derrek Higgs, *Review of the Role and Effectiveness of Non-Executive Directors* (London: Department of Trade and Industry, 2003).
[2] Desmond Wright and Brian Creighton, *Rights and duties of directors* (2nd edn, London Butterworths 1991) 48.
[3] ibid.
[4] Vanessa Finch, 'Company Directors: Who cares about skill and care?' (1992) 55 MLR 179, 200.

anything short of culpable or gross negligence.[5] This approach was highlighted in the case of *Re Brazilian Rubber Plantations and Estates Ltd*[6] where Neville J noted that:

> '[a director] is not bound to bring any special qualifications to his office. He may undertake the management of a rubber company in complete ignorance of everything connected to rubber, without incurring responsibility for the mistakes which result from such ignorance.'

This followed the argument forwarded by Lord Hatherley in *Turquand v Marshall*[7] that, however ridiculous and absurd the conduct of directors might seem, it was the misfortune of the company's board that it chose such unwise directors, but ultimately, in any event, the directors could simply be removed. To such an extent that in *Pavildes v Jensen*[8] Dankqwerts J. saw difficulty in leaving the company in the control of what he called 'a set of amicable lunatics.'[9] This low standard of expectation was also applied to insolvency proceedings. Prior to the Global Financial Crisis the last bank in the UK to suffer a 'run' was Overend, Gurney & Co.[10] Subsequently the bank failed and lead to one of the most high profile crashes of the 19th Century. When proceedings were brought against the directors of the institution the court was invited to identify the standard of care of a director. The court purported that the standard of care required was one of:

> 'ordinary prudence whether or not the directors exceeded the powers entrusted to them, or whether, if they did not ... they were cognisant of facts of such a character, so plain, so manifest, and so simple of appreciation, that no men with any ordinary degree of prudence, acting on their own behalf, would have entered into such a transaction as they entered into.'[11]

The early case law appears to focus mainly on non-executive directors, as it was considered that executive directors would be held accountable under an implied term of skill and care within their contracts of employment,[12] or alternatively, a specific clause in the articles of the company.

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[5] ibid.
[6] [1911] 1 Ch 425.
[7] (1869) 4 Ch App 376.
[8] [1956] Ch. 565 Ch D.
[9] ibid 570.
[10] *Overend, Gurney & Co v Gibb,* (1872) LR 5 HL 40.
[11] ibid 486-7.
[12] *Lister v Romford Ice and Cold Storage Co Ltd* [1957] AC 555, 572-573.

Re City Equitable Fire: Subjective Standard of Skill, Care and Dilligence

The historical idea of a director, as a well-meaning amateur, has been enshrined in the case of *Re City Equitable Fire Insurance Co Ltd,*[13] and more specifically, the classic test formulated by Romer J for directors' negligence. Romer J held:

> '(1) A director, in the performance of his duties, need not exhibit a greater degree of skill than may reasonably be expected from a person of his knowledge and experience.
>
> (2) A director is not bound to give continuous attention to the company's affairs; his duties are of an intermittent nature to be performed at periodical board meetings and at meetings of any committee of the board on which he happens to be placed. A director is not required to attend all such meetings, but ought to attend when reasonably able to do so.
>
> (3) Having regard to the exigencies of business, and in the absence of grounds for suspicion, a director is justified in trusting officers of the company to perform their duties honestly.'[14]

The standard of care expected of a director under the law was an extremely low one. The Director was not expected merely by virtue of their office to possess any particular skills.[15] This followed the earlier case of *Lagunas Nitrate Co v Lagunas Syndicate*[16] and Lindley MR where he stated:

> 'if the directors act within their powers, if they act with such care as is reasonably expected from them, having regard to *their knowledge and experience,* and if they act honestly for the benefit of the company they represent, they discharge both their equitable as well as their legal duty to the company [emphasis added].'[17]

Leading to what has critically been referred to as the honestly stupid defence of negligence of the 'amiable lunatic',[18] in that as long as a director believed they were acting in the best interests of the company, then they would be free from any formal challenge to his duty of skill and care below gross negligence. Or, as one commentator put it, it allows members to appoint a 'half-wit' for a director.[19] This, once again, reinforces the idea of the gentleman amateur carrying out a hobby, and

[13] [1925] Ch 407.
[14] ibid 428.
[15] Wright and Creighton (n2) 50.
[16] (1899) 2 Ch 392.
[17] ibid 435.
[18] Andrew Hicks, 'Directors liability for management errors' (1994) 110 LQR 390, 392 quoting *Pavildes v Jensen* (n 8).
[19] ibid 393.

no case highlights this more than the case of *Re Denham Co Ltd.*[20] In *Re Denham* the defendant, a Mr Crook, was a director of a company and recommended the payment of a dividend out of capital, which was unlawful. As a result an action was brought against the defendant on the grounds of negligence. The court held that the defendant was not liable for his negligent act for as Chitty J stated: 'Mr. *Crook* is a country gentleman; he is not a skilled accountant.'[21] Whilst clearly the decision is dated in its use of language, what it does show is a clear statement of intent by the courts to treat defendants extremely favourably when analysing their liabilities for negligence when acting in their role as a director. It is almost humorous to state that a gentleman who runs a country estate could not possibly understand the basic ideas of accounting when dealing with company accounts simply because he was a 'country gentleman'.

The second limb of Romer J's explanation made it quite clear that although a director is expected to attend board meetings, and make a contribution to the running of the company, if they chose not to take an active role, then they could not be held liable for their inaction. This has come to be epitomised by the case of *Re Cardiff Bank (Marquis of Bute case).*[22] Where the Marquis of Bute was appointed as a director and president of the Cardiff Savings Bank at the ripe old age of six months. In the following thirty-eight years, he attended only one board meeting. During this time, massive frauds occurred within the bank, and when an action was brought against the Marquis the court held that he was not liable for breach of duty in failing to attend board meetings, since he had not given any such undertaking. Sterling J remarked: 'Neglect or omission to attend meetings is not, in my opinion, the same thing as neglect or omission of a duty which ought to be performed at those meetings.'[23]

The court is clearly stating that, if a director chooses to be inactive, then that director cannot be held liable for their inactivity. The court distinguished between failure to perform an undertaking, and performing the undertaking but doing so negligently, i.e. non-feasance versus malfeasance. It is only the latter that will impose liability for negligence.

Finally, where a director has delegated duties entrusted to him in a proper fashion, in accordance with the Articles, he is entitled to rely on the information given to him. For example, in *Dovey and Metropolitan Bank (of England and Wales) Ltd v Cory*[24] the liquidator of a bank sued a director for breach of duty in not ascertaining the true condition of the bank, assenting to the payment of

[20] (1884) LR 25 Ch D 752.
[21] ibid 767.
[22] [1892] 2 Ch 100.
[23] ibid 109.
[24] [1901] AC 477.

dividends out of capital, and advancing capital to directors without security. In this case, the director had relied on fraudulent balance sheets and on statements of the chairman and general manager of the bank, this reliance however, had been conducted in good faith. It was held that the director was not negligent in his duties in not detecting the fraudulent acts of the general manager and other officers. A director is entitled to rely on a subordinate put in a position of trust for the express purpose of attending to the detail of management. However, it is not possible for a director to exclude themselves completely from responsibilities through the action of delegation to others. This was made clear in *Selangor United Rubber Estates Ltd v Cradock*[25] where directors were held liable when they should have been aware of a wrong, even though they were in fact ignorant of it.

Objective Standard in Romer J's Decision

The test introduced by Romer J. has always been interpreted as subjective; however, it can perhaps be argued that Romer J himself did not necessarily believe that the test should be solely subjective. His decision further elaborated his belief that there is a necessity to take into consideration some minimum objective standards when dealing with gross negligence as Romer J stated:

> '... [W]hether or not directors exceeded the powers entrusted to them, or whether if they did not exceed their powers they were cognizant of circumstances of such a character, so plain, so manifest, and so simple of appreciation, that no men with any ordinary degree of prudence, acting on their own behalf, would have entered into such a transaction as they entered into.'[26]

Statements such as this have influenced a body of academics to argue that there has always been a basic objective minimum standard to the directors' duties of skill, care and diligence.[27] Commentators have noted in the past that that the three pronged test set out by Romer J in Re City Equitable Fire was 'in addition'[28] to the basic objective stance he purported as it was qualified further by the words 'a director of a life insurance company, for instance, does not guarantee that he has the skill of an actuary or physician.'[29] If this interpretation is correct then what should have followed is the application of a two-pronged test that set out a basic standard that was required to be adhered to under Romer J's second paragraph as stated above, and then the further application of the subjective standard of care as set out in the three pronged Romer test. Commentators have argued that this qualification does not allow for the standard of care to be reduced to the level of a

[25] [1967] 2 All ER 1255.
[26] *Re City Equitable Fire Insurance Co Ltd*[1925] Ch 407, 486-7.
[27]Hicks (n18) 392.
[28] ibid.
[29] *Re City Equitable Fire Insurance Co Ltd* (n26) 428.

half-wit,[30] and thus, Romer J was intending to install an objective minimum. It is argued that this may very well have been the intention of Romer J when he devised his three prong test. Whilst there is an unequivocal logic to this line of reasoning, the courts did not interpret it as such; instead the courts chose to apply the three stage Romer test strictly. In doing so, it is argued that the courts took a policy decision to afford directors a greater degree of protection. The result of this protection is a continuation of the protection of the 19th Century amateur. This subsequently turned directors into a protected class of people.

Continued Recognition of Directors as a Safeguarded Class

The continued recognition of directors as a safeguarded class proceeded well into the 1980's and, in particular s.13 of the Supply of Goods and Services Act 1982:

> 'In a contract for the supply of a service where the supplier is acting in the course of a business, there is an implied term that the supplier will carry out the service with reasonable care and skill.'

This was an extremely important provision which introduced a statutory implied term that the supplier of services would provide services of a reasonable standard. This very clearly was an attempt to introduce a standard of care for all suppliers of services, directors included. However, yet again directors were shielded from increased scrutiny and were exempt from this provision, along with advocates, before it even came into force by the Supply of Services (Exclusion of Implied Terms) Order 1982 Art.2 (2) which reads:[31]

> Section 13 of the Supply of Goods and Services Act (which provides that, in a contract for the supply of a service where the supplier is acting in the course of a business, there is an implied term that the supplier will carry out the service with reasonable care and skill) shall not apply to the following services:—
>
> ... (2) the services rendered to a company by a director of the company in his capacity as such.

Rising standards of commercial education inevitably increased the standard of skill required of directors.[32] This combined with more onerous governance standards; greater accountability and transparency started a trend that has required higher standards of conduct and increasing the demands on directors when discharging their obligations and duties. The question that is posed is

[30] Hicks (n18) 393.
[31] Supply of Services (Exclusion of Implied Terms) Order 1982, SI 1982/1771.
[32] Vincent Powell-Smith, *The Law and Practice relating to Company Directors* (London Butterworths 1969).

why then were directors given this added level of protection under the 1982 order? The exclusion of liability of directors for standards of care and skill would appear to run directly contradictory to the company law ideology of the time, that being the creation of greater accountability within a directors role. It was not until the late 1980s that any real legislative reformation began to materialise. Following the trend of the time of increased commercial education, it would appear that the legislature attempted to reform the subjective standards imposed by Romer, and sought to introduce more of an objective stance to directors' duties of skill, care and diligence.

The First Wind of Change: Insolvency Act 1986 s.214

The revolution regarding the standard of skill and care began with a series of director disqualification cases during the late 1980's, which were based on the actions brought using s.214 of the Insolvency Act 1986 and the provisions on wrongful trading. Following recommendations made by the Cork Report,[33] the enactment of S.214 created a more efficient and accessible mechanism through which directors of insolvent companies could be held accountable for conduct which was prejudicial to the interests of their corporate creditors.[34] The intention of s.214 was to deter irresponsible directorial conduct[35] during a time when a company would be entering into difficulties. Under section 214 if a director did not take every step possible to minimise the potential loss to creditors, then the courts may hold that director liable to make a personal contribution to the companies' assets. S.214 was the first piece of legislation that required the courts to apply an objective standard of care when assessing whether a director was liable for wrongful trading. To establish whether the director was *prima facie* liable under s.214, it was necessary to show that the director was aware or ought to have been aware that there was no reasonable prospect of the company avoiding liquidation; and he then proceeded to continue to conduct the affairs of the company to the detriment of the liquidators.

The Insolvency Act 1986 s.214(4) states:

> For the purposes of subsections (2) and (3), the facts which a director of a company ought to know or ascertain, the conclusions which he ought to reach and the steps which he ought to take are those which would be known or ascertained, or reached or taken, by a reasonably diligent person having both-

[33] Department for Trade and Industry, *Insolvency Law and Practice, Report of the Review Committee* (Cmnd 8558 1982) (the Cork Report).
[34] Steve Griffin, *Personal Liability and Disqualification of Company Directors* (Hart Publishing 1999) 57.
[35] ibid 61.

(a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to the company, and

(b) the general knowledge, skill and experience that that director has.

It is clear that, by introducing section 214(4)(a), the legislature was intending to apply an objective standard as to what a reasonably diligent person would have done given the same facts, a decision that was confirmed in the first case reported on the provisions, *Re Produce Marketing Consortium Ltd*[36] where Knox J held that:

> 'The facts which the [directors] ought to have known or ascertained and the conclusions that they ought to have reached are not limited to those which they themselves, showing reasonable diligence and having the general knowledge, skill and experience which they respectfully has, would have known, ascertained or reached, but also those that a person with the general knowledge skill and experience of someone carrying out their functions would have known, ascertained or reached.'[37]

This reinterpretation was the first attempt by the courts to introduce an objective standard of liability on directors and, although it had a very limited application, it wasn't very long before it was adopted as the general desired mode of assessment of directors' duties of skill, care and diligence. What is interesting to note is that this piece of legislation was enacted only four years after the exclusion order circumventing the liability of directors for the provision of services as noted above. Whilst not conclusive of a rapidly changing ideology, it would appear that the production of the Cork report threw the earlier legislation into question.

The modern development of the law towards an s.214 objective standard was first noted in *Dorchester Finance Co Ltd v Stebbing.*[38] The non-executive directors sought to rely on the second limb of the Romer J test by arguing that having agreed to no board meetings ever taking place they could justify this by relying on auditors to do a 'proper job.'[39]

Foster J opined that, although the common law still required a director to show a sufficient level of skill in accordance with his own abilities following *Re City Equitable Fire Insurance*, with regards to the level of diligence, what was required was 'such care as an ordinary man might have expected to

[36] [1989] 5 BCC 569.
[37] *Re Produce Marketing Consortium Ltd* [1989] 5 BCC 569, 593.
[38] [1989] BCLC 498.
[39] David Ipp, 'The Diligent Director' (1997) Comp Law 162.

take on his own behalf.' This has very clear overtones of an objective standard as Davies notes in particular, 'This is an objective test and one pitched at a high level, since presumably an ordinary man will be diligent in the promotion of his own affairs.'[40] Fosters comments encouraged academics to consider the possibility of the differentiation between the implementation of a subjective duty of skill and the introduction of an objective standard of care.[41] Luckily, academics and the courts alike did not have to wait long for the clarification of what was considered to be the modern standard of skill, care and diligence. For it appears that, during the early 1990's, Hoffman LJ attempted a one man crusade to update and bring the common law firmly in line with the theories enshrined in s.214.

The Decisions of Hoffman LJ and his Crusade for an Objective Standard

Hoffman LJ began with the case of *Norman v Theodore Goddard*[42] where he (sitting in the High Court) theorised an objective requirement, running alongside the subjective, that a director must possess the skill 'that may reasonably be expected from a person undertaking those duties.'[43] Hoffman LJ qualified his statement, '[A] director who undertakes the management of the company's properties is expected to have reasonable skill in property management, but not in off-shore tax avoidance.'[44] On such a basis, a degree of professional management or skill on the part of directors is now required. This was combined with the subjective standard that was accorded previously to create a new dual standard of care; skill and diligence, and very clearly in the hope of aligning the general duties of a director of skill, care and diligence with their duties to creditors if the company were to become insolvent. Further to this, Hoffman LJ also noted that in consideration of what a director might reasonably know, the court should take into account the knowledge, skill and experience which the person actually had; but they should also consider what skills and experience a person carrying out those functions should have. This is a very obvious departure from the traditional subjective views that predate *Norman v Theodore Goddard* in cases such as *Re Brazilian Rubber* as already mentioned above, and a clear attempt to align the law with what can be found in s.214 of the Insolvency Act 1986.

Hoffman LJ then went further *in Re D'Jan of London Ltd*[45] (again sitting as an additional judge of the Chancery Court)and stated unequivocally that 'the duty of care owed by a director at common law is

[40] Paul Davies and Sarah Worthington *Gower & Davies: Principles of Modern Company Law* (9th edn, Sweet and Maxwell 2012) 642.
[41] Bryan Clark, 'The director's duty of skill and care: subjective, objective or both? (1999) Scots Law Times 239.
[42] [1992] BCC 14.
[43] ibid 15.
[44] ibid.
[45] [1993] BCC 646.

accurately stated in section 214 of the Insolvency Act 1986'.[46] So it would appear that, following the decision in *Re D'Jan of London* and *Norman v Theodore Goddard,* a director's actions are measured against the actions which would have been taken by a reasonably diligent person. Observed both objectively according to the level of skill and experience which might be expected of a person carrying out the functions of the director, and also subjectively, according to the level of general skill, skill knowledge and experience the director actually has. However, this is only to be taken into account if the director's skills, knowledge and experience are greater than that of the ordinary person, and therefore it may increase the standard expected of the director but never reduce it below the objective minimum.

The Legitimacy of the Decisions of Hoffman LJ

It is important to take a moment to analyse the appropriateness of the decisions of Hoffman LJ: as far back as Dicey, the rule of law has governed that law is to be made by the legislature and not the judiciary; judges are there to simply apply the law and not make it. As Dicey writes,

> 'Parliament is the supreme legislator, but from the moment Parliament has uttered its will as lawgiver, that will become subject to the interpretation put upon it by the judges of the land.'[47]

Therefore, what we can derive from this is that judges are only there to interpret the law and not create it. Now it may be argued that Hoffman LJ is simply interpreting Parliament's wishes in applying s.214 of the Insolvency Act 1986, as it was at the time, the most up to date piece of legislation and therefore the wish of Parliament. However, it could be argued that whilst s.214 may have been the most recent piece of legislation, it was not the most relevant. s.214 is restricted to a very small area of application, namely when a bank has become insolvent, and as such it may be argued that s.13 of the Supply of Goods and Services Act 1982 would be more relevant, or more specifically the exemption afforded to Directors by the Supply of Services (Exclusion of Implied Terms) Order 1982 Art.2 (2). S.13 of the Supply of Goods and Services Act 1982 imposed an implied term that the supplier of services would provide *all* services at a reasonable standard, and that standard was to be based on objective standards. Directors were exempt from this and, as a result, were still bound solely by the parameters set out by Romer J. Therefore, strictly speaking, Hoffman LJ should have applied the Romer test in *Norman v Theodore Goddard* and *Re D'Jan of London,* and

[46] ibid 648.
[47] Albert Dicey, *Introduction to the Study of the Law of the Constitution* (London: Macmillan 1885) 273.

not the less relevant objective test set out in s.214 of the Insolvency Act 1986 *and* s.13 of the Supply of Goods and Services Act 1982.

If that is the case, then the question that needs asking would be why then, would Hoffman LJ apply a more stringent test to directors in the everyday application of their duties? Following the rule of law, a judge is there to simply apply the law and not make it, and arguably the most relevant, albeit not most recent piece of legislation, exempted directors from a more stringent objective standard of care. The answer may lie in the fact that, it is argued, Hoffman LJ chose to apply his own morality to the case in an attempt to create an outcome that he believed was correct. If this statement were to be true, then although Hoffman LJ was agreeing with the trend of the time of greater accountability, it could be argued that he was incorrect in his decision to fundamentally alter the law and should have left that to Parliament. What is intriguing is that this is not the first time that judges had applied their own ideas of morality to cases in an attempt to create the outcomes they so desired. Interestingly enough, during the early 1990's there appeared to be a penchant for judicial activism in this way. In the same year as *Norman and Theodore Goddard,* another case decided in the House of Lords which came to a rather similar conclusion. The criminal case of *RvR*[48] was another such example. In this case, the House of Lords abolished the exemption that man could not rape his wife. In similar recommendations, the Law Commission recommended that legislation be introduced to confirm the removal of the marital exemption for the charge of rape.[49]The criminal law exemption that a man could not rape his wife was based upon an 18th idea, and in particular, the ideas of Sir Matthew Hale that 'the husband cannot be guilty of a rape committed by himself upon his lawful wife, for by their mutual matrimonial consent and contract the wife hath given herself up in this kind unto her husband which she cannot retract.'[50]

However, before Parliament had chance to alter the law, the House of Lords took it upon themselves to alter the common law. Lord Keith, in the lead judgment, in declaring that 'the common law is, however, capable of evolving in the light of changing social, economic and cultural developments'[51] argued that such an exemption did not reflect the modern state of affairs, and that the status of women 'has changed out of all recognition'[52] and no longer was the wife 'subservient chattel of the husband.' He continues by stating:

[48] *R v R (Rape: Marital Exemption)* [1992] 1 A.C. 599 (HL).
[49] Law Commission, *Rape with Marriages* (Law Com No 205, 1992).
[50] Matthew Hale, *History of the Pleas of the Crown*, vol 1 (1736) 629.
[51] *R v R (Rape: Marital Exemption)* (n 48) 616.
[52] *R v R (Rape: Marital Exemption) [1992]* (n 48) 617.

> 'Hale's proposition involves that by marriage a wife gives her irrevocable consent to sexual intercourse with her husband under all circumstances and irrespective of the state of her health or how she happens to be feeling at the time. In modern times any reasonable person must regard that conception as quite unacceptable.'[53]

As a result, the House of Lords decided that the exemption that a husband cannot be guilty of raping his wife no longer applies in modern society, thus altering the law. As Giles points out in *RvR* 'the appellate judges believe that they have the power to change what the common law 'is', she goes on to point out that 'It is fairly clear that the decision breaches the traditional principles of statutory interpretation.'[54]This has been reinforced by Smith and Hogan who noted that '[i]t is arguable that this decision flouted the will of Parliament but the result was highly desirable.'[55]

So, whilst it would be difficult to argue that morally there is no way to object to the judiciary taking the stance that they did, legally once again, we see the judiciary interjecting in the law where they deem it to be morally justifiable to do so. Judgments like *RvR* and Hoffman LJ in *Re D'Jan* may sit well on a moral footing, but strictly speaking, they have been decided incorrectly by judges imparting their own moral standpoint, which they should not have done so. It would be an extremely brave (or foolhardy) person who would attempt to argue that *RvR* was decided incorrectly: however, there have been examples of judicial law making having been overturned by subsequent courts. For example, in the case of *DPP v Shaw*[56] the House of Lords declared that it had the power to create new common law offences in order to protect public morality, whilst this was eventually discredited by *Knuller*.[57]

It is argued that, although Hoffman LJ (like Lord Keith in *RvR*) probably had only the best of intentions in likening the the test to that of s.214 of the Insolvency Act 1986, strictly speaking, he may have acted ultra vires in altering the law and not waiting for Parliament to do so. Of course, Hoffman LJ was proven to be correct in the long run with modern writers agreeing that '[T]he duty to exercise reasonable care, skill and diligence mirrors the tests laid down in section 214 of the Insolvency Act 1986. As such, it reflects the judicial development of this duty in recent years and includes an objective assessment of a director's conduct.'[58]However, it is not the theory or morality

[53] ibid.
[54] Marianne Giles, 'Judicial law-making in the criminal courts: the case of marital rape' (1992) Crim LR 407, 410.
[55] David Ormerod, *Smith and Hogan's Criminal Law* (13th edn OUP 2011) 747.
[56] [1962] AC 220.
[57] [1973] AC 435.
[58] See Lord Sainsbury of Turnville's remarks during debates on the Company Law Reform Bill, later enacted as the Companies Act 2006 see HL Deb 11 January 2006, vol 677, col 184.

that has been called into question in this section, rather the means by how Hoffman LJ chose to take the law upon himself and alter it as he saw fit instead of waiting for Parliament to do so.

Is There Any Justification in Hoffman LJ's Decisions?

Hoffman LJ's decisions, although perhaps wrong in doing so, can potentially be explained by the changing nature of the director and, in particular, the nature of the non-executive director. During the same time, the Cadbury Committee released a report in 1992 that noted in particular that non-executive directors had come to hold a special function within the company, namely to: 'Safeguard the shareholders from incompetence on behalf of the executive directors.' This is a much more intricate role than the well-meaning amateur of the late 19th Century, who simply lent their name and standing to the company. The Cadbury Committee clearly saw the non-executive director as much more of a check and balance on the Company, in particular 'if the chairman is an executive director, a senior non-executive director should be appointed in order to maintain a balance between the executive and the non-executive.'[59] He continued by remarking however, that this 'should not detract from the primary contribution which they are expected to make, as equal board members, to the leadership of the company.'[60] A far cry from the type of directors found in cases such as *Re Cardiff Bank (Marquis of Bute case)* where the Marquis attended board meetings only once in thirty eight years. This expectation by the courts that the non-executive director take a much more active role can also be seen in the case of *Dorchester Finance Co Ltd v Stebbing*,[61] where it was held there is no difference in the duties owed by executive directors and non-executive directors.

The increased expectations placed on directors is echoed by Hoffman LJ himself in *Bishopgate Investment Management Ltd v Maxwell (no2),*[62] he remarks:

> 'In the older cases the duty of a director to participate in the management of a company is stated in very undemanding terms. The law may be evolving in response to changes in public attitudes to corporate governance, as shown by the enactment of the provisions consolidated in the Company Directors Disqualification Act 1986.'

He did however, qualify his statement in *Bishopgate* where he went on to comment obiter that a duty for a director to participate in the management of the company would depend on the manner

[59] Cadbury, *Report of the Committee on the Financial Aspects of Corporate Governance* (London: Gee Publishing, 1992) para 4.3.
[60] ibid para 4.7.
[61] [1989] BCLC 498, para 130B.
[62] [1993] BCC 120.

in which the particular company's business was organised and the part the director could reasonably be expected to play.[63]

As previously noted, there were the beginnings of an objective standard prior to Hoffman LJ going back as early as *Re City Equitable Fire Insurance Co Ltd*, however, it was not until Hoffman LJ interpreted it as such, that the courts began to impose the higher duty than that of simply the subjective knowledge of the individual. It is interesting to note, nevertheless, that although the Cadbury Committee and the judiciary perceived the nature of a director's duty to be changing with an increased onus on director activism, directors themselves did not share the sentiment. A good example of this came in the Auditors General Report of 1993, where it was found that 58% of directors questioned did not know of the Company Directors Disqualification Act 1986 and other leading pieces of legislation.[64]

Whatever the reading of *Re City Equitable Fire*, it is safe to say following the efforts of Hoffman LJ in *Norman v Theodore Goddard* and *Re D'Jan of London Ltd*, the modern common law duties of skill, care and diligence during the 1990's followed the dual objective/ subjective standard set out in s.214 of the Insolvency Act 1986. Hoffman LJ's position was affirmed by a series of cases that followed, in *Bishopgate*[65]where it was held, that a director could not rely on the opinion of fellow directors that a transfer of shares in a pension fund was a proper one, nor avoid liability by showing that the transfer would have gone ahead without his concurrence.

Further in *Re Continental Assurance Co of London Plc*[66] the defendant, a non-executive director of a company, and its parent company who both collapsed. The wholly owned subsidiary had made advances to the parent company which was in breach of provisions prohibiting financial assistance towards the purchase of shares. Although the director did not realise that there was indebtedness between the subsidiary and its holding company, it was reasonable, that given his background as an auditor accountant, he should have read and understood the company's statutory accounts.

It was not only the judiciary who was in favour of a new objective/subjective test. The Law Commission of England and Wales and the Scottish Law Commission published a joint consultation document,[67] the document recommended the approach found within the Insolvency Act 1986 s.214(4) should be adopted more generally, and what was forwarded by Hoffman LJ in that they

[63] Parry, 'Delegation of directors' duties after Re Barings Plc' (1999) 25 Company Law Newsletter.
[64] Lee Roach, 'The directors' duty of skill and care: has the Commission got it right?' (1999) 20 Bus LR 51.
[65] *Bishopgate Investment Management Ltd (in liquidation) v Maxwell (No2)* [1994] BCC 120.
[66] [1997] 1 BCLC 48.
[67] Law Commission, *Company Directors: Regulating Conflicts of Interest and Formulating a Statement of Duties* (Law Com CP No 153, 1999).

believed that the dual objective/subjective approach to be the modern day approach for directors duties of skill, care and diligence. The Joint Commissions in particular noted:

> 'We provisionally consider that such a dual test is appropriate generally not merely where the company is on the verge of insolvency... all directors should be subject to a general standard of care and a particular director should not be able to rely on his own particular lack of knowledge or experience to avoid being subject to that general standard. On the other hand, we consider it fair that if he has some special expertise, he should have to exercise it.'[68]

Further to this, the commission recommended introducing a s.309A into the Companies Act 1985 that read as follows:

> 'A director of a company owes the company a duty to exercise the care, skill and diligence which would be exercised in the same circumstances by a reasonable person having both—(a) the knowledge and experience that may reasonably be expected of a person in the same position as the director, and (b) the knowledge and experience which the director has.'[69]

The recommendation clearly follows the previous theories purported by Hoffman LJ and the Insolvency Act 1986 s.214(4).

The Modern Definition: Companies Act 2006 s.174

Following the decisions by the judiciary and the Joint Law Commissions, it was clear then that the intended modern position of a director's duty of skill, care and diligence was enshrined in s.214(4) of the Insolvency Act 1986 as observed by Hoffman LJ. This carried through into the new millennium, as it has now been enacted into legislation following the creation of the Companies Act 2006. The provision can be found in s.174 of the Companies Act 2006 which states:

> 'S. 174 Duty to exercise reasonable care, skill and diligence:
>
> (1)A director of a company must exercise reasonable care, skill and diligence.
>
> (2)This means the care, skill and diligence that would be exercised by a reasonably diligent person with—

[68] ibid 292.
[69] Law Commission, *Company Directors: Regulating Conflicts of Interest and Formulating a Statement of Duties* (Law Com No 261, 1999) 184.

(a) The general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company, and

(b) The general knowledge, skill and experience that the director has.'

It can clearly be seen that the provision has been transposed from that of s.214 (4) of the Insolvency Act near verbatim, and confirms the desire by the legislature to continue with the dual objective/subjective criterion that was developed during the 1990's. It appears the Act's sole intention, with regards to this provision, was to codify the already existing law, and not to alter or develop the law.[70] This is made clear in the explanatory notes where it points out that:

> 'This duty codifies the director's duty to exercise reasonable, care, skill and diligence…[it] now mirrors the tests laid down in section 214 of the Insolvency Act 1986, which includes an objective assessment of a director's conduct. This section is modelled on that section.'[71]

Lord Sainsbury was also clear to note that 'the [Companies Act 2006] will codify the common law duty of care, skill and diligence without substantive amendment…The Bill does not make this duty more onerous.'[72]

Objective vs. Dual Objective/Subjective Standard of Care

Although the provision was largely ignored during the Hansard debates,[73] the Lords did hold some discussion as to the relevance of the second limb of the test. Namely the subjective element, and what has been argued to be the more onerous obligations it imposes on directors with higher degrees of skill and competence:[74] it is an interesting argument and one that should be explored. Baroness Bottomley, in particular, was quick to press the idea that having an onerous subjective standard running alongside the objective minimum would have a detrimental effect on many small to medium sized businesses.[75] Her line of argument went as follows; if talented directors with greater knowledge and experience are expected to adhere to higher standards, then this may dissuade them from taking up a role, the possibility of an increased liability on them may be considered to be simply too onerous and thus, the possible director may simply instead conduct

[70] This can be seen by the lack of discussion on s.174 during House of Lords debates. See generally HL Deb 11 January 2006, vol 677.
[71] Explanatory Notes to the Companies Act 2006 para 336.
[72] HL Deb 11 January 2006, vol 677, col 245.
[73] For example the House of Commons did not even enter into debate on the provision.
[74] See in particular the comments of Baroness Bottomley at HL Deb 11 January 2006, vol 677, col 200.
[75] ibid col 201.

consultancy work for the aforementioned institution. Quoting directly from Patience Wheatcroft, the *Times* business and city editor, Bottomley noted:

> '2006 could be the year when quoted companies find that there are simply not enough directors to go round. The rewards do not compensate for the risks involved and people of the right calibre will not volunteer.'[76]

Barroness Bottomley used the example of former non-executive director of Equitable Life, Jennie Page, as an example of a public servant of 'great ability and integrity' who had been 'so scarred by recent episodes' that she may be dissuaded from taking up another post. Page noted at the time:

> 'It's very difficult to think the circumstances of non-executives are well-defined or well-protected in this day and age . . . If a climate of litigation by boards against their predecessors becomes a generality, you can see how being a non-executive could be a very dangerous thing to be.'[77]

The author finds this to be a passage so rife with inaccuracies it borders on fiction. After the failings of Equitable Life Assurance society in the early 21st Century, Lord Penrose conducted an independent report[78] with the intention '[T]o enquire into the circumstances leading to the current situation of the Equitable Life Assurance Society... to identify any lessons to be learnt for the conduct, administration and regulation of life assurance business; and to give a report thereon to Treasury Ministers.'[79]

In his report, he criticised the non-executive directors directly for being 'ill-equipped', 'ill-prepared' and 'incompetent.'[80] Lord Penrose also directly criticised the directors for having a lack of understanding of the Society's financial position.[81] There was an action brought against the directors by Equitable Life Assurance with regards to failures in their duties as directors. Whilst the case against the directors was ultimately dropped, it is argued that these are the very sort of directors that the legislation is intending to dissuade from taking up the role, and it is argued that if the likes of Jennie Page and others branded 'ill-prepared' and 'incompetent' were deterred from acting as non-executive directors in the future, then the legislation will have served its purpose.

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[76] ibid.
[77] ibid col 201.
[78] Lord Penrose, 'Report of the Equitable Life Enquiry' (HM Treasury March 2004) found at http://webarchive.nationalarchives.gov.uk/+/http://www.hm-treasury.gov.uk/penrose_report.htm.
[79] Lord Penrose, 'Letter from Lord Penrose to Financial Secretary Ruth Kelly MP, December 2003 found at http://webarchive.nationalarchives.gov.uk/+/http://www.hm-treasury.gov.uk/penrose_report.htm.
[80] Lord Penrose (n78) Part 7 para 90.
[81] ibid para 91.

Lord Freeman also voiced some concerns 'Will it discourage non-executive or executive directors from coming forward for both large and small companies?'[82] However, his disagreements were not as venerate as he himself could not answer his own question, and did not consider there to be sufficient evidence to do so at that point.

The idea that more onerous obligations may dissuade potentially talented directors from taking up a post as an executive or non-executive director is not a new one, and is one that has been discussed in academic commentary before. Clark in particular purported that a higher subjective standard of care is only applicable to specific cases, and in particular, to s.214 of the Insolvency Act 1986 because of the very nature of insolvency legislation, when a company becomes insolvent it is the creditors interests that are in need of protection. They are unable to exert as much control over the activities of directors in the way shareholders are able to do so, and therefore, should be afforded greater protection from negligent directors' actions.[83] He purports that a solely objective test would be far more attractive as 'directors are not penalised for their additional skills, expertise and experience...The argument is plain. Whilst a stringent objective standard would deter incompetent individuals from taking up directorships within companies, it would also provide an incentive to encourage incumbent directors to hone and polish their existing skills.'[84]

Dissuading directors from broadening their skill sets and experiences is a further argument put forward by the increased subjective standard nay-sayers, and again purports directors to be very cynical individuals. The idea that a director will actively choose not to improve their existing skills for fear of being held accountable for them, and as a result harming the company in the long run, is quite a mistrustful view to take of the modern director.

The author finds the arguments against the inclusion of a heightened subjective standard of care to be conceptually flawed. It is argued that it is necessary to look at the intention of the legislation and what it set out to do. As has already been explored, the duty of skill, care and diligence is expected to ensure that those who are acting for the company, are acting to the basic standards that are expected of them by their appointees. The reason directors command such vast salaries (both executive and non-executive directors) is because they are employed for the skills and experience they possess, and the ability of them to apply those skills and experiences to improve the business for the benefit of the members as a whole. As Lord Goldsmith remarks, it is often only appropriate to appoint a director because of his particular qualifications or experiences,[85] often 'the shareholders

[82] HL Deb 11 January 2006, vol 677, col 209.
[83] Bryan Clark, 'The director's duty of skill and care: subjective, objective or both?' (1999) S.L.T. 239, 242.
[84] ibid.
[85] HL Deb 6 February 2006, vol 678, col GC284.

of the company, when looking at the board of directors and deciding whether they want to invest or do business with it, may be encouraged and comforted by that.' This idea was confirmed by the Law Commission in early consultations in the development of the Companies Act 2006.[86]

It must be pointed out also that no person is being forced to take up a highly lucrative role as a non-executive director of a major institution: if a director is recruited on the belief that he is endowed with a particular skill and expertise, then it is appropriate that he should be judged according to that standard.

Alongside this debate, it was also interesting to note that there was an attempt to introduce a further duty, or at least bring it to the consideration of the House, by Lord Judd. Lord Judd argued that the duty of care should be extended, not only to the immediate beneficiaries of the company, i.e. the shareholders, but also that the duty of care should be extended further afield; and in particular toward communities and the environment.[87] This was a first attempt to introduce stakeholder theory into the duty of care, and although it received very little support, it is an example of the changing nature of the company and a point that is touched on elsewhere in the thesis.[88]

So, it would appear to all accounts that the modern standard of duty of skill, care and diligence is that which has been set out in s.174 of the Companies Act 2006. The original purpose of the Companies Act 2006 was to codify Company Law into a single document; however, it is still necessary to refer back to the old common law when we attempt to investigate the content of the duty.

The Substantive Content of the Duty of Skill, Care and Diligence

The modern definition as to the content of the duty of skill, care and diligence can be found in *Re Barings Plc (No5).*[89] The Re Barings series of cases have become infamous as an example of poor management, and in particular, lack of managerial control over one '*rogue trader*.'[90] The facts of Barings are now common knowledge, Nick Leeson, a derivative trader employed by the bank's Singapore office was speculating on the futures market of the Singapore Money Exchange (SIMEX). Due to management errors in the division of responsibilities, Nick Leeson was allowed to run up liabilities of £827 Million ($1.3 Bn), concealing the losses in an unnamed client account (the infamous 88888 account). His actions ultimately bankrupted the 233 year old bank who, at one time,

[86] Law Commission (n 67).
[87] HL Deb 11 January 2006, vol 677.
[88] See Chapter V and the Duty to Promote the Success of the Company.
[89] *Secretary of State for Trade and Industry v Baker (No.5)* [1999] 1 BCLC 433.
[90] A story that was immortalised by Hollywood in 1999 by the film 'Rogue Trader'.

boasted clients as illustrious as the Queen. The Secretary of State for Trade and Industry then sought orders under section s.6 of the Company Directors Disqualification Act 1986 against a number of senior executives of the company, on the grounds that the conduct of the directors made them 'unfit to be concerned in the management of a company'.[91] During his judgment, Parker J outlined what he perceived to be the modern content of the duty of skill care and diligence:[92]

> (i) Directors have, both collectively and individually, a continuing duty to acquire and maintain a sufficient knowledge and understanding of the company's business to enable them properly to discharge their duties as directors.
>
> (ii) Whilst directors are entitled (subject to the articles of association of the company) to delegate particular functions to those below them in the management chain, and to trust their competence and integrity to a reasonable extent, the exercise of the power of delegation does not absolve a director from the duty to supervise the discharge of the delegated functions.
>
> (iii) No rule of universal application can be formulated as to the duty referred to in (ii) above. The extent of the duty, and the question whether it has been discharged, must depend on the facts of each particular case, including the director's role in the management of the company.

It is clear that the reinstatement of the duty to exercise reasonable skill and care has been altered considerably through the series of cases discussed above from its earlier statement by Romer J in *Re City Equitable Fire.* First, Parker J notes that there is now a continuing duty to acquire and maintain sufficient knowledge. This is a clear departure from the earlier cases *of Re Cardiff Savings (Marquis of Bute case)*, and adopts the theories previously brought through by Hoffman LJ in *Dorchester Finance Co Ltd v Stebbing* and *Bishopgate Investment Management Ltd v Maxwell (no2).* No longer can anyone taking up a directorship regard it simply as an honorific position.[93]

However, what is more important is the second part of Romer's analysis. Following Romer J's comments, a director is clearly able to delegate responsibilities for, as has been noted earlier, 'The business of life could not go on if people could not trust those who are put in a position of trust for the express purpose of attending to details of management.'[94] Such a delegation does not absolve directors completely from all responsibilities, or as Lord Woolfe puts it, '[E]ach individual director owes duties to the company to inform himself about its affairs and to join with his co-directors in

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[91] Company Director's Disqualification Act 1986 s.6.
[92] *Secretary of State for Trade and Industry v Baker (No.5)* (n 89) 489.
[93] Adrian Walters, 'Directors' duties of care, skill and diligence.' (1999) Comp Law 142.
[94] *Dovey v Corey* (n 24) 486.

supervising and controlling them.'[95] This is in keeping with the modern analysis of the director of a company (and in particular the non-executive director) being much more involved with the day to day running of the company, and not simply being able to delegate all duties. It mirrors and reinforces the theories behind the minimum standard of care seen within s.174 of the Companies Act 2006. As was noted by Sir Richard Scott V-C:

> 'Overall responsibility is not delegable. All that is delegable is the discharge of particular functions. The degree of personal blameworthiness that may attach to the individual with the overall responsibility, on account of a failure by those to whom he has delegated particular tasks, must depend on the facts of each particular case. Sometimes there may be a question whether the delegation has been made to the appropriate person; sometimes there may be a question of whether the individual with overall responsibility should have checked how his subordinates were discharging their delegated functions. Sometimes the system itself, in which the failures have taken place, is an inadequate system for which the person with overall responsibility must take some blame.'[96]

It has been shown that the modern expectation on the non-executive director is one of increased participation within the board. This has been emphasised in the Cadbury and Greenbury reports as mentioned above. Further reports have enhanced this idea, and the Hampel Report[97] outlines clearly a desire to increase non-executive activism. In particular, it emphasises that the non-executive directors should 'demonstrate objectivity and robust independence of judgment when necessary.'[98] A clear indication of the expectations on non-executive directors to serve as checks or balances because as the report noted if there is not sufficient constraints an 'individual or small group of individuals can dominate the board's decision taking.'[99] Although non-executive directors are not expected to undertake the same duties as an executive of the board they are still bound to a duty to monitor the board.[100] Finally, the Hampel Report observed that in order to fulfil their role as monitor of the board's activities it is necessary that the majority of non-executive directors should be independent.[101] The Report defined independent as being 'independent of management and free

[95] *Re Westmid Packing Services Ltd* [1998] 2 BCLC 646, 653.
[96] *Secretary of State for Trade and Industry v Baker (No.5)* (n 89) 487.
[97] Hampel *Committee, The Hampel Report on Corporate Governance-Final Report* (London: Gee, 1998).
[98] ibid 2.5.
[99] ibid III.
[100] ibid 3.7.
[101] ibid 3.9.

from any business or other relationship which could materially interfere with the exercise of their independent judgement.'[102]

The culmination of the discussions of the role of the non-executive director came in 2003 when Derek Higgs conducted a 'Review of the role and effectiveness of non-executive directors' [103](Higgs Report). This report outlined four very distinct roles a non-executive director was expected to undertake whilst appearing on a board; it was broken down into four separate headings[104]:

> Strategy: Non-executive directors should constructively challenge and contribute to the development of strategy.
>
> Performance: Non-executive directors should scrutinise the performance of management in meeting agreed goals and objectives and monitor the reporting of performance.
>
> Risk: Non-executive directors should satisfy themselves that financial information is accurate and that financial controls and systems of risk management are robust and defensible.
>
> People: Non-executive directors are responsible for determining appropriate levels of remuneration of executive directors and have a prime role in appointing, and where necessary removing, senior management and in succession planning.

Once again it is necessary to remark on the clear and obvious alteration in the role of the non-executive. The non-executive is seen now more as a gatekeeper there to monitor the executive activity, much different to the Victorian idea of the 'good natured amateur.' By doing this 'the role of the non-executive director is therefore both to support executives in their leadership of the business and to monitor and supervise their conduct.'[105] This idea of the non-executive director as a gatekeeper has carried through and was replicated in the Combined Code.[106]

Under s.1 of the Code it is the role of the non-executive director to scrutinise the performance of management. As can be seen within the provision the non-executive director acting as a gatekeeper

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[102] ibid 4.12.

[103] Derek Higgs, *Review of the Role and Effectiveness of Non-Executive Directors* (London: Department of Trade and Industry, 2003).

[104] ibid 27.

[105] ibid para 6.6.

[106] There have been three separate versions of the combined code the final one being published in 2008, the others being published in 2003 and 2006. The combined code is a document published by the Financial Reporting Council (FRC) that gives guidelines as to what is perceived as good Corporate Governance practice, and it is expected that companies will comply wholly or substantially with its provisions. The code adopts a comply or explain ethos in that if a company or its employees choose not to comply with one or more of the provisions of the Code, it must explain to its shareholders clearly and carefully exactly why that is.

'should satisfy themselves on the integrity of financial information and that financial controls and systems of risk management are robust and defensible.'[107] It again reiterates the need for a balance of executive and non-executive directors[108] and the creation of a senior independent director.[109]

This continues, under Schedule B, with specific guidance as to the possible liability for non-executive directors in regards to the breach of their duty of skill, care and diligence. It clearly outlines that the non-executive directors must keep themselves updated with their skills, knowledge and familiarity with the company.[110] Furthermore, where the non-executive director has concerns about the running of the company they must ensure that they are addressed by the board; if such concerns are not resolved the non-executive director should ensure that they are recorded.[111] Ultimately, if the concerns cannot be resolved then it may be the duty of the non-executive director to resign.[112]

The most recent document is the Stewardship Code that was published in July 2010[113] and was revised in 2012 to be the UK Corporate Governance Code 2012; the code builds on the work of the investigatory arms of the Treasury Select Committee and other investigatory bodies following the recent financial crisis. Its aim was to 'enhance the quality of engagement between institutional investors and companies to help improve long-term returns to shareholders and the efficient exercise of governance responsibilities.'[114] An extremely insightful and well-meaning document which purports some real and interesting changes which would warrant a full chapter on its own, however as this was only published in 2010, and subsequently revised in 2012, its contents would not have been in the mind frame of the directors of the largest financial companies during the 2007-2008 financial crises and as a result is only included here for completeness sake.

All of these ideas directly mirror the earlier theory that non-executive directors are now expected to take a much more active role within the company. However as has already been discussed these are not legally binding as standalone theories, but still offer strong guidance as to when a director may be in breach of their statutory duties of skill, care and diligence.

[107] Financial Reporting Council, *Combined Code* (June 2008) 5.
[108] ibid para 3.2.
[109] ibid para 3.3.
[110] ibid Schedule B 2(ii).
[111] ibid
[112] ibid
[113] FRC, Effective Company Stewardship: Next Steps (September 2011) accessed at http://www.frc.org.uk/images/uploaded/documents/UK%20Stewardship%20Code%20July%2020103.pdf.
[114] *Financial Reporting Council, The UK Corporate Governance Code* (September 2012) 1.

Liability of Inactive Directors: *Lexi Holdings v Luqman*

Returning to the statutory duties of skill, care and diligence of a director it is necessary to analyse the liability of inactive directors. Inactive directors are defined as directors that make no attempt to discharge their duties and therefore fail to carry out the criteria as set out in the Corporate Governance Code and legislation. Historically inactive directors have been subjected to very little judicial investigation, as Sterling J remarked 'Neglect or omission to attend meetings is not, in my opinion, the same thing as neglect or omission of a duty which ought to be performed at those meetings.'[115]

However, more recently, following the developments of Hoffman LJ and the introduction of the objective minimum standard, it would appear that the inactive director will now be subjected to far more scrutiny. The courts have acknowledged that simply delegating a role does not absolve a person completely from their duty of skill and care, as Lord Woolf remarked in *Re Westmid Packing Services*[116] 'A proper degree of delegation and division of responsibility is of course permissible, and often necessary, but total abrogation of responsibility is not.' This case was referring to a particularly dominant director controlling both the board and the opinions of the non-executive directors, although it would appear that this has general application as Lord Woolf then qualifies his theory by noting:

It is of the greatest importance that any individual who undertakes the statutory and fiduciary obligations of being a company director should realise that these are inescapable personal responsibilities. The appellants may have been dazzled, manipulated and deceived by Mr Griffiths but they were in breach of their own duties in allowing this to happen.[117]

Langley J in *Equitable Life Assurance v Bowley*[118] affirmed the requirement of directors to continually monitor those who have been delegated functions within the company, by stating directors cannot have 'unquestioning reliance upon others to the job.'[119] Clearly following *Bowley* and *Re Barings* directors owe a duty to keep themselves informed but how far does this extend?

The case of *Lexi Holdings Plc (in admin.) v Luqman* brought this issue to the fore.[120] Initially it is necessary to outline the facts of the case. Initially the case was brought before the courts that two

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[115] *Re Cardiff Savings Bank* [1892] 2 Ch 100.
[116] *Re Westmid Packing Services Ltd; Secretary of State for Trade and Industry v Griffiths (No.3)* [1998] BCC 836 at 842B.
[117] ibid 843C.
[118] [2003] BCC 829.
[119] ibid 837.
[120] *Lexi Holdings Plc (in admin) v Luqman* [2009] BCC 716.

defendants Mozuna (M) and Zaurian (Z) were liable for the losses that had been incurred by way of their authorisation of the actions of another director namely their brother Shaed (S). This authorisation, it was argued, was not by positive means but instead because they had both been inactive in, and willfully ignorant of the affairs of the company.

Mr Justice Briggs held that there was clear inactivity on the part of the directors. In doing so he restated the concept in *Re Barings* that no company director may simply pass on management of company's affairs to colleagues without committing a breach of duty, as there still remained an obligation of supervision. He remarks that complete inactivity as a director 'is by definition unreasonable,' and continues with his analysis by pointing out that 'the defence that complete inactivity was a sufficient discharge of her fiduciary and common law duties fails the reality test.' As a result the defendants could not rely on s.727 of the Companies Act 1985 (now s.1157 of the Companies Act 2006) which allows the courts to give relief to a director who has breached his duty to the company where he has acted 'honestly and reasonably.'

Ultimately the defendants were held not to be responsible on the grounds of causation as Briggs J was not sufficiently convinced that their inactivity as directors had caused such misappropriation, or any loss to the company in respect of them. Briggs J used the ability of S to deceive M and Z as a factor of their exculpation for he believed that if they had made inquiries as to the misappropriation he was sure 'Shaid would have satisfied any questions from his sisters as to the authenticity of his loan account by similar and equally false explanation.'[121] The fact that Shaid was a convincing liar appeared to absolve the defendants from liability.

The case was then heard in the Court of Appeal and the appellate court judges took an entirely different stance to that of the High Court. The courts held both M and Z were liable for the amounts claimed by Lexi. In this case the prior conduct of S and the relationship M and Z had with him held the courts to believe that M and Z should have known that their brother was of questionable character and should have taken steps to ensure that they were not dominated for 'it is in itself a breach of duty by the remaining directors to allow themselves to be dominated or bamboozled by one of their number.'[122]

In coming to their decision the court of appeal have taken a polemic view to that of Briggs J in that in allowing themselves to be misled or coerced then that in itself was deemed to be a breach of duty, and it is argued that this decision sets a much lower threshold as to what would constitute a breach

[121] *Lexi Holdings (In admin.) v Monuza Akthar Luqman, Zaurian Parveen Luqman* [2008] EWHC 1639 (Ch) para 68.
[122] *Lexi Holdings Plc (in admin) v Luqman* (n120).

of the objective standard of care. No longer can a director argue that a persuasive board member could convince them of the merits of their idea. It is purported that this is a direct result of the desire for independence of non-executive directors as was recommended in the Higgs Report and carried through to the Corporate Governance Code.

It its therefore argued that the underlying concept that is to be found in *Lexi Holdings Plc v Luqman,* is that directors can no longer rely on their inability to ask questions of a persuasive and controlling director as a means of escaping personal liability. Instead the inactivity of the directors to ask questions of the executive director will result in them breaching their duty of skill, care and diligence. It is argued that this has effectively lowered the threshold of the objective standard of care; as no longer can a non-executive director argue that they did not need to ask questions of the extremely persuasive or bullish individual for if they would have the director would have simply convinced them otherwise. Under the law they would now have to show actual evidence of them attempting to question the directors to discharge their duty of care.

This theory has general applicability, and it is argued that the theories found within *Lexi Holdings Plc v Luqman* can be applied to the major financial institutions, and the problems they have suffered since the 2007/2008 financial crisis. Prior to this, it is necessary to note the different types of businesses involved. There are clearly two very different scales of operations between Lexi Holdings, and the institutions that entered into difficulty during the financial crisis: Lexi Holdings although boasting a large turnover was predominantly a family run business with the four siblings sitting on the board of directors. Comparing this to the large financial institutions, the make-up of their boards are much broader, usually with varying degrees of directorial professionals possessing extensive business and financial experience between them. It is however argued that *Lexi Holdings* is not an anomalous case that is bound to its very specific facts. This is because it is possible to trace a direct progression of the law from *Re Westmid Packing Services* and *Re Barings* which supports this conclusion and as such it is argued will lead to a broader application of the theory found within the case in future judgments. It is the very fact that the directors of the large financial companies have varying backgrounds and experiences that should have lead them to ask questions of the executives of the financial institutions and their specific business models, and 'not allow themselves to be dominated or bamboozled by one of their number.'[123]

The question then is whether that is true and has there been any examples within the financial sector that may substantiate this argument?

[123] *Lexi Holdings Plc (in admin) v Luqman* (n120).

Examples of Potential Reform from Australia

There has been substantial fallout following the financial crisis. This has occurred predominantly through the media, however it would appear that there may also have been an ideological shift in the mind-set of the judiciary following the financial crisis. It is believed that this shift in mind-set has led to an increase in the expectations of the role of the non-executive directors as proactive members of the board following *Lexi Holdings*. Whilst *Lexi Holdings* up until recently may have been defined as a single judgment decided upon its own facts, there is now evidence to suggest that the professional nature of the role of the director will now come under even further scrutiny in the future.

If this were the case then there would be a clear shift in the language and decisions of the judiciary following the crisis. Whilst the fallout from the crisis is still being felt there have been some decisions that that have illustrated this point. The *Healey*[124] case is one such example stemming from Australia and the first example dealing directly with the results of the financial crisis. In the case the Australian Securities and Investments Commission (ASIC) successfully brought an action against the entire board of the company in question. The case itself factored around the breach of s.180(1) of the Corporation Act 2001 (Cth) (the Act).

Section 180 of the Act provides:

> 'A director or other officer of a corporation must exercise their powers and discharge their duties with the degree of care and diligence that a reasonable person would exercise if they:
>
> a. were a director or officer of a corporation in the corporation's circumstances; and
>
> b. occupied the office held by, and had the same responsibilities within the corporation as, the director or officer.'

As can be observed the duty of skill care and diligence as set out under the Australian legislation practically mirrors that of the objective minimum standard as set out in the UK. The Australian legislation has the same minimum objective standard of conduct, with directors unable to merely 'go through the paces,'[125] with a requirement of a greater level of diligence expected of them. This level of expectation is based upon the same values as those set out in general Corporate Governance Theory that the director must be an active part of the control function of the company. A director is

[124] *ASIC v Healey* [2011] FCA 717.
[125] Pollock J in *Francis v United Jersey Bank* (1981) 432 A 2d 814 quoted with approval by Clarke and Sheller JJA in *Daniels v Anderson* (1995) 37 NSWLR 438.

not an ornament, but an essential component of corporate governance.[126] The central question in the case was outlined by Middleton J as:

> ‘whether directors of substantial publicly listed entities are required to apply their own minds to, and carry out a careful review of, the proposed financial statements and the proposed directors’ report, to determine that the information they contain is consistent with the director’s knowledge of the company’s affairs, and that they do not omit material matters known to them or material matters that should be known to them.’[127]

ASIC’s case was based upon a central argument that the directors’ duty under s.180 required them to properly read and understand financial statements, and once they understood and disseminated the knowledge, to then apply that knowledge to make informed opinions to the board of directors. What was interesting to draw from the case is that six of the seven defendants were non-executive directors and all were found to be honest people. It was not their honesty that was found to be lacking, but instead they had failed to take all reasonable steps required of them by not reading the documents, and most importantly relying on the expertise of those who had drafted them for their accuracy. This blind reliance on those that drafted the financial reports is the essence on which the case turned. Middleton J opined and reiterated the modern ideology of a director as a gatekeeper of the company. He noted that:

> ‘[T]he case law indicates that there is a core, irreducible requirement of directors to be involved in the management of the company and to take all reasonable steps to be in a position to guide and monitor.’

He relied upon this idea, to find the defendants guilty of breaching their statutory duty to exercise reasonable skill, care and diligence by not reading financial statements carefully enough. In doing so, he stated that:

> All directors must carefully read and understand financial statements before they form the opinions which are to be expressed in the declaration.’[128]

Whilst this on face value appears to be little more than an expression that a director must read any documents that are given to him or her; Middleton J went on further to discuss the nature of the

[126] *ASIC v Healey* [2011] (n124) para 19.
[127] ibid para 13.
[128] *ASIC v Healey* [2011] (n124) para 17.

role of the director and the required knowledge when discharging his duties arising from s.180 of the Corporation Act.

> 'This accumulated knowledge [of the validity of financial statements] arises from a number of responsibilities a director has in carrying out the role and function of a director. These include the following: a director should acquire at least a rudimentary understanding of the business of the corporation and become familiar with the fundamentals of the business in which the corporation is engaged; a director should keep informed about the activities of the corporation; whilst not required to have a detailed awareness of day-to-day activities, a director should monitor the corporate affairs and policies; a director should maintain familiarity with the financial status of the corporation by a regular review and understanding of financial statements; a director, whilst not an auditor, should still have a questioning mind.'[129]

Therefore on face value one would assume that the director under Middleton J is not expected to be the business' auditor, or accountant, and perhaps the scrutiny required of them is not so great. However they must not be completely dormant in exercising their duties and as in *Lexi Holdings* passivity is not enough. This is reinforced by his statement that although infinite knowledge[130] is not required of the director he must not simply 'go through the motions'[131] as he puts it. As a general principle therefore one could conclude that, for a director to discharge their obligations, they must simply inform themselves of the advice or information provided by others, and from that advice then develop informed opinions. But if there are no reasonable grounds to suspect that the advice or information was incorrect or misleading, they will be protected from liability.

It is argued however that Middleton J may have inadvertently increased the reliance of the role of the gatekeeper of the company on non-executive directors, by purporting it to be a necessity for them to scrutinise documentation that may not necessarily be within their expertise. Midleton J remarks that:

> 'Even so, a director, whatever his or her background, has a duty greater than that of simply representing a particular field of experience or expertise. A director is not relieved of the duty to pay attention to the company's affairs which might reasonably be expected to attract inquiry, even outside the area of the director's expertise.'[132]

[129] ibid para 17.
[130] ibid para 20.
[131] ibid para 174.
[132] ibid para 18.

This is interesting to read as by their very definition directors are brought into companies for those very expertise that are sought to be relied upon. It may be difficult for a director to know whether the information was incorrect or misleading if they did not have the experience of auditing or knowledge of accounting matters. It is purported that this may be an onerous obligation to put onto directors. It is argued he extends the duty beyond the classic idea of *Re Baring,*[133] to take into consideration the knowledge that the director has, and instead extends this to go beyond his own expertise, to a fundamental duty of protection.

The case at its very least has shown that directors need to be attentive to their responsibilities, and must play an active rather than passive role when performing duties.[134] It is argued, however, that Middleton J formulated the idea that the duty of skill and care goes further towards what may be defined as creating an idealistic idea of the perfect standard of care of a director. It is interesting to question whether Middleton J has now created a standard of the perfect director. In doing so has Middleton J extended the scope from the ordinary director acting within their role? If Middleton J has created a standard akin to that of an idealistic director and not necessarily a reasonably competent one then this would be clear evidence in the shift of ideology in the judiciary mentioned previously. Further to this Middleton J does not expand unto what circumstances are to be defined as 'affairs which might reasonably be expected to attract inquiry?' These questions remain unanswered by Middleton J and in the future will lead to further query.

The shift in ideology can be further identified in a subsequent series of cases emanating from Australia known collectively as the James Hardie series of cases.[135] Once again ASIC commenced civil penalty proceedings against a number of directors within a large corporation for breach of their statutory duty of care and diligence under s.180(1). Specifically for the purposes of the thesis an action was brought against seven non-executive directors for approving an announcement and draft information memorandum concerning the establishment of a holding company within the group (James Hardy Industries NV). The Court of First Instance found that the directors at its board meeting on February 15 2001 approved a draft containing misleading disclosures about the adequacy of the compensation fund for asbestos victims without having exercised care, therefore breaching their

[133] *Secretary of State for Trade and Industry v Baker (No.5)* (n89) 489.
[134] Jean Du Plessis and Iain Meaney, 'Directors' liability for approving financial statements containing blatant incorrect items: lessons from Australia for all directors in all jurisdictions' (2012) Comp Law 273, 274.
[135] *ASIC v Macdonald* (no.11) [2009] 287*, ASIC v Hellicar* [2012] HCA 17 (HC (Aus)) *Sharon v ASIC* [2012] HCA 18 (HC (Aus)).

duty of skill, care and diligence. Following a successful appeal by the defendants the case ultimately reached the Australian High Court who overturned the appeal by the directors.[136]

In its decision the Australian High Court reaffirmed the decision of the trial court and found that the Draft Announcement was tabled and approved by the non-executive directors contrary to their duties under s.180(1). In doing so the court reiterated the requirements and responsibilities of directors to take reasonable steps to place themselves in a position to guide and monitor the management of the company.'[137]

Now once again the courts stated that directors were not required to exhibit a greater degree of skill in the performance of their duties than may reasonably be expected for persons of commensurate knowledge and experience, in the relevant circumstances.[138] However the case does provide what has been described as a 'wake-up call'[139] for non-executive directors and their requirement to engage in due diligence at a board meeting. Ignorance of issues or passivity at the board meeting is not an excuse for exoneration from liability.

The *Hardie* case reinforces the necessity of non-executives to engage proactively in board meetings, and to ensure they fully understand any documentation when making resolutions. Any passivity at the board meeting would not be an excuse to be absolved from liability, echoing *Healey* and also the *Lexi Holdings* case from the UK. Whilst some have argued that this does not necessarily extend the duty of care and diligence under s.180(1),[140] and therefore one could infer by definition s.174. It is argued that what may be now defined as inactivity on the part of the director has changed from simply one who carte blanche refuses to engage with the board, and shifts instead to one who does not conduct in-depth scrutiny of executive dealings (specifically in this case financial accounts), even if they do not have the knowledge or capability to do so.

Of course it is important to remark that these cases are strictly not binding on the UK courts and as such it would be foolish to draw sweeping statements from them, however more recently within the UK there have been further developments that substantiate the argument that inactive directors will be subject to greater scrutiny than perhaps they had been pre-financial crisis.

[136] *ASIC v Hellicar* (n135) 36.
[137] ibid 255.
[138] ibid 236 citing the case of *Australian Securities Commission v Gallagher* (1993) 11 WAR 105.
[139] Sheikh Solaiman 'The landmark James Hardie case in Australia: a wakeup call for non-executive directors' (2013) Comp Law 180, 190.
[140] ibid 190.

The First Glimmer of Change: Weavering Capital (UK) Ltd

In *Weavering Capital (UK) Ltd (In Liquidation) v Peterson*[141] the claimant company and its liquidators sought relief against directors after the company entered into alleged fraudulent transactions at the behest of the company's chief executive, and managing director Mr Peterson. The court held that Mr Peterson was liable for breach of his fiduciary duties to Weavering Capital as a director and in the tort of deceit.[142]There were a number of other defendants within the case and it is with these that the interesting points of the case turn. It is necessary to look at two other defendants within the case, namely Mrs Peterson (the Mr Peterson's wife) who was a non-executive director of the company, and Mr Platt who, although not a director of WCUK was a senior and highly paid employee.

It was purported that although Mrs Peterson did not commit the fraud herself, contrary to s.174 of the Companies Act 2006 she negligently permitted the alleged fraud to happen. In circumstances similar to that of *Lexi Holdings* Mrs Peterson was accused of breaching her duty of skill, care and diligence in not asking questions of the transactions in board meetings, the prosecution relied upon the observations of Parker J in *Re Barings (No 5)*[143] and more specifically his citation of the Australian case of *Daniels v. Anderson*[144] it was noted that:

> 'A person who accepts the office of director of a particular company undertakes the responsibility of ensuring that he or she understands the nature of the duty a director is called upon to perform. That duty will vary according to the size and business of the particular company and the experience or skills that the director held himself or herself out to have in support of appointment to the office. None of this is novel. It turns upon the natural expectations and reliance placed by shareholders on the experience and skill of a particular director…The duty includes that of acting collectively to manage the company.'[145]

It was argued[146] therefore that whilst Mrs Peterson was entitled to delegate particular functions, it was maintained that the exercise of the power to delegate did not in this case absolve Mrs Peterson from the duty to supervise the discharge of the delegated functions. Counsel acting for Mrs Peterson purported that Mrs Peterson acted reasonably in assuming that Mr Peterson was managing the

141 [2012] EWHC 1480 (Ch) and the subsequent Court of Appeal judgment *Weavering Capital (UK) Limited (in liquidation), Geoffrey Bouchier and Paul Clark (as joint liquidators (formerly joint administrators)) of Weavering Capital (UK) Limited v Charanpreet Dabhia, Edward Platt* [2013] EWCA Civ 71.
142 para 147.
143 [2000] 1 BCLC 523.
144 (1995) 16 ACSR 607, 668.
145 ibid 668.
146 ibid para 161.

company properly, it was submitted that she could only have been liable if she had had cause (in the form of what was described as a 'red flag') to be alerted to the fact that there was something amiss. It is this idea of a 'red flag' or something that is glaringly obvious that is interesting, if the courts were to agree then it would purport that a non-executive might not necessarily have an obligation that was so onerous as had first been purported following the *Lexi Holdings* and Australian cases.

However the courts disagreed, and Proudman J held that Mrs Peterson could not escape liability for negligence by stating that she had a confined area of responsibility.[147] He further remarked that he found it 'legally unsustainable for her to assert that she can escape liability by saying she only had a limited role in the management of WCUK and was not alerted to wrongdoing by her husband.'[148]In a judgment that has striking similarities to that of *Lexi Holdings* Proudman J continued by stating:

> 'Mrs Peterson not only omitted to ask questions, but positively approved the swap trading strategy. If she had acquired a sufficient knowledge and understanding of WCUK's business, she would have known that the swaps contravened the OM and could not, consistently with her duties, have approved that strategy.'[149]

This is interesting as it once again affirms the ideas in the *Lexi Holdings, Healey and Hardie* cases that directors are bound to investigate the dealings of their company. One element that must be considered in the reasoning of the case is the size of the company, Proudman J was quick to point out that the company was relatively small in size whilst there was a demarcation of roles, everyone was aware of what everyone else did and often one director would fill in for another.[150] As a result this called into doubt Mrs Petersons arguments of lack of knowledge.

The case of Mr Platt is an interesting one, and whilst strictly not dealing with s.174[151] and one that mirrors *Lexi Holdings* as it is purported not only did he have actual knowledge of the transactions, and although he was not deemed to have acted fraudulently he was instead over-promoted and 'swallowed everything that Mr Peterson told him.'[152] Once again we see an example of a convincing chief executive exerting pressure on a senior member of the company and that member was held liable for negligence for not resisting that pressure and failing to recognising that the swaps were not genuine instruments. The Judge opined that he was given too much to do and did it

[147] ibid para 173.
[148] ibid.
[149] ibid para 177.
[150] ibid para 163.
[151] He was eventually held liable for negligence under the FSA Statements of Principle and Code of Practice for Approved Persons (APER). As a senior employee, he did not conduct the firm's business with due care, skill and diligence (APER Principle 2).
[152] ibid para 202.

unquestioningly,[153] and whilst not doing so fraudulently the judge concluded that he could not 'infer that Mr Platt was doing other than his "incompetent best.'[154]

An interesting and final note to be made on this case is that on appeal counsel for Mr Platt submitted that the judge at first instance had not identified the specific knowledge, skills and experience that D had or were to be expected of him, or how the required standard had not been met. This arguably would have been an ideal opportunity for the courts to set out specific criteria to define what the relevant required standards were for a director.[155] Unfortunately McCombe LJ circumvented the opportunity by declaring that:

> 'provided a judge recognises the law's requirements as to the duties placed upon directors and, having reviewed the facts, considers that the relevant duty has been broken, it is not necessary to spell out any further what the duty is or the standard of care to be exercised by the particular director whose conduct is being called into question.'[156]

Once a breach has been established it is still necessary to show that there is a sufficient causal link between the breach of duty by the director and the losses suffered by the company for the defendant to be held liable.[157] Where the breach in itself is an omission to act then as Hoffman LJ remarks 'the plaintiff must prove that compliance would have prevented the damage.'[158] Again this was reiterated in *Lexi Holdings* for had M and Z acted and informed the board then the losses would have been prevented, their failure to act resulted in their liability. It must also be noted that the duty of care must be in respect of the type of loss that has occurred as was laid out in *Re Continental Assurance Co of London Plc (No4).*[159]

Conclusion

It is important to remember that directors by their very role will take decisions that involve risk. As a result of that risk not all decisions will be successful. A director will not automatically be deemed negligent due to the fact that the company has suffered a loss; however it would appear that following the financial crisis there may have been a growing judicial intolerance toward non-executive directors becoming passive within their roles. This intolerance will force directors to reconsider the cultural norms within their institutions. As a corporate governance mechanism it is

[153] ibid para 207.
[154] ibid para 206.
[155] ibid para 28.
[156] ibid para 29.
[157] *Cohen v Selby* [2001] 1 BCLC 176.
[158] *Bishopgate Investment Management Ltd (in liquidation) v Maxwell (No2)* (n 65) 139.
[159] *Singer v Beckett* [2007] 2 BCLC 287.

possible to observe a clear cultural change within the financial system, implemented by the development of the objective standard of care under s.174 of the Companies Act 2006. It has been argued by Du Plessis that the actions of the directors in the *Healey* case were simply contrary to their statutory duties and obligations, and therefore Justice Middleton's ruling would not have differed at a different time, nor if the financial crisis had not occurred.' [160]However it is purported it is because of the very financial crisis and the increased scrutiny of non-executives that these cases were not only brought but were pursued so vehemently. One need only observe the response of the ASIC chairman in the wake of the *Hardie* decisions, Mr Medcraft, when commenting on the final decision of the High Court noted:

> 'We made it clear when launching these proceedings that the action was in the public interest as it would involve the responsibility of executives and non-executives when boards of public companies make important or 'bet the farm' type decisions...ASIC took this case to the highest court in the land and I am certain this case has and will be studied in boardrooms across Australia and in legal circles, and I know that it is already shaping corporate behaviour and is having a positive deterrent effect.'[161]

This pursuit of justice is a clear illustration of the viability of the duty to change culture within the financial sector. It can do this through an increased focus of shareholders to hold directors to account through objective standards of care. It is no coincidence that this follows on from the backlash of the recent financial crisis, but what is interesting is the sheer level of responsibility now placed upon non-executive directors in their role as gatekeeper. It appears that the courts are beginning to lose patience with directors of large institutions, we need only look at the curt way Mr Justice Peter Smith addresses the actions of HBOS and its directors[162] following the discontinuation of the disqualification proceedings following the well documented 'Farepack Collapse.'[163] The mere fact the presiding judge, Peter Smith J, took the 'extraordinary step' to issue a statement criticising the conduct of the group's main lender, HBOS, in itself speaks volumes of the frustrations of the judiciary, however his words leave little doubt as to his opinion of the bank and its directors:

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[160] Du Plessis and Meaney (n 134) 277.
[161] Greg Medcraft, 12-85MR Decision in ASIC's appeals in James Hardie matter, Statement (3 May 2012) accessed at http://www.asic.gov.au/asic/asic.nsf/byheadline/12-85MR+Decision+in+ASIC%E2%80%99s+appeals+in+James+Hardie+matter?openDocument.
[162] *Secretary of State v Fowler and others* Judges Statement (21 June 2012).
[163] The Farepak group was a Christmas hamper saving club that entered into difficulties and ultimately collapsed in October 2006, the collapse left nearly 120,000 largely low-income customers out of pocket by around £37m. See Jane Croft, 'Farepak directors begin legal battle' *Financial Times* (24 May 2012).

> 'It is ironic that if the bank's reputation for playing hardball had been repeated by the government two year later, HBOS would not be here and that is something else that HBOS [and presumably its directors] might like to think about.'[164]

So to reiterate, following the financial crisis, the modern principle of the Duty of Skill, Care and Diligence is still to be found under s.174 of the Companies Act 2006. The duty is based directly on previous case law, with the judiciary believing that the legislation simply codified the previous law.[165] This duty is a two tiered duty starting with a metaphorical glass floor of an objective standard, which may be increased dependant on the specific skills of the director. In analysing the duty and its content it can be observed that the objective standard of care has the capacity, within a holistic approach, to change the culture of banking and prevent a reoccurrence of the Global Financial Crisis. Whilst it may be farfetched to say that directors, and in particular non-executive directors, are now expected to be perfect, following the crisis there has been a clear cultural shift that has departed away from classic cases such as *Grimwade v Mutual Society* whereby it was noted that *'*directors are not bound to be wiser than those who appointed them.*'*[166] This shift adopted within a multi-faceted approach is the key to ensuring a change in cultural expectations and norms within the financial crisis.

Chapter V: The Duty to Promote the Success of the Company: Promoting real success or simply appeasing stakeholders?

[164] ibid para 124.
[165] *Gregson v HAE Trustees Ltd* [2009] 1 All E.R. (Comm) 457 para 24.
[166] (1885) 52 L.T. 409, 415.

Chapter V: The Duty to promote the Success of the Company: Promoting real success or simply appeasing stakeholders?

This chapter intends to analyse a particularly significant duty that a director owes to the company: The duty to promote the success of the company under s.172 of the Companies Act 2006. The chapter will investigate the impact of this provision following its enactment and, more specifically, will analyse its perceived failings following the 2007-2009 Global Financial Crisis. It is the goal of the chapter to show whilst it has its fallacies the fiduciary duties encompassed under s.172 have the ability to contribute to an improvement in banking culture. The chapter will begin by analysing the conflicting theories as to in whose interests a company should be run. This is more commonly known as the shareholder versus stakeholder debate and will culminate in the assessment of a new model known as Enlightened Shareholder Value (ESV). The chapter will proceed then by mapping out the law prior to the enactment of s.172 paying close attention to both the previous common law principles and the build up to the 2006 Act, focusing in particular on two governmental white papers and the Company Law Reform Bill 2005. Finally it will conclude by way of an in depth analysis of s.172 and its impact following the Global Financial Crisis. The chapter highlights the major failings in the drafting of the legislation, principally the lack of an objective standard of care and the inability of the current provisions to protect the interests of stakeholders to a satisfactory level.

In Whose Interests Should a Company be Run

There has always been considerable debate as to for whose benefit a company should be run; historically the common law has found that directors duties are owed to the company and not to individual shareholders.[1] This was reiterated more recently by Lord Goldsmith before Parliament during the Hansard Debates preceding the enactment of the CA 2006:

> '...the duty is to promote the success for the benefit of the members as a whole-that is, for the members as a collective body-not only to benefit the majority shareholders, or any particular shareholder or section of shareholders...'[2]

In 1998 the Department of Trade and Industry commissioned a review with the intention of modernising Company Law.[3] Essentially prior to the Review, Company Law within the UK was based firmly on 19th Century trade practices and it was considered that a new overhaul of company law was required.[4] The review was presided over by the Company Law Review Steering Group (CLRSG). Their recommendations were to 'encourage responsible behaviour by making clear that in promoting the success of the company for the benefit of its members as a whole, directors must take account of long-term as well as short-term consequences.'[5] In their deliberations the CLRSG noted that it was imperative for them to resolve whose interests directors should take into consideration when making decisions.[6]

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[1] *Percival v Wright* [1902] 2 Ch 401.
[2] HL Deb 6 February 2006 vol 678 cols 255-256.
[3] Company Law Review, *Modern Company Law for a Competitive Economy* (DTI, 1998).
[4] Department for Trade and Industry, *Modernising Company Law* (White Paper , Cm 5553, 2002) preface.
[5] Company Law Review, *Modern Company Law for a Competitive Economy: Final Report* (DTI, 2001) xvii.
[6] Company Law Review, *Modern Company Law for a Competitive Economy: The Strategic Framework* (DTI, 1999) para 5.1.1.

Shareholder vs. Stakeholder Theory

Historically there have been two competing theories as to for whose benefit the company should be ran, they are the Shareholder Primacy Theory which seeks to solely promote the interests of the shareholders as a body as a whole. Alternatively, the Stakeholder or Pluralist Theory aims to be more altruistic in promoting the wider interests of the stakeholders of the company,[7] alongside the interests of the shareholders. The debate can be traced back to an original discussion held soon after another financial crisis, this time the Wall Street Crash of the late 1920's. During 1932 a debate was purported between two leading Professors of the day. The scholarly debate was well documented in the Harvard Law Review and has come to be known as the Berle-Dodd debate. Professor Berle was a firm believer in the model of Shareholder Primacy and expounded the view that 'all powers granted to a corporation or to the management of a corporation...are necessarily and at all times exercisable only for the ratable benefit of all the shareholders as their interests appears.'[8] Based firmly on Agency Theory, Berle observed a rise of professional managers that had operational control of the institution with no ownership,[9] and believed that as agents of the shareholders the directors should manage corporate assets in the best interests of their principals. Supporters of Shareholder Primacy Theory purport that it is only through the promotion of shareholder interests can business associations achieve maximum overall prosperity and welfare.[10] Professor Dodd on the other hand disagreed quite categorically with the Shareholder Primacy Theory of corporate governance preferring a more inclusive pluralistic Theory, he argued for 'a view of the business corporation as an economic institution which has a social service as well as a profit-making function.'[11] For a long time these were the only two competing theories considered by academics and practitioners alike. It is argued that the Companies Act 2006 may have changed this by attempting to bring the two sides of what would appear to be a corporate spectrum to some form of mutually beneficial centre. This may have been done by the creation of a third Theory of corporate governance in what has been termed as the Enlightened Shareholder Value (ESV) approach. Before the chapter is able to analyse the benefits and/or problems of such an approach it is necessary to outline and analyse the original two theories of shareholder and stakeholder.

[7] Examples of stakeholders include employees and creditors.
[8] Adolf Berle Jr, 'Corporate Powers as Powers in Trust' (1930-31) 44 Harvard Law Review 1049, 1049.
[9] Jeswald Salacuse, 'Corporate Governance in the new century' (2004) 25(3) Company Lawyer 69, 71.
[10] Simon Mortimore et al, 'Company Directors, Duties, Liabilities and Remedies'(OUP 2009).
[11] Merrick Dodd, 'For Whom Are Corporate Managers Trustees?' (1932) 45 Harvard Law Review 1145, 1148.

Shareholder Primacy Theory

Shareholder Primacy Theory has been the principal supposition in Ango-American corporate governance,[12] the proposition affirms the belief that the shareholders are owners of the company and as the owners; the company should be run solely for their benefit.[13] Milton Friedman, the Nobel Prize- winning economist, argues the shareholders of a corporation are the owners of the business, and as a result the only 'social responsibility of business is to increase its profits.'[14] This Theory is firmly entrenched in the opinion that the legal model of a company is that of principal-agent,[15] with the shareholders being the principals and the directors the agents.[16] There have been several academics that have argued quite robustly that this is not the case and the idea of agency Theory through ownership of the company is a fallacy.[17] However it is postulated that the relationship is sufficiently close enough for the purposes of this chapter to be analysed in those terms. As shareholders are the principals and owners of the company, it is theorised that they will bear the risk of the undertakings of the directors. If the company fails to be profitable and ultimately enters liquidation then the shareholders will be placed at the bottom of the distribution structure,[18] and will ultimately lose out. Conversely if the company is run in a profitable manner the shareholders will benefit directly from the company's increase in fortunes.[19] It is therefore purported that the directors are compelled to promote the interests of the shareholders.

There have been a number of counter-arguments against the promotion of shareholder interests. One observation that has be made is that often what are perceived as the benefits of the Shareholder Primacy model are closely tied to the weaknesses of the Stakeholder Theory model (and vice-versus): For any standard corporation the primary intention of shareholders in purchasing shares of that company is an expected return on their investment through an increase in share price or dividends, as a result it is imperative for the company to maximise its profits to allow for this

[12] Sarah Kiarie, 'At crossroads: shareholder value, stakeholder value and enlightened shareholder value: Which road should the United Kingdom take?' (2006) ICCLR 329, 329.
[13] ibid 329.
[14] Milton Friedman, 'The Social Responsibility of Business Is to Increase Its Profits,' NY Times Mag, Sep 13 1970, 122.
[15] For agency theory see for example Eugene Fama and Michael Jensen, 'Separation of Ownership and Control' (1983) 26 Journal of Law and Economics 301.
[16] Philip Goldenberg, 'Shareholders v Stakeholders: The Bogus Argument' (1998) 19(2) Comp Law 34, 35.
[17] See in particular Lynn LoPucki, 'The Myth of the Residual owner: An Empirical Study' (2004) 82 Wash ULQ 1341 and Lynn Stout, 'Bad and Not-so-Bad Arguments for Shareholder Primacy' (2002) 75 Southern California L Rev 1189, 1192–1193.
[18] Michael Bradley et al, 'The Purposes and Accountability of the Corporation in Contemporary Society: Corporate Governance at a Crossroads' (1999) 62 LCP 9, 38.
[19] Andrew Keay, 'Enlightened shareholder value, the reform of the duties of company directors and the corporate objective' (2006) Lloyds Maritime and Commercial Law Quarterly 335, 338.

return for its owners.[20] Shareholder Primacy Theory allows the directors of the company to engage in a strategy of using profit maximisation as the primary objective of the company. Undertaking profit maximisation would act as an incentive for the company to create the goods and services that are demanded by consumers, thus also offering the possibility of third party benefits. If the director is expected to take other stakeholder considerations into consideration, by following Stakeholder Theory, then this will detract from the main task of profit maximisation and will have a detrimental effect on shareholder returns.[21]

As has already been noted Shareholder Primacy Theory is based on Agency Theory that forwards the premise that the directors as agents of the company are employed to manage the company's business for the owners (i.e. shareholders) who do not have either the time or the capacity to do so themselves. Keay argues that if there was no shareholder value principle then directors might engage in opportunistic behaviour he calls 'shirking.'[22] This will increase agency costs as the company would have to incur costs in monitoring the work of the directors[23] to ensure that they were running the company correctly for the owners. Under Shareholder Primacy there is a clear accountability structure; directors are accountable to the shareholders to promote the success as they see fit (generally profit maximisation). If stakeholder interests are to be taken into account when business decisions are being made then there may be a dilution in the ability to hold directors to account. If directors are accountable to a number of different stakeholders then this in itself may generate a series of conflicting interests, all of which must be taken into account for a director to conform to their legal duties. Under Shareholder Primacy this problem is alleviated with one single objective, that of profit maximisation, therefore if a director fails to satisfy this single criteria then there would be a clear and undisputable ground to hold them to account. If compared with Stakeholder Theory then it is clear how this can be directly beneficial for the company, under Stakeholder Theory the potential number of different stakeholders is infinite and their interests could theoretically also be infinite, it is unclear how a director would be expected to discriminate between legitimate competing interests. It has also been noted that an individual may be affected in different capacities as a stakeholder (i.e. they may be an employee and also be worried about an environmental impact etc).[24] When there are conflicting rights how can a director be sure as to

[20]Berle Jr, 'Corporate Powers as Powers in Trust' (n 8) 1049.
[21] Salacuse, 'Corporate Governance in the new century' (n 9) 75.
[22] By shirking it is understood that Keay means that the director will avoid or neglect his duties or responsibilities, Keay even goes as far as to suggest that it could be tantamount to an abuse of their position for their own financial gain.
[23] Keay, 'Enlightened shareholder value, the reform of the duties of company directors and the corporate objective' (n 19) 338.
[24] Kiarie (n 12) 338.

whose rights to give greater weight? If a director is able to cherry pick the interest they wish to promote then this may confer a wide discretion that may be liable to abuse. Kiarie also points out that stakeholder rights may be unenforceable as it would be very difficult to prove that their right should prevail in any given case.[25] Whilst this theory shows better control of the corporate body there have been visible limitations identified in the most recent financial crisis.[26]

Some academics contend that there may be private property issues when assessing in whose interests a company should be ran.[27] As the shares of a company are a private accumulation of wealth Shareholder Primacy Theory respects the idea of the shares being private property, as it allows the shareholders to determine how to employ their own wealth. Pettet argues that if an alternative view such as Stakeholder Theory is implemented instead then this would infringe on Article 1 of the European Convention of Human Rights which confers on every natural and legal person the right to the peaceful enjoyment of their possessions.[28] Whilst it is acknowledged that on face value this may be correct, on further reflection this may be a circumspect argument. Following the previous common law cases such as *Percival v Wright*[29] the director's duty is to the company as a whole and therefore the entire body of shareholders, and not necessarily one individual shareholder and their allotted share value. It would be very difficult, nay impossible, to argue that each individual shareholder would be able to enjoy peaceful enjoyment of their share of the company without any influence from any other shareholder of a company.

As an alternative Nexus of Contract Theory purports that a company is a collection of complex private agreements, with each interested party able to negotiate for their own best interests. Following on from this idea it has been argued that stakeholders, such as employees and creditors, are able to negotiate for their own in interests usually in the form of contractual agreements that they make with the company. In comparison shareholders are not able to negotiate individually for any specific terms to forward their own interests, as an alternative their only real way of retribution is the removal of directors at the AGM,[30] it has been argued therefore by some that this makes them vulnerable.[31] Whilst again an interesting point in theory the reality is often very different and it conceivably possible that this is simply a moot point as the reality in most cases is that the degree of

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[25] ibid 339.
[26] In particular see Chapter VII on remuneration of directors and shareholder activism
[27] Ben Pettet, *'Company Law'* (Longman Publishing London 2005) 63.
[28] ibid.
[29] *Percival v Wright* (n 1).
[30] Although this may have changed to a limited extent following the remuneration reforms outlined in chapter VII.
[31] Luigi Zingales, *Corporate Governance*, in *The New Palgrave Dictionary of Economics and Law* (MacMillan, Basingstoke, 1997) 501.

bargaining power a stakeholder has when negotiating with a company is very small and the balance of power is usually heavily weighted for the benefit of the company.[32] Whilst this may be the case, it is purported that the protection extended to stakeholders under the law is far greater than that given to shareholders. As an example the protection extended to employees under employment law is substantial and wide reaching,[33] therefore it is considered that there may be an argument that it would be fair and equitable for the shareholders to be protected and in the words of Fisher 'privileged by the company.'[34]

Through the vehicle of different artificial legal theories and running parallel to the previous discussions of theoretical advantages, there have also been a number of practical efficiency arguments that support the implementation of the concept of Shareholder Theory. Firstly as already noted, promoting the interests of shareholders through profit maximisation, creates the best environment for the creation of wealth and has been argued previously as the basis for economic growth.[35] If this is compared to Stakeholder Theory, under Stakeholder Theory it would be necessary to include other interests in a director's decision and as a result this would be at the detriment of profit maximisation. Secondly Shareholder Primacy Theory takes into consideration the expertise of directors. Directors are employed by a business association due to their experience and specialist knowledge in business matters, whether these skills are formed in general business experience or alternatively in the specific fields the company conducts business within. They are not on the other hand experts in the balancing of social interests, it would therefore be far more efficient for them to continue with the job they are skilled at, that being entrepreneurs and profit maximisers.[36]Expecting them to balance social interests against the interests of running the profitable company is arguably a misallocation of valuable resources which will create inefficiency in the company.

Whilst not taking social interests into consideration directly through the vehicle of shareholder value it is argued that in the pursuit of creating wealth businesses they may already satisfy their social objectives. Through the creation of wealth social objectives such as the provision of employment, and the creation of cheap consumer products[37], are achieved.[38] The external benefits that a

[32] Deryn Fisher, 'The enlightened shareholder- leaving stakeholders in the dark: will section 172(1) of the Companies Act 2006 make directors consider the impact of their decisions on third parties?' (2009) ICCLR 10, 11.
[33] Kiarie (n 12) 330.
[34] Fisher (n 32) 11.
[35] Friedman (n 14) 122-126.
[36] Kiarie (n 12) 332.
[37] The benefit of an increase in the number of consumer products is that new entrants into a market will increase competition and ultimately drive down overall prices for consumers.
[38] James Wallace, 'Value maximisation and stakeholder theory: Compatible or not?' (2003) 15(3) Journal of Applied Corporate Finance 1120, 1121.

company generated also extends to the wider community as can be identified in the redistribution of wealth through tax revenues from a profitable business.

Historically Shareholder Primacy Theory has been the cornerstone of UK Company Law, as the CLRSG noted the present law allows shareholders peace of mind as it ensures that 'directors are required to manage the business on their behalf...'[39] If a pluralistic approach were to be adopted then this would demand constraints on shareholder control, since stakeholders would require a binding interest in the decision making of the company. This would be a radical movement from the classical British corporate structure and would be likely to attract very little support from current corporate institutions and their members.

Whilst Shareholder Primacy Theory has been the cornerstone of UK Company Law, there have been attempts to introduce a Stakeholder Theory of company law by parliament within the UK. One such example can be identified under s.309 of the Companies Act 1985.

Under s.309 of the Companies Act 1985:

> '(1) The matters to which the director of a company are to have regard in the performance of their functions include the interests of the company's employees in general, as well as the interests of its members.
>
> (2) Accordingly, the duty imposed by this section on the directors is owed by them to the company (and the company alone) and is enforceable in the same way as any other fiduciary duty owed to a company by its directors.'

This clearly identifies a stakeholder body, namely employees, as those that are required to be considered when making executive decisions. This is very clearly a shift away from the classical definition of Shareholder Primary Theory towards that of Stakeholder Theory. This provision was met with significant criticism and will be analysed in greater depth later in the chapter, it is sufficient at this point to state that the measures that were intended to protect non-shareholder interests were seen to be inadequate.[40]

Whilst not meeting with great support within the UK and US, Stakeholder Theory is the leading corporate theory in Europe and Asia. Outside the Anglo-American markets Stakeholder Theory has gained much greater provenance, this can be observed through the use of two examples of

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[39] Company Law Review, *Modern Company Law for a Competitive Economy: The Strategic Framework* (n 6) para 5.1.5.
[40] Lee Roach, 'The paradox of the traditional justifications for exclusive shareholder governance protection: expanding the pluralist approach.' (2001) Comp Law 9.

Stakeholder Theory in place in two of the largest modern economies in the world, those of Germany and Japan. Continental Europe and Japan operate a different corporate structure to that of the classic Anglo-American Shareholder Primacy model. As an alternative the onus is on the protection of minority shareholders from expropriation by controlling parties.[41] As a result both of these countries are far more willing to invoke a corporate governance system expounding the principles of Stakeholder Theory. Germany has implemented Stakeholder Theory in the form of its codetermination system that allows employees a voice in management by allowing them to sit on the supervisory board.[42] Conversely Japan pursues Stakeholder Theory through its relational board structure.[43] In Japan the directors of corporations allow representatives from key stakeholder interest groups to sit on their boards. This visibility and position on the board is a function of the institutions relationship with those constituencies, and is completely unrelated to any shares that the stakeholders may hold in the firm. Whilst on the face of it, this may be beneficial as it offers stakeholders a voice; it has been argued that as leading flagships of Stakeholder Theory the two nations have suffered massive economic downturns in recent years. Of course this cannot be attributed solely to Stakeholder Theory as other Shareholder Primacy based nations have also suffered considerably in recent times. However there have been some that have commented that the implementation of Stakeholder Theory may have exacerbated the situation; so much so that Kiarie points out that Japan may even be moving away from a Stakeholder Theory of corporate governance and may be reverting back to the old system of shareholder Primacy.[44]

The CLRSG point out what they considered to be a major disadvantage with the Pluralist or Stakeholder approach. In essence it is based on the idea that a company should serve a wider range of interests. In doing so it is clear that the interests of a number of groups should be promoted without the interests of a single group (shareholders) prevailing. This, it has been documented, would in theory enable the directors to override shareholder's interests in circumstances where this would be in the interests of the company as widely defined by the stakeholders.[45]

Stakeholder Theory

Historically, the Anglo-American approach to corporate governance has considered Shareholder Primacy Theory to be paramount. More recently, and in particular in continental and Asian

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[41] Jeswald Salacuse, 'Corporate Governance in the new century.' (2004) 25(3) Company Lawyer 69, 71.
[42] Mark Roe, 'German codetermination and securities markets.' (1999) Columbia Journal of European Law 3, 9.
[43] Salacuse (n 43) 75.
[44] Kiarie (n 12) 339.
[45] Company Law Review, *Modern Company Law for a Competitive Economy: The Strategic Framework* (n 6) para 5.1.12-5.1.13.

jurisdictions, there has been the arrival of a more altruistic theory of the company known as the Stakeholder or Pluralist Theory. It derives from what has been defined as a communitarian idea of the company,[46] under which directors are compelled to run the company for the benefit of all potential stakeholders. Stakeholder Theory hinges on the fundamental ideal that the company itself should serve a broader social purpose other than simply benefiting the shareholders.[47] This modern theory forwards the preposition that humans live in a shared community with inherent benefits values and goals. Within this shared community a company is regarded as 'a community of interdependence, mutual trust and reciprocal benefit.'[48] There have been numerous definitions purported as to what constitutes a stakeholder. Freeman defines stakeholders as 'those groups without whose support the organisation would cease to exist',[49] and 'any group or individual who can affect or is affected by the achievement of the organisation's objectives.'[50] Lord Pattern notes, arguably somewhat cynically, that '[t]he very word stakeholders can very soon mutate into the whole population of the country.'[51] Wallace considers the definition to be extremely broad and to include all parties that can affect or be affected by a company's activities.[52] Whereas Sternberg takes a results based approach in defining who could be a stakeholder by 'recognising that [a wide variety of] people are more likely to take an interest in a process when they are materially involved [in the] outcome.'[53] Whatever the definition it is clear that Stakeholder Theory is far broader in its application than Shareholder Theory and is attempting to incorporate those persons that are directly or indirectly affected by the company.

An important point to note prior to its analysis is that Stakeholder Theory does not purport that the institution should sacrifice the interests of shareholders for those of stakeholders. Instead it considers that the interests of stakeholders should have equal weighting to those of the shareholders when directors are making business decisions. The interests of shareholders run parallel to those of the stakeholder because it is purported that, the shareholders as a body are only

[46] See for example David Millon, 'New Directions in Corporate Law: Communitarians, Contractarians and Crisis in Corporate Law' (1993) 50 Washington and Lee L Rev 1373.
[47] Andrew Keay, 'Enlightened shareholder value, the reform of the duties of company directors and the corporate objective.' (n 19) 340.
[48] David Millon, 'Communitarianism in Corporate Law: Foundations and Law Reform Strategies' in L Mitchell (ed), *Progressive Corporate Law* (Boulder, Colorado, Westview Press, 1995), 10.
[49] R. Edward Freeman, *Strategic Managment: A Stakeholder Approach* (Pitman, Boston 1984) 31.
[50] ibid 46.
[51] see Lord Patterns opinions HL Deb 11 Jan 2006 vol 667, col 215.
[52] James Wallace, 'Value maximisation and stakeholder theory: Compatible or not?' (2003) 15(3) Journal of Applied Corporate Finance 1120.
[53] Elaine Sternberg, *Corporate Governance: Accountability in the Marketplace* (Institute of Economic Affairs, London 2004) 127.

another subset of stakeholders. As another subset of stakeholders they are only another example, like employees and other stakeholders who have vested interests in the company.

There have been a number of strong arguments for the promotion of the Stakeholder Theory of regulation. These arguments have been born out of the apparent or perceived failings of Shareholder Primacy Theory. The first argument expounded by the stakeholder group is the use of Stakeholder Theory to combat what has been termed as short-termism that is inherent in Shareholder Theory. Under Shareholder Theory a director is expected to profit maximise, in doing so a director is only expected to look at short term gains and profitability. During the 1990's the promotion of profit maximisation, or share price maximisation, combined with short term incentives for directors was seen to be one of the underlying causes in a series of high profile company failures both in the UK and US. One example of this perceived failure was in the case of the collapse of the energy company Enron, the results of which led one academic to remark that '[t]he true lesson of Enron is that until the power of shareholder value norm is broken, effective reform of corporate governance will be on hold.'[54] The ability of maximising share price to the detriment of the long-term health of the company has been seen as one of the fundamental floors of Shareholder Primacy Theory, Stakeholder Theory combats this by taking into consideration what has been defined as a long term and altruistic approach to achieving success in a company. Stakeholder Theory is not driven singularly by an increase in share price, Stakeholder Theory is concerned with wider gains that benefit the wider community.

Combined with a more altruistic approach to achieving success of the company, Stakeholder Theory attempts to challenge one of the more fundamental arguments of promoting shareholder interests. Under Shareholder Theory it is perceived that the shareholder is best placed to bear the residual risk of the company, in that if the company fails then the group that will suffer the loss will ultimately be the shareholders as they will suffer a loss through a drop in the share price. As a direct result it is therefore purported that they warrant the sole consideration of the directors when making decisions that may affect the company. This argument is an interesting one, and yet may be a fallacy. It is argued that it is not only the shareholders that bear the residual risk of a company's activities, and combined with the risks of shareholders other groups such as employees may also bear inherent risks and are therefore entitled to governance protection. Whilst there is no denying if a company performs poorly and its share price falls then shareholders will incur loss, however just as importantly, if the same institution were to perform badly and ultimately downsize or fold then this can have massive adverse effects on stakeholders. To give just one example if an organisation were

[54] Suzanne Konzelmann & Simon Deakin, 'Learning from Enron' (2004) 12(2) Corporate Governance 134, 141.

to downsize due to poor performance then this would have an adverse effect on employees as they will lose their incomes through unemployment or redundancy. Alternatively it may have a knock on effect on secondary industries within the community e.g. shops, restaurants etc which have grown out of the demand of the institution. So whilst it is very difficult, nay impossible to argue that shareholders do not bare some residual risk, it is contended that it is being overly simplistic to argue that they are the only group of people to bear any risk of an institution failing.

Supporters of Shareholder Primacy Theory consider the interests of shareholders to be paramount, as they are in the best position to reprimand directors who do not take their interests into consideration. This is done through exclusion votes at the annual general meeting, however more recently a number of academics have challenged this long standing idea asserting that in reality, shareholders do not hold any real power over the company in monitoring the activities of the board. It has been prepositioned that shareholders often only control a very small amount of shares and with that voting rights, as a result the lack of individual control may make shareholders apathetic to the day to day running's of the company.[55] It is argued that although an interesting point it fails to take into account the fact that the nature of the ownership of companies has changed in recent years. The emergence of large scale institutional shareholders may result in renewed shareholder engagement in the running of a company. Even if there is not a resurgence in shareholder activism it must still be remembered that decisions on the day to day running of the company should ultimately fall on the head of the directors and not on shareholders, as that is the whole reason for their employment in the first place and not forgetting the large remuneration packages they command. Some have argued that the idea of Shareholder Primacy Theory militates against developing trust relationships with stakeholders. This line of reasoning follows that if stakeholders interests are not taken into account this may alienate them and thus will have an adverse effect on morale. The result of which may lead to discouraging stakeholders from making beneficial investments in the company which could result in long term benefits. As we have moved into the 21st Century and the information age, the role of the employee has become more important than ever. If stakeholder interests are considered in directors decisions then this may encourage high quality input which will ultimately benefit the company in the long run.[56]

More fundamental to alienating stakeholders; it is believed that there is a further major difficulty in justifying the idea of shareholders as owners of the company (Shareholder Ownership Theory) expounded by Shareholder Primacy. Under Shareholder Primacy the company is owned by the

[55] Kiarie (n 12) 339.
[56] ibid.

shareholders, and therefore it is expected that the company is to be ran for their interests as owners. This idea is a questionable one, because when a company becomes incorporated it attains its own separate legal personality. As Lord Halsbury L.C. notes '[i]t seems to me impossible to dispute that once the company is legally incorporated it must be treated like any other independent person with its rights and liabilities appropriate to itself.'[57] It therefore follows that any persons who are either natural or created through legal means are incapable of being owned. A point emphasised in *Bligh v Brent*[58] as the court held that shareholders in this case had no direct interest in any property owned by the company, only the right to a dividend.[59] Its effect being that the share had become an item of property distinct from the property of the corporation.[60]

The theory of the company as a nexus of private contracts, as expounded by Shareholder Primacy, has been questioned more recently as being a fallacy. As an alternative academics have offered the Organic Model Theory of company law. This offers a substitute hypothesis that the company as a whole should not be viewed as property of any one person or group of people (i.e. shareholders). Instead it should be viewed as a separate social institution with an independent identity. Many academics have expounded the desire and expectation that companies should be socially responsible and public companies in particular have a much wider social footprint than can be described by a series of contracts.[61] If this is to be believed it is postulated that the only theory of company law that can fully take into account the wider social duties of the company is Stakeholder Theory.

Not all commentators adhere to the Agency Theory of the company, that being directors are agents of the company and as a result should run the company for the benefit for the owners (namely the shareholders). Goldenberg for example believes it to be a misconception;[62] it has been noted that the obligation on directors may be to shareholders; but not solely to current shareholders but future shareholders also. Therefore theoretically the needs of the stakeholders could be considered if they are in line with the desire of a company to maximise value on a long term basis.[63] On first reading this may be an argument that Agency Theory may not preclude the adoption of a more pluralistic approach.[64] However it is disputed that this may be a misapprehension, it is clear that if one is to

[57] *Salomon v Salomon & Co. Ltd* [1897] AC 2, 30-31.
[58] (1837) 2 Y & C Ex 268.
[59] Lee Roach, 'The paradox of the traditional justifications for exclusive shareholder governance protection: expanding the pluralist approach.' (2001) Comp Law 9, 10.
[60] Paul Ireland, 'Company Law and the Myth of Shareholder Ownership' (1999) 62 MLR 32, 41.
[61] See for example Dean, 'Stakeholding and Company Law' (2001) 22 Comp Law 66, 67 Kiarie (n 12) 329, 330 and Fisher (n 32) 12.
[62] Goldenberg (n 16) 36.
[63] ibid 37.
[64] Fisher (n 32) 11.

follow this line of argument the obligation on directors is still for the benefit of shareholders, and the only time a stakeholder's interest is considered is when they are running congruent with shareholders' interests. As a result it is easy to make the transition to argue that as a self-standing interest for a stakeholder it is largely unenforceable. It is only in the overlapping of the stakeholders' interests with an alternative shareholder interest that may give it grounds for reproach. Keay believes that without the Shareholder Primacy model of governance then directors may shirk their responsibilities and thus induce agency costs for monitoring.[65] It is purported it may not be the case that shareholder value resolves this. It was noted over 70 years ago by Berle and Means,[66] that the separation of ownership and control that comes about by the shareholder model of the company allows the management a greater amount of freedom on the part of the directors to pursue goals at variance with the maximisation of shareholder returns. It is argued that it is not the idea of profit maximisation that would resolve the problems of shirking but instead clear outlines of the role and duties. This can easily be achieved under Pluralist Theory with a correctly drafted contract of employment.

Finally it is possible to argue that Shareholder Primacy Theory is now an out-dated concept. It is a product of 19th Century company law theory and as a result reflects the views and ideas of that era. More recently there has been a trend in both academia and the private sector to adopt a more altruistic approach to the running of a company; this has developed into the idea of Corporate Social Responsibility (CSR). CSR is the recognition that companies are vehicles of globalisation[67] that allow for economic growth. However in doing so often this may result in environmental degradation, human rights abuses or other unethical behaviour. CSR attempts to curb this corporate misbehaviour by recognising that companies are socially responsible for the peripheral impact of their commercial behaviour. Pluralist Theory would allow for the consideration of such ideas when directors are making decisions on behalf of the company. CSR may not only be politically beneficial to the company but it may also offer some financial benefits. If a company adopts more socially responsible practices it may reduce costs by reducing wastage and increased overheads in maintaining a good reputation.[68] As already mentioned through CSR there has been a growing trend in the imposition of both social and environmental obligations on modern companies and modern company law. Increasingly it has been argued 'that free enterprise cannot be justified because it is

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[65] Keay (n 19).
[66] Adolf Berle & Gardiner Means, *The modern corporation and private property* (Macmillan, New York 1935).
[67] Adefolake Adeyeye, 'The limitations of corporate governance in the CSR agenda' (2010) 31(4) Comp Law 114.
[68] Kiarie (n 12) 334.

good for business. It can be justified only because it is good for society.'[69] These theories have been implemented elsewhere in voluntary codes of conduct, one of the best examples of this can be observed under the Equator Principles. Under the Equator Principles, financial institutions sign and commit to an agreement to not providing loans to projects where the borrower will not, or is unable to comply with, their respective social and environmental policies and procedures.[70] At present 72 financial institutions in 27 countries adopt the Equator Principles including some of the largest financial institutions in the world. E.g. Barclays P.L.C., Credit Suisse Group, HSBC Holdings Plc, JP Morgan Chase Co, Citigroup Inc. and Royal Bank of Scotland.[71]

Finding the Middle Ground: Enlightened Shareholder Value

Historically the UK has based Director's Duties on common law rules and equitable principles, including a provision to act in the 'best interests of the company.'[72] This has been interpreted as the best interest of present and future shareholders, clearly adopting the Shareholder Primacy model. Prior to the creation of the 2006 Act the Company Law Review Steering Group (CLRSG), in undertaking their review of director's duties had the option of recommending the implementation of either of the two theories above. As is clear to see there are positive and negative aspects to both approaches, and these were discussed and reviewed extensively by the CLRSG. The CLRSG discussed at length whether the duty of directors to act in the interests of the company

> '[S]hould be interpreted as meaning simply that they should act in the interests of the shareholders, or whether they should also take account of other interests, such as those of employees, creditors, customers, the environment, and the wider community.'[73]

There were strong arguments put forward for the adoption of the pluralist model and the inclusion of wider interests as separate independent purposes.[74] Ultimately however, the CLRSG did not recommend the pluralist approach, coming to the conclusion that the obligations of each director are fundamentally for its members collectively 'that is, it sets as the basic goal for directors the success of the company in the collective best interests of shareholders'.[75] Instead the CLRSG recommended a completely new theory known as Enlightened Shareholder Value Theory (ESV). ESV like Shareholder Primacy Theory is based on the idea that maximising shareholder value is the best

[69] See the comments of Lord Haskel HL Deb 11 Jan 2006 vol 667 col 230.
[70]For an explanation see the following website: http://equator-principles.com/index.php/about-ep/about
[71] http://www.equator –principles.com/index.php/about-ep/about/16-members-and-reporting/13.
[72] *Percival v Wright* (n 1).
[73] Company Law Review, *Modern Company law for a Competitive Economy* (n 3) para 3.7.
[74] Company Law Review, *Strategic Framework* (n 6) para 5.1.12.
[75] Company Law Review, *Modern Company Law for a Competitive Economy Final Report* (n 5) para 3.8.

means of securing overall prosperity.[76] However, unlike Shareholder Primacy Theory, this is subject to developing relationships of trust with stakeholders. The CLRSG argued that this was the best way to ensure sustainability and secure overall prosperity and welfare.[77] Under ESV the basic goal for directors is still to promote the success of the company for the benefit of its members as a whole; but that, to reach this goal, directors would need to take a properly balanced view of the implications of decisions over time, and foster effective relationships with employees, customers and suppliers, and in the community more widely.[78]

ESV takes a long term approach to corporate governance when compared to Shareholder Primacy, and it is believed is an attempt to reach a middle ground between the two competing theories of governance. It is intended to offer stakeholders a voice in the decisions of a company whilst maintaining the Anglo-American tradition of maximising shareholder value. It is postulated that this would result in the framing of director's duties in a way that is far more inclusive. Whilst the adoption of a pluralist model would also satisfy the criteria of both long termism and greater stakeholder interaction, the CLRSG found that there were strong philosophical arguments for the adoption of ESV over Pluralist Theory. In particular it argued that the use of ESV would limit directors' discretionary power, thus reducing the possibility of abuse.[79] Further, it considered the use of Stakeholder Theory to be unnecessary, as conceptually, the same result could be achieved by ensuring maximum synergy between shareholders' and wider interests through ESV. Finally the CLRSG were slightly wary to the fact that if pluralism was adopted over ESV this could enable directors to frustrate takeover bids against the wishes of shareholders where a wider public interest requires it.[80]

The Government was keen to support the ideas of the CLRSG. Lord Goldsmith emphasised this support:

> 'The Company Law review considered and consulted on two main options. The first was 'enlightened shareholder value', under which a director must first act in the way that he or she considers, in good faith, would be most likely to promote the success of the company for its members... The Government agrees this is the right approach. It resolves any confusion in the mind of directors as to what the interests of the company are, and prevents any

[76] Company Law Review, *Strategic Framework* (n 6) para 5.1.11.
[77] ibid para 5.1.17.
[78] Department for Trade and Industry, *Company Law Reform* (White Paper, Cm 6456, 2005) 20.
[79] Company Law Review, *Modern Company Law for a Competitive Economy Final Report* (n 5) para 3.24.
[80] ibid.

inclination to identify those interests with their own. It also prevents confusion between the interests of those who depend on the company and those of the members.'[81]

This was reemphasised by, the then secretary of state for trade and industry, Alastair Darling, who also pointed out the benefits of adopting the ESV model.

> 'For the first time the Bill includes a statutory statement of directors' general duties. It provides a code of conduct that sets out how directors are expected to behave. That enshrines in statute what the law review called 'enlightened shareholder value.' It recognises that directors will be more likely to achieve long term sustainable success for the benefit of their shareholders if their companies pay attention to the wider range of matters... Directors will be required to promote the success of the company in the collective best interest of the shareholders, but in doing so they will have to have regard to a wider range of factors, including the interests of employees and the environment.'[82]

A series of white papers[83] and the Company Law Reform Bill 2005 ultimately led to the codification of Enlightened Shareholder Value under s.172 of the Companies Act 2006.[84] S.172 safeguards the principle of Enlightened Shareholder Value, by framing it in a statutory duty to promote the success of the company for the benefit of its members as a whole. The success of the company will only be achieved by taking into consideration both the short term and long term interests of the company. This includes wider interests such as those of employees, customers, suppliers and the general effects on the environment. In their deliberations it was clear that government did not consider the shift to ESV to be a radical one that required any fundamental change to existing company law.[85] In fact, it was clear from deliberations that they considered there to be no actual revision of the law; but instead simply the updating and codification of previously held principles.[86] Their reasoning behind this was quite interesting, it was the belief of government that there was already evidence of the principle of ESV being employed in UK statutory law. This belief was based on the inclusion of s.309 of the Companies Act 1985. Previously considered when analysing Stakeholder Theory, s.309 (1) states that when directors of a company are performing the functions of their role the matters to which they are to have regard is to include the interests of the company's employees. Once again

[81] Lord Goldsmith, HL Deb 6 February 2006 vol 678 col GC255.
[82] Alistair Darling, HC Deb 6 June 2006 vol 447 col 125.
[83] Department for Trade and Industry, *Modernising Company Law* (White Paper , Cm 5553, 2002) and Department for Trade and Industry, *Company Law Reform* (White Paper, Cm 6456, 2005).
[84] The details of s.172 will be discussed at length later in the chapter.
[85] House of Commons Trade and Industry Committee, *The White Paper on Modernising Company* (HC 2002-03, 439).
[86] ibid para 14.

this has already been shown to be an example of Pluralist Theory of governance. However it would appear that s.309 would fit better within ESV Theory, as the provision does go on to note in s.309(2) that the duties are owed directly to the company itself (and only the company). As a result the employees do not have any direct right to lodge a complaint if they consider that their interests have not been taken into account.

The concept of Enlightened Shareholder Value was introduced and advocated by the CLRSG in the first instance as a means to improve the current Anglo-American Shareholder Primacy Theory. It was the intention of the CLRSG, and subsequently government, to encourage directors to take a long term and wider reaching approach to company interests whilst at the same time ensuring that the company in the first case is run for the benefit of its members as a whole. Before the chapter is able to explore the ability of s.172 to hold persons to account it is necessary to discuss the common law principles that were in place prior to the enactment of the Companies Act 2006 and the previous duty to act *bona fide* in the best interests of the company.

Common Law: Duty to Act *Bona Fide* in the Best Interests of the Company

At first glance the s.172 duty to promote the success of the company has no clear predecessor in either case law or earlier legislation. As Lord Freeman points out:

> 'Clause 156 [became s.172] for example, which concerns the duty to promote the success of the company, introduces in subsection (1) the entirely new concept of promoting the success of the company for the benefit of its members as a whole.'[87]

Its enactment into the Companies Act 2006 was the first time the theory was given a legal foundation, however it is hardly controversial to suggest that the duty to promote the success of the company may have derived from the earlier common law duty to act *bona fide* in the best interests of the company.

The duty to act in the best interests of the company is a long standing fiduciary duty a director owes to the company. As a fiduciary of a company the director is expected to act to promote the interests of the company and not to act for any collateral purpose. In *Re Smith and Fawcett Ltd*[88] Lord Greene MR stated that directors were required to act 'bona fide in what they consider - not what a court may consider - is in the interests of the company, and not for any collateral purpose.'[89] Similarly in

[87] HL Deb 6 Feb 2006 vol 678, col GC 239.
[88] [1942] Ch 304.
[89] ibid at 306.

Dorchester Finance v Stebbing[90] Foster J stated that 'a director must exercise in him as such, honestly, in good faith and in the interests of the company...'[91]

Examples of what would be considered to be acting *bona fide* in the best interests of the company are numerous; in *Punt v Symons*[92] Byrne J held that the issuing of shares by a director of a company with the intention to frustrate a possible takeover was not *bona fide* 'for the general advantage of the company.' Further examples include incidents whereby directors had sought to use their position to obstruct potential takeovers, for example in *Hogg v Cramphorn*[93] and *Howard Smith v Ampol*,[94] in both cases it was held that directors must use their powers for the purposes for which they were intended and in doing so must act in the best interests of the company and not for some collateral purpose,[95] namely in placing their own interests above those of the company.

Similarities can be observed between the earlier fiduciary provision and those set out in s.172 CA 2006. The focus of the duty is to ensure that the director who is placed in a fiduciary position does not abuse that position. It is a clear attempt to resolve what has already been discussed as the agency problem. To many the duty to act in the best interests of the company was, prior to the enactment of s.172 of the Companies Act 2006, perhaps the most essential duty expected of a director in his role in the company:

> '...the fundamental duty to which a director is subject, that is the duty to act in what he in good faith considers to be the best interests of his company... The duty is expressed in these very general terms, but that is one of its strengths: it focuses on principle not on the particular words which judges or the legislature have used in any particular case or context. It is dynamic and capable of application in cases where it has not previously been applied but the principle or rationale of the rule applies. It reflects the flexible quality of the doctrines of equity.'[96]

Some academics have argued that s.172 simply affirms *Percival v Wright*[97] in statutory form[98] and it has already been observed that the latest case law[99] may support this theory, Lord Glennie for example pointing out that '[t]here was no equivalent [to s.172] in the earlier Companies Acts, but

[90] [1989] BCLC 498.
[91] ibid.
[92] [1903] 2 Ch 506.
[93] [1967] Ch 254.
[94] [1974] AC 821.
[95] Stephen Girvin, *Charlesworth's Company Law* (18th ed, Sweet & Maxwell, 2010).
[96] *Item Software (UK) Ltd v Fassihi* [2004] EWCA Civ 1244 see judgment of Arden LJ.
[97] *Percival v Wright* (n 1).
[98] Nicholas Bourne, *Bourne on Company Law* (4th ed, Routledge Cavendish, 2008).
[99] Andrew Keay, 'Office-holders and the duty of directors to promote the success of the company.' (2010) Insolv Int 129.

these sections [s.171 and s.172] appear to little more than set out the pre-existing law on the subject.'[100] However it is contended that whilst at face value the two provisions are similar there are a number of very clear, and deliberate, differences between 'promoting the success of the company' and acting in the 'best interests of the company.' The most obvious difference, and one that this chapter will return to in due course, is the lack of an objective standard of care. To give a brief explanation as this issue will be considered in more depth later both provisions hinge on a subjective standard of care, for example, in the legislation a director must act in the way he considers, in good faith, would be most likely to promote the success of the company. Therefore by acting in the way he considers this is clearly a subjective test. Similarly in *Regentcrest Plc v Cohen*[101] Parker J remarked that the correct question that needed to be asked is 'whether the director honestly believed that his act or omission was in the interests of the company[102].' This was affirmed by *Extrasure Travel Insurance Ltd v Scattergood*[103] where the courts held that an act done in the unreasonable belief that it was in the interests of the company is not in breach of fiduciary duty, provided the belief was held honestly. So the standard test for both is subjective, however it is argued that this standard subjective test was supplemented by an objective test in the previous common law duty, whilst Parliament categorically refused to draft the 2006 Act in those terms.

Whatever a person's opinion of whether the two duties are exactly the same or not, it is clear that s.172 does have a clear historical development from the common law, and in particular the duty to act *bona fide* in the best interests of the company.

The Development of s.172 Companies Act 2006

It has been shown that the CLRSG recommendations of Enlightened Shareholder Value were implemented by s.172 of the Companies Act 2006. It is the intention of the next part of the chapter to explore the history of the development of the legislation with the intention of attempting to analyse the intention of Parliament when enacting the provision.

[100] *West Coast Capital (LIOS) Ltd, Petitioner* [2008] CSOH 72 para 21; *Southern Counties Fresh Foods Ltd, Re Cobden Investments Ltd v RWM Langport Ltd* [2008] EWHC 2810 (Ch).
[101] [2001] 2 BCLC 80.
[102] ibid 105.
[103] [2003] 1 BCLC 598 para 90-97.

Modernising Company Law White Paper 2002: the Failed Objective Minimum Standard

The literature on the legislative reformation began with an initial white paper in 2002,[104] in this paper Government chose to adopt the recommendations of the CLRSG verbatim.[105] Clause 19 of the 2002 white paper gave effect to Schedule 2. It was the intention of schedule 2 to codify for the first time the ideas forwarded by the CLRSG, and more directly intended to create a duty to promote the success of the company. The new duty to promote the success of the company was intended to strictly follow the governance ideals of ESV. Paragraph 2 of the Schedule stated that:

> 2. A director of a company must in any given case
>
> a) Act in the way he decides, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole (excluding anything which would breach his duty under paragraph 1 or 5); and
> b) In deciding what would be most likely to promote the success, take account in good faith of all the material factors that it is practicable in the circumstances for him to identify.

The paper then went on to consider what would be deemed to be the material factors:

> (1) In this paragraph, 'the material factors' means-
>   a) The likely consequences (short and long term) of the actions open to the directors, so far as a person of care and skill would consider them relevant; and
>   b) All such other factors as a person of care and skill would consider relevant, including such of the matters in Note (2) as he would consider so.
>
> (2) Those matters are-
>   a) The company's need to foster its business relationships, including those with its employees and suppliers and the customers for its products and services;
>   b) Its need to have regards to the impact of its operations on the communities affected and on the environment;
>   c) Its need to maintain a reputation for high standards of business conduct;
>   d) Its need to achieve outcomes that are fair as between its members.

As can be observed the underlying theory of ESV runs to the very nature of the clause. Under cl.2 (b) a director would be expected to take into consideration a number of different matters. It is clear

[104] Department for Trade and Industry, *Modernising Company Law* (White Paper, Cm 5553, 2002).
[105] ibid 64 para 34.

that under the white paper this would include a number of separate stakeholder interests. One may argue that this is in line with a pluralist approach; however a director need only take account of stakeholder interests, and most importantly, must not forward those interests if they would be in conflict with shareholder interests. Ensuring that shareholder interests are held in greater regard than stakeholder interests clearly is in conflict with stakeholder theory, thereby reinforcing the CLRSG in their attempt to introduce ESV into UK corporate governance by not creating a standalone duty for directors to consider stakeholder interests.

This is hardly surprising given the trend in corporate governance at the time, however what is perhaps more surprising, and arguably more important to note, is that under cl.2 (b) of Sch.2 there was an attempt to introduce an objective minimum standard into the legislation. When a director decides what would most likely promote the success of the company he must take into consideration all the 'material factors', those being 'the likely consequences (short and long term) of the actions open to the directors, so far as a person of care and skill would consider them relevant'. Using the standard of a person of care and skill is a clear attempt to introduce an objective minimum standard similar to what has been developed in the common law,[106] and now given a statutory footing under s.174 of the Companies Act 2006. This is extremely important for if it is contrasted with the previous common law duty to promote the best interests of the company we can see that there is a direct conflict. As was briefly noted under the previous common law principles the general stance the courts took was a subjective one:

> 'The question is not whether, viewed objectively by the court, the particular act or omission which is challenged was in fact in the interests of the company; still less is the question whether the court, had it been in the position of the director at the relevant time, might have acted differently. Rather, the question is whether the director honestly believed that his act or omission was in the interests of the company.'[107]

The introduction of an objective minimum standard would arguably have been a significant step forward in accountability and as such will form the basis of a theory of minimum standards that will be developed further in the chapter.

Company Law Reform White Paper 2005

The creation of an objective minimum would have followed the continuing trend in corporate governance at the time of increased accountability. Unfortunately this appeared to be in direct

[106] See Chapter IV.
[107] *Regentcrest Plc v Cohen* (n100) judgment of Parker J at 105.

confliction with the governments' initial ideas for the new act. The DTI stated quite categorically in the same white paper that although it did intend to implement the CLRSG recommendations of codifying the duties of directors it intended to do so 'without changing the essential nature of the duties.'[108] It is purported therefore that the DTI may have misunderstood the impact the provision may have had on the law if it was implemented in its form at that point. This confusion was partly resolved by the publication of a further governmental white paper in 2005.[109] The corresponding provisions in the 2005 white paper were found under cl.B3:

> (1) As director of a company you must act in the way you consider, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole.
>
> (2) Where or to the extent that the company is established for purposes other than the benefit of its members, your duty is to act in the way you consider, in good faith, would be most likely to achieve those purposes.
>
> (3) In fulfilling the duty imposed by this section you must take account (where relevant and so far as reasonably practicable) of—
>
> (a)The likely consequences of any decision in both the long and short term
> (b) Any need of the company-
> (i) To have regard to the interests of its employees
> (ii) To foster its business relationships with suppliers, customers and others
> (iii) To consider the impact of its operations on the community and the environment, and
> (iv) To maintain a reputation for high standards of business conduct.
>
> (c) The need to act fairly as between the members of the company who have different interests.
>
> (4) The duty imposed by this section has effect subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company.

Once again this white paper expounded the virtues of adopting the ESV approach, noting it was for the directors themselves to decide what they would consider in good faith is most likely to promote

[108] Department for Trade and Industry, *Modernising Company Law* (White Paper, Cm 5553, 2002) 3.4.
[109] Department for Trade and Industry, *Company Law Reform* (White Paper, Cm 6456, 2005).

the success of the company for the benefit of the members as a whole.[110] The terminology and language that is used in clause B3 shows a clear intention by government to implement the theoretical ideals proposed by ESV. Directors had to consider the need to act fairly as between the members of the company who have different interests. Long-term performance of the company has to be considered by directors, and an array of interests of those who might be categorised loosely as stakeholders.[111] There was a clear intention by government under the white paper to implement ESV, but what is perhaps more interesting to note is not what appears in the clause; but instead what has been omitted. The objective minimum standard found in the 2002 White Paper was overlooked in Cl. B3 of the 2005 White Paper and also the Company Law Reform Bill 2005. Both deleted any reference to the test adopting a strict subjective test instead.

During the same time there were also movements in other common law jurisdictions towards the Enlightened Shareholder Value model, this was expounded by Major and Dechamps JJ. In the Supreme Court of Canada case of *Peoples Department Stores v. Wise*:[112]

> 'We accept as an accurate statement of law that in determining whether they are acting with a view to the best interests of the corporation it may be legitimate, given all the circumstances of a given case, for the board of directors to consider, inter alia, the interests of the shareholders, employees, suppliers, creditors, consumers, governments and the environment... At all times, directors and officers owe their fiduciary duties to the corporation. The interests of the corporation are not to be confused.'[113]

Company Law Reform Bill 2005

The culmination of both of the white papers and arguably influenced by *Peoples Department Stores v. Wise* was the introduction by government of a new Company Law Reform Bill. The Bill was introduced into the House of Lords on November 1st 2005. What was previously clause B3 in the 2005 white paper had now become cl. 156:

> Cl. 156 Duty to promote the success of the company

[110] ibid Explanatory notes para B17.
[111] Andrew Keay, 'Section 172(1) of the Companies Act 2006: an interpretation and assessment.' (2007) 28(4) Comp Law 106, 107.
[112] [2004] 3 SCR 461.
[113] ibid para 42-43 as reported in John Lowry 'The duty of loyalty of company directors: bridging the accountability gap through efficient disclosure' (2009) CLJ 608, 616.

(1) A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole.

(2) Where or to the extent that the purposes of the company consist of or include purposes other than the benefit of its members, his duty is to act in the way he considers, in good faith, would be most likely to achieve those purposes.

(3) In fulfilling the duty imposed by this section a director must (so far as reasonably practicable) have regard to—

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

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

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

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

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

(f) the need to act fairly as between members of the company.

(4) The duty imposed by this section has effect subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company.

As was previously noted the objective minimum standard that was found in the 2002 White Paper has once again been excluded from the Company Law Reform Bill 2005. This is surprising given the trend of financial regulation at that time, however what is even more surprising is that it appears government may have gotten slightly confused in their understanding of the subjective nature of the provision they had set out. In the Guidance on Key Clauses to the Company Law Reform Bill the DTI stated quite clearly that in having regard to the factors in cl.156 directors must comply with their duty to exercise reasonable skill, care and diligence.[114] Therefore it is hard to justify the reasoning of the legislature that chooses to remove the objective minimum standard and yet directs the reader to then consider the same objective minimum in the guidance to the clause.

[114] Department for Trade and Industry, *Guidance on Key Clauses to the Company Law Reform Bill* (8 November 2005) para 63.

This provision was debated hotly in both houses but with very little change in the enacted legislation. There was direct discussion as to the viability of the introduction of a Pluralistic Theory, however ultimately it was not considered to be the best approach.

> 'There are three main reasons why we do not believe it would be the best way forward: a pluralist approach would muddy the waters unhelpfully; directors would lack clarity about what they were meant to be doing; and it would, in practice, be more difficult for anyone to hold directors to account. Secondly, company law reform is not a suitable vehicle for our wider agenda on corporate social responsibility. Issues such as environmental protection and health and safety are very important, but they should not be addressed through company law reform. The best way to promote responsible business behaviour is to show how such behaviour leads to business success.'[115]

After one of the longest consultation periods in parliamentary history, the cumulative total of all changes was a single minor change in the order of the terms and the omission of the words 'so far as is reasonably practicable'.

Companies Act 2006 s.172 the Duty to Promote the Success of the Company

It has been established that there was a long standing desire to enact the concept of ESV in statutory form, and this ultimately culminated in the adoption of s.172 of the Companies Act 2006. The next part of the chapter intends to analyse the provisions within s.172 in greater depth. It is purported that s.172 of the Companies Act 2006 may have failed to achieve its objectives. The Company Law Reform Bill had four general key objectives: enhancing shareholder engagement and a long-term investment culture; ensuring better regulation and a "think small first" approach; making it easier to set up and run a company; and providing flexibility for the future.[116] It is the first objective of enhancing shareholder engagement and a long-term investment culture that is relevant for the current discussion.

So has the legislation achieved its objectives? Following the most recent financial crisis it would appear not, there have been a number of clear criticisms of the ability of current corporate governance provisions to hold directors to account. There have been a number of different institutions that have heaped criticism on the ability of corporate governance provisions to hold directors accountable. The UK Treasury Select Committee voiced their criticism of the accountability

[115] Lord Sainsbury of Turville HL Deb 11 Jan 2006 vol 667 col 244.
[116] ibid col 182.

of the current provisions in its report on the 2007-2009 financial crises. [117] In their analysis of the crisis the Select Committee noted that there were 'important...corporate governance failures in the banking sector.'[118] The Committee focused their analysis by questioning of the viability of s.172 and in particular whether the s.172 duty to promote the success of the company succeeded in ensuring that directors did consider the 'likely consequences of any decision in the long term.'[119] Ultimately the Committee concluded that s.172 did not succeed in promoting long term shareholder engagement, and that there were clear corporate governance failings. The Committee called for the boards of the financial institutions to take responsibility for failing in their duty to establish a culture within their institutions which supported both innovation and risk management.[120] Reinforcing the views of the Treasury Select Committee the OECD Steering Group on Corporate Governance argued that weak governance across all of the leading financial institutions was a major cause of the financial crisis.[121] The Turner Review was also quick to criticise governance and risk management decisions taken by the directors of institutions generally however refused to make any concrete criticisms or accusations preferring instead to wait for the publication of the Walker Review on Corporate Governance.[122]

The Walker Review on Corporate Governance was released in 2009 and was particularly critical of the current structure of corporate governance. The review considered there to be weaknesses in a number of areas, including (but not limited to) risk management, board quality and practice, control of remuneration, and in the exercise of ownership rights.[123] It noted that there were deficiencies in the division between external regulation and monitoring by regulators and shareholders, and internal monitoring by directors, the result of which being that taxpayers and employees (stakeholders) ended up paying for the cost of the systemic failures arising from inadequate performance by directors. In finding these deliberations the Review established that the duty to promote the success of the company failed in ensuring directors take a balanced view of long term implications of decisions.[124] The review was extremely critical overall and whilst s.172 was singled

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[117] House of Commons Treasury Committee, *Banking Crisis: Reforming Corporate Governance and Pay in the City* (London Stationary Office, HC 2008-09, HC 519).
[118] ibid.
[119] ibid EV 286.
[120] ibid para 134.
[121] Grant Kirkpatrick, 'The Corporate Governance Lessons from the Financial Crisis.' (2009) 96 Financial Market Trends 1 for the OECD accessed at http://www.oecd.org/home/0,2987,en_2649_201185_1_1_1_1_1,00.html [accessed on 16 September 2014].
[122] Turner Review, *A Regulatory Response to the Global Banking Crisis* (FSA Discussion Paper 09/2, 2009) Chapter 2 para 2.8.
[123] Walker Review, *A review of corporate governance in UK banks and other financial industry entities: Final recommendations* (26 November 2009) 8.
[124] ibid para 2.3.

out for criticism it was not the only provision to withstand pressure as the report considered there were a number of other major failings in the legislation.[125]

One interesting point that the review did note, was that it did not consider that the improving of corporate governance provisions would have any lasting effect in the prevention of future financial crises.[126] The review whilst pointing out that there has been clear failings in governance, came to the conclusion that that there would be 'no advantage and considerable potentially serious negative consequences from any broadening in the statutory specification of the responsibilities of directors on BOFI boards.'[127] More specifically the review did not see any reason to alter the provisions in s.172, for example, pointing out that they considered the inherent duty to consider decisions for the long term was fine and that there was 'no practical way... to greater specificity in statute than is currently provided in s.172.'[128] Instead the Walker Review perceived the answer to lie instead in guidance and principles found in the Combined Code without need for new primary legislation. Believing that new legislation would be unlikely to improve or 'contribute positively' to the strengthening of good corporate governance.[129] It is argued that this is quite narrow sighted, soft law alone has already been proven to be unsuccessful in achieving the objectives of good governance[130] and it is argued and that there are some very clear and deliberate steps that may be taken by the amendment of primary legislation to resolve some of the perceived problems in corporate governance.

S.172 Duty to Promote the Success of the Company

Following these criticisms it is necessary to examine s.172 and the inherent perceived problem in more detail. S.172 of the Companies Act 2006 came into force on October 1st 2007 and is defined as follows:

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

[125] ibid para 2.
[126] ibid para 1.18.
[127] ibid para 2.10.
[128] ibid para 2.7.
[129] ibid para 2.29.
[130] See Chapter IV on s.174.

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

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

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

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

(f) the need to act fairly as between members of the company.

(2) Where or to the extent that the purposes of the company consist of or include purposes other than the benefit of its members, subsection (1) has effect as if the reference to promoting the success of the company for the benefit of its members were to achieving those purposes.

(3) The duty imposed by this section has effect subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company.

As has already been established, s.172 sought to encourage companies to behave in a more socially responsible way. The provision attempts to provide regulatory protection for social and environmental interests, however this must be qualified by ensuring that these interests do not conflict with the main interest of promoting the success of the company for its members as a whole. The legislature made clear that, under s.172 stakeholders do not rank equal to shareholders nor do they have an independent priority in directors' decision making. Instead the consideration of their interests is only extended to where this promotes the success of the company for the benefit of its members.[131]There have been clear failings in corporate governance, and they can be traced back to the provisions directly, the next part of the chapter will seek to address a number of fundamental problems with s.172.

Can Success be Defined?

The fundamental duty of a director is to promote the success of the company, and whilst this seems straight forward it is unclear what is actually meant by the term 'success.' A highly controversial point when first brought before parliament, Government perceived that what would constitute

[131] John Lowry (n 112) 616.

success would be entirely for the director to decide under their own good faith judgment.[132] This alone would appear to leave a wide opportunity of discretion on behalf of the directors; however Lord Goldsmith sought to clarify the position, upon analysis of his clarification it is purported that he may have attempted to attach certain limitations on the perceived directors' discretion:

> 'Success means what the members collectively want the company to achieve. For a commercial company, success will usually mean long-term increase in value. For certain companies, such as charities and community interest companies, it will mean the attainment of the objectives for which the company has been established....I have indicated that usually for a company it will be a long-term increase in value, but I can imagine commercial companies that would have a different objective as to their success.'[133]

For most companies, as was acknowledged in the Parliamentary debates, success would be defined in terms of long-term increase in shareholder value reflecting the economic success of the company.[134]There was substantial criticism heaped towards the concept of success both in academia and within the legal profession.[135] The main direction of the criticism was framed under the ideal that if the concept of success was implemented then the result of that implementation would be to replace the former duty to act in the company's best interests. Whilst interesting conceptually many criticised the replacement of a well-established fiduciary with an extensive body of case law. The Law Society believed that what constituted success was far from clear, instead they argued that the concept of 'in the interests of the company' was far clearer as it was supported by an existing body of case law.[136] There were a number of attempts in the discussions of the legislation in parliament, to re-enact and restore the original concept of 'best interest',[137] however ultimately they failed and it was determined that success would be the new concept that the legislation would implement. So it is clear that the concept of success is still quite vague, although it has been argued that it is only as vague as 'best interests.'[138] One of the main intentions of Parliament in the creation of the Companies Act 2006 was to codify a list of directors' duties that were more accessible and

[132] Explanatory notes to the Companies Act 2006, para 327.
[133] HL Deb 6 February 2006 vol 678 col GC256.
[134] HL Deb 6 February 2006 vol 678, GC 258.
[135] See for example Law Society, *Response to the Company Law reform (*White Paper, Cm 6456, 2005).
[136] ibid 6.
[137] See for example Amendment no.s 156 and 157 HL Deb 6 February 2006 vol 678 col GC253.
[138] James Edelman, 'When Do Fiduciary Duties Arise?' (2010) 126 LQR 302 at 322.

understandable to the lay director. Arguably the inclusion of the concept of success has resulted in a provision that is more confusing than its predecessor.

Duty to Act in Good Faith: a Subjective Provision

It is purported that one of the major problems with s.172 can be found under s.172(1) and the requirement that a director of a company must act in the way *he considers*, in good faith, would be most likely to promote the success of the company*[Emphasis added].* It is clear that under the provision the director is expected to exercise their own discretion and the standard that he is expected to adhere to is a subjective one. A director must act in the way he considers, not what the court may consider,[139] in good faith, would be most likely to promote the success of the company for the benefit of its members. This was clearly set out in the guidance on key clauses to the 2006 Act:

> '[T]he decision as to what will promote success [of the company], and what constitutes such success, is one for the directors' good faith judgment. This ensures that business decisions on, for example, strategy and tactics are for the directors, and not subject to decision by the courts, subject to good faith.'[140]

This affirms the stance of the earlier common law duty to act in the best interests of the company as noted by Lord Wilberforce in *Howard Smith Ltd v Ampol Petroleum Ltd*[141]

> '[T]here is no appeal on merits from management decisions to courts of law: nor will courts of law assume to act as a kind of supervisory board over decisions within the powers of management honestly arrived.'[142]

And emphasised by Parker J in *Regentcrest plc v Cohen*[143]

> 'The question is not whether, viewed objectively by the court, the particular act or omission which is challenged was in fact in the interests of the company; still less is the question whether the court, had it been in the position of the director at the relevant time, might have acted differently. Rather, the question is whether the director honestly believed that his act or omission was in the interests of the company.'[144]

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[139] This follows on from the case of *Re Smith & Fawcett Ltd* (n 88) 306 and the judgment of Lord Greene.
[140] Guidance on key clauses Companies Act 2006, 64.
[141] *Howard Smith Ltd v Ampol Petroleum Ltd* (n 93).
[142] ibid 832.
[143] *Regentcrest plc v Cohen* (n 100).
[144] ibid 105.

Following from this it is clear that the directors' belief need not be a reasonable one. All the director need prove is that the belief at the time was an honest one. If it is found that the director honestly believed that they were acting in the best interests of the company then they are not in breach of any fiduciary duty.[145]

Underlying this theory is the traditional approach that the courts have taken in refusing to review business judgments taken by the directors and, in particular, avoided reviewing situations with the benefit of hindsight. [146] That approach has long been epitomised by the famous dictum of Lord Eldon LC in *Carlen v Drury*[147] to the effect that the court is not to be required 'to take the management of every playhouse and brewhouse in the kingdom.' As Lord Wilberforce put it in *Howard Smith Ltd v Ampol Petroleum Ltd*[148]

> 'There is no appeal on merits from management decisions to courts of law: nor will courts of law assume to act as a kind of supervisory board over decisions within the powers of management honestly arrived at'.

This position has been highly criticised by academics as it offers no standards against which to hold a director accountable. As Fisher puts it once a director proves that they made a decision in good faith it makes their position 'virtually unassailable.'[149] The guidance to the new act notes that 'it will not be sufficient to pay lip services to the factors.' Short of actual documentary evidence of a box ticking exercise it might well be difficult to prove that directors have just paid lip service to the requirements in s.172.

The Potential Objective Standard of Care

There are clear failings in the application of a subjective standard in holding directors to account for their actions. As a result the commentator believes it is now necessary to introduce an objective minimum standard to the directors' duty to promote the success of the company. It is argued that this may be done in two ways:

Firstly the legislature may bring an amendment to the current Companies Act 2006 to reinstate the objective minimum standard that was found in Clause 19 of the 2002 Governmental White Paper.[150]

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[145] See *Extrasure Travel Insurances Ltd v Scattergood* (n 102) 619.
[146] See for example *Regentcrest v Cohen* (n 100) 106-107, also *Facia Footwear Ltd v Hinchcliffe* [1998] 1 BCLC 218, 228.
[147] (1812) 1 Ves & B 154, 158.
[148] *Howard Smith Ltd v Ampol Petroleum Ltd* (n 93) 1131.
[149] Fisher (n 32) 15.
[150] Department for Trade and Industry, *Modernising Company Law* (White Paper , Cm 5553, 2002).

Under cl.2(b) of Sch.2 of the paper 'In deciding what would be most likely to promote the success, take account in good faith of all the material factors that it is practicable in the circumstances for him to identify.' This would allow for greater accountability of directors by subjecting them to an objective minimum standard of conduct. This conduct would be much easier to monitor and would allow force directors to act in a more responsible manner.

Alternatively the courts could use the existing legislation to impose an objective standard on directors. Initially it is difficult to see how the courts could do this, it is clear that under s.172 the legislation unequivocally refers only to a subjective test. Nevertheless it is contended that under s.170 (4) of the Companies Act 2006, the general duties of directors are expected to be:

> 'applied in the same way as common law rules or equitable principles, and regard shall be had to the corresponding common law rules and equitable principles in interpreting and applying the general duties.'

It is clear that if there is previous evidence of the courts imposing objective minimum standards to conduct, then this theoretically could still be imposed following the 2006 Act, arguably this may be the case. On a cursory glance of the materials it does not appear to be so, under the common law duty to act bona fide in the best interests of the company the courts have clearly said previously that this is to be a subjective test.[151] However upon further analysis the courts have noted that in the modern definition of a director there have been problems in justifying having a subjective test for determining whether they had breached their duty to act *bona fide* in the best interests of the company. As a result objective considerations have been introduced by the courts in some instances to supplement the subjective test.

Pennycuick J first noted his and the courts concerns in *Charterbridge Corp Ltd v Lloyds Bank Ltd*.[152] Under *Charterbridge* Pennycuick J believed instead that the proper test would be one of an objective minimum standard, whereby whether an intelligent and honest man in the position of a director of the company involved could have reasonably believed that the transaction in question in the case was for the benefit of the company.[153]Again on its own this would appear to be an anomalous case; however the cracks in the subjective test appear when the courts are asked to consider the unreasonableness of a director's actions. It is argued that the courts will not accept, without consideration, a director's purported argument that he acted *bona fide* when the facts might appear to suggest otherwise. Bowen LJ believed that *bona fide* cannot be the sole test, for as he pointed out

[151] *Regentcrest plc v Cohen* (n 100) 105.
[152] [1970] Ch 62.
[153] *Charterbridge Corp Ltd v Lloyds Bank Ltd* [1970] Ch 62 para 75 [1969] 2 All ER 1185, 1194.

a lunatic may act perfectly *bona fide* yet perfectly irrationally.[154] In the already cited case of *Regentcrest* Parker LJ remarks that 'the question is whether the director honestly believed that his act or omission was in the interests of the company.' However Parker LJ goes on to qualify his statement by imposing what may be argued as the first step towards an objective minimum standard:

> 'The issue is as to the director's state of mind. No doubt, where it is clear that the act or omission under challenge resulted in substantial detriment to the company, the director will have a harder task persuading the court that he honestly believed it to be in the company's interest; but that does not detract from the subjective nature of the test.'[155]

Whilst not a categorical objective minimum standard and Parker LJ clearly states that this 'does not detract from the subjective nature of the test.' It is argued that the mere fact that he is considering what the objective person would believe in the resulting substantial detriment test then this could form the basis of a shift to an objective minimum standard. It is purported that this has been impliedly accepted by the courts in the recent case of *Re Genosyis Technology Management Ltd.*[156] In this case two directors entered into a settlement agreement with a customer on behalf of the company, under the agreement the company gave up a claim for 1.25 m Euros (which was instead paid to the parent company) and instead gained a maximum of £166,000. The courts noted that even if it was accepted that the directors acted honestly in the belief that this settlement was in the best interests of the company, the courts said that they had no reasonable grounds for that belief and as a result were in breach of their duties, and disqualified.[157]

The courts may also have sought to instil an objective minimum standard outside the grounds of reasonableness, often where the bad faith of a director is relatively evident the courts will chose to adopt more of an objective stand. For example in *Neptune (Vehicle Washing Equipment) Ltd v Fitzgerald (no2)*[158] the court quickly determined that a director was acting in his own interests and not the interests of the company, when he awarded himself an *ex gratis* payment of £100,000 from the company on termination of his service contract with the company.[159] Again in *Extrasure Travel Insurance Ltd v Scattergood*[160] the defendant directors authorised the transfer of capital to another company in the same group to enable the second company to pay a creditor without any honest

[154] *Hutton v West Cork Rly Co* (1993) 23 ChD 654, 671.
[155] *Regentcrest v Cohen*[2001] 2 BCLC 80, 106-107.
[156] *Wallah v Secretary of State for Trade and Industry* [2007] 1 BCLC 208.
[157] ibid 213.
[158] [1995] BCC 1000.
[159] *Neptune (Vehicle Washing Equipment) Ltd v Fitzgerald (no2)* [1995] BCC 1000, 1017.
[160] *Extrasure Travel Insurance Ltd v Scattergood* (n 102).

belief that the transfer was in the interests of the transferor company. The court found that the directors made the transfer simply because the other company needed the money and not in the interests of their own company, the reason being simply because the second company were being pressed by creditors for repayment. As a result it was held that the directors were in breach of their duties. Finally in the more recent case of *Item Software (UK) Ltd v Fassihi*[161] Arden LJ stated that if a director embarks on a course of action without considering the interests of the company and there is no basis on which he or she could reasonably have come to the conclusion that it was in the interests of the company, the director will be in breach.

Following this, it is purported, that there may have already been attempts by the courts to impose the objective standard, not directly but instead indirectly in their affirmation of the previous common law duties following the enactment of the 2006 Act. In *Re West Coast Capital (LIOS) Ltd*[162] Lord Glennie expressed the view that section 172 of the 2006 Act did little more than set out the pre-existing law on the subject. It is argued that following this case and also *Cobden Investments Ltd v RWM Langport Ltd*,[163] where the courts also affirmed that s.172 reflects the pre-existing case law on the duty, the courts are clearly allowing the imposition of the previous common law duties under the veil of s.170(4) of the Companies Act 2006. This was confirmed (although only in the court of sessions) in the case of *Eastford Limited v Thomas Graham Gillespie, Airdrie North Limited*[164] where Lord Hodge remarked on the flexibility of interpretation of s.170(4) pointing out that '[t]he interpretation of the statements will therefore be able to evolve.'[165] And again in *Re Southern Counties Fresh Foods Ltd*[166] where Warren J, when comparing the new and old formulations of the duty stated, '[t]hey come to the same thing', adding that the test 'both under general law and under CA 2006, is a subjective one.' However he later remarked that ' a breach will have occurred if it is established that the relevant exercise of the power is one which could not be considered by any reasonable director to be in the interests of the company.' Thus it is purported that Warren J in discussing the 'reasonable director' may have inadvertently introduced an objective standard of care under the current regulatory framework.

It is also interesting to note that there was a further amendment posed at the House of Commons stage which could have resulted in the imposition of an objective standard. The amendment would

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[161] *Item Software (UK) Ltd v Fassihi* (n 95).
[162] *Re West Coast Capital (LIOS) Ltd* (n 99).
[163] [2008] EWHC 2810 (Ch).
[164] [2009] CSOH 119.
[165] ibid para 9.
[166] [2008] EWHC 2810 Ch para 53.

have changed the wording of s.172(1) from 'have regard to' to 'endeavour to.' This amendment was rejected but the discussions showed a further attempt to impose said objective standard:

> 'Whereas 'have regard...to' is a subjective test- a director can say that he has thought about the six secondary duties listed in clause [172] ... and may or may not have done more about them – 'must endeavour to' is an objective test, requiring some evidence of having sought to abide by those duties before deciding whether it was in the best interests of the company to do so.'[167]

This is evidence also that Parliament at the time was still considering the possibility of imposing objective standards even if the amendment itself failed.

So it is clear that there have been times in the previous case law that the courts have attempted to put in place an objective minimum standard for directors in their duty to act *bona fide* in the best interests of the company. As a result it is argued that the courts may continue to do so under s.170(4) of the Companies Act 2006. It is purported that some may voice concern with this line of argument by pointing out that parliament expressly rebutted the implementation of an objective standard by removing it from the 2005 white paper, 2005 Bill and ultimately the Companies Act 2006. Whilst there may be some merit to the argument that if Parliament wished to instil an objective minimum they could simply have written it into the legislation, for example like under s.174 and the Duty of Skill, Care and Diligence. However the author is more inclined to agree with a converse argument that Parliament impliedly accepted, knowing the state of the common law, that the courts would introduce objective considerations into an assessment of a director's actions.[168] This theory is further reinforced by the Guidance on Key Clauses to the Company Law Reform Bill which stated that in having regard to the factors in cl.156 [s.172] directors must comply with their duty to exercise reasonable skill, care and diligence. It is purported that as a result government were impliedly consenting to the confirmation of an objective minimum standard to the duty to promote the success of the company.[169]

Benefit of the Members as a Whole

Under s.172 a director is expected to act for the benefit of the members as a whole. This means that a director is to act for the benefit of all members, not only the majority shareholders, and most

[167] Patrick Hall HC Deb 17 October 2006 vol 450 col 763.
[168] Andrew Keay, 'Section 172(1) of the Companies Act 2006: an interpretation and assessment.' (n 110) 107.
[169] DTI, *Guidance on Key Clauses to the Company Law Reform Bill* (2005) para 63.

certainly not any individual shareholders. [170] This is also clearly a restatement of the previous common law position in *Mutual Life Insurance Co of New York v Rank Organisation.*[171] In the case the directors of the company decided to make an issue of shares to its existing ordinary shareholders however they chose to exclude any ordinary shareholders from the US and Canada. The excluded shareholders brought an objection to this but the court concluded that the directors had exercised their powers fairly as between the different shareholders. This was because that in excluding the North American shareholders they had not affected neither their shares nor any of the rights attached to them and the purported grievance that was suffered was purely due to the shareholders personal situation. This was reemphasised in *Re BSB Holdings Ltd (No2)*.[172] The courts held in this case that when the group of directors undertook a complex financing agreement they should have considered the effect of the proposals on the different groups of shareholders within the company. It is interesting to note also that when the company is part of a larger group the director's duty is to the act in the interests of the individual institution and not the overall interests of the group. A failure to have regard to the interests of the separate legal entity may be grounds for disqualification.[173]

Having Regard to (Amongst other Matters)

In promoting the success of the company, directors are to have regard to a number of different factors.[174] To have regard to it would appear Parliament intended directors 'to think about' and 'to give proper consideration to.'[175] Directors' consideration of these points is imperative and an 'integral part'[176]of their duty to promote the success of the company. Under s.172(1) there are six separate matters to which a director must have regard, in deciding whether a particular decision will promote the success of the company. The list is not exhaustive and that is made clear by the legislation that notes that a director is to have regard to 'amongst other matters'[177]. As a result, it is important to note that a director would be in breach of their duty if they failed to take into account any matter which they may consider relevant in promoting the success of the company.[178]

[170] Lord Goldsmith, HL Deb 6 February 2006 vol 678 col 256.
[171] [1985] BCLC 11.
[172] [1996] 1 BCLC 155.
[173] *Secretary of State for Trade and Industry v Goldberg* [2004] 1 BCLC 597, 650.
[174] S.172(1).
[175] Margret Hodge, the Minister of State for Industry and the Regions; DTI, *Duties of company directors: ministerial statements* (June 2007) 9.
[176] Davey Ka Chee-Wu, 'Managerial behaviour, company law, and the problem of enlightened shareholder value.' (2010) 31(2) Comp Law 53.
[177] S.172(1).
[178] Paul Davies, *Gower and Davies Principles of Modern Company Law* (8th ed, Sweet & Maxwell, 2008) 16-29.

The enumeration of the six matters do not impose free standing duties, it is clear under the legislation that there is one single primary duty to promote the success of the company. The six considerations are there to guide a director in the completion of this primary duty; however it is not intended that this be a box ticking exercise each matter has to be independently considered.[179] It is at this point that it is necessary to compare this with a more pluralistic approach, a pluralistic approach would allow for the six wider interests to be parable to and not subordinate to, or as a means of achieving, shareholder value. They would be valid in their own right, i.e. the interests of a number of groups should be advanced without the interests of a single group (shareholders) prevailing.[180] This approach was highly criticised by the CLRSG as it would both enable and require, the directors to override shareholders' interests in circumstances where this would be in the interests of the company as widely defined by the stakeholders. Instead what we have is closer to the idea of ESV as the legislation does not require this but instead attempts to use the stakeholder interests as guidelines to the completion of the primary duty to promote the success of the company.

It is purported that in enacting this provision Parliament failed to observe a number of serious floors in the drafting. Firstly, the list offers no guidance to directors as to the weight that should be attached to any of the six matters; it was believed that this should be left up to directorial discretion.[181] Further to this subsequent issues arise when there is a conflict between the interests.

The Need to Act Fairly as Between Members of the Company

The list of factors which directors are to have regard in s.172 is expressly made non-exhaustive, and there has been a distinct absence of guidance from Parliament as to how each individual factor should be weighted. In general this may not be a problem, however difficulties may arise when two of the interests are in conflict, for example, if a director chose to wind up a loss making division of a company. The winding up of the division may benefit the company in the long run but may have an adverse effect on employees (through redundancy) or the wider community (if the department were relocated).

As the list is not exhaustive the problem is further exacerbated when directors are expected to take into account considerations that are not listed under s.172. This was implicitly acknowledged by

[179] HL Deb 6 February 2006 vol 678 col 852.
[180] Company Law Review, *Modern Company Law for a Competitive Economy: The Strategic Framework* (n 6) para 5.1.12-5.1.13.
[181] Margret Hodge, the Minister of State for Industry and the Regions; STI, Duties of company directors: ministerial statements (June 2007), 9.

Sales. J in the case of *R(on the application of People & Planet) v HM Treasury*[182] (discussed in detail below). In this case the judge recognised that UKFI could properly seek to influence the RBS board to have regard both to environmental *and* human rights considerations. Whilst the environment is explicitly recognised in s.172(1)(d) human rights are not, though such obligations might be read into the requirement to have regard to the impact of the company's operations 'on the community,' also mentioned in s.172(1)(d) or 'the desirability of the company to maintain a reputation for high standards of business conduct' within s.172(1)(e). But by placing the two obligations on a par with each other it demonstrates the lack of any real significance to the inclusion on the list in s.172.

The weighting of these factors is assumed to be a subjective matter for the directors, given the reference to management decisions being a matter for the directors' judgment and therefore would be difficult to challenge. This is consistent with more recent case law, in *Iesini v Westrip Holdings*[183] Lewison J noted that in regards to an application under the Companies Act 2006 s.261, how there were several cases where some directors acting in accordance with s.172 would think it worthwhile to continue with a claim but others would not. The weighing of all the relevant considerations was 'essentially a commercial decision which the court is ill-equipped to take, except in a clear case.'[184]

Interests of the Employees

s. 172(1) (b) provides that when considering how to act in a way that would be most likely to promote the success of the company, a director must have regard to the interests of the company's employees. It is noticeable that the interests of employees are to be considered only in the context of benefits to members. This provision replaces an earlier independent requirement that the directors were to have regard to the interests of the company's employees in general as well as the interests of its members.[185] The Company Law Review Steering Group believed that s.309 should be repealed because they saw a danger that it might be interpreted as enabling directors to prefer employees' interests to those of shareholders, which would threaten the principle of Shareholder Primacy.[186] It has already been shown that under Shareholder Primacy and Enlightened Shareholder Value the duty of the director is to the shareholder. This, it would appear, would be in line with the previous common law stance if we are to look at cases such as *Park v Daily News Ltd,*[187] in this case a

[182] [2009] EWHC 3020 (Admin).
[183] [2009] EWHC 2526 (Ch) [2010] BCC 420.
[184] ibid para 85-86 see Stephen Copp, 'Section 172 of the Companies Act 2006 fails People & Planet?' (2010) 31(12) Comp Law 406, 408.
[185] Companies Act 1985 s.309.
[186] Company Law Review, *Modern Company Law for a Competitive Economy: The Strategic Framework* (n 6) para 5.1.20 to 5.1.23.
[187] [1962] Ch 927.

single shareholder obtained an injunction to restrain directors from making payments to employees in excess of their legal entitlements where a business was ceasing to exist. Yet more recently there have been some examples of the courts allowing directors to take employee interests into consideration when making business decisions. In *Re Saul D Harrison & Sons Plc*[188] the courts stated that it was appropriate for directors to carry on running a company inter alia in terms of protecting the interests of employees. This is extremely interesting as it would appear to be in direct contradiction to the earlier stance of Park, however it may be the first (and perhaps only) time that s.309 was enforced correctly. Whatever the reasoning it is clear that under s.172 a director must now consider the effect his decisions have on employees.

Interests of the Environment

During the parliamentary debates on s.172 one of the major focuses of the discussions was the inclusion of environmental concerns. Under s.172(1)(d) the director of a company is to have regard to the impact of the company's operations on the community and the environment when making decisions. Although modern company law, in the majority, now accepts that companies have a positive role to play in promoting best social and environmental practices.[189] Some politicians feared that the new provisions would enable stakeholders to bring an action to block directors' decisions on environmental grounds. The Honourable member for Workingham for example, Mr John Redwood, posed the question:

> 'Would that provision [now s.172] give people living near a quarry, a coal mine or a nuclear power station the right to take the company in question to court because they did not like the activity, even though it was legal and had all the health and safety permissions?'

The short answer to this, it would appear, is a resounding no. S.172 does not give stakeholders an individual right to bring an action. Nor does it allow them to halt decisions as in the scenario posed by Mr Redwood above. The then secretary of state for trade and industry, Alistair Darling, gave a clear response to the question also:

> 'No, it would not. The requirement is for the director, in reaching a decision, to have regard to all such matters, including the impact on the community. We cannot have a situation in which, essentially, two groups of people are running a company—one being the directors and the other being people who like or do not like what the company is doing and ask the courts to second-guess the company's decisions. If we as a society decide that we do not want quarries,

[188] [1995] 1 BCLC 14.
[189] HL Deb 6 February 2006 vol 678 col GC265.

> the best way to achieve that outcome is to pass legislation forbidding them. If quarries are legal, and provided that all planning permissions are obtained and other legal obligations are met, directors are entitled to reach that decision, because their duty is to the company. However, they do have to have regard to what they are doing. This is an important step forward and many in the other place were deeply opposed to it, but I hope that the House will support it.'[190]

This was affirmed by Lord Goldsmith who, whilst supporting the need to protect environmental issues, did not believe that they should be addressed through company law reform.[191] This is slightly misleading as the recurring theme of the new legislation is the implementation of Enlightened Shareholder Value, and one of the guiding principles of this theory is to place on a statutory footing the requirement of consideration of wider social and environmental issues.

So on the whole, it would appear that there has been very little movement on the ability of environmental stakeholders to influence the decisions of directors for their benefit. That is until the financial crisis and the nationalisation of a number of financial institutions, and the case of *R(on the application of People & Planet) v HM Treasury*.[192] This is an extremely interesting case, and as such it is important to set out the facts first. The case involves a challenge by activists to the approach taken by Government in its ownership of the financial institution RBS, and in particular its conflict with the Government's own stated policy on issues of climate change. This conflict was put to the courts via an application for judicial review, and in doing so People & Planet argued that HM Treasury's policy as to the UKFI's management of RBS was unlawful. What is important in the judgment is not the application specifically but instead the reasoning behind it, People & Planet argued that the policy was not adopted after proper consideration by HM Treasury in accordance with the *Green Book*. In particular this contained three sub-grounds, namely that HM Treasury had failed properly to evaluate the arguments for a more interventionalist policy, that it had regard to an irrelevant consideration, specifically the desirability of industry-wide regulation as opposed to a policy focused on just two banks (RBS and Lloyds Banking Group), and there was a misdirection of law by HM Treasury as to the effect of the Companies Act 2006. And thirdly the policy was alleged unlawful on human rights grounds.

Sales J. Rejected the application for permission as he considered that whilst UKFI could seek to influence the RBS board to have regard to environmental considerations in accordance with their

[190] HC Deb 6 June 2006 vol 447 col 129.
[191] HL Deb 6 February 2006 vol 678 col GC253.
[192] *R(on the application of People & Planet) v HM Treasury* (n 181).

s.172 duty, it would have been wrong for HM Treasury '...to seek to impose its own policy in relation to combating climate change and promoting human rights on the board of RBS, contrary to the judgment of the Board.' He continued by pointing out that to go beyond this would have cut across the duties of the RBS board as set out in s.172, however he did not go so far as to say that there was an 'absolute legal bar to the introduction of a different policy.'[193]

So as a result for those interested in forwarding the interests of the environment it is not a welcomed decision. It is clear that the courts will not allow environmental interests to be pursued in direct conflict with the general body of shareholder interests. Sales J. repeatedly emphasised the risk of minority shareholder litigation if a company's share value were to drop because of a directors actions to take into account environmental interests.[194] Whilst Copp clearly agrees with the approach taken by Sales J., in that he believes that '[c]ompany law is not the appropriate vehicle for the achievement of environmental or human rights objectives beyond what the law requires generally.'[195] It is argued that it goes against the fundamental ideals that were being constructed when the provision was enacted. It is clear government did not want a free standing right for stakeholders to be able to bring an action on environmental grounds. However they would be expected to be considered by directors when making decisions as under s.172(1)(f) there is a 'need to act fairly as between members of the company.' The case of *People & Planet* simply emphasises the fundamental floors in the drafting of s.172. In having regard to a list of specific factors there is no way to offer any weighting to each of the factors. Or guarantee that all of the factors are to be taken into consideration when a director is making their decisions.

Interests of Creditors

Under the previous common law duties directors of an insolvent company must have regard to the interests of its creditors. A series of cases during the 1980's firmly established that the b*ona fide* rule to act in the best interests of a company extended to the company's creditors if the company became involved in financial distress. The series began with *Lonrho Ltd v Shell Petroleum Co Ltd*[196] whereby Lord Diplock first referred to the interests of the creditors as something that the directors should take account of. Affirmed in *Liquidator of West Mercia Safetywear Ltd v Dodd*[197] the Court of Appeal held that a director of an insolvent company must have regard to the interests of its creditors. During the same time s.214 of the Insolvency Act 1986 was enacted, known as the

[193] Copp (n 183) 407.
[194] Minority shareholders can bring actions under the Companies Act 2006 s.994.
[195] Copp (n 183) 408.
[196] [1980] 1 WLR 627.
[197] [1988] BCLC 250.

‘wrongful trading’ provision its effect was to allow liquidators to commence an action against directors of a company if that company’s assets were not sufficient to pay its debts at the time of liquidation.[198] It would then be up to the directors to prove that they had taken every reasonable step possible, with a view to minimising the potential loss to the company’s creditors.[199] If the courts are not satisfied they may order the directors to make such contribution to the company’s assets as the court thinks proper,[200] thus imposing a positive obligation on directors to take the interests of creditors into account when making business decisions.[201] More recently it has been observed that the provision still holds true as in *Colin Gwyer & Associates Ltd v London Wharf (Limehouse) Ltd*[202] in surmising the case the judge remarked that it was imperative for a director of a company that was insolvent, or of dubious solvency, to take account of the interests of creditors. S.172 retains this obligation to the creditors verbatim. S.172(3) states ‘The duty imposed by this section has effect subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company.’ Therefore it would appear that subsection (3) clearly maintains the positions of the common law and wrongful trading provisions with no alterations allowing some academics to conclude that it is simply a ‘reminder’[203] of the previous common law and legislative provisions.

Commencing Actions for Breach/Enforceability

Whilst the concept of Enlightened Shareholder Value has appeared on the whole to have had a positive effect on ensuring that directors take into consideration the interests of stakeholders, it would appear that there may be serious problems in ensuring directors always take their interests into account. The main recurring question that appears is whether any stakeholders of a company have the ability to take any legal action against directors, if it is found that they have not taken their interests into account when making decisions? The short answer appears to be no, as with the law prior to the Act the only persons capable of bringing an action are the shareholders. Shareholders are, under the Act, given the right to bring derivative proceedings (subject to the court approval) against directors in respect of a cause of action vested in the company (s.260(1)(a) of the Act).

Stakeholders do not appear to have any power in enforcing their own interests, however this is nothing new, and it is argued that Parliament should have known this at the time of the creation of

198 S.214(6) Insolvency Act 1986.
199 S.214(3) Insolvency Act 1986.
200 S.214(1) Insolvency Act 1986.
201 See generally, Andrew Keay, ‘Wrongful trading and the liability of company directors: a theoretical perspective.’ (2005) 25(3) Legal Studies 431.
202 [2003] 2 BCLC 153.
203 Alistair Alcock, ‘An accidental change to directors’ duties?’ (2009) Comp Law 362.

s.172. The CLRSG directly acknowledged that there was already a problem with regards to this issue under s.309 of the Companies Act 1985.[204] Under s.309 directors must take into account the interests of employees as well as shareholders when making decisions, however there is no power for stakeholders to take up proceedings if they consider their interests to have been impugned. It is now widely accepted that s.309 has no teeth, the provision has hardly been used and there is very little case law on the section. Ultimately a right without a remedy is worthless.[205]

Likewise there is nothing specific in the Act that allows for stakeholders to enforce the duty that is imposed upon them.[206] Keay has outlined a number of different situations where an action could be brought about:

1. Where a member invested in the company for the long haul, and he or she feels that the action of the directors does not have regard to the long term. The member might feel that the directors are overly myopic and that could well mean that the member will receive less in the long run.
2. A member is also an employee of the company and is concerned that the directors did not have regard to the interests of the employees
3. A member is concerned that the directors have not had regard for the need to promote business relationships with suppliers, customers or others and is likely to damage the company in the future.
4. There are members of the company living in the community in which the company operates, and they believe that the community will be adversely affected by the actions of the directors, and that will, as a consequence, affect the lives of the members.
5. A member has concerns wider that his own interests and feels obliged to take proceedings because of a heightened sense of community interest.[207]

As is clear to see that under these terms the only time a stakeholder is able to enforce derivative proceedings is when that stakeholder is also a shareholder, and the person brings an action because their own self interest in the company is affected in a detrimental way in another capacity.

[204] Company Law Review, *Modern Company Law for a Competitive Economy: The Strategic Framework* (n 6) para 5.1.21.
[205] Morey McDaniel, 'Bondholders and Stockholders' (1988) 113 Journal of Corporation Law 205, 209.
[206] Demetra Arsalidou, 'Shareholder Primacy in cl.173 of the Company Law Bill 2006.' (2007) Comp Law 67, 68.
[207] Andrew Keay, *Directors' Duties* (Jordans, 2009) 146-147.

Conclusion

The chapter has analysed the application of the s.172 duty to promote the success of the company. The statutory changes developed under the Companies Act 2006 have established a new system of corporate governance within the UK. The chapter has shown that since the Berle-Dodd debates neither shareholder, nor stakeholder theories of corporate governance have resolved the debate as to ''in whose interests should a company be run?' As an alternative the establishment of the Enlightened Shareholder Value system of governance has brought greater accountability to directors of financial institutions. ESV like Shareholder Primacy Theory is based on the idea that maximising shareholder value is the best means of securing overall prosperity.[208] However, unlike Shareholder Primacy Theory, this is subject to developing relationships of trust with stakeholders. The greater accountability developed through ESV, whilst clearly acting as an aid to curbing excessive risk taking, is not without its issues. In its inception it was heralded as a radical provision that would ensure directors would take into consideration the wider interests of stakeholders. Whilst it may have been created with the best of intentions, the subjective nature of the provision would appear to be nearly impossible to enforce.[209] Some academics have been more critical and have considered that the effect of s.172 is only likely to be educational, and will have no real restrictive effect on business decisions taken in good faith by directors.[210] But whilst this may be true of the current provisions, whilst some see that as a floor, it is argued that it is just as important to re-educate and adjust the attitudes of directors following the financial crisis. The provision does this without imposing stricter rules on directors.

The behaviour of directors during the crisis was extremely risky and the provisions did little to curb the short term attitude of the directors. It has been purported however that with very small alterations to the legislation, or alternatively a wider interpretation, s.172 could have a very real and positive curbing effect on rogue directors, who do not act to promote the success of the company for the benefit of its members as a whole. The thesis purports that the easiest way to ensure a shift in the culture of banking is to reinstate the failed objective minimum standard as developed under the 2002 Modernising Company Law White Paper.[211] This shift can form part of the multi-faceted approach that has been developed by the thesis to change the culture of banking and prevent a reoccurrence of the Global Financial Crisis.

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[208] Company Law Review, *Strategic Framework* (n 6) para 5.1.11.
[209] Fisher (n 32).
[210] The Rt Hon The Lord Millet, Alistair Alcock, Michael Todd, *Gore-Brown on Companies* (45th Ed ,Jordans 2014) Ch15[10A].
[211] Department for Trade and Industry, *Modernising Company Law* (White Paper , Cm 5553, 2002).

Chapter VI: The Business Decision Rule

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The primary function of a director is to make decisions on behalf of the company. If the decisions the director make are sub-optimal, then this can have a significant impact on the company. The ability of the courts to question the decisions of directors has been a longstanding issue; there has been reluctance by the judiciary to voice any opinion on such decisions. This has been defined as The Business Decision Rule (BDR).[1] The BDR is a 19th Century common law development, whereby the judiciary will respect the decisions made by a director, and will not question their validity, so long as the director has satisfied their equitable and tortious duties.

The intention of the chapter is to show, that although the Law Commission categorically refused to place the BDR on a statutory footing by codifying directors duties under s. 171-177 of the Companies Act 2006 the legislature has *de facto* implemented the Business Decision Rule under a process defined by the thesis as the Business Decision Shield. The Business Decision Shield is a doctrine of abstention whereby, if a decision made by a director does not fall within one of the duties as set out under s.171-177 of the Companies Act 2006, the courts will simply refuse to look at any action focusing on the decision. The effect of the Business Decision Shield is to reduce the scope of applicability of the BDR, allowing for an increase in the levels of accountability, in particular following the 2007-09 Global Financial Crisis. The increase in accountability will aid in the

[1] The Business Decision Rule has also been called the 'Internal Management Rule' and the 'Business Judgment Rule' for the purposes of this chapter all are considered to be the same.

multifaceted approach to bring together both external financial regulations with internal corporate governance structures in the light of the financial crisis.

The chapter will begin by outlining the historical reasoning behind the development of the Business Decision Rule through economic and legal analysis, it will continue by noting the difficulty in finding a single definition of the Business Decision Rule and the reasons for the creation of such a rule. It will then continue to map out the development of the early case law surrounding the BDR and compare the definition with that of the US and Australia, drawing out the points made by the Law Commission prior to the 2006 Act. The chapter will conclude by purporting that the best definition that can be found for a Business Decision Rule is a *de facto* rule found collectively under s.171-177 of the Companies Act 2006. Whilst it is not a single definition akin to that of Australia, it is by all sense of the word the definition that has been sought under the UK version of the Business Decision Rule. The Chapter will conclude by showing that following the Global Financial Crisis there has been a decrease in the applicability of the Business Decision Rule following the 2007-09 Global Financial Crisis.

The History of the Business Decision Rule

The 'Business Decision Rule' is a 19th Century doctrine that has developed into the cornerstone of modern UK Company Law. Its original ideology was based upon the preposition that the courts would categorically refuse to engage in supplanting their own views on business decisions in lieu of decisions made by directors. Seeded deep within private law ideology the courts were extremely reluctant to engage in a process of second guessing the decisions of directors of a company and instead sought to allow grievances to be dealt with internally. There is no exhaustive definition of the rule and ironically perhaps for such an important doctrine it appears to stem from a single quote in Carlen v Drury. '[T]his court is not to be required on every occasion to take the management of every playhouse and brewhouse in the kingdom.'[2] The 19th Century construct was born out of an era of non-interventionalism by the courts in business decisions; this is highly understandable given both the political and economic ideologies of the day.

The early 19th Century saw a vast and ever-growing empire in full effect. The British Empire extended across the globe expounded by the liberal free trade theories of Adam Smith[3] and others[4] of the

[2] *Carlen v Drury* (1812) 1 Ves. & B.154.
[3] Adam Smith, *An Inquiry Into the Nature and Causes of the Wealth of Nations, Vol. I ed. R. H. Campbell and A. S. Skinner, vol. IIa of the Glasgow Edition of the Works and Correspondence of Adam Smith* (OUP 1976).
[4] See for example David Ricardo, *On the Principles of Political Economy and Taxation* (1817 London: John Murray).

time who were suspicious of government intervention, this was combined with the belief that institutions needed to survive in an ever expanding world of competition and free enterprise. If one is to consider the role of the judiciary within this societal structure it is possible to observe the reasoning behind such a system of non-interventionalism. If we are to agree with the ideas of academics like Griffith,[5] then what we can observe is a judiciary that are motivated, and directly influenced by both the political and economic ideologies of their time. No judge sits in a glass vacuum, nor are they able to make politically neutral decisions as they are often 'placed in positions where they are required to make political choices which are often presented to them...as determinations of where the public interest lies;'[6] if we are then to superimpose this onto the political ideologies of the early 19th Century, we can see them to be ones of rapid growth combined with free market thinking that sought to encourage the development of business and commerce. The utilitarian writings of Bentham[7] helped to enforce the liberal ideas, and with his affirmation of Smith and of *laissez-faire,* Bentham's writings encouraged and gave voice to a growing philosophy of non-interventionalism by all facets of the state. During the same period Colderidge, whilst ideologically opposed to Bentham, was also expounding the ideal of capitalist enterprise and criticised any interventionalist actions by the state:

> 'The state, again, was no longer considered, according to the old ideal, as a concentration of the force of all the individuals of the nation in the hands of certain of its members, in order to the accomplishment by systematic co-operation. It was found that the State was a bad judge of the wants of society; that it in reality cared very little for them; and when it attempted anything beyond that police against crime, and arbitration of disputes, which are indispensable to social existence, the private sinister interest of some class or individual was usually the prompter of its proceedings...Government altogether was regarded as a necessary evil, and was required to hide itself, to make itself as little felt as possible.'[8]

It was clear that at the time there was a philosophy of non-interventionalist policy within the state. It is argued that this was not the singular reasoning for the early development of the theory of the BDR, the economic reasons for this non-interventionalism ran congruently with the fact that directors during this time were 'gentlemen amateurs'. Historically the director of a company was seen as an amateur of 'good standing in the community,' during the 19th Century a gentleman of

[5] John Griffith, 'The politics of the judiciary' (5th edn Fontana Press 1997).
[6] ibid 336.
[7] See generally John Stuart Mill, 'John Stuart Mill on Bentham and Colleridge' (4th edn, Chatto & Windus London 1967).
[8] ibid 136.

good standing would lend his name and with it his reputation to enhance the prestige of the company. Particularly with regards to non-executive directors very little was expected in relation to the running of the company. The most evocative example of this can be seen in the case of *Re Cardiff Bank (Marquis of Bute case).*[9] In this case the Marquis of Bute was appointed as a director and president of the Cardiff Savings Bank at the age of six months. In the following thirty-eight years he attended only one board meeting. During this time, massive frauds occurred within the bank and in an action for the liquidator of the bank the court held that the Marquis was not liable for breach of duty in failing to attend board meetings, since he had not given no such undertaken. Sterling J remarked: 'Neglect or omission to attend meetings is not, in my opinion, the same thing as neglect or omission of a duty which ought to be performed at those meetings.'[10] His only duty was to lend his status to the institution on whose board he was sitting.

Combining these two ideological themes we can see clearly the reasoning behind the initial development of the policy of non-interventionalism. Whilst this was clearly the policy of the time and the judges sought to distance themselves from making what had been come to be known as business decisions, they did not do so completely. As already identified the rule stems from the case of *Carlen v Drury*, what is interesting to note however is that this was never intended to be an absolute rule and was qualified by Lord Eldon where he noted that 'refusal or neglect of the committee to act' in a case of delinquency 'clearly made out' might raise a case 'for prompt and immediate interference'.[11] The decisions were still bound by rules of Equity and Tort.

The Business Decision Rule

One of the major problems in analysing the viability of the BDR is that there is no single definition. Giraldo believes it '[I]s a doctrine that protects officers of an institution from personal liability if they have acted in good faith, with due care, and within the officers authority.'[12] Eisenberg on the other hand considers the rule to be a standard of review of a directors' decision.[13] Arsalidou took the BDR to mean that 'if a director is found to have acted without self-interest, in an informed manner and with the rational belief that the taken decision was in the best interests of the company, then he will

[9] [1892] 2 Ch 100.
[10] ibid 109.
[11] *Carlen v Drury* (n 2) 159.
[12] Carlo Giraldo, 'Factors governing the application of the Business Judgment Rule: an empirical study of the US, UK, Australia and EU' found at http://www.javeriana.edu.co/juridicas/pub_rev/documents/6-Laguado.pdf.
[13] Michael Eisenberg, Whether the Business-Judgment Rule Should be Codified (1995) California Law Revision Commission vol. 28, 35.

not be found to be in breach of the duty of care.'[14] It is argued that all three are in some degree correct, however the rule does not fit wholly into any single category convincingly. The main reason for this, may be, that globally no single common law jurisdiction applies the rule in the same way. In Australia for example the BDR is seen as a defence to an action;[15] whereas within the UK the BDR is more akin to a barrier to bringing an initial claim or action to court.

Whatever the specific wording of the definition it is generally accepted that the BDR is based upon a balance between two competing ideas Bainbridge calls 'Authority' and 'Accountability.[16] The BDR seeks to draw an efficient balance between the need to encourage entrepreneurship within a predetermined scope of risk taking and the need for judicial review for acts taken by a director that go on outside the agreed parameters of their role.[17]

An excellent example of the working definition of the BDR was outlined by Bowen LJ in *Hutton v West Coast Railway Co*:

> '[a] railway company, or the directors of the company, might send down all the porters at a railway station to have tea in the country at the expense of the company. Why should they not? It is for the directors to judge, provided it is a matter which is reasonably incidental to the carrying on of the business of the company, and a company which always treated its employees with Draconian severity, and never allowed them a single inch more than the strict letter of the bond, would soon find itself deserted—at all events, unless labour was very much more easy to obtain in the market than it often is. The law does not say that there are to be no cakes and ale, but there are to be no cakes and ale except such as are required for the benefit of the company.'[18]

The modern theory of the BDR can be seen to encompass the non-interventionalist policies of the past, and the modern definition can now be described as a doctrine of abstention where by the courts will refuse to review decisions made by the directors of a company, unless specific preconditions for review have been set out.[19] These preconditions encompass equity, tort and common law duties that the director ought to owe to the company. Commentators have sought to

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[14] Demetra Arsalidou, 'Objectivity versus Flexibility in Civil Law Jurisdictions and the Possible Introduction of the Business Judgment Rule in English Law,' (2003) Deakin Law Review 8 (2) 335-348.
[15] S.180 Corporation Act 2001 (Australia).
[16] Stephen Bainbridge, 'The Business Judgment Rule as Abstention Doctrine.' Vanderbilt Law Review Vol 57:1, 83.
[17] Arsalidou (n 14).
[18] *Hutton v West Cork Railway Co.* (1883) 23 Ch D 654 at 672.
[19] Bainbridge (n 16) 83.

define the preconditions;[20] however it is argued that they have been unsuccessful and it is further argued that the correct definition for the BDR can now be found under the Companies Act 2006 s.171-177.

Why Is the Business Decision Rule Required?

One of the fundamental roles of the court is to mediate disputes between individuals, why then are the courts actively attempting to absolve themselves from carrying out their duty? There have been a number of reasons put forward as to why the BDR is a necessary construct, some are more convincing than others, although they can be generally categorised under the following headings:

Inadequacy of the Courts to Review Business Decisions

It has been argued previously that the courts are not in the correct position to make business decisions for any given company.[21] It has been forwarded by some that the courts, and the judges therein, do not have the knowledge of the given business areas to second guess questions such as 'should we employ another accountant?' or 'should we invest in further stock?' These decisions are what can be described as pure business decisions, and it is imperative to avoid undesirable judicial intervention in these types of decisions. One important factor to reiterate is that there is no objective standard of correctness.[22] Each decision made by a director at a given time is unique and it would, arguably, be impossible to recreate the environment under which the decision was taken. There is no formula for the creation of the 'perfect decision' and in looking at the decisions after the event occurs exposes judges to the problem of hindsight. Hindsight review of decisions is a major problem; and something that the courts have actively tried to avoid.[23] For example Parker J in *Regentcrest*[24] refers to the 'danger of applying hindsight.'[25] He reiterates that:

> 'It is all too easy to analyse the course of the struggle for the survival of Regentcrest after the event, and to pick over specific decisions taken at the time, without making proper allowance for the exigencies of the moment.'[26]

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[20] See for example Sharfman and his four conditions Bernard S. Sharfman, 'The Enduring Legacy of Smith v. Van Gorkom'(2008) 33 DEL J CORP L 287.
[21] Norman Veasy and Julie Seitz, 'Business Judgment Rule in the Revised Model Act, the Trans Union Case, and the ALI Project--A Strange Porridge' (1984-85) 63 Tex. L. Rev. 1483.
[22] Annette Greenhow, 'The Statutory Business Judgment Rule: Putting the Wind into Directors' Sails' (1999) 11(1) *Bond Law Review*, Article 4.
[23] See *The Charitable Corporation v Sutton* (1742) 26 All ER 642 and *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821, 834.
[24] *Regentcrest plc (in liquidation) v Cohen and another* [2001] BCC 494.
[25] ibid para 127.
[26] ibid.

There is a serious risk that judges will attempt to make results based decisions. By that, the judge will base the merits and the quality of the decision purely on its result through hindsight and will find it very difficult to distinguish between competent, and negligent management, as unfavourable results often will be regarded, ex post, as having been foreseeable and, therefore, preventable ex ante. [27] The courts have actively attempted to mitigate against this in the past.[28] That is not to forget that both judges and directors are fallible; neither can have perfect knowledge of business, nor do we live in a zero failure society. Therefore it has been argued that as long as the director has acted in good faith and without acting for their own interests then that should be sufficient to absolve them from liability. As both the courts and the boards of directors are fallible then the question that must be asked is; who should have the final say as to the correct business decision? Is it the businessman with his specialist knowledge of the area, or the judge who has no knowledge of the area at all?

To Encourage Business Risk

Directors of companies are required to make decisions with imperfect information. As a result there will be some form of risk to the decision encourages individuals to take up the post of director by protecting them from liability.[29] As far back as the earliest cases[30] there has been a perception that to be entrepreneurial then an officer or director has to undertake risks, if there is excessive liability imposed on directors it could stifle innovation. The argument that was been repeatedly forwarded is that persons of reason, intellect and integrity would refuse to serve as directors of an institution if the law expected a greater degree of prescience not possessed by people of ordinary knowledge.[31]

The need for a competitive market within the global economy is a desire shared by all nations and overly stifling the decisions of directors would negate against this. There is an economic argument that states that in granting directors the freedom to make decisions free from excessive liability this will create efficient behaviour and improve shareholders' investment. The result of this achievement is an efficient corporate governance structure that allows boards the freedom to drive the company forward within a framework of effective accountability.[32]

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[27] Bainbridge (n 16) 124.
[28] See for example *Re Sherborne Associates Ltd[*1995] BCC 40 and the decision of Lewison J in *Secretary of State for Trade and Industry v Goldberg* ([2004] 1 BCLC 597, 613.
[29] See the Delaware case of *Percy v Millaudon* (1829) 8 Mart. (n.s.) 68, 77-78, discussed in Samuel Arsht, 'The Business Judgment Rule Revisited' (1979-80) 8 Hofstra L. Rev. 93.
[30] *Carlen v Drury* (1812) 1 Ves. & B.154.
[31] Arsht (n 28).
[32] William Carney 'the ALI's Corporate Governance Project: The Death of Property Rights?' (1993) 61 Geo. Wash. L. Rev. 898.

Under the Anglo-American Shareholder Primacy Theory, and subsequently Enlightened Shareholder Value[33] directors have a legal obligation to run the company for the benefit of its shareholders and maximise their interests. Under shareholder primacy theory this means attempting to maximise profit. To do this directors often have to make difficult and often risky decisions in an attempt to profit maximise, often with incomplete or non-perfect information. As has been mentioned above directors are not infallible and if there is excessive liability imposed on them then the conflict between shareholder primacy and liability may make the role of the director completely unpalatable. The director is in a no win situation, to explain this if a director attempts to make a risky decision because he is bound to do so under profit maximisation and the result of this decision is to incur a loss, then he may incur liability. Alternatively if the director chooses to employ a far more conservative business plan forgoing opportunities to profit maximisation he may also be found liable for negligently not maximising shareholder wealth.

Respect for Private Law Theory: The Shareholder/Director Relationship

Directors' liability and corporate governance in general is steeped firmly within private law, and in doing so there is an inherent desire to respect the private law framework within which the company is set. Under private law there is an underlying principal to respect the will of the owners of the institution i.e. the shareholders. It is their decision to install the directors of an institution to office or alternatively to invest in an already pre-existing board. In doing so they are giving their authority to the director to conduct the business decisions of the company for the benefit of the shareholders.[34] If the judiciary were to interfere with a perfectly legitimate decision made by a director then this would have the result in removing the authority of the shareholders and supplant that of the judges themselves.

> '[T]he Business Judgment Rule is the offspring of the fundamental principle... [that] the business and affairs of a Delaware corporation are managed by or under its board of directors. ... The Business Judgment Rule exists to protect and promote the full and free exercise of the managerial power granted to Delaware directors. In other words, the rule ensures that the default is deference to the board's authority as the corporation's central and final decision maker.'[35]

[33] See Chapter V.
[34] For example see *Joy v North* (1982) 692 f2D 880.
[35] *Smith v Van Gorkom,* (Del. 1985) 488 A. 2d 858.

Under this idea the shareholders, in placing the directors into their positions, have relinquished sovereignty of their control over the company in lieu of the decisions of the directors. Clearly then enforcing Bainbridge's idea of authority over accountability and the entrenching of the BDR.

As already mentioned judicial scrutiny of business decisions may be undesirable because of the nature of the role of the judiciary, however there may be far more fundamental reasons to discourage external reviews of decisions. If there is an external review of a decision of the directors or the board of management then there is an argument that this may also be harmful to the structure of the board itself. The efficiency and synergy of the board highly depends on the individual relationships and ways of working that members develop to produce a balanced board. If each decision that is being made is then subject to further external review this will break down the balance of the board and result in negative external costs.

Early UK Case Law and the Establishment of a Business Decision Rule

Before the chapter attempts to map out the development of the UK BDR it is important to note that there is a difficulty in assessing its application because of the very nature of the rule. The courts do not stick to any single term to define what they consider to be a BDR. Very often the judiciary used vague or loose language to define what they believed to be this fundamental principal. What is always observed throughout the series of cases however is the clear deference the courts take to the decision of the director.

The development of the director from the ideology of the Victorian gentleman[36] resulted in directors being treated as 'trustees' or quasi-trustees'.[37] Treating them as such, resulted in them being bound by the general rules of equity on the one hand but also it freed directors from liability for anything short of culpable and gross negligence.[38] This approach was highlighted in the case of *Re Brazilian Rubber Plantations and Estates Ltd* where Neville J noted that:

> '[a director] is not bound to bring any special qualifications to his office. He may undertake the management of a rubber company in complete ignorance of everything connected to rubber, without incurring responsibility for the mistakes which result from such ignorance.'[39]

[36] Ralph Wright & Brian Creighton, 'Rights and duties of directors' (2nd edn, Butterworths 1991) 48.
[37] Vanessa Finch, 'Company Directors: Who cares about skill and care?' (1992) 55 MLR 179, 200.
[38] ibid.
[39] [1911] 1 Ch 425.

This followed the argument forwarded by Lord Hatherley in *Turquand v Marshall*[40] that however ridiculous and absurd the conduct of directors might seem it was the misfortune of the company that it chose such unwise directors, but ultimately, in any event, the directors could simply be removed. To such an extent that *Paviides v Jensen*[41] Dankqwerts J. agreed to leave the company with what he called 'a set of amicable lunatics.'[42] So it is clear to see the common law doctrine of the BDR being developed by an ideological backdrop of non-interventionalism. This can be clearly seen in *Allen v Gold Reefs of West Africa Ltd;*[43] the case was concerned with the power of the company to alter the articles of association. It was held that the court was unable to interfere with the alteration of the companies articles unless the change was not bona fide for the benefit of the company.

> 'the power thus conferred on companies to alter the regulations contained in their articles is limited only by the provisions contained in the statute and the conditions contained in the company's memorandum of association. Wide, however, as the language of s.50 of the Companies Act, 1862 is, the power conferred by it must, like all other powers, be exercised *subject to those general principles of law and equity which are applicable to all powers conferred on majorities and enabling them to bind minorities*. It must be exercised, not only in the manner required by law, but also bona fide for the benefit of the company as a whole, and it must not be exceeded.' [Emphasis added][44]

Again we can see the courts opting out of the option to interfere in business matters, save for the exercise of equitable or tortious means.

Non-interventionalist thinking was cast into doubt momentarily by *Dafen Tinplate Co v Llanelly Steel Co Ltd*[45] the presiding judge took a polar opposite view to that of the BDR and attempted to apply judicial intervention as to what the correct outcome of the case should be, Peterson J purported that '...[w]henever the Court and the shareholders may differ in opinion upon what is for the benefit of the company, the view of the Court must prevail...' this is a clear (and completely unprecedented) ideological shift from what had historically been a conservative judicial system when it came to interfering with business decisions, and unsurprisingly the decision was not very popular.

[40] (1869) 4 Ch App 376.
[41] [1956] Ch. 565 Ch D.
[42] ibid 570.
[43] [1900] 1 Ch. 656.
[44] ibid 671.
[45] (1907), [1920] 2 Ch 124.

The view was politely questioned and ultimately disregarded in *Shuttleworth v Cox Brothers.*[46] Atkin LJ was quick to uphold the idea of the BDR and its standing within English law, 'it is not matter of law for the Court whether or not a particular alteration is for the benefit of the company, nor is it the business of a judge to review the decision of every company in the country on these questions.'[47] The *Shuttleworth* case therefore appears to reaffirm the view that the courts are not willing to look at what it considered to be purely business decisions, however once again the absolute nature of the rule was brought into question on the basis of general equitable principles. These equitable principles were carried further by the potential development of tortuous liability as Scrutton LJ in *Shuttleworth* pointed out:

> 'Now when persons, honestly endeavouring to decide what will be for the benefit of the company and to act accordingly, decide upon a particular course, then, provided there are grounds on which reasonable men could come to the same decision, it does not matter whether the Court would or would not come to the same decision or a different decision. It is not the business of the Court to manage the affairs of the company. That is for the shareholders and directors.'[48]

The BDR was reinforced by the subsequent case of *Re Smith and Fawcett Ltd*[49] whereby Lord Greene MR remarked that:

> 'The principles to be applied in cases where the articles of a company confer discretion on directors with regard to the acceptance of transfers of shares are, for the present purposes, free from doubt. They must exercise their discretion bona fide in what they consider – *not what a court may consider*- is in the interests of the company, and not for any collateral purpose.'[emphasis added][50]

This then continued well into the latter half of the 20th Century as initially by Oliver J as he remarked in *Re Halt Garage* that 'It is not for the courts to manage the company.'[51] And then in Devlin v Slough Estates where Dillon J purported that 'The court does not interfere with the business judgment of directors in the absence of allegations of mala fides.'[52]

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[46] [1927] 2 KB 9.
[47] ibid 26.
[48] ibid 23.
[49] [1942] Ch. 304.
[50] ibid 306.
[51] *Re Halt Garage* (1964) Ltd [1982] 3 All ER 1016, 1039 per Oliver J.
[52] *Devlin v Slough Estates Ltd and others* [1983] BCLC 497, 504 per Dillon J.

The Development of the Modern Director and the Persistence of the BDR

The paper expanded into some significant depth on these earlier cases not simply for historical reasons, but because the cases map out the very clear logic of what the intended nature of the BDR to be; that being a protective intention of the courts with directors becoming the beneficiaries of that protection. As has already been discussed the BDR is a 19th Century construct borne out of a classical economic ideology of *lassaiez-faire*, combined with the belief that the courts needed to protect the amateur director. The development of the modern director saw a shift, from well-meaning amateur to professional with liabilities for wrong doing. The development of the objective standard of care by Hoffman LJ which began with the case of *Norman v Theodore Goddard*[53] and ultimately concluded with *Re D'Jan of London Ltd*[54] and the establishment of the standard found under the Insolvency Act 1986 s.214 is a well-documented one.[55] During the same time the Cadbury Committee released a report in 1992 that noted in particular that non-executive directors had come to hold a special function within the company, namely to: 'Safeguard the shareholders from incompetence on behalf of the executive directors.'[56] This is a much more intricate role than the well-meaning amateur of the late 19th Century who simply lent their name and standing to the company. The Cadbury Committee clearly saw the non-executive director as much more of a check and balance on the Company in particular 'if the chairman is an executive director, a senior non-executive director should be appointed in order to maintain a balance between the executive and the non-executive.'[57] This is a far cry from the type of directors found in cases such as *Re Cardiff Bank*[58] *(Marquis of Bute case)* where the Marquis appointed upon his birth attended board meetings only once in thirty eight years. It might therefore be concluded that one of the main reasoning's for a BDR was to protect the well-meaning amateur one would expect to observe a shift in the case law away from the protection of the director towards greater accountability and ultimately the erosion of the BDR.

Startlingly we can observe quite the opposite, as the BDR appears to be followed in the proceeding cases. Firstly in the case of *Re Tottenham Hotspur Plc*[59] when the court was asked to form an opinion on the dismissal of a premier league football manager by the board of Tottenham Hotspur FC. When

[53] [1992] BCC 14.
[54] [1993] BCC 646.
[55] See for example: Bryan Clark, 'The director's duty of skill and care: subjective, objective or both? (1999) S.L.T. 239, Andrew Hicks, 'Directors' Liability for Management Errors' (1994) 110 LQR 390 and Finch (n 36).
[56] Cadbury, Report *of the Committee on the Financial Aspects of Corporate Governance* (London: Gee Publishing, 1992).
[57] ibid para 4.3.
[58] [1892] 2 Ch 100.
[59] [1994] 1 BCLC 655.

asked the courts stated,'[W]hether Mr Venables dismissal was in the best interest of Tottenham is not a matter for the court to decide that is a matter for the Tottenham board to whom this decision is entrusted under the company's constitution.'[60] If viewed in isolation this decision could be dismissed as inconsequential since the case concerned a pre-trial order overriding a board's decision. This however was followed by a number of successive cases that have very clearly cemented the BDR in modern jurisprudential thinking. Parker J when asked to adjudicate on the nature of a director's fiduciary duty in *Regentcrest plc (in liq.) v Cohen*[61] opined *that*

> '[T]he question is not whether, viewed objectively by the court, the particular act or omission which is challenged was in fact in the interests of the company; still less is the question whether the court, had it been in the position of the director at the relevant time, might have acted differently.'[62]

Parker J's deference to the directors decisions enforces the judicial belief that they are not there to supplant the decision of a director and thus is affirmed by Parker J's reference to Lord Greene and his passage in *Re Smith and Fawcett Ltd*, affirmed by the subsequent case of *Re Barings*.[63]

So it is clear to observe that although the classical ideology of the BDR was developed for the amateur director it has survived through to the modern day through the vehicle of a combination of fiduciary duties and the tort of negligence. The courts are keen to make deference to the judgement of the directors and are extremely reluctant to voice an opinion that may be tantamount to supplanting the views of the directors with their own opinion. Again observing through the lens of authority and accountability there is a clear deference to the authority of the directors over their personal accountability.

[60] ibid 660.
[61] [2001] BCC 494.
[62] ibid para 120 *see also Devlin v Slough Estates Ltd and others*[1983] BCLC 497, 504 whereby Dillon J opined that '[t]he court does not interfere with the business judgment of directors in the absence of allegations of mala fides'.
[63] See for example *Re Barings (no5)* [1999] 1 BCLC 433.

Alternative Jurisdictions that Follow the Business Decision Rule: USA and Australia

United States of America

The BDR is not an entirely British construct it has been applied across a number of different jurisdictions. And whilst its application has been diverse, and different, the general theories and grounds of establishment appear to be universal.

The BDR, whilst established in the UK contrary to claims of some academics,[64] has often been long overlooked by both the judiciary and academic literature. This has not been the case in the US where there is a large body of jurisprudence that already discusses the merits of such a rule. For example Rosenberg remarks that US '[c]orporate law does not allow the aggrieved to seek legal action against a corporation just because its directors made a bad decision.'[65]

The Delaware version of the BDR is fundamentally the same as that of the UK. The US courts will not review the substantive decision of a director so long as it satisfies their fiduciary duties of good faith and loyalty, and satisfies the respective standard of care. It is based predominantly on a number of 1980's cases that began with *Aronson v Lewis*.[66] In this case the judges found there to be,

> 'a presumption that in making a business decisions the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. Absent of an abuse of discretion, that judgment will be respected by the Courts. The burden is on the party challenging the decision to establish facts rebutting the presumption'. [67]

What is clear is that there was a reluctance of the courts to interfere with what it deemed to be purely internal issues, however once again this was subject to both equitable and tortious principles, those principles that appear to be startlingly similar to those found in the earlier UK case law. The important part to recognise however was that 'it is presumed that decisions of disinterested directors are made in good faith for a rational purpose, with due care, and in the honest belief that they are acting in the best interests of stockholders.'[68] The fact that this assumption has to be

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[64] Mohammed Hemraj, 'The Business Judgment Rule in corporate law.' (2004) ICCLR 192,194, the American case of *Percy v. Millaudon* 8 Mart. (n.s.) 68 (La. 1829) came a full 17 years after *Carlen v Drury.*
[65] David *Rosenberg, 'Galactic Stupidity and the Business Judgment Rule'* (2007) 32 J Corp L 301.
[66] *Aronson v Lewis*, 473 A.2d 805, 812 (Del. 1984).
[67] ibid.
[68] (473 A.2d 805).

rebutted shows a clear intention of the judges to distance themselves from any fundamental business decisions within the courts.

The US Business Judgment Rule whilst taking into consideration the fiduciary duties of good faith and loyalty is focused firmly on the duty of care and as such, the director is under an obligation to inform themselves fully 'of all the information reasonably necessary to make an informed decision.'[69] This being affirmed by the *Technicolor*[70] case whereby directors in that case were expected to take an 'active and direct role in the context of the sale of a company from beginning to end,' and not be 'passive instrumentalities during merger proceedings.' [71]

How the Business Judgment Rule differs within the US is that it is seen very much as a defensive construct. In that it is not a relevant consideration until after a decision has been made and the provision is used as a defence to an attack on the reasonableness of the decision as is clearly stated in the Delaware Code section 141(a)[72]

So what we can summarise from this is that if the four following conditions have been met then the courts will refuse to look at the business decision of a director:

1. The director mush have made a decision
2. The director must have informed himself with respect to the business judgement to the extent he reasonably believes appropriate under the circumstances
3. He must have acted in good faith
4. He may not have acted to promote his own interests

Where the US rule differs from that of the UK however is that it is based on a subjective tort of negligence, this is a much lower threshold to satisfy and as a result a much easier defence to prove.

Australia

Conversely in 1998 the Australian government placed their 'Business Judgment Rule' on a statutory footing by enacting s.180 of the Corporation Act 2001.[73] Under the legislation a 'business judgment' means 'any decision to take or not to take action in respect of a matter relevant to the business operations of the corporation.'[74] If a director makes a bona fide judgment that satisfies the criteria

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[69] *Smith v Van Gorkom* 488 A.2d 858 (Del. 1985).
[70] *Cede & Co. V Technicolor, Inc.,* 634 A.2d 345, 368-71 (Del. 1993).
[71] ibid 372.
[72] DEL. CODE ANN> tit. 8, 141(a) (2001 & Supp. 2004 & Interim Supp. 2005).
[73] Corporate Law Economic Reform Progress Bill of 1998 (CLERP)
s.180 of the Corporation Act 2001.
[74] S.180(3).

set out in s.180(2) of the Corporation Act 2001 his decision will not be subject to judicial review as he will be judged to have met his duty of skill, care and diligence and their equivalent duties at common law and in equity. The four requirements are that he (a) makes the judgment in good faith for a proper purpose; (b) he does not have a material personal interest in the subject matter of the judgment; (c) he informs himself about the subject matter of the judgment to the extent he reasonably believes to be appropriate; and (d) he rationally believes that the judgment is in the best interests of the corporation.

Unsurprisingly, as it was directly influenced by the American case law,[75] the criteria set out in the Australian statute bears striking similarities to that of their American counterparts whereby the courts will not review a decision. The reasoning's for the establishment of the Australian statutory Business Judgment Rule were explained in the explanatory memorandum.[76] It was pointed out that the general aim of such a statutory rule was to offer directors a safe harbour from personal liability in relation to honest, informed and rational business judgments.[77]' To place this into context this

The fundamental purpose of the BJR, as it was explained in the Explanatory Memorandum, was to protect the authority of directors in the exercise of their duties, not to insulate directors from liability. It was pointed out that whilst it was accepted that directors should be subject to a high level of accountability, a failure to expressly acknowledge that directors should not be liable for decisions made in good faith, may lead to failure by the company and its directors to take advantage of opportunities that involve responsible risk taking.[78] It is still an accepted principle that directors should not be held liable for mere errors of business judgment.[79] The move by Australia to codify the Business Judgment Rule was not intended as a radical one but simply to 'remove the uncertainty for directors and should lead to better management processes within companies for the taking of decisions.'[80]

The Australian BJR defence did not develop at random and was a clear reaction to the court of appeal decision of *Daniels v Anderson*.[81] In *Daniels v Anderson* the Australian court for the first time introduced an objective standard of care for negligent directors. They departed from the classical idea of liability for nothing short of 'gross negligence' as set out by the classic British case of *Re City*

[75] Hemraj (n 63) 198.
[76] The Parliament of the Commonwealth of Australia, House of Representatives, *Explanatory Memorandum to the Corporate Law Economic Reform (CLERP) Bill 1998* (ISBN 0642 37879 7).
[77] ibid para 6.1.
[78] ibid para 6.3.
[79] See Jean Du Plessis 'Open sea or safe harbour? American, Australian and South African Business Judgment Rules compared: Part 2 (2011) Comp Law 377, 380.
[80] (n 75) Para 2.4.
[81] (1995) 16 ACSR 759.

Equitable Fire Insurance Co.[82] and instead over a series of cases the development of the objective standard of care was spawned.

Other jurisdictions have a similar response to the BDR, in Italy directors cannot be held liable for the negative results of the company, provided they have complied with their obligations.[83] Germany have also codified the rule under the German Stock Corporation Act 2005 s.93. It is interesting to point out at this point that whilst the majority of jurisdictions follow the Business Judgment Rule the United Arab Emirates have taken a much harsher rule by stating pursuant to Article 111 of the Federal Law No.8 of 1984 on Commercial Companies, the manager is liable to the company, the partners and all third parties for 'all acts of fraud or abuse of power, all violations of the law... and all errors in management.'

UK Statutory Definition

As has been noted although the director has observed greater levels of accountability the BDR is still a doctrine that is very much alive in the mind-set of the judiciary. If this is the case then should the doctrine be placed on a greater statutory footing? And if so then why has it not? It is purported that if we analyse the BDR as a doctrine of abstention then the legislature may have inadvertently codified the BDR under Part 10 Chapter 2 of the Companies Act 2006, namely the director's duties provisions.

The BDR was discussed only briefly in the development of the Companies Act 2006. The Law Commission[84] categorically rejected the need for the development of a BDR statutory defence along the lines of what has more recently been enacted in Australia under s.180 of the Corporation Act 2001. The report noted that there was no need for such a defence pointing out that the courts already respect commercial decisions under the general law and as a result they did not see any reason to codify.[85] The Law Commission took the view that Australia was going through a period of concern as to the increase in liabilities of directors following the *Daniels v Anderson*[86] case. This case expanded the possible liabilities of directors, more specifically non-executive directors in by noting that all directors were bound by objective standards of care. The case took a dim view of passive directors and argued that directors needed to be much more proactive.

[82] *Re City Equitable Fire Insurance Co Ltd*[1925] Ch 407.
[83] (Court of Appeal of Milan, March 3, 2004, Supreme Court, cae no. 3652/1997.
[84] Law Commission and Scottish Law Commission, *Company Directors: Regulating Conflicts of Interests and Formulating a Statement of Duties* (1999) Law Com. No.261; Scot Law Com. No.173, 53.
[85] ibid 5.26.
[86] (1995) 16 ACSR 607 (at first instance, *AWA Ltd v Daniels* (1991-2) 7 ACSR 759).

The Law Commission took the view that as 'the UK courts do not currently review the commercial decisions made by directors in good faith or judge them with the wisdom of hindsight'[87] then the issues of *Daniels v Anderson* did not concern them. It is purported however that the very same issues had come to light only a few years earlier. The Cadbury Committee clearly saw the non-executive director as much more of a check and balance on the Company in particular 'if the chairman is an executive director, a senior non-executive director should be appointed in order to maintain a balance between the executive and the non-executive.'[88] Not only this, soon after the Hampel Report[89] outlined clearly a desire to increase non-executive activism. In particular it emphasised that the non-executive directors should 'demonstrate objectivity and robust independence of judgment when necessary.'[90] A clear indication of the expectations on non-executive directors to serve as checks or balances because as the report noted if there is not sufficient constraints an 'individual or small group of individuals can dominate the board's decision taking.'[91] This was eventually taken up by the judiciary in *Re Baring*[92]*s* whereby Parker J noted that in discharging their duty the opinion of the court must 'depend on the facts of each particular case, including the director's role in the management of the company.'[93]The Law Commission therefore ultimately concluded that:

> 'The courts currently do not judge directors with the wisdom of hindsight and do not 'second-guess' directors on commercial matters. There is nothing to suggest that this long-established judicial approach would not apply. It would in any event be difficult to formulate a business judgment principle without either narrowing it or making it too rigid.'[94]

So it is very clear that the Law Commission considered the BDR to still be a very important one. It eluded to the fact that there would be a possibility of enacting such a rule however it would be too difficult without narrowing or making the rule too rigid. The problems of rigidity were noted in different parts of the law commissions document however in those it was purported that statutory codification outweighed the possibility of setting rigid standards.[95]

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[87] Law Commission and Scottish Law Commission (n 83) 5.24.
[88] Cadbury Report (n 53) para 4.3.
[89] Hampel *Committee, The Hampel Report on Corporate Governance-Final Report* (London: Gee, 1998).
[90] ibid 2.5.
[91] ibid III.
[92] *Secretary of State for Trade and Industry v Baker (No.5)* [1999] 1 BCLC 433.
[93] ibid 489.
[94] Law Commission (n 83) para 5.28.
[95] See for example setting out a statutory duty of care at Law Commission (n 83) para 4.8.

The Business Decision Shield

The current rule is a doctrine which allows the courts to refuse to review a decision in its entirety, not allow for a defence to a decision that has already made. The UK BDR creates a barrier to bringing a claim if a director can show that he has satisfied his fiduciary and tortious obligations.

It may be argued that the legislature has inadvertently codified the BDR in the Companies Act 2006. Following the enactment of the Act directors' equitable and tortious duties that were once found under the common law were enacted into legislation under part 10 chapter 2.

The general duties are set out as follows:

s.171 Duty to act within powers

s.172 Duty to promote the success of the company

s.173 Duty to exercise independent judgment

s.174 Duty to exercise reasonable skill, care and diligence

s.175 Duty to avoid conflicts of interest

s.176 Duty not to accept benefits from third parties

s.177 Duty to declare interest in proposed transaction or arrangement

These duties collectively encompass all of the equitable and tortious duties found in the previous common law and place them on a single statutory footing. Now if we are to look at these duties, not individually, but as a collective we begin to see the creation of what the author calls the Business Decision Shield. Individually each duty cannot be seen to be the BDR but if it is possible to look back at what is considered to be the definition we may begin to lift the fog from our view. As already noted the modern definition is described as a doctrine of abstention where by the courts will refuse to review decisions made by the directors of a company unless specific preconditions for review have been set out.[96] In the UK those preconditions have firmly been stated as the equitable and tortious duties a director is expected to adhere to. Whilst the author agrees that the UK does not have a statutory BDR like the one in Australia where it is seen as a defence to an action, as a doctrine of abstention whereby the courts will simply refuse to look at an action unless it breaches one of the equitable or tortious duties then the BDR has now been codified under the statute.

[96] Bainbridge (n 16) 83.

This reasoning is all the more believable when one looks at the intentions of the parties in enacting both the Australian defence and the collective UK duties. In both cases the legislature wanted greater clarity with regards to the possible liabilities of directors,[97] and in both cases this had come on the back of a number of high profile domestic cases.[98] Whilst the vehicles of doing so have been different the ultimate deference to the decisions of directors has remained intact in both the UK and Australian jurisdictions.

It is beyond the remit of this paper to assess the viability of such a rule but it may be noted that as a result of the development of the objective standards of care in recent history the overall scope of the Business Decision Rule may have dwindled.[99]

The Global Financial Crisis: A Shift in Ideological Thinking?

So if we are to accept that the BDR has now been placed on a statutory footing, ideologically why are directors still now seen as a class that needs protecting? They are clearly no longer amateurs with many of the major directors, particularly non-executive directors earning a small fortune for their roles sitting on boards. The development of the professional director in the 1980's brings them in line with professional workers and their duty of care has developed to reflect as such.[100]

Therefore should they still have the protection of the courts? Or has the ideology shifted so greatly as to render the BDR obsolete. Looking back at the original reasoning of the courts, we can observe that there is still a serious apprehension by the courts to attempt to hold a director culpable for decisions that have resulted in losses. It is purported that following the most recent financial crisis, there has been an ideological shift towards greater accountability. The accountability argument is not a new one, there has been a general progression towards greater accountability of directors, through the vehicle of negligence based case law and legislation from the late 1980's.[101] However it is only since the most recent financial crisis that the scales have now appeared to tip far more in the favour of accountability of directors over their authorisation to do what they please in the name of the company.

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[97] See Department for Trade and Industry, *Modernising Company Law* (White Paper , Cm 5553, 2002) and Law Commission (n 53).
[98] In the UK the Hoffman J developments and in Australia *Daniels v Anderson.*
[99] See for example the cases of *Lexi Holdings Plc (in admin.) v Luqman* [2003] BCC 829 in the UK and *Austrlian Securities and Investments Comission v Healey* [2011] FCA 717 in Australia.
[100] See for example, the objective standard of care under s.174 Companies Act 2006.
[101] One need only examine the judgments of Hoffman LJ in Norman v Theodore Goddard, Re D'Jan of London.

The best example of this, can be observed in the FSA report into the failure of RBS, [102] the report was damming in its criticism of the board of directors and their decisions that resulted in some quite catastrophic losses on the part of the bank. Repeatedly the FSA noted that: 'While external factors were undoubtedly important in RBS's failure, banks are run by people and those in board and senior management positions are responsible for the decisions they make.'[103] The report was extremely critical of the decisions of the board which had been undertaken, particularly with regards to the decision to purchase ABN AMRO, on the basis 'of due diligence which was inadequate in scope and depth, and which hence was inappropriate in light of the nature and scale of the acquisition and the major risks involved.'[104] However the report noted that '[i]t is only with hindsight that it is clear that there were specific decisions taken by the RBS Board and senior management which placed RBS in a more vulnerable position than other banks when the financial crisis developed between 2007 and 2008.'[105] So whilst being critical of the decisions of the board of directors they ultimately concluded that the fault could only be proven with hindsight.

Whilst it is clear that the FSA reinforced the BDR indirectly:

> 'Errors of commercial judgement are not in themselves sanctionable unless either the processes and controls which governed how these judgements were reached were clearly deficient, or the judgements were clearly outside the bounds of what might be considered reasonable. The reasonableness of judgements, moreover, has to be assessed within the context of the information available at the time, and not with the benefit of hindsight.'[106]

What is important to point to is an increase in the perceived need for accountability of the actions of the directors and not the failure in the accountability of those specific directors. One of the most important examples of this and one of the bases for the authors belief in an ideological shift towards greater accountability is the discussion of the possibility of the imposition of a 'strict liability' test for directors of financial institutions.[107] The FSA did not come down on one side or the other with regards to the test but what is fascinating is the willingness to even discuss such a change.

Is a strict liability test viable for the directors, strict liability is only really seen where the party is in a better financial position that the person committing the tort, take vicarious liability as an example:

[102] FSA, 'The failure of the Royal Bank of Scotland: Financial Services Authority Board Report' (FSA Dec 2012).
[103] ibid para 572.
[104] ibid para 19.
[105] ibid para 572.
[106] ibid 7.
[107] ibid 353.

an employer will be liable for the wrongs of an employee in the course of their employment. The classical justifications for this are:

1. that the victim should be able to seek compensation from a course better placed financially than the employee who committed the tort.
2. Loss distribution service
3. Employer derives an economic benefit from the employees' work and therefore should bear any related burdens.

There are clearly major issues with a strict liability test. A 'strict liability' legal sanction based approach raises complex legal issues relating to burden of proof and human rights. It might in particular cases result in injustice, and might discourage some high quality and high integrity people from being willing to work in banks, given the large personal liability involved.[108] Whilst it is unlikely that the result of the report would be to create a strict liability test there is no denying the possibility of an ideological shift towards greater accountability of directors for their actions.

The caveat for any of this analysis must be based on an assumption that the case in point is talking strictly talking about financial institutions and not companies in general:

> 'The ABN AMRO acquisition illustrates the point. The due diligence conducted was inadequate to assess the risks. But it was typical of all contested takeovers, and in non-bank sectors of the economy launching a bid on the basis of limited due diligence might be a reasonable risk to take if the Board believed that the upside opportunities justified it. If the acquisition went wrong, shareholders would suffer, and it would be for them to decide whether to sanction the management or Board by firing them. Banks are different because excessive risk-taking by banks (for instance through an aggressive acquisition) can result in bank failure, taxpayer losses, and wider economic harm. Their failure is of public concern, not just a concern for shareholders.'

As a result it may be argued that the increase in accountability that has been noted by this document is based strictly within the financial sector however the recent Walker Review whilst still reinforcing some of the ideas behind the BDR,[109] also discussed quite openly the shift away from allowing 'complacency' and the possibility that the recent financial crisis created a 'new situation' for

[108] ibid 9.
[109] For example not judging decisions with the benefit of hindsight Walker Review, *A review of corporate governance in UK banks and other financial industry entities: Final recommendations* (26 November 2009) 1.17.

the directors of all companies.[110] Ultimately the Walker Review concluded that there would be no advantage and considerable potentially serious negative consequences from any broadening in the statutory specification of the responsibilities of directors,[111] however once again it is the very fact that they are discussing the possibility of broadening statutory liability means that there may have been the aforementioned ideological shift away from the authority of the directors to greater accountability.

Real Change? The Example of the USA and the Limited Hope for Reform

As a result of the financial crisis there may have been a fundamental shift in ideology, it is purported that the losses incurred and the perceived fault of the directors has now caused a shift in the balance between authority and accountability in favour of holding directors to account. This may in turn result in the diminishing or ultimate abolishment of the BDR. Or will it? The evidence from the US might state the contrary. Serious scandals in Enron and Walt Disney in the early 2000’s previously questioned the accountability of directors at the time of failure. It is believed that these examples of mass director and business failure, and subsequent litigation, show that the courts may still enforce the BDR albeit on incorrect or outdated theory. A similar downturn on a much smaller scale to that of the recent financial crisis in *Brehm v Eisner,*[112] when discussing the substantive duty of care under Delaware law the court was quick to remark that:

> ‘such a concept is foreign to the Business Judgment Rule. Courts do not measure, weigh or quantify directors’ judgments. We do not even decide if they are reasonable in this context. Due care in the decision making context is *process* due care only.’[113]

The courts in this case are clearly allowing for the judgment of the directors to override those of the judiciary. This was affirmed by Chancellor Chandler in the subsequent case where it was noted:

> ‘The redress for failures that arise from faithful management must come from the markets, through the action of shareholders and the free flow of capital, and not from this Court. Should the Court apportion liability based on the ultimate outcome of decisions taken in good faith by faithful directors or officers, those decision-makers would necessarily take decisions that minimize risk, not maximize value. The entire advantage of the risk-taking, innovative,

[110] ibid 1.18.
[111] ibid Appendix 3.
[112] 746 A.2d 244 (Del. 2000).
[113] ibid 264.

> wealth-creating engine that is the Delaware corporation would cease to exist, with disastrous results for shareholders and society alike.'[114]

Whilst this may lead academics to the conclusion that here the courts are clearly affirming the ideology of economic theory of *lassaiez-faire* and free market that the BDR is built upon. This may possibly be distinguished from the UK version of the rule as the duty of care in the US is a purely subjective one and not built on an objective minimum standard of care as is the case in the UK.[115]

Scope of the BDR Following the Development of the Objective Standard of Care

As has already been discussed in the thesis over the past 20 years there has been a development of the objective standard of care now found under s.174 of the Companies Act 2006[116] and whilst it could be argued that the BDR has been enacted into statute, it is purported that the scope of its application could now be decreasing following the cases of Lexi Holdings v Luqman[117] and the Australian case of Healey.[118]

The chapter will not go into an in-depth discussion of these cases, as this has already been done in other parts of the thesis,[119] but if we recall the discussion of these two key cases it is evident that the judiciary have increased the scope of decisions deemed reviewable under s.174. For example in *Lexi Holdings,* if a director agrees with the decisions of a convincing and controlling director without asking sufficiently probing questions this is actionable. Conversely in *Healey*, the signing off on properly audited accounts without reading them not a business decision under the Business Decision Rule and therefore reviewable under s.174.

Conclusion

This chapter has shown that the Business Decision Rule is a 19th Century construct based on legal and economic reasoning, whereby the judiciary will refuse to enter into a debate as to the substance of a director's decision they have made when acting in the name of the company so long as his

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114 Re *Walt Disney Co. Derivative Litg.* (Disney IV), No. CIV.A. 15452, 2005 WL 2056651 at 2.
115 s.174 Companies Act 2006.
116 See Chapter IV.
117 *Lexi Holdings (In admin.) v Monuza Akthar Luqman, Zaurian Parveen Luqman* (n 99).
118 *ASIC v Healey* (n 99).
119 See Chapter IV.

equitable and tortious duties have been met. The chapter has shown that the doctrine is still applicable in the 21st Century although its scope may have reduced.

Against the reasoning of the Law Commission and perhaps inadvertently, the UK legislature has now codified the Business Decision Rule under the Companies Act 2006 without intending to do so. This has been done through the development of the concept defined by the author as the Business Decision Shield. The Business Decision Shield is a doctrine of abstention whereby, if a decision made by a director does not fall within one of the duties as set out under s.171-177 of the Companies Act 2006, the courts will simply refuse to look at any action focusing on the decision.

The Business Decision Rule was used to promote an entrepreneurial spirit within company law, and to encourage directors to make difficult and risky decisions in an attempt to profit maximise, often with incomplete or non-perfect information. However, following the Global Financial Crisis there has been a shift away from the authority of the director towards a culture of accountability. This has come through and resulted in the reduction of the scope of the Business Decision Rule. Reducing the scope of the Business Decision Rule is another step in developing the multifaceted approach the author believes is imperative in ensuring a shift in banking culture following the Global Financial Crisis. The holistic approach will address the limitations of prudential regulation ensuring that improving corporate governance structures will aid in altering behavioural expectations and norms.

Chapter VII: Director Remuneration: Help or Hindrance to Corporate Governance

Chapter VII: Director Remuneration: Help or Hindrance to Corporate Governance

> 'Inappropriate incentives for management and employees within institutions' remuneration frameworks are considered to have been among the factors that led institutions to implement short-term oriented and excessively risky strategies, in that they granted disproportionate rewards on the upside and insufficient penalties on the downside.'[1]

During the recent financial crisis, UK banks were provided with nearly £1.3 Tn in support.[2] During the same time there have been a number of high profile criticisms of remuneration structures within the financial industry and more specifically, remuneration packages of directors of those institutions. The development of a 'rewards for failure' culture has been quoted heavily in the media,[3] and in academia.[4] The chapter will attempt to answer a number of fundamental questions with regards to the make-up, and viability, of current remuneration practices as an aid to good corporate governance. In the wake of the financial crisis the remuneration of directors has become a high profile issue. Following the crisis there have been two specific areas where there has been significant criticism, shortly after the financial crisis hit the focus of the media criticism circulated around the exit payments of outgoing executives who had presided over significant losses during the financial crisis.[5] More recently the criticism has evolved away from specific exit payments, to a much more general criticism of the overall levels of remuneration awarded to directors of financial institutions. Whilst the greatest criticism has been directed towards the directors of those institutions that have received state aid, there appears to be a general discourse towards the high remuneration packages awarded to directors at a time of financial difficulties within the market.[6]

[1] EBA Final draft regulatory technical standards on criteria to identify categories of staff whose professional activities have a material impact on an institution's risk profile under Article 94(2) of Directive 2013/36/EU, EBA/RTS/2013/11, 5.
[2] See Chapter I for an outline of the Global Financial Crisis.
[3] For example Jill Treanor, 'Barclays AGM: shareholders large and small protest over pay and bonuses' *The Guardian* (24 April 2014).
[4] See for example Habib Jouber and Hamadi Fakhfakh, 'Pay for luck: new evidences from the institutional determinants of CEOs' compensation' (2012) Int JLM 485 or Chrispas Nyombi, 'Corporate Personality: the Achilles' heel of executive remuneration policy' (2014) Int JLM 184.
[5] Perhaps the most high profile of these is disgraced former head of RBS former Sir Fred Goodwin see Robert Winnett, 'How Sir Fred Goodwin walked away with 693000 a year for life' *The Telegraph* (London, 27 February 2009).
[6] This is most clearly illustrated in the case of state owned or backed financial institutions, see for example the bonuses awarded to Lloyds Banking Groups Executives in March 2014 reported at Jill Treanor 'Lloyds' top management bonuses potentially worth more than £27m' *The Guardian* (London, 24 March 2014).

Ironically it was not very long ago that banking was considered as 'one of the relatively low paid industries',[7] compared to some of the more classical professions of law and medicine. This changed with the financial boom of the 1980's and salaries have grown exponentially ever since. Most recently this has been illustrated in the EBA Report of 2012 where there were a declared 2714 people on salaries in the UK financial sector totalling over £1 Million per year.[8] These figures can be seen as excessive, and infuriating to many, given that during the same period of time there have been significant financial losses made by the same institutions, that resulted in some cases of governmental bailouts.

The public unrest culminated in 2012 with a number of large scale shareholder revolts across both the financial sector and ancillary industries. The revolt has since been dubbed the 'Shareholder Spring', in acknowledgement of the earlier Arab Spring of 2010, and its reasons will be investigated later in the chapter. It is imperative for remuneration to be examined in the light of good corporate governance structures, as imperfect remuneration policies have the capacity to undermine the safety and soundness of the financial markets.

The chasing of high, short term profits during the financial crisis, led to generous bonus payments to directors and employees without adequate regard to the longer-term risks they imposed on financial institutions.[9] Whilst remuneration structures need to attract and motivate men having characteristics necessary for success in the industry,[10] it is believed that shareholders must not allow directors to take unnecessary risks. 'The shareholders' role in governance is to appoint the directors… and to satisfy themselves that an appropriate governance structure is in place.[11] The question that therefore needs to be posed is whether these criticisms may be justified? And to what extent remunerations structures in financial institutions can be an aid to good corporate governance?

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[7]Arch Patton, *Men, Money and Motivation* (MCGraw-Hill Book Company 1961) 67.
[8] European Banking Authority, 'EBA Report: High Earners 2012 Data' (EBA 2013) accessed at www.eba.europa.eu/documents/.../EBA+Report+High+Earners+2012.pdf *[accessed on 4 September 2014].*
[9] Financial Stability Forum, 'FSF Principles for Sound Compensation Practices' (April 2009) Now the Financial Stability Board.
[10] Walker Review, *A review of corporate governance in UK banks and other financial industry entities: Final recommendations* (26 November 2009) Section D.
[11] Cadbury Review, Report *of the Committee on the Financial Aspects of Corporate Governance (London: Gee Publishing, 1992)* para 2.5.

What Is Remuneration and Can Directors be Paid?

'No Profit Rule'

Remuneration is defined as a sum of money paid for work or a service[12] however within the UK there is no automatic entitlement to any remuneration or reimbursement for any expenses that occur as a result of the directors' office.[13]

> 'A director is not a servant. He is a person who is doing business for the company, but not upon ordinary terms. It is not implied from the mere fact that he is a director, that he is to have a right to be paid for it. In some companies… there is a special provision for the way in which the directors should be paid; in others there is not. If there is a special provision for the way in which they are to be paid, you must look to the special provision to see how to deal with it. But if there is no special provision their payment is in the nature of a gratuity.'[14]

A director is not an employee of the company merely due to his role as a director.[15] Holding office as a director does not grant a status of employment, instead the director acts as a service provider for the company acting under a contract for services. Under this contract the director owes fiduciary obligations. Under these fiduciary obligations a director may not profit from his role. Based upon agency theory the director must not benefit from his role as this would place him in conflict with his principal. Whilst this is ideologically sound, in reality it would be highly unlikely that any director would accept office, and conduct the affairs of the business without any form of recompense. It is therefore accepted that directors of a company may be paid a fee for the work they undertake. Any remuneration must however be authorised by the company's articles.[16]

If the articles of association clearly state the method and value of remuneration a director is to be paid then the courts are extremely reluctant to interfere with the decision. When properly authorised under the articles, a director can sue for the full amount of payment owed whether a company makes a profit or not.[17] However when there has not been a resolution a director cannot claim *quantum meruit* for services undertaken.[18]

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[12] Oxford English Dictionary Definition.
[13] *Re George Newman & Co.* [1895] 1 Ch. 654.
[14] ibid 672.
[15] *Hutton v West Cork Railway Co* (1883) 23 ChD 654.
[16] *Guinness Plc v Saunders* [1990] 1 All ER 652.
[17] *Re Lundy Granite Co.* (1872) 26 L.T. 673.
[18] *Re Richmond Game Property Co. Ltd* [1964] 3. All E.R. 936.

Forms of Executive Compensation

Executive compensation is governed not by legislation, but instead by soft law. First issued in 1992 the UK Corporate Governance Code outlines standards of best practice in relation to remuneration structures that are expected for directors. The latest edition to be published was adopted in September 2012.[19]Under the Code it is expected that a director's remuneration package consist of both fixed and variable elements.[20]

A directors' remuneration package is likely to be composed of several different discrete elements:

1. Salary, a directors' initial rate of compensation, it will be set out in their service contract along with any associated rights and obligations. This is a fixed salary that is not affected by performance of the company.

2. Bonus, additional compensation over and above annual the annual salary which is directly linked to the performance of the firm.

3. Executive (or Employee) Stock Options (ESO), the ESO extends the right to a director to purchase stock at a predetermined excise price over a specified time period. There predominantly have performance criteria attached.

4. Long Term Incentive Plans (LTIPs), these are similar to the executive stock option in that there will be performance criteria attached but both the criteria and payment will be subject to a much longer period of time, and most importantly are not tied to the company's share price.

5. Pension Plans, Remuneration packages will also include details on pension contributions for directors.

It is clear that there can be a combination of different forms of remuneration within the same package. There is an important balance that must be struck between cash components and more speculative performance related elements of remuneration. Historically the performance elements were seen as much more of a side incentive behind that of the salary. This changed quite dramatically in the late 1980's with the emergence of the executive share option, and with it the so called 'bonus culture', the ESO and subsequently the LTIP were used to supplement the more traditional base plus bonus components of executive reward. The 'bonus culture' referred to in the

[19] Financial Reporting Council, *UK Corporate Governance Code* (September 2012) Section D.
[20] ibid.

media is linked to both the ESOs and LTIPs. These variable forms of remuneration focus on aligning the level of pay to the performance of the institution, through the distribution of equity shares. Generally, the distribution of shares to directors through variable remuneration is seen as an aid to good corporate governance. So much so that under the UK Corporate Governance Code it is expected that 'a significant proportion of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance'.[21] There can be significant criticism found where these rewards do not appear to be aligned clearly enough with the profitability of the company, this could result in the director still receiving significant levels of remuneration whilst the institution suffers a loss, this has been dubbed the 'rewards for failure' debate.[22]

Performance Related Pay and Agency Theory

As mentioned there has been an ideological shift away from fixed remuneration, to performance related remuneration based upon the success of the company. The intention of this shift is to greater align the interests of the directors, and shareholders, in an attempt to resolve what academics have defined as the 'Agency Problem.'

In the majority of larger companies, and all of the major financial institutions during the financial crisis, the day-to-day decisions of the company are made by managers and not the owners. These managers are employed for their expertise and experience to make the important daily decisions that affect the company. As a manager, it has been argued, that when making those decisions the directors may take different considerations into account than those of the owners.[23] These differences in opinion could result in either loses, or loses of opportunity to increase profits and are known collectively as the 'Agency Problem'. Under Agency Theory directors are engaged as agents of a business to run the company's affairs on behalf of the owners, namely the shareholders, who have neither the time nor capacity to run the company.[24] The decisions the agents make cannot always be guaranteed to be the same as those the owner would have made if placed in the same position, and this is particularly apparent for decisions that offer a disproportionate share of benefits to the managers compared to the costs. A good example might be the use of company assets to benefit the director through the purchase of a corporate aircraft or alternatively the redecoration of the

[21] Financial Reporting Council (n 19).
[22] Vince Cable, 'Oral Statement by the Rt Hon Vince Cable, Secretary of State for Business, Inovation and Skills, on Directors' Pay: 20 June 2012' (BIS, 2012) accessed at http://www.bis.gov.uk/assets/biscore/business-law/docs/o/12-899-oral-statement-on-directors-pay.pdf [Accessed on 4 September 2014].
[23] See Chapter V The Duty To Promote the Success of the Company and s.172.
[24] See Andrew Keay, *The Enlightened Shareholder Value Principle and Corporate* Governance (Routledge 2013) 21.

directors' offices.[25] An added agency problem in large public corporations is that executive directors are hired and monitored by the board under the remuneration committee and not by the owners; this third agency variable will be discussed later in the chapter. Agency Theory has been epitomised by the works of Professor Michael Jensen, which he developed in the late 1970's and early 80's.[26] It is interesting to note, however, that more recently there have been a number of academics that have called into question Jensen's theories. Keay in particular purports that there is a lack of transferability of the Jensen model to the UK shareholder-director relationship.[27]

The Executive Stock Option (ESO)

The initial reasoning for the development of the Executive Stock Option was based upon the belief that it redraws the nature of the contract between firms' executives and its shareholders. It does this by effecting a closer alignment between the two groups' interests. It aligns the main interest of the shareholder, which is increasing share price and therefore shareholder wealth. With the interest of the director, who would gain a personal benefit from an increase to the share price by the exercise of their own stock options. This theory began to gain prominence during the latter half of the 1980's and was advocated for by leading academics at the time, particularly from the US.[28] Jensen and Murphy considered that creating a positive relationship between share price appreciation and ESO-related rewards was an assured way of ensuring wealth maximisation for the shareholders. The Executive Stock Option offers further benefits in that it is a relatively simple instrument to implement, it offers very little in administrative costs. Coupled with the increased levels of disclosure allows simplicity of method of reward.

The Long Term Incentive Plan (LTIP)

The LTIP can be seen as a conditional ESO, here unlike the ESO, it is shares (or shares and cash; or in some extreme circumstances just cash) rather than a right to purchase stock which are awarded to executives. The main advantage of an LTIP is that any awards made under them are done at a level of relative performance which can be defined by the structure of the LTIP itself, this can be done over a specified period of time and may be subject to short term restrictions. The LTIP can be seen therefore as a refined version of the ESO, and one which offers the same benefits with fewer disadvantages. The LTIP offers a much more tailored, company specific mechanism for rewarding

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[25] Michael Jensen and William Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure' (1976) 3(4) Journal of Financial Economics 305.
[26] ibid.
[27] Keay, *The Enlightened Shareholder Value Principle and Corporate* Governance (n 24) 21.
[28] See for example Michael Jensen and Kevin Murphy, 'CEO Incentives: It's Not How Much You Pay, But How.' (1990) 68(3) Harvard Business Review 138.

executive performance. This is insensitive to bull and bear market trends and as a result the theory is that executives can earn their LTIP gains.

During the late 1980's and 1990's there came a large body of statistical evidence to corroborate this theory. The first study to analyse performance-pay as an incentive rather than a reward came from Murphy in 1985,[29] analysing the directors of 72 US firms over a 17 year period, he found strong links between performance related pay and both shareholder return and firm size. Abowd also found some evidence of a causal link between the uses of incentive based remuneration and increased shareholder return.[30] These theories were once again affirmed by Jensen and Murphy,[31] the data they collected after analysing 1688 executives between 1974 and 1986 showed a very strong correlation between a well-structured stock option, and a positive effect on share price therefore theoretically increasing shareholder wealth. So it would appear that there is both theoretical and empirical evidence to suggest that the granting of equity to directors and senior management, as a form of incentive, offers quite clear and distinct benefits to shareholders through increases to shareholder wealth.

Criticism of Performance Related Pay

Immediately following the financial crisis, performance related pay garnered support from the major reports,[32] however more recently there has been strong criticism of executive compensation by shareholders, politicians and the media. These three bodies have been incensed by reports that allegedly show executives receiving vast amounts of remuneration at a time when the companies they control are posting significant losses. These vast sums are, in the majority, the exercising of ESOs and LTIPS that have been earned by the directors in previous years. Before analysing the criticism for variable remuneration that has come out of the most recent financial crisis, it is interesting to note that there was a strong body of highly critical literature with regards to equity based remuneration before this.

Criticism Prior to the Global Financial Crisis: The United States, Michael Eisner and Disney

Michael Eisner was appointed CEO of the Disney Corporation in 1992, for the next five years he oversaw a rapid expansion of the business that resulted in a trebling of profits, adding $13 billion in

[29] Kevin Murphy, 'Corporate performance and Managerial Remuneration: An Empirical Analysis' (1985) 7 Journal of Accounting and Economics 11.
[30] John Abowd, 'Does Performance-based Managerial Compensation Affect Corporate Performance' (1990) 43 (3) Industrial and Labour Relations Review 52.
[31] Michael Jensen and Kevin Murphy, 'Performance Pay and Top-management Incentives' (1990) 98 Journal of Political Economy 225.
[32] See for example Walker Review (n 10).

value to the firm, and more than doubling the stock price from $14.33 to $33. Eisner's annual salary in 1997 was $750,000 and he received $9.9 million in bonus. But that was not all, over that time he had accrued substantial Executive Stock Options. So much so that during the same year he exercised options to the value of $565 million, creating a total compensatory package of $575.7 million.[33] If the story had ended there then it would have been clear Eisner had satisfied his obligations, he had aligned his interests with those of the owners (shareholders) and increased shareholder wealth considerably. However it did not end there, after Eisner had cashed in his stock options the Disney share price began to fall and Disney's profits plunged. Following a number of poor decisions by the board, including a $1Bn loss in its go.com network, in 2001 Disney posted a $158 million loss and the stock price plummeted to $20.72.[34] As a result the shareholder body was extremely critical of Eisner and the Disney board, many sought protection from directors who had been 'voraciously pillaging companies with little heed of shareholders'.[35]

So early statistical data has shown that equity based incentive rewards further aligned the interests of shareholders with those of the director, with a view to resolving the agency problem. More recently there have been substantial criticisms of both the ESO and the LTIP more recently.[36] The ESO uses the increase in share price as a measure of individual executive performance. This is extremely crude; in a bull market a director would gain substantial rewards irrespective of whether his performance warranted it. Conversely in a bear market a director may not be amply rewarded for sustaining a constant share price when the rest of the market is falling. It has been proven that the share price is more likely to increase when directors have their interests aligned with it. To boost profits a director has an incentive to forego research and development to boost short term gain against long term opportunity; this is quite clearly not in the companies' best interests for short term gains over long term failures. One argument previously forwarded in favour of the LTIP is that it offers a much more tailored, company specific mechanism for rewarding executive performance. However it is argued that this is insensitive to bull and bear market trends, and as a result an executive could potentially still receive bonuses through their LTIPs whilst the company is suffering a loss. ESOs offer the possibility for unscrupulous directors to bolster short term share prices which does not reflect improved performance. This may allow directors to make large returns over short periods of time both compromising and distorting executive function.

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[33] Debra Lau, 'Forbes Faces: Michael Eisner' *Forbes* (16 January 2001).
[34] ibid.
[35] Scheherazade Rehman, 'Are new rules of law needed for US Corporate Governance? (2004) IBLJ 797, 803.
[36] See for example Peter Burbidge, 'Creating high performance boardrooms and workplaces – European corporate governance in the twenty first century' (2003) ELRev 642, 648 or Mohammed Hemraj, 'Spotlight on executive remuneration' (2005) Comp Law 149, 150.

During the 1990s the ESO was popularised by support from both industry and leading academics as a low-cost way to pay executives, however even during this time there was some evidence to the contrary.[37] Jensen and Murphy point out that the real cost of an option is the opportunity cost the firm gives up by not selling the option on the open market. They argue that because employees are risk averse and undiversified, employees will naturally value options less than they cost the company to grant. They further go on to suggest that as the company's cost exceeds the employee's value, options are an expensive way to convey compensation to risk-averse employees. This argument is fundamentally floored, in making such a judgment Jensen and Murphy freely concede:

> 'In making this statement, we ignore inside information held by the employee about the prospects of the firm, and also ignore the potential incentive benefits accruing to shareholders when employees hold options.'[38]

However it is argued, that by doing so they are missing the fundamental reasoning behind the granting of options, the alignment of shareholder and stakeholder goals is the primary reasoning eliminating the 'agency problem'. They further suggest that to resolve the problem, the perceived loss of not selling the option on the open market should be recognised in the firm's accounting statements to counteract this perceived loss.[39] It is purported that this may not necessarily be correct, yes the option does have an opportunity cost on the open market but to an outsider the option is just that, an option that he has no control over. However to an employee he will perceive (possibly even misguidedly) that if he were to work harder than the value of his option would increase. Therefore the real value of the option for the employee would be of a higher value than it would be on the open market. It is purported that the difference in value would be the opportunity cost lost by the company in selling the option on the open market.

A lot of the discussion has focused on the US due to high profile cases like Disney and Enron, however it can be argued quite convincingly that the ESO and LTIP model of rewarding executives was replicated in the UK due to the global nature of the markets and the massive discrepancies between the earning potential of UK and US senior executives.[40]Following the boom of the 1980s a study by Conyon and Murphy documented differences in UK and US CEO pay, CEO's in US earned 45 percent higher cash compensation and 190 % total compensation. It was clear that the discrepancy

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[37] Michael Jensen and Kevin Murphy, 'Remuneration: Where we've been, how we got to here, what are the problems, and how to fix them' (2004) Finance Working Paper No 44/2004, 8.
[38] ibid.
[39] ibid, 38.
[40] Brian Main, Charles O'Reilly and Graef Crystal, 'Over Here, Over There: A comparison of Top Executive Pay in the UK and the USA' 4 (1990) International Contributions to Labour Studies 115.

between the remuneration levels was due to the excise of ESOs and as a result executives in the UK began to adopt the American remuneration model.

How is Executive Remuneration Decided?

Remuneration Committee

A director's pay is determined by the Remuneration Committee.[41] The committee is designed to resolve the potential conflict between the interests of the executives, and the firm's owners (namely shareholders).[42] The remuneration committee consists of a minimum of three non-executive directors who are independent of management, and free from any business that could interfere with the exercise of independent judgment; their role is to decide levels of executive remuneration. And although the committee may invite both the chief executive and external advisers to give recommendations on individuals no person is allowed to be present when his or her remuneration or contractual arrangements are discussed.[43] It is important to note that the committee also determines the level of performance related pay a director is awarded. The independence of the directors sitting on the board is paramount to the viability of the committee, such independence is an integral part of establishing the legitimacy of the committee. It is the role of the committee to demonstrate to all of the stakeholders in the company that the remuneration of directors is set by members who have no personal interest in the outcome of the decisions whilst taking into consideration the interests of shareholders (as owners) and to the financial and commercial health of the company.

Where did the Remuneration Committee come from?

Levels of pay of British top executives rose dramatically in the latter part of the 1980s, and this caused many commentators to question the extent to which such pay rises reflected increased performance of such executives, as opposed to what John Kenneth Galbraith has termed 'a warm personal gesture by the individual to himself.'[44]

The establishment of the remuneration committee was a key provision of the Cadbury committee.[45] The Remuneration Committee ensures that the levels of remuneration afforded to directors are sufficient to attract, but also limit payment to executive directors to what the company can afford.

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[41] Financial Reporting Council, *The UK Corporate Governance Code* (September 2012) Section D.1.
[42] This conflict will be examined further subsequently in the chapter.
[43]ibid Section D.2.
[44] Brian Main and James Johnston, 'Remuneration Committee as an Instrument of Corporate Governance.' (1992) Davis Hume Institute Hume Occasional Paper no.35.
[45] Cadbury Committee (n 11) 4.42.

Failure by a director to ensure that the board fixes affordable salaries may show the director's unfitness and be a ground for a disqualification order, there is no such thing as a 'going rate'.[46] Cadbury was affirmed by the Greenbury Committee who purported in 1995 that it was imperative that boards establish remuneration committees comprised of independent non-executive directors who would report fully to the shareholders each year about the company's executive remuneration policy, including full disclosure of the elements in the remuneration of individual directors.[47]

Who Should Make up the Remuneration Committee

More recently discussions have shifted towards the make-up of the Remuneration Committee. As already noted the committee must be made up of a minimum of three non-executive directors who are independent of management. The discussion following the financial crisis has revolved around whether it is proper, and appropriate, for executives that are active in one company to act as non-executives on the remuneration committees of another company.[48] There is a fear that as an executive director, they may be more generous in their awards as their own self-interest to see generally higher remuneration rewards be distributed across the sector. The FRC recently consulted on the matter[49] and concluded that there appeared to be very little to no practical evidence that current practices are creating any governance issues. The only evidence currently available supports this idea.[50] There would appear to be no significant connection to what they define as 'executive non-executives' and a generally higher value in remuneration. In a study conducted over a ten year period between 2003-2012 the authors found no significant correlation between the presence of executives on remuneration committees and any significant increases in the levels of executive remuneration.

Non-Executive Independence

More pertinent an issue perhaps is whether there is true non-executive independence. With strong, persuasive CEO's leading the boards of directors, it is purported that it would require an extremely

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[46] *Secretary of State for Trade and Industry v Van Hengel* [1995] 1 BCLC 545.
[47] Greenbury Committee, 'Directors' Remuneration: Report of a study group chaired by Sir Richard Greenbury' (London: Gee Publishing, July 1995).
[48] See generally Financial Reporting Council, *Directors' Remuneration: Consultation Document* (Financial Reporting Council, London October 2013).
[49] Financial Reporting Council, *Proposed Revisions to the UK Corporate Governance Code: Consultation* Document (London: April 2014) accessed at https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Proposed-Revisions-to-the-UK-Corporate-Governance-File.pdf [Accessed on 4 September 2014].
[50] Iain Gregory-Smith and Brian Main, 'Response to FRC Consultation on Directors' Remuneration' (November 2013) found at https://frc.org.uk/Our-Work/Publications/Corporate-Governance/Directors-Remuneration-Consultation-Document/Responses-to-consultation/Prof-Main-and-Dr-Gregory-Smith.aspx [accessed 05 Sep 2014] 5.

strong and forceful non-executive director to stand up to them.[51] It is argued that although remuneration committees predominantly consist of a majority, or more usually entirely, of non-executive directors, these non-executives are 'effectively chosen by, or only with the full agreement of, senior management.'[52] It is interesting to consider that all of the remuneration packages now so widely criticised as flawed and inappropriate, were once approved by an 'independent' remuneration committee. These issues can be best illustrated by the example of Alison Carnwath, Alison sat on the remuneration committee of Barclays bank throughout the financial crisis up until her unexpected resignation in 2012.[53] Whilst citing 'personal issues' for her resignation, it would be a naïve person who did not formulate a link between this and the recent high profile issues with executive pay-outs. She herself was quoted as stating that Barclays remuneration committee faced 'a lot of pressures' when dealing with the executives of the bank.

> 'When it comes to the top echelons of Barclays, obviously the remuneration committee has to make its own decisions, and there are a lot of pressures that come to bear. It's not easy, and we don't always get it right. We clearly didn't get it right this year. The shareholders were a little upset, although they weren't upset in the same way as we've seen at other companies; our proposals did get through.'[54]

In 2010 BIS brought, what was previously considered to be a purely academic debate, to the forefront of commercial discussions.[55] The BIS consultation built upon the work of the Treasury Select Committee, who feared there was a lack of sufficient independence so as to be able to align remuneration with the long-term interests of the shareholders. [56] Alongside this, the committee questioned whether the current make-up of the remuneration committee were sufficiently sensitive to wider factors, such as pay and employment conditions elsewhere in the company or the group. It is purported that one solution to these problems may be to alter the composition of the remuneration committee, in particular to include shareholder and employee representatives.[57] Germany for example already have revised its corporate governance code in 2009 in response to the financial crisis to encompass employee directors under its corporate governance code,

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[51] For example Fred Goodwin of RBS or Adam Applegarth and the Northern Rock Case Study under Chapter VII.
[52] Allen Sykes, Overcoming Poor Value Executive Remuneration: Resolving the Manifest Conflict of Interest' (2002) 10(4) Corporate Governance: An International Review.
[53] Jill Treanor, 'Barclays pay chair Alison Carnwath quits' *The Guardian* (London, 25 July 2012).
[54] Helen Roxburgh, 'Out of the ordinary: Alison Carnwath' *Economia* (27 July 2012) accessed at http://economia.icaew.com/people/august12/out-of-the-ordinary.
[55] BIS, *A long term focus for Corporate Britain – a call for evidence* (October 2010) para 5.11.
[56] Treasury Committee, *Banking Crisis: reforming corporate governance and pay in the City* (HC 2008-09, 519) para 77.
[57] ibid.

'The management board is responsible for independently managing the enterprise in the interest of the enterprise, thus taking into account the interests of the shareholders, its employees and other stakeholders with the objective of sustainable creation of value.'[58]

It would appear however that there is not the same impetus for such reforms within the UK, whilst recommended by the independent high pay commission in their 2011 report:[59] The Commission believed there to be a requirement that '[e]mployees be represented on remuneration committees. The Commission proposes this should be voluntary, with the threat of legislation or fines if not implemented within a three year period.' A Private Member Bill was introduced into parliament to implement such a requirement.[60] Under the Bill:

'1(1) Any public company which has a remuneration committee shall provide that at least one place on the committee shall be reserved for a person representative of the employees of that company.

(2) The company may determine whether such persons shall have a vote on the remuneration committee.'

However there does not appear that there is much appetite for such a bill, for as to date it appears to have been shelved.

Legal Interferences in Remuneration Structures: Can they Help Good Governance?

It has been purported that under agency theory it is the shareholders who are best suited to guide and discipline directors in the carrying out of their duties.[61] It is interesting therefore, to note that up until recently shareholders have had no binding powers of control over the remuneration structures of their agents, namely the directors. Whilst formal remuneration is not governed by the law, it is purported that there has been some attempt by subsequent legislatures to curtail remuneration through legal means. The remainder of the chapter will investigate whether they have been successful and if so has this been an aid to good Corporate Governance. Following the

[58] Government Commission, *German Corporate Governance Code* (May 13, 2013) para 4.1.1 translated at *www.telekom.com/static/-/155606/2/dcgc-120515-si.*
[59] High Pay Commission, 'More or Less: what has happened to pay at the top ad does it matter? (www.highpaycommission.co.uk, High Pay Commission 2011).
[60] Executive Pay and Remuneration HC Bill (2013-14) [105] 1(1).
[61] John Matheson and Brent Olson, 'Corporate Law and the Longterm Shareholder Model of Corporate Governance.' (1992) 76 Minnesota Law Review 1313, 1328.

implementation of a number of domestic and European provisions,[62] a new set of controversial provisions have been introduced in an attempt to increase disclosure and curtail the levels of remuneration of those working within financial institutions. The next part of the chapter will focus around three key points of the provisions that have aimed to increase legal control over remuneration structures, namely Disclosure, Legal Interventions in Executive Remuneration and Clawback.

1. Disclosure

What is Disclosure?

Perhaps the least controversial provision to attempt to legally restrict, and control executive decision making is the concept of disclosure. Disclosure, with regards to remuneration, is the release of information on remuneration structures and their relationship with the performance of the company to the shareholders.[63] In doing so, the shareholders of the company gain a greater insight into the negotiating effectiveness of the board, and by receiving the information; they will be in a position to take appropriate action based upon that information. In the case of the UK currently, this can be through voting during the AGM. As minimal intervention in regulatory control it has been advocated by many who perceive that such interference is all that is required in a free market economy.[64]This part of the chapter will assess the ability of disclosure requirements to control executive decision making as an aid to good corporate governance.

Theory on the Use of Disclosure

Free market ideology claims that private contracts between shareholders and directors should not be interfered with by law, however for shareholders to make informed decisions as to the viability of directors they must have sufficient information to make informed decisions. The first theoretical debates began in the US in the mid 1960's with economists such as Stigler,[65] Friend[66] and Herman and Robbins Werner.[67] They argued that disclosure requirements could lead to efficient financial

[62] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC Text with EEA relevance [2013] OJ L 176.
[63] Guido Ferrarini, Niamh Moloney, Christina Vespro, 'Executive Remuneration in the EU: Comparative Law and Practice.' (2003) ECGI Law Working Paper 09/2003, 14.
[64] For Example see Hampel committee at 1.9.
[65]George Stigler, 'Public Regulation of the Securities Markets' (1964) 38 Journal of Business 117.
[66] Irwin Friend and Edward S. Herman, 'The SEC Through a Glass Darkly' (1964) 37 Journal of Business 382.
[67] Sidney Robbins and Walter Werner, 'Professor Stigler Revisited' (1964) 37 Journal of Business 406.

markets and a reduction in capital costs as directors remuneration policies could be scrutinised by shareholders.

The development of disclosure requirements within the UK can be traced back to the work of the investigative committees of the 1990s. Cadbury initially began by noting that shareholders had a role to play in the governance of directors of the company,[68] dealing specifically with remuneration Cadbury purported that the overriding principle should be that of openness. Shareholders were entitled to a full and clear statement of directors' present and future benefits, and how they were determined. It was recommended that in disclosing directors' total emoluments and those of the chairman and highest-paid UK director, separate figures should be given for their salary and performance-related elements and that the criteria on which performance is measured should be explained. Relevant information about stock options, stock appreciation rights, and pension contributions should also be given.[69] The theory underlying these decisions being that such disclosure would strengthen shareholders' control over levels of compensation for loss of office. This initial report was the catalyst for academic debate into shareholder activism as a means of good governance.[70] The first report to discuss the potential problems of directors' remuneration was the Greenbury report.[71] Central to the Greenbury report recommendations were the strengthening of accountability, and enhancing the performance of directors. This was to be achieved partly through disclosure in an annual report to the shareholders, within this report was to be the company's remuneration policy, including full disclosure of the elements in the remuneration of individual directors.[72] These provisions were ultimately incorporated into the Corporate Governance Code.[73]

Full disclosure was once again affirmed as the loadstar for executive supervision by the Hampel committee in 1998, Hampel quick to reiterate the non-interventionalist nature of the provisions did not seek to control remuneration,[74] and noted that the soft touch approach allowed flexibility that specific legal restrictions would not have. In his opinion accountability was imperative for business

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[68] Cadbury Report (n 11) para 3.4 'Boards of directors are accountable to their shareholders and both have to play their part in making that accountability effective. Boards of directors need to do so through the quality of the information which they provide to shareholders, and shareholders through the.ir willingness to exercise their responsibilities as owners.'.

[69] ibid 4.40.

[70] See for example John Lowry, 'Reconstructing shareholder actions: a response to the Law Commission's Consultation Paper' (1997) Comp Law 247, 252, Vanessa Finch, 'Board performance and Cadbury on corporate governance' (1992) JBL 581, 586 or Christopher Riley, 'The American Law Institute's principle of corporate governance' (1995) Comp Law 122.

[71] Greenbury Report (n 48).

[72] Greenbury Report (n 48) 5.5.

[73] *Financial Reporting Council, The UK* Corporate Governance Code (n 19).

[74] Hampel *Committee, The Hampel Report on Corporate Governance-Final Report* (London: Gee, 1998) 1.9.

prosperity, and he purported that disclosure was the most important element of this.[75]Although he did note that the disclosure requirements at that time may have led to a disproportionate part of annual reports being devoted to these subjects.[76]

Internationally there was also a drive for greater transparency, the International Corporate Governance Network (ICGN), issued its recommendations on best practice for executive remuneration in 2003. ICGN recommended the 'fundamental requirement for executive remuneration is transparency'. This should include disclosure of base salary, short-term bonuses, long-term incentives, and any other payments or benefits. In 2006 updated ICGN Remuneration Guidelines focussed on transparency, accountability and the performance basis. Alongside this, the Organisation for Economic Co-operation and Development produced its own principles of good corporate governance. Within these the OECD outlined its own recommendations on disclosure and transparency,[77] under the provisions it was required that the board produce a remuneration policy for members of the board and key executives, and information about board members, including their qualifications, the selection process, other company directorships and whether they are regarded as independent by the board.[78]

Legal Requirements to Disclose

The first provisions that required disclosure of directors' remuneration can be traced to The Directors' Remuneration Report Regulations 2002.[79] Building on the works of the previous committees, it was introduced by the UK government to 'increase accountability, transparency, and performance linkage of executive pay.'[80] It was partly in response to widespread perception that director remuneration practices were generating the so-called 'rewards for failure' culture.[81] The regulations required a detailed report on directors' pay to be produced by the compensation committee[82] as part of their annual reporting cycle. The report had to be approved by the board of directors,[83] and also the company had to hold a shareholder vote on the directors' remuneration

[75] ibid 2.10.
[76] ibid 1.9.
[77] OECD Principles of good corporate governance (2004) at part V *www.oecd.org/dataoecd/32/18/31557724.pdf.*
[78] ibid at 4.
[79] The Directors' Remuneration Report Regulations 2002, SI 2002/1986.
[80] Jonathan Baird and Peter Stowasser. 'Executive Compensation Disclosure Requirements: The German, UK and US Approaches' (PLC Document 4-101-7960, PracticalLaw.com, 23 September 23 2002).
[81] ibid.
[82] Now the Remuneration Committee.
[83] The Directors' Remuneration Report Regulations 2002 (n 80) reg 3.

report at the AGM. This vote was not binding on the directors and was simply advisory, once again affirming the UK light-touch approach to regulation.

The 2002 Regulations and its report were subsequently integrated into the Companies Act 2006(hereon the 2006 Act), under the 2006 Act s.420 requires the directors of a company to prepare a directors' remuneration report with its contents outlined under s.421. It is important to draw to attention that, like the 2002 regulations, under s.439 the company is required to give notice to the members of the intention to move an ordinary resolution on the directors' remuneration report for the financial year. This vote once again is not binding on the remuneration committee, or the board generally, it is simply persuasive. This lack of binding power will be investigated further in the chapter.

Shareholder Activism

Disclosure is required to encourage shareholder activism but why? There is a large body of evidence to suggest that shareholder activism forms a strong governance mechanism that would allow boards to overcome certain 'social-psychological barriers in negotiating with CEOs on behalf of shareholders.'[84] Shareholder 'voice' if formalised has the potential to form a significant deterrent to director risk taking.[85] Although it may be argued that as the vote is only advisory it bears no compulsion for remuneration committees to adhere to it. But in reality it would be tantamount to corporate suicide if a committee chose to ignore the opinions of its shareholders.

It is suggested that a much more transparent and open remuneration policy would be beneficial in resolving the so called 'agency problem'. Statistical evidence prior to the global financial crisis has shown that there is a correlation between the introduction of more transparent and open remuneration policies, and a greater correlation of equity release to directors with company performance. The most recent study by Balachandran, Ferri and Maber documented a sample of firms before the enactment of the Directors Disclosure Regulations (2000-2002) and then after (2003-2005). The evidence was quite interesting, it noted that although there was no change in the actual level and growth rate of directors pay. There was a significant increase in the sensitivity of directors cash compensation to negative operating performance and in the sensitivity of CEO total

[84] Sudhakar Balachandran, Fabrizio Ferri and David Maber, 'Solving the executive compensation problem through shareholder votes? Evidence from the UK' (2008) Harvard Business School accessed at http://www.london.edu/assets/documents/facultyandresearch/Solving_the_Exec.pdf [accessed on 5 September 2014].
[85] Lucian Bebchuk, William Friedman and Alicia Townsend, 'Written Testimony Submitted Before the Committee on Financial Services United States House of Representatives Hearing on Empowering Shareholders on Executive Compensation' (8 March 2007) accessed at http://www.law.harvard.edu/faculty/bebchuk/pdfs/2007_HFSC.pdf [accessed on 5 September 2014].

compensation to negative operating and stock performance.[86] So analysing this data it would appear that it may be purported that it is not the release of equity that is the problem but poorly constructed packages that may 'reward for failure'. Further evidence of the success of the UK transparency theory of remuneration can be shown by the US attempts to adopt similar provisions. In April 2007 the House of Representatives approved a bill seeking to introduce 'say on pay' rules similar to the UK.[87] Soon after this, a bill was introduced in the Senate[88] by (then) Presidential Candidate Barack Obama.[89] The Bill was passed in 2010 as the Investor Protection and Securities Reform Act 2010. Further to this the last piece of empirical evidence to investigate the effectiveness of disclosure requirements in the US found a positive correlation between mandatory disclosure requirements, and the focusing of directors towards maximisation of shareholder wealth.[90]

There is however a body of literature that suggests that increasing shareholder activism may not necessarily have such a strong impact on remuneration decisions, as far back as 1992 the Cadbury Committee warned against allowing shareholders to vote on remuneration.

> 'A director's remuneration is not a matter which can sensibly be reduced to a vote for or against; were the vote to go against a particular remuneration package, the board would still have to determine the remuneration of the director concerned.'[91]

There has been a plethora of academics that have also forwarded such arguments.[92] Their arguments are based on an early 1990's theory that shareholders prefer to take a much more hands off approach to monitoring the company. This theory suggests that the average shareholder may only hold a very small percentage of a company's equity, and therefore has very little incentive to interfere because the benefit they are likely to receive will not equal the time and effort they undertake.[93] It is purported however that this is simply not true, even in the early 1990's there had been incidents of shareholder activism.[94] This has grown considerably in the past couple of years also and will be explored later in the chapter with relation to the 'Shareholder Spring of 2012.'

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[86] ibid.
[87] Rep Frank Barney 'Shareholder Vote on Executive Compensation Act' (H.R. Bill 1257).
[88] Sen Barak Obama, (Senate Bill 1811).
[89] Reed Walton, 'U.S. Senate Takes Up "Say on Pay" Bill' (Riskmetrics, Risk & Governance Blog, 30 April 2007).
[90] Michael Greenstone, Paul Oyer and Annette Vissing-Jorgensen, 'Mandated disclosure Stock Returns, and the 1964 Securities Acts Amendments.' NBER Working Paper Series working Paper 11478, 33 accessed at http://www.nber.org/papers/w11478 [accessed on 5 September 2014].
[91] Canbury Committee (n 11) para 4.43.
[92] Andrew Griffiths, 'Directors' Remuneration: Constraining the Power of the Board' [1995] LMCLQ 372, 373
[93] Lee Roach, 'The Directors' Remuneration Report Regulations 2002 and the disclosure of executive remuneration' (2004) Comp Law 141.
[94] In 1987 the remuneration package of the Burtons chairman, Sir Ralph Halpern was reduced from £8 million to £2.5 million following pressure from institutional shareholders.

Responses Following the GFC: Has Disclosure Worked?

Under the 2006 Act, formal disclosure was a legal requirement during the financial crisis, and as a result it is clear that in the future disclosure alone will be unable to stop a future crisis. Nor would one expect it to, however perhaps the more pertinent question to be asked is can disclosure still be an aid to good governance?

It appears that there is still a strong theoretical appetite for directors' remuneration disclosure requirements within the UK financial system. The Walker Review generally appears to opt to maintain the current norm in regulation. Whilst specifically addressing the disclosure of 'high end' remuneration, the Walker Review was reluctant to increase the level of disclosure of formal remuneration.[95] It was noted in particular that working in a global setting it was important not to adversely hinder UK listed companies against their international competitors.[96] Debate did spark around the publishing of individual director's remuneration packages,[97] however such a provision was deemed to be too invasive, and largely irrelevant for overall corporate governance. Walker preferred to focus on remuneration committee reports, and to ensure that the committee review performance indicators, as oppose to executives total remuneration, were available to shareholders. Walker concluded that the remuneration committee report should confirm that the committee is satisfied with the way in which performance objectives are linked to the related compensation structures for the company, and explain the principles underlying the performance objectives and the related compensation structure if not in line with those for executive board members.[98] This requirement ultimately forces committees to justify their decision and thought processes. It is purported that this would be far more relevant and important than focusing on individual remuneration figures. Individual headline figures could detract from the overall debate, with shareholders focused too much on the total value of what may be perceived as 'excessive remuneration.' This argument is supported to some extent by the shareholder spring of 2012 and also more recent episodes of shareholder activism.[99] Ultimately Walkers final recommendations relating to 'high end employees' included the need to:

> 'Disclose the remuneration of employees earning £1m or more. Disclosure should be in bands, noting the number of employees in each band, the areas of business activity in which they are

[95] Walker Review (n 10) 7.11.
[96] ibid 7.12.
[97] ibid 7.11.
[98] ibid Recommendation 30.
[99] See for example the HSBC AGM on the 23rd of April 2014.

involved (where possible) and, within each band, the main elements of salary, cash bonus, deferred shares, LTIPS and pension contributions.'[100]

These recommendations have been affirmed by other organisations such as the Financial Stability Forum[101], under their Principles for Sound Practice[102] the FSF noted that 'Firms must disclose clear, comprehensive and timely information about their compensation practices to facilitate constructive engagement by all stakeholders.'

Binding Vote on Disclosure

Following the financial crisis; BIS consulted on the reform of the remuneration system as a whole, it considered proposing even greater transparency through disclosure.[103] This culminated in a proposal[104] for all listed companies to include an annual binding vote on the company's future remuneration policy. This deferred significantly from the previous light touch approach as it allowed direct shareholder opinion to be taken account of. It also required an increased level of support for votes on future remuneration policy (beyond what was previously a simple bare majority) and an annual advisory vote on how remuneration policy was implemented in the previous financial year. Finally it also required a binding vote on exit payments above one year's salary. These proposals were ultimately taken on by the legislature and inserted into cl.57 of the Enterprise and Regulatory Reform Bill, introduced into the House of Commons on May 23, 2012.

The Bill came into force as the Enterprise and Regulatory Act 2013. Amongst other things the intention of the act was to increase transparency, to ensure greater understanding of the link between pay and performance. The main intention of the act was to introduce a binding vote on general pay policy that will be explored in the next part of the chapter. However alongside the act, was the introduction of a piece of regulation that questions the current theories of executive control. The Large and Medium-sized Companies and Groups (Accounts and Reports) (Amendment) Regulations 2013, the intention of the regulations is to make it much easier for shareholders to find and identify the information that is required under disclosure. Possibly the most contentious provision under the regulations is that the report now requires a single total figure of remuneration for each director.[105] Under the Regulations a committee is required to publish not only the total amount of remuneration for each director, but

[100] Walker Review (n 10) Recommendation 31.
[101] Now the Financial Stability Board (FSB).
[102] Financial Stability Forum, 'FSF Principles for Sound Compensation Practices' (April 2009).
[103] BIS, *Executive Pay: Shareholder Voting Rights Consultation'* (March 2012).
[104] BIS consults on enhancing shareholder voting rights over directors' remuneration (2012) 313 Co. L.N. 1.
[105] Large and Medium-sized Companies and Groups (Accounts and Reports) (Amendment) Regulations 2013 s.4(1).

also the total amount of salary and fees;[106] all taxable benefits;[107] and perhaps most importantly, money or other assets received or receivable for the relevant financial year as a result of the achievement of performance measures and targets.[108] Therefore it is clear that each individual director's salary is now being placed up for scrutiny as a result of the regulations. This will have a significant impact on voting practices during subsequent AGMs. The disclosure of individual remuneration packages for directors is in direct conflict with the wishes of Walker and the other post GFC reports.

As an exercise it is interesting to note that the UK government also released a further Companies' Remuneration Reports Bill 2009[109] this bill intended to make alterations to the Companies Act 2006, including a new provision under s.430A under which every public company has to publish a ratio 'between the total annual remuneration of the highest paid director or executive and the total annual average remuneration of the lowest paid ten per cent of the workforce.'[110] Moreover to ensure that the shareholders have no way of missing the ratios the information must appear 'in bold type on the first page of the chairman's statement, chief executive's statement or directors' report',[111] although this has not been enacted to date.

Shareholder Spring 2012

Another effect of increased disclosure is the ready availability of information for shareholders to disseminate the quality of directors' actions. One result of this has been dubbed the *Shareholder Spring of 2012*.The Shareholder Spring (from here on the 'Spring') of 2012 was a series of shareholder demonstrations during the annual AGM season of 2012, these defiance's manifested themselves in the form of negative voting responses over the annual remuneration reports put forward by a number of boards of directors. This dissent was reported in the media to have been a sign of open rebellion against what was perceived to be runaway boardroom pay at a time of financial austerity,[112] interestingly the spring has been largely ignored by academia.[113] The Spring has been characterised by a number of high profile resignations, and is seen as an example of investors

[106] ibid s.7(1)(a).
[107] ibid s.7(1)(b).
[108] ibid s.7(1)(c).
[109] Remuneration Reports HL Bill (2008-09) [4].
[110] ibid s.430 A (1).
[111] ibid s.430A (2).
[112] See for example: 'Shareholder rebellions: an interactive timeline' *The Guardian* (Wednesday 9 May 2012) accessed at http://www.theguardian.com/business/interactive/2012/may/09/shareholder-rebellions [accessed on 05 September 2014].
[113] The only article to briefly mention the spring was David Millman, 'Directors, governance and managerial responsibility: new developments in UK law (2013) Co LN 1.

(particularly institutional investors)attempting to curtail what have been perceived as excessive remuneration packages on behalf of the directors of the institutions. What began with an open revolt by Barclays shareholders, developed into the biggest response by shareholders to executive power since the crisis.

It is argued that there developed two specific indicators of shareholder dissatisfaction during the Spring: Primarily shareholder dissatisfaction was exercised by either, voting against the remuneration reports, or purposefully abstaining from voting as a sign of protest. This act was not to legally veto the remuneration reports (as at the time of the spring the votes were not binding), but instead to allow those that were disgruntled with executive remuneration, an opportunity to register their dissatisfaction with a view to allow directors to rethink their decisions. Secondly, shareholders showed their dissatisfaction by refusing to re-elect either the CEO at the time of the AGM, or perhaps far more telling, certain non executive directors that were involved in the remuneration processes. Usually this manifested itself as the chairman of the remuneration committee.

Why did they Revolt: Rewards for Failure?

The Spring attracted significant media attention, and it is important to highlight for the current chapter, as the initial incident of open rebellion came at the AGM of a financial institution, Barclays PLC. Historically shareholders have very rarely interfered with institutions and AGMS were often reduced to a box ticking exercise, so much so that it lead one minister to accuse shareholders of behaving like 'absentee landlords.'[114] So why then did shareholders suddenly decide to revolt against director remuneration?

The Shareholder Spring so dubbed by a number of news agencies had its beginnings much earlier. Following the financial crisis the level of executive remuneration continued to grow at an alarming rate. Rises in executive remuneration had outstripped employee remuneration by nearly three times year on year in the lead up to the global financial crisis.[115] During the same period of time BIS also noted that CEOs in the UK earn over 120 times that of the average worker.[116] In 2009 it was observed that basic salaries of executives of the FTSE 100 companies were still increasing by as much as 10% notwithstanding the fact that at that time the global recession had taken full effect, with

[114] Kate Burgess, 'Myners urges 'absentee landlord' shareholders to be more involved' *Financial Times* (22 April 2009) accesses at http://www.ft.com/cms/s/0/6633de06-2ed7-11de-b7d3-00144feabdc0.html#axzz35ac2FYRh [accessed on 5 September 2014].
[115] BIS, *Executive Remuneration: Discussion Paper* (September 2011) para 13-22 which noted on average employee earnings grew 4.7% per year over the past 12 years, compared to 13.6% for FTSE 100 CEOs.
[116] ibid para 2.

their companies losing up to one third of their value.[117] In 2009 for example, the Marks and Spencer CEO Sir Stuart Rose's pay package increased from £1.375 million to £1.765 million at the same time the company posted a pre-tax fall in profits of 40%.[118] What is interesting is that it is not just the banks that have seen these failures with remuneration packages. Chelsea Building Society had their strength rating cut despite their CEO Peter Walsh still earning £522,000. Newcastle Building Society was also downgraded in 08-09 although the company directors were still paid a total of £1.1 million.[119]Leading reports at the time were warning that levels of high pay were 'corrosive' to the UK economy,[120]the High Pay Commission highlighted astronomical increases in executive pay over the years, using Barclays as an example, showing that CEO remuneration had increased by nearly 5000% in 30 years while average wages during the same period had increased just threefold.[121]The same report showed that in 2010 the average FTSE 100 executive earned 145 times the average worker.[122] In its final report the commission stated that 'excessive top pay is deeply damaging to the UK as a whole'. Very clearly showing underlying issues brewing prior to the Spring. These worries were reiterated by government, a study by BIS in 2010 showed that between 1999 and 2009 FTSE 100 CEO remuneration rose annually by 13.6% on average whilst an average annual increase in the FTSE 100 index of 1% was observed.[123] These and other reports led Vince Cable, the Business Secretary, to opine that:

> 'In the last decade we have seen extreme increases in top executive pay which appear to be completely unrelated to the performance of companies. They are therefore acting against the interests of shareholders and consumers.'[124]

Moving into 2011, during a time of pay freezes and mass redundancy programmes, studies suggested that 80% of Chief Executives still received some form of pay rise.[125] This continued into 2012 whereby the first grumbles by institutional investors were given voice. The 'Accountability in

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[117] Julia Finch and Simon Bowers, 'Executive pay keeps rising, Guardian survey finds' The Guardian (14 September 2009) accessed athttp://www.theguardian.com/business/2009/sep/14/executive-pay-keeps-rising [accessed on 4 September 2014].
[118] Sathnam Sanghera, 'Business Life: M&S rubber chicken should go bouncing back' *The Times* (8 June 2009).
[119] ibid.
[120] High Pay Commission (n60).
[121] ibid.
[122] ibid.
[123] BIS, *A Long term focus for Corporate Britain – a call for evidence* (BIS/10/1225, October 2010) para 5.5.
[124] As quoted in Allegra Stratton, 'High executive pay 'corrosive' to the UK economy, report warns' *The Guardian* (London, 22 November 2011) accessed at http://www.theguardian.com/business/2011/nov/22/high-executive-pay-corrosive-economy [accessed on 4 September 2014].
[125] KPMG, 'KPMG's Guide to Directors' Remuneration 2012' (KPMG, 2012) 2 accessed at www.kpmg.com [accessed on 4 September 2014].

Business'[126] report found that 95% of all institutional investors that were questioned believed that pay was too high across all major companies including financial institutions. The same report also highlighted that 83% of all institutional investors when questioned stated that there should also be arrangements to 'claw back' pay. In 2012 it was reported that the average CEO salary amounted to just over £3M.[127] During the same time, the European Banking Authority published data[128] showing that during 2012 the UK had the largest amount of 'high earners,' defined as those people whose pay package totals at least EUR1 million,[129] in all EU member states. Totalling 2,714 individuals their average total remuneration per individual was a staggering £1,951,572. However this also includes 1272 persons who are defined as 'identified staff'[130] which includes 'Executive members of the credit institution or investment firms' corporate bodies, depending on the local legal structure of the institution.'[131] If this is compared to other major European nations, it can be observed that France for example had only 177 high earners, of which 121 were identified staff. And Germany had 212 people who met the threshold with 146 of these being identified staff. These figures were exacerbated by high profile media accounts of so called 'reward for failure' reports spanning the major news broadcasters. Examples include coverage of a top banker at Barclays was handed a £9m leaving deal following his resignation after the LIBOR scandal. [132] And Barclays own CEO Bob Diamond, and his 'windfall' £14M pay package.[133] It is important to note that neither Barclays, nor the financial sector as a whole, were alone in their criticism as other industries have faced similar criticism[134] over the same period. All of this evidence collectively can be seen to be generating an air of negativity towards directors generally, and also more specifically towards directors of financial institutions. In the small piece of anecdotal evidence above we can see that the UK had nearly 10x as many identified staff as Germany who were earning such significant pay packages.

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[126] The Share Centre, 'Accountability in Business.' (April 2012) accessed at http://blog.share.com/2012/04/13/a-step-too-far-in-executive-pay/10558 [accessed on 4 September 2014].
[127] KPMG (n 126) 3.
[128] EBA, 'EBA Report High Earners Data 2012' (EBA, 2012) accessed at https://www.eba.europa.eu/documents/10180/16145/EBA+Report+High+Earners+2012.pdf [accessed on 4 September 2014].
[129] EBA, 'Guidelines on the data collection exercise for High Earners' (EBA, 2012) 4.1 accessed at https://www.eba.europa.eu/documents/10180/107643/EBA-GL-2012-05---GL-5-on-remuneration-data-collection-exercise-_1.pdf [accessed on 4 September 2014].
[130] The definition of identified staff can be found in the CEBS, 'CEBS Guidelines on Remuneration Policies and Practices' (2010) accessed at https://www.eba.europa.eu/-/cebs-guidelines-on-remuneration-policies-and-practices [accessed on 4 September 2014].
[131] ibid para 16.
[132] Jill Treanor, '£9M leaving deal for Barclays deputy Jerry del Missier' *The Guardian* (26 July 2012).
[133] Jill Treanor, 'Barclays prepares to apologise over handling of Bob Diamond's pay' *The Guardian* (26 April 2012).
[134] Juliette Garside, 'Carphone boss to be paid £34M despite Best Buy UK failure' *The Guardian* (28 June 2012).

Barclays and the April Revolt

As the first AGM of the new season there were early rumours and grumblings that there may be shareholder pressure on the Barclays board to amend their remuneration decisions, in light of recent financial difficulties.[135] It was believed that some shareholders would use the AGM to express their dissatisfaction to what appeared to be overly generous managerial remuneration packages, reportedly only as many as 10% of the total shareholder total vote would seek to make a point, however what came next was not expected by many.

On 27th April 2011 Barclays bank held their annual AGM,[136] it was here that the first shots were fired as shareholders were asked to vote to approve the Barclays Bank remuneration report for 2011. 27% of total votes cast opted against the approval of the report, with this number increasing to 32% if deliberate abstentions were taken into account.[137] This was far greater than the original 10% that was envisaged and sent shockwaves throughout the financial sector,[138] there was an open outcry from shareholders during the AGM, who accused the directors of allowing 'excessive' and 'obscene' payments to some of their major directors.[139] The disgruntlement became so apparent that Barclays chairman Marcus Agius issued a public apology over the handling of the then CEOs £17m pay package. [140] The level of shareholder dissatisfaction was further emphasised during voting for director re-election, and in particular during the re-election of Alison Carnwath the chairman of the remuneration committee and the person who sanctioned the pay deals of the executives. When put to the vote 20% voted against her re-election, 24% if deliberate abstentions were taken into account.[141] The rebellion was a massive shock to the board and the sector as a whole. So much so that soon after those at the top paid the ultimate price. Within three months of the April AGM both

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[135] Jill Treanor (n 134).

[136] Marcus Agius, 'Barclays PLC Notice of Annual General Meeting: Message from the Group Chairman (Barclays, 2011) accessed at http://reports.barclays.com/ar10/files/pdfs/barcar10_notice.pdf [accessed on 4 September 2014].

[137] Including abstentions 2578739714 out of 8192444820 shares see Barclays PLC 'Barclays Annual Report' (2012) accessed at http://www.barclays.com/content/dam/barclayspublic/docs/InvestorRelations/PrivateShareholders/2012AGM/poll-results.pdf [accessed on 4 September 2014].

[138] Harry Wilson and Andrew Trotman, 'Barclays AGM: as it happened: April, 2011' *The Telegraph* (London 27 April 2011).

[139] ibid.

[140] Marus Agius, 'Barclays 2012 AGM Chairman's Statement' (April 2012) 4 accessed at http://www.barclays.com/content/dam/barclayspublic/docs/InvestorRelations/PrivateShareholders/2012AGM/agm-statements.pdf [accessed on 4 September 2014].

[141] ibid.

the CEO, Bob Diamond, and chairman of the remuneration committee, Alison Carnwath, had resigned.[142]

Dissenting Voting of Remuneration Reports

Significant levels of voting against the remuneration reports were a theme of the Spring, with large volumes of shareholders seeking to register their dissatisfaction with the board decisions. Some of the largest rebellions were not seen within the financial sector. For example, in the case of Pendragon car dealership,[143] who saw their remuneration report actually voted down with 69% of Pendragon investors not voting in favour.[144] This clearly sent a message to the board, as a direct result the board withdrew attempts to increase bonuses for directors by 50%. Mutiny extended to the media industry with 46% of shareholders of Trinity Mirror voting against the remuneration report, this figure rose to 54% if deliberate abstentions were taken into account. Once again as a result, a top scalp was claimed in the form of CEO Sly Bailey, Ms Bailey resigned from the company[145] following pressure from leading shareholders to reduce her remuneration package.[146]

No industry was safe, medical technology business Smith & Nephew[147] saw 30% of investors failing to approve the company's remuneration report.[148]And moving into retail nearly 30%[149] of investors voted against the remuneration report of Capital Shopping Centres.[150] South Africa based Central Rand Gold[151] saw a massive 75% of investors voting against their remuneration report.[152] Energy company Cairn saw 67% of votes cast against the remuneration report, again rising to 76% with abstentions.[153]Purported to have been on the back of a controversial £1.4m "loss of office" payment

[142] Although it can be argued that Bob Diamond resigned in relation to the LIBOR scandal that broke soon after the AGM.
[143] Now PendragonPLC see http://www.pendragonplc.com/.
[144] 67.18% against with 1.89% withholding votes Pendragon PLC, 'Pendragon PLC: Results of Annual General Meeting' (10 May 20112) accessed at http://online.morningstarir.com/ir/pdg/ir.jsp?page=news-item&item=1024407682167276 [accessed on 4 September 2014].
[145] Josh Halliday and Lisa O'Carroll, 'Trinity Mirror chief executive Sly Bailey steps down' *The Guardian* (London, 3 May 2012).
[146] Kate Burgess, 'Trinity under pressure over chiefs pay' *Financial Times* (2 May 2012).
[147] FTSE 100 medical devices company see http://www.smith-nephew.com/uk/.
[148] A significant proportion of the 30% were abstentions, 24% Smith & Nephew, 'Smith & Nephew: 2012 AGM Voting' (April 2012) accessed at http://www.smith-nephew.com/investor-centre/agm/2012-agm-poll-results/ [accessed on 4 September 2014].
[149] Capital Shopping Centres Group PLC, 'Capital Shopping Centres Group PLC: Result of AGM' (April 2012) accessed at http://www.investegate.co.uk/ArticlePrint.aspx?id=20120425131507H5859 [accessed on 4 September 2014].
[150] Capital Shopping Centre hold large investments in a number of shopping precincts including Manchester's Trafford Centre and the Metrocentre in Gateshead. See Jill Treanor, 'Pirc recommends voting afainst Smith & Nephew pay plans' *The Guardian* (12 April 2012).
[151] The company is listed in London.
[152] Jill Treanor, 'Website lets public express anger at City pay' *The Guardian* (30 April 2012).
[153] http://www.cairnenergy.com/index.asp?pageid=27&newsid=387.

made to the chairman Sir Bill Gammell,[154] this clearly led to shockwaves through the board and a response by the chairman of the Remuneration Committee Jackie Sheppard who remarked that:

> 'We have taken on board and acknowledge the way shareholders have cast their proxy votes on remuneration.
>
> We have listened to shareholders' concerns, having had extensive dialogue with investors in recent weeks. Cairn has learned from the recent consultation and is committed to listening closely to shareholders views on governance.'[155]

Other companies saw similar results with 50% of voters at William Hill rejecting the remuneration report,[156] rising to 52% with abstentions. And industrial materials group Cookson saw a revolt of over 31pc of shareholders voting against the company's remuneration report, 32% with abstentions. At advertising company WPP there was a massive 60% of investors voting against the remuneration report, it was reported to have been directed in particular towards CEO Sir Martin Sorrell's £13m remuneration package.[157]

Focusing back within the financial sector Aviva, a leading insurance company, saw 59% of shareholders voting against their remuneration report. And during the AGM comments were directed towards the remuneration structure of Andrew Moss the CEO, he resigned from his position soon after.[158] Prudential PLC, the financial services group, also saw large levels of shareholder dissatisfaction with 30% voting against the remuneration report, [159] rising to 34% if abstentions were taken into account.

So it can be concluded that there were a large number of institutions that actively sought to vote down the remuneration reports of their boards during the Spring. Whilst it was foreseen that there would have been some ill feeling from shareholders, the shock factor came about due to the sheer

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[154] Jill Treanor, ''Shareholder spring' spreads to Aviva and William Hill' *The Guardian* (8 May 2012).
[155] Cairn Energy, 'Cairn Energy: Results of AGM' (17 May 2012) accessed at http://www.cairnenergy.com/index.asp?pageid=27&newsid=387 [accessed on 4 September 2014].
[156] William Hill, William Hill PLC: 2012 AGM Proxy Voting Figures' (8 May 2012) accessed at http://www.williamhillplc.com/~/media/Files/W/William-Hill/siteware/pdf/agm/proxy-figures-2012.pdf [accessed on 4 September 2014].
[157] Jill Treanor (n 155).
[158]Aviva, 'Voting Results of 2012 Annual General Meeting' (3 May 2012) accessed at http://www.aviva.com/media/news/item/voting-results-of-2012-annual-general-meeting-16915/ [accessed on 4 September 2014] The Telegraph 'Andrew Moss steps down as Aviva chief' *The Telegraph* (8 May 2012).
[159] Prudential PLC, 'Prudential PLC Annual General Meeting 2012' (17 May 2012) accessed at http://www.prudential.co.uk/~/media/Files/P/Prudential-Corp/agm-information/2012/results-of-votes.pdf [accessed on 4 September 2014].

level of shareholder dissent. For as already pointed out it was only envisaged that around 20% of investors would vote against such a remuneration package.[160]

Voting Down Director Re-election

The second clear indicator of shareholder unrest was through voting either against, or in abstention from, re-electing directors. When looking at the remuneration of directors during the crisis, there are three specific roles that need to be addressed for impact. They are the CEO, chairperson of the remuneration committee, and any other members of the remuneration committee. These three roles are the central hub of any institutions remuneration structure and as such allow the shareholder the greatest impact when voicing their opinion. It is the role of the chairperson of the remuneration committee to oversee the remuneration structures of the company's directors, executive and non-executive, and as such any vote not in favour of their re-election, it is argued, could be perceived as a direct attack on the remuneration structures of the company more generally.

Voting out directors following poor or inappropriate business decisions is not a new concept. One need only look at the actions of the Bank of America shareholders who in 2009, voted to remove Ken Lewis from his position as Chairman of the Board of Bank of America following the controversial acquisition of Merrill Lynch.

As already noted the first shareholder group to do this were Barclays where 20% of total shareholder votes were in the negative when asked to re-elect Alison Carnwath, rising to 24% with abstentions, the then chairperson of the remuneration committee. Continuing through the financial industry, at Aviva, Scott Wheway, again chairperson of the remuneration committee saw 13% of shareholders refusing to approve his reappointment as a non-executive director.[161] Cookson saw rebellions against five separate directors all seeing over 13% of shareholders failing to back their re-election.[162] Chairman of William Hill Plc's remuneration committee, David Edmonds, saw a protest vote of 7% not in favour of his re-election.[163]Whilst the company chairman Gareth Davis saw 6 % of shareholders against his re-election. Further afield at Cairn, 10% of shareholders voted against Sir Bill's re-election as chairman. [164]Whilst these figures do not seem to be significant if we compare them to the levels of dissent that are normally seen at an AGM (normally in the regions of 1-3%) we can see a significant increase relative to earlier positions.

[160] Dan Sabbagh, 'Sly Bailey faces further protest at Trinity Mirror AGM' *The Guardian* (8 May 2012).
[161] Aviva (n 159) 12.59% (211,971,614 out of a possible 1,683,422,188 shares).
[162] Cookson Group Plc, 'Result of AGM' (17 May 2012).
[163] William Hill (n 157).
[164] Cairn Energy (n 156).

These figures offer an illustration as to the level of shareholder dissatisfaction during the financial crisis, however it was not just in the UK the shareholder spring took effect. Shareholder rebellion during this time was not solely an English construct, similar incidents of shareholder revolt were occurring in the US. Citigroup had a plan to pay chief executive Vikram Pandit almost $10m rejected.[165] GE saw protesters escorted out of the AGM shouting ‘pay your fair share’ in reference to reports that the company had paid no corporation tax.[166]

Remuneration Problems or Simply Poor Performing Companies?

There has been some discussion to suggest that this was simply shareholders expressing their dissatisfaction against underperforming companies and not necessarily to do with remuneration packages specifically.[167] However if one analyses the discussions during the AGMs, it is clear that remuneration was most certainly at the forefront of shareholders collective consciousness. It has already been noted that shareholders at Barclays perceived some of the remuneration structures to be ‘excessive’ and ‘obscene’, but this occurred in other institutions also.

What was also interesting is that sometimes, whilst the shareholders did not appear to openly revolt against the company though voting, they still used the AGM to vocally express their disappointment in remuneration structures; one such company was drugs group AstraZeneca. Just prior to their AGM CEO David Brennan resigned, during the AGM there was significant pressure on the board to elaborate on the scenario.[168] The shareholders were particularly angry about the reports his severance package was allegedly around £4.5m.[169] As a result during that AGM the resolution to confirm the remuneration report was opposed by 9% of the group,[170] this could be seen as further evidence of shareholders showing dissatisfaction at the remuneration report, although it was only slightly higher than the previous year’s voting at 5%.[171] What was more significant, was the comments made by individual shareholders, as they voiced their dissatisfaction with the exit

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[165] Pratap Chatterjee, ‘Do Not Pay Dozen: 12 CEOs who met shareholder spring revolts’ (14 June 2012) accessed at http://www.corpwatch.org/article.php?id=15743 [accessed on 4 September 2014].
[166] ibid.
[167] *KPMG* (n126).
[168] Julia Kollewe, ‘AstraZeneca boss David Brennan quits under pressure from investors’ *The Guardian* (26 April 2012).
[169] Mark Wembridge, ‘ExAstraZeneca chief given £4.5M Payout,’ *Financial Times* (16 July 2012).
[170]See AstraZeneca, ‘AstraZeneca 2012 AGM Results’ (April 2012).
[171] See AstraZeneca PLC, ‘AstraZeneca Annual General Meeting 28 April 2011’ (28 April 2011) accessed at http://www.astrazeneca.com/cs/Satellite?blobcol=urldata&blobheader=application%2Fpdf&blobheadername1=Content-Disposition&blobheadername2=MDT-Type&blobheadervalue1=inline%3B+filename%3DResults-of-voting.pdf&blobheadervalue2=abinary%3B+charset%3DUTF-8&blobkey=id&blobtable=MungoBlobs&blobwhere=1285657339351&ssbinary=true [accessed on 4 September 2014].

payments being made to the outgoing CEO. For example one private shareholder was reported to have stated to the board during the annual meeting: 'It seems a lot is being paid for very little – by which I mean paltry shareholder returns.'[172]

Was There a Shareholder Spring At All?

The position indicated above clearly suggests that there was a significant surge of dissatisfaction expressed towards a number of institutions and the decisions of their boards, however when examined across the market as a whole, it appears that there may be a different story to tell. It is argued that whilst reported heavily by the press there may not have been such a mass rebellion as first thought. Studies have suggested that there were only 10 companies in the FTSE 100 that experienced 'significant opposition'[173] to their remuneration report. This has been strengthened by the fact that, outside the already given examples, there was a significant drop in dissatisfaction levels from those seen in the previous year. Therefore it may be suggested that the examples shown above were in fact isolated incidents, that were not entirely related to pay in isolation, but instead each company had a number of contributing factors which led to shareholder dissatisfaction beyond simply remuneration levels.

Indeed, various studies of what happened during the spring appear to reach very similar conclusions, and it would perhaps appear that the Spring's effect was more significant as a newspaper headline than to the sector as a whole. One study has shown that out of a sample of just over 300 annual meetings, the average vote against pay reports was 7.64% in the first six months of 2012, compared to 6.1% in the same period a year earlier.[174] Reinforcing this idea Fair Pensions subsequently concluded that while the remuneration defeats had had a 'significant impact', they did not 'represent a sea change in investor attitudes either to stewardship generally or remuneration practice in particular'.[175] Supporting this Manifest concluded that there was an increase in the average level of dissent registered in all explicit votes on remuneration to 11.7%, which was an increase on the previous year of 9.6%. What was more interesting perhaps was that whilst an increase these figures were significantly below the dissent levels of 16% and 12.4% seen in 2002 and 2003 respectively.[176]

[172] Comment made by a Mr John Farmer reported at Julia Kollewe (n 169).
[173] Significant opposition is defined as remuneration report resolutions that experienced greater than 20% of votes against or abstaining. KPMG (n 126) 8.
[174] The Observer 'A year after the shareholder spring, the green shoots of rebellion are withering' *The Observer* (10 March 2013).
[175] ibid.
[176] ibid.

Has Greater Disclosure and the Shareholder Spring Had Any Lasting Effect?

It is very difficult for the moment to analyse whether these provisions have had any lasting effect, however using anecdotal evidence it would appear that there may be a serious shift in culture towards stronger corporate controls. It appears that in general bonuses are falling.[177] In 2014 nearly a quarter of FTSE 100 companies froze the salary of their chief executive and that pay increases, at less than 3%, have been largely been in line with the rest of the workforce. Companies now believe that their remuneration committee's pay decisions are more focused on fairness between executives and the wider workforce because of new disclosure rules.[178] This is interesting to note as prior to this, in the eight years leading up to the GFC pay increases for executive directors routinely outperformed those of the general workforce, and were typically 6% to 7% per annum. So much so it led one commentator to note:

> 'The 2014 annual meeting season is shaping up to be another year of restraint. Despite fears that executive pay inflation would take off again as the economy recovers, this doesn't seem to be the case. Executives are seeing only modest salary increases and bonuses continue to fall. Remuneration committees are approaching any increase in pay-outs with caution to ensure they accurately reflect performance and satisfy shareholders.' [179]

Combining disclosure with the ability of the media and shareholders in general to apply social pressure, it is argued that even though shareholders do not have formal controlling powers over directors, the ability to voice their dissatisfaction could result in significant changes in corporate decision making, therefore improving corporate governance. It has been shown previously that media pressure can aid shareholders in applying pressure on directors to curb excessive decision making.[180] Dyke and Zingales were studying the media pressure in relation to environmental decision making as opposed to director remuneration, but these results would theoretically apply just as well to the voting on remuneration policy.

It is purported that the increased disclosure requirements have allowed shareholders to place sufficient pressure on directors to ensure that they modify their behaviour, and as such has offered a positive aid to corporate governance, but alone disclosure will not be a fix all. Whilst it is too soon to

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[177] Larry Elliot, 'Executive bonuses fall for third year' The Guardian (London, 1 April 2014).
[178] PriceWaterhouseCoopers, '2013: A year of restraint for executive pay' (January 2013) 4 accessed at http://pdf.pwc.co.uk/executive-pay-2013-a-year-for-restraint.pdf [accessed on 4 September 2014].
[179] ibid.
[180] Alexander Dyke and Luigi Zingales, 'The Corporate Governance Role of the Media.' (2002) Working paper, Harvard Businesss School and the University of Chicago accessed at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=335602 [accessed on 4 September 2014].

disseminate whether report voting has any lasting impact one thing that is sure is that there has been significant legislative responses to the Spring of 2012. These responses have come in the form of legal sanctions on remuneration, the next part of the chapter will analyse these sanctions and their viability as a vehicle for good corporate governance.

2. Legal Interventions in Remuneration Structures

The genesis of the latest attempt to regulate managerial reward is a direct response to the recent financial crisis and more recently the aforementioned 'Shareholder Spring' in 2012. As already mentioned the majority of the dissent was linked to what appeared to be overly generous managerial remuneration packages. During the Spring shareholders did not have a binding vote on remuneration, but instead were given an advisory vote on general remuneration policy. The question therefore that needs to be asked is whether shareholders or the state should be able to legally interfere with the setting of remuneration policy in general or individual remuneration packages?

These two avenues are significantly different and will be approached separately; firstly the chapter will investigate whether Shareholders should be given a binding vote on remuneration policies and individual pay structures. The piece will then proceed by analysing the reasoning behind and viability of governmental interferences restricting levels and types of pay.

Shareholder Binding Vote on Policy

Should Shareholders have a Binding Vote on Executive Remuneration?

One debate that has developed following the recent crisis is whether shareholders should have a binding vote on the remuneration packages of directors. The ability of major shareholders to exert influences on boards of their investee companies was identified as a key issue following the most recent financial crisis.[181] It has long been established as a duty of the shareholder, and in particular the institutional shareholder, to voice their opinions in forums such as the Annual General Meeting.[182] What has been identified during the Shareholder Spring is that there may be some correlation between shareholder voting and executive restraint.[183] The question therefore is whether this level of influence should be increased to enable them to directly approve or reject remuneration policies and/or individual remuneration packages.

[181] Walker Review (n 10) 7.22.
[182] ibid.
[183] See previously in the chapter.

Academically there has been little to no support for allowing direct shareholder intervention into remuneration decisions. Bebchuk for example believes that voting on executive remuneration is limited.[184] Although he did note as a caveat that there may be some use of shareholder intervention in establishing 'outer limits' to what boards can award. The Hampel Review considered shareholder voting to be a 'responsibility' of shareholders to make, but remained silent on the use of direct voting requirements for shareholders.[185] One could argue that it was not a parameter of the review and therefore would not be considered, however what was interesting to observe was the general reluctance to intervene extended as far as to suggest that the remuneration report to shareholders should not be a standard item of agenda for the AGM.[186]

The Walker Report opted against a binding vote on executive remuneration reports as it was considered too difficult to implement.[187] As an alternative it recommended that:

> 'If the non-binding resolution on a remuneration committee report attracts less than 75 per cent of the total votes cast, the chairman of the committee should stand for re-election in the following year irrespective of his or her normal appointment term.'[188]

The ability to hold a director to the vote could theoretically aid in the adjustment of director decision making and culture however this was not to be as subsequently the Enterprise and Regulatory Reform Act 2013 was enacted.

Shareholder Control of Remuneration Structures

Enterprise and Regulatory Reform Act 2013

Under the most recent Enterprise and Regulatory Reform Act 2013 (ERRA 2013) it would appear that there may be a movement towards greater regulatory control of remuneration. Before the document is explored it is important to place the provisions in context, it has already been noted that there has been some use of the shareholder discretionary vote during the Shareholder Spring of 2012, what was clear from the Spring was that non-binding discretionary voting was not universally effective.[189] When announcing the reforms that ultimately culminated in the ERRA 2013, the

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[184] Lucian Bebchuk and Jesse Fried, *Pay without Performance: The unfulfilled promise of Executive Compensation* (Harvard University Press, 2004) 198.
[185] Hampel Review (n 75) 2.14.
[186] ibid 4.21.
[187] Walker Review (n 10) 7.22.
[188] ibid recommendation 36.
[189] BIS, *Directors' pay: guide to Government reforms* (BIS, 2012) accessed at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/31378/12-900-directors-pay-guide-to-reforms.pdf [accessed on 4 September 2014].

government noted that, whilst the advisory vote was designed to give shareholders an effective and more focused way in which to influence directors pay. The feedback from shareholders was that many companies were not responding adequately to their concerns.[190] As a result the government sought to introduce the first binding vote on a company's pay policy.

Based upon the BIS policy document *Directors' pay: guide to Government reforms.*[191] It was established that whilst the advisory shareholder vote was designed to give shareholders an effective and more focused way in which to influence directors' pay, feedback from shareholders is that many companies showed that institutions were not responding adequately to their concerns. As a result Government sought to introduce a binding vote on executive remuneration under the ERRA 2013, the intention of the ERRA 2013 was to allow shareholders to be better prepared to hold companies to account.[192]

The ERRA 2013 is the first piece of binding legislation that has required a binding vote on remuneration, whilst this is not a binding vote on specific remuneration packages, it has created a requirement for the approval of general remuneration policy under S.79. S.79 inserts a new requirement into s.439A of the Companies Act 2006 which creates a binding shareholder approval of the directors' remuneration policy; this is intended to be done by ordinary resolution at least every three years. Further to the new remuneration policies, the act created a legally binding obligation to ensure that no payments may be made to directors that are not consistent with the approved directors' remuneration policy, unless it has been approved by members.[193]

Disclosures of exit payments, the infamous golden parachute clauses, have also been addressed slightly by the most recent Enterprise and Regulatory Reform Act 2013. Under s.79 the Act inserts a new s.421 (2A) sub clause into the Companies Act 2006. Under the Act it requires the directors' remuneration report to publish the policy of the company with respect to the making of remuneration payments and payments for loss of office. This whilst again is not necessarily binding on any individual director, when exercised in conjunction with the new s.439A approval provisions it will allow for discussion and binding approval from shareholders.

[190] ibid 2.
[191] ibid.
[192] Vince Cable (n 22).
[193] S.226B Companies Act 2006 as amended by s.80 Enterprise and Regulatory Reform Act 2013.

Are Binding Votes Effective?

Business Secretary Vince Cable was extremely positive about the reforms and he believed that this created real powers for shareholders. 'Our reforms mean shareholders will now no longer be kept in the dark. They now have powerful tools for every shareholder – big or small – to speak up and challenge companies over excessive pay'.[194] But is this really the case, the provisions do require a binding vote at least every three years on remuneration policy but it does not require the disclosure or binding vote on individual remuneration packages, it is by no means invasive and only requires an ordinary vote.

More recently there have even further attempts to introduce, binding shareholder votes. The Executive Pay and Remuneration Bill 2013-14 was published on 6 September 2013 this Bill proposed to introduce an annual binding vote on executive remuneration. Under the bill:

> 's.2 (1) Each public company limited by shares shall, at each annual general meeting, propose a motion specifying the remuneration of executives employed by the company, and the result of the vote shall be binding on the company.
>
> (2) No motion under subsection (1) shall be treated as agreed to unless the shareholdings of those shareholders who vote in favour comprise at least 75 per cent of the shareholdings of all shareholders who vote on the motion.
>
> (3) In this section, "executive" means any executive director of the company. '

If introduced the Bill would require a binding vote by special resolution. It is believed that due to the nature of the special resolution vote this may have been a greater aid to corporate governance. A special resolution is usually reserved for votes that are deemed fundamental to the company for example alteration of articles[195] or a change in name.[196] Introducing remuneration approval as a special resolution would place control of executive remuneration on the same statutory footing. It is purported that given the level of exposure and interest executive remuneration has accrued both prior, and since the financial crisis, it would be correct to consider it as fundamental to the company. The Bill would be far more invasive to company policy than anything that has come before, however as a Private Members Bill it does not appear to have garnered much support, the Bill lapsed on the 4 September 2013, and there does not appear to be any attempts to by Parliament to reintroduce it.

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[194] BBC, 'New executive pay rules give shareholders binding vote' *BBC* (1 October 2013).
[195] S.21(1) Companies Act 2006.
[196] S.77(1) Companies Act 2006.

Whilst there are clear provisions for the implementation of there is currently no guidance as to how boards should respond if the company fails to obtain the majority in support of a resolution on remuneration.[197] The Regulations require, in the annual remuneration report, disclosure of the details of the votes on the previous year's report and where there was a significant vote against either resolution, to give a summary of the reasons, where known, and any actions taken in response. However, this would not

Restricting the Amount of Remuneration: The Bonus Cap and Curbing Excessive Remuneration

'[R]idiculous levels of remuneration are going unchallenged as the norm when there is no clear evidence of correlation with performance.'[198] A common theme stemming from the financial crisis is the belief that levels of executive remuneration are spiralling out of control. In an effort to curb remuneration there have been movements in Europe to place legal sanctions to curb remuneration structures and in particular the apparently excessive bonuses that directors receive.

One of the reasons for executive pay inflation in the UK is companies trying to keep up with their global competitors in the war for talent. The vast growth in Executive Remuneration levels has been well documented throughout this chapter and the author does not intend to repeat all of the statistics save to note that, one 2011 BIS paper pointed out that CEOs in the UK earned over 120 times the salary of the average worker,[199] and the gap is growing with on average employee earnings growing 4.7% per year from 2000-2011, compared to 13.6% for FTSE 100 CEOs.[200]

The question then posed is whether the legislature should introduce legal sanctions that restrict forms and levels of executive remuneration.

[197] Financial Reporting Council (n 50) Proposed Revisions to the UK Corporate Governance Code: Consultation Document' (London: April 2014) accessed at https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Proposed-Revisions-to-the-UK-Corporate-Governance-File.pdf [Accessed on 4 September 2014].
[198] Rt Hon Vince Cable, *Oral statement to Parliament: Association of British Insurers Conference* (BIS June 2011) accessed at https://www.gov.uk/government/speeches/association-of-british-insurers-conference [Accessed on 4 September 2014].
[199] BIS, *Executive Remuneration, Discussion Paper* (BIS/11/1287, September 2011) para 2.
[200] ibid.

Non-Interference

Historically, it has been the opinion of the judiciary, that the courts should not interfere with the private law matter of setting levels of remuneration within a director's compensation package, based on the concepts of non-interference already discussed in some depth in the thesis:[201]

> 'It is not for a judge to express any opinion upon such matters as whether the amount [of directors' remuneration] is too large or too small: the directors of the company know a great deal [more] about these matters than [a judge] can possibly do.'[202]

This was confirmed by the judiciary in *Re Halt Garage*,[203] whereby Oliver J purported that the level of remuneration awarded was a matter for the management of the company, provided that there had been a genuine exercise of company's powers. Affirmed by Dillon J:

> 'If the articles require a specific body to determine the remuneration, it seems to me that the amount…must be a matter of management for the company to determine in accordance with its constitution which expressly authorises payment for directors' services.'[204]

There is a common law limit to this based on the equitable duty of fraud on the minority. A company has the ability and capacity to pay a reasonable level of remuneration, but a director's duty is to act bona fide in the best interests of the company. So in *Re Smith & Fawcett*[205] the judiciary would only interfere if no reasonable board of directors could have concluded that the level of remuneration was justified. Further to this even after the financial crisis bodies have been reluctant to impose restrictions on remuneration schemes. The Financial Stability Forum principles for Sound Compensation Practices[206] have been developed to reduce incentives towards excessive risk taking that may arise from the structure of compensation schemes, however once again the FSF reiterate that the provisions are *not* intended to prescribe particular designs or levels of individual compensation.[207] The FSF reiterate that 'One size does not fit all – financial firms differ in goals, activities and culture, as do jobs within a firm. However, any compensation system must work in concert with other management tools in pursuit of prudent risk taking.'[208]

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[201] See for example the explanations on Judicial non interference in Chapter V The Business Decision Rule.
[202] *Henderson v Bank of Australia* (1888) 40 ChD 170 per North J at182.
[203] *Re Halt Garage (1964) Ltd* [1982] 3 All E.R. 1016, 1023-1033.
[204] ibid 1039.
[205] [1942] Ch 304.
[206] Financial Stability Forum (n 9).
[207] ibid.
[208] ibid.

The European Bonus Cap: Capital Requirement Directive IV

More recently there have been attempts to regulate the proportions of remuneration that can be given as a financial bonus. Once again a backlash stemming from the recent financial crisis, under the Capital Requirements Directive IV, the EU legislature has introduced measures to curb disproportionate levels of remuneration by introducing a 'bonus cap'. In an attempt to tackle what was perceived as excessive risk taking by directors,[209] under Article 94(1)(g) a new legal requirement to limit the amount of variable remuneration a director can be awarded has been introduced. Under the Directive the variable element of executive remuneration (bonus), cannot exceed 100% of the fixed component (salary) of the total remuneration.[210] There is the possibility to increase this ratio to a maximum of 200% of the fixed component, so long as certain criteria are met. Under the Directive the ratio may be increased to 200% when a qualified majority involving either a minimum representation requirement for shares of 50% and a voting majority of two thirds, or no minimum representation requirement and a 75 % voting majority approve the proportional increase.[211]

Ultimately if this is disseminated, we can see that there is now a legal limit on the ratio between fixed and some elements of variable remuneration. The ratio is at 1:1, and may be raised to a maximum of 2:1 provided that where there is a 50 per cent quorum, 66 per cent of votes are in favour of doing so or, in the event that no 50 per cent quorum is reached, 75 per cent are in favour. What is also interesting to note is that the 100% threshold is deemed to be a maximum level of bonus. The directive allows the Member States to set an even lower maximum percentage if they deem it to be too high.[212] It is highly unlikely that member states will do such a thing given the free market nature of the European Union but interesting none the less. These provisions had to be implemented by 1 January 2014.

Such a significant interference in private contractual law has been at the forefront of the Member States attention since the Directive was released, however it is interesting to note that it did not form part of the original proposals of the CRD IV and instead was a late addition.[213] So will such an interference into private contractual law benefit corporate governance of financial institutions?

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[209] European Commission, Capital Requirements – CRDIV/CRR – Frequently Asked Questions (2013) accessed at http://europa.eu/rapid/press-release_MEMO-13-690_en.htm?locale=en [Accessed on 4 September 2014].
[210] Article 94(1)(g)(i).
[211] Article 94(1)(g)(ii).
[212] Article 94(1)(g)(ii).
[213] Proposal for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on the access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms and amending Directive 2002/87/EC of the European Parliament and of the Council on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate

The theory underlying the bonus cap is based upon an intention to reduce overall risk within the system, remuneration skewed towards short term performance encourages short term risk-seeking. Reducing the total amount of bonus available reduces the incentive to take greater risk, whilst allowing the director a significant amount of remuneration over and above his base salary. This has garnered some support, where concerns have been noted that pay structures in which performance bonuses constitute a substantial fraction of total remuneration encourage short-term behaviour.[214]

Will a Bonus Cap Work?

In theory there is a clear economic argument to restrict the percentage of bonuses awarded to directors, however whether the limit on the proportion of bonuses will be successful remains to be seen. It is argued that there are two clear problems with the bonus cap as it stands; firstly the bonus cap is a crude method of examination that will simply lead to increases in fixed remuneration. And secondly the cap will not be effective as it will lead to a new form of payment namely the 'role based payments'. These payments will be paid on a monthly basis, and this in itself may lead to a shift back towards short-termism, directly against the aims of the directive.

Initial responses to the cap have not been positive. Prior to the release of the directive the Walker Review had specifically addressed the idea of capping remuneration levels and directly rejected such a notion.[215] This was affirmed by the more recent Parliamentary Commission on Banking Standards, who when asked about capping bonuses, concluded that they were not convinced that such a 'crude bonus cap is the right instrument for controlling pay.'[216] Current governor of the Bank of England Mark Carney agreed 'absolutely' with the Commission,[217] as did the previous Governor Mervin King.[218]

It is argued that the cap will have a significant adverse effect on good corporate governance, as instead of simply reducing the variable levels of remuneration; it will also drive up fixed executive remuneration rather than reduce overall levels. Fixed remuneration whilst important has been

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[2011] Com 0453 accessed at http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52011PC0453 [accessed on 4 September 2014].

[214] Kay Review, Kay Review of UK Equity Markets and Long-Term Decision Making Final Report (July 2012) 11.5 accessed at http://www.ecgi.org/conferences/eu_actionplan2013/documents/kay_review_final_report.pdf [accessed on 4 September 2014].

[215] Walker Review (n 10) at 7.1.

[216] Parliamentary Commission, Changing Banking for Good - Parliamentary Commission on Banking Standards (HC 2013-14, 175-I) para 851.

[217]Treasury Committee, Oral Evidence: Bank of England November 2013 Financial Stability Report (HC 2013-14, 987) Q3 accessed at http://data.parliament.uk/writtenevidence/WrittenEvidence.svc/EvidenceHtml/5636 See http://www.parliamentlive.tv/Main/Player.aspx?meetingId=14628 [accessed on 4 September 2014].

[218] Parliamentary Commission (n 217) para 849.

termed as 'essentially cash out of the door'[219] and as such cannot be subject to further measures such as clawback,[220] which would pose a significant disadvantage and limit good corporate governance. Lord Turner noted that the cap could reduce the potential for recouping deferred awards:

> 'The danger of the cap on bonuses [...] is that if salaries simply increase as a result, we will have less that we can force to be deferred and therefore force to be clawed back. It is quite right that we have made bonuses deferred, paid in either equity or bail-inable debt, and subject to clawback. If you go too far in the direction of saying that there should not be bonuses at all, we lose an element of flexibility.'[221]

It is further argued that imposing restrictions will not stop remuneration committees from creating more innovative forms of remuneration that can circumvent the legal cap.[222] It is purported that this is already happening, formal questions have been made by the EU regulators to the Bank of England requesting reasoning as to why they have been allowing new forms of 'fixed pay' that the regulator argues banks are using to circumvent the new regime.[223] The creation of so called 'role based payments' have been introduced as a monthly, or twice-yearly cash and share based allowance that would be tied directly to seniority. It would appear that these payments would be adjusted up or down on an annual basis, effectively creating a second form of bonus payment structure. These payments have been reported to have been used by HSBC,[224] Barclays and Lloyds amongst other financial institutions.[225] The payments have not been well received on the continent with a number of European MEPs calling for the Commission to bring an action against the UK regulators for allowing such provisions.[226] It is purported that these payments are a major problem that will lead to a shift away from long term thinking back towards short termism, with bankers looking to produce a quick return for their 'role based payment.'

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[219] ibid para 844.
[220] See part 3 on Clawback.
[221] Parliamentary Commission, (n 217) para 848.
[222] Supported by Former Governor of the Bank of England, Sir Mervin King at Parliamentary Commission, (n 217) para 849.
[223] Alex Barker, 'EU questions Bank of England over UK bank bonus approvals' *Financial Times* (5 February 2014).
[224] Jill Treanor, 'HSBC hands allowances to hundreds of bankers to avoid EU bonus cap' *The Guardian* (24 February 2014).
[225] Jill Treanor, 'Barclays and Lloyds sidestep EU rules and hand bosses almost £1M in shares' *The Guardian* (5 March 2014).
[226] Jennifer Rankin and Jill Treanor, 'Bankers' bonus cap architect says EU must sue UK government' *The Guardian* (4 March 2014).

Within the UK hierarchy there is very little support for the financial cap on bonuses. The UK government has launched legal action in the European Court of Justice specifically to oppose the sanctions,[227] whilst the results of that challenge will not be available before the thesis is completed, the judgement of the courts will be interesting to consider at a later date. Although it may be possible to make a provisional guess as to the result. It is interesting to note that this is only one of a number of different European Sanctions on the financial sector that the government has sought to challenge in the ECJ.[228] These challenges it would appear have been ineffective with one already being struck out by the court.[229]

It would appear that there is very little support garnered across the UK for the bonus cap from the established hierarchy. However it would appear that there may be some initial circumstantial evidence that the bonus cap may be having a positive effect on corporate governance. Following the implementation of the provisions, a number of companies have seen their requests to increase bonuses voted down in AGMs.[230] Perhaps most significantly the UK government voted against increasing the bonus cap of the directors of publicly owned RBS.[231]These nay votes appear to be curbing excessive remuneration structures, in a way that advisory voting never could.

3. Clawback

What is Clawback?

Clawback is defined as the exercising of an ex-post risk adjustment to remuneration awards.[232] Using these adjustments institutions can either lower subsequent cash remuneration awards, or award a lower number of instruments (usually shares) to directors based on a performance basis. This allows institutions to take into account any subsequent performance of a company, and any potential risk outcomes allowing them to recoup levels of variable pay if there is a downturn in performance, or as a result of a risk management failure.[233] Clawback has become the new loadstar for shareholder

[227] HM Treasury, 'Press Release: Legal challenge launches into new rules on bankers' pay (25 September 2013) accessed at https://www.gov.uk/government/news/legal-challenge-launched-into-new-rules-on-bankers-pay accessed on [5 September 2014].
[228] Others include challenges to the Short Selling Regulation and the Financial Transactions Tax.
[229] Case C-209/13 United Kingdom v Council [2014] OJ C 171.
[230] Jill Treanor, 'Barclays AGM: shareholders large and small protest over pay and bonuses' *The Guardian* (24 April 2014).
[231] Jill Pickard, 'RBS forced to scrap plans to pay bonuses at up to 200% of salary' *Financial Times* (25 April 2014).
[232] PRA, PARA expectations regarding the applicatyion of malus to variable remuneration' (SS2/13, 2013) para 3 accessed at http://www.bankofengland.co.uk/pra/Documents/publications/policy/2013/appofmalusss2-13.pdf [accessed on 4 September 2014].
[233] ibid.

activism following the most recent crisis, and in particular the shareholder spring of 2012, the ability of remuneration committees to exercise these ex-post adjustments has been heralded as an aid to ensuring good corporate governance within financial institutions.[234] But will clawback aid in ensuring good corporate governance, or simply alienate directors from the institutions they manage?

As an example of a clawback regime[235] most recently the CEO of Lloyds Banking Group, António Horta-Osório, was awarded a right to receive shares under a 'Deferred Bonus Plan' totalling approx. £1.7m for his performance during 2013.[236] The bonus was subject to forfeiture provisions (malus) that required, as a condition that the share price must remain above 73.6 pence on average for any 126 consecutive trading days in the five years following grant. Now the value of 73.6 pence per share is not an arbitrary number and is instead set intentionally, as it was the average paid per share by taxpayers for their stake in the company when the bank was bailed out in 2008.

Whilst the terms malus and clawback have been bandied around interchangeably by the press in recent times they are two distinct mechanisms that may be applied simultaneously but mean two very different things:

(1) Malus: An arrangement that permits the institution to prevent vesting of all or part of the amount of a deferred remuneration award in relation to risk outcomes or performance.[237]
(2) Clawback: A contractual agreement 'whereby the staff member agrees to return ownership of an amount of remuneration to the institution under certain circumstances. This can be applied to both upfront and deferred variable remuneration.'[238]

It is the intention of malus provisions to prevent variable remuneration being paid where the directors' behaviour has been deemed to be insufficient. Malus provisions have grown in prominence following the financial crisis as they seem to go hand in hand with the requirement of deferred payment schemes and on the recommendations of a number of leading institutions to focus more on long term performance incentives as opposed to short term gains.[239] Conversely

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[234] See for example Committee of European Banking Supervisors, CEBS Guidelines on Remuneration Policies and Practices (10 December 2010) accessed at https://www.eba.europa.eu/documents/10180/106961/Guidelines.pdf [accessed on 4 September 2014].
[235] It is actually a malus provisions within the contract.
[236] 2,155,227 Shares under a Deferred Bonus Plan based on a share price of 78.878 pence. Lloyds Banking Group PLC, 'Lloyds Banking Group PLC – Notification of transactions by persons discharging managerial responsibilities ("PDMRs") in ordinary shares of the group of 10 pence each ("shares") (London Stock Exchange 24 March 2014) accessed at See http://www.londonstockexchange.com/exchange/news/market-news/market-news-detail.html?announcementId=11901945 [accessed on 4 September 2014].
[237] CEBS (n 235).
[238] ibid.
[239] See for example Walker Review (n 10) Recommendation 33 or Kay Review Recommendation 15 'Companies should structure directors' remuneration to relate incentives to sustainable long-term business performance.

clawback provisions intend to recoup remuneration already paid to the director due to the failure of a director to satisfy given criteria.

Are Malus or Clawback Provisions Required Under Law?

Clawback provisions have, up until recently, not had any form of legal status within the UK. As has been the policy of the legislature and the courts, there has been a reluctance to impose any form of legal constraints on private service contracts between directors and the companies they work for. Following the financial crisis there appears to have been a shift in ideology. For those directors working specifically within financial institutes, there has been a regulatory shift towards greater interference, as has been discussed earlier in the chapter. Whilst this has been a much more recent event clawback provisions had been discussed in Europe even before the crisis. The 2006 Capital Requirements Directive observed that variable remuneration should be considered as contracted for subject to any 'reductions in pay-outs of amounts previously earned, including through malus or clawback arrangements.'[240] Whilst not requiring remuneration packages to be subject directly to clawback provisions it clearly shows them to be in the consciousness of the legislature at the time. The true regulatory shift came following the implementation of CRD IV. Under the directive mandatory adoption of clawback regimes have been implemented.[241] Under the CRD variable remuneration is subject to malus or clawback arrangements up to 100% of the total variable remuneration.[242] This has been adopted by the Financial Conduct Authority directly into the Remuneration Code.[243]

It is interesting to note that it is also a legal requirement under the Financial Services (Banking Reform) Act 2013 s.31[244] that institutions inform the regulator[245] in the event they take disciplinary action which results in the clawback of remuneration from a director. It is clear that this may therefore potentially have an impact on the approved person's regime of the Bank of England and as such may lead to a curbing of director risk taking for fear of being disqualified.

Looking further afield other jurisdictions have also sought to implement clawback regimes into their financial regulatory systems. The Swiss for example whilst not subject to the Capital Requirements

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Long-term performance incentives should be provided only in the form of company shares to be held at least until after the executive has retired from the business'.

[240] European Directive 2006/48/EC, Section 11 point 23 (q).

[241] Directive 2013/36/EU.

[242] Directive 2013/36/EU Article 94 (m).

[243] Remuneration Code SYSC 19A.3.51A (1) [A firm must] ensure that any of the total variable remuneration is subject to malus or clawback arrangements.

[244] inserting a new s.64C into FSMA 2000.

[245] The Prudential Regulatory Authority.

Directive IV[246] have proposed similar provisions to those found under CRD IV therefore further endorsing the clawback regime. In 2010 the Swiss Financial Market Supervisory Authority (FINMA) introduced a circular on 'Minimum standards for remuneration schemes of financial institutions'[247] under which they outlined 10 principles which FINMA considered being minimum standards for the industry. Whilst only binding on the larger financial institutes[248] all other financial institutions were to have regard to the principles as guidelines of best practice. One of the main principles refers to the requirement that 'Deferrals [of remuneration] link remuneration with the future development of performance and risk'[249] ultimately this provision outlines clearly the requirement to take into consideration clawback regimes when considering then remuneration packages of directors of financial institutions:

> 'Where this [deferral of remuneration] promotes risk awareness and sustainability and is appropriate, the company should structure its compensation policy and rules so as to make it possible to cancel deferred remuneration in whole or in part where losses have been generated in the area of responsibility of the person concerned. '[250]

Who Should the Clawback Provisions Apply To?

In its most recent statement[251] the PRA attempted to explain who should have these clauses placed into their contract, what was clear from the documentation is the overarching belief that the clawback provisions should not be used sparingly or solely be limited 'to employees directly culpable of malfeasance.'[252] The PRA made clear that they would require a 'general firm-wide policy on *ex-post* risk adjustment.'[253] This was recommended to extend beyond simply individuals, but also extend much wider to incidents of collective responsibility. Where there was a failure of risk management and no individual was at fault, under a system of collective responsibility a firm should apply clawback provisions to whole groups, and extend so far as to consider reductions ranging from

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[246] Switzerland is not a member of the European Economic Area.
[247] FINMA, 'Minimum standards for remuneration schemes of financial institutions.' (Circular 2010/01, 2010) accessed at www.finma.ch/e/regulierung/Documents/finma-rs-2010-01-e.pdf *[accessed on 4 September 2014].*
[248] Those with a minimum of CHF 2Bn.
[249] FINMA (n 248) Principle 7.
[250] ibid para 55.
[251] Prudential Regulation Authority, 'PRA expectiations regarding the application of malus to variable remuneration' (SS2/13, October 2013) .
[252] ibid 11.
[253] ibid 13.

firm wide bonus pools or relevant business units.[254] Therefore it is clear that the intention was to apply clawback provisions to as many persons as possible.

So is Such a Widespread Use of Recovery Clauses Beneficial to Aiding Good Governance?

So does a policy of applying the clawback regime to directors' remuneration structures aid corporate governance? There would appear to be a strong correlation between the implementation of clawback provisions, and the potential for re-adjusting director behaviour within financial institutions. The Walker Review recommended the use of 'deferred incentive payments as the main mechanism for adjusting risk'[255] and went further to purport that '[c]lawback should be used as the means to reclaim amounts in limited circumstances of misstatement and misconduct.'[256] This is further emphasised by the Combined Code that states there is a necessity to structure directors' terms of appointment to ensure that '[t]hey should take a robust line on reducing compensation to reflect departing directors' obligations to mitigate loss.' [257]

Whilst a relatively new concept, there have been some discussions as to the viability of its impact on executive decision making.[258] Gregory-Smith and Main concluded that the percentage proportion of remuneration that is discretionary, and therefore susceptible to clawback provisions amounted to around 38% of total remuneration awarded. As a result it was concluded that the potential incentive effect might be 'significant.'[259] Whilst it appears that there is strong support for an ex-post adjustment for realigning the actions of the directors with those of the shareholder it is argued that it is not as simplistic as simply implementing the clauses into the contracts. A far more interesting and difficult question that needs to be asked is when should those clawback provisions be exercised?

When Should Clawback be Exercised?

The majority of the discussion to date has focused on the necessity of the implementation of the provisions into contracts, to support governance. In doing so it is the upheld belief that clawback has the ability to realign the decisions of the director with the interests of the financial institution and its shareholders. It is purported however that the discussion has failed to take into consideration an extremely important and relevant issue. Under what circumstances the provisions should be exercised?

[254] ibid 12.
[255] Walker Review (n 10) Recommendation 33.
[256] ibid.
[257] *Financial Reporting Council* (n 19) D.1.4.
[258] Gregory-Smith and Main (n 51).
[259] ibid 2.

Under the CRD IV it is on the onus of the individual institutions to set their own criteria as to when malus or clawback is to be exercised.[260] They did however attempt to offer some guidance as to the sort of criteria that was expected, it is important to note that the list is not exhaustive. In particular the directive outlined situations where the staff member participated in or was responsible for conduct which resulted in significant losses to the institution;[261] or failed to meet appropriate standards of fitness and propriety.[262] The directives provisions have been inserted directly into the PRA's Remuneration Code[263] largely verbatim.[264] Once again the Code outlines that it is necessary for institutions to set their own criteria.[265] And examples include where the director participated in or was responsible for conduct which resulted in significant losses to the firm[266] and where the director failed to meet appropriate standards of fitness and propriety.[267] Whilst not surprising it is interesting that the Remuneration Code copied the provisions largely verbatim to include significant losses to the firm. If we look at the earlier discussions within the UK, the provisions of clawback and malus were only expected to be implemented when an individual undertook some form of misconduct or error.[268] The extension to scenarios whereby the company simply suffered a loss extends the provisions significantly.

Whilst losses to the institution can be determined pretty easily the appropriate standards of fitness and propriety are much more difficult to define. To understand such criteria it is necessary to look further afield. The CRDIV built upon the work of the Committee of European Banking Supervisors and more specifically their work on remuneration policies and practices.[269]Under the guidelines the CEBS attempted to outline example criteria as to when an institution would be expected to exert its clawback procedures:

> 's.137 a. evidence of misbehaviour or serious error by the staff member (e.g. breach of code of conduct and other internal rules, especially concerning risks);
>
> b. whether the institution and/or the business unit subsequently suffers a significant downturn in its financial performance (specific indicators are to be used);

[260] CRD IV (n 63) Article 94 (n).
[261] ibid Article 94 (n)(i).
[262] ibid Article 94 (n)(ii).
[263]Prudential Regulation Authority, Remuneration Code (SYSC 19A) 3.51A.
[264] ibid 3.52 .
[265] ibid 3.51A (2).
[266]ibid 3.51A (3)(a).
[267] ibid 3.51A (3)(b).
[268] As recommended under Walker Review (n10) Recommendation 33.
[269] CEBS (n 235) s.137.

c. whether the institution and/or the business unit in which the staff member works suffers a significant failure of risk management;

d. significant changes in the institution's economic or regulatory capital base.'

So once again it is imperative to reiterate that the clawback criteria are to be set by the remuneration committee in the first instance, however it is clear that there will be some cross over with the recommended criteria. Whilst it is understandable that if a director conducts themselves in a way that is improper in the eyes of the shareholders, then they should not benefit financially for such actions. However the problems arise when the director's personal remuneration package is at conflict with the profitability of the company. Simply because the company as a whole did not make a profit does not necessarily mean that the individual director did not perform their duties correctly. How this is decided has also been suggested by the CEBS to not simply be a formulaic approach but instead could be based on both quantitative measures and informed judgment.[270] It is argued by the CEBS that this judgmental approach is of a greater benefit as it can take into account extra circumstances that are difficult to capture in a more formulaic approach. Whilst that is correct, it is purported that allowing these decisions to be dependent on subjective criteria may open the decision making to persuasion from executive directors. It would take a remuneration committee with a strong lead to vote against a remuneration structure whereby a director could not have been proven to have performed any misconduct or strict errors of judgment. CEBS outline that there must be specific indicators used, but once again offer no guidance as to what these indicators must be.

Potential for Change

More recently the FRC and the Bank of England have sought commentary on potentially extending the situations as to when it may be appropriate to exercise clawback provisions. The FRC are also proposing to make revisions to the UK Corporate Governance Code,[271] these changes if enacted will take effect from 1 October 2014. Under the new provisions the FRC wish to move from the previous requirement that 'consideration should be given to the use of provisions'[272] for recovery, and instead strengthen provisions to one that requires that variable pay schemes 'should include provisions that would enable the company to recover sums paid or withhold the payment of any sum'. What was interesting about this, in particular, is that the Council moved away from the normal parameters of comply or explain and with the intention to make it mandatory. It is also interesting that the FRC are seeking to delete the 'exceptional circumstances of misstatement or misconduct', this would have

[270] ibid 138.
[271] Financial Reporting Council (n 50).
[272] UK Corporate Governance Code (n 19) 26.

the objective of not constraining[273] the best practice being developed in the area. In its place, the Code intends to be revert back to what the CRD first intended, in placing the control back into the hands of the remuneration committee for them to 'specify the circumstances in which it considers it would be appropriate to use recovery provisions'[274] for performance related pay.

Further to this, recent proposals by the Bank of England[275] have sought to resolve what they have deemed as a failure in 'culture and strategy' to do so they have purported to extend the scenarios whereby clawback regimes may be enforced under the remuneration code. In particular, when a director could have been reasonably expected to be aware of the failure or misconduct at the time but failed to take adequate steps to promptly identify, assess, report, escalate or address it;[276] or by virtue of their role or seniority could be deemed indirectly responsible or accountable for the failure or misconduct, including senior staff in charge of setting the firm's culture and strategy.[277]

It is this second provision that is particularly revealing and is purported to be a clear reflection of the current state of feeling towards directors generally. Including that provision sends a clear message that any senior member of an institution, namely a director or senior management, would be subject to clawback provisions simply due to his position or status. These changes by both of these institutions would result in a potential widening of the application of clawback and malus provisions. This is clearly echoes the intention of the CRD IV and its underlying principles. However it is very difficult to examine so soon after the crisis as to whether clawback will be successful. Firstly is how to measure their success, often these provisions are used as a deterrent to ensure directors make the most appropriate decisions, as a result there would be no measurable loss if they are successful. Secondly the extension of the provisions to encompass scenarios whereby a simple loss could render a remuneration package unenforceable could lead to a loss in director confidence.

Conclusion

The chasing of high, short term profits during the financial crisis, led to generous bonus payments to directors and employees without adequate regard to the longer-term risks they imposed on financial institutions. [278] Whilst remuneration structures need to attract and motivate individuals having

[273] FRC (n 50) 6.
[274] ibid D.1.1.
[275] Prudential Regulation Authority, 'Bank of England consultation paper: Clawback' (6/14, March 2014) accessed at www.bankofengland.co.uk/pra/Documents/.../2014/clawbackcp6-14.pdf *[accessed on 4 September 2014].*
[276] ibid 2.6(a).
[277] ibid 2.6(b).
[278] Financial Stability Forum, 'FSF Principles for Sound Compensation Practices' (April 2009) Now the Financial Stability Board.

characteristics necessary for success in the industry,[279] it is believed that shareholders must not allow directors to take unnecessary risks**.** It is clear that poorly composed remuneration structures can encourage excessive risk taking by directors, and exacerbate the cultural issues that permeate throughout the financial sector.

The chapter has shown that a balanced remuneration structure can greater align the interests of the directors and shareholders to overcome the 'Agency Problem.' Performance related pay can be a positive influence on executive decision making, so long as it is properly structured.

Whilst formal remuneration is not governed by the law, it has been shown that there has been some attempt to curtail remuneration through legal means. Disclosure, with regards to remuneration, is the release of information on remuneration structures and their relationship with the performance of the company to the shareholders. Greater disclosure has resulted in greater activism by shareholders dubbed the Shareholder Spring of 2012. Whilst not entirely successful, the dissent shown by the Spring has already had a positive impact on curtailing what was deemed to be excessive remuneration structures on behalf of the director. It appears that in general bonuses are falling.[280] PWC for example noted that in an analysis of executive remuneration structure of FTSE 100 companies between 2012 and year end September 30 2013,[281] that whilst remuneration awards for chief executive officers (CEOs) was £1.14 million, their bonuses were on average 1% lower than in 2012. This continued a trend that has seen bonuses fall for a third successive year in 2013.[282]

Whilst this in itself may not be ground breaking and circumstantial at best what was particularly interesting was when surveyed by PWC almost two-thirds (60%) of FTSE 100 companies expected the total remuneration packages of senior executives to be maintained within 10% of current levels over the next five years.[283] This is a far cry from a runaway remuneration scenario whereby from 2000-2008 pay increases for executives outstripped those of the general workforce and were typically 6% to 7% per annum.[284] An untenable scenario best summed up by Vince Cable the business secretary who pointed out that 'Over the last decade, the pay of our top executives has

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279 Walker Review, *A review of corporate governance in UK banks and other financial industry entities: Final recommendations* (26 November 2009) Section D.
280 Larry Elliot, 'Executive bonuses fall for third year' The Guardian (London, 1 April 2014).
281 PriceWaterhouseCoopers (n 179).
282 When compared to the PWC, 'Getting the balance of executive pay right' (January 2012).
283 PriceWaterhouseCoopers (n 179) 2.
284 PriceWaterhouseCoopers (n 179) 4.

quadrupled, but it has not always been an indication of how well a particular company has performed.'[285]

Going forward it has been shown that well structured remuneration can alter the behaviour of a director away from the perceived norm. The cultural problems of short-term excessive risk taking can be alleviated by adopting a broader holistic approach including supervision, regulation and corporate governance. Remuneration is a fundamental monitoring tool for the multi-faceted approach adopted by the thesis, and if incorrectly structured can have severe negative effects on the culture of banking and the ability of the system to prevent a reoccurrence of the Global Financial Crisis.

[285] BIS, 'Press Release: Sweeping reforms to directors' pay and narrative reports come in to force' (BIS, September 2013) at https://www.gov.uk/government/news/sweeping-reforms-to-directors-pay-and-narrative-reports-come-in-to-force [accessed on 4 September 2014].

Chapter VIII: Northern Rock, a Case Study

Chapter VIII: Northern Rock a Case Study

In 2007, Northern Rock Plc was hit by a global liquidity squeeze which the Company argued was dramatic but also completely unforeseeable.[1]The failure of the business model of Northern Rock produced the first run on a British Bank in over 140 years and led to nationalisation. Not since 1866 and the collapse of Overend, Gurney & Co[2] had the UK banking system seen the effects of such a catastrophic failure in governance. It is therefore evident that Northern Rock is an ideal case study to test the theories proposed by the thesis. Northern Rock is a particularly good example to use, not only due to the actions of the Board, but also due to the unprecedented volume of information obtained relating to the decision making processes of the Northern Rock Board prior to, and during, the 2007-09 financial crisis.[3] It is notoriously difficult to get directors to comment on the business models they employ, however following the 'Run on the Rock' enquiry it is argued that the liquidity squeeze may not have been as unforeseeable as the directors made out, and due to the aggressive expansionist policies set out by Mr Adam Applegarth (Chief Executive Officer) and his Board, Northern Rock were unable to handle a sudden contraction of liquidity within the market. This case study will show how an application of the multifaceted approach outlined in the thesis could have potentially altered the decision making culture of Northern Rock and potentially, prevented the run from occurring. It will highlight that the inactivity of the non-executive directors to voice concerns over corporate policy leaves them vulnerable to substantial criticism and potential liability for failing in their corporate governance duties. The studies that have previously been undertaken on Northern Rock have focused quite specifically on the relationship between the Bank and its Regulator the FSA,[4] and have not considered the application of various corporate governance mechanisms to critique the role and actions of the senior management of Northern Rock and the underlying business strategy in place. This chapter, drawing together the arguments made across the thesis, will fill this knowledge gap. First however it is necessary to discuss the history and development of Northern Rock.

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[1] Treasury Committee, *The run on the Rock Volume II oral and written evidence* (HC 2007-08, 56-II) 388.
[2] For an excellent analysis of the history of Overend & Gurney see Geoffrey Elliott, *The Mystery of Overend & Gurney: A Financial Scandal in Victorian London* (London: Methuen Publishing Co, 2006).
[3] Focusing in particular on the study Treasury Committee, *The Run on the Rock* (HC 2007-08 56-I) and the evidence contained within Treasury Committee, *The run on the Rock Volume II oral and written evidence* (n 1).
[4] See for example Franco Bruni and David T. Llewellyn*, The failure of Northern Rock: A multi-dimensional case study (* SUERF- The European Money and Finance Forum, 2009).

Northern Rock Prior to the Global Financial Crisis

Northern Rock can trace its origins to the mid 19th Century, and two earlier Building Societies: the Northern Counties Permanent Building Society[5] and the Rock Building Society.[6] The two building societies merged in 1965 to form the Northern Rock Building Society. Northern Rock continued to trade and expand as a building society up until 1997 when, as part of a growing trend of building societies at the time, it opted to demutualise. Through demutualisation the company was subsequently floated on the stock exchange. The purpose of demutualisation was to allow for external investment that would allow for rapid growth. The idea worked spectacularly; in 1997 Northern Rock had assets of only £15.8 Bn,[7] however following demutualisation assets grew rapidly (by over 650%) to over £101 billion by the end of 2006.[8]Most importantly the demutualisation removed the constraints that had previously been placed on them by the Building Societies Act 1986. This afforded Northern Rock much greater commercial freedom to, for example, expand into different markets. Although they subsequently had the opportunity to expand into different banking businesses, Northern Rocks core business model focused predominantly on secured lending through UK residential mortgages,[9] to the extent that, by the end of 2006, 89.2% of all of Northern Rocks assets were held in residential mortgages. To achieve this rapid growth the company began to borrow heavily in the wholesale market.

During the same time the corresponding retail funding did not grow at anywhere near the same rate. At the end of 1997 retail deposits accounted for £9.9 Bn of liabilities.[10] By the end of 2006, retail deposits and funds had only grown to £22.6 billion, compared with the six-fold increase in Northern Rock's assets.[11]As a result the proportion of the total liabilities and equity of Northern Rock, retail deposits and funds had fallen from 62.7% in 1997 to 22.4% in 2006. This figure was reported to be significantly low when compared to market comparators such as Alliance & Leicester[12] (at 43%) and Bradford & Bingley[13] (at 49%.)[14] The business model was defended by the then Chairman of the Board of Northern Rock, Dr Ridley, stating that 'we had a smaller retail deposit book than many other institutions, although there are many like us overseas'.[15]Further to those

[5] Established in 1850.
[6] Established in 1865.
[7] Northern Rock Annual Report 1998, 31.
[8] Northern Rock Annual Report 2006, 59.
[9] Northern Rock, Community Report 2006, 9.
[10] Northern Rock Annual Report 1998, 48.
[11] Northern Rock Annual Report 2006, 91.
[12] Alliance & Leicester Annual Report and Accounts 2006, 49.
[13] Bradford and Bingley 2006 Annual Report and Accounts, 43.
[14] Treasury Committee, *The Run on the Rock* (n 3) 14
[15] Treasury Committee, *The Run on the Rock Volume II oral and written evidence* (n1) Q 401.

comments the Chief Executive, Mr Adam Applegarth, was quick to defend the quality of the Northern Rock loan book stating that Northern Rocks arrears had been roughly half of the industry standard.[16] Whilst it is hardly surprising that the Board would seek to defend their decisions, the quality of the Northern Rock loan book was further endorsed by both Hector Sants of the FSA[17] and Mervyn King the governor of the Bank of England at that time.[18] In the first six months of 2007 Northern Rock continued to expand more and more into the securitization markets, so much so that its new mortgage lending accounted for around one-quarter of all mortgage loans in the UK.[19]

Northern Rock and the Events of Late 2007

In the summer of 2007 the financial system was shaken by what has been described as a 'dislocation in the market.'[20] Due to the American sub-prime mortgage market there was a drop in the confidence of mortgage backed securities. The sub-prime mortgage was supplied to individuals with poor credit history; due to their poor credit history applicants would not qualify for conventional mortgages. Instead they were supplied with sub-prime mortgages that were charged at higher rates of interest, in an attempt to counteract the increased possibility of risk by default. During the early part of the 21st Century there was a housing boom in the US and lenders were much more liberal in granting such loans based upon low interest rates and high capital liquidity at the time. However during 2007 a series of mortgage delinquencies and foreclosures called into doubt the sub-prime business model and triggered a general flight from the product. The subsequent crisis caused an international liquidity shortage which affected Northern Rock quite dramatically. During the same time there also began to develop doubt in the viability of the Northern Rock business model.[21]

As a result of both of these issues, on the 9th August inter-bank and other financial markets suffered a de facto freeze in lending. Soon after the freeze it became evident that, due to their business model, Northern Rock would face severe problems if the markets stayed frozen for a prolonged period of time.[22]After internal discussions within the tripartite system, on Thursday 16 August the Chairman of Northern Rock spoke directly to the Governor of the Bank of England about the

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[16] ibid Q243.
[17] ibid Q 195.
[18] ibid Q 1696.
[19] ibid Q 195.
[20] Peter Yeoh, The Challenges and Implications of Systemic Risks for Finanical Regulation' (2010) Comp Law 389, 393.
[21] David Llewellyn, 'The Northern Rock Crisis: a multi-dimensional Problem' 15 in Franco Bruni and David T. Llewellyn*, The failure of Northern Rock: A multi-dimensional case study (* SUERF- The European Money and Finance Forum, 2009).
[22] Treasury Committee, *The Run on the Rock* (n 3) 35.

possibility of a support operation.[23] The liquidity freeze continued and ultimately Northern Rock approached the Bank of England for financial support. The support operation was due to be announced on Monday 17 September,[24] however on the evening of Thursday 13 September the BBC reported that Northern Rock plc had asked for, and received, emergency financial support from the Bank of England.[25] The reporting was premature and caused panic within the financial system and country at large. The terms of the funding were finalised in the early hours of Friday 14 September and announced at 7.00 am that day. The result of that announcement, and the perceived confirmation of the BBC report, was tantamount to pandemonium. Long queues began to form outside branches of Northern Rock, with depositors desperate to remove any funds they had within the Institution. The Northern Rock website crashed and its customer service phone lines jammed.[26] Over the next three days around £3 Bn of deposits were withdrawn from the bank.[27] To put this into context, £3 Bn represented around 11 per cent of the bank's total retail deposits held at the time.[28] The speed and impact of the run was phenomenal, the unexpected volume of requests meant that the announced emergency facility, which had been envisaged as a 'backstop', actually needed to be called upon almost immediately.[29]The fear generated by the rapid momentum of the run led the Chancellor of the Exchequer to announce a guarantee of all deposit liabilities in Northern Rock:

> 'In the current market circumstances, and because of the importance I place on maintaining a stable banking system and public confidence in it, I can announce today that following discussions with the Governor and the Chairman of the FSA, should it be necessary, we, with the Bank of England, would put in place arrangements that would guarantee all the existing deposits in Northern Rock during the current instability in the financial markets. This means that people can continue to take their money out of Northern Rock. But if they choose to leave their money in Northern Rock, it will be guaranteed safe and secure.'[30]

[23] ibid.
[24] Treasury Committee, *The Run on the Rock Volume II oral and written evidence* (n 1) Q 577.
[25] Robert Peston, 'The Rock and Me' *BBC* (16 October 2007) accessed at http://www.bbc.co.uk/blogs/legacy/thereporters/robertpeston/2007/10/16/index.html [accessed on 23 September 2014].
[26] Treasury Committee, *The Run on the Rock Volume II oral and written evidence* (n 1) Qq 345, 678.
[27] 'Panic on the high street: Customers at crisis-hit Northern Rock withdraw £1 billion in a day' *Daily Telegraph* (15 August 2007) and George Walker, 'Sub-prime loans, inter-bank markets, financial support' (2008) 29 *Company Lawyer* 22.
[28] ibid.
[29] Treasury Committee, *The Run on the Rock Volume II oral and written evidence* (n 1) Q 529.
[30] HM Treasury, Statement by the Chancellor of the Exchequer on financial markets (17 September 2007).

As a result of the announcement, the market began to calm and the run was halted. Subsequently to the initial support, 'additional facilities' were made available to Northern Rock in October 2007.[31]

Initially, the Government sought to ensure that ownership of the bank remained within the private sector. The Chancellor announced in November 2007 that whilst bids were being considered, any sale would require the approval of Government.[32]The Board of Northern Rock tendered no less than ten separate bids. The lead bid was reported to have been from a coalition led by Sir Richard Branson's Virgin Group.[33] Ultimately, no single bid was approved and after failing to find a private buyer for the troubled bank, in February 2008 the UK Government announced its intention to nationalise the bank.[34] The Banking (Special Provisions) Act 2008 nationalised Northern Rock and the Northern Rock plc Transfer Order 2008 transferred Northern Rock into state ownership.[35]In 2009, the Northern Rock plc Transfer Order 2009 restructured the company into two separate businesses. The perceived 'good' retail and wholesale deposit parts of Northern Rock were retained under the name 'Northern Rock Plc', whilst a second 'Northern Rock (Asset Management) Plc was established to separate and contain the banks toxic mortgage book and other whole deposits deemed too risky for the main institution. After initially failing to purchase Northern Rock in 2007, in 2011 the Virgin Group tabled a second bid for the newly restructured deposit arm of the Northern Rock bank.[36]The sale of Northern Rock plc to Virgin Money Holdings was announced on 17 November 2011 for an initial £747 Million and further potential payments of £280 Million.[37]The sale was completed on 1 January 2012, however it is interesting to note that the total £1Bn spent by Virgin Group was still considerably lower than the £1.4 Bn spent by Government in aid during the run on the bank.

The Northern Rock Board During September 2007

Within banks as with corporations generally, it is the Board of Directors who sets the general culture of the organisation and it is only through change in its perception of risk and attitudes to growth rates, that banking culture may be reformed for the better. The identification of deep rooted, cultural, perceptions of risk and acceptable business strategy must come from the most senior members of the board. It is necessary to analyse the actions and potential liabilities of the Board members of Northern Rock both before, and during the Global Financial Crisis. It is important to note

[31] The revised facility was amended on 9 October 2007. See Treasury Committee, *The Run on the Rock* (n 3) 341.
[32] ibid.
[33] BBC News, 'Virgin Pursues Northern Rock Deal' *BBC* (12 October 2007).
[34] Alistair Darling, Chancellor's statement on Northern Rock, (17 February 2008).
[35] Transferral was completed on 22 February 2008.
[36] Lars Paulsson 'JC Flowers, Virgin Money Bid for Northern Rock' *Bloomberg* (30 July 2011).
[37] HM Treasury, 'Press Release: Chancellor announces sale of Northern Rock plc' (17 November 2011).

that during the crisis the Northern Rock Board was formed of thirteen directors who met regularly throughout the year. The Board consisted of eight non-executive and five executive directors, who met as a Board on no less than eleven occasions throughout the previous year.[38] The Board adhered to the Combined Code,[39] and were sufficiently trained for their roles.[40] The chapter will begin with profiling the main directors during the troubled times starting with the Chief Executive Officer and continuing with the three main non-executive directors during the crisis:

Mr Adam Applegarth, Chief Executive Officer

Mr Applegarth joined Northern Rock as a graduate trainee in 1983. He quickly rose within Northern Rock having been appointed head of planning in 1989, assistant general manager in 1992, executive director in 1996 and finally was made chief executive in 2001. At that point he was the youngest ever FTSE 100 chief executive at the age of 39.[41] Mr Applegarth was renowned for being very driven, he was seen as extremely ambitious and the aggressive growth strategy at Northern Rock directly mirrored Mr Applegarth's personal approach. It has also been reported that these bullish tactics resulted in the majority of the executives being quite intimidated by him,[42] evidenced clearly by his necessity to have arrears reported at half the CML average. Although Mr Applegarth had spent twenty four years working at Northern Rock, the last six as chief executive, amazingly when questioned by the Treasury Select Committee he by is own admission stated: 'I am not a qualified banker.'[43] It would appear to be poetic irony that this was in answer to question 666 of the Select Committee evidence, and yet epitomises the dangerous nature of the Northern Rock Board make up, and their lack of banking experience, a point that will be analysed further. He ultimately quit as chief executive in November 2007.[44]

Dr Matt Ridley, Chairman of Northern Rock

Dr Ridley was appointed to the Board in 2004 having spent thirteen years on the Board.[45] At the Treasury Select Committee hearing Dr Ridley described himself as a businessman citing his participation on a number of different Boards as evidence of his extensive experience,[46] however Dr Ridley had no previous banking experience prior to his appointment to the Board of Northern Rock.[47]

[38] Northern Rock Annual Report 2006, 11.
[39] ibid 12.
[40] ibid.
[41] Northern Rock: So who is Adam Applegarth? *This is Money* (16 September 2007).
[42] Anthony Hilton, 'Demands of the city forced bps collapse' *London Evening Standard* (28 July 2010).
[43] Treasury Committee, *The Run on the Rock Volume II oral and written evidence* (n 1) Q 666.
[44] Philip Aldrick and Katherine Griffiths, 'Rock chief and seven directors quit' *Telegraph* (17 November 2007).
[45] Treasury Committee, *The Run on the Rock Volume II oral and written evidence* (n 1) Q 385.
[46] ibid Q 386.
[47] ibid Q 387.

Dr Ridley is a zoologist by profession and it is difficult following his tenure as Chairman of Northern Rock to not observe a certain irony in his publication *The Rational Optimist: How Prosperity Evolves.*[48] It is argued the actions and business strategy was most certainly optimistic, completely irrational and clearly didn't lead to a prosperous company, so much so Dr Ridley presided over the first run on a bank since Overend Gurney in 1866. Although not having any personal experience of banking his father Viscount Ridley was also chairman from 1987 to 1992 and sat on the Board of Northern rock for 30 years. Following the financial scandal at Northern Rock Dr Ridley resigned as chairman in October 2007.[49]

Sir Ian Gibson, Senior Independent Director

Sir Ian Gibson was a trusted and well respected man in the business world. Sir Ian began his directorship career in the motor industry with his first Board appointment to the Board of Nissan Motor Manufacturing in 1987 he was then made managing director two years later. In 1999 he became the first European senior vice-president of Nissan Motor Company in Japan, and was knighted in the same year for his services to the motor industry. Sir Ian's experiences branched out further than just the motoring sector, during his career Sir Ian has been Chairman of BPB plc, was on the Court of the Bank of England, has been Chairman of Trinity Mirror, and was Deputy Chairman of Asda Group plc and a non-executive director of GKN plc and Greggs plc.[50] Sir Ian's extensive business experience spanning across a wide range of sectors theoretically made him an ideal candidate for the role of senior independent director, however it must also be pointed out prior to his appointment Sir Ian had no experience in banking or financial services.

Sir Derek Wanless, Chairman of the Audit and Risk Committee

Sir Derek had extensive experience within the financial sector. In 1967 he joined Westminster Bank, a constituent of the present NatWest Bank, rising to become NatWest's Director of Personal Banking from 1986-1988. He was subsequently appointed group chief executive in March 1992. He held this position for the next seven years until his retirement in October 1999. Sir Derek's experience within the sector led him to some quite pivotal roles, for example he is chairman of the Financial Services National Training Organisation[51]and in March 2001 was appointed by then Chancellor Gordon Brown to conduct a review of the long-term trends that might affect the health care service in the UK. Again it appears poetic irony that Sir Derek penned a 2002 report entitled 'Taking a Long-Term View.' Such

[48] Dr Matt Ridley, *The Rational Optimist: How Prosperity Evolves* (HarperCollins 2010).
[49] Treasury Committee, *The Run on the Rock* (n 3) 18.
[50] See Sir Ian Gibsons Biography at http://www.morrisons-corporate.com/About-us/Board-members-biographies/ [accessed on 23 September 2014].
[51] 'Profile: Derek Wanless' *BBC News Channel* (25 February 2014).

ac position can only be observed as directly contradictory to the business model he oversaw and approved during his term as a non-executive director at Northern Rock. Highly educated he has an MA in Mathematics from Cambridge University, is a qualified Statistician and Banker and attended the Program for Management Development at Harvard.[52] Sir Derek resigned at the same time as Mr Adam Applegarth on the 16th of November 2007.[53]One recurring theme we can see within this selection of the Board however is that between the CEO and three chief non-executive directors only one had any professional banking qualifications and only Mr Applegarth and Sir Derek Wanless any prior banking experience, a point quite startling in itself.

Could an Application of Good Corporate Governance Structures Have Changed the Culture at Northern Rock?

This chapter seeks to answer whether, having known that they were pursuing such extreme growth rates, improved application of good Corporate Governance structures could have changed the culture and decision making processes within Northern Rock? Further to this could a change in culture have altered the decisions of the executive and non-executive directors for the better? In doing so, this case study of Northern Rock has identified three specific issues:

Issue 1: Adam Applegarth, The Northern Rock Business Model and the Director's Duty to Promote the Success of the Company

This thesis has shown that the application of s.172 of the Companies Act 2006 has established a new system of corporate governance within the UK known as Enlightened Shareholder Value. The intention of the establishment of the ESV system of governance has to bring greater accountability to directors of companies. This was to be done by greater aligning the decision making process of the directors with the perceived wishes of the owners, namely the shareholders, in the pursuit of profit maximisation.

It has already been reported that following the demutualization of Northern Rock in 1997, the company led an extremely aggressive expansionist business model which by 2006 had allowed the bank to grow its assets from £15.8 Bn to £101 Bn.[54] It has also been shown that the development of their business model resulted in 89.2% of its assets contained within securitised mortgages.[55] The

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52 HM Treasury, Biographical Information about Derek Wanless accessed at http://webarchive.nationalarchives.gov.uk/+/http://www.hm-treasury.gov.uk/consultations_and_legislation/wanless/consult_wanless_info.cfm accessed on [24 September 2014].
53 Treasury Committee, *The Run on the Rock* (n 3) 18.
54 ibid 11.
55 ibid 82.

intentions of the business model were clearly to increase growth of the company and Northern Rock were extremely confident in the quality of their business model,[56] however further evidence has now emerged that bring into the question the quality of the decisions made under the Northern Rock 'virtuous circle' business model.[57]

Outside the bank, commentators remarked that the business strategy was one of many 'extremes.'[58] A factor not lost on then Governor of the Bank of England, Mervyn King, who was quick to point out that the rapid growth strategy undertaken by Northern Rock resulted in the bank growing at a rate three times faster than any other bank at that time.[59] Even before the crisis hit the Chancellor of the Exchequer denounced the behaviour of Northern Rock, he noted that in the early part of 2007 Northern Rock undertook a strategy at odds with the market trends and 'had aggressively expanded its market share.'[60] Sir John Gieve, Deputy Governor of the Bank of England, admitted that the Northern Rock business model made it 'more vulnerable than other banks.'[61] Combined with a steady fall in the share price, between January and September 2007,[62] this should have been a warning signal to the Board of directors to reconsider their aggressive expansionist policy. Mr Applegarth commented that the bank was only expanding at the same rate that it had been doing for many years (20% per annum plus or minus 5%) but it is argued what whilst making this remark he failed to take into account the changing nature of the financial sector.[63] Following the demutualisation of the bank in 1997 the period had been one largely of prosperity. For a bank whose main line of business was wholesale mortgage lending it had benefited greatly from the rapid housing price increases of the early 2000's, but it is argued that the change in the market that began in 2006 was one that should have altered the business model of a bank that was so heavily dependent on wholesale funding. The rapid expansion continued into the first half of 2007 where Northern Rock was running a business model that was taking 19% of the net new lending. If this is to be compared to HBOS, who at the time was one of the largest lenders in the market, during the same time only captured 8% of new net lending.[64]The eventual conclusion from the Treasury Select Committee outlined that they believed '[T]he directors pursued a reckless business model which was

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[56] Treasury Committee, *The Run on the Rock Volume II oral and written evidence* (n 1) Q 388.
[57] Northern Rock Annual Report 2006.
[58] Treasury Committee, *The Run on the Rock Volume II oral and written evidence* (n 1) Q 401.
[59] ibid Q 9.
[60] Treasury Committee, *The Run on the Rock Volume II oral and written evidence* (n 1) Q 749.
[61] ibid Q 8.
[62] Even prior to the troubles in August the share price had fallen from £12 in January 2007 to roughly £8 by the end of July. See Treasury Committee, *The* R*un on the Rock* (n 3) 23.
[63] Treasury Committee, *The Run on the Rock Volume II oral and written evidence* (n 1) Q 452.
[64] ibid Q 444.

excessively reliant on wholesale funding.[65] Whilst the governor of the Bank of England commented that the business strategy was fatally floored.[66] As a result of the poor managerial decisions Northern Rock posted losses of £167.6 million in 2007,[67] however, as a direct result of the actions of the Board during the crisis the losses then rose to £1.36 Billion in 2008.[68] More importantly, it meant that an injection of £26Bn worth of loans from the Bank of England was required and ultimately led to the nationalisation of Northern Rock in February 2008.

Each of these decisions can clearly be seen to be breaching any one of the list of factors a director must have regard to under s.172 (1). For example, pursuing a growth strategy at odds with the rest of the market is clearly going to have negative consequences in the long term.[69] Whilst this is the case the greatest problem with regards to accountability, is that the six matters do not impose free standing duties, and as such the director only needs 'to think about' and 'to give proper consideration to'[70] those factors. A Director cannot be held liable if they do not consider a specific factor, even though Parliament considered Directors' consideration of them to be imperative and an 'integral part'[71] of their duty to promote the success of the company.

More recently further evidence of poor managerial decisions have emerged from the actions of two executive directors in particular. In 2010 evidence emerged that Mr David Baker (former deputy chief executive) and Mr Richard Barclay (former managing credit director) deceived shareholders by concealing 1,917 mortgages to borrowers. As a result the Financial Services Authority (FSA) fined David Baker £504,000 and Richard Barclay £140,000.[72]

The FSA revealed that in December 2006 Mr Baker became aware that the loans were omitted from mortgage arrears figures, which formed part of the management information and subsequent communications made to the market; Mr Baker knowingly did not escalate this information satisfactorily nor make any formal record that this issue had arisen. [73] This was heightened by Mr David Jones (finance director) for when he became aware of the situation in mid-January 2007 he agreed to continue to allow false mortgage arrears figures to appear in footnotes accompanying the

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[65] Treasury Committee, *The* R*un on the Rock* (n 3) 3.
[66] ibid 18.
[67] Northern Rock Annual Report 2007.
[68] Northern Rock Annual Report 2008.
[69] Companies Act 2006 s.172(1)(a).
[70] Margret Hodge, the Minister of State for Industry and the Regions; DTI, *Duties of company directors: ministerial statements* (June 2007) 9.
[71] Davey Ka Chee-Wu, 'Managerial behaviour, company law, and the problem of enlightened shareholder value.' (2010) 31(2) Comp Law 53.
[72] FSA, FSA Communication Document: FSA fines and bans former Northern Rock deputy chief executive and credit director for misreporting mortgage arrears figures (FSA/PN/066/2010 2010).
[73] FSA, Final Notice to Mr David Baker (13 April 2010) 2.3(1).

2006 annual accounts. As Margret Cole FSA director of enforcement of financial crime points out: '[David Jones] had numerous opportunities to put things right, but failed to do so.'[74]

The reasoning behind their actions is quite distressing but unfortunately unsurprising given the growth strategy of the Board and in particular the chief executive. From 2005, staff members at Northern Rock were under pressure to ensure that they reported arrears and possession figures on loans at half the CML average.[75]In an attempt to do this, whilst balancing the aggressive growth strategy that was expected of them the DMU (Debt Management Unit), Mr Baker improperly reduced the number of reported impaired loans. If Baker and Jones had reported correct figures the FSA believed that Northern Rock's arrears would have increased by more than 50%, or repossessions figures by about 300%.[76] It is interesting to note however that even prior to these revelations, not everyone was truly satisfied that the asset portfolio of Northern Rock was as profitable as first perceived. The academic Professor William Buiter was highly critical of the aggressive expansion pointing out

> 'I like healthy growth but it is hard to believe that the quality of the asset portfolio and the ability to vet the credit-worthiness of your borrowers does not suffer when you take 20% of the net increase and 40% to 50% of the gross increase in activity in this half year period, [Jan 2007-July 2007] so I think that they were an organisation that was clearly engaged in high-risk behaviour.'[77]

The actions of both directors can be perceived as a direct result of the extreme Northern Rock business model, set in place by Mr Adam Applegarth.

In defence of the Northern Rock Board, expansionist policies were not limited solely to Northern Rock, as subsequent failures have shown, a number of institutions entered into significant difficulties pursuant to similar policies of rapid growth. The clearest example of executive failure can be observed in the Royal Bank of Scotland following its acquisition of ABN Amro. There was no due diligence undertaken of ABN Amro in the six months prior to the deal being approved and amazingly still received unanimous support of the RBS Board.[78] This single transaction resulted in a £24.1 Bn loss in 2008, a point all more poignant to make given the bank would have been profitable and not

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74 FSA Press release, 'FSA bans and fines former Northern Rock finance director £320,000 for misreporting mortgage arrears figures' 27 July 2010.

75 FSA, FSA Final Notice to Mr David Andrew Jones (27 July 2010) 4.2.

76 ibid 5.1.

77 Treasury Committee, *The Run on the Rock Volume II oral and written evidence* (n 1) Q 854.

78 Treasury Committee, *Banking Crisis: reforming corporate governance and pay in the City,* (HC 2008-09, 519) 22.

subsequently entered into difficulties had it not acquired the Dutch Bank.[79] Similar issues occurred with the merger of Lloyds TSB and Halifax Bank of Scotland.[80]

So there was a clear business model outlined by Mr Adam Applegarth, who may or may not have considered some of the factors set out under s.172. The question therefore is whether the decisions made satisfied the director's duty to promote the success of the company, set out under s.172 of the Companies Act 2006 and in particular the subjective standard of care.

As has already been established,[81] s.172 sought to encourage companies to behave in a more socially responsible way. It is clear that under the provision the director is expected to exercise their own discretion and the standard that he is expected to adhere to is a subjective one. A director must act in the way he considers, not what the court may consider,[82] in good faith, would be most likely to promote the success of the company for the benefit of its members. It is the subjective standard of care that may be the greatest stumbling block to potential cultural reform. As has already been highlighted earlier in the thesis following cases such as *Regentcrest plc v Cohen*[83] the decision the director makes need not be a reasonable one, so long as the director believed that at the time they were acting in the best interests of the company, and that their belief was an honest one. It is clear that Mr Applegarth believed that his business model was prudent.[84]

When asked specifically whether he felt he had done anything wrong, whilst expressing regret he reiterated that: 'It was a good business model but, clearly, it could not deal with the unforeseen global freezing of the liquid markets.'[85] During questioning he repeatedly mentioned that the failures of the bank were due to an unforeseeable global freeze.[86] There is no duty under s.172 to predict the unforeseeable simply to act in the way that they perceive would promote the success of the company. Under s.172 a director is also expected to act for the benefit of the members as a whole. This means that a director is to act for the benefit of all members, not only the majority shareholders, and most certainly not any individual shareholders. [87] There is no indication from any of the evidence that Mr Applegarth was acting for the interests of any individual shareholder.

[79]Roman Tomasic and Folarin Akinbami, 'Towards a new corporate governance after the global financial crisis' (2011) ICCLR 237, 243.
[80] For an excellent discussion of the facts see Roman Tomasic and Folarin Akinbami (n 75) 243.
[81] See chapter V.
[82] This follows on from the case of *Re Smith & Fawcett Ltd* (n 88) 306.
[83] [2001] 2 BCLC 80.
[84] Treasury Committee, *The Run on the Rock Volume II oral and written evidence* (n 1) Q 423.
[85] ibid Q 474.
[86] ibid Q 434.
[87] Comments of Lord Goldsmith at HL Deb 6 February 2006 vol 678, col 256.

In conclusion, following the criticism outlined earlier, and in particular the problems of enforceability of s.172, it would appear that the duty to promote the success of the company had little effect on the decision making process of Adam Applegarth and the business model of Northern Rock. It may be argued however that with very small alterations to the legislation, or alternatively a wider interpretation, s.172, the provisions could have a very real and positive curbing effect on rogue directors, who do not act to promote the success of the company for the benefit of its members as a whole. Such reform would strengthen the ability of s.172 to reign in excessive risk taking and contribute to the establishment of a more prudent culture within banks.

Issue 2: The role of the Non-executive Director and the directors' duty of skill, care and diligence under s.174

The theoretical role of the non-executive director as gatekeeper has been discussed in quite some depth, to briefly remind the reader the current duty of skill care and diligence is to be found under s.174 of the Companies Act 2006.

Under the current duty a director's actions are measured against the actions which would have been taken by a reasonably diligent person. Observed both objectively according to the level of skill and experience which might be expected of a person carrying out the functions of the director, and also subjectively, according to the level of general skill, skill knowledge and experience the director actually has. This case study will look to examine the decisions of the directors through this vehicle, and in particular the decisions of the three non-executive directors.

The ability of the non-executive to hold the executive market participants to account is the fundamental 'role of the non-executive director…and to monitor and supervise their conduct.'[88] However it is purported that it was the risk monitoring within Northern Rock that dramatically failed.[89] It is purported that a greater reliance on formal corporate governance structures would improve this by altering the general culture imposed within an institution. Whilst the culture begins with the CEO it has been identified that 'there is a core, irreducible requirement of directors to be involved in the management of the company and to take all reasonable steps to be in a position to guide and monitor.'[90]

[88] Derrek Higgs, *Review of the Role and Effectiveness of Non-Executive Directors* (London: Department of Trade and Industry, 2003) para 6.6.
[89] The de Larosière Group, *The High Level Group on Financial Supervision in the EU* (European Commission, 25 February 2009) para 122.
[90] *ASIC v Healey* [2011] FCA 717 para 17.

The only way to ensure that a non-executive fulfils that role is to ensure that they fulfil their duties under the Companies Act 2006, and conversely their potential liabilities if they fail to fulfil their obligations. To investigate the potential liability of the three non-executive directors, it is necessary first to analyse whether any of them had any further skill, knowledge or experience that would raise the threshold of liability from the basic objective standard of a prudent director, to that where their subjective skill would result in them falling under s.174(2)(b) of the Companies Act 2006. First and foremost Dr Matt Ridley clearly has no specialist skill or experience that would allow for the original objective standard of care to be raised any further. Dr Ridley is a zoologist by profession and although he has sat on the Board for an extensive period of time, it is difficult to argue how that would raise his threshold of knowledge any higher than that of any normal director that had done the same. It is argued that the same is true of Sir Ian Gibson. It is true Sir Ian has extensive managerial and business knowledge and would be expected to apply his experience with regards to his position; however it is difficult to argue that he has any specialist skill that would be of benefit to the Board that would lead to a rising to a subjective standard. Sir Ian spent the majority of his career in the motoring industry and although he may have extensive experience in business, this experience would be exercised in the same way that any reasonable director would do concurrent with the objective standard.

The situation differs substantially upon analysis of the position of Sir Derek Wanless, Sir Derek Wanless had substantial financial experience. Having been the chief executive of a leading financial institution for over seven years, and being a qualified banker, it is argued that he would be expected to bring those specialist skills to his role as a director. Sir Derek Wanless would be under a duty to use his knowledge of the financial sector, and more specifically financial products and their effect on the Northern Rock business model whilst he was fulfilling his role as a non-executive. As a result it is argued that both Dr Matt Ridley and Sir Ian Gibson hold an objective duty of skill care and diligence as found under s.174(2)(a) of the Companies Act 2006. Whilst conversely Sir Derek Wanless also owes the objective duty under the same section, however the level of his duty is raised based on his subjective knowledge and experience in the financial sector and therefore he owes a heightened subjective duty found under s.174(2)(b) of the Companies Act 2006 when dealing with financial decisions. The chapter will therefore treat Dr Ridley and Sir Ian Gibson together under the objective minimum standard, subsequently Sir Derek Wanless and the greater subjective standard of care will be analysed (however it must be pointed out that Sir Derek Wanless would still be subjected to the objective minimum along with Dr Ridley and Sir Ian Gibson).

The Board of Northern Rock repeatedly stated that the bank was hit by an unpredictable liquidity squeeze that could not have been foreseen.[91] Whilst it is imperative that any analysis must not be made through hindsight, there were very specific and clear warnings given to the banks and in particular Northern Rock prior to the run that, it is argued, should have made the non-executive directors question the business model that had been put before them at Board meetings.

The first clear indication that came from the authorities was in January 2007 when the FSA released their financial risk outlook report stating 'if economic conditions were to deteriorate, this could lead to crowded exits, draining liquidity from the market and causing erratic price swings in commodities.'[92] Following this, in April 2007 the Bank of England released their financial stability report where they clearly noted '[r]ecent developments in the US sub-prime mortgage market have highlighted how credit risk assessment can be impaired in these markets and how participants can be hit by sharp reductions in market liquidity.'[93] Within this report it was also noted that 'it is important to stress test and take those stress tests into account.'[94] Further evidence to the fact was given by the Governor of the Bank of England, Mervyn King, who expressed clear warnings to the financial sector in June 2007,[95] in his Mansion House speech he remarked that 'liquidity of the markets in complex instruments… is unpredictable.'[96] Finally Northern Rocks share price was as clear an indicator as any that problems were afoot. The share price was rapidly falling between January and July 2007, at a rate that was not the same as the industry trend.[97] A drop in share price greater than a market trend was a clear indication of possible problems as seen by an objective market stance. All of these examples, by the admission of the directors, were apparent to them and taken into consideration whilst fulfilling their roles as directors.[98] So it is clear there had been several very obvious and direct warnings of the dangers of over reliance on wholesale funding that the directors were aware of and yet the non-executives remained silent.

As the Higgs report notes a non-executive director should both challenge and contribute to the development of strategy, and monitor financial controls and ensure systems of risk management are

[91] Treasury Committee, *The Run on the Rock Volume II oral and written evidence* (n 1) Q 404.
[92] FSA, 'Financial Risk Outlook' (January 2007) 22.
[93] Bank of England, 'Financial Stability Report' (Vol 21, April 2007) 5.
[94] Treasury Committee, *The Run on the Rock Volume II oral and written evidence* (n 1) Q 633.
[95] Speech by Mervyn King, Governor of the Bank of England at the Lord Mayor's Banquet for Bankers and Merchants of the City of London at the Mansion House (June 2007) accessed at http://www.bankofengland.co.uk/publications/speeches/2007/speech313.pdf [accessed on 24 September 2014].
[96] ibid 6.
[97] Treasury Committee, *The Run on the Rock Volume II oral and written evidence* (n1) Q 529.
[98] ibid Q 633.

robust and defensible.[99] It is argued that these signals should have led the non-executive directors to at least question the business model of the executives, and not simply be appeased by the executives. Whilst not questioning the business model Mr Gibson stated that he was fully aware of the risks of the business,[100] and under questioning in the Treasury Select Committee the directors argued to a point that after the third month of 2007 the directors began to see several warning signs of the US sub-prime problems.[101] At this point it was purported by the directors that there was a change in strategy to reduce the rate of growth of the company.[102] On the face of things this would appear to be a positive response by the Board, to reduce the rapid expansionist policies in light of dramatic market shifts; however the reality of the situation is far different. By his own admission Mr Applegarth reported that following the implementation of the new business model the rate of growth would have actually been reduced to 16-17%.[103] That is correct, following warnings of a large shift in the financial market outlook, the company reduced its aggressive expansionist policy by a mere 2-3%, and therefore it is very difficult to see any significant slowing of growth at all. And yet through all of this, it appears the non-executive directors remained mute. Not even just mute, but positively approving a growth rate, which the committee members themselves remarked as being pretty aggressive compared to their 'dull businesses' that some of them had been running in the past.[104] The Select Committee was highly critical of the directors' actions asking repeatedly of the directors 'where were the cautious voices.'[105]

As a result if these decisions are to be considered in the light of s.174 of the Companies Act 2006 both Sir Ian Gibson and Dr Riley owed a duty to the company to be an independent voice and to act as gatekeepers to the aggressive policies put forward by the executives. The non-executive directors were inactive in voicing concerns over a recklessly aggressive business model in the face of clear evidence to the contrary. Since the issues of Northern Rock have unfolded a number of cases have been decided, in particular the case of *Lexi Holdings.*[106] Although different on facts to *Lexi Holdings* (here there was no fraud committed by the director) the fundamental concepts are the same. Both Gibson and Riley owed a duty to monitor the risks posed to the business model and ensure good strategy, in not voicing a protest to the impeding problems their inactivity it is argued would result in the breaching of their duty of skill care and diligence. The mere fact that they remained silent in the

[99] Higgs (n 88).
[100] Treasury Committee, *The Run on the Rock Volume II oral and written evidence* (n 1) Q 389.
[101] ibid Q 427.
[102] ibid Q 431.
[103] ibid Q 449.
[104] ibid Q 453.
[105] Ibid Q 447.
[106] *Lexi Holdings Plc (in admin) v Luqman* [2009] BCC 716.

face of a dominating director such as Mr Applegarth meant that following *Lexi Holdings Plc* they would potentially be in breach of their duty of skill, care and diligence under s.174(2)(a) in allowing 'themselves to be dominated or bamboozled by one of their number.'[107]

What risk prevention procedures were put in place? There was a Risk Committee chaired by Sir Derek Wanless whose job it was to monitor risks to the business model. Sir Derek was happy with the strategy taken by the Board and the operation with the risk committee itself.[108] However it is argued that his previous experience in the financial sector should have led him to question the business model far more rigorously than he did. Sir Derek was brought in to the company following his work at NatWest, during his time at that company; in 1997 NatWest led an aggressive strategy into the US market. A £90 million loss was uncovered in its trading books and was overlooked by NatWest's' review of its risk controls.[109] This is clear evidence of a director who had experience of aggressive expansionist business models, and in particular expansionist business models that have not worked. It is argued that Sir Derek should have brought this experience to his role in the risk committee of Northern Rock. Yet by his own admission, the strategy had been in place before he joined the Northern Rock Board in 2000,[110] and still having taken up the position did not voice any concerns over such an aggressive strategy simply dismissing it as a 'growth strategy.'[111] Dr Ridley attempted to justify the capture of 19% of new lending in the first 6 months of 2007 by remarking that 'we did not increase the rate of mortgage lending in the first half of 2007.'[112] But in doing so it is argued that he is missing the very point, the markets had been rapidly changing and the bank had been informed on several occasions that markets were tightening. There may have not been any *increased* lending but it is argued that there should have been steps to *reduce* the rate of growth with the changing financial environment. Sir Derek Wanless denied that this was an aggressive strategy, claiming that during the first half of 2007 Northern Rock had only 10% of the market in new lending, but eventually under questioning conceded that this was in fact 19% of new lending after repayments.[113] Sir Derek's experience in the financial sector should have led to him questioning the business model, applying his own knowledge of aggressive business strategies. The diversification of Northern Rock was a defence that was brought up repeatedly by the directors; the directors argued that diversifying into different business areas allowed them to continue on such an aggressive

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[107] ibid.
[108] Treasury Committee, *The Run on the Rock Volume II oral and written evidence* (n 1) Q 437.
[109] ibid Q 472.
[110] ibid Q 473.
[111] ibid.
[112] ibid Q 445.
[113] ibid Q 465-471.

growth strategy whilst ensuring a suitable reduction in risk.[114] However upon further analysis it is clear that 75-80% of all of Northern Rock's business was in securitisation, if this is to be compared with other banks HBOS for example only hold 20% of business in securitisation.[115] There is therefore very little diversification whatsoever, Sir Derek Wanless should have known this and, it is argued, failed in his duty of skill care and diligence under s.174(2)(b) as a result.

There was clearly pressure applied to executives to report pleasing figures to the chief executive, then following the more recent cases of *Re Westmid Packing*,[116] *Lexi Holdings Plc and Weavering Capital (UK) Ltd (In Liquidation) v Peterson*[117] it is the duty of the non-executive directors to be the independent voice and ask questions of the Board and the business model that was been implemented. It is argued that Dr Ridley and Sir Ian Gibson did not do this and their inactivity in the face of very clear evidence that there may have been some problems with the business model adopted by the executives of the company resulted in the breach of their objective standard of care. The mere fact that they were appeased by Mr Applegarth 'it is in itself a breach of duty by the remaining directors to allow themselves to be dominated or bamboozled by one of their number'[118] and therefore it is argued that if the decisions were made today the influence of s.174(2)(a) of the Companies Act 2006 may alter the decision making process of the directors. Further to this the fact that Sir Derek Wanless had previous financial experience meant that he should have applied that knowledge to his role as chair of both audit and risk committees. It is argued that he did not do this sufficiently well and as a result allowed a recklessly aggressive growth strategy to continue in the face of clear evidence to the contrary, it is purported that as a result there is a question of potential liability under s.174(2)(b) and his subjective duty of care.

In conclusion, whilst the directors failed to monitor and regulate the decision making processes within Northern Rock. It is argued that following the financial crisis, and *Lexi Holdings* and *Weavering Capital,* if the same decisions were made today, the most recent case law would force the directors of the company to purse more rigorous questioning of the decisions of the executive director, and his aggressive business model. This in turn can aid in the multifaceted approach opined by the thesis.

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[114] ibid Q 463.
[115] ibid Q 659.
[116] *Re Westmid Packing Services Ltd; Secretary of State for Trade and Industry v Griffiths (No.3)* [1998] BCC 836 at 842B.
[117] [2012] EWHC 1480 (Ch) and the subsequent Court of Appeal judgment *Weavering Capital (UK) Limited (in liquidation), Geoffrey Bouchier and Paul Clark (as joint liquidators (formerly joint administrators)) of Weavering Capital (UK) Limited v Charanpreet Dabhia, Edward Platt* [2013] EWCA Civ 71.
[118] *Lexi Holdings* (n 106).

Issue 3: Remuneration structures at Northern Rock

The final part of the chapter intends to address the remuneration structures of the Board, in an attempt to recognize whether a shift in remuneration culture may have been a contributing factor to the decisions made during the troubles.

The thesis has already demonstrated that there is a clear link between the structures of remuneration within a financial institution and the business decisions taken by that institutions senior management. Whilst remuneration structures need to attract and motivate individuals having characteristics necessary for success in the industry,[119] it is believed that shareholders must not allow directors to take unnecessary risks**.** It is clear that poorly composed remuneration structures can encourage excessive risk taking by directors, and exacerbate the cultural issues that permeate throughout the financial sector.

Northern Rock as a company had a clear and comprehensive remuneration structure prior to the financial crisis.[120] The 'Northern Rock Executive Directors Remuneration Package' consisted of a basic salary, an annual cash bonus, a deferred share scheme and a long term incentive plan.[121] The Remuneration Package structure encompassed both performance and non-performance related elements and at first glance offered an excellent balance to resolve the agency problems that permeate through from a misalignment of the interests of the directors and shareholders. Therefore it would appear that Northern Rock were following good governance guidelines as discussed earlier in the thesis. The Annual Reports confirmed that the Board recognized the need to ensure that performance related remuneration should align the interests of Executive Directors with those of the shareholders.[122] They also identified that the use of performance related elements of remuneration must focus on both short term and long term corporate performance targets. [123]

In 2006 the Executive Directors' remuneration package comprised:

- Basic salary, pension benefits and other benefits in kind;
- An annual cash bonus worth up to 100% of salary;
- A Deferred Share Scheme, with awards of shares equal in value to the cash bonus (i.e. up to 100% of salary) subject to the Company achieving real Earnings Per Share ("EPS") growth of 3% p.a. over a three year period;

[119] Walker Review, *A review of corporate governance in UK banks and other financial industry entities: Final recommendations* (26 November 2009) Section D.
[120] Northern Rock Annual Report 2006, 18.
[121] ibid.
[122] ibid 18.
[123] ibid.

• A Bonus Matching Plan, where Executives could invest their cash bonus in shares and receive an award of Matching Shares of an equivalent value subject to the Company achieving real EPS growth of 3% p.a. over a three year period;

• A Long-Term Incentive Plan ("Old LTIP"), with conditional awards of shares worth up to 100% of salary subject to a TSR performance condition relative to other FTSE 100 companies.[124]

Whilst theoretical elements are important, what is just as important is to show the total amounts each director was receiving, just prior to, and during the financial crisis. The table below shows a breakdown of the director remuneration structures for the year predating the crisis in 2006:[125]

Director	Salary (£000)	Cash Bonus (£000)	Deferred Share Scheme Rights Granted	Bonus Matching Plan Rights Granted	Long Term Incentive Plan Rights Granted for 2007	Market Price (£)
A J Applegarth	690	660	55,315	55,315	76,351	11.98
D F Baker	455	435	34,517	34,517	50,676	11.98
R F Bennett	455	435	34,517	34,517	50,676	11.98
Dr Ridley	300	X	X	X	X	X
Sir Ian Gibson	80	X	X	X	X	X
Sir Derek Wanless	86	X	X	X	X	X

[124] ibid.
[125] ibid 25-27.

What may be observed is a clear, logical structure that sought to balance both performance and non-performance related pay. Unfortunately, however, this was not the end of the story and in early 2007 the remuneration structure changed. At the annual AGM in April 2007 shareholders approved a new remuneration structure in favour of the executive directors.

The 2007 Changes to the Remuneration Structures at Northern Rock

The new remuneration structure was significantly more favourable than the old structure. It is argued that this change in structure orchestrated a cultural shift within the bank towards more risky decision making with the hope to increase short term benefits for the directors.

Firstly the total potential benefits to be accrued from 'The Short Term Bonus Scheme' increased to 200% of salary with half of any bonus earned compulsorily deferred in shares for three years.[126]However it was the new Share Matching Plan that was most controversial. The Share Matching Plan replaced the previous Deferred Share Scheme. Under the previous scheme if the company grew by at least 3% p.a, then the company would match the scheme at a ratio of 1:1. This in itself was not excessive, and was well within what would be considered as good corporate governance. Conversely the new Share Matching Plan that was approved prior to the run offered significantly better gains for the directors, and perhaps may go some way in explaining the continued growth strategy of the directors. The new plan allowed executives to voluntarily invest in shares up to the value of their after tax cash bonus with a potential award of Matching Shares at a 2:1 ratio, if the company achieved real EPS growth of 15% p.a.[127] This gave a clear incentive to directors to continue in pursuit of their aggressive growth strategy. It was in their interests to ensure growth remained above 15%, even at the detriment of the overall viability of the company. It is fascinating to note that a number of institutional shareholders had already voiced their concerns of the remuneration structures even prior to the financial crisis. Hermes, were one of the first institutional shareholders to raise questions about the Northern Rock business model, its remuneration and accounting disclosure.[128] David Pitt-Watson noted what he believed to be 'Perverse incentives' at work at Northern Rock.[129] Mr Peter Montagnon stated that the Association

[126] ibid 19.
[127] A breakdown of the new plan was outlined in the Annual Report 2006 and was approved at the Northern Rock AGM 2007.
[128] Treasury Committee, The run on the Rock Volume II oral and written evidence (n 1) Ev 336.
[129] ibid.

of British Insurers perceived the bonus policy to be 'too generous'[130] and had brought their reservations to the attention of the Board.[131]

Conclusion

The chapter has shown that an application of the multifaceted approach outlined in the thesis could have potentially altered the decision making culture of Northern Rock. It has highlighted the significant problems of enforceability of s.172 and the limited effect it would appear to have had on the decision making process of Adam Applegarth and the business model of Northern Rock. Although it did highlight the potential effect the provision could have with some minor amendments. The chapter has shown that the duty of skill, care and diligence is pivotal in ensuring non-executive directors monitor, and purse more rigorous questioning of the decisions of the executive director. This in turn can aid in the multifaceted approach opined by the thesis. Whilst it has shown what effect good corporate governance can have on the culture of an institution it has also shown the effect of poorly constructed remuneration packages have on corporate governance and the decision making processes of executive directors for the worse. It has shown that the decisions of the Northern Rock Board encourage high risk growth strategies particularly through remuneration incentives. These were a tangible contributing factor to the problems Northern Rock faced during 2007.

The case study has shown that good corporate governance can change the culture of a UK based financial institution, however there would appear to be a flaw to such a position and that is shareholder activism. For good corporate governance to be successful it requires an active shareholder base. It is argued that this has already occurred both with the Shareholder Spring of 2012. [132]

[130] ibid Q 1423.
[131] ibid.
[132] See chapter VII.

Chapter IX Thesis Conclusion

Chapter IX Thesis Conclusion

The 2007-09 Global Financial Crisis has been described as the greatest crisis in the history of financial capitalism.[1] The failure of the global financial system was triggered by the 'Great American Real Estate Bubble,' however it quickly developed into a global liquidity squeeze that left financial markets at the brink of collapse. This thesis has demonstrated that the general culture of banking prevalent at the time both caused and exacerbated the crisis. The Business Strategies were excessively risky, focusing on short-term gains, at the expense of financial security. It is therefore purported that to mitigate the risks of any future global financial crisis a fundamental change in the culture of banking is needed. Behavioural expectations and norms must be redefined and more prudent strategies inculcated. The thesis has shown the only way to hope to achieve such a cultural shift is to employ a holistic approach, encompassing supervision, regulation and crucially corporate governance mechanisms.

Previous debates within the UK have tended to focus on macro and micro regulatory reform.[2] However, it is purported that it was in many cases, risk monitoring and management practices within financial institutions that dramatically failed.[3] Whilst prudential regulation is important, the thesis has shown that it alone is insufficient to change the culture within the financial system; a multi-faceted approach is needed. Whilst the new regulatory powers that have been adopted are, on the whole, to be welcomed, formal financial regulation has substantial limitations when addressing the culture within an institution.

The limitations can be addressed by improving Corporate Governance structures. There were many cases where internal risk management was ineffective[4] and where senior management failed to adequately identify and constrain excessive risk taking. A greater reliance on formal corporate governance structures would improve this by altering the general culture imposed within an institution. Corporate culture begins with the Chief Executive and their senior management team, and as such it is their decision making processes that were analysed in the thesis.

The thesis has further shown that the use of fiduciary obligations as a means to hold directors to account has been largely ignored during the financial crisis, with the focus being clearly towards holding the regulator accountable, a decision that saw the abolition of the Financial Services

[1] Lord Turner, *The Turner Review: A regulatory response to the global banking crisis* (March 2009) Intro.
[2] Walker Review, *A review of corporate governance in UK banks and other financial industry entities: Final recommendations* (26 November 2009) 9 and see chapter 1.
[3] The de Larosière Group (n 16) para 122.
[4] Turner (n 1) 89.

Authority in 2012. The thesis has shown however that a more rigorous application of the objective standard of care under the duty of skill, care and diligence has the capacity to change the decision making processes of a director for the better. The objective standard has forced real change in the mind-sets of non-executive directors ensuring that they consider their role as 'gatekeeper' much more seriously. The provision has not gone so far as to state that non-executive directors need be perfect in their decision making processes, however, following the crisis, s. 174 has driven a clear cultural shift that has departed away from classic cases such as *Grimwade v Mutual Society* whereby it was noted that *'directors are not bound to be wiser than those who appointed them.'*[5] This shift adopted within a multi-faceted approach is the key to ensuring a change in cultural expectations and norms within the financial crisis.

Conversely s. 172 has been shown to largely be a 'toothless tiger' when attempting to hold management to account. It has been argued, however, that with very minor amendments to the provisions, for example the imposition of an objective standard of care or alternatively a wider interpretation of relevant factors by the judiciary, s.172 could have a very real and positive curbing effect on rogue directors, who do not act to promote the success of the company for the benefit of its members as a whole. However, even without such reform the thesis has shown that the provisions do aid in re-educating and adjust the attitudes of directors. Ensuring as much has the capacity to play a vital role within the culture of banking post Global Financial Crisis.

The Business Decision Rule, whilst initially developed to promote an entrepreneurial spirit within company law, and to encourage directors to make difficult and risky decisions in an attempt to profit maximise is still in the mind-set of the 21st Century director. However its general applicability appears to have been reduced in recent years. Reducing the scope of the Business Decision Rule is another step in developing the multifaceted approach the author believes is imperative in ensuring a shift in banking culture following the Global Financial Crisis.

The chasing of high, short term profits during the financial crisis, led to generous bonus payments to directors and employees without adequate regard to the longer-term risks they imposed on financial institutions. [6] Whilst remuneration structures need to attract and motivate individuals having characteristics necessary for success in the industry,[7] it is argued that some of the remuneration structures allowed directors to take unnecessary risks. Increased legal intervention in the form of

[5] (1885) 52 L.T. 409, 415.

[6] Financial Stability Forum, 'FSF Principles for Sound Compensation Practices' (April 2009) Now the Financial Stability Board.

[7] Walker Review, *A review of corporate governance in UK banks and other financial industry entities: Final recommendations* (26 November 2009) Section D.

disclosure requirements and claw back regimes can alter the behaviour of a director away from their original norm. Remuneration is a fundamental monitoring tool for the multi-faceted approach adopted by the thesis, and if incorrectly structured can have severe negative effects on the culture of banking and the ability of the system to prevent a reoccurrence of the Global Financial Crisis.

The central thesis, around the need for corporate governance mechanisms to play a full part in the legal and regulatory response to the Global Financial Crisis, as part of a cohesive package of measures necessary to effect cultural change within banking has been tested in the context of the collapse of Northern Rock Plc. This case study has highlighted how greater emphasis on existing Corporate Governance measures such as s.172, s.174 and remuneration, could have been effective in changing the decision making processes and prevailing culture within Northern Rock IT is this culture shift which reform to the prudential regulatory environment alone is unlikely to achieve.

Whilst the thesis has shown that the multifaceted approach could work if applied, it is not without its potential issues, the most obvious of which is the need for an active shareholder base to enforce the duties. As has already been shown the duties are owed to the Company 'as a whole' and as such it is the company who is the proper plaintiff in any action. If the company refuses to bring an action against senior management then the system would have to rely on shareholder activism, through minority shareholder provisions. Whilst there have been some examples of shareholder activism since the crisis, for example the Shareholder Spring of 2012, it remains to be seen whether the appetite for activism will continue when the Global Financial Crisis disappears into distant memory. It is argued that there may be a stronger appetite than first thought following the recent case of *R. (on the application of SRM Global Master Fund LP) v Treasury Commissioners*. The case concerned a conglomerate of shareholders of Northern Rock who in 2009 for judicial review against the government.[8] In their claim they purported that the legislation relating to the assessment of compensation payable to them as former shareholders of Northern Rock plc following its nationalisation in February 2008 was unfair and incompatible with their rights under the European Convention on Human Rights 1950 Protocol 1 Art.1. The shareholders case was rejected and subsequently pursued to the Court of Appeal, where the case failed on appeal.[9] The result of the case is important, as it shows that the shareholder will not have a satisfactory form of relief if the institution enters into financial difficulties, and subsequently has to be nationalised. As a result this may encourage shareholders to become more active in the monitoring of the senior management of their given institution to ensure that the institution does not end up within these measures.

[8] *R. (on the application of SRM Global Master Fund LP) v Treasury Commissioners* [2009] EWHC 227 (Admin).
[9] *R. (on the application of SRM Global Master Fund LP) v Treasury Commissioners* [2009] EWCA Civ 788.

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